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The Development of the Model Form Operating Agreement: An Interpretative Accounting

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THE DEVELOPMENT OF THE MODEL FORM OPERATING AGREEMENT: AN INTERPRETATIVE ACCOUNTING

JOHN R. REEVES* AND J. MATTHEW THOMPSON**

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Introduction

The American Association of Petroleum Landmen (AAPL) Form 610 Model Form Operating Agreement¹ has been in use in the oil and gas industry in one form or another since 1956. The various versions of the Model Form Operating Agreement continue to be widely used. Reference to a joint operating agreement in the context of an oil and gas matter normally concerns one of the versions of the Model Form Operating Agreement.

Based upon an empirical analysis, it appears that ten years ago, relatively few cases dealt specifically with the AAPL Form 610 Model Form Operating Agreement. Within the last few years, however, a growing number of appellate decisions address the Model Form Operating Agreement. These cases provide lawyers with some insight and guidance concerning the interpretation and application of the various versions of the AAPL Form 610 Model Form Operating Agreement.

The following article provides a comprehensive analysis of various court decisions that specifically address one of the versions of the AAPL Form 610 Model Form Operating Agreement. Part I of this article begins with a brief historical accounting of the development of the AAPL Form 610 Model Form Operating Agreement. Part II provides an analysis of the general relationship created by the Model Form Operating Agreement between the designated operator and the non-operators. The remainder of this article provides a discussion of court decisions interpreting specific provisions of the Model Form Operating Agreement.²

I. History of the Model Form Operating Agreement

Until 1956, no standard form operating agreement had been accepted and used in the oil and gas industry. However, members of the industry made efforts during this period to develop a standard agreement to be used in connection with oil and gas operations. The following discussion provides a brief historical accounting of the development of the Model Form Operating Agreement.

1. The AAPL Form 610 Model Form Operating Agreement will, at times, be referred to as the "Model Form Operating Agreement."

2. The specific provisions of the Model Form Operating Agreement will generally be discussed in the order in which they appear in the 1977 AAPL Form 610 Model Form Operating Agreement.

A. 1956 Version

The development of the Model Form Operating Agreement began in 1952, when a group of oil and gas representatives, mostly landmen, from Tulsa and Oklahoma City, Oklahoma, decided to prepare a standard form of the operating agreement.³ This group invited many of the larger oil and gas companies to attend a meeting in Tulsa, at which the parties would discuss the possibility of preparing a standardized joint operating agreement. As a result of this meeting, the representatives appointed a steering committee comprised of seven members, which met for two years in an effort to prepare a model form agreement. Based on numerous forms of operating agreements previously used by various oil and gas companies and after approximately two years of drafting, the steering committee finalized a proposed form agreement and presented it to a legal committee for review.⁴ After approximately two more years of refinement, the agreement was ready to be presented to the oil and gas industry.

In 1956, Mr. John Folks presented the form at the annual meeting of the American Association of Petroleum Landmen held in Denver, Colorado. At about the same time, the Ross-Martin Company of Tulsa, Oklahoma, distributed the 610 Form and the COPAS Accounting Procedure to its several thousand individual and corporate customers.⁵ The AAPL endorsed the agreement at the 1956 meeting; this endorsement marks the origin of the standardized operating agreement used by the oil and gas industry today.

In 1967, the AAPL revised limited portions of the 1956 form. Also, as a result of an agreement with the Ross-Martin Company, the AAPL changed the form name of the agreement from the "Kraftbilt 610 Agreement" to "AAPL Form 610."⁶

B. 1977, 1982, and 1989 Versions

Since the finalization of the original Model Form Operating Agreement in 1956, the agreement has been substantially revised on various occasions. In 1977, a restructuring and revision of the 1956 Model Form Operating Agreement resulted in the 1977 AAPL Form 610 Model Form Operating Agreement. Thereafter, in 1982, the 1977 Model Form Operating Agreement was revised slightly, resulting in the 1982 AAPL Form 610 Model Form Operating Agreement. Finally, in March 1986, an operating agreement revision committee was formed at the request of then AAPL President, Mr. Omar Humble, to consider further revisions to the 1982 version of the Model Form Operating Agreement. Three attorneys and four landmen served on this committee. The committee distributed the first working draft to representatives of nine major oil and gas companies and one large independent oil and gas company for review and discussion. After further refinement, the committee submitted the final

3. J.O. Young, *Oil and Gas Operating Agreements: Producers 88 Operating Agreements, Selected Problems and Suggested Solutions*, 20 ROCKY MT. MIN. L. INST. 197, 199 (1975).

4. *Id.* at 199-200.

5. *Id.* at 200.

6. *Id.*

draft to the AAPL for approval, which resulted in the most recent version of the Model Form Operating Agreement, the 1989 AAPL Form 610 Model Form Operating Agreement.

II. *The Relationship Between Operator and Non-Operators*

One of the fundamental purposes of the Model Form Operating Agreement is to establish and define the relationship between the operator and each of the non-operators with regard to the development of the applicable lands covered by the agreement. In *Exxon Corp. v. Crosby-Mississippi Resources, Ltd.*,⁷ the United States District Court for the Southern District of Mississippi described the AAPL Form 610 Model Form Operating Agreement as follows:

Form 610 is a standard form agreement used frequently in joint oil drilling ventures between Operators and Non-Operators that governs the exploration and development of oil, gas and mineral leases and interests, and covers, among other matters, the responsibilities of the Operator, the expenditures and liabilities of the Operator and the Non-Operator, the payment of royalties and the procedures for exploration, drilling and development.⁸

Each version of the AAPL Form 610 Model Form Operating Agreement specifically states that the liability of the parties is to be several, not joint or collective. Each party is responsible only for its proportionate share of the costs of developing and operating within the applicable lands.⁹ Each version of the Model Form Operating Agreement generally provides that it is neither the intention of the parties to create, nor should the agreement be construed as creating a partnership or other association, and that the parties are not to be held liable as partners or members of any such association.¹⁰

The 1989 version of the Model Form Operating Agreement specifically states that the parties to the agreement are not to be considered fiduciaries or to have established any type of confidential relationship.¹¹ However, this agreement does provide that the parties have an obligation to act in good faith in their dealings with each other with respect to the activities under the agreement.¹² Although the various versions

7. 775 F. Supp. 969 (S.D. Miss. 1991).

8. *Id.* at 971-72. See also *Hill v. Heritage Resources Inc.*, 964 S.W.2d 89, 110-12 (Tex. App. - El Paso 1997, no writ), for a detailed description of the purpose of a Model Form Operating Agreement.

9. Model Form Operating Agreement art. VII.A (Am. Ass'n of Petroleum Landmen) (Form 610-1989) [hereinafter 1989 Model Form]; Model Form Operating Agreement art. VII.A (Am. Ass'n of Petroleum Landmen) (Form 610-1982) [hereinafter 1982 Model Form]; Model Form Operating Agreement art. VII.A (Am. Ass'n of Petroleum Landmen) (Form 610-1977) [hereinafter 1977 Model Form]; Model Form Operating Agreement § 22 (Am. Ass'n of Petroleum Landmen) (Form 610-1956) [hereinafter 1956 Model Form].

10. 1989 Model Form, *supra* note 9, at art. VII.A; 1982 Model Form, *supra* note 9, at art. VII.A; 1977 Model Form, *supra* note 9, at art. VII.A; 1956 Model Form, *supra* note 9, § 22.

11. 1989 Model Form, *supra* note 9, at art. VII.A; 1982 Model Form, *supra* note 9, at art. VII.A; 1977 Model Form, *supra* note 9, at art. VII.A; 1956 Model Form, *supra* note 9, § 22.

12. 1989 Model Form, *supra* note 9, at art. VII.A; 1982 Model Form, *supra* note 9, at art. VII.A;

of the Model Form Operating Agreement expressly provide that the agreement does not create a mining or other partnership and that the parties are not liable as partners, courts interpreting these provisions have generally adopted three different approaches to analyzing the relationship created by the Model Form Operating Agreement. These courts also, in their analysis of the agreement, distinguish between the relationship of the operator to the non-operators and the relationship of the non-operators to third parties. Specifically, courts distinguish the relationship of the non-operators to third-party creditors who have provided services at the request of the operator in the development of the lands under the agreement.

A. Approach 1: Fiduciary Duty Created by the Agreement

In certain decisions, courts have refused to give effect to the specific language in the Model Form Operating Agreement, which language disavows the creation of a fiduciary relationship between or among the parties to the agreement. In these cases, courts nevertheless impose duties and obligations upon the parties that are fiduciary in nature. One of the most frequently cited cases dealing with the relationship of the operator and the non-operators under the Model Form Operating Agreement is *Reserve Oil, Inc. v. Dixon*.¹³

1. Trustee-Type Relationship Created

Reserve Oil concerned the 1956 AAPL Form 610 Model Form Operating Agreement. In this case, the lower court dismissed the action, holding that the Model Form Operating Agreement did not create a fiduciary relationship between the parties, did not create an agency relationship between the parties, and did not create any obligation to return specific money, which was alleged to have been converted.¹⁴

The Tenth Circuit Court of Appeals disagreed with the lower court's analysis of the Model Form Operating Agreement, holding that the agreement created a trustee-type relationship and imposed a duty of fair dealing between the operator and the non-operators.¹⁵ In reaching this conclusion, the appellate court discussed the various provisions of the Model Form Operating Agreement which the court found as the basis for such trustee-type relationship.¹⁶

1977 Model Form, *supra* note 9, at art. VII.A; 1956 Model Form, *supra* note 9, § 22.

13. 711 F.2d 951 (10th Cir. 1983).

14. *Id.* at 953.

15. *Id.*

16. The court stated:

The contract vests ownership of the oil and gas produced from the wells in the parties in the same percentage that they own interests in the well. The contract also grants the owners the right to dispose of their oil and gas as they see fit — that is, by taking it in kind or selling it themselves. "In the event any party shall fail to make the arrangements necessary to . . . dispose of its proportionate share of the oil and gas produced from the [well], Operator shall have the right . . . , but not the obligation, to purchase such oil and gas or sell it" The contract also provides for the sharing of the costs and expenses of operating the well. It authorizes the operator to bill the other parties in advance for their proportionate shares of the estimated costs to be incurred during the succeeding month and requires each party to pay its estimated share of costs within fifteen days from

Based upon the various provisions of the 1956 Model Form Operating Agreement, the court found that the contract did not simply create an indebtedness of the operator to pay to the other owners their share of the profits from the well production.¹⁷ Rather, the Model Form Operating Agreement gave each party ownership and full control over its proportionate share of the oil and gas.¹⁸ Under the agreement, the operator had the right to invade the non-operator's province only when the non-operator failed to dispose of its own production; additionally, this right was revocable by the non-operator.¹⁹ Further, the court explained that if the operator exercised its right to dispose of the owner's production, the operator could take the proceeds from the sale of the production for its own use only to the extent necessary to cover the non-operator's unpaid proportionate share of the costs of production.²⁰

The court remarked that the operator had no right to or interest in either the oil and gas itself, or the proceeds from sales beyond the non-operator's unpaid proportionate share of the costs.²¹ Based on this interpretation of the Model Form Operating Agreement, the court concluded that the agreement created a trustee-type relationship, imposing a duty of fair dealing between the operator and the non-operator.²² However, the court stated that it did not "mean to imply that there is a general agency relationship as to third parties, which, of course, is specifically disavowed in the contract itself."²³

In reaching its conclusion concerning the trustee-type relationship under the Model Form Operating Agreement, the appellate court relied upon the decision of the Oklahoma Supreme Court in *Young v. West Edmond Hunton Lime Unit*.²⁴ In *Young*, the Oklahoma Supreme Court held that the operator of a secondary recovery unit established under the police power of the state by the Oklahoma Corporation Commission stood as a fiduciary in relation to the royalty owners in the unit.²⁵ The distinction between *Young* and *Reserve Oil* is that in *Reserve Oil* the Tenth Circuit interpreted a voluntary, private agreement, while in *Young* the Oklahoma Supreme Court considered the relationship between parties created through the exercise of the police power of the state under the applicable Oklahoma statutes by the Oklahoma

receipt of the estimate. If any party fails to pay, the operator is granted a preferred lien in, *inter alia*, the delinquent party's oil and gas or the proceeds from its sale. The operator is also authorized to collect the delinquent party's share of costs directly from that party's purchasers, out of the sale proceeds, up to the amount owed by that party. The contract establishes a joint account to keep track of the costs and to credit against them the amounts paid into the fund by the owners.

Id. at 952-53 (alterations in original) (citations and footnote omitted).

17. *Id.* at 953.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. 275 P.2d 304 (Okla. 1954).

25. *Id.* at 309-10.

Corporation Commission. Thus, the Tenth Circuit erred in relying on this Oklahoma case.

In *Leck v. Continental Oil Co.*,²⁶ the Oklahoma Supreme Court reinforced the concept of a fiduciary or trustee-type duty being imposed on an operator as espoused in *Young*. The court decided the issue of whether the district court had subject matter jurisdiction to adjudicate an action brought by mineral interest owners against the operator of such owners' unit seeking damages based on the operator's alleged breach of a fiduciary duty. The mineral interest owners argued that the operator breached its fiduciary duty by allowing the mineral interest owners' correlative rights to be violated by not protecting their unit from uncompensated drainage caused by an offset well operated by the operator.²⁷

The Oklahoma Supreme Court noted that it had previously recognized the existence of a fiduciary duty owed by a unit operator to the royalty owners and lessees who were either parties to a unitization agreement or subject to the order creating the unit.²⁸ The court determined that this duty was created not by the lease agreement, but rather by the unitization order and agreement.²⁹ The court concluded that it was incumbent upon the mineral interest owners to show what, if any, violation of the fiduciary duty occurred under the lease agreement.³⁰

2. Overpayments to Operator by Non-Operator Held in Trust

In *In re Mahan & Rowsey, Inc.*,³¹ the Tenth Circuit Court of Appeals again considered the relationship between an operator and non-operators under a joint operating agreement.³² *Mahan & Rowsey* concerned an operator who overbilled a non-operator for the non-operator's share of the well costs. The operator filed a petition under Chapter 11 of the Bankruptcy Code. The non-operator filed an action in the bankruptcy court attempting to recover the overpayments.

Relying on *Reserve Oil*, the Tenth Circuit Court of Appeals upheld the bankruptcy court's ruling that the operating agreement between the parties created a trustee-type relationship.³³ Thus, the court concluded that the operator held the overpayments in trust for the non-operator.³⁴ In this regard, the Tenth Circuit Court of Appeals stated:

The principal issue is whether the district court correctly held that a trust arose out of the conduct of the parties. We conclude the district

26. 800 P.2d 224 (Okla. 1989).

27. *Id.* at 225.

28. *Id.* at 229. In reaching this conclusion, the court cited the holdings in *Young, Reserve Oil, West Edmond Hunton Lime Unit v. Young*, 325 P.2d 1047 (Okla. 1958), and *Olsen v. Texaco, Inc.*, 587 P.2d 976 (Okla. 1978).

29. *Leck*, 800 P.2d at 229.

30. *Id.*

31. 817 F.2d 682 (10th Cir. 1987).

32. It is difficult to determine from the opinion whether the decision involved the Model Form Operating Agreement.

33. *Mahan & Rowsey*, 817 F.2d at 684.

34. *Id.*

court was right. We noted in *Reserve Oil* that an operating agreement of the type present in this case created a "trustee type relationship imposing a duty of fair dealing between the operator and the non-operator owners in the matter of distribution of the shares among the owners." What results from the fiduciary relationship thereby created is a constructive trust imposed on the operator. Because money was given to the operator for a particular purpose (for example, the payment of a debt), the operator received the money in trust to apply it to the intended purpose.³⁵

The court concluded that because of the fiduciary relationship imposed upon the operator by the operating agreement and other equitable considerations, the operator had an obligation to properly bill the non-operator and to pay the sums received only for the non-operator's share of the completion and operating expenses.³⁶ Therefore, the non-operator could trace the trust funds into the commingled funds of the operator.³⁷ The court cautioned that only the lowest balance in the commingled account in the operator's possession prior to the date of bankruptcy was subject to the constructive trust.³⁸

3. Operator's Acquisition of Interest in Derogation of Non-Operator's Title Held in Trust

In *Texas Oil & Gas Corp. v. Hawkins Oil & Gas, Inc.*,³⁹ the Arkansas Supreme Court considered the relationship between the operator and the non-operator under a joint operating agreement.⁴⁰ The parties entered into an operating agreement in 1981. The non-operator provided various abstracts and title opinions to the operator. After reviewing the abstracts and title opinions, the operator determined that the oil and gas lease acquired by the non-operator did not include all of the interests of a decedent in the subject lands. The operator, without notice to the non-operator, acquired a lease from the true owners contrary to the leasehold interest of the non-operator.

The Arkansas Supreme Court upheld the trial court's determination that the joint operating agreement created a fiduciary relationship between the operator and the non-operator.⁴¹ In reaching this conclusion, the court determined that the operating agreement created a joint venture between the operator and the non-operator even though such joint venture did not exhibit every element of a partnership.⁴² The parties' relationship was one of trust and confidence that resulted from their execution

35. *Id.* (quoting *Reserve Oil*, 711 F.2d at 953).

36. *Id.*

37. *Id.*

38. *Id.* at 685.

39. 668 S.W.2d 16 (Ark. 1984).

40. It is difficult to determine from the decision whether the case involved a Model Form Operating Agreement.

41. *Texas Oil*, 668 S.W.2d at 17.

42. *Id.*

of the joint operating agreement.⁴³ Because of this relationship, the operator owed a duty of fair dealing to the non-operator.⁴⁴ Thus, the operator held the oil and gas lease acquired in derogation of the interest of the non-operator in trust for the non-operator.⁴⁵

The first line of cases, therefore, appears to disregard the specific language of various versions of the Model Form Operating Agreement and focuses on the substance of the relationship between the parties, finding a trustee-type or fiduciary relationship.

B. Approach 2: Fiduciary Relationship Limited by Agreement

In the second line of decisions addressing the Model Form Operating Agreement, courts have found that the operating agreement may, in some instances, create a joint venture, partnership, or other arrangement that normally establishes some type of fiduciary relationship. However, according to these decisions, the Model Form Operating Agreement creates a standard of conduct by which to measure the operator's actions vis-à-vis the non-operator, which is less than a typical fiduciary standard. The courts in these particular cases have not held the parties to a fiduciary standard, but to the standard of conduct agreed to and set forth in the operating agreement.

1. Joint Venture Created, but Fiduciary Duty Limited by Agreement

In *Frankfort Oil Co. v. Snakard*,⁴⁶ the non-operator claimed the operator violated the joint operating agreement⁴⁷ because the operator failed to disclose geological and geophysical information pertaining to the oil structures that were being developed under the joint operating agreement. Furthermore, the non-operator alleged that the joint operating agreement created a joint venture, which in turn created a fiduciary relationship. The non-operator asserted that the operator breached his fiduciary duty because of the operator's alleged misrepresentation of the potential productivity of the field to the north and east of the area developed, when the field was subsequently shown to be productive to the south and east.

In analyzing the non-operator's allegations, the Tenth Circuit Court of Appeals found that the agreements between the parties created a joint venture, resulting in a fiduciary relationship.⁴⁸ In this regard, the court remarked:

43. *Id.*

44. *Id.*

45. *Id.*; see also *Mud Control Lab. v. Covey*, 269 P.2d 854, 859 (Utah 1954) (holding that pursuant to the terms of the parties' joint operating agreement [not an AAPL Form 610 Model Form Operating Agreement], a mining partnership existed and the non-operator was liable as a partner for the debts incurred by the mining partnership).

46. 279 F.2d 436 (10th Cir. 1960).

47. While *Frankfort Oil* does not appear to address the Model Form Operating Agreement, the court's analysis has been applied in subsequent decisions interpreting the Model Form Operating Agreement. See, e.g., *Tenneco Oil Co. v. Bogert*, 630 F. Supp. 961 (W.D. Okla. 1986).

48. *Frankfort Oil*, 279 F.2d at 443. These agreements consisted of four different contracts between the parties concerning the development of the lands in question.

By their November 11, 1954, contracts the parties entered into a common undertaking involving jointly-owned property and a sharing of the profits. They were engaged in a joint adventure. The relationship so created was fiduciary in character and required the utmost good faith on the part of both parties. The extent and effect of such relationship is determined by the written agreements between the parties defining and delineating the powers and rights of each. In such a situation, it is presumed that they delegated all the powers they wished to confer upon each other and withheld all powers or authority not affirmatively delegated. The relationships between them are controlled by the terms of their agreements voluntarily made.⁴⁹

In analyzing the non-operator's assertion that the operator had breached its fiduciary duty by withholding geological and geophysical information, the court stated that the operator did not have a contractual obligation to divulge that information under the joint operating agreement.⁵⁰ The contracts between the parties did entitle the non-operator to certain information, but the non-operator did not claim that such information was withheld from him.⁵¹ The court concluded that the non-operator was requesting the court to rewrite the parties' agreements, and that this request clearly exceeded the court's power.⁵²

Interestingly, the court determined that the non-operator's assertion that the operator violated its fiduciary duty by misrepresenting the facts as to the preferred development of the area was unfounded.⁵³ While the operator attempted to justify its opinion that the field lay to the north, the non-operator insisted that the field developed to the south.⁵⁴ The fact that the non-operator's opinion was substantiated by later drilling showed that the non-operator had better judgment than the operator.⁵⁵ However, the opinions and conclusions of the operator did not breach any contractual fiduciary duty unless these opinions and conclusions resulted in some overreaching of the non-operator.⁵⁶ In this case, the court concluded that there was no overreaching.⁵⁷

2. Joint Venture Created, but Agreement Limits Duty to Drill Additional Well

In *Tenneco Oil Co. v. Bogert*,⁵⁸ the United States District Court for the Western District of Oklahoma adopted the analysis in *Frankfort Oil* to analyze the provisions of what appears to be the 1956 AAPL Form 610 Model Form Operating Agreement. In *Tenneco*, the parties entered into an operating agreement covering Section 4 and

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.* at 443-44.

53. *Id.* at 444.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. 630 F. Supp. 961 (W.D. Okla. 1986).

the designated operator drilled a productive well in the section. Shortly thereafter, the operator drilled and completed a well in adjoining Section 3, completing such well in the same formation from which the well in Section 4 was producing.

The non-operator under the applicable joint operating agreement did not know of the drilling of the well in Section 3. Upon learning of such well, the non-operator claimed that the well was draining Section 4. The non-operator asserted that the operator had a duty under the joint operating agreement to drill an increased density well in Section 4 to protect such section from drainage by the well in Section 3. Because the operator failed to drill an increased density well, the non-operator alleged that the operator breached its fiduciary duty arising under the joint operating agreement.

