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## A Flock of Trouble: Liability Under Oil and Gas Joint Operating Agreements After *Seagull v. Eland*

Christopher S. Kulander

David W. Lauritzen

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# A FLOCK OF TROUBLE: LIABILITY UNDER OIL AND GAS JOINT OPERATING AGREEMENTS AFTER *SEAGULL V. ELAND*

Christopher S. Kulander† and David W. Lauritzen‡

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## I. INTRODUCTION

Texas jurisprudence has long recognized that the leasehold estate associated with a mineral interest is characterized as a fee simple determinable. Joint Operating Agreements (JOAs) are the (sometimes lengthy) agreements wherein the leasehold interest holders stipulate how the leasehold estate is to be developed, who is to be the operator, how the operator is to collect money from and propose new projects to the non-operating leasehold interest holders, and how the operator will account for his expenses to the non-operators.<sup>1</sup> JOAs can be very complex and share many of the features of a rental contract. For example, JOAs typically contain provisions providing for operator's

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† Associate in Corporate (Energy), Haynes & Boone, LLP, Houston, Texas; B.S. Geology (1993) M.S. Geophysics (1995), Wright State University; Ph.D. Geophysics—Petroleum Seismology (1999), Texas A&M; J.D. (with distinction) University of Oklahoma (2005).

‡ Shareholder in Litigation, Cotton, Bledsoe, Tighe & Dawson, P.C., Midland, Texas; B.A. Political Science (with Honors) Yale University (1992); J.D. University of Texas, (1996).

1. 3 EARNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 17.3(A)(1) (Matthew Bender 2007) (2d ed. 1998).

remedies against non-operators for timely payment of expenses and delineate various non-consent procedures and penalties.<sup>2</sup>

Handed down initially in June 2006 and confirmed later that year in December, *Seagull v. Eland*<sup>3</sup> involves two JOAs wherein a non-operator, Eland Energy, Inc., assigned its working interest to Nor-Tex Gas Corporation, which subsequently went bankrupt.<sup>4</sup> Seagull Energy Exploration & Production, Inc., co-lessee, was operator under both JOAs and went after Eland for its assignee's debt.<sup>5</sup> The case wound up before the Texas Supreme Court.<sup>6</sup> Citing several landlord-tenant cases and contractual litigation, the Supreme Court imposed liability under the two JOAs to the prior non-operating working interest owner Eland, which had assigned its interest to the current defaulting non-operator years earlier.<sup>7</sup> That such an interpretation of the operating agreements is against the intent of the original parties to the agreement—and the oil and gas industry as a whole—is axiomatic to most within the industry. Furthermore, even if the Court's interpretation (analogizing operating agreements to landlord-tenant rental agreements) is correct, the Court changed landlord-tenant law when it imposed liability against Eland, an intermediate non-operating interest owner. Traditional landlord-tenant law only imposes liability on the defaulting renter or the original renter.

The Court's decision may result in a variety of unintended consequences that will adversely affect the entire oil and gas industry. Former working interest owners will be subject to effectively limitless liability. Exploration and production will be chilled. The court system opens itself to further burdensome litigation. These events cannot have been the intention of the Supreme Court when its opinion appeared to go against industry practice and usage. However, being a relatively recent decision, it cannot be determined at this time to what extent this decision will be refined or modified in the future.

## II. CASE HISTORY

Seagull Energy Exploration & Production, Inc. (Seagull) was the operator under two substantially similar JOAs that covered two oil and gas leases off the coast of Texas in Blocks 828 and 831, Mustang Island Area.<sup>8</sup> In 1994, Eland Energy, Inc. (Eland) bought a 1.09375% interest in Block 828 from General Atlantic Resources, Inc. (Atlantic) and a 9.41719% portion of the leasehold working interest in Block 831

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2. *Id.*

3. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342 (Tex. 2006).

4. *Eland Energy, Inc. v. Seagull Energy E & P, Inc.*, 135 S.W.3d 122, 123–24 (Tex. App.—Houston [14th Dist.] 2004), *rev'd*, 207 S.W.3d 342 (Tex. 2006).

5. *Id.*

6. *Seagull*, 207 S.W.3d at 342.

7. *Id.* at 346–47.

8. *Id.* at 344.

from UMC Petroleum Corporation (UMC).<sup>9</sup> These purchases were made after the previous working interest owners had entered into form JOAs regulating operations on the leases. When Eland accepted assignment of the working interest, it also agreed to assume liability for a proportionate portion of the obligation, financial and otherwise, arising from the underway operations on the subject area.<sup>10</sup>

Two years later, Eland decided to auction the working interests it had acquired from Atlantic and UMC.<sup>11</sup> Nor-Tex Gas Corporation (Nor-Tex) was the successful bidder and received an assignment of all of Eland's interest in the leases and the operation agreement.<sup>12</sup> As is usual in the oil and gas industry, the assignee, Nor-Tex, agreed to assume liability for the proportionate part of the interest that it had received from Eland—receiving the same liability that Eland agreed to carry when it received its assignment two years earlier from Atlantic.<sup>13</sup> All three courts that have considered this case agree that Eland effectively passed all working interest that it had received in the assignment.<sup>14</sup>

Nor-Tex later defaulted on its financial obligations under the JOAs and, as often happens in these cases, filed bankruptcy.<sup>15</sup> Seagull, unable to wring the money it was owed from Nor-Tex, demanded the assignor of Nor-Tex's interest—Eland—to cover the costs owed by its assignee.<sup>16</sup> Eland, believing that such a demand was against standard industry practice, balked, and litigation ensued.<sup>17</sup>

Seagull sued both Nor-Tex and Eland.<sup>18</sup> It asserted standard breach-of-contract claims and sought reimbursement plus lawyer's fees.<sup>19</sup> In addition, Seagull filed for summary judgment, pleading that Eland and Nor-Tex were jointly and severally liable as a matter of law for breach of the terms of the JOA.<sup>20</sup> Specifically, Seagull asserted in its pleading that (1) Eland had not procured assignment approval and was still party to the JOAs; (2) Eland was therefore required to cover the sums defaulted upon by Nor-Tex; and (3) the assignment of Eland to Nor-Tex did not affect a transfer of liability for the amount owed Seagull.<sup>21</sup> Eland countered with a motion for summary judgment, ar-

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9. *Id.*

10. *Id.*

11. *Eland Energy, Inc. v. Seagull Energy E & P, Inc.*, 135 S.W.3d 122, 123 (Tex. App.—Houston [14th Dist.] 2004), *rev'd*, 207 S.W.3d 342 (Tex. 2006).

12. *Id.*

13. *Id.*

14. *Seagull*, 207 S.W.3d at 344.

15. *Eland*, 135 S.W.3d at 124.

16. *Id.*

17. *Seagull*, 207 S.W.3d at 344.

18. *Id.*

19. *See Eland*, 135 S.W.3d at 124.

20. *Id.*

21. *Id.*

guing that the clear language of the JOAs absolved them of costs owed the operator after the transfer.<sup>22</sup>

The trial court granted Seagull's motion, ruling in an interlocutory order that while Nor-Tex was liable to Seagull, the liability was jointly and severally borne by Eland and, as a matter of contract law, Eland was still liable for the sums owed Seagull, having breached the JOAs by failing to reimburse Seagull.<sup>23</sup>

To those unfamiliar with oil and gas law generally and JOAs specifically, *Seagull* seemingly presents a situation similar to the classic "landlord multiple successive tenant privity" question. The JOAs in *Seagull* were executed in 1984. For example, Atlantic, one of two Eland predecessors in interest, was an original signer of one of the Agreements.<sup>24</sup> After Atlantic assigned its working interest to Eland, Eland assigned the interest to Nor-Tex.<sup>25</sup> In this, the case resembles the situation of a landlord who rents a premises to Tenant 1, who assigns his interest to Tenant 2, who, in turn, assigns his interest to Tenant 3, who fails to fulfill the requirements of the lease and thus ignites litigation by the lessor against all three tenants. In the classic rental situation, the landlord has a cause of action against Tenant 1 through privity of contract and a cause of action against Tenant 3 through privity of estate, but has no cause of action against Tenant 2 because he has neither privity of contract nor estate.<sup>26</sup> Texas does have a statute which prevents a tenant from subleasing his leasehold to any other person without the prior consent of the landlord.<sup>27</sup> However, industry practice and the lease forms used for JOAs are not sub-leases prohibited by the Texas code and allow for such assignments of interest.