In assessing the duty of the operator to the non-operator, the court found that the applicable joint operating agreement contained language that specifically proscribed any joint or collective liability between the parties, and that disclaimed any intent of the parties to create a partnership or render themselves liable as partners.⁵⁹ The court noted that in section 5 of the agreement, "Operator of the Unit Area," the operator had an obligation to conduct all operations in a good and workmanlike manner.⁶⁰ Pursuant to section 5, the operator was not liable to other parties for losses sustained or liabilities incurred, except those losses which resulted from the operator's gross negligence or breach of the provisions of the joint operating agreement.⁶¹

In analyzing the relationship of the parties under the joint operating agreement, the court stated:

Even though the present joint operating agreement may be seen to create a joint venture with attendant fiduciary duties, the court is mindful that the term "fiduciary" is easily bandied-about without precision. "The scope of the transactions affected by the relation and the extent of the duties imposed are not identical in all fiduciary relations." In the case of joint ventures to develop oil and gas properties, the law is well established that the determination of the existence and extent of such duties is controlled by the terms of the agreement between the parties.⁶²

The non-operator alleged that the operator violated the trust that the non-operator placed in the operator and prevented the non-operator from taking corrective action to prevent drainage to Section 4 by the well in Section 3 by withholding certain information relating to the Section 3 well.⁶³ The court noted that section 14 of the agreement, "Access to Unit Area," guaranteed the non-operator reasonable access to "information pertaining to the development or operation" in Section 4. Under section 14 of the agreement, the operator was required, upon request from the non-operator,

59. *Id.* at 966.

60. *Id.*

61. *Id.*

62. *Id.* at 967 (citations omitted).

63. *Id.*

to furnish certain information.⁶⁴ The agreement also specifically granted the non-operator the right to perform an audit.⁶⁵ The non-operator did not allege a breach of any of these provisions.⁶⁶ Rather, the non-operator sought to have the court provide it with the benefit of information (i.e., the alleged drainage) that the operator acquired from its operations in the adjoining section.⁶⁷

The court declined to impose a duty on the operator under the Model Form Operating Agreement to either share the requested information concerning the alleged drainage or to drill another well in Section 4.⁶⁸ Based on section 7, "Test Well," section 11, "Limitation on Expenditures," and section 12, "Operations By Less Than All Parties" of the agreement, the operator and non-operator each had a specifically defined and limited right to drill an additional well, with or without the other's consent.⁶⁹ These provisions, however, did not impose an obligation on the operator to drill any well, with the exception of the test well specifically provided for in the joint operating agreement.⁷⁰

The court concluded that given both the detailed provisions of the joint operating agreement and the legal requirements for drilling an additional well, it had no basis for reading into the parties' agreement a fiduciary duty obligating the operator to drill an additional well simply because it had knowledge of drainage by the offset well in the adjoining section.⁷¹ The operator and non-operator, as sophisticated participants in the business of developing oil and gas properties, could not be presumed incapable of including an express provision in their agreement to create the duty requested by the non-operator had they so intended or desired.⁷²

3. Duty of Good Faith Limited to Provisions of Agreement

The Tenth Circuit also addressed the concept of limiting the duties and obligations of an operator to those set forth in the applicable joint operating agreement, as discussed in *Frankfort Oil*. In *Davis v. TXO Production Corp.*,⁷³ the parties entered into two joint operating agreements covering two drilling and spacing units.⁷⁴ The operator attempted to establish what appeared to be a secondary recovery unit that would encompass the lands covered by the two joint operating agreements. Based on

64. *Id.* at 967-68.

65. *Id.* at 968.

66. *Id.*

67. *Id.* The adjoining section, being a different unit area, was not covered by the applicable joint operating agreement.

68. *Id.* at 969.

69. *Id.* at 968-69.

70. *Id.* at 969. The court noted that the joint operating agreement could not eliminate the fact that neither the operator nor the non-operator had any authority to drill the requested increased density well in Section 4 until the Oklahoma Corporation Commission issued an increased density order authorizing the drilling of the well. *Id.*

71. *Id.*

72. *Id.*

73. 929 F.2d 1515 (10th Cir. 1991).

74. It is unclear whether the joint operating agreements involved in *Davis* were Model Form Operating Agreements.

discussions between the non-operator and a lessor in certain oil and gas leases held by the non-operator, the lessor withdrew his consent to the proposed plan of unitization covering the proposed secondary recovery unit.

The operator alleged that the non-operator caused various lessors to sue the operator, and that the non-operator provided technical expertise and information to assist the lessors in these lawsuits. The operator sued the non-operator for breach of an alleged implied covenant of good faith and fair dealing owed the operator under the joint operating agreements.

The Tenth Circuit Court of Appeals upheld the lower court's determination that, based on the analysis in *Frankfort Oil*, under Oklahoma law there can be no breach of an implied duty of good faith to perform under a joint operating agreement, absent a breach of a specific contractual provision in the joint operating agreement.⁷⁵ The court noted that the operator did not dispute that the non-operator's actions did not constitute a breach of any express provision in the joint operating agreement.⁷⁶ Rather, the operator based its cause of action on the existence of an implied duty of good faith independent of any fiduciary duty between cotenants.⁷⁷ The operator asserted that, as a general principle of contract law, neither party to a contract may do anything to destroy or injure the other party's right to receive the fruits of the contract.⁷⁸

In analyzing the operator's claims, the court concluded that the actions of the non-operator did not destroy the operator's right to receive the benefits of the joint operating agreements.⁷⁹ The joint operating agreements did not provide for a plan of unitization for a secondary recovery unit or require the non-operator's cooperation in such a scheme.⁸⁰ The joint operating agreements also did not prohibit the non-operator from communicating its opinions concerning the proposed plan of unitization to its lessors.⁸¹ The operator failed to sufficiently allege that the non-operator's actions injured the joint estate or otherwise deprived the operator of any fruits of the joint operating agreements.⁸² Consequently, the court declined to extend the duty of cotenants (i.e., the duty of good faith and fair dealing) of an oil and gas lease beyond the express provisions contained in the joint operating agreements.⁸³

75. *Davis*, 929 F.2d at 1519.

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*; see also *Andrau v. Mich. Wis. Pipe Line Co.*, 712 P.2d 372 (Wyo. 1986). In *Andrau*, the Wyoming Supreme Court followed the principles announced in *Frankfort Oil* and held that the parties to the joint operating agreement had limited their fiduciary obligations by the specific contract provisions. *Andrau*, 712 P.2d at 376-77. The court determined that the factual situation at issue in *Andrau* was distinguishable from the facts involved in *Reserve Oil and Young, Id.* at 375; see also *Connaghan v. Maxus Exploration Co.*, 5 F.3d 1363, 1365 (10th Cir. 1993) (holding that, under Wyoming law, the terms of the 1956 Model Form Operating Agreement did not, expressly or impliedly, impose any fiduciary duty on the operator).

4. Joint Venture Created, with Contractual Standard of Conduct Less than a Fiduciary Standard

In *Dime Box Petroleum Corp. v. Louisiana Land & Exploration Co.*,⁸⁴ the Tenth Circuit Court of Appeals considered the relationship, under Colorado law, of the operator and non-operator under the 1977 AAPL Form 610 Model Form Operating Agreement. In *Dime Box*, the parties had entered into one or more Model Form Operating Agreements under which the plaintiff was the non-operator and the defendant was the operator.

In analyzing the relationship of the parties, the Tenth Circuit found that under Colorado law, a fiduciary relationship exists between parties to a joint venture.⁸⁵ Under Colorado law, three elements must exist to establish a joint venture: (1) a joint interest in property; (2) an express or implied agreement to share in the losses or profits of the venture; and (3) conduct showing cooperation in the venture.⁸⁶ In this case, the court specifically found that the parties had created a joint venture.⁸⁷

The court next considered whether the parties had contracted for a standard by which to measure the operator's conduct rather than utilizing the standard imposed upon a fiduciary.⁸⁸ The court determined that under article V.A, "Designation and Responsibilities of Operator," of the 1977 Model Form Operating Agreement, the operator had no liability to the non-operator except as may arise from the operator's gross negligence or willful misconduct.⁸⁹ In other words, the operator had no liability to the non-operator for negligence or unintentional misconduct.⁹⁰ The court found that "this measure of conduct bears no relationship to the yardstick used to measure the conduct of a fiduciary."⁹¹

The court determined that the operating agreement was a legitimate product of the parties' negotiations.⁹² The non-operator did not allege that the joint operating agreement was a contract of adhesion, that the parties had unequal bargaining power, or that the operator utilized fraud or misrepresentation to induce the non-operator to enter into the agreement.⁹³ The court concluded that the parties contracted for a standard by which to measure the operator's conduct that differed from the standard applicable to a fiduciary.⁹⁴ Therefore, even though the court recognized the Model Form Operating Agreement as creating a joint venture, the court did not hold the operator to a fiduciary standard. Instead, the court held the operator to the standard of conduct contemplated in the agreement.⁹⁵

84. 938 F.2d 1144 (10th Cir. 1991).

85. *Id.* at 1146.

86. *Id.* at 1147.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 1147-48.

91. *Id.* at 1148.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*; see also *Doheny v. Wexpro Co.*, 974 F.2d 130 (10th Cir. 1992). In *Doheny*, the Tenth Circuit held that the parties had contracted for a standard of conduct that differed from the standard of conduct contemplated in the agreement. Published by University of Oklahoma College of Law Digital Commons, 2001

C. Approach 3: Relationship Limited to Contractual Provisions — No Fiduciary Duty

The third approach to the relationship of the operator and the non-operator under the Model Form Operating Agreement is best illustrated by various Texas cases and one Oklahoma case. In these cases, the courts have followed the express language of the joint operating agreement, refusing to impose any type of implied obligation into the agreement.

1. Texas

In *Hamilton v. Texas Oil & Gas Corp.*,⁹⁶ the Texas Court of Appeals decided the issue of whether the 1956 AAPL Form 610 Model Form Operating Agreement created a joint venture, with an accompanying fiduciary relationship. The resolution of this issue turned on whether the parties to the joint operating agreement were engaged in a joint venture.⁹⁷

The court outlined the elements of a joint venture as follows: (1) mutual rights of control; (2) community of interest; (3) the sharing of profits as principals; and (4) the sharing of losses, costs, or expenses.⁹⁸ With respect to the first element, mutual rights of control, the court concluded that under the 1956 Model Form Operating Agreement, the non-operators were wholly excluded from participation in the drilling, operating, and control of the well in question, even though the non-operators paid part of the cost of drilling the well and visited the well site.⁹⁹ The court also found that the operator had full control of all operations and that the parties were severally, not jointly, liable under section 5, "Operator of Unit," and section 22, "Liability of Parties," of the 1956 Model Form Operating Agreement.¹⁰⁰ Therefore, as a matter of law, the parties did not enter into a joint venture, and no form of fiduciary duty existed between the parties.¹⁰¹

Circuit Court of Appeals relied upon its analysis in *Dime Box* in determining whether the joint operating agreement (a non-model form operating agreement) at issue created a fiduciary duty under Wyoming law. *Doheny*, 974 F.2d at 135. The court found that the duties alleged to have been breached were not duties contemplated in the joint operating agreement; nor were these duties that naturally arose as corollaries to the obligations contained in the agreement. *Id.* Therefore, plaintiffs did not show that the operator owed duties (i.e., a fiduciary duty) other than those outlined in the operating agreement. *Id.* Also, because the plaintiffs made no showing that the operator had breached a specific duty set out in the joint operating agreement, they failed to raise a question of fact concerning the breach of any implied covenant of good faith and fair dealing. *Id.*; see also *Oryx Energy Co. v. Tatex Energy*, 779 F. Supp. 144 (D. Colo. 1991). In *Oryx*, the court upheld certain provisions of a joint operating agreement that limited the liability of the operator to operations conducted in bad faith. *Oryx*, 779 F. Supp. at 146. The court noted that the validity of agreements specifically limiting the liability of unit operators had been recognized by both Oklahoma state courts and a United States federal court in Colorado. *Id.* (citing *Dime Box* and *Tenneco Oil*).

96. 648 S.W.2d 316 (Tex. App. - El Paso 1982, writ ref'd n.r.e.).

97. *Id.* at 321.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*; see also *Youngstown Sheet & Tube Co. v. Penn.*, 355 S.W.2d 239 (Tex. Civ. App. - Austin

However, the court did find that under section 5 of the 1956 Model Form Operating Agreement, the operator had the duty to conduct all operations in a good and workmanlike manner.¹⁰² Under the facts of such case, the appellate court found that the operator did not perform his duties in a good and workmanlike manner, constituting a material breach of the joint operating agreement.¹⁰³

In *Texstar North America, Inc. v. Ladd Petroleum Corp.*,¹⁰⁴ the Texas Court of Appeals considered whether the 1982 AAPL Form 610 Model Form Operating Agreement contained an implied duty of good faith and fair dealing. Under the joint operating agreement in question, the operator had drilled and completed a producing well. The non-operator had subsequently drilled another well in lands offsetting the initial well, but in the same reservoir as the initial well.

The operator became concerned that the offset well was draining hydrocarbons from the initial well. The operator proposed to fracture stimulate the initial well to improve production and prevent drainage by the non-operator's offset well.

Under article VI.B.1, "Proposed Operations," and article VII.D.2, "Rework or Plug Back," of the joint operating agreement, the operator could not conduct the fracture stimulation on the initial well without the consent of all parties to the agreement. The non-operator refused to consent to the proposed fracture stimulation. The operator brought an action against the non-operator for breach of an alleged implied duty of good faith and fair dealing under the joint operating agreement.

In analyzing the operator's allegations, the court found that articles VI.B.1 and VII.D.2 of the joint operating agreement were clear, unambiguous, and set forth the terms and conditions under which a well could be reworked or, in this case, fracture stimulated.¹⁰⁵ These provisions required that the operator obtain approval from all of the non-operators prior to conducting such operations.¹⁰⁶

The court determined that the operator's reliance upon an implied duty of good faith and fair dealing was without merit.¹⁰⁷ The court pointed out that the operator conceded that no Texas case supported its position that an implied duty of mutual

1962, writ granted); *U.S. Truck Lines v. Texaco, Inc.*, 337 S.W.2d 497 (Tex. Civ. App. - Eastland 1960, writ ref'd). In both *Truck Lines* and *Youngstown*, the Texas Court of Appeals determined that under the subject joint operating agreements, the specific elements for a partnership or joint venture were absent, those being the elements of mutual agency and joint operation. These cases did not deal with the Model Form Operating Agreement. However, the concepts espoused in these cases have been subsequently applied to the Model Form Operating Agreement by appellate courts in Texas.

102. *Hamilton*, 648 S.W.2d at 324.

103. *Id.* The court noted that under section 5 of the joint operating agreement, the operator was liable for damages resulting from acts constituting gross negligence or a breach of the provisions of the joint operating agreement. *Id.* Having found that the conduct of the operator constituted a material breach of the agreement, the court held that damages were properly awarded against the operator. *Id.*

104. 809 S.W.2d 672 (Tex. App. - Corpus Christi 1991, writ denied).

105. *Id.* at 677.

106. *Id.*

107. *Id.* at 678. The court noted that the Texas Supreme Court had previously rejected the notion that an implied duty of good faith and fair dealing existed in every contract. *Id.* at 677 (citing *English v. Fischer*, 660 S.W.2d 521 (Tex. 1983)). The courts recognized this duty only when there was a "special relationship" between the parties to the contract. *Id.*

cooperation existed between working interest owners who were parties to a joint operating agreement.¹⁰⁸ Therefore, the court held that under articles VI.B.1 and VII.D.2 of the 1982 Model Form Operating Agreement, which expressly and unambiguously provided the terms under which a party could withhold consent to a rework procedure, no implied covenant existed to the contrary.¹⁰⁹

In *Johnston v. American Cometra, Inc.*,¹¹⁰ the non-operators sued the operator under a 1977 AAPL Form 610 Model Form Operating Agreement for the operator's alleged failure to make take-or-pay claims with the gas purchaser. The operator alleged that it was not obligated to make take-or-pay claims on behalf of the non-operators because under Texas law and the joint operating agreement, the parties were not joint venturers. Therefore, the operator had no fiduciary duty to make such claims.

The operator argued that article V.A, "Description and Responsibilities of Operator," of the 1977 Model Form Operating Agreement, limited its obligations and affirmative duties to the express terms of the agreement which did not impose an express, affirmative obligation to make the take-or-pay claims.¹¹¹

The court rejected the operator's argument, stating that article VII.A, "Liability of Parties," of the 1977 Model Form Operating Agreement provides, "It is not the intention of the parties to create, nor shall this agreement be construed as creating, a mining or other partnership or association, or to render the parties liable as partners."¹¹² The court determined that the parties intended in the joint operating agreement to delegate operational and managerial control to the operator while shielding the non-operators from liability.¹¹³ The court recognized that in prior Texas cases, the courts gave this desired effect to the Model Form Operating Agreement when the rights of third parties were involved.¹¹⁴

108. *Id.*

109. *Id.*; see also *Taylor v. GWR Operating Co.*, 820 S.W.2d 908 (Tex. App. - Houston 1991, writ denied). In *Taylor*, the court agreed with the *Texstar* decision that parties to a joint operating agreement do not generally owe each other the duty of utmost good faith and fair dealing. *Taylor*, 820 S.W.2d at 912. Also, based on the analysis in *Hamilton v. Texas Oil & Gas Corp.*, 648 S.W.2d 316 (Tex. App. - El Paso 1982, writ ref'd n.r.e.), the court determined that the parties did not create a joint venture under the 1956 Model Form Operating Agreement because the operator had full control of all operations and the joint operating agreement provided for several, not joint, liability. *Id.*; see also *Smith v. L.D. Burns Drilling Co.*, 852 S.W.2d 40 (Tex. App. - Waco 1993, no writ); *Anderson v. Vinson Exploration, Inc.*, 832 S.W.2d 657, 667 (Tex. App. - El Paso 1992, writ denied) (holding that a joint operating agreement does not establish a joint venture as a matter of law).

110. 837 S.W.2d 711 (Tex. App. - Austin 1992, writ denied). *Johnston* clarified to a great extent the analysis of the relationship of the operator and non-operator under the Model Form Operating Agreement as set out in the cases cited above.

111. The operator relied upon a series of cases, including *Youngstown*, in which the operator's third-party creditors sought to hold non-operators liable based on partnership, agency, and joint venture principles. *Id.* at 715. The court rejected the operator's reliance on this authority, stating that these cases addressed the relationship between the operator and third parties, and were not dispositive of the issues raised by the non-operators. *Id.*

112. *Id.* at 716.

113. *Id.*

114. *Id.*

In this case, the court determined that under the joint operating agreement, the operator had the authority to bind the non-operators to a contract for the sale of their gas.¹¹⁵ The court held that although the Model Form Operating Agreement did not create a joint venture, thereby imposing a *fiduciary* duty, this did not mean that the operator owed *no duty* whatsoever to the non-operators under the Model Form Operating Agreement.¹¹⁶ In fact, the court found that the non-operators' cause of action did not depend upon a finding that the operator owed a fiduciary duty to the non-operators under the agreement.¹¹⁷ Rather, under article V.A of the joint operating agreement, the operator had a duty to perform "in a good and workmanlike manner."¹¹⁸ Thus, the operator owed a duty to the non-operators under the Model Form Operating Agreement to perform as a reasonably prudent operator.¹¹⁹

2. Oklahoma

The Oklahoma Supreme Court, in *Sparks Bros. Drilling Co. v. Texas Moran Exploration Co.*,¹²⁰ followed, in part, the concepts set forth in the Texas cases discussed above. In *Sparks Bros.*, the Oklahoma Supreme Court considered whether a joint operating agreement similar to the 1956 or 1977 AAPL Form 610 Model Form Operating Agreement created a mining partnership. In framing its discussion, the Oklahoma Supreme Court stated the dispositive issue was whether the non-operator was a mining partner of the operator of the well.¹²¹ If a mining partnership existed, then the non-operator was jointly and severally liable for the costs incurred in operations under the operating agreement.¹²² However, if a mining partnership did not exist, then the non-operator was severally liable only to the extent of its interest in the subject well.¹²³

Reviewing the provisions of the joint operating agreement, the court explained that the agreement gave each party the right to take and dispose of its share of the oil and gas.¹²⁴ The agreement specifically provided that the parties were severally, not jointly or collectively, liable and that the agreement should not be construed as creating a mining partnership.¹²⁵ The court also noted that the operating agreement held each party responsible only for its share of the costs of developing and operating the subject well.¹²⁶

Further, the court found that the operating agreement specifically provided that the relationship of the parties should be treated as a partnership for tax purposes only.¹²⁷

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. 829 P.2d 951 (Okla. 1991).

121. *Id.* at 952.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

With respect to the subject well, the agreement provided that the operator had full and direct control of all operations.¹²⁸ However, the agreement contained a provision permitting the override of this control by a vote of the parties chargeable with the costs of the operation in proportion to their obligations for those costs.¹²⁹ The parties, however, never exercised this voting control.¹³⁰

Turning to the issue of whether the joint operating agreement created a mining partnership, the court stated that in order for a mining partnership to be created in Oklahoma, three elements must exist:¹³¹ (1) a joint interest in the property; (2) either an express or implied agreement to share in the profits and losses of the operations, and (3) cooperation by the parties in the project.¹³² In this case, the court specifically found that the third prong of the test had not been met; namely, the parties did not cooperate in the project.¹³³

The court explained that, in a prior decision, it had defined cooperation in a project as "'actively joining in the promotion, conduct or management' of a project."¹³⁴ A joint operating agreement by itself does not create a mining partnership.¹³⁵ The court stated, however, that a mining partnership can arise from the behavior of the parties.¹³⁶

In this case, the acts of the non-operator were insufficient to prove cooperation in the drilling of the well in question.¹³⁷ Although the non-operator received reports, questioned billings, hired a pumper to evaluate the well in contemplation of assuming operations of the well, and completed other similar tasks, the court concluded that any prudent investor would act similarly to protect his investment.¹³⁸ These acts, then, did not create a mining partnership between the parties.¹³⁹

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at 953.

132. *Id.* (citing *Jenkins v. Pappas*, 383 P.2d 645, 647 (Okla. 1963)).

133. *Id.*

134. *Id.* (quoting *Jenkins*, 383 P.2d at 647).

135. *Id.*

136. *Id.*

137. *Id.* at 954.

138. *Id.*

139. *Id.*; see also *Crosby-Miss. Res., Ltd. v. Saga Petroleum U.S., Inc.*, 767 F.2d 143 (5th Cir. 1985). Applying Mississippi law, the court held the 1956 Model Form Operating Agreement did not create a joint venture. *Id.* at 147. The court stated that in order for there to be a joint venture, there must be (1) a joint proprietary interest, (2) the right of mutual control, and (3) an agreement, express or implied, to share in the profits of the venture. *Id.* The court found that the tenor of the 1956 Model Form Operating Agreement, as well as the explicit contractual language and the undisputed facts in the case, indicated that the parties did not intend to share profits from the marketing of refined petroleum products, the alleged joint venture. *Id.* Even if the parties did establish a joint venture, the court commented that the duties pertaining to such joint venture would not extend beyond a reasonable interpretation of the Model Form Operating Agreement, which did not include the marketing of refined petroleum products. *Id.*; see also *Caddo Oil Co., Inc. v. O'Brien*, 908 F.2d 13, 17 (5th Cir. 1990) (holding that the subject joint operating agreement, which apparently was not a Model Form Operating Agreement, did not create a fiduciary relationship between the operator and the non-operator, but rather imposed on the operator the duty to act as a prudent operator); *Prentice v. Amax Petroleum Corp.*, 220 So. 2d 783, 787 (La. Ct.

III. The Enforceability of Exculpatory Language

In cases that define the relationship between the operator and the non-operator by examining the express provisions of the Model Form Operating Agreement, there remains the question of the enforceability of the exculpatory language in the Model Form Operating Agreement, which further limits the liability of the operator. Section 5, "Operator of Unit," of the 1956 Model Form Operating Agreement contains exculpatory language providing that the operator has no liability to the other parties to the agreement for losses sustained, or liabilities incurred, except as may result from the operator's gross negligence or from the operator's breach of the provisions of the agreement. Article V.A, "Designation and Responsibilities of Operator," of the 1977, 1982, and 1989 Model Form Operating Agreements provides that the operator shall have no liability to the other parties for losses sustained or liabilities incurred, except as may result from gross negligence or willful misconduct.

In *Stine v. Marathon Oil Co.*,¹⁴⁰ a non-operator sued the operator under a 1977 AAPL Form 610 Model Form Operating Agreement. The non-operator alleged that the operator breached certain provisions of the joint operating agreement by failing to deliver to the non-operator operations of two wells covered by the agreement prior to the operator plugging and abandoning the wells. The non-operator asserted that the plugging and abandoning of the wells damaged the wellbores, causing the non-operators to drill replacement wells in order to test the shallower formations encountered in the plugged and abandoned wells. Furthermore, the non-operator asserted that the operator refused to share certain information as required by the joint operating agreement.

On appeal, the Court of Appeals for the Fifth Circuit focused its analysis on article V, "Operator," of the 1977 Model Form Operating Agreement.¹⁴¹ Article V.A, "Designation and Responsibilities of Operator," provided that the operator "shall conduct all such operations in a good and workman like manner, but it shall have no liability as Operator to the other parties . . . except as may result from gross negligence or willful misconduct."¹⁴² The court determined this clause was sufficiently clear and unambiguous.¹⁴³ The court explained that the provision used the word "liability," a very broad legal term whose meaning includes "legal responsibility" and "responsibility for torts."¹⁴⁴ The court determined that this provision sufficiently stated the parties' intent.¹⁴⁵

In its decision, the court relied upon an article in the *Rocky Mountain Mineral Law Institute* commenting on article V of the Model Form Operating Agreement:

App. 1969) (holding that the express provisions of the joint operating agreement, which was not a Model Form Operating Agreement, did not create a joint venture or a fiduciary relationship among the parties).

140. 976 F.2d 254 (5th Cir. 1992).

141. *Id.* at 259.

142. *Id.*

143. *Id.* at 260.

144. *Id.*

145. *Id.*

Such clauses do not, of course, purport to authorize the operator to act in a negligent manner. They do however, purport to exculpate the operator from liability for negligent injury to the joint property and partially indemnify him against liability for negligence injury to third parties. Under Art. V., the operator would not be liable to the nonoperators if his negligent drilling resulted in the well blowing out.¹⁴⁶

The court concluded that the tenor of the exculpatory provision suggested that the operator was not liable for good-faith performance of its duties under the 1977 Model Form Operating Agreement, but was liable for acts outside the scope of its power under the agreement.¹⁴⁷ In this case, the operator could not be held liable for any action relating to the completion, testing, or turnover of any well drilled under the provisions of the joint operating agreement unless the non-operator could prove that the operator acted willfully or with gross negligence.¹⁴⁸ The court found that this protection extended to the operator's various administrative and accounting duties, including the recovery of costs pursuant to the parties' joint operating agreement.¹⁴⁹

Additionally, the court determined that the protection of the exculpatory clause extended not only to the acts unique to the operator, but also to any acts performed under the authority of the joint operating agreement as operator.¹⁵⁰ This protection would include breaches of the joint operating agreement as well as acts performed as operator pursuant to the operating agreement that amounted to tortious interference with contracts with third parties.¹⁵¹

The court concluded that the exculpatory clause in the 1977 Model Form Operating Agreement shielded the operator from liability for any act taken in its capacity as operator if authorized by the agreement, except for gross negligence or willful misconduct.¹⁵² Consequently, the court reversed and remanded the case for a new trial with the jury to determine, based on the court's interpretation of the exculpatory clause, whether the operator's actions constituted willful misconduct or gross negligence.¹⁵³

146. *Id.*

147. *Id.* at 261.

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* at 267; *see also* Archer v. Grynberg, 738 F. Supp. 449 (Utah 1990). In *Archer*, the court held that the operator was not liable pursuant to article V.A, "Designation and Responsibilities of Operator," of the 1977 Model Form Operating Agreement except for gross negligence or willful misconduct. *Archer*, 738 F. Supp. at 451. The court determined that its construction of article V.A comported with the understanding in the oil and gas industry that it is prudent to limit the liability of an operator to non-operators under a joint operating agreement. *Id.* at 452; *see also* Lancaster v. Petroleum Corp., 491 So. 2d 768, 773-74 (La. Ct. App. 1986) (holding that an operator, found by the trial court not to be negligent in causing a well blowout, could not be liable under the exculpatory language of section 5, "Operator of Unit," of the 1956 Model Form Operating Agreement because there could be no finding that the operator was grossly negligent).

IV. Loss of Title

Each version of the Model Form Operating Agreement provides that the parties shall own the interests in the equipment and materials acquired in connection with operations conducted under the joint operating agreement, and in all production of oil and gas from the lands covered by the agreement, as set forth in Exhibit A attached to the agreement.¹⁵⁴ The various versions of the Model Form Operating Agreement also address the situation in which an oil and gas lease or interest, covered by the agreement and used in calculating the interests as shown on Exhibit A to the agreement, is lost, and how such loss will affect the interests shown on Exhibit A.¹⁵⁵

A. Failure of Title

In *Dooley v. Cordes*,¹⁵⁶ the Oklahoma Supreme Court interpreted section 2.B, "Failure of Title," of the 1956 AAPL Form 610 Model Form Operating Agreement. *Dooley* involved parties who had entered into a joint operating agreement covering the oil and gas lease of the plaintiff, which lease had been acquired from the owner of a term mineral interest. Exhibit A to the joint operating agreement showed the plaintiff owning 3.125% of the working interest in the unit area. The term mineral interest subject to the plaintiff's oil and gas lease terminated, resulting in the termination of the plaintiff's lease. The plaintiff asserted that because of a special provision added to section 30 of the 1956 Model Form Operating Agreement, plaintiff maintained its 3.125% working interest in the unit area regardless of the fact that its oil and gas lease covering such interest had terminated.

The Oklahoma Supreme Court stated the only issue on appeal was whether the operator, by entering into the Model Form Operating Agreement, was obligated to regard plaintiff as owning 3.125% of the working interest in the applicable unit even though the plaintiff's lease had terminated.¹⁵⁷ The court focused its analysis on the provisions of the joint operating agreement.

The failure of title provision contained in section 2.B of the agreement states that the interest of a party whose lease is affected by a failure of title will thereafter be

154. 1989 Model Form, *supra* note 9, at art. III.B ("Interests of Parties in Costs and Production"); 1982 Model Form, *supra* note 9, at art. III.B; 1977 Model Form, *supra* note 9, at art. III.B; 1956 Model Form, *supra* note 9, § 4; *see also* *Fuel Exploration, Inc. v. Novotny*, 374 N.W.2d 838 (Neb. 1985). In *Fuel Exploration*, the Nebraska Supreme Court determined ownership of equipment acquired by the operator under the 1977 AAPL Form 610 Model Form Operating Agreement, but erroneously placed upon land not covered by the operating agreement. The court ruled that, as a matter of law, the operator and non-operators under the 1977 Model Form Operating Agreement, specifically article III.B, "Interests of Parties in Costs and Production," and article VII.B, "Liens and Payment Defaults," owned the equipment in question and were entitled to possession. *Fuel Exploration*, 374 N.W.2d at 841-43.

155. 1989 Model Form, *supra*, note 9, at art. IV.B ("Loss of Leases For Other Than Title Failure"); 1982 Model Form, *supra* note 9, at art. IV.B (same); 1977 Model Form, *supra*, note 9, at art. IV.B (same); 1956 Model Form, *supra* note 9, §§ 2.B, 2.C.

156. 434 P.2d 289 (Okla. 1967).

157. *Id.* at 292.

reduced in the unit area by the amount of the interest lost.¹⁵⁸ The plaintiff claimed that a special provision added to section 30 of the Model Form Operating Agreement modified the failure of title provision.¹⁵⁹ This special provision stated that if the plaintiff did not desire to advance his proportionate share of the costs of the test well as provided for in section 7, "Test Well," of the agreement, the operator could advance such costs.¹⁶⁰ Upon advancing such costs, the operator would be entitled to withhold and sell the production from the test well attributable to the interest of the plaintiff until 200% of such costs had been recovered by the operator.¹⁶¹ The plaintiff asserted that this special provision was added for the purpose of ensuring his entitlement to 3.125% of the working interest share of the production from the applicable unit, irrespective of any failure of title.¹⁶²

The court rejected the plaintiff's argument, finding that he was subject to the failure of title provision.¹⁶³ In evaluating the plaintiff's argument, the court stated:

In our opinion, this argument is not convincing and fails to show why — if Dooley had been intended to be excepted from the operation of the provisions of the Agreement's section 2B(2) — the simple expression "except David L. Dooley" would not have clearly and practically implemented such an intention.¹⁶⁴

The court concluded that there was no conflict between the failure of title provision and the special provision in section 30, and that no ostensible uncertainty was created by these two provisions.¹⁶⁵ The court found no reason or justification to look elsewhere because the written agreement itself resolved the controversy.¹⁶⁶ Finally, the court recognized that the recorded oil and gas leases covering the lands within the unit area set forth in the Model Form Operating Agreement normally comprise the basis for the fractional tabulations or computations set forth on Exhibit A to the agreement.¹⁶⁷

B. Loss of Title for Other than Failure of Title

In *Huggs, Inc. v. LPC Energy, Inc.*,¹⁶⁸ the Court of Appeals for the Fifth Circuit interpreted and applied section 2.C, "Loss of Leases For Other Than Title Failure," of the 1956 AAPL Form 610 Model Form Operating Agreement in connection with the loss of oil and gas leases covered by the operating agreement. Some of the leases at issue were lost due to the failure to pay delay rentals. Others were lost because

158. *Id.*

159. *Id.* at 293.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* at 293-94.

165. *Id.* at 295.

166. *Id.*

167. *Id.*

168. 889 F.2d 649 (5th Cir. 1989).

the operator failed to commence drilling or reworking operations within the specified time period after the cessation of production from the well on the applicable lease.

The court found that under section 2.C of the joint operating agreement, if a lease is permitted to expire, the loss is not a failure of title, but is a joint loss which does not affect the allocation of interests between the parties.¹⁶⁹

C. Changes in Interest Due to Changes in Drilling and Spacing Units

In addition to a change in a party's interest within the contract area resulting from the loss of an oil and gas lease, a party's interest in a well drilled under a Model Form Operating Agreement may also change because of an alteration in the drilling and spacing unit in which the well covered by the operating agreement is located. *Kaiser Aluminum Exploration Co. v. Celeron Oil & Gas Co.*,¹⁷⁰ a Louisiana Court of Appeal decision, addressed this situation.

In *Kaiser*, the Commissioner of Conservation had issued an order establishing a 640-acre geographic unit designated as the Sand Unit H, with the Baxter No. 1 well as the unit well. Such unit was operated under a 1956 AAPL Form 610 Model Form Operating Agreement. Subsequently, the Commissioner of Conservation issued an order dissolving the geographic unit and creating a geological unit. In the original geographic unit, the non-operator's participation in the Baxter No. 1 well was calculated in the agreement at 33.5657%. However, because of the creation of the geological unit, which excluded a considerable portion of the non-operator's leasehold acreage, the non-operator's participation lessened considerably.

The non-operator filed a declaratory action seeking a judicial determination that its interest in the original geographic unit was fixed at 33.56575% and that it was entitled to 33.5657% of the production attributable to that portion of the prior geographical unit now lying within the new geological unit. The non-operator argued that section 4, "Interests of Parties," of the 1956 Model Form Operating Agreement, and Exhibit A attached thereto, set forth the unit description and the participation by the leasehold owners. The non-operator further claimed that these provisions exhibited the parties' clear intent to fix for all time the non-operator's participation in the unit acreage and production attributable thereto.

The operator refuted the non-operator's analysis based, in part, upon section 28, "Claims and Lawsuits," of the 1956 Model Form Operating Agreement, which provided that legal fees in defending lawsuits "shall be considered costs of operation and shall be charged to and paid by all parties in proportion to their then interest in the Unit Area."¹⁷¹ The operator also relied upon section 25, "Acreage or Cash Contributions," of the joint operating agreement which provided that any party who makes an acreage contribution in lieu of a cash contribution shall make an assignment "to all parties to this agreement in proportion to their interests in the unit

169. *Id.* at 655.

170. 526 So. 2d 374 (La. Ct. App. 1988).

171. *Id.*

area at that time.¹⁷² The operator asserted that these provisions evidenced the parties' intention not to permanently fix their respective interests in the unit.

In analyzing the parties' respective arguments and reviewing the 1956 Model Form Operating Agreement, the court stated that the only conclusion it could reach was that the agreement failed to specifically state whether the parties' interests were fixed for all time.¹⁷³ The court determined that the joint operating agreement was ambiguous and susceptible to different interpretations concerning the fixing of the parties' interests.¹⁷⁴ Thus, the appellate court reversed the trial court's grant of summary judgment in favor of the non-operator and remanded the case for a trial on the merits.¹⁷⁵

The Tenth Circuit Court of Appeals in *Pasternak v. Lear Petroleum Exploration, Inc.*¹⁷⁶ reached a different conclusion than the Louisiana Court of Appeal in *Kaiser Aluminum* regarding the effect, under the Model Form Operating Agreement, of a change in a drilling and spacing unit created by the applicable conservation body exercising the police power of the state. In *Pasternak*, the parties had entered into a 1956 AAPL Form 610 Model Form Operating Agreement covering Section 23. The Oklahoma Corporation Commission had established a 640-acre drilling and spacing unit in Section 23 for the applicable formation. Under the Model Form Operating Agreement, the parties agreed to participate, according to an agreed ratio of interests and for a specified period of time, in all oil and gas produced from Section 23.

The operator drilled and completed a producing well in the SW¼ of Section 23. The Oklahoma Corporation Commission subsequently respaced Section 23 for the relevant formation from one 640-acre drilling and spacing unit to eight 80-acre drilling and spacing units. The plaintiff subsequently acquired oil and gas leases covering the NE¼ of Section 23 through a farmout agreement from one of the non-operators to the joint operating agreement. The parties made the farmout agreement specifically subject to the joint operating agreement. The plaintiff drilled two wells on the acreage acquired. Various other parties to the joint operating agreement claimed interests under such agreement in the wells drilled by the plaintiff.

On appeal, the plaintiff claimed that upon the Oklahoma Corporation Commission's reformation of the 640-acre drilling and spacing unit to eight 80-acre drilling and spacing units, the scope of the joint operating agreement became limited to the 80-acre drilling and spacing unit on which the initial well, drilled under the agreement, was located. The plaintiff asserted that after the respacing, the joint operating agreement did not cover any of the parties' interests in the NE¼ of Section 23 where the plaintiff had drilled its wells.

172. *Id.*

173. *Id.*

174. *Id.* at 377.

175. *Id.* at 378.

176. 790 F.2d 828 (10th Cir. 1986).

The Tenth Circuit Court of Appeals rejected the plaintiff's contention,¹⁷⁷ explaining that the Oklahoma Corporation Commission has the statutorily prescribed duty to prohibit and control waste and to protect correlative rights.¹⁷⁸ The court also explained, however, that the jurisdiction of the Corporation Commission is limited to its statutorily prescribed duties.¹⁷⁹ The rights to produce a designated quantity of hydrocarbons from a well, and owner-operator interests and obligations, are the proper subjects of a private agreement, provided that the private agreement does not cause or grant a license to commit waste or diminish correlative rights.¹⁸⁰

The court concluded that the plaintiff did not demonstrate that the joint operating agreement encouraged waste or allowed a party to take more than its share from the common source of supply in derogation of correlative rights.¹⁸¹ Also, the plaintiff showed no indication that the division of rights and obligations as set out in the Model Form Operating Agreement undermined the public interest served by respacing the 640-acre drilling and spacing unit.¹⁸² Therefore, the court held that the respacing order of the Oklahoma Corporation Commission could not limit the scope of the joint operating agreement.¹⁸³ Thus, the district court did not err in determining that the parties to the joint operating agreement did, in fact, own by virtue of such agreement an interest in the wells drilled by the plaintiff.¹⁸⁴

V. Resignation or Removal of Operator

Each version of the AAPL Form 610 Model Form Operating Agreement provides a space for the parties to specifically designate which party will be "Operator" under the agreement.¹⁸⁵ These forms further address the manner in which and the conditions under which the designated operator may resign or be removed.¹⁸⁶

In *Lancaster v. Petroleum Corp. of Delaware*,¹⁸⁷ the Louisiana Court of Appeal considered whether the operator breached the provisions of the 1956 AAPL Form 610 Model Form Operating Agreement by failing to give ninety days notice of its resignation as operator, and by threatening to plug and abandon the subject well without the consent of the non-operators. The operator in *Lancaster* argued that the ninety-day notice requirement, as provided for in paragraph 1 of section 21,

177. *Id.* at 835-36.

178. *Id.* at 835.

179. *Id.* at 836.

180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

185. 1989 Model Form, *supra* note 9, at art. V.A ("Designation and Responsibilities of Operator"); 1977 Model Form, *supra* note 9, at art. V.A (same); 1982 Model Form, *supra* note 9, at art. V.A (same); 1956 Model Form, *supra* note 9, § 5 ("Operator of Unit").

186. 1989 Model Form, *supra* note 9, at arts. V.B.1, V.B.3 ("Resignation or Removal of Operator" and "Effect of Bankruptcy" respectively); 1982 Model Form, *supra* note 9, art. V.B.1 ("Resignation or Removal of Operator"); 1977 Model Form, *supra* note 9, art. V.B.1 (same); 1956 Model Form, *supra* note 9, §§ 19, 21 ("Selection of New Operator" and "Resignation of Operator" respectively).

187. 491 So. 2d 768 (La. Ct. App. 1986).

"Resignation of Operator," of the joint operating agreement was not necessary because of section 12, "Operations By Less Than All Parties," and paragraph 2 of section 21, "Resignation of Operator," of the agreement.¹⁸⁸

The court rejected the operator's contention, finding that neither section 12 nor paragraph 2 of section 21 relieved the operator of the obligation of giving ninety days notice as required by paragraph 1 of section 21 of the joint operating agreement.¹⁸⁹ Thus, the court concluded that the operator's resignation without ninety days advance written notice to the non-operators constituted a breach of the 1956 Model Form Operating Agreement.¹⁹⁰

Additionally, the court found it abundantly clear that the operator did not have the requisite consent of the non-operators when the operator threatened to plug and abandon the subject well.¹⁹¹ The court held that the operator's threat to plug and abandon the subject well was unreasonable and also held that the threat constituted a breach of the operating agreement.¹⁹²

VI. The Selection of Successor Operator

In addition to the provisions in the various versions of the AAPL Form 610 Model Form Operating Agreements providing for the designation of an operator and the resignation and removal of an operator, these agreements also contain provisions addressing the selection of a successor operator.¹⁹³

A. Right to Change Vote for Successor Operator

In *Oxley v. General Atlantic Resources, Inc.*,¹⁹⁴ the Oklahoma Supreme Court considered whether section 19, "Selection of New Operator," of the 1956 AAPL Form 610 Model Form Operating Agreement, permitted a non-operator to change its vote for a successor operator within sixty days after notification of the sale of the current operator's interest in the contract area.

In *Oxley*, BHP, the original operator under the 1956 Model Form Operating Agreement, sold its interest in the contract area to the defendant and notified all parties of its resignation as unit operator. The defendant subsequently gave notice to the non-operators that the defendant would assume the duties of operator as BHP's "representative," and then requested that the non-operators appoint a successor operator.

The plaintiff, one of the non-operators, asked the other non-operators to appoint it as the successor operator under the joint operating agreement. Eberly, another non-

188. *Id.* at 776.

189. *Id.* at 777.

190. *Id.*

191. *Id.*

192. *Id.*

193. 1989 Model Form, *supra* note 9, at art. V.B.2 ("Selection of Successor Operator"); 1982 Model Form, *supra* note 9, at art. V.B.2 (same); 1977 Model Form, *supra* note 9, at art. V.B.2 (same); 1956 Model Form, *supra* note 9, § 19 ("Selection of New Operator").

194. 1997 OK 46, 936 P.2d 943.

operator, voted initially for the defendant as operator, but then changed its vote in favor of the plaintiff within the sixty-day period provided for in section 19 of the joint operating agreement. With Eberly's vote the defendant would have been elected successor operator; however, after Eberly changed its vote, the plaintiff accumulated enough votes to be elected successor operator. The plaintiff sought a judgment declaring it the duly elected successor operator.