This case was initially litigated as a bench trial at the district court level.<sup>28</sup> The trial court passed final judgment that included the prior summary-judgment edict while tacking on two further judgments.<sup>29</sup> First, both Eland and Nor-Tex were found to be jointly and severally liable to Seagull for the sum total of \$268,418.99, in addition to lawyer fees, costs, and prejudgment and postjudgment interest.<sup>30</sup> Second, because of Eland's cross-action against Nor-Tex, the court ruled that Nor-Tex had to indemnify Eland for whatever Seagull was awarded—cold comfort considering Nor-Tex had since wrapped its mortal coil in the shroud of bankruptcy.<sup>31</sup>

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22. See *Seagull*, 207 S.W.3d at 344.

23. *Eland*, 135 S.W.3d at 124.

24. *Id.*

25. *Id.*

26. See 718 Assocs., Ltd. v. Sunwest N.O.P., Inc., 1 S.W.3d 355, 361 (Tex. App.—Waco 1999, pet. denied).

27. TEX. PROP. CODE ANN. § 91.005 (Vernon 2007).

28. *Eland*, 135 S.W.3d at 124.

29. *Id.*

30. *Id.*

31. *Id.*

### III. THE OPERATING AGREEMENTS

The promulgation of industry standard forms, including operating agreements, is a major function of the American Association of Petroleum Landmen (AAPL). The AAPL's Model Form Operating Agreement 610 is the most prevalent operating agreement form used within the United States.<sup>32</sup> The AAPL also authored the Model Form 2000 Offshore (Shallow Water) Operating Agreement, Offshore (Deep Water) Operating Agreement, and will soon formally release a model Offshore (Deep Water) Operating Agreement 2006. These model forms are in wide use and are substantially similar to the agreements at issue in the present case such that they will all be adversely affected by the Supreme Court's recent decision.

While it would be unnecessary and wasteful to include the entire JOA agreement in this text, it is important to delineate the relevant portions of the JOA that the courts considered as this case wound through the appeals process. First, both assignments through which Eland acquired the interest in the properties at issue contained the following provision:

It is understood and agreed by the parties hereto that this Agreement is made subject to the [operating agreements covering the properties] and [Eland] agrees to assume and be liable for a proportionate part of the obligations created by [the operating agreements covering the properties].<sup>33</sup>

Second, in the Purchase and Sale Agreement through which Eland obtained its interest from its predecessor, Eland approved the following terms:

On the Closing Date, ownership of all production attributable to the Properties conveyed to [Eland] and all other attributes of ownership, including liabilities and obligations arising after the Effective Date or assumed hereunder, shall pass as of the Effective Date.

[Eland] shall assume all liability and obligation for acquiring and ensuring compliance with all permits, licenses, and other authorizations which are required under federal, state and local laws with respect to pollution or protection of the environment relating to the Properties. . . .

[Eland], as owner of the Properties acquired on the Closing Date, shall, by consummation of the transactions contemplated by this Agreement, obligate itself to assume and timely discharge all duties, obligations and liabilities of the owner of the Properties.<sup>34</sup>

The operating agreements by which Eland agreed to be bound when they consented to accept the assignments of working interest began with the following definitions:

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32. There are four versions of this form, dated 1956, 1977, 1982, and 1989.

33. *Eland*, 135 S.W.3d at 126.

34. *Id.*

- 2.10 Participating Interest. The respective percentage of participation of each Party electing to participate in each of the operations conducted hereunder, including the production of Oil and Gas, based on ownership in the Lease.
- 8.1 Basis of Charge to the Parties. Operator shall pay all costs and each Party shall reimburse Operator in proportion to its Participating Interest.
- 8.6 Unpaid Charges. If any Party fails to pay the charges due hereunder within sixty (60) days after rendition of Operator's statement, the other Participating Parties shall, upon Operator's request, pay the unpaid amount in proportion to their interests. Each Party so paying its share of the unpaid amount shall be subrogated to Operator's security rights to the extent of such payment.
- 8.7 Default. If any Party does not pay its share of the charges when due, Operator may give such Party notice that unless payment is made within fifteen (15) days, such Party shall be in default. Any Party in default shall have no further access to the maps, records, data, interpretations, or other information obtained in connection with operations. A defaulting Party shall not be entitled to vote on any matter until such time as said Party's payments are current. The voting interest of each non-defaulting Party shall be in the proportion its Participating Interest bears to the total non-defaulting Participating Interest.
- 14.1 Platform Salvage and Removal Costs. When the Parties owning a platform mutually agree to dispose of such platform, it shall be disposed of by the Operator as approved by such Parties. The costs, risks, and net proceeds, if any, resulting from such disposition shall be shared by such Parties in proportion to their Participating Interests.
- 14.4 Abandonment Operations Required by Governmental Authority. Any well abandonment or platform removal required by governmental authority shall be accomplished by Operator with the costs, risks, and net proceeds, if any, to be shared by the Parties owning such well or platform in proportion to their Participating Interests.
- 15.1 Withdrawal. A Party may withdraw from this Agreement as to a Lease by assigning, to the other Parties who do not desire to withdraw, all its interest in such Lease and the wells, platforms and Facilities used in operations on such Lease. . . . The assignees, in proportion to the respective interests so acquired, shall pay the assignor for its interest in the wells, plat-

forms and Facilities, the current cost of salvaging same, plugging and abandoning of wells, and removal of all platforms and Facilities, as determined by the Parties. In the event such withdrawing Party's interest in such salvage value is less than such Party's share of the estimated costs, the withdrawing Party shall pay the Operator, for benefit of the non-withdrawing Parties, a sum equal to the deficiency.

- 26.1 Successor and Assigns. This Agreement shall be binding upon and inure to the benefit of the Parties and their respective heirs, successors, representatives and assigns and shall constitute a covenant running with the Lease. Each party shall incorporate in any assignment of an interest in the Lease a provision that such assignment is subject to this Agreement.<sup>35</sup>

#### IV. THE OPINION OF THE COURT OF APPEALS

After meeting defeat on the district court level, Eland appealed and the Texas Court of Appeals (14th District—Houston) found for Eland and dismissed Seagull's summary judgment claim.<sup>36</sup> In the appeal, Eland argued that the district court mistakenly found it liable under the JOA for the costs of Seagull after Eland had assigned to Nor-Tex and that under the unambiguous language of the JOA, no contractual compulsion existed for such liability.

First, the appellate court noted that it is a question of law whether a contract is ambiguous and that a contract is ambiguous when "its meaning is uncertain and doubtful or is reasonably susceptible to more than one interpretation."<sup>37</sup> The appellate court agreed with both parties that the JOAs at issue were unambiguous and that the court could construe them as a matter of law.<sup>38</sup>

The question considered was simply put: given the unambiguous language of the operating agreements, did each agreement impose a duty on Eland to pay Seagull any share of the operating expenses after the assignment of its interest in the properties at issue?<sup>39</sup> The court noted that in Seagull's appellate brief, no language was cited demonstrating that Eland owed it any share of the operating expenses.<sup>40</sup>

The court noted that Seagull promoted four arguments in defense of its claim without citing any on-point case law.<sup>41</sup> First, it claimed

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35. *Id.* at 126–27.

36. *Id.* at 129.

37. *Id.* at 125 (citing *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1996)).