In its analysis, the Oklahoma Supreme Court framed the issue on appeal as whether section 19, "Selection of New Operator," of the 1956 Model Form Operating Agreement permitted an owner to change its vote for a successor operator within sixty days after notification of the sale of the current owner's interest.¹⁹⁵ The court determined that the joint operating agreement did not expressly address whether a party could change its vote for a successor operator, which created an ambiguity.¹⁹⁶ The court pointed out that the parties had cited no authority construing section 19 of the joint operating agreement.¹⁹⁷ The court viewed the joint operating agreement as a contract, and explained that the agreement must be construed to conform to the intentions of the parties.¹⁹⁸

The court stated that a construction or interpretation of section 19 of the Model Form Operating Agreement that permitted a change in a vote for a successor operator during the sixty-day period would not promote instability or uncertainty as to the operations under the agreement.¹⁹⁹ The court found that, pursuant to section 19, the original operator was to operate the well for not more than 120 days or until the non-operators selected a successor operator who could take over the duties of an operator.²⁰⁰ Thus, the operation of the wells could run smoothly, even though the successor was not determined until sixty days after the parties were notified of a sale.²⁰¹ The court found that the defendant had taken over operations under the joint operating agreement only because of the purchase agreement with BHP requiring it to assume BHP's duties under the joint operating agreement.²⁰²

Furthermore, the court relied on custom and usage in the oil and gas industry as an important guide to resolving the ambiguity in the Model Form Operating Agreement and determining the intent of the parties to such agreement.²⁰³ Consequently, the court remanded the case to the trial court with instructions that if the evidence showed that, based on custom and usage in the oil and gas industry, vote

195. *Id.* ¶ 3, 936 P.2d at 944.

196. *Id.* ¶ 12, 936 P.2d at 945.

197. *Id.* ¶ 13, 936 P.2d at 945.

198. *Id.*

199. *Id.* ¶ 15, 936 P.2d at 946.

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.* ¶ 17, 936 P.2d at 946. The court noted that the Model Form Operating Agreement incorporates industry custom and usage. *Id.* ¶ 19, 936 P.2d at 946 (citing *Heiman v. Atl. Richfield Co.*, 891 P.2d 1252, 1251 (Okla. 1995)).

changes during the sixty-day period were not permitted, then the trial court should construe the 1956 Model Form Operating Agreement accordingly.²⁰⁴

B. Selection of Successor Operator by Estoppel

Even with a specific provision setting forth the procedure for selection of a subsequent operator, parties to the AAPL Form 610 Model Form Operating Agreement may occasionally select a successor operator without complying with the specific provisions of the agreement. An Oklahoma court addressed such a situation in *Oklahoma Oil & Gas Exploration Drilling Program 1983-A v. W.M.A. Corp.*²⁰⁵

In April 1987, WMA acquired the working interests in twenty-eight wells from the designated operator under 1977 AAPL Form 610 Model Form Operating Agreements. WMA then assumed operations of the wells without first obtaining new operating agreements designating WMA as operator or complying with the subsequent operator's election provisions under the applicable joint operating agreements. WMA operated the wells for several months, issuing joint interest billings to the non-operators.

The non-operators filed suit seeking to remove WMA as operator and to obtain an accounting of certain costs incurred by WMA and billed to them. The trial court found that the non-operators consented to WMA's operation of the wells and were therefore estopped from denying WMA's status as operator.²⁰⁶

On appeal, the Oklahoma Court of Appeals stated the issue to be resolved as whether WMA was the operator pursuant to the applicable joint operating agreements.²⁰⁷ The court found that the Model Form Operating Agreements provided specific procedures for the resignation of operators and the election of subsequent operators.²⁰⁸ In this case, no formal selection process existed prior to WMA's assumption of operations.²⁰⁹ However, WMA had assumed operations and operated the wells without protest through much of 1987.²¹⁰

The court explained that, under certain circumstances, words or conduct of a party may operate to estop him from demanding strict compliance with contract terms.²¹¹ If a party leads one to believe that he will not insist upon literal performance of a contract term and the other party detrimentally relies thereon, the first party will be estopped from demanding literal compliance.²¹²

204. *Id.*

205. 877 P.2d 605 (Okla. Ct. App. 1994).

206. The trial court found that the non-operators knew for several months that WMA was acting as operator. Also, the non-operators paid joint interest billings, which included operating costs on the wells, while WMA was acting as operator. *Id.* at 608.

207. *Id.* at 609.

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.*

The court based its decision on the fact that the non-operators knew of WMA's operation of the wells in April 1987.²¹³ Additionally, the non-operators paid portions of the joint interest billings submitted by WMA, which referred to WMA as operator of the subject wells.²¹⁴ Yet, the non-operators failed to object to WMA's operation until late in 1987.²¹⁵ The court found that WMA relied on the non-operators' payment of the joint interest billings and the non-operators' failure to object to WMA's operation of the wells.²¹⁶ WMA operated the wells, incurring costs for the benefit of all working interest owners.²¹⁷ Based on these undisputed facts, the court concluded that the non-operators were estopped to deny WMA's status as operator of the wells.²¹⁸

VII. *The Obligations of Operator in Connection with Test or Initial Well*

Each version of the AAPL Form 610 Model Form Operating Agreement provides for the drilling of a test or initial well within the lands covered by the operating agreement. The agreements provide for the commencement date, the location, and the total depth or target formation for such well.²¹⁹ All versions of the Model Form Operating Agreement obligate the operator to drill the test or initial well to the designated depth or target formation unless the well encounters granite or other practically impenetrable substance, or encounters a condition in the hole which renders further operations impractical.²²⁰

In *Lerblance v. Continental Oil Co.*,²²¹ the United States District Court for the Eastern District of Oklahoma interpreted a provision of a joint operating agreement that appears to be section 7, "Test Well," of the 1956 AAPL Form 610 Model Form Operating Agreement. Pursuant to this provision, the operator had an obligation to drill the test well to a "depth sufficient to test the Spiro formation, expected at a depth of approximately 13,000 feet, unless granite or other practically impenetrable substance is encountered at a lesser depth or unless all parties agree to complete the well at a lesser depth."²²²

The operator drilled the well to a depth of approximately 7600 feet but determined that because of problems encountered in the wellbore, the wellbore should be plugged

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.*

219. 1989 Model Form, *supra* note 9, at arts. VI.A, VI.F ("Initial Well" and "Termination of Operations" respectively); 1982 Model Form, *supra* note 9, at art. VI.A ("Initial Well"); 1977 Model Form, *supra* note 9, at art. VI.A (same); 1956 Model Form, *supra* note 9, § 7 ("Test Well").

220. 1989 Model Form, *supra* note 9, at art. VI.F.; 1982 Model Form, *supra* note 9, at art. VI.F.; 1977 Model Form, *supra* note 9, at art. VI.F. The 1956 Model Form Operating Agreement, however, does not expressly relieve the operator of the obligation to drill the test well if conditions are encountered in the hole which render further drilling or other operations impractical.

221. 437 F. Supp. 223 (E.D. Okla. 1976).

222. *Id.* at 224.

and abandoned because further remedial operations or further attempted drilling was not prudent. Without the consent of the non-operators, the operator plugged and abandoned the well. The non-operators sued the operator for breach of section 7 of the joint operating agreement.

The court determined that the operator had encountered a "practically impenetrable substance" within the meaning of section 7 of the joint operating agreement, as evidenced by the inordinate difficulties encountered by the operator in drilling the well.²²³ The court found that the circumstances relieved the operator of its obligation to continue further operations in the test well under such section.²²⁴ The court further found that the agreement did not require the operator to obtain the consent of the non-operators before plugging and abandoning the subject well.²²⁵

The last sentence of section 7 provided that if the operator desires to "plug and abandon the test [well] as a dry hole," then the operator must first secure the consent of all parties to the plugging.²²⁶ The court defined a dry hole as "a completed well which is not productive of oil and/or gas (or which is not productive of oil and/or gas in paying quantities)."²²⁷ Thus, a well must have been completed to qualify as a dry hole.²²⁸

Because the subject well had never been completed or tested the target formation, the well was not a dry hole and was not covered by the last sentence of section 7 of the joint operating agreement.²²⁹ Consequently, the operator did not have an obligation to give notice to, or obtain consent from, the non-operators prior to plugging and abandoning the test well.²³⁰

VIII. Subsequent Operations

Each version of the AAPL Form 610 Model Form Operating Agreement includes provisions prescribing the manner in which a well or operation subsequent to the initial or test well may be drilled or conducted under the joint operating agreement.²³¹ Each of the Model Form Operating Agreements sets forth a procedure

223. *Id.* at 228. The court considered the difficulties the operator encountered and determined the operator had come across a "practically impenetrable substance." *Id.* These difficulties included the following: the formations' tendency to cave in; the steep dip of the beds being penetrated which made it difficult for the drill bit to maintain vertical penetration; abrupt and severe deviation; 1200 feet of iron that the operator lost in the hole; the more than \$600,000 expended to obtain a depth of approximately 7600 feet; and the fact that the total cost of the well would have been in excess of \$1.2 million with the cost of sidetracking or drilling a window in the casing and drilling the well to the projected depth, if such activities were mechanically possible. *Id.*

224. *Id.* at 229.

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.* The 1977, 1982, and 1989 Model Form Operating Agreements expressly expand conditions in the test well that will relieve the operator of its obligation to continue operations. These expansions include encountering conditions in the wellbore that render further drilling or other operations impractical.

231. 1989 Model Form, *supra* note 9, at art. VI.B ("Subsequent Operations"); 1982 Model Form, <https://digitalcommons.law.ou.edu/olr/vol54/iss2/2>

for the parties to commit to participate or not to participate in the proposed subsequent well or other operation.²³² These provisions further provide for certain "penalties" to be applied to the interests relinquished by the parties who elect not to participate or to go "non-consent" in the proposed subsequent well or other operation.²³³

A. Sidetrack Operation in Initial Well Not Subsequent Operation

In *Holt Oil & Gas Corp. v. Harvey*,²³⁴ the Court of Appeals for the Fifth Circuit was asked to interpret article VI.B, "Subsequent Operations," of the 1977 AAPL Form 610 Model Form Operating Agreement to determine whether a sidetrack operation in the initial well constituted either a continuation of such initial well or a subsequent operation under the agreement. In *Holt*, the operator was to drill the initial well under the joint operating agreement to a true vertical depth of 6900 feet, or to a depth sufficient to test the Marmaton formation. After drilling the initial well to a depth of 6700 feet and encountering numerous problems in the well, the operator proposed to sidetrack the well in order to drill to a depth sufficient to evaluate the Marmaton formation.

After receiving the proposal, the non-operator informed the operator that he would not pay any expenses in connection with the sidetrack operation. The operator continued unsuccessfully with the sidetrack operation. The operator sued the non-operator for the non-operator's proportionate share of the well costs incurred in connection with the sidetrack operation.

The non-operator claimed that the sidetrack operation was a subsequent operation under article VI.B of the 1977 Model Form Operating Agreement. Therefore, he was not liable for the costs incurred in such operation absent his prior approval. The trial court refused to find that, as a matter of law, the subsequent operations provision in article VI.B of the 1977 Model Form Operating Agreement covered the sidetrack operation in the initial well.

On appeal, the Court of Appeals for the Fifth Circuit stated that "the interpretation of an unambiguous contract is a matter of law to be decided by the court."²³⁵ The determination of whether a particular contract is ambiguous is also a question of law.²³⁶ In analyzing the 1977 Model Form Operating Agreement, the court concluded that the contract did not clarify whether the sidetrack operation constituted a subsequent operation or an initial operation with respect to the initial well.²³⁷

supra note 9, at art. VI.B (same); 1977 Model Form, *supra* note 9, at art. VI.B (same); 1956 Model Form, *supra* note 9, § 12 ("Operations By Less Than All Parties").

232. *Id.*

233. *Id.*

234. 801 F.2d 773 (5th Cir. 1986).

235. *Id.* at 780.

236. *Id.*

237. *Id.* at 780-81. In discussing the subsequent operations provision, the court stated:

The JOA defines subsequent operations to include "any well on the Contract Area other than [the initial well]" or any operation intended to "rework, deepen or plug back a dry hole [or a well] not then producing in paying quantities" The provision defining

The court also discussed whether or not the provisions of article VII.D, "Limitations on Expenditures," of the 1977 Model Form Operating Agreement applied to the sidetrack operation.²³⁸ This provision limited the amount the operator could spend on any single project, but excepted expenditures made in connection with a previously authorized well.²³⁹ Again, the court determined that the application of article VII.D to the sidetrack operation in the initial well presented the same ambiguity as article VI.B.²⁴⁰ The court determined that if the sidetrack operation was a continuation of the initial well, then the spending limit in article VII.D might be inapplicable because such article expressly excepted from its coverage the drilling of a previously authorized well.²⁴¹

The court noted that the provisions of article VII.D appeared to emphasize expenses incurred during the course of subsequent operations.²⁴² If the sidetrack operation was a second well or a subsequent operation, then article VII.D would apply.²⁴³ The court found sufficient evidence in the record to support the jury's decision that the sidetrack operation was not a subsequent or other operation under the 1977 Model Form Operating Agreement.²⁴⁴

B. Sidetrack Operation Constitutes Subsequent Operation — Not Plugging and Abandonment of Well

In *Jackhill Oil Co. v. Powell Production, Inc.*,²⁴⁵ the Michigan Court of Appeals resolved a conflict between the parties' interpretations of article VI.B, "Subsequent Operations," and article VI.E.2, "Abandonment of Wells That Have Produced," in the 1977 AAPL Form 610 Model Form Operating Agreement. *Jackhill Oil* involved an operator who proposed the redrilling of the initial well to a different bottomhole location because the well had become unprofitable. The operator believed that article VI.B of the 1977 Model Form Operating Agreement covered this operation. One of the non-operators did not agree to participate in the redrilling operation, claiming that

subsequent operations does not mention sidetrack operations. A sidetrack could be considered a well "other than the initial well." On the other hand, the provision for an initial well indicates an intent to drill as necessary to test the Marmaton formation. The Campbell 1 operation resulted in an incomplete test of the Marmaton formation because the hole was lost. The sidetrack operation could be considered merely a continuation of the initial test effort.

Id. (alterations in original).

238. *Id.* at 781.

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.* Interestingly, article VI.B of the 1977 Model Form Operating Agreement does not specifically mention a sidetrack operation. However, article VI.B of each of the 1982 and 1989 Model Form Operating Agreements does specifically address sidetrack operations. These subsequent Model Form Operating Agreements removed the uncertainty that existed in article VI.B of the 1977 Model Form Operating Agreement.

245. 532 N.W.2d 866 (Mich. Ct. App. 1995).

the operation constituted the plugging and abandonment of the initial well, governed by article VI.E.2 of the operating agreement.

Under article VI.E.2 of the agreement, if a well were proposed to be abandoned, then any party not in agreement with the proposal had the right to take over the well and purchase the other parties' interests in the well. In such event, the other parties agreeing to the plugging proposal would assign all of their interests in the well, related equipment, and the leasehold estate to the party objecting to the plugging proposal.

In this case, the non-operator refusing to participate in the proposed redrilling operation tendered the monies required under article VI.E.2. However, the other parties refused this tender, claiming that article VI.B covered the proposed operation. The operator conducted the redrilling operation, but the operation proved to be unsuccessful.

The non-operator who refused to participate in the redrilling operation filed suit, claiming that the other parties had confiscated its interest in the initial well and that it had the right to acquire all interests in such well under the provisions of article VI.E.2. The trial court ruled in the favor of the defendants.

On appeal, the Michigan Court of Appeals relied upon the reasoning set forth in an unpublished opinion from the court and stated:

In *Krol*, the defendant had engaged in a "sidetrack" operation, which involved creating an opening in the casing of the old well and drilling through to a new bottom hole. There, the Court concluded that a well must be both plugged and abandoned before operating agreement language pertaining to the salvage of an abandoned well becomes applicable.²⁴⁶

The court believed that, in this case, the operator had embarked upon a sidetrack operation similar to that performed in *Krol*.²⁴⁷ Both parties plugged the original bottomhole, but used a significant portion of the upper wellbore, which they had preserved, to drill to the new location.²⁴⁸

The court determined that because the operator and the non-operators who consented to drilling to the new bottomhole location did not intend to plug and abandon the well, and because the well was, in actuality, plugged but not abandoned,

246. *Id.* at 868 (citing *Krol v. Amoco Prod. Co.*, No. 132336 (Mich. Ct. App. Mar. 5, 1992) (per curiam)). The court further reasoned:

In *Krol*, the plaintiffs alleged that the defendant had "plugged and abandoned" an oil well, entitling them to an assignment of the defendant's interest in the well under their contract. The language in the *Krol* agreement was similar to that found in § VI.E.2 of the operating agreement here. The defendant in *Krol* countered that, although it had plugged a portion of the well, the record showed undisputed efforts to preserve the well, not abandon it.

Id.

247. *Id.*

248. *Id.*

article VI.E.2 of the 1977 Model Form Operating Agreement did not apply.²⁴⁹ Rather, article VI.B covered the operation.²⁵⁰ Therefore, the objecting non-operator was not entitled to the other parties' interests in the subject well, the related equipment, or the leasehold under article VI.E.2 of the agreement.²⁵¹

C. Proper Notice of Subsequent Operation

The subsequent operations provision in each version of the AAPL Form 610 Model Form Operating Agreement provides that a party's receipt of written notice triggers the time period for a party to make an election as to a proposed subsequent operation.²⁵² A party proposing to conduct a subsequent operation under a Model Form Operating Agreement must provide proper written notice to the applicable parties in order to commence the running of the election period.²⁵³

In *AcadiEnergy, Inc. v. McCord Exploration Co.*,²⁵⁴ the Louisiana Court of Appeal considered the issue of what constitutes proper notice under article VI.B.1, "Proposed Operations," of the 1977 AAPL Form 610 Model Form Operating Agreement so as to trigger the requisite election period. In *AcadiEnergy*, the non-operator argued that because the notice under article VI.B.1 of the joint operating agreement was deficient, the non-operator never declined to participate in the proposed subsequent well and, therefore, never forfeited its interest in such proposed subsequent well under the provisions of article VI.B.²⁵⁵ The operator claimed that the non-operator forfeited or relinquished its interest in the proposed subsequent well.

On appeal, the court explained that under article VI.B.1, the parties must be given written notice of five facts.²⁵⁶ These five facts are (1) the work to be performed, (2) the location of the proposed well, (3) the proposed depth of the proposed well, (4) the objective formation, and (5) the estimated cost of the operation.²⁵⁷

The court concluded that the non-operator in question had not received written notice of the requisite five facts as to the proposed well, which was subsequently drilled and completed.²⁵⁸ The party drilling the subsequent well argued that no new proposal was necessary because the non-operator had indicated it did not like the objective formation in the well.²⁵⁹ However, the court found that the non-operator had expressed a desire to participate in the proposed subsequent well if the location

249. *Id.* at 868-69.

250. *Id.* at 869.

251. *Id.*

252. 1989 Model Form, *supra* note 9, at art. VI.B; 1982 Model Form, *supra* note 9, at art. VI.B; 1977 Model Form, *supra* note 9, at art. VI.B; 1956 Model Form, *supra* note 9, § 12.

253. *Id.*

254. 596 So. 2d 1334 (La. Ct. App. 1992).

255. *Id.* at 1341.

256. *Id.* at 1342.

257. *Id.*

258. *Id.*

259. *Id.*

of the well changed.²⁶⁰ The non-operator had also requested and received additional information on the proposed well.²⁶¹

The appellate court concluded that under the terms of the 1977 Model Form Operating Agreement, the non-operator did not receive written notice of the requisite five facts relating to the proposed subsequent well before it was drilled, and could not make a determination of whether to participate in the well.²⁶² Therefore, the appellate court affirmed the trial court's determination that the non-operator did not decline to participate in the subject well and did not relinquish its interest in such well under the joint operating agreement.²⁶³

D. An Authority for Expenditure Is Proper Notice of Subsequent Operation

In *French v. Joseph E. Seagram & Sons, Inc.*,²⁶⁴ the Texas Court of Appeals considered whether an "Authority for Expenditure" (AFE) sent out by an operator in connection with a proposed subsequent operation under section 12, "Operations By Less Than All Parties," of the 1956 AAPL Form 610 Model Form Operating Agreement met the requirements of this section as to written notice of the proposed operation.

In *French*, the operator sent out an AFE covering a proposed subsequent well to be drilled under the joint operating agreement. The AFE set forth the location, the proposed depth, the objective formation, and the estimated cost of the proposed subsequent well. The non-operators executed and returned the AFE forms, agreeing in writing to participate in the proposed subsequent well. Subsequently, the non-operators refused to pay their proportionate shares of the costs of the subsequent well. The operator then filed suit against the non-operators for their shares of the well costs.

The operator argued that execution of the AFE obligated the non-operators to pay their respective proportionate shares of the costs of the subsequent well. The non-operators argued that the AFE forms were not sufficient to meet the requirements of section 12 of the joint operating agreement. The non-operators argued that section 12 not only provided for notice to the parties, but also provided for an election by the non-operators as to whether they wished to participate in an operation by fewer than all of the parties to the joint operating agreement. The non-operators asserted that because the AFE forms were executed before the non-operators knew that all parties were not participating in the proposed subsequent operation, the elections made by returning the AFE forms did not bind them.

On appeal, the court characterized the non-operators' argument as an attack on the sufficiency of the notice given under section 12.²⁶⁵ The court determined that according to the non-operators, the notice under section 12 must also show that all

260. *Id.*

261. *Id.*

262. *Id.*

263. *Id.*

264. 439 S.W.2d 448 (Tex. Civ. App. - El Paso 1969, writ ref'd n.r.e.).

265. *Id.* at 450.

of the parties were not participating so that a party could know what he agreed to with respect to the proposed operation.²⁶⁶

The court found that the parties agreed that the joint operating agreement was not ambiguous and that extrinsic evidence was not necessary to construe it.²⁶⁷ The court further determined that the AFE forms sent out by the operator met the requirements of section 12 regarding written notice of the proposed operation.²⁶⁸ The court rejected the arguments of the non-operators, finding that the 1956 Model Form Operating Agreement did not expressly require notice of a failure of the parties to agree on the proposed subsequent well.²⁶⁹ Accordingly, the court refused to write into the joint operating agreement a provision requiring notice of overt failure to agree regarding a subsequent operation.²⁷⁰ The court found that with the exception of the operation of wells already agreed upon, the procedure to be followed for a subsequent operation was set forth in section 12.²⁷¹ Accordingly, the court upheld the trial court's decision that the operator gave the non-operators proper notice under section 12 of the 1956 Model Form Operating Agreement in regard to the proposed subsequent operation.²⁷²

E. Proper Election as to a Subsequent Operation

While *AcadiEnergy* and *French* addressed the requirements of the written notice necessary to trigger the election period under the subsequent operations provision of the Model Form Operating Agreement, the Texas Court of Appeals in *C & C Partners v. Sun Exploration & Production Co.*²⁷³ addressed the requirements for a non-operator to make a proper election to consent to or to participate in a proposed subsequent operation under the Model Form Operating Agreement. *C & C Partners* involved a non-operator who denied liability for the costs incurred in the drilling of certain wells under article VI.B, "Subsequent Operations," of the 1977 AAPL Form 610 Model Form Operating Agreement.

266. *Id.*

267. *Id.*

268. *Id.*

269. *Id.* at 451.

270. *Id.* Under the 1977, 1982, and 1989 Model Form Operating Agreements, if less than all parties approve a proposed subsequent operation, then each "consenting" party may limit its participation and liability to its interest, or may elect to carry its proportionate share of the "non-consenting" parties' interests. 1989 Model Form, *supra* note 9, at art. VI.B; 1982 Model Form, *supra* note 9, at art. VI.B; 1977 Model Form, *supra* note 9, at art. VI.B. Furthermore, under these versions of the Model Form Operating Agreement, the proposing party has the right to withdraw the proposal in the event of inadequate participation by the parties. 1989 Model Form, *supra* note 9, at art. VI.B; 1982 Model Form, *supra* note 9, at art. VI.B; 1977 Model Form, *supra* note 9, at art. VI.B.

271. *French*, 439 S.W.2d at 451.

272. *Id.*; see also *M&T, Inc. v. Fuel Res. Dev. Co.*, 518 F. Supp. 285 (D. Colo. 1981). In *M&T*, the court held that the point at which a party may go non-consent is determined, in the absence of an express written agreement, by industry custom and practice. *M&T*, 518 F. Supp. at 292. Accordingly, when the costs incurred in the drilling of a well exceed the estimated costs in the applicable AFE, a consenting party may not then elect to go non-consent. *Id.* at 291.

273. 783 S.W.2d 707 (Tex. App. - Dallas 1989, writ denied).

The non-operator alleged that it had not consented to the subsequent operations conducted under the joint operating agreement and that such consent was a condition precedent to the non-operator's liability. In support of its argument, the non-operator attempted to present testimony in the lower court concerning an alleged industry practice regarding the use of authorizations for expenditures (AFE) to obtain consent for drilling and completion expenditures. The trial court excluded this testimony.

The non-operator also attempted to offer testimony that the consent requirements of article VI.B.1, "Proposed Operations," of the 1977 Model Form Operating Agreement must be evidenced in writing by means of an AFE. The non-operator asserted that because no AFE evidencing consent was introduced into evidence, the operator failed to prove a condition precedent to the non-operator's liability. Therefore, the operator failed to prove that the non-operator was liable for the costs incurred. The trial court found in favor of the operator.

In analyzing article VI.B.1 of the 1977 Model Form Operating Agreement, the Texas Court of Appeals stated:

We conclude that the contract provisions regarding consent are unambiguous. The contracts clearly require consent, but they do not specify that any particular form of consent is required. Consent by telephone is permitted but not required under certain circumstances. Any telephoned notice or response (consent or nonconsent) is required to be confirmed in writing. Thus, the only requirement of a writing is in the case of *confirmation of consent or nonconsent* or confirmation of notice of a proposed operation. Confirmation of consent is obviously distinct and separate from consent itself, as to which there is no requirement of a writing. Moreover, the contract plainly does not state that consent is invalid or ineffective if it is not confirmed in writing. The provisions on consent also contain absolutely nothing about AFEs.²⁷⁴

Because the 1977 Model Form Operating Agreement was unambiguous, the court was required to give effect to the objective intent of the parties as expressed in their agreement.²⁷⁵

The court determined that the non-operator offered its evidence in an attempt to alter the provisions regarding consent under article VI.B of the 1977 Model Form Operating Agreement.²⁷⁶ Because the 1977 Model Form Operating Agreement was unambiguous, the trial court properly excluded the parol evidence.²⁷⁷

274. *Id.* at 714-15.

275. *Id.*

276. *Id.*

277. *Id.* at 715; *see also French*, 439 S.W.2d at 450 (holding that a non-operator's execution of an AFE constituted an election to participate as a consenting party under section 12 of the 1956 Model Form Operating Agreement); *Colo. Springs Nat'l Bank v. Ferebee*, 486 P.2d 456, 459 (Colo. Ct. App. 1971) (holding that a non-operator, who had notice of a proposed drilling program, was deemed to be a non-consenting party under what appeared to be section 12 of the 1956 Model Form Operating Agreement because such party had not expressly elected to be a consenting party).

The Texas Court of Appeals, in *Hill v. Heritage Resources, Inc.*,²⁷⁸ rejected the analysis of the court in *C & C Partners*. Among many other issues, *Hill* considered the form of consent necessary to constitute consent to participate in a proposed subsequent well under the subsequent operations provision of the 1982 AAPL Form 610 Model Form Operating Agreement.

Heritage, one of the parties to the applicable joint operating agreement, asserted, in part, that under the provisions of the 1982 Model Form Operating Agreement, a party could orally consent to participate in the drilling of a subsequent well. In asserting this argument, Heritage relied upon the analysis in *C & C Partners*.

The Texas Court of Appeals rejected the argument of Heritage and the analysis set forth in *C & C Partners*, basing its rejection upon the unambiguous language of the 1982 Model Form Operating Agreement.²⁷⁹ The court in *Hill* determined that the court in *C & C Partners* erroneously held that because the applicable Model Form Operating Agreement was unambiguous and did not specify a particular form of consent, an oral consent under the subsequent operations provision of the joint operating agreement was sufficient to obligate or commit a party to participate in a proposed subsequent well.²⁸⁰

In rejecting the court's analysis in *C & C Partners*, the court in *Hill* stated as follows:

The Dallas Court's conclusion is, however, only dicta, as the question in that case was whether or not consent had to be evidenced by means of a AFE [sic]. We certainly agree that consent or non-consent to participate in the drilling of a new well does not need to be in any particular form; however, we disagree that it can be oral. The *C & C Partners* Court concluded that the contract provisions only required written confirmation of responses to telephonic notices, and that since confirmation of consent was distinct and separate from consent, there was no requirement of a writing. This logic fails for two reasons. First, telephonic notices and responses are limited by the operating agreement to "rework, plug back or drill deeper" operations and then only when the drill rig is on location. Article VI.B.1. Second, article XII of the operating agreement provides:

"All notices authorized or required between the parties and required by any of the provisions of this agreement, unless otherwise specifically provided, shall be given in writing by mail or telegram, postage or charges prepaid, or by telex or telecopier"

We find article XII to plainly require written consent or non-consent to a proposal to drill a subsequent well.²⁸¹

278. 964 S.W.2d 89 (Tex. App. - El Paso 1997, no writ).

279. *Id.* at 134.

280. *Id.* at 133.

281. *Id.* at 133-34.

F. Right to Change Election as to a Subsequent Operation

Each version of the subsequent operations provision in the Model Form Operating Agreements provides that if any applicable party elects not to participate in the proposed operation, then, in order to receive the benefits of such provision, the proposed subsequent operation must be commenced within a specified period of time and completed with due diligence. While it is not specifically stated in each version of the subsequent operations provision, it appears that if the proposed subsequent operation is not commenced within the specified time period, the proposal terminates and any interest relinquished under such subsequent operations provision reverts in or reverts to the party electing or being deemed to have elected to go non-consent. Questions arise concerning the relationship between a consenting party and a non-consenting party during the period of time between the end of the election period and prior to the actual commencement of the proposed subsequent operation.

A particularly instructive case addressing the subsequent operations provision is *Nearburg v. Yates Petroleum Corp.*,²⁸² in which the New Mexico Court of Appeals construed article VI.B.1 and VI.B.2 of the 1977 AAPL Form 610 Model Form Operating Agreement. Nearburg (apparently a non-operator) proposed an additional well under the applicable 1977 Model Form Operating Agreement. Yates (apparently the designated operator under the joint operating agreement) received Nearburg's proposal letter on December 1, 1994, but failed to respond within the applicable thirty-day period. In fact, on December 29, 1994, Yates obtained a drilling permit to allow Yates to drill the proposed additional well. Yates first contacted Nearburg concerning the proposed additional well by letter dated January 11, 1995. In this letter, Yates stated that it proposed to drill the additional well covered by Nearburg's proposal.

Nearburg filed an action seeking, in part, a judgment declaring Nearburg the operator of the proposed well and declaring Yates a non-consenting party under the applicable provisions of the 1977 Model Form Operating Agreement. Yates counterclaimed, asserting that it was the operator of the proposed well and was a consenting party. The district court dismissed Nearburg's complaint with prejudice and entered a declaratory judgment that Yates was to be considered a consenting party under the operating agreement. Nearburg appealed the trial court's decision.

On appeal, Yates argued that under the applicable non-consent provisions, an election not to participate constitutes an offer to relinquish the party's interest in production from a proposed operation, and that this offer can be accepted by the proposing party's action in actually commencing work within the election period.²⁸³ Therefore, until Nearburg, the proposing party, accepted Yates' offer by actually commencing the proposed operation, Yates had the right to change its election by

282. 1997 NMCA 69, 943 P.2d 560.

283. *Id.* ¶ 11, 943 P.2d at 566.

withdrawing its offer.²⁸⁴ Yates argued that it had terminated its offer to relinquish its interest to Nearburg by its letter of January 11, 1995.²⁸⁵

The New Mexico Court of Appeals rejected Yates' argument as "a strained interpretation of the operating agreement."²⁸⁶ Specifically, the court of appeals explained that Yates' argument was inconsistent with the express language of the Model Form Operating Agreement, which required an election to be made within thirty days.²⁸⁷ Also, Yates' argument failed to account for the fact that by signing the operating agreement, the parties had agreed to the relinquishment of rights by operation of the non-consent penalty provisions.²⁸⁸

Nearburg, on the other hand, argued that the subsequent operations provision in the Model Form Operating Agreement created an option.²⁸⁹ Thus, Nearburg's proposal to jointly drill the proposed well was an offer that Nearburg was bound to keep open for thirty days.²⁹⁰ According to Nearburg, because time was of the essence, Yates' attempted notification by letter dated January 11, 1995, was too late, and ineffective to timely exercise the option.²⁹¹

The New Mexico Court of Appeals rejected Nearburg's option analysis as well. The court explained that if a timely election by Yates would have created a contract to drill the proposed additional well, then Nearburg's option argument might be persuasive.²⁹² However, the Model Form Operating Agreement did not make it clear that Nearburg would have been bound to proceed with the drilling of the proposed well if Yates had made a timely election to participate.²⁹³ The court determined that if Nearburg was not obligated to proceed with the proposed operation even if Yates had accepted Nearburg's proposal, it did not constitute an offer and did not confer in Yates the power to create a contract by acceptance.²⁹⁴

In its analysis, the court of appeals construed the non-consent penalty provisions under the 1977 Model Form Operating Agreement, not as an option, but as a covenant triggered by a condition precedent, or as a covenant or promise subject to a condition.²⁹⁵ The court determined that the "covenant" was the agreement by the non-consenting party to temporarily relinquish the specified amount of its interest in production in exchange for the consenting party bearing the risk of the operation.²⁹⁶ The "condition" was the election not to participate in the proposed operation.²⁹⁷

284. *Id.*

285. *Id.*

286. *Id.* ¶ 12, 943 P.2d at 566.

287. *Id.*

288. *Id.*

289. *Id.* ¶ 13, 943 P.2d at 566.

290. *Id.*

291. *Id.*

292. *Id.* ¶ 15, 943 P.2d at 567.

293. *Id.*

294. *Id.*

295. *Id.* ¶ 17, 943 P.2d at 567.

296. *Id.*

297. *Id.*

In addition, pursuant to the subsequent operations provision, in order to be entitled to the benefits of article VI.B.2 (providing for the non-consent penalty), the consenting party must actually commence work on the proposed operation within the specified time period.²⁹⁸ The court assumed that this requirement constituted an additional condition on the application of the non-consent penalty provisions.²⁹⁹ The court construed this condition as wholly within the control of the consenting party. Thus, if the consenting party commenced operations within the applicable time period, the consenting party was entitled to the non-consent penalty.³⁰⁰ The court concluded that this condition provided no opportunity for the non-consenting party to change its election between the end of the applicable notice period³⁰¹ and the date of actual commencement of operations on the proposed additional well.³⁰²

In making its determination, the district court determined that the operating agreement did not specify whether a party who initially elects to participate in a proposed well may or may not change that election before the other party has taken substantial action and suffers harm.³⁰³ The district court found that inadvertence caused Yates' failure to respond to Nearburg's proposal, and that Yates informed Nearburg that Yates intended to drill the proposal well before Nearburg suffered any prejudice.³⁰⁴ Thus, Yates could retract or change its election not to participate, and be treated as a consenting party. Interpreting the operating agreement to the contrary would effect a forfeiture, which New Mexico law disfavors.³⁰⁵

However, the court of appeals specifically refused to grant Yates equitable relief by reading into the Model Form Operating Agreement a right to change an election any time before the other party suffers prejudice, or substantially relies on the previous non-consent election.³⁰⁶ Changing a party's election seemed inconsistent with the express provisions of article VI.B of the Model Form Operating Agreement, which established a detailed time schedule and specific deadlines in connection with a proposed subsequent operation.³⁰⁷

The court of appeals concluded that the relinquishment of Yates' interest under the subsequent operations provision did not constitute a forfeiture; therefore, the district court had no basis to use its equitable powers to excuse Yates' failure to make a timely election.³⁰⁸ Under the clear and unambiguous provisions of the Model Form Operating Agreement, failure to elect to participate in a proposed subsequent operation within the applicable time period constitutes an election not to participate

298. *Id.* ¶ 17, 943 P.2d at 567-68.

299. *Id.* ¶ 17, 943 P.2d at 568.

300. *Id.*

301. Under the 1977 Model Form Operating Agreement, the applicable notice period was thirty days.

302. *Nearburg*, 1997 NMCA 69, ¶ 17, 943 P.2d at 568.

303. *Id.* ¶ 18, 943 P.2d at 568.

304. *Id.*

305. *Id.*

306. *Id.* ¶ 24, 943 P.2d at 569.

307. *Id.* ¶ 25, 943 P.2d at 569.

308. *Id.* ¶ 30, 943 P.2d at 570-71.

and when such condition occurs, the non-consent penalty results.³⁰⁹ Thus, Yates' election to participate in regard to Nearburg's proposal was too late and Yates was a non-consenting party.³¹⁰

G. Enforceability of Non-Consent Penalty Provisions

Under the subsequent operations provision in each version of the Model Form Operating Agreement, if the election period is properly triggered and a party elects not to participate in the costs of the proposed subsequent operation, then the non-consenting party relinquishes its interest in, and share of, production from the subsequent operation until the net proceeds from the sale of such share of production equal certain percentages (ranging normally from 200% to 500%) of the costs incurred in such subsequent operation. Consenting parties under the subsequent operations provision of the Model Form Operating Agreement greatly rely on the enforceability of these "penalty" provisions.

In *Hamilton v. Texas Oil & Gas Corp.*,³¹¹ the Texas Court of Appeals evaluated whether the penalty provisions under section 12, "Operations By Less Than All Parties," of the 1956 AAPL Form 610 Model Form Operating Agreement were unenforceable as a matter of law. The court of appeals characterized the penalty provisions of section 12 as a liquidated damages clause.³¹² To enforce a liquidated damages clause, the court must find that (1) the breach causes harm that is impossible or difficult to estimate, and (2) the amount of liquidated damages is a reasonable prediction of just compensation.³¹³

The *Hamilton* court explained that the penalty provisions contained in section 12 were "designed to compensate for the financial risks that consenting parties to the J.O.A. are subject to, considering the ultimate possibility that the well may be a nonproducer."³¹⁴ Finding the penalty provisions unenforceable as a penalty would allow non-consenting parties to participate in the venture without risk.³¹⁵

Lastly, the court determined that penalty provisions between 200% and 500% were standard in the industry.³¹⁶ The court concluded that because of the substantial financial risk suffered by the consenting parties and because the percentage was to be paid only from production, the 400% penalty provided for in section 12 of the 1956 Model Form Operating Agreement involved in the case was valid and enforceable.³¹⁷

309. *Id.* ¶ 33, 943 P.2d at 571.

310. *Id.*

311. 648 S.W.2d 316 (Tex. App. - El Paso 1982, writ ref'd n.r.e.).

312. *Id.* at 321.

313. *Id.*

314. *Id.*

315. *Id.*

316. *Id.*

317. *Id.*; see also *In re Sam Oil, Inc.*, 817 P.2d 299, 302 (Utah 1991) (holding a penalty provision similar to the subsequent operations provision in the Model Form Operating Agreement was designed to ensure that non-participating owners do not benefit from the successful outcome of risk they do not take).

The New Mexico Court of Appeals in *Nearburg* reached the same conclusion as the Texas Court of Appeals in *Hamilton* regarding the enforceability of the non-consent penalty provisions under the Model Form Operating Agreement. In *Nearburg*, the New Mexico Court of Appeals analyzed the enforceability of the non-consent penalty provisions under the 1977 AAPL Form 610 Model Form Operating Agreement.

While reaching the same conclusion as to enforceability, the New Mexico Court of Appeals took issue with *Hamilton's* analysis. In this regard, the New Mexico Court of Appeals stated as follows:

We note preliminarily that, although we follow custom by referring to the operating agreement provisions at issue as a "penalty," they do not meet the definition of a penalty as set forth in the Restatement and *Corbin on Contracts*. A penalty is a term fixing unreasonably large liquidated damages and is ordinarily unenforceable on grounds of public policy because it goes beyond compensation into punishment. It has been held that a non-consent penalty similar to the one at issue in this appeal was a valid liquidated damages provision rather than an unenforceable penalty provision. We do not agree with the *Hamilton* court's analysis because a liquidated damages provision applies in case of a breach of contract. The parties to the operating agreement are not obligated to participate in all proposed operations, and a non-consent election cannot convincingly be characterized as a breach. Therefore, we do not regard the non-consent penalty provision as involving liquidated damages or an unenforceable penalty.³¹⁸

The New Mexico court did agree with *Hamilton* concerning the purpose of the penalty provisions. The New Mexico court viewed the non-consent penalty as the agreed-upon reward to the consenting party for taking the risk, and the agreed-upon delay or limitation of profits incurred by a non-consenting party for avoiding it.³¹⁹ The court found that the parties to the joint operating agreement had agreed to reward the risk taking by temporarily reallocating interests in production until the party electing to assume the risk received an agreed-upon return on its investment.³²⁰ The non-consent penalty provisions under the Model Form Operating Agreement created a carried interest that rewarded the risk-taking party.³²¹

H. Liability of a Non-Consent Party

Once a non-operator elects (or is deemed to have elected) to go "non-consent" under the subsequent operations provision of the Model Form Operating Agreement, all versions of the agreement provide, in essence, that the "consenting" parties bear

318. *Nearburg v. Yates Petroleum Corp.*, 1997 NMCA 69, ¶ 10, 943 P.2d 560, 565-66 (citations omitted).

319. *Id.* ¶ 16, 943 P.2d at 567.

320. *Id.*

321. *Id.*

the risks associated with conducting the subsequent operations.³²² This might lead a non-operator to assume that upon electing to go "non-consent," such non-operator would not be liable for any actions taken in connection with the subsequent operation, especially if the non-consenting party's relinquished interest remained with the consenting parties who received the production from the subsequent operation. However, this assumption may not be well founded given certain judicial decisions.

1. Non-Consent Party's Liability for Plugging

In *Railroad Commission v. Olin Corp.*,³²³ the Texas Court of Appeals ascertained the liability for the costs of plugging a gas well of non-operators who had elected to go non-consent in a reworking operation in the gas well pursuant to article VI.B of the 1977 AAPL Form 610 Model Form Operating Agreement. By going non-consent, the non-operators relinquished their interests in the well, and their share of production from the well, until the operator recovered the non-operators' shares of costs plus an additional percentage of such costs from production proceeds.

In *Olin*, the operator had reworked the gas well at issue, but the well blew out. The Texas Railroad Commission subsequently maintained the well. The Commission issued an order declaring the non-operators jointly and severally liable to control and plug the well, even though such parties had gone non-consent as to the reworking operation in the well. The non-operators sought a declaratory judgment interpreting the Commission's rules and the validity of the above-described order. The trial court determined that because the non-operators had gone non-consent before the Commission ordered such parties to plug the subject well, the Commission order was without authority and void.³²⁴

On appeal, the Texas Court of Appeals determined that under Texas law, if an operator of a well cannot be found or is no longer in existence or has no assets with which to properly plug a well, the Texas Railroad Commission has the power and authority to order the non-operators to plug the well.³²⁵ The court held that under section 89.002(a)(3) of the Texas Natural Resources Code (the Code), a "non-operator" was defined as "'a person who owns a working interest in a well at the time the well is about to be abandoned or ceases operation and is not an operator as defined in . . . this Subsection.'"³²⁶ The court also noted that section 89.002(b) also provides that the terms "operator" and "non-operator" as used in the section "'do not mean a royalty interest owner or an overriding royalty interest owner.'"³²⁷

322. 1989 Model Form, *supra* note 9, at art. VI.B; 1982 Model Form, *supra* note 9, at art. VI.B; 1977 Model Form, *supra* note 9, at art. VI.B; 1956 Model Form, *supra* note 9, § 12.

323. 690 S.W.2d 628 (Tex. App. - Austin 1985, writ ref'd n.r.e.). In *Olin Corp. v. Railroad Commission*, 701 S.W.2d 641 (Tex. 1985), the Texas Supreme Court refused the application for a writ of error from the decision of the Texas Court of Appeals, approving only the result reached by the court of appeals regarding the non-consenting parties' liability for the plugging of the subject well.

324. *Olin*, 690 S.W.2d at 629.

325. *Id.* at 629-30.

326. *Id.* at 630 (alteration in original).