38. *Id.* (citing *Am. Mfrs. Mut. Ins. Co. v. Schaefer*, 124 S.W.3d 161, 161–62 (Tex. 2003)).

39. *Id.* at 124–25.

40. *Id.* at 128.

41. *Id.* at 128–29.



that Eland remained liable for the expenses at issue because none of the other parties to the operating agreement expressly released Eland from liability despite the assignment to Nor-Tex. In dismissing this claim, the court noted simply that no provision in the agreements imposed any such obligation and that, if Eland and Nor-Tex wanted such an arrangement, such language would and should have been added to the assignment and operating agreements.<sup>42</sup>

Second, Seagull pointed to two provisions in the operating agreements, Article 14.1 (“Platform Salvage and Removal Costs”) and Article 14.4 (“Abandonment Operations Required by Governmental Authority”), as insufficient to release Eland from its alleged liability under Texas law. The court dismissed this claim, saying again that under the unambiguous language of the agreement, no liability was imposed.<sup>43</sup>

Third, Seagull pointed to Article 15.1 (“Withdrawal”), claiming that while the provision created a withdrawal mechanism for Eland, it did not release Eland from plugging and abandonment liability. The court noted that while Article 15.1 allows a party to withdraw, it does not mandate that a party withdraw instead of assigning its interest, nor is a party required first to offer its interest to other parties with a working interest in the area covered by each JOA. The court noted that while other parties in a JOA may want to squash attempts by one of their fellow JOA co-parties to assign its interest to an unsophisticated or financially unstable entity, they can do this through the language of the JOA, either through bans of such assignments, requirement of approval by the other parties, or preferential rights of purchase. That they did not do so in this case was seen by the court as indicative that assignments were in no way discouraged or curtailed by the agreements.<sup>44</sup>

Fourth and finally, Seagull made the public policy argument that allowing Eland to assign its interest would lead to widespread assignment of working interests to insolvent companies in an effort to avoid plugging and abandonment responsibilities. The court dismissed this claim as well, noting that it is generally not up to the court to determine the wisdom of contractual obligations between parties and opining that since the language was unambiguous, the court was neither obliged nor permitted to consider anything beyond the actual contract provisions.<sup>45</sup>

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42. *Id.* at 129.

43. *Id.*

44. *Id.*

45. *Id.* at 129 (citing *Royal Indemnity Co. v. Marshall*, 388 S.W.2d 176, 181 (Tex. 1965)).

## V. THE OPINION OF THE TEXAS SUPREME COURT

After defeat at the appellate level, it was Seagull's turn to appeal, this time to the Texas Supreme Court. The high court reversed and found Eland liable for Nor-Tex's costs despite its assignment to Nor-Tex because neither Seagull, the operator, nor the language of the JOA had expressly released Eland from liability.<sup>46</sup>

Seagull once again argued that Texas contract law recognizes that an assignor's financial obligations survive assignment unless the contract expressly states otherwise or the assignor secures a release. Further, Seagull argued that the language of the JOAs did not provide such an explicit release and that the Court should therefore apply the rule maintaining liability.<sup>47</sup> Eland answered that the JOA language indicated that the general rule did not apply because the language and industry custom essentially acted as a novation. Therefore, the duty of Eland to pay the costs of operating the leases ceased at the moment it assigned its interest.<sup>48</sup> The Court correctly noted that just because two parties disagree on a contract's meaning does not mean it is ambiguous<sup>49</sup> and that it would interpret the contract under the seminal *Coker* criteria:

[In order to derive a contract's intent, the Court would] examine and consider the entire writing in an effort to harmonize and give effect to all the provisions of the contract so that none will be rendered meaningless. No single provision taken alone will be given controlling effect; rather all the provisions must be considered with reference to the whole instrument.<sup>50</sup>

The Court then went on to quote the provisions in the JOAs that Eland cited in its response, all of which are included in those listed above in Section III.<sup>51</sup>

The Court then dismissed Eland's conclusion that these provisions indicate Eland is not liable for post-assignment charges by stating,

[N]owhere do [the cited clauses in the JOA] mention the subject of release or the consequences which are to follow the assignment of a working interest. . . . The operating agreement simply does not explain the consequences of an assignment of a working interest to a third party. Thus, we disagree with Eland that the parties expressly agreed that an assignment of a working interest was to operate as a novation, effectively ending any further obligation of the assignor under the operating agreement.<sup>52</sup>

46. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 347 (Tex. 2006).

47. *Id.* at 345.

48. *Id.*

49. *Id.* (citing *Sun Oil Co. (Delaware) v. Madeley*, 626 S.W.2d 726, 727 (Tex. 1981)).

50. *Id.* (citing *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983)).

51. *Id.* at 345-46.

52. *Id.* at 346.

Next, the Court cited four cases dealing with assignment of contractual obligations. However, the four cases considered by the Court in *Seagull* when examining the question of whether a non-operator who has assigned his interest without a novation is liable to the Operator for subsequent under- or non-payment of joint interest billings (JIBs) are not in any way germane to how a JOA or the underlying mineral leasehold has ever been operated.<sup>53</sup> The cited cases deal with a sex-change operation,<sup>54</sup> a legal malpractice claim,<sup>55</sup> the sale of crude oil under the UCC,<sup>56</sup> and a dispute between a landlord and a second renter.<sup>57</sup>

Specifically, the Supreme Court first cited *Farah v. Mafrige & Kormanic, P.C.*<sup>58</sup> and *Univ. of Tex. Med. Branch at Galveston v. Allan*<sup>59</sup> for the principle that, generally speaking, “a party cannot escape its obligations under a contract merely by assigning the contract to a third party.”<sup>60</sup>

*Farah* dealt with a homebuilder attempting to sue a firm and individual lawyers for malpractice regarding a suit he had them file on his behalf against banks that had financed his construction business.<sup>61</sup> In *Farah*, the court ruled that the defendants had not shown that the homebuilder’s breach of contract claim against the first credit providing bank had accrued as a matter of law when the first bank stopped advancing credit.<sup>62</sup> The defendants had originally raised the defense of statute of limitations by claiming that the cessation of credit from the first bank triggered the four year statute of limitations despite a subsequent delegation of its duty under the agreement to a successor bank.<sup>63</sup> However, the court here ruled that a party cannot avoid liability under a contract that ended by delegating its obligation to perform to another entity.<sup>64</sup> This case is easily distinguishable from *Seagull* in that it deals with financing a single, simple, and discreet construction project instead of a complex, on-going, and potentially multi-faceted development project.

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53. Nor, it should be mentioned, are any of the four cases cited by the Texas Supreme Court regarding assignments and liability mentioned in *any* of the leading legal treatises dealing with oil and gas law.

54. *Univ. of Tex. Med. Branch at Galveston v. Allan*, 777 S.W.2d 450, 452 (Tex. App.—Houston [14th Dist.] 1989, no writ).

55. *Farah v. Mafrige & Kormanic, P.C.*, 927 S.W.2d 663 (Tex. App.—Houston [1st Dist.] 1996, no writ).

56. *W. Oil Sales Corp. v. Bliss & Wetherbee*, 299 S.W. 637 (Tex. Comm’n. App. 1927, judgm’t adopted).

57. *Cauble v. Hanson*, 249 S.W. 175 (Tex. Comm’n App. 1923, judgm’t adopted).

58. *Farah*, 927 S.W.2d at 677.

59. *Allan*, 777 S.W.2d at 453.

60. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 346–47 (Tex. 2006).

61. *Farah*, 927 S.W.2d at 669.

62. *Id.* at 677–78.

63. *Id.* at 677.