327. *Id.*

The court resolved two issues on appeal.³²⁸ First, the court decided whether a carried interest is sufficient as a divestiture of title to remove a party from the definition of "non-operator." Second, the court decided whether section 89.0002(b) of the Code exempts only royalty interest and overriding royalty interest owners from the plugging obligations.³²⁹

Regarding the first issue, the court commented on the dearth of authority discussing what interest a non-consenting working interest owner holds after electing to go non-consent under the subsequent operations provision of the Model Form Operating Agreement.³³⁰ The parties to the appeal characterized each non-consenting party's retained interest as a "Manahan-type" carried interest.³³¹ Agreeing with the parties, the court explained:

In the Manahan type carried interest, the carried party . . . has a *future interest* in a portion of the working interest which is so limited as to become possessory after the carrying party has recovered certain specified costs during the payout period . . . [the carried party retains] a *reversionary interest* in part of the working interest, which reversion occurs when the carrying party has recovered the specified costs during the payout period.³³²

The court remarked that the retention of a future interest does not logically amount to an irrevocable divestiture of title.³³³ The non-operators retained some property interest in their working interest, which they then relinquished under the joint operating agreement in connection with the subsequent operations conducted in the subject well.³³⁴

Turning to the second issue, the court opined that the statute in question exempted only royalty interest and overriding interest owners from the terms "operator" and "non-operator."³³⁵ The court pointed out that the language in the statute was presumed to be selected and used with care.³³⁶

Thus, the court held that because the non-operators owned a reversionary interest in part of the working interest at the time the Commission ordered plugging of the subject well and because section 89.002(b) exempts only royalty interest and overriding royalty interest owners from the plugging obligation, the legislature intended to authorize the Commission to order non-operators who had elected to go non-consent under the Model Form Operating Agreement to plug the subject well.³³⁷ The court concluded that the non-operators could have avoided liability for the

328. *Id.*

329. *Id.*

330. *Id.*

331. *Id.*

332. *Id.*

333. *Id.* at 631.

334. *Id.*

335. *Id.*

336. *Id.*

337. *Id.*

plugging of the subject well had they permanently assigned out all of their interest in the well.³³⁸ However, because the non-operators retained part of the working interest, they were liable for the plugging of the well.³³⁹

2. *Non-Consent Party's Liability for Pollution*

An Oklahoma case, *Texaco Inc. v. Berry Petroleum Corp.*,³⁴⁰ discussed the analysis set forth in *Olin*. In *Texaco*, the designated operator drilled a well under a 1977 AAPL Form 610 Model Form Operating Agreement. The operator completed the well in the Morrow-Springer formation, having penetrated the Atoka formation. Two of the non-operators elected to go non-consent as to the Morrow-Springer formation in the well.

Texaco originally acquired a working interest in the subject well from the operator and subsequently acquired the interests of the non-consenting parties as relinquished under the joint operating agreement. Texaco participated in the subject well as to the Morrow-Springer formation under the joint operating agreement. The operator subsequently filed bankruptcy.

The owners of the land on which the subject well was located complained to the Oklahoma Corporation Commission that the well polluted the ground water underlying their land. Based upon apparent threats from the Oklahoma Corporation Commission to take legal action against Texaco and the other working interest owners in the well, Texaco plugged the well. Texaco sought contribution for the costs of plugging the subject well from, among others, the non-operators who had elected to go non-consent in connection with the Morrow-Springer formation in the well.

In analyzing the liability of the non-operators for the costs associated with the plugging of the well, the court viewed the 1977 Model Form Operating Agreement as unambiguous.³⁴¹ The non-operators argued that as non-consenting parties as to the Morrow-Springer formation in the well, Texaco, as a consenting party, could not seek recovery from them.³⁴² Under article VI.B.2, "Operations By Less Than All Parties," of the joint operating agreement, the consenting parties bore the entire cost and risk of the subsequent operation.³⁴³ Texaco argued that because the non-operators retained an interest in the Morrow-Springer formation, liability could be imposed on such non-operators for the pollution damage resulting from the well.³⁴⁴ Texaco asserted that, as owners of interests in the well, the non-operators remained liable for the abatement of any nuisance created by the subject well, such as pollution.³⁴⁵

338. *Id.*

339. *Id.*

340. 869 F. Supp. 1523 (W.D. Okla. 1994).

341. *Id.* at 1528.

342. *Id.*

343. *Id.*

344. *Id.*

345. *Id.*

The court disagreed with Texaco's theory concerning the non-operators' liability, reiterating the analysis set forth in *Olin, supra*, concerning article VI.B.2 of the 1977 Model Form Operating Agreement.³⁴⁶ Namely, although the non-operators had elected to go non-consent, such election did not divest the parties of their entire interest in the Morrow-Springer formation in the well.³⁴⁷ The court found that completion of the well in the Morrow-Springer formation triggered the farmout provisions of the letter agreement, under which the designated operator of the well acquired the non-operators' interests below the base of the Atoka formation. This acquired interest included any reversionary interest created by the carried interest under the Model Form Operating Agreement.³⁴⁸

The court concluded that this fact distinguished this case from *Olin*, in which the reversionary interest holders did not relinquish their entire interests upon the occurrence of a special event.³⁴⁹ The court also stated that without the farmout provision, it would question whether the non-operators' reversionary interests were sufficient to impose liability.³⁵⁰ However, because the non-operators had relinquished their entire interest, including any reversionary interests, in the Morrow-Springer formation in the well, the non-consenting owners were not liable for any pollution emanating from any formation where the non-operators were non-consenting parties.³⁵¹ Alternatively, the court suggested that the non-consenting owners could be held liable for pollution emanating from formations encountered in the subject well where such non-operators retained their working interests.³⁵²

IX. The Right to Take Production in Kind

Each version of the Model Form Operating Agreement contains a provision dealing with a party's right to take in kind, or separately dispose of, such party's proportionate share of the oil and gas produced from a well covered by the operating agreement.³⁵³ Furthermore, this provision allows the operator to purchase or sell to another purchaser a party's proportionate share of the oil and gas produced from any

346. *Id.* at 1528-29.

347. *Id.* at 1529.

348. *Id.*

349. *Id.* at 1529-30.

350. *Id.* at 1530.

351. *Id.*

352. *Id.* In *Texaco*, the court found that the provisions of the 1977 Model Form Operating Agreement, which provided for liability based on the percentage of ownership as set forth in the agreement, altered the contribution scheme called for by Oklahoma statutes and Oklahoma Corporation Commission rules. *Id.* at 1531; *see also* 12 OKLA. STAT. § 832(B) (1991); OCC-OGR 165:10-11-3. The court concluded that while this particular statute and Oklahoma Corporation Commission rule may impose joint and several liability on parties for the plugging of wells, the parties are free to contract as they wish in regard to a contribution scheme. *Texaco*, 869 F. Supp. at 1531. The court found that any recovery by Texaco from the non-operators was limited to the percentages listed in the Model Form Operating Agreement. *Id.*

353. 1989 Model Form, *supra* note 9, at art. VI.G ("Taking Production in Kind"); 1982 Model Form, *supra* note 9, at art. VI.C (same); 1977 Model Form, *supra* note 9, at art. VI.C ("Right to Take Production in Kind"); 1956 Model Form, *supra* note 9, § 13 (same).

well covered by the operating agreement when such party has failed to make arrangements for the taking in kind, or separately disposing of, such party's proportionate share.

Under the 1956 Model Form Operating Agreement, if a party fails to take in kind or otherwise dispose of its share of the oil and gas and the operator exercises its right to sell such party's proportionate share of the oil and gas to a third-party purchaser, the operator is obligated to sell such gas "at not less than the market price prevailing in the area, which shall in no event be less than the price which Operator receives for its portion of the oil and gas produced from the Unit Area."³⁵⁴

The 1977 and 1982 Model Form Operating Agreements provide that if the operator exercises its right to sell a party's share of the oil and gas to a third party purchaser, the operator must sell the non-taking party's share of the oil and gas "at the best price obtainable in the area for such production."³⁵⁵ The 1989 Model Form Operating Agreement provides that if the operator elects to sell to a third-party purchaser a non-taking party's proportionate share of the oil and gas, such sale "shall be in a manner commercially reasonable under the circumstances, but Operator shall have no duty to share any existing market . . . or to obtain a price . . . equal to that received under any existing market"³⁵⁶

A. Resolution of Conflict Between Ownership Provision and Taking-in-Kind Provision

In *Harrell v. Samson Resources Co.*,³⁵⁷ the Oklahoma Supreme Court faced the issue of whether a gas balancing dispute should be resolved by allowing balancing-in-kind, pre-depletion cash balancing, or cash balancing upon depletion. As part of its decision, the court had to determine the legal relationship of the working interest owners under the terms of a 1956 Model Form Operating Agreement. Specifically, the court addressed the apparent conflict between section 4, "Interest of Parties," and section 13, "Right to Take Production in Kind," of the 1956 Model Form Operating Agreement.

In *Harrell*, the parties entered into a 1956 Model Form Operating Agreement, without a gas balancing agreement. Conoco served as the designated operator of the Deputy No. 21-1 well. Plaintiffs, as working interest owners in such well, contracted to sell their share of the gas to Producers Gas Company, while Samson contracted to sell its share of the gas from such well to El Paso Natural Gas Company. Because of a contract dispute with Producers, plaintiffs did not sell any gas from the Deputy No. 21-1 well for almost two years, with 100% of the gas for such time period being allocated to Samson and its purchaser, El Paso. Plaintiffs were in an underproduced status as to gas balancing.

354. 1956 Model Form, *supra* note 9, § 13 ("Right to Take Production in Kind").

355. 1982 Model Form, *supra* note 9, at art. VI.C ("Taking Production in Kind"); 1977 Model Form, *supra* note 9, at art. VI.C ("Right to Take Production in Kind").

356. 1989 Model Form, *supra* note 9, at art. VI.G ("Taking Production in Kind").

357. 1998 OK 69, 980 P.2d 99.

At the time Samson was overproduced for purposes of gas balancing, Samson attempted to sell its interest in the Deputy No. 21-1 well at an auction. Plaintiffs objected to the attempted sale and demanded cash balancing from Samson. Eventually, plaintiffs filed suit against Samson, presenting the trial court with the issue of cash balancing. The trial court ordered pre-depletion cash balancing, but the court of appeals reversed the decision, holding that plaintiffs' claim for cash balancing was time barred. The Oklahoma Supreme Court granted certiorari.

The Oklahoma Supreme Court considered the working interest owners in the Deputy No. 21-1 well as cotenants as to the oil and gas produced and sold from such well by virtue of section 4 of the 1956 Model Form Operating Agreement covering such well.³⁵⁸ The court relied upon the specific language in section 4 providing that "all production of oil and gas from the Unit Area, subject to the payment of lessor's royalties, shall also be owned by the parties" as their interests are set forth in Exhibit A to the operating agreement.³⁵⁹ The court concluded that this ownership clause of the operating agreement created a cotenancy as to production from the contract area.³⁶⁰

The court further pointed out that section 13, "Right to Take Production in Kind," of the 1956 Model Form Operating Agreement provided that each owner *shall* take such party's share of production in kind and separately dispose of it.³⁶¹ The court concluded that section 4 and section 13 of the 1956 Model Form Operating Agreement appeared to be contradictory with respect to the legal relationship between the parties.³⁶² The court stated that the ownership clause, section 4, created a cotenancy in the oil and gas produced, but the take-in-kind provision, section 13, was antithetical to a cotenant relationship.³⁶³ The court recognized that requiring each owner to take and separately market such owner's gas could cause gas imbalances to occur and that the operating agreement in question contained no provision for gas balancing among the separately selling owners.³⁶⁴

The court relied upon Professor Eugene Kuntz who had previously written that "take-in-kind" provisions were included in operating agreements to avoid the tax consequences of being classified as an association taxable as a corporation.³⁶⁵ Professor Kuntz recognized the general assumption that a party who takes in kind owns the gas taken, while the gas of the party not taking in kind remains in the ground. However, Professor Kuntz further noted that in the absence of a specific

358. *Id.* ¶ 8, 980 P.2d at 102.

359. *Id.*

360. *Id.* ¶ 9, 980 P.2d at 103. The Oklahoma Supreme Court further pointed out that while the 1956 Model Form Operating Agreement created a cotenancy between the parties, the ownership clause in each of the 1977 and 1982 Model Form Operating Agreements specifically provides that such agreement shall not be deemed a cross-conveyance of interests. *Id.*; see also *Reserve Oil, Inc. v. Dixon*, 711 F.2d 951 (10th Cir. 1983).

361. *Harrell*, 1998 OK 69, ¶ 10, 980 P.2d at 103.

362. *Id.* ¶ 11, 980 P.2d at 103.

363. *Id.*

364. *Id.*

365. *Id.* ¶ 12, 980 P.2d at 103.

balancing agreement, the usual operating agreement does not express such intention.³⁶⁶ The court also relied on Professor Kuntz's observation that the ownership provision has the literal effect of making the owners cotenants in the oil and gas produced, which would render the taking-in-kind provision meaningless.³⁶⁷

The court decided to reconcile section 4 and section 13 of the 1956 Model Form Operating Agreement by finding that the ownership clause created a cotenant-like relationship between the parties as to the gas sold, but that each owner had the right to separately take and market its own share, subject only to a duty to account to the other owners.³⁶⁸ After establishing the legal relationship of the parties under the 1956 Model Form Operating Agreement, the court concluded that the trial court's judgment allowing pre-depletion cash balancing at a weighted average price did not go against the clear weight of the evidence.³⁶⁹

B. Fair Market Value or Best Price Obtainable for a Party's Share of Oil and Gas Sold by Operator

Under all forms of the Model Form Operating Agreement, if a party does not take in kind or separately dispose of such party's proportionate share of the oil and gas produced from a well covered by the operating agreement, the operator has the right, but not the obligation, to sell such party's proportionate share to a third party.³⁷⁰ In *Holloway v. Atlantic Richfield Co.*,³⁷¹ the Texas Court of Appeals interpreted the language contained in the 1977 and 1982 Model Form Operating Agreements concerning the obligations of an operator who has exercised its right to sell a non-taking party's proportionate share of oil and gas to a third-party purchaser "for the account of the non-taking party at the best price obtainable in the area for such production."³⁷²

In *Holloway*, Henderson Clay Products (HCP) entered into an agreement with B&A, a wholly owned subsidiary, to market HCP's gas at the maximum lawful price per MMBtu, which was \$6.50. B&A entered into a contract with Ensearch, under which B&A dedicated its gas to Ensearch to be purchased at an agreed price. Subsequently, HCP entered into a 1977 or 1982 Model Form Operating Agreement with various working interest owners, including Holloway.³⁷³

366. *Id.*

367. *Id.*

368. *Id.* ¶ 13, 980 P.2d at 103. While the court did not address any claims under Oklahoma's Sweetheart Gas Act, 52 OKLA. STAT. §§ 544-547 (1991) (renumbered to 52 OKLA. STAT. §§ 581.7-581.10 by Laws 1992, ch. 190, § 29), the court noted that the Act created a statutory cotenancy as to gas produced after the effective date of such act, May 3, 1983. *Id.*

369. *Id.* ¶ 32, 980 P.2d at 108.

370. 1989 Model Form, *supra* note 9, at art. VI.G; 1982 Model Form, *supra* note 9, at art. VI.C; 1977 Model Form, *supra* note 9, at art. VI.C; 1956 Model Form, *supra* note 9, § 13.

371. 970 S.W.2d 641 (Tex. App. - Tyler 1998, no writ).

372. 1982 Model Form, *supra* note 9, at art. VI.C; 1977 Model Form, *supra* note 9, at art. VI.C.

373. It is difficult to determine from the reported case whether the Model Form Operating Agreement involved was a 1977 or 1982 form. In any event, the applicable language is the same in each

In the mid-1980s, oil and gas prices fell drastically and Ensearch breached its gas contract with B&A, resulting in B&A suing Ensearch to enforce the contract. Arco purchased HCP and B&A, which resulted in a settlement of the lawsuit with Ensearch. Ensearch agreed to take higher quantities of gas at a lower price, \$2.90 per MMBtu.

Arco, as operator under the operating agreement, marketed the proportionate share of oil and gas of the mineral interest owners, including Holloway, at the lower price for a short period of time, but then completely discontinued these marketing efforts. Holloway sued Arco, alleging in part that Arco, as operator, breached the provisions of the applicable operating agreement by failing to market his gas at "the best price obtainable in the area" pursuant to the agreement. Holloway asserted that the best price obtainable in the area was the price under the original gas contract between B&A and Ensearch and that when Arco, as operator, amended the gas contract with Ensearch in settlement of the lawsuit, resulting in Holloway receiving a lower price, Arco violated the provisions of the operating agreement.

The Texas Court of Appeals determined that as a matter of law, "when a gas well owner reserves the right to take the production of the well in kind, the production of that well is not dedicated."³⁷⁴ The court further stated that if the gas is not dedicated, an owner cannot enforce against the operator the original contract between the operator and its subsidiary or its subsidiary and the gas purchaser.³⁷⁵ The court concluded that the best price obtainable could have been, but was not necessarily, the unenforced contract price of \$6.50 per MMBtu.³⁷⁶

Furthermore, the court concluded that Arco had established that it sold Holloway's gas for amounts equal to or exceeding the fair market value for undedicated gas.³⁷⁷ However, the court stated that "market price" and "best price obtainable" are not synonymous terms.³⁷⁸ The court reasoned that, by the exercise of reasonable effort, a seller can obtain more favorable terms than fair market value for gas produced and sold.³⁷⁹

The court concluded that although Arco did not breach any duty to Holloway for its failure to seek enforcement of the B&A contract, Arco had failed to offer any evidence that the original higher contract price was not the best price obtainable in the area, or that it could not have obtained that higher price for Holloway.³⁸⁰ The court stated that although the price Arco obtained for Holloway's gas may have been the best price obtainable in the area, Arco did not present evidence of that fact. Therefore, the lower court improperly granted summary judgment.³⁸¹ Accordingly,

374. *Holloway*, 970 S.W.2d at 644.

375. *Id.*

376. *Id.*

377. *Id.*

378. *Id.*

379. *Id.*

380. *Id.*

381. *Id.*

the court of appeals reversed the lower court's decision granting summary judgment on this issue.³⁸²

X. Abandonment of Wells; Delay Rental, Shut-in Well Payments, and Minimum Royalties; and Surrender of Leases

Each version of the Model Form Operating Agreement contains a provision dealing with the plugging and abandonment of wells.³⁸³ This provision limits a party's right to plug and abandon certain wells. The provision also gives a party the right, under certain conditions, to assume operations of a well if the well is proposed to be plugged and abandoned and the parties disagree as to whether the well should be plugged and abandoned.

Each version of the Model Form Operating Agreement also contains a provision dealing with the payment of delay rentals, shut-in well payments, and minimum royalties under the oil and gas leases covered by the agreement. This provision addresses the consequences of a party's failure to make proper payment of any delay rental, shut-in well payment, or minimum royalty. Furthermore, this provision imposes upon the operator certain obligations to notify the non-operators when a well is shut-in and when a well is returned to production.³⁸⁴

Furthermore, each version of the Model Form Operating Agreement contains a provision limiting the right of a party to surrender, in whole or in part, any oil and gas lease covered by the agreement. Under this provision, if a party desires to surrender an oil and gas lease covered by the joint operating agreement, the other parties have the right to acquire the lease.³⁸⁵

A. Operator's Duty to Notify Non-Operator of Abandonment of Well

Section 16, "Abandonment of Wells," of the 1956 AAPL Form 610 Model Form Operating Agreement was interpreted and differentiated from section 17, "Delay Rentals and Shut-in Well Payments," of such agreement in *Norman v. Apache Corp.*³⁸⁶ *Norman* involved an operator who, in July 1990, decided to terminate production from a well drilled under the 1956 Model Form Operating Agreement. In December 1990, the operator informed the non-operators that the well had been shut-in and was to be plugged and abandoned. The non-operators requested that the

382. *Id.*

383. 1989 Model Form, *supra* note 9, at art. VI.E ("Abandonment of Wells"); 1982 Model Form, *supra* note 9, at art. VI.E (same); 1977 Model Form, *supra* note 9, at art. VI.E (same); 1956 Model Form, *supra* note 9, § 16 ("Abandonment of Wells").

384. 1989 Model Form, *supra* note 9, at arts. IV.B.2, VII.E ("Loss by Non-Payment or Erroneous Payment of Amount Due" and "Rentals, Shut-in Well Payments and Minimum Royalties" respectively); 1982 Model Form, *supra* note 9, at arts. IV.B.2, VII.F (same); 1977 Model Form, *supra* note 9, at arts. IV.B.2, VII.F (same); 1956 Model Form, *supra* note 9, § 17 ("Delay Rentals and Shut-in Well Payments") (joint loss version and individual loss version).

385. 1989 Model Form, *supra* note 9, at art. VIII.A ("Surrender of Leases"); 1982 Model Form, *supra* note 9, at art VIII.A (same); 1977 Model Form, *supra* note 9, at art VIII.A (same); 1956 Model Form, *supra* note 9, § 24 (same).

386. 19 F.3d 1017 (5th Cir. 1994).

operator continue operation of the well, but subsequently learned that the operator had already ceased operations on the well. Furthermore, the specific periods of time for the commencement of additional operations under the applicable leases had expired resulting in the loss of the leases.

The non-operators sued the operator, alleging, in part, breach of contractual duties under the 1956 Model Form Operating Agreement. Specifically, the non-operators alleged that the operator had breached the 1956 Model Form Operating Agreement by failing to notify the non-operators under section 17, "Delay Rentals and Shut-in Well Payments," when the operator shut-in the subject well. The non-operators contended that the operator's termination of production in July 1990, constituted a "shut-in" of the subject well and was covered by section 17. The operator argued that it did not "shut-in" the subject well as contemplated in section 17, but instead "abandoned" the well and was thus subject to the provisions of section 16 of the joint operating agreement.

The district court concluded that the term "shut-in," as used in section 17, did not contemplate the permanent cessation of production.³⁸⁷ Accordingly, the trial court found in favor of the operator.³⁸⁸

On appeal, the Fifth Circuit court explained that under section 17 of the 1956 Model Form Operating Agreement, the operator had an obligation to promptly notify each working interest owner when a well was shut-in.³⁸⁹ However, section 16 of the agreement did not impose upon the operator a contractual duty to notify the non-operators when it abandoned a well (i.e., ceased production permanently).³⁹⁰

Furthermore, the Fifth Circuit agreed with the lower court that the term "shut-in" is a generic term used to refer to the closing of the valves through which oil and gas flow through a well.³⁹¹ The term also has a legal meaning that refers to the closing of valves "when production at a well capable of producing in paying quantities is temporarily halted to repair or clean the well to allow reservoir pressure to build, or for lack of market."³⁹²

The court of appeals emphasized that the express language of section 17 also supported the conclusions of the lower court.³⁹³ The court noted that the agreement phrased the mandatory notice requirement in section 17 in the conjunctive, thus requiring the operator to promptly notify each non-operator of (1) the date on which any gas well located on the unit was shut-in, (2) the reason for the shut-in, and (3) the date on which the well was restored to production.³⁹⁴ In everyday usage, the term "restores" means "to bring back into existence or use," "to reestablish," or "to bring back to an original condition."³⁹⁵ The court concluded that the third re-

387. *Id.* at 1027.

388. *Id.*

389. *Id.*

390. *Id.* (citing *Fuller v. Phillips Petroleum Co.*, 872 F.2d 655, 658-59 (5th Cir. 1989)).

391. *Id.*

392. *Id.*

393. *Id.*

394. *Id.*

395. *Id.* at 1028.

quirement of the notice provision and the fact it was joined conjunctively to the other two requirements indicates that section 17 contemplates a temporary cessation of production.³⁹⁶

Having found that section 17 of the 1956 Model Form Operating Agreement contemplated only a temporary cessation of production, the appellate court determined that section 16 of the agreement governed the operator's duty with respect to giving notice to the non-operators that production from the subject well had permanently ceased and the operator intended to abandon the well.³⁹⁷ In the court's opinion, section 16 did not mandate that the operator give the non-operators notice of an impending lease termination because of the operator's intent to plug and abandon the well.³⁹⁸ Therefore, the court concluded that the district court did not err in granting the operator summary judgment on the issue.³⁹⁹

B. Operator's Duty to Notify Non-Operator of Impending Lease Termination — Surrender of Lease Versus Termination of Lease

As noted above, the court in *Norman* relied in part upon the analysis set forth in *Fuller v. Phillips Petroleum Co.*⁴⁰⁰ In *Fuller*, the Court of Appeals for the Fifth Circuit interpreted and applied the provisions of section 16, "Abandonment of Wells," and section 24, "Surrender of Leases," of the 1956 Model Form Operating Agreement.⁴⁰¹

In this case, the test well covered by the Model Form Operating Agreement ceased production in January 1983 because of a casing leak. The two oil and gas leases of the operator expired by their own terms in March 1983 due to the cessation of production from the leased premises. The operator notified the non-operator in April 1983 of its intent to plug and abandon the test well. The non-operator objected to the operator plugging and abandoning the test well. Despite the non-operator's objection, the operator plugged and abandoned the test well, and the non-operator subsequently filed suit against the operator claiming that the operator breached the 1956 Model Form Operating Agreement.

On appeal to the Fifth Circuit, the non-operator asserted that, as a matter of law, the operator breached the 1956 Model Form Operating Agreement by failing to notify the non-operator of the operator's intent to plug and abandon the test well prior to the expiration of the operator's two oil and gas leases in the unit area. The non-operator argued that the operator had an obligation under the joint operating agreement to

396. *Id.* In addition, the appellate court observed that no Fifth Circuit or Texas case had even insinuated that the term "shut-in," as used in the 1956 Model Form Operating Agreement, referred to the permanent cessation of production. *Id.*

397. *Id.* at 1029.

398. *Id.*

399. *Id.*

400. 872 F.2d 655 (5th Cir. 1989).

401. The parties to the 1956 Model Form Operating Agreement involved in this case had apparently deleted a provision after section 16, but before section 24. The deleted provision was probably section 18, "Preferential Right to Purchase," with the remaining provisions renumbered accordingly. Therefore, section 24 of the 1956 Model Form Operating Agreement was evidently renumbered to section 23.

notify the non-operator that both of the operator's oil and gas leases would expire at the end of sixty days following the cessation of production from the test well. The non-operator based this argument on sections 16 and 24 (renumbered to 23) in the 1956 Model Form Operating Agreement.

In analyzing the non-operator's argument, the appellate court noted that the 1956 Model Form Operating Agreement did not contain an express provision requiring an operator to notify a non-operator of an impending lease termination.⁴⁰² Thus, the non-operator in this case asked the court to imply such a duty based upon other provisions of the joint operating agreement.⁴⁰³

With regard to section 16, the appellate court concluded that this section expressly mandated only notice of a party's intent to plug and abandon a well, and did not require notice of an impending lease termination.⁴⁰⁴ In support of its conclusion, the court noted that other provisions of the 1956 Model Form Operating Agreement directly recognized the possibility of the occurrence of the expiration or loss of an underlying lease.⁴⁰⁵ The court held that section 16 did not impose upon the operator, directly or by implication, any duty to notify the non-operator of its intent to plug and abandon the test well while the underlying leases of the operator were still valid.⁴⁰⁶ The court found that the operator had notified the non-operator of its intent to plug and abandon the subject well in accordance with the provisions of section 16 and that the operator had not breached this section of the joint operating agreement.⁴⁰⁷

The non-operator also asserted that the operator breached the provisions of section 24 (renumbered to 23), "Surrender of Leases." The court found that the "Surrender of Leases" provision required the consent of all parties before the surrender, in whole or in part, of any lease affecting the unit area covered by the joint operating agreement, or in the absence of such consent, the assignment of such lease to the non-consenting parties.⁴⁰⁸ The non-operator asserted that the operator's action in allowing the operator's oil and gas leases to terminate due to cessation of production from the test well constituted an affirmative surrender of the operator's leases, requiring the consent of all parties to the 1956 Model Form Operating Agreement.

In analyzing this argument, the court of appeals explained the legal difference between the terms "surrender" and "termination" of a lease.⁴⁰⁹ The term "surrender," as used in the oil and gas industry, refers to a lessee's contractual right to voluntarily relinquish all or a part of the leased premises to the lessor.⁴¹⁰ This permits the

402. *Fuller*, 872 F.2d at 657.

403. *Id.*

404. *Id.* at 659.

405. *Id.* The other provisions referenced by the court were section 2.B, "Failure of Title," section 2.C, "Loss of Leases For Other Than Title Failure," section 17, "Delay Rentals and Shut-in Well Payment," and section 23 (renumbered to 22), "Renewal or Extension of Leases."

406. *Fuller*, 872 F.2d at 659.

407. *Id.*

408. *Id.*

409. *Id.*

410. *Id.*

lessee to keep the most profitable portion of the lease and give up the least profitable portion.⁴¹¹ The court concluded that a surrender of an oil and gas lease may only occur while the lease is in effect.⁴¹² In contrast, "termination" of an oil and gas lease refers to the expiration of the lease by its own terms.⁴¹³ This expiration is triggered by the operator's failure to maintain operations on the leased premises.⁴¹⁴

The court concluded that the operator's oil and gas leases in this case expired by virtue of the express terms of the leases, which provided for termination in the event of the cessation of operations on the leased premises.⁴¹⁵ The court determined that the "Surrender of Leases" provision of the 1956 Model Form Operating Agreement did not apply and did not impose a duty on the operator to notify the non-operator of the impending termination of the operator's oil and gas leases.⁴¹⁶

C. Surrender of Lease Versus Assignment of Lease

In *Pasternak v. Lear Petroleum Exploration, Inc.*,⁴¹⁷ the Court of Appeals for the Tenth Circuit analyzed section 24, "Surrender of Leases," of the 1956 AAPL Form 610 Model Form Operating Agreement in the context of an assignment of an oil and gas lease subject to the joint operating agreement. In *Pasternak*, plaintiff acquired an oil and gas lease from defendant under a farmout agreement made subject to a 1956 Model Form Operating Agreement. Plaintiff subsequently drilled two wells. The non-operators to the 1956 Model Form Operating Agreement claimed interests in the wells by virtue of the joint operating agreement.

Plaintiff claimed that the farmout from defendant constituted a surrender of a lease in the unit area as contemplated by section 24, "Surrender of Leases," in the 1956 Model Form Operating Agreement. Plaintiff also claimed that by operation of the final portion of section 24, the acreage on which the two wells of plaintiff were located was no longer subject to the joint operating agreement.

The Tenth Circuit rejected plaintiff's analysis of section 24.⁴¹⁸ The court found that defendant had not *surrendered* its leasehold interest, but had *assigned* the leasehold interest to plaintiff.⁴¹⁹ Plaintiff had then agreed to conduct exploration and drilling operations on the leasehold, with defendant retaining an overriding royalty interest.⁴²⁰ The court concluded that section 24 of the 1956 Model Form Operating Agreement did not apply to the assignment from defendant to plaintiff.⁴²¹ Accor-

411. *Id.*

412. *Id.*

413. *Id.* at 660.

414. *Id.*

415. *Id.*

416. *Id.*

417. 790 F.2d 828 (10th Cir. 1986).

418. *Id.* at 834.

419. *Id.*

420. *Id.*

421. *Id.*

dingly, defendant's interest remained subject to the Model Form Operating Agreement.⁴²²

XI. Liens and Payment Defaults

Each version of the AAPL Form 610 Model Form Operating Agreement contains a provision granting to the operator and to each of the non-operators a lien on and a security interest in the various oil and gas interests, personal property, fixtures, oil and gas as produced, and proceeds covered by the Model Form Operating Agreement.⁴²³ This provision in each version of the Model Form Operating Agreement ensures that the parties who pay the costs and expenses incurred in connection with any operation have some security against which they may collect from a defaulting party or be reimbursed for expenses paid on behalf of a defaulting party.

A. Perfection of Operator's Contractual Lien

In *Amarex, Inc. v. El Paso Natural Gas Co.*,⁴²⁴ the United States Bankruptcy Court for the Western District of Oklahoma certified to the Oklahoma Supreme Court the following question of law:

May the operator of an oil and gas lease perfect its contractual operator's lien against the interest of another working interest owner by filing a lien in the form of a mechanic's and materialman's lien statement, 42 O.S. §§ 144, 146 (1981), or must the operator perfect its interest within the recording statutes as an instrument affecting real estate? 16 O.S. §§ 93, 94, 95, and 96. Stated another way, must an oil and gas operator comply with real estate recording requirements or those of statutory oil and gas lien statements in order to perfect a contractual, consensual joint operator's lien against the interest of another working interest owner.⁴²⁵

The Oklahoma Supreme Court answered the above-described certified question specifically in regard to the contractual lien granted under article VII.B, "Liens and Payment Defaults," of the 1977 AAPL Form 610 Model Form Agreement. The Oklahoma Supreme Court found that the operator's lien created by the 1977 Model

422. *Id.*; see also *Stine v. Marathon Oil Co.*, 976 F.2d 254 (5th Cir. 1992). In *Stine*, the Fifth Circuit analyzed article VIII.A, "Surrender of Leases," of the 1977 Model Form Operating Agreement in the context of an assignment of oil and gas leases subject to the joint operating agreement. The court found that logic dictates that a party does not abandon property by attempting to sell that property; the intent to surrender property is patently inconsistent with the intent to sell it. *Stine*, 976 F.2d at 265-66. The court concluded that article VIII.A of the 1977 Model Form Operating Agreement did not apply to the oil and gas lease as assigned. *Id.*

423. 1989 Model Form, *supra* note 9, at art. VII.B ("Liens and Security Interests"); 1982 Model Form, *supra* note 9, at art. VII.B ("Liens and Payment of Defaults"); 1977 Model Form, *supra* note 9, at art. VII.B (same); 1956 Model Form, *supra* note 9, § 9 ("Operator's Lien").

424. 772 P.2d 905 (Okla. 1989).

425. *Id.* at 906.

Form Operating Agreement was a contractual lien on oil and gas leases.⁴²⁶ The court reasoned that because an oil and gas lease creates an interest in real property, the appropriate place to file a contract granting a contractual lien against an oil and gas lease is in the land records of the county in which the leasehold is located.⁴²⁷

The court stated that the joint operating agreement, as the contract creating the lien, is the preferred instrument to be filed in the land records.⁴²⁸ The court emphasized the importance of having the joint operating agreement, as filed, signed by the owner of the property encumbered by the contractual lien granted by such agreement.⁴²⁹

The court further stated that while the filing of the joint operating agreement is the preferred method of perfecting the contractual lien granted thereunder, the contractual lien will be perfected against the leasehold intended to be encumbered by the filing of another document in the land records of the county where the leasehold is located.⁴³⁰ This document must be executed by the owner of the interest burdened by the lien, must fully describe the terms of the lien and the leases and lands encumbered, and must be executed, attested, and acknowledged in accordance with the applicable recording statutes.⁴³¹ The court pointed out that under the Oklahoma statutory scheme, every instrument made by a corporation affecting real estate must be executed as provided by title 16 of the Oklahoma Statutes.⁴³²

In this case, the Oklahoma Supreme Court found that because no lien statement or operating agreement executed by the owner of the interest to be burdened was filed in the land records of the appropriate county, the operator under the joint operating agreement in question failed to perfect its contractual operator's lien as granted in article VII.B of the 1977 Model Form Operating Agreement.⁴³³ The court pointed out that although the operator failed to perfect its contractual lien under the 1977 Model Form Operating Agreement, this failure did not necessarily preclude the operator from obtaining and perfecting a lien for labor performed and materials furnished under the joint operating agreement. These liens would be obtained pursuant to an entirely separate and independent statutory procedure set forth in sections 144 and 146, title 42 of the Oklahoma Statutes.⁴³⁴

The version of article VII.B in the 1989 Model Form Operating Agreement specifically mandates that each of the parties execute and acknowledge a recording

426. *Id.*

427. *Id.* at 908.

428. *Id.*

429. *Id.* at 908-09.

430. *Id.* at 909.

431. *Id.*

432. *Id.*

433. *Id.*; see also *Enduro Oil Co. v. Parish & Ellison*, 834 S.W.2d 547, 549 (Tex. Civ. App. - Houston 1992, writ denied) (holding that the operator under a 1977 Model Form Operating Agreement had not converted a non-operator's share of proceeds from a producing well when the operator retained such proceeds and applied them to the non-operator's share of unpaid well costs because the operator had a lien upon and the right to collect the non-operator's share of the proceeds from the sale under article VII.B, "Liens and Payment Defaults," of the joint operating agreement).

434. *Amarex*, 772 P.2d at 909.

supplement and any financing statements necessary to perfect the liens and security interests granted in the agreement. This provision also authorizes the operator to file the Model Form Operating Agreement or the recording supplement as a lien or mortgage in the applicable real estate records, and as a financing statement with the proper office under the Uniform Commercial Code. The 1989 Model Form Operating Agreement clearly intends to give effect to the Oklahoma Supreme Court's ruling in *Amarex* and ensure that each of the parties has adequate protection by perfecting the contractual liens and security interests granted in such agreement.

B. Constructive Notice of Unrecorded Operator's Contractual Lien

As indicated in *Amarex*, recordation of the agreement itself in the appropriate real estate records provides the surest method of perfecting the contractual lien granted under the Model Form Operating Agreement. However, the operator's contractual lien under the Model Form Operating Agreement may still have priority over other lienholders even though the agreement is not filed of record if reference to the agreement is contained in a recorded instrument in the chain of title to the property involved.

The Texas Court of Appeals addressed such a situation in *MBank Abilene, N.A. v. Westwood Energy, Inc.*,⁴³⁵ In *MBank*, what appears to be a Model Form Operating Agreement granted the operator a first and prior lien against the interest of each party to the operating agreement. The parties did not record the agreement. One of the non-operators secured a debt to the bank through a deed of trust covering several of the oil and gas leases covered by the joint operating agreement. Furthermore, the non-operator assigned all its interest in the oil and gas produced and sold from the subject oil and gas leases as security to the bank.

The operator sued the non-operator to collect for expenses incurred in operations under the joint operating agreement and to foreclose the contractual lien on the leasehold interests. The bank, joined as a defendant, asserted that it had a superior lien to the lien claimed by the operator under the unrecorded joint operating agreement.

The Texas Court of Appeals determined that in assignments within the chain of title to the subject oil and gas leases, references were made to the applicable joint operating agreement.⁴³⁶ The court concluded that the bank was "bound by every recital, reference and reservation contained in or fairly disclosed by any instrument that formed an essential link in the chain of title under which [the bank claimed]."⁴³⁷ The court held that the bank had notice of the liens contained in the prior unrecorded joint operating agreement because such agreement was referred to in instruments that formed an essential link in the chain of title under which the bank claimed.⁴³⁸ Therefore, the contractual lien granted to the operator by the joint

435. 723 S.W.2d 246 (Tex. App. - Eastland 1986, no writ).

436. *Id.* at 250.

437. *Id.* (quoting *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 908 (Tex. 1982)).

438. *Id.*

operating agreement was found to be superior to the lien granted to the bank by the non-operator.⁴³⁹

XII. Limitation on Expenditures and Activities

Each version of the AAPL Form 610 Model Form Operating Agreement contains a provision limiting the type of operation or activity the parties may conduct under the agreement. This limitation depends on either the type of well involved or the estimated cost of the proposed operation or activity.⁴⁴⁰

A. Operator's Duty to Notify Non-Operators of Rework Operation

In *LPCX Corp. v. Faulkner*,⁴⁴¹ the Oklahoma Supreme Court interpreted section 11, "Limitation on Expenditures," of the 1956 AAPL Form 610 Model Form Operating Agreement. In *LPCX*, the operator had drilled a commercially productive well. The operator performed a workover operation on the well for the express purpose of repairing a casing leak. The operator did not notify the non-operators prior to the commencement of the rework operation.

After the operator completed repair of the casing leak, the well only produced sporadically. The non-operators informed the operator that, in their opinions, it was not prudent to continue to operate the well with such limited production. Eventually, the non-operators sued the operator alleging, in part, that the rework operation, an attempt to correct a casing leak, was both unnecessary and unauthorized under the provisions of section 11 of the joint operating agreement.

On appeal, the Oklahoma Supreme Court affirmed the jury's determination that, based on the evidence presented, section 11 of the 1956 Model Form Operating Agreement had been breached.⁴⁴² The court explained that section 11(b) of the 1956 Model Form Operating Agreement provided that no well was to be reworked except in accordance with section 12, "Operations By Less Than All Parties," of the agreement.⁴⁴³

Although no party claimed that the provisions of section 12 were complied with, the court found that the non-operators had demonstrated that the provisions of section

439. *Id.*; see also *Syring v. Sartorius*, 277 N.E.2d 457 (Ohio Ct. App. 1971). In *Syring*, the court found that the lien granted under an operating agreement, with language similar to that contained in section 9, "Operator's Lien," of the 1956 Model Form Operating Agreement, was not a mechanic's lien, but was a contractual lien on the proceeds from the sale of the oil and gas produced under the operating agreement. *Syring*, 277 N.E.2d at 458. The court characterized the lien on the proceeds arising from future sales of oil and gas produced under the operating agreement as an equitable lien on the property not yet in existence at the time the parties entered the operating agreement. *Id.* The court determined that the lien was enforceable on the property when acquired at a subsequent time. *Id.*

440. 1989 Model Form, *supra* note 9, at arts. VI.C, VI.D ("Completion of Wells; Reworking and Plugging Back" and "Other Operations" respectively); 1982 Model Form, *supra* note 9, at art. VII.D; 1977 Model Form, *supra* note 9, at art. VII.D; 1956 Model Form, *supra* note 9, § 11 ("Limitation on Expenditures").

441. 818 P.2d 431 (Okla. 1991).

442. *Id.* at 435.

443. *Id.* at 436.

11 had, in fact, been violated.⁴⁴⁴ Specifically, the operator did not attempt to show prior notification of the reworking operation as provided for in section 11(c) of the joint operating agreement.⁴⁴⁵

Furthermore, section 11(c) of the joint operating agreement provided that the operator could not undertake any single project reasonably estimated to require an expenditure in excess of \$10,000 without the consent of all parties. The court found that the non-operators had produced evidence that the operator could reasonably expect the rework operation to cost more than the dollar limitation specified in section 11(c), and that the operator actually spent more than four and one-half times such limitation.⁴⁴⁶ Thus, the court found that the jury was justified in determining that section 11(c) of the joint operating agreement had been violated as to prior notification of the rework operation.⁴⁴⁷

The operator further contended that repairing parted casing was not a rework operation as contemplated in section 11 of the 1956 Model Form Operating Agreement. However, the operator's own witness testified that the casing leak repairs were workover operations and that a workover rig had been used to make the casing leak repairs.⁴⁴⁸ The operator also argued that repairing the casing leak was an emergency and thus not subject to the prior notification provisions of section 11.⁴⁴⁹ Yet the non-operator's witness testified that the information provided by the operator on the well's status at the time the leak was present did not show emergency conditions.⁴⁵⁰

Finally, the court rejected the operator's contention that only section 12, "Operations By Less Than All Parties," of the 1956 Model Form Operating Agreement applied because the non-operators were non-consenting parties, thus not needing notification.⁴⁵¹ The court determined that section 12 only applied if all parties could not agree upon the reworking of a dry hole or a well not then producing in paying quantities.⁴⁵² The court further determined that section 12, by its express language, was inapplicable in this case because the parties failed to present evidence showing that the subject well was not producing in paying quantities, or was not capable of producing in paying quantities, during the relevant times.⁴⁵³ Accordingly, the court upheld the jury's determination that the operator breached the joint operating agreement by the method in which the operator performed the workover.⁴⁵⁴

444. *Id.*

445. *Id.* At trial, the operator presented evidence of drilling reports, showing work in progress, in an attempt to show compliance with the notice requirement under section 11(c). The jury rejected this evidence, and the court agreed with the jury's determination. *Id.*

446. *Id.*

447. *Id.*

448. *Id.*

449. *Id.*

450. *Id.*

451. *Id.*

452. *Id.* at 436-37.

453. *Id.* at 437.

454. *Id.*

B. Approval Necessary for Rework Operation

In *Texstar North America, Inc. v. Ladd Petroleum Corp.*,⁴⁵⁵ the Texas Court of Appeals determined the conditions that had to exist before a well could be reworked under the 1982 AAPL Form 610 Model Form Operating Agreement. In *Texstar*, the operator fracture stimulated a well covered by the joint operating agreement while the well was producing in paying quantities. One of the non-operators objected to the fracture stimulation and refused to pay its proportionate share of the costs of the operation.

The Texas Court of Appeals, in analyzing article VII.D.2, "Rework or Plug Back," of the 1982 Model Form Operating Agreement, found the provision unambiguous and enforceable according to its terms.⁴⁵⁶ The court considered the fracture procedure a "rework" procedure as that term is used in article VII.D.2 of the joint operating agreement.⁴⁵⁷

The court further explained that article VII.D.2 provided, in relevant part, that "[w]ithout 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 of this agreement."⁴⁵⁸ The court found that article VI.B.2 of the 1982 Model Form Operating Agreement concerned only those wells not producing in paying quantities.⁴⁵⁹ Therefore, because the operator fracture stimulated the subject well while it was producing in paying quantities, the operator needed the non-operator's consent before it could perform the procedure.⁴⁶⁰ The operator's actions constituted a breach of the 1982 Model Form Operating Agreement.⁴⁶¹

XIII. Acreage or Cash Contributions

Each of the versions of the AAPL Form 610 Model Form Operating Agreement contains a provision dealing with the contribution of cash or acreage made toward the drilling of a well or any operation on the lands subject to the joint operating agreement.⁴⁶² This provision establishes a method of handling such contributions for the benefit of all parties who are participating in the drilling or other operation under the agreement.⁴⁶³

455. 809 S.W.2d 672 (Tex. App. - Corpus Christi 1991, writ denied).