64. *Id.*

*Allan* dealt with a patient's sex change operation and subsequent lawsuit by the hospital to recover proceeds from the trans-gendered patient's insurance policy.<sup>65</sup> The insurance company had first paid the hospital for the sex-change operation, but then demanded the money back after disputing the necessity of such "treatment."<sup>66</sup> The hospital returned the money to the insurer and sought recovery from the patient, who in turn did not pay and filed for bankruptcy.<sup>67</sup> Later, the patient and the insurance company reached an agreement where the insurer would pay \$10,000.00 toward the settlement of the lawsuit.<sup>68</sup> The hospital intervened, seeking to recover the proceeds of the settlement agreement.<sup>69</sup> The hospital claimed that the lower court erred in granting a Motion for Summary Judgment to the patient because his/her assignment transferred to the hospital the exclusive right to collect the insurance proceeds.<sup>70</sup> In short, the assignment of insurance benefits was given in return for the hospital to perform the sex-change operation.<sup>71</sup> Thus, this case is easily differentiated from the situation in *Seagull* as the assignment in *Allan* was made in consideration for services rendered whereas in *Seagull* the assignment occurred long before, and quite separate from, the services for which the Operator would later seek recovery. Simply put, in contrast to *Farah*, where the three parties involved in litigation were all financially intertwined, the assignor in *Seagull* received no benefit from the provider of services after the assignment and was completely removed from the transaction that gave rise to Plaintiff's action against Eland's successor.

Subsequently, the Texas Supreme Court cited *Western Oil Sales Corp. v. Bliss & Wetherbee*<sup>72</sup> and *Cauble v. Hanson*<sup>73</sup> for the notion that, as a general rule, "a party who assigns its contractual rights and duties to a third party remains liable unless expressly or impliedly released by the other party to the contract."<sup>74</sup> *Western Oil Sales Corp.* considered the situation wherein a partnership agreed with an oil company to deliver all crude produced and stored in a discrete property in an agreement that also included a statement that "this agreement shall extend to and be binding on the parties hereto, their heirs,

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65. *Univ. of Tex. Med. Branch at Galveston v. Allan*, 777 S.W.2d 450, 452 (Tex. App.—Houston [14th Dist.] 1989, no writ).

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *W. Oil Sales Corp. v. Bliss & Wetherbee*, 299 S.W. 637, 638 (Tex. Comm'n App. 1927, judgm't adopted).

73. *Cauble v. Hanson*, 249 S.W. 175, 178 (Tex. Comm'n App. 1923, judgm't adopted).

74. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 347 (Tex. 2006).

executors, administrators, successors, and assigns.”<sup>75</sup> Western Corporation later assigned its interest to American Oil Company.<sup>76</sup> American Oil Company demanded that the partnership/sellers continue to make deliveries under the sales contract, but this demand was refused by the partnership/sellers unless Western Corporation recognized its liability under the contract.<sup>77</sup> Western Corporation refused to recognize and renounced its liability.<sup>78</sup> Later the partnership/sellers assigned their own interest in the oil properties and all rights of action against the Western Oil Sales Corporation stemming from the contract litigation.<sup>79</sup> The successors in interest then brought suit against Western Corporation for damages resulting from the alleged breach of contract.<sup>80</sup> The court ruled that the Western Corporation was not released from its contract by the assignment to the American Oil Company, holding that the clause extending liability to assignors as well as subsequent assignees governed.<sup>81</sup> Simply put, the operating agreement in question in *Seagull* contains no such warranty as the agreement in *Western Oil Sales Corp.* did.

Finally, the Supreme Court in *Seagull* cited *Cauble* also for the general rule that a party who assigns his contractual rights remains liable unless expressly or impliedly released by the other party to the contract.<sup>82</sup> This case concerned a promissory note given for the rental of land that was later assigned to a second renter. The second renter eventually defaulted and the landowner went after the original renter.<sup>83</sup> This case, too, is very different than the *Seagull* situation. First, the instrument at issue is a JOA, not a promissory note. As is industry custom, interests in JOAs are very commonly assigned between parties and to new parties. In contrast, the promissory note in *Cauble* contained an express covenant to pay the note, which required the original grantor of the note to pay if his assignee did not.<sup>84</sup>

After this enumeration of decisions cited by the Texas Supreme Court in support of its opinion, it is of interest to further examine other jurisprudence and analysis that exist related to the issue of operator liability. The Houston Court of Appeals decision in *Seagull* has been the benchmark for assignor liability of interests covered by a

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75. *W. Oil Sales Corp.*, 299 S.W. at 637.

76. *Id.*

77. *Id.* at 638.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 347 (Tex. 2006).

83. *Cauble v. Hanson*, 249 S.W. 175, 176 (Tex. Comm'n App. 1923, judgment adopted).

84. *Id.* at 177.

JOA, being cited in many of the noteworthy oil and gas law treatises.<sup>85</sup> The only other Texas case for this point of law cited by *The Law of Oil and Gas in Texas* is *Geodyne Energy Income Production Partnership I-E v. Newton Corp.*,<sup>86</sup> in which the court considered when liability accrues among assignor and assignee of JOA non-working interests regarding the statutory need to plug a well.<sup>87</sup> When the operator sought to recover the portion of plugging costs from the assignee, the assignee, in addition to bringing a cross-claim for violations of the Texas Security Act (TSA), sued the interest assignor, claiming that the interest had been assigned after the period of non-production that mandated plugging of the well.<sup>88</sup> The court agreed, saying that application of the TSA's remedy of revocation of sales occurred such that title to the non-operating interests remained with assignor and thus they were liable for plugging expenses accruing from that non-operating interest.<sup>89</sup> Had title passed to the assignee before the accrual of plugging expenses, the assignee would have had to pay.<sup>90</sup> This case acknowledges that when expenses accrue, the non-operating party that owns the interest at that point in time is liable, not successors nor predecessors-in-interest.<sup>91</sup>

#### A. *Misapplication of Landlord-Tenant Law*

Even if landlord-tenant principles apply, the Supreme Court significantly broadened these principles in its application of liability to Eland, the intermediate interest owner. The Court treated the subject operating agreements as analogous to landlord-tenant agreements. As to the parties in the present dispute, arguably the closest analogy to the landlord-tenant contract is the underlying lease agreement originally between the United States as lessor and Seagull Energy as lessee. Seagull subsequently assigned portions of its lease interests to other parties, including the predecessors-in-interest to Eland. By the time Eland purchased its leases in 1994, previous parties had already executed the operating agreements at issue.<sup>92</sup>

In the landlord-tenant context, a lease between the landlord and the original tenant is the subject of any later assignment from one lessee to another. On this basis, liability may remain with the original par-

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85. See, e.g., 14 WILLIAM V. DORSANEO III, TEXAS LITIGATION GUIDE § 210A.20 (2008); BRUCE M. KRAMER & PATRICK H. MARTIN, THE LAW OF POOLING AND UTILIZATION §17.02 (3d ed. Oct. 2007).

86. *Geodyne Energy Income Prod. P'ship I-E v. Newton Corp.*, 97 S.W.3d 779 (Tex. App.—Dallas 2003), *rev'd in part*, 161 S.W.3d 482 (Tex. 2005).

87. *Id.* at 782.

88. *Id.* at 782–83.

89. *Id.* at 785–86.

90. *Id.* at 787–88.

91. *Id.* at 788.

92. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 344 (Tex. 2006).

ties to the lease agreement. However, in the oil and gas context, the interest in land derived from an oil and gas lease between a lessee (who may also be a party to an operating agreement including other parties with no interest in the particular lease) and a third party lessor (unrelated to the operator) is the subject of the assignment.<sup>93</sup> The transfer or assignment of the lease from one party to another is *subject* to the operating agreement.<sup>94</sup> The operating agreement itself is not the object of the assignment; it is an encumbrance on the leasehold estate, and the rights and duties relating to the agreement follow the transfer of an interest in the encumbered lease.<sup>95</sup>

Even if the Court's landlord-tenant analysis is accurate, it has radically altered this law. As discussed in the landlord-tenant cases, traditional landlord-tenant law requires privity of contract or privity of estate for a landlord to enforce a rental obligation.<sup>96</sup> Consequently, while a landlord will have a cause of action for breach against the original tenant (privity of contract) and against the current breaching tenant (privity of estate), that landlord does not have a cause of action against intermediate tenants because there is neither privity of contract nor privity of estate against those intermediate tenants.<sup>97</sup> In the *Seagull* case, Eland was clearly an intermediate party (having taken its interests from General Atlantic Resources and UMC Petroleum Corporation before assigning them to Nor-Tex).<sup>98</sup> Consequently, even if the landlord-tenant analysis did apply, the Supreme Court expanded the doctrine in applying liability to Eland.

### B. *Contrary to Conventional Oil and Gas Jurisprudence*

The Court's decision is overwhelmingly in opposition to the intent, understanding, and common usage of the oil and gas industry. An operating agreement is a contractual arrangement between two or more parties for the joint development and operation of different and varied mineral interests.<sup>99</sup> The agreement's fundamental purpose is to provide a legal structure whereby cotenants in land can efficiently develop oil and gas while protecting themselves from the hazards of imputed liability associated with mining partnerships and joint ventures.<sup>100</sup> As the El Paso Court of Appeals has written,

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93. *Id.* at 346–47.

94. *Id.*

95. *Id.*

96. *See* *Interstate Fire Ins. Co. v. First Tape, Inc.*, 817 S.W.2d 142, 145 (Tex. App.—Houston [1st Dist.] 1991, no writ.).

97. *718 Assocs., Ltd. v. Sunwest N.O.P., Inc.*, 1 S.W.3d 355, 361 (Tex. App.—Waco 1999, pet. denied).

98. *Seagull*, 207 S.W.3d at 344.

99. *See* *Universal Consol. Oil Co. v. Los Angeles*, 21 Cal. Rptr. 61, 68 (Cal. Dist. Ct. App. 1962).

100. *See, e.g., Rankin v. Naftalis*, 557 S.W.2d 940, 943 (Tex. 1977); *Berchelmann v. W. Co.*, 363 S.W.2d 875, 877 (Tex. Civ. App.—El Paso 1962, writ ref'd n.r.e.) (citing

[W]e are not dealing with an ordinary contract. Joint Operating Agreements, standardized forms developed over years by the industry to govern ventures in the development of oil and gas properties, are simply not everyday fixtures of life. They govern operations involving immense financial risk and reward; the parties to J.O.A. are experienced and sophisticated and generally have balanced bargaining positions. These are agreements which involve liabilities and obligations unique to the legal and technical peculiarities of the oil and gas industry.<sup>101</sup>

Since the birth of the oil and gas industry, the joint operation of mineral properties has facilitated the development of tracts whose operating rights have been divided among owners of undivided interests. Operating agreements came into widespread use by the 1920's, particularly in co-tenant situations.<sup>102</sup> Historically, joint operations have contributed to efficiency in the industry and conservation of a depleting resource.<sup>103</sup> The coordination necessary for joint operations has typically been achieved through the use of an operating agreement. The use of this instrument has become so widespread that it is now considered, after the oil and gas lease, to be the most common instrument in the industry.<sup>104</sup>

In 1956, the AAPL published the first version of its model form operating agreement, designated AAPL Form 610, now the most popular form in use.<sup>105</sup> While there are other operating agreement forms, most have evolved from one of the earlier forms developed by the AAPL, including domestic offshore JOAs such as the agreement that is at issue in the case here.<sup>106</sup> "As a result, judicial and academic concepts developed in the context of one JOA or one dispute are increasingly viewed as generally applicable to all JOAs."<sup>107</sup>

Even before the promulgation of the first AAPL form, operating agreements did not permit continuing liability once a party assigned its interest. Oil and gas practice and usage—as agreed by witnesses

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Youngstown Sheet & Tube Co. v. Penn. 363 S.W.2d 230 (Tex. 1962)). See also SMITH & WEAVER, *supra* note 1, § 17.3(A)(2).

101. Hill v. Heritage Res., Inc., 964 S.W.2d 89, 112 (Tex. App.—El Paso 1997, pet. denied).

102. See, e.g., Potlach Oil & Ref. Co. v. Ohio Oil Co., 199 F.2d 766, 767 (9th Cir. 1952) (citing a 1922 agreement); Hughes v. Samedan Oil Corp., 166 F.2d 871 (10th Cir. 1948) (discussing a 1927 form agreement).

103. Gary B. Conine, *Property Provisions of the Operating Agreement—Interpretation, Validity, and Enforceability*, 19 TEX. TECH L. REV. 1263, 1264 (1988).

104. Gulf Oil Corp. v. Southland Royalty Co., 478 S.W.2d 583, 594 (Tex. App.—El Paso 1972), *aff'd*, 496 S.W.2d 547 (Tex. 1973); Conine, *supra* note 103, at 1264–65. See generally Robert C. Bledsoe, *Problem Areas in Drafting Operating Agreements—Some Suggested Solutions* (Oct. 15, 1981) (unpublished manuscript, on file with Authors).

105. See Conine, *supra* note 103, at 1273–74.

106. Ernest E. Smith, *Joint Operating Agreement Jurisprudence*, 33 WASHBURN L.J. 834, 835 (1994).

107. *Id.*



and experts for both parties at the trial level—overwhelmingly support this long-standing construction.<sup>108</sup>

In the event of a default by a current non-operator (such as Nor-Tex), it has been industry practice and usage for the operator to look only to the current remaining non-operators to absorb their proportionate share of the costs and expenses incurred by the defaulting party. The only common exception to this rule is that an operator could pursue a former working interest owner if that working interest owner consented to participation in a specific operation prior to assigning away its interest.<sup>109</sup>

## VI. UNINTENDED CONSEQUENCES

Cautionary tale histrionics can be tiresome, but if strictly interpreted, *Seagull v. Eland* could invite some burdensome and unwelcome jurisprudence. In discussing the lower appeals court decision, *Eland Energy, Inc. v. Seagull Energy E & P, Inc.*,<sup>110</sup> one commentator stated:

If the Texas Supreme Court takes the *Eland* case on appeal and ultimately holds, based upon a general principle of contract law, that an assignor and assignee of an oil and gas working interest are jointly and severally liable for costs and expenses arising after the assignment, the industry will suffer results that were unintended by the very parties who drafted the relevant agreements. *The custom, practice, and general understanding in the industry is that an assignor of oil and gas working interests is no longer liable to the operator and the other working interest owners for the costs and expenses relating to that interest that are incurred after the transfer, including residual liability such as plugging and abandonment.* Most standard form joint operating agreements, onshore and offshore, provide for as-

108. See 2 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 503.2, at 582 (Patrick H. Martin & Bruce M. Kramer eds., 2007) (1959); Fabené J. Welch, *The Boomerang: Transferring Residual Liabilities Towards the End of the Lease*, in STATE BAR OF TEX. 22ND ANNUAL ADVANCED OIL, GAS & ENERGY RESOURCE LAW COURSE 7-4 (2004). See also *Nat'l Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517, 521–22 (Tex. 1995) (Court allows evidence of trade usage to interpret contractual terms); *Energen Res. MAQ, Inc. v. Dalbosco*, 23 S.W.3d 551, 557 (Tex. App.—Houston [1st Dist.] 2000, pet. denied) (where a contract is silent on a matter that needs to be explained by evidence, trade usage is admissible to show the parties' intent); *Intratex Gas Co. v. Puckett*, 886 S.W.2d 274, 277–78 (Tex. App.—El Paso 1994, no writ) (when construing an unambiguous contract, courts should consider the commercial context of the transaction, including what is considered the industry norm and reasonable and prudent practices and usage); *KMI Cont'l Offshore Prod. Co. v. ACF Petroleum Co.*, 746 S.W.2d 238, 241 (Tex. App.—Houston [1st Dist.] 1987, writ denied).