456. *Id.* at 677.

457. *Id.*

458. *Id.*

459. *Id.*

460. *Id.*

461. *Id.*

462. 1989 Model Form, *supra* note 9, at art. VIII.C ("Acreage or Cash Contributions"); 1982 Model Form, *supra* note 9, at art. VIII.C (same); 1977 Model Form, *supra* note 9, at art. VIII.C (same); 1956 Model Form, *supra* note 9, § 25 (same).

463. *Id.*

A. Purpose of Acreage or Cash Contribution Provision

In *Martin Exploration Co. v. Amoco Production Co.*,⁴⁶⁴ the Louisiana Court of Appeal discussed the underlying purpose of the acreage or cash contributions provision of the Model Form Operating Agreement. *Martin* dealt specifically with article VIII.C, "Acreage of Cash Contributions," of the 1977 AAPL Form 610 Model Form Operating Agreement.

In March 1980, Amoco and Gulf finalized a farmout agreement covering interests in the "red acreage" in return for Amoco drilling a well in a unit that included this acreage. In January and February 1981, after lengthy negotiations, Amoco and MECO entered into a 1977 Model Form Operating Agreement covering, in part, the "red acreage." The joint operating agreement went into effect January 1, 1980.

In April 1981, MECO made demand on Amoco for its alleged share of the "red acreage" acquired by Amoco from Gulf. MECO asserted a claim to this share of the "red acreage" based upon its participation in the drilling of the well on such acreage under the joint operating agreement and article VIII.C, "Acreage or Cash Contributions," of the operating agreement. Upon Amoco's refusal to tender the interest, MECO instituted an action against Amoco alleging that Amoco breached the 1977 Model Form Operating Agreement.

MECO argued that the joint operating agreement, containing article VIII.C, was effective as of January 1, 1980, and that the Amoco-Gulf farmout agreement was executed in March 1980, subsequent to the effective date of the joint operating agreement. Therefore, MECO claimed that the Amoco-Gulf farmout agreement constituted an acreage contribution that Amoco had an obligation to share with MECO under article VIII.C of the joint operating agreement.

Amoco asserted that pursuant to article III.B of the 1977 Model Form Operating Agreement, the respective percentage or fractional interests of the parties were set out in Exhibit A to the joint operating agreement. This exhibit showed Amoco with the acreage farmed-in from Gulf and showed Gulf with no interest in the contract area *before* payout of the well, but with an interest *after* payout, as provided for in the farmout agreement.

The Louisiana Court of Appeal determined the 1977 Model Form Operating Agreement to be clear, concise, and unambiguous.⁴⁶⁵ Thus, the court did not consider parol evidence in interpreting the agreement.⁴⁶⁶ The court rejected the position of MECO, finding the position contrary to the purpose of article VIII.C of the 1977 Model Form Operating Agreement.⁴⁶⁷ In this regard, the court stated:

The purpose of the Contribution Clause is to protect the participants of a joint operating agreement against the possibility that one of them might obtain an undue advantage from an outsider at the expense of those paying for the operations. *Superior Oil Co. v. Cox*, 307 So. 2d

464. 637 So. 2d 1202 (La. Ct. App. 1994).

465. *Id.* at 1207.

466. *Id.*

467. *Id.*

350, 355[, 50 O&GR 323, 332] (La. 1975). Exhibit "A" set forth the percentage of interests of each party under the agreement. Article III.B provided that all costs and liabilities incurred in operations under the agreement were borne and paid by the parties according to the interests as shown in Exhibit "A." Likewise, all production of oil and gas was owned by the parties in the same manner. Thus, without the Contribution Clause, when one of the participants in the operating agreement receives a contribution toward the operations from someone not a party to the agreement, the recipient of the contribution profits at the expense of his partners.

In the case at hand, regardless of the effective date of the operating agreement, Amoco obtains no undue advantage because the red acreage was clearly already a part of the contract area. . . . Amoco could not have drilled this well on the red acreage unless they had previously acquired the rights to that red acreage.

Also, Exhibit "A" reflects that the red acreage is already accounted for in Amoco's percentage of interest. Thus, Amoco is bearing the costs of the production of this well for its own acreage and for the red acreage acquired from Gulf through the farmout agreement. Thus, no undue advantage has been obtained by Amoco in this instance.⁴⁶⁸

Based on the above analysis the court concluded that MECO was not entitled to share in the "red acreage" under the provisions of article VIII.C, "Acreage or Cash Contributions," of the 1977 Model Form Operating Agreement.⁴⁶⁹

B. Acreage Received from Outsider as Incentive or Compensation for Drilling

As indicated above, the court in *Martin* relied, in part, upon the analysis set forth by the Louisiana Supreme Court in *Superior Oil Co. v. Cox*.⁴⁷⁰ In *Superior Oil*, the court determined whether certain oil and gas leases acquired under a farmout agreement were subject to section 25, "Acreage or Cash Contributions," of a 1956 AAPL Form 610 Model Form Operating Agreement.

In analyzing section 25 of the joint operating agreement, the court noted that the parties did not cite any authority interpreting this particular provision.⁴⁷¹ The court stated that if section 25 was clear and unambiguous, it would cover only acreage that is acquired as an incentive toward, or compensation for, drilling a well.⁴⁷² In this case, the court found that the rights to the oil and gas leases in question under the farmout agreement did not mature until the Department of Conservation included the acreage in a conservation or production unit that contained a producing well.⁴⁷³ The court concluded that under the facts involved, there was serious doubt that the farmee

468. *Id.* at 1207-08 (citations omitted).

469. *Id.* at 1208.

470. 307 So. 2d 350 (La. 1975).

471. *Id.* at 355.

472. *Id.* at 354.

473. *Id.*

had received the interest in the oil and gas leases as either an incentive for drilling the subject well or as compensation for drilling the subject well.⁴⁷⁴

The court further stated that if section 25 of the 1956 Model Form Operating Agreement served to protect the parties against the possibility that one of them might obtain an undue advantage from an outsider at the expense of those paying for the operations, the section had a legitimate function.⁴⁷⁵ However, the court concluded that the parties had not offered any reason why they would suffer if two or more of them, but not all, reapportioned their ownership interests between themselves.⁴⁷⁶

The court concluded that *if* section 25 was clear and unambiguous, then such provision did not apply in this case because (1) the leases in question were not acquired by the farmee as a "contribution . . . toward drilling a well," and (2) the farmee's acquisition of the leases did not affect the other parties' proportionate interests in the production from the unit, except as provided for in the prior contract to assign.⁴⁷⁷ However, the court decided that the provisions of section 25 were, in fact, unclear and ambiguous, stating:

The one clear idea, applicable to the case before us, to be drawn from this discussion, is that "contributions" are made by outsiders — those not party to the joint operating agreement. Only in this way — when one of the participants in the joint operating agreement receives a contribution toward the operations from someone not a party to the joint operating agreement — does the function of the clause become clear. Only in this way does the recipient of the "contribution" profit at the expense of his partners.

Since the clause before us does not limit "contributions . . . toward the drilling of a well" to those made by outsiders, there are doubts about its function and meaning.⁴⁷⁸

The court concluded that because of the uncertain nature of section 25 of the 1956 Model Form Operating Agreement, the court could rely upon the actions of the parties in connection with the acquisition of the oil and gas leases to determine whether the parties intended the acreage in question to be shared under the joint operating agreement.⁴⁷⁹ Based on the parties' actions, it appeared that the parties did not contemplate that the leases in question would be considered an "acreage contribution" under section 25 of the joint operating agreement.⁴⁸⁰

474. *Id.*

475. *Id.* at 355.

476. *Id.*

477. *Id.*

478. *Id.* at 356.

479. *Id.*

480. *Id.*; see also *Harper Oil Co. v. Yates Petroleum Corp.*, 733 P.2d 1313, 1316 (N.M. 1987) (holding that article VIII.C, "Acreage or Cash Contributions," of the 1977 Model Form Operating Agreement, when read in connection with article VI.B.2, "Operations By Less Than All Parties," and two other nonuniform amendments to the agreement, rendered the joint operating agreement ambiguous).

XIV. *The Preferential Right to Purchase*

All versions of the AAPL Form 610 Model Form Operating Agreement contain a provision addressing the right of a party to the agreement to acquire the interest of another party to the agreement when that other party desires to sell its interest subject to the agreement.⁴⁸¹ While all of the versions of the Model Form Operating Agreement contain a preferential right to purchase provision, the parties very often strike this provision from the agreement.

In fact, the 1989 Model Form Operating Agreement attempts to incorporate this industry practice of striking this provision by allowing the parties to check a box if the parties want the preferential right to purchase provision to apply. If the parties do not check the box, the preferential right to purchase provision does not apply. Thus, the parties do not need to physically strike through the language in the form agreement.

A. *Conveyance of Interest Between Subsidiaries*

In *Questa Energy Corp. v. Vantage Point Energy, Inc.*,⁴⁸² the Texas Court of Appeals considered whether the preferential right to purchase provision in article VIII.G of the 1977 AAPL Form 610 Model Form Operating Agreement was triggered by a conveyance of interests subject to the agreement between subsidiary corporations of a parent corporation. In *Questa*, certain entities to the joint operating agreement were wholly owned subsidiaries of a Canadian company. The Canadian company decided to discontinue its operations in the United States and entered into an agreement whereby the U.S. properties of the Canadian company, as held by the wholly owned subsidiaries, would be conveyed to an Oklahoma corporation. In exchange, a majority of the shares of the common stock of that Oklahoma corporation would be issued to the Canadian company.

Plaintiff, who was not notified of the transaction, filed suit alleging that the transaction triggered the plaintiff's rights under the preferential right to purchase provision of the joint operating agreement. The trial court directed a verdict in favor of the defendants.

In determining whether the transaction invoked the plaintiff's preferential right to purchase, the Texas Court of Appeals noted that the plaintiff did not dispute that the entities covered by the joint operating agreement were wholly owned subsidiaries of the Canadian company.⁴⁸³ The plaintiff also did not dispute that the transaction included all of the interests in the properties covered by the Model Form Operating Agreement, which the Canadian company owned through its subsidiaries.⁴⁸⁴ The court concluded that the transaction effectively transferred the subject interests to the

481. 1989 Model Form, *supra* note 9, at art. VIII.F ("Preferential Right to Purchase"); 1982 Model Form, *supra* note 9, at art. VIII.F (same); 1977 Model Form, *supra* note 9, at art. VIII.G (same); 1956 Model Form, *supra* note 1, § 18 (same).

482. 887 S.W.2d 217 (Tex. App. - Amarillo 1994, writ denied).

483. *Id.* at 221.

484. *Id.*

Oklahoma corporation, which, in turn, became a subsidiary of the Canadian company by virtue of the stock transfer.⁴⁸⁵

Shifting its discussion to the joint operating agreement, the court specifically found that article VIII.G of the 1977 Model Form Operating Agreement was unambiguous.⁴⁸⁶ Accordingly, the court sought to determine the intentions of the parties by including this provision in the joint operating agreement.⁴⁸⁷ The court explained:

In an operating agreement, the preferential right to purchase serves two purposes. First, it assures its holder an opportunity to acquire further interests in a contract area. In joint operating agreements, each owner believes that the other interests in the subject property are of some value. The preferential right, therefore, assures each owner the opportunity to purchase those valuable rights should a co-owner of an interest decide to sell his interest to a third party. It thus allows those owners, who may have been at risk in exploratory efforts which contributed to the development of the property, to have an opportunity to acquire an additional interest in the property before a third party who did not participate in such risk.

Secondly, and perhaps more importantly, the preferential right to purchase ensures that the owners retaining their interest in the contract area have some degree of control in excluding undesirable participants who may not have the necessary financial ability to bear their share of expenditures or who might frustrate development with management and engineering philosophies which current owners oppose.⁴⁸⁸

In this case, the court determined that the "structure and working" of article VIII.G evidenced the parties' intent to accomplish these two purposes.⁴⁸⁹ Accordingly, the court held that, prior to the transaction in question, subsidiaries of the Canadian company held the interests covered by the Model Form Operating Agreement.⁴⁹⁰ The transaction simply transferred those interests to another entity controlled by the Canadian company rather than to an outside entity.⁴⁹¹ Because the interests of the Oklahoma corporation continued to be burdened with the preferential right to purchase, the plaintiff was not exposed to the risk of an undesirable outsider holding the interests.⁴⁹² Also, the plaintiff did not lose its potential opportunity to acquire the interests if the Oklahoma corporation attempted to sell the interests to an outsider.⁴⁹³ Thus, the court found that the transaction did not trigger the plaintiff's rights under the preferential right to purchase provision of the joint operating agreement.⁴⁹⁴

485. *Id.*

486. *Id.*

487. *Id.*

488. *Id.* at 222.

489. *Id.*

490. *Id.*

491. *Id.*

492. *Id.*

493. *Id.*

494. *Id.*; see also *Marken v. Goodall*, 478 F.2d 1052, 1055 (10th Cir. 1973) (holding that the

B. Rule Against Perpetuities Inapplicable

Another case discussing the preferential right to purchase provision is *Producers Oil Co. v. Gore*.⁴⁹⁵ In *Producers*, the Oklahoma Supreme Court decided the following questions certified by the Court of Appeals for the Tenth Circuit:

(1) Does the Oklahoma Rule Against Perpetuities apply to the interest created by the preemptive option provisions of the oil and gas lease operating agreements [involved in the cause]?

(2) If the answer to the first question be in the affirmative, then, would it be within the power of a court in Oklahoma to reform the described provisions, either pursuant to statutory authority . . . or under common law cy pres powers, so as to save them from invalidity under the Rule Against Perpetuities?⁴⁹⁶

The Oklahoma Supreme Court found that the rule against perpetuities does not apply to contractual preemptive options in operating agreements covering oil and gas leases.⁴⁹⁷ The court reasoned that a preemptive right or right of first refusal differs from an ordinary option because an ordinary option creates in the optionee a *power to compel* the owner of the property to sell it at a stipulated price whether or not the party is willing to sell.⁴⁹⁸ A party cannot compel an owner to sell by virtue of a preemptive right, or a right of first refusal.⁴⁹⁹ A preemptive right is triggered only when, or if, an owner decides to sell, and then only obligates the owner to offer the property first to the person holding the preemptive right.⁵⁰⁰ Further, a preemptive right only requires an owner to offer the property at the stipulated price or at a price at which the owner would sell to a third party.⁵⁰¹ The preemptive party has the right to elect whether it will buy the interest upon receiving notice of the proposed sale.⁵⁰² If the preemptive party decides not to buy, the owner may sell to any third party at the price of his choosing.⁵⁰³

plaintiff was barred by the doctrine of laches from asserting its preferential right to purchase an interest because of the plaintiff's delay in asserting such right until after the acquiring party had successfully completed a risky business venture that increased the value of the lease).

495. 610 P.2d 772 (Okla. 1980).

496. *Id.* While the preferential right to purchase provision at issue in *Producers* was not the specific provision contained in the AAPL Form 610 Model Form Operating Agreement, the provision was similar to the provision in the model form. The court in *Producers* stated that the most universally accepted definition of the common law rule against perpetuities is that no interest in property is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest. *Id.* at 774.

497. *Id.* at 773.

498. *Id.* at 773-74 (emphasis added).

499. *Id.* at 774.

500. *Id.*

501. *Id.*

502. *Id.*

503. *Id.*

The Oklahoma Supreme Court specifically found that the preferential right to purchase provision is generally held not to be a restraint on alienation.⁵⁰⁴ An owner may elect to sell at any time and the alienation is not hindered if no set price is made a part of the preemption.⁵⁰⁵ Although the rule against perpetuities is intended, to some extent, to prevent restrictions on alienation, it focuses on the duration of the rights rather than absolute restraints.⁵⁰⁶

In this case, the court remarked that the subject oil and gas leases and the joint operating agreement covering them had a built-in duration.⁵⁰⁷ Oil and gas production cannot last indefinitely and the rights are always terminable.⁵⁰⁸ The preemptive right in the joint operating agreement would last only as long as the leases covered by the agreement remained in effect.⁵⁰⁹ If the leases expired, neither party would have anything to convey under the right of preemption.⁵¹⁰ The court concluded that the rule against perpetuities did not apply to the preferential right to purchase provision in the joint operating agreement.⁵¹¹

C. Preferential Right Not a Prohibition on Partition

In *Komarec v. Perrine*,⁵¹² the Oklahoma Supreme Court considered whether the preferential right to purchase provision in a joint operating agreement included an implied covenant not to partition the undivided interests in the oil and gas leases subject to the joint operating agreement.⁵¹³

Under the agreement, the court determined that no express provision in the agreement prohibited the parties from seeking to partition in invitum.⁵¹⁴ Because the joint operating agreement concerned the operation of certain oil and gas leases instead of the disposition of those leases, the court found as follows: "Generally speaking, the law favors the partition of property held by cotenants. . . . courts are adverse to any rule which compels unwilling persons to use their property in common. . . . [and that] a denial of the remedy of partition can only be justified in the most extreme cases"⁵¹⁵ The court concluded that the preferential right to purchase provision did not prevent the parties from seeking to partition the undivided interests in the oil and gas leases covered by the joint operating agreement.⁵¹⁶

504. *Id.*

505. *Id.*

506. *Id.*

507. *Id.*

508. *Id.*

509. *Id.* at 776.

510. *Id.*

511. *Id.*

512. 382 P.2d 748 (Okla. 1960).

513. It is not clear from the *Komarec* opinion whether the joint operating agreement was an AAPL Form 610 Model Form Operating Agreement. However, the court's description of the agreement is similar conceptually to the 1956 Model Form Operating Agreement.

514. *Komarec*, 382 P.2d at 750.

515. *Id.*

516. *Id.*

Interestingly, the 1956 Model Form Operating Agreement does not contain any provision dealing with a party's right to partition the interests covered by the joint operating agreement. Subsequent to *Komarec*, the 1977, 1982, and 1989 Model Form Operating Agreements contain a provision stating that, if permitted by the laws of the applicable state, each party owning an undivided interest in the area covered by the agreement waives any and all rights to partition and have set aside in severalty its undivided interest therein.⁵¹⁷

XV. Execution by Less than All Parties

A. Creation of Two Separate Agreements

In *Osborn v. Rogers*,⁵¹⁸ the Oklahoma Supreme Court determined the effect of the execution by two parties of a proposed joint operating agreement, with a third party having deleted certain provisions from the form operating agreement.

In *Osborn*, three parties owned an interest in an oil and gas lease. The defendant executed the original joint operating agreement covering the subject land, which designated the plaintiff as the operator. Public Service Company of Tulsa (Public Service) executed the joint operating agreement, but only after certain deletions had been made to the agreement. The defendant did not sign or approve the deletions to the joint operating agreement as made by Public Service.

In analyzing the relationship of the three parties, the Oklahoma Supreme Court found that the parties had in essence created two separate joint operating agreements, one between the plaintiff and the defendant and the other between the plaintiff and Public Service.⁵¹⁹ The court found that the rights of the defendant should be determined under the operating agreement the defendant had signed without the deletions made by Public Service.⁵²⁰ Because there were two separate joint operating agreements, there was no agreement between Public Service and the defendant. Thus, in the plaintiff's action, the defendant could not claim the benefits of the joint operating agreement between Public Service and the plaintiff with the deleted provisions.⁵²¹

B. Agreement Binding on Signatory Parties

In *IMCO Oil & Gas Co. v. Mitchell Energy Corp.*,⁵²² plaintiff argued that a joint operating agreement, which appears to be a 1956 Model Form Operating Agreement, was not valid because while the agreement contained signature blocks for all of the interest owners, the agreement was only executed by two of the parties. Plaintiff asserted that a condition precedent existed that *all* of the listed parties must sign the joint operating agreement before such agreement would become valid.

517. 1989 Model Form, *supra* note 9, at art. VIII.E ("Waiver of Rights to Partition"); 1982 Model Form, *supra* note 9, at art. VIII.E (same); 1977 Model Form, *supra* note 9, at art. VIII.F.

518. 363 P.2d 219 (Okla. 1961).

519. *Id.* at 221.

520. *Id.* at 222.

521. *Id.*

522. 911 S.W.2d 916 (Tex. App. - Fort Worth 1995, no writ).

The Texas Court of Appeals rejected plaintiff's argument concerning the condition precedent.⁵²³ In analyzing the applicable operating agreement, the court pointed out that such agreement expressly stated at the beginning, "THIS AGREEMENT, entered into this 6th day of March, 1972, between Westland Oil Development Corp., hereinafter designated as 'Operator' and the *signatory* parties other than Operator."⁵²⁴ The court stated that the above quoted language expressly indicated that the agreement became effective between those who chose to sign the document. Such language modified the use of the word "parties" throughout the remainder of the operating agreement to refer only to those who actually signed the agreement.⁵²⁵ The court concluded that the agreement did not contain any condition precedent, and was intended to become binding among those parties who signed the agreement.

The court explained that IMCO was not a *party*, either signed or unsigned, to the applicable operating agreement.⁵²⁶ The court noted that this was not a situation where a signatory party to an agreement attempted to hold a non-signatory party liable under the contract or vice versa.⁵²⁷ The court found that IMCO, a complete stranger to the applicable operating agreement, attempted to impose an implied condition precedent into the agreement and argue what the parties intended, in spite of the express language of the agreement.⁵²⁸ The court concluded that the applicable operating agreement did not contain any condition precedent and became effective between the parties who actually signed the agreement.⁵²⁹

Conclusion

The numerous cases discussed or cited in this article demonstrate the growing number of decisions concerning the AAPL Form 610 Model Form Operating Agreement. This wealth of jurisprudence reflects the widespread use of the Model Form Operating Agreement in the oil and gas industry. Most of the cases discussed in this article have found the Model Form Operating Agreement to be clear, unambiguous, and enforceable as drafted; these decisions should give some comfort to the parties who must interpret and apply the provisions of the Model Form Operating Agreement. Furthermore, these decisions upholding the enforceability of various provisions serve as a tribute to the time and effort put in by the drafters of the various versions of the Model Form Operating Agreement.

523. *Id.* at 920.

524. *Id.*

525. *Id.*

526. *Id.*

527. *Id.*

528. *Id.*

529. *Id.* The 1989 AAPL Form 610 Model Form Operating Agreement provides in article XV.A, "Execution," that the operating agreement is binding upon a non-operator when the agreement has been executed by such non-operator and the operator, notwithstanding the fact that the agreement is not then or thereafter executed by all of the parties to whom the agreement is tendered or who are listed on Exhibit A attached to the agreement as owning an interest in the contract area or who, in fact, own interests in the contract area.