109. See *Geodyne Energy Income Prod. P'ship I-E v. Newton Corp.*, 97 S.W.3d 779, 787–88 (Tex. App.—Dallas 2003), *rev'd in part on other grounds*, 161 S.W.3d 482 (Tex. 2005); *Union Oil Co. v. Cheyenne Oil Props., Inc.*, 2002-1330, p.10 (La. App. 3 Cir. 3/5/03); 839 So. 2d 1170, 1176 (addressing costs accruing prior to the assignment).

110. *Eland Energy, Inc. v. Seagull Energy E & P, Inc.*, 135 S.W.3d 122 (Tex. App.—Houston [14th Dist.] 2004), *rev'd* 207 S.W.3d 342 (Tex. 2006).

signability and contemplate the unpaid costs and expenses attributable to a defaulting co-interest owner are to be paid, *pro rata*, by the other current participants. Concerns about the financial viability of assignees are routinely dealt with by the industry with familiar contractual provisions such as preferential rights to purchase, consents to assignment, and requirements for the posting of bonds or other collateral to secure outstanding obligations. Financial investors and industry participants alike have relied for decades on the ability of the selling party to successfully shed itself of future liabilities attributable to oil and gas properties after it has conveyed its interest in the properties. *A particularly harsh result occurs when the unpaid liabilities are for joint interest expense for on-going operations as was, in part, the case in Eland.* In this case, the assignor who thought it had walked away from the sold assets unexpectedly is responsible for expenses related to future operations with no right to share in the benefits derived from such operations.<sup>111</sup>

Under the Supreme Court's final opinion, the particularly harsh result admonished above is potentially at hand. Furthermore, as a corollary to the above, the purpose of the typical oil and gas lease is to administratively combine a number of disparate interests to efficiently exploit mineral interests. The net result of the *Seagull* decision will be to chill such cooperation. In the largest sense, this is an undesirable outcome, particularly in today's energy environment, where greater American independence from foreign oil production is a desirable goal.

### A. *Spreading Litigation*

This decision also brings into focus a number of other unintended consequences. First, the Court's decision will have the practical effect of potentially crowding the courts with litigants. In addition to these novel lawsuits that will arise as operators move through the chain of predecessors to impose liability for current defaulting non-operators, the incentive will also exist for operators with defaulting (or merely slow-paying) non-operators to avoid traditional remedies against those non-operators in favor of a lawsuit against a predecessor (or predecessors) with deep pockets.

This decision could also spread litigation in that whenever an operator files suit against a predecessor non-operator, that predecessor will have an incentive to join every other non-operator that has ever owned the interest at issue. Alternatively, a finding of liability against a predecessor non-operator will result in subsequent lawsuits for contribution against those same predecessor non-operators. Under any of these scenarios, the court system becomes congested with unwilling litigants who may not have owned a particular interest at issue for decades.

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111. Welch, *supra* note 108, at 7-3 (emphasis added).

*Seagull* effectively makes all predecessors in title liable for breaches caused by a successive leaseholder, irrespective of how far removed in time that leaseholder is. The interests in operating agreements can be, and typically are, assigned numerous times. This decision, by extending liability to all predecessors in interest that have not acquired express releases to their assignments, dramatically changes the liability landscape of a JOA, effectively making all predecessors liable for the malfeasance of a single successor that may be several times removed from the initial or subsequent assignee.

Another consideration that makes the *Seagull* decision unworkable is the history of mergers and buy-outs that has occurred in the oil and gas industry. For example, under the facts of *Seagull*, Eland Energy received its interest from UMC Petroleum Corporation and to General Atlantic Resources, Inc.<sup>112</sup> UMC Petroleum Corporation eventually merged into Ocean Energy, which in turn was bought by Devon Louisiana Corporation.<sup>113</sup> Devon also acquired Seagull Energy E & P, Inc., the plaintiff in *Seagull*.<sup>114</sup>

Under the questionable rule laid down in this decision, the Court has made not only Eland, but also General Atlantic and UMC Petroleum Corporation, as predecessors-in-title to Nor-Tex, liable for Nor-Tex's non-payment of joint interest billings.<sup>115</sup> *Seagull* is also, therefore, able to sue Ocean and Devon. Since Devon owns *Seagull*, this case could reach the ludicrous situation in which Devon winds up suing itself.

Alternatively, should Devon realize this dilemma and not sue itself, Eland would be entitled to bring in Ocean and Devon on a contribution basis, again resulting in Devon effectively suing itself. As stated above, because there is no effective statute of limitations or statute of repose for predecessors-in-interest, liability and litigation could well be endless.

### B. Denial of Traditional Defenses

The operating agreement does not have a fixed term, but rather typically extends itself until the expiration of all leasehold estates within the operating area.<sup>116</sup> Consequently, the term at issue is potentially a long-term venture that binds all parties to procedures and obli-

112. *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 344 (Tex. 2006).

113. Ocean Energy, Inc., Current Report (Form 8-K), at 2 (Mar. 27, 1998); Ocean Energy, Inc., Current Report (Form 8-K), at 2 (Feb. 23, 2003).

114. Brief on the Merits of Petitioner Seagull Energy E & P, Inc. at 3 n.1, *Seagull Energy E&P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342 (Tex. 2006) (No. 04-0662).

115. See *Seagull*, 207 S.W.3d at 347 (extending the predecessors in title rule that the court applied to Eland).

116. See SMITH & WEAVER, *supra* note 1, § 17.3(A)(1).

gations until the benefits to be derived from the development of the contract area have elapsed.<sup>117</sup>

The Court's decision denies predecessor non-operators the use of time-barred defenses such as the statute of limitations, laches, and statute of repose. For example, assume Non-operator A is the original signatory to an operating agreement with a 25% interest. Non-operator A assigns its interest to Non-operator B in 1950. Non-operator B reassigns the interest to Non-operator C in 1955. Fifty years later, in 2005, Non-operator S purchases that interest and subsequently defaults on its obligations to the Operator. The Operator sues Non-operator S in 2006, well within the limitations period as to Non-operator S. The Operator discovers that Non-operator S is insolvent, performs a title search, and finds that Non-operator B is still in existence. Operator sues pursuant to the *Seagull* decision. Despite the fact that Non-operator B has not owned its interest in over fifty years, it suddenly finds itself in a lawsuit to which it has no time-barred defenses.

### C. Denial of Nonconsent Contractual Protections

The Court's decision is particularly troublesome to the oil and gas industry in that operations under a JOA are made voluntarily by each of the signatories to the agreement. That is, parties to the agreement can elect to participate or not (go "nonconsent") in particular projects encompassed by the operating agreement. However, under *Seagull*, a predecessor in title may be found liable for a later assignee's participation in a project within an operating agreement in which the predecessor-in-interest would never itself have chosen to participate.

Additionally, operating agreements are often amended, split, or otherwise modified into very different agreements than those the original signers or their immediate successors envisioned. Holding these prior parties liable for projects that they may not have agreed upon themselves or even considered when the original operating agreement was drafted is especially harsh, particularly considering that while such predecessors may suffer liability, they gain no benefit through successful operations under the agreement.

JOAs contain protective measures that allow non-operators to remove themselves from financial obligations for particular projects within the scope of the operating agreement. A non-operator who elects not to participate in a certain project can choose to step aside and effectively remove itself from any liability to pay for such project. Additionally, the JOA and any attached accounting protocols provide additional rights to non-operators and allow them to monitor the financial outlays made by the operator. With the *Seagull* decision, predecessors-in-interest, who do not receive any authorizations for expenditure, notices, or accounting updates, could be liable for these ex-

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117. Conine, *supra* note 103, at 1309–10.

penses. Additionally, the predecessors to the alleged non-payor have no opportunity to elect not to consent to a certain operation authorized under the operating agreement that a contemporaneous non-operator can invoke.

Logically and conversely, predecessor rights should also be expanded, resulting in onerous burdens for current interest owners. Currently, predecessors such as Eland Energy are unable to invoke the traditional non-operator procedures such as an accounting or non-consent election, presumably because they are not in contractual privity with the operator or the other non-operators in projects. As stated above, this is a highly inequitable result with respect to these predecessor non-operators. Conversely, the *Seagull* decision could be read to permit such protections to the predecessors-in-interest. This also has a negative practical result, as current operators will be obligated to provide notice of proposed operations to all predecessors. Further, both the operators and current non-operating interest owners would be finally financially responsible for the production of accounting requests by predecessor non-operators. Conceivably, any financial benefit to producing an oil or gas well could easily be eaten up by the accounting requirements of a voluminous number of predecessors-in-interest that would not have a financial constraint to limit such requests.

#### D. *Loss of Accuracy in Risk Analysis*

Another practical effect of the *Seagull* opinion is that it will be more difficult to assess risk with respect to oil and gas leases. Consequently, entities that require a risk analysis—such as insurers and bankers—will be unable to determine such issues. Under the worst scenarios, rhetorically, what insurance carrier will write a policy for a company or individual with millions or even billions of dollars of potential liability over past assets? Likewise, what bank will provide financing to a company or individual with such potential debt extending decades into the past?

#### E. *Onerous Approval Hurdles*

The *Seagull* decision holds that under the operating agreement at issue, and similar operating agreements such as the AAPL model forms, a predecessor non-operator will remain liable for a current non-operator's default unless it secures the exculpatory waiver of the operator in assigning its interest. However, the decision implies a far more onerous obligation. The operator and all non-operators are cotenant parties to the operating agreement, and all parties have significant mutual rights under the agreement. Under this holding, a non-operator that attempts to assign a leasehold interest must receive approval of the assignment from *all* parties to the JOA, not just the op-

erator, to effect a novation. In the situation of absentee or incaltrant non-operators, such approval may be impossible or may require additional litigation to appoint a receivership to effectuate the assignment.

#### F. Collateral Effects Outside the Oil & Gas Industry

As stated earlier, the Court's decision may radically affect traditional landlord-tenant law. Although traditionally a landlord has only been able to proceed against the initial renter and the current occupant of the landlord's rental property, the *Seagull* decision now appears to permit a landlord to seek payment from any sublessor between the initial renter and the current occupant. This concern is, however, largely mitigated by the standard commercial rental contract promulgated by the Texas Apartment Association.<sup>118</sup> This contract is frequently used in the residential rental industry and requires explicit approval by the landlord of any subleasing activity.<sup>119</sup> Most commercial rental agreements also contain express approval provisions.

However, the reach of *Seagull* is not potentially restricted to just rental agreements. A clever attorney no doubt will be able to come up with a number of creative applications of the *Seagull* decision.<sup>120</sup> For example, many Texas homeowners belong to a property owners association. It is common for a property owners association to have a monthly fee as well as occasional charges for the common areas of a housing development. Like oil and gas leases, residential homes are typically sold frequently over a long period of time. Conceivably, current Homeowner D could refuse to pay his property owners association dues. This deficiency, and additional assessments, could result in a situation where the homeowners' equity is insufficient to cover the amounts due to the property owners association. Under *Seagull*, the property owners association could then conceivably approach any other former owner of the home (Homeowners A, B, and/or C) and demand that they pay Homeowner D's debt unless the former homeowners could show that the property owners association had explicitly approved the prior home sale (assignment).

### VII. FALLOUT

Since the decision is so recent, it is largely too early to see what effect *Seagull* will have on the industry. Groups of oil and gas lawyers and landmen have pondered how future contracts should be drafted and what processes producers should undertake to extradite themselves from future litigation arising from stiffed operators climbing the

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118. Texas Apartment Association, Sample Apartment Lease Contract, <http://www.taa.org/assets/PDF/renter/2007%20apartment%20lease%20-%20for%20website.pdf>.

119. *Id.*

120. *See, e.g.,* Boldrick v. BTA Oil Producers, 222 S.W.3d 672, 677 (Tex. App.—Eastland 2007, no pet.).

chain of title back in time from a deadbeat assignee.<sup>121</sup> Brad Miller, general counsel for the Permian Basin Petroleum Association, has said *Seagull* could mean “‘very significant changes in what I believe has been Texas law for a long time.’ . . . ‘It’s a very significant change in the law and my suggestion is to modify operating agreements.’ . . . ‘While you’re still in the deal is the time to fix this.’”<sup>122</sup>

Although the Authors suspect that courts in the future might quarantine this case within the strict boundaries of its facts, we admit not enough time has passed to determine if such narrowing of the holding of *Seagull* has occurred. As of the writing of this Article, only one case has cited *Seagull*, wherein the Court of Appeals (Eastland) distinguished a case involving an action brought by the assignee of an overriding royalty interest in a lease in which the assignor had a working sublease interest.<sup>123</sup> The dispute in *Boldrick* arose from royalty payments made to the assignee that were requested to be returned. The court held that the assignee’s royalty was governed by a JOA that covered lands including the lease from which the assignee’s royalty interest was carved. Furthermore, in the JOA, under Paragraph 31(b), any interests made after the signing of the JOA—such as the overriding royalty interest at issue—would be specially made subject to the terms of the JOA.<sup>124</sup>

This determination led the court to rule that, under the non-consent provisions of the JOA, the overriding royalty interest could be charged with a pro rata share of all expenses and costs as if it were a working interest.<sup>125</sup> The overriding royalty owner relied on *Seagull* in an attempt to show that, in some cases, an owner who assigns an interest in a lease covered by a JOA continues to have an ownership interests.<sup>126</sup> The court disagreed, opining,

We find that case to be distinguishable. In *Seagull* . . . [t]he court based its ruling on the fact that the operating agreement did not deal specifically with the issue of an assignment of a working interest to a third party. In the case at bar, the joint operating agreement does have a specific provision that deals with what happens to an overriding royalty interest [subsequently] created by a nonconsenting party.<sup>127</sup>

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121. See Mella McEwen, *Legislative, Judicial Actions Could Affect Basin Oil Operators*, MIDLAND REP.–TELEGRAM, Feb. 16, 2007, available at <http://www.mywesttexas.com/articles/2007/02/16/import/20070216-archive30.txt>; Robin Forte, *Helpful Hints: Seagull v. Eland—AAPL and IPAA File Amicus Brief with Texas Supreme Court*, LANDMAN, July/August 2006, at 3, available at [http://www.landman.org/landman\\_archive/](http://www.landman.org/landman_archive/) (search month “July/August,” year “2006,” and keyword “Helpful Hints”).

122. McEwen, *supra* note 121.

123. See *Boldrick*, 222 S.W.3d at 672.

124. *Id.* at 674.

125. *Id.*

126. *Id.* at 677.

127. *Id.* (citations omitted).

How much different this “specific provision”—Paragraph 31(b)—is from the provisions discarded by the court in *Seagull* the Authors leave to the reader’s judgment, saying only that narrowing or widening the interpretation of provisions in a JOA, and whether they continue to apply or not to assignors of interests, will be the axis upon which contractual interpretations in future cases will revolve.

A close analysis of the wording of the AAPL JOA and what was intended by it regarding assignor liability for charges after assignment comes from Michel Curry’s article *A Look at the Maintenance of Uniform Interest in Joint Operating Provisions*.<sup>128</sup> This article examines “Article VIII.D—Maintenance of Uniform Interest” on the 1989 AAPL onshore operating agreement and speculates that, while Article VIII.D has been roundly criticized for being unenforceable to prevent partial assignments, it contains language that clearly contemplates release of the assignor from further liability. First, Article VIII.D evidences the parties’ intention to affect a novation with respect to subsequent assignees. Second, it expressly preserves liability for costs accrued before the assignment, thus indicating an intention that the threshold of discharge for all subsequent liability occurs after the effective time of the transfer. Finally, it plainly expresses that the JOA language means to release an assignor from subsequent liability since the liens invoked by the JOA run with the transferred interest until paid. Such language would be superfluous unless the JOA considered that the assignor was released from liability by transferring its interest to another.<sup>129</sup>

Because of the *Seagull* case, the AAPL forms committee is considering proposing language to be used in operating agreements as follows:

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128. MICHEL E. CURRY, A LOOK AT THE MAINTENANCE OF UNIFORM INTEREST PROVISION IN JOINT OPERATING AGREEMENTS, IN 24TH ANNUAL ADVANCED OIL, GAS AND ENERGY RESOURCES LAW COURSE, ch. 22 (State Bar of Texas 2006).

129. *Id.* The relevant portion of Article VIII.D “Maintenance of Uniform Interest” in the 1989 JOA form reads as follows:

any transferee of an ownership interest in any Oil and Gas Lease or Interest shall be deemed a party to this agreement as to the interest conveyed from and after the effective date of the transfer of ownership, provided, however, that the parties shall not be required to recognize any such sale, encumbrance, transfer or other disposition for any purpose hereunder until thirty (30) days after they have received a copy of the instrument of transfer or other satisfactory evidence thereof in writing from the transferor or transferee. *No assignment or other disposition of any interest by a party shall relieve such party of obligations previously incurred by such party hereunder with respect to the interest transferred, including without limitation the obligation of a party to pay all costs attributable to an operation conducted hereunder in which such party has agreed to participate prior to making such assignment, and the lien and security interest granted by Article VII.B shall continue to burden the interest transferred to secure payment of any such obligation.*

(emphasis by Michel E. Curry, highlighting language seen as absolving assignors of charges incurred after assignment).



Any assignment or transfer of an Oil and Gas Lease or Oil and Gas Interest subject to this Operating Agreement shall relieve the transferor from liability for the cost and expense of operations conducted thereafter, provided that the transferor shall remain liable for and shall cause to be paid its proportionate part of the cost and expense of all operations conducted prior to the actual transfer, except that costs and expenses of all operations conducted prior to the actual transfer, except those costs and expenses arising out of or directly related to a specific operation in which the transferor elected (or was deemed to have elected) not to participate pursuant to Article VI [of the A.A.P.L. form, the Non-Consent provision]. From and after the effective date of said assignment or transfer, the transferee shall be deemed to be a party to this Operating Agreement.<sup>130</sup>

As for drafting language that would alleviate such liability as seen in *Seagull*, a couple of other practitioners have considered the problem. Renée F. McElhaney, an appellate litigation specialist in San Antonio, suggests getting a written release of all subsequent obligations by the operator while still owning a portion of the working interest.<sup>131</sup> In addition, she suggests placing in the assignment of working interest a novation that all monies owed under the operating agreement—and all future obligations—are passed to the assignee.<sup>132</sup> For practitioners still using pre-1989 forms of the AAPL Operating Agreement, the Authors have seen the following language added to “Article VIII.D—Maintenance of Uniform Interest” in an attempt to fend off the liability that found Eland:

No assignment or other disposition of any interest by a party of their part of this agreement or of any Oil and Gas Lease or Interest shall relieve such party of obligation previously incurred by such party hereunder with respect to the interest transferred, including without limitation the obligation of a party to pay all costs attributable to an operation conducted hereunder in which such party has agreed to participate prior to making such assignment. Any subsequent transferee of an ownership interest in any Oil and Gas Lease or Interest shall effect a novation of the transferor as to any costs attributable to an operation conducted hereunder in which such transferor is no longer a working interest owner of any Oil and Gas Lease or Interest or this agreement. Upon assignment of any Oil and Gas Lease or Interest, assignor shall no longer bear any obligation subsequently incurred by assignee or any successor of assignee with respect to the interest transferred and this agreement.

No litigation has occurred to further define whether such language would help avoid liability rooted in the operating agreement. How-

130. James E. King, *A.A.P.L. Board of Directors Quarterly Meeting Report*, REG. (Ark-La-Tex Ass'n Prof. Landmen, Shreveport, La.), Jan. 2007, at 3.

131. Renée F. McElhaney, *Practice Points for Texas Supreme Court Opinions* (June 16 2006) (on file with author).

132. *Id.*

ever, those who have considered the issue agree that firms looking to avoid the problem invoked by *Seagull* need to consider it prior to assigning their working interest. Although the operating agreements in play in the *Seagull* case were not 1989 AAPL forms, they did share many common elements, and future court interpretation of clauses in any form agreement will be of keen interest to producers worried about their liability in light of the reasoning of *Seagull*. The Authors hope that future courts will more closely scrutinize the language of all clauses to an operating agreement and will yield opinions better reflecting oil and gas industry standards.

## VIII. CONCLUSION

The Court's decision in *Seagull* effectively makes all predecessors in title to an interest liable for breaches caused by a successive leaseholder unless they have presciently acquired express approval of their assignments. The interests in JOAs can be, and usually are, assigned numerous times. In fact, a leasehold interest in a JOA such as that being discussed here can be assigned dozens of times over the decades that a JOA may be effective. This decision, extending liability to all predecessors in interest, dramatically changes the liability landscape of a JOA, effectively making all predecessors in interest liable for the malfeasance of one successor in interest that may be several times removed from the initial or subsequent assignee.

This phenomenon is particularly troublesome in that any operations under a JOA are made voluntary by each of the assignors of the agreement. That is, parties to the agreement can choose to participate—or not—in particular projects encompassed by the JOA. Thus, a predecessor in title may be found liable for a later assignee's participation in a project within a JOA that the predecessor in interest would never itself have chosen to participate in. In addition, JOAs are often amended, split, or otherwise polymorphed into very different agreements than the agreements the original signers or their immediate successors envisioned. Holding these previous parties in the chain of title of the leasehold interest liable for projects they may not have agreed to themselves or even considered when the original JOA was drafted seems especially harsh, particularly considering that while they may suffer liability, they gain no covert benefit through successful operations under the JOA. Simply put, a party facing liability for a JOA that runs aground on successors' actions would stand to gain no benefit if the JOA blossoms into a financial bonanza. JOAs contain protective measures which allow non-operators to remove themselves from financial obligations for particular projects within the scope of the JOA. A non-operator who chooses not to participate in a certain project can elect to step aside and effectively remove himself from any liability to pay for such project. In addition, the JOA and any attached accounting protocols allow non-operators to monitor the finan-

cial outlays made by the operator. If the Supreme Court's decision in *Seagull* stands as the final word on subsequent non-operator liability, predecessors in interest, who did not receive any authorization for expenditure (AFE) notices or other accounting updates, could be liable for these expenditures. In addition, the predecessors in interest to the alleged non-payor have no opportunity to not consent to a certain operation authorized under the JOA that a contemporaneous non-operator can invoke.

Another consideration that makes the Supreme Court's decision a continuing challenge is the mergers and buy-outs that occur in the petroleum industry. For example, in the situation presented in *Seagull*, Eland received its interest from UMC Petroleum Corporation and General Atlantic Resources, Inc. UMC Petroleum Corporation eventually merged into Ocean Energy, which in turn was bought by Devon. Devon also acquired Seagull Energy E&P, Inc., the plaintiff in this case. Under the questionable rule laid down in this case, the Supreme Court would make not only Eland but also General Atlantic and UMC Petroleum Corporation, as predecessors in title to North Texas Leasehold, liable for North Texas' non-payment of joint interest billings. Seagull could also sue Ocean and Devon. Since Devon owns Seagull, this case could reach the pathological situation wherein Devon could sue itself. The ill-conceived rule laid out by the Supreme Court in *Seagull* provides no time limitation on liability for these predecessors in interest that are now to be held liable for successor's actions. Theoretically, every predecessor in interest, any company it merges into or is bought by, or any previous company which divested the predecessor in interest of the JOA would all be liable. Effectively, liability becomes endless and the resulting litigation boundless.