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Joint Operating Agreements, What You Think You Get Ain't Necessarily What You Get

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JOINT OPERATING AGREEMENTS

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INTRODUCTION

When oil and gas attorneys and landman talk about their profession to persons outside the "patch", it's quite obvious the outsiders don't have a clue as to what it takes to get an oil and gas well drilled, and the terminology utilized in this business is highly sophisticated to the point it scares folks.

What if you had never reviewed an oil and gas lease, and your kinfolk asked you to advise them of whether or not an oil and gas lease was fair, needed modification or special conditions, and by the way, what does it mean? What am I getting myself into?

What if you are a divorce lawyer, insurance defense lawyer, or what if you're a junior landman attempting to secure an oil and gas lease from a party who says, " I think I want to participate in this well. Can you basically tell me what it means to participate in the drilling of a well"?

The goal of this paper is to give you a few things to think about concerning joint operating agreements (JOA), and things to avoid. Specifically, I'll be talking about the relationship between the operator and non-operators.

Joint operating agreements are contractual agreements between one party identified as the operator and at least one other party known as a non-operator which requires the operator to drill the initial obligatory well, and the non-operator to pay its proportionate share of the operating expenses. In other words, if you are a signatory party to a JOA, you have agreed to pay your proportionate share of drilling costs up to a casing point in the initial test well, and if you are the operator, you have agreed to drill the test well to casing point, and plug the well if it is a dry hole.

In Arkansas, a JOA is generally utilized when numerous parties participate in the drilling of a test well. In northern Arkansas, due to the large spacing units, and the inability to get all the parties to agree on drilling a well, there is an integration on the initial exploratory well, and the JOA is approved by the Oil and Gas Commission in the oil and gas integration proceedings. In southern Arkansas it is not uncommon for there to be no integration proceeding, and the parties simply negotiate a JOA between themselves. When joint venturers are involved, parties will create an exploration agreement, and then there will be a JOA attached to the exploration agreement to provide that if a well is drilled, the agreement between the parties concerning the drilling of the well will be governed by an agreed upon JOA.

I was involved with a joint venture wherein our company and two other companies hired a consulting geologist to generate prospects in the state of Wyoming. The parties all shared in the expenses of the geologist, and when prospects were generated, the parties jointly acquired oil and gas leases, and ultimately oil wells were drilled in Wyoming governed by the JOA which was attached to the exploration agreement.

In Arkansas, the typical scenario is for oil and gas companies to individually acquire leases in the drilling and spacing unit, these parties then pool their acreage, and drill the well. If all parties are in agreement, and there are no unleased mineral owners, no integration proceedings are required, and if the parties are not agreement, the integration proceedings will go forward. Companies generally have their preferences in regard to additions to JOAs.

At integration proceedings, in regard to joint operating agreements, the Arkansas Oil and Gas Commission has specified a few areas where the Commission is concerned, and these areas are as follows:

a. Gas balancing agreements;
b. Accounting procedures;
c. Preferential right to purchase;

A lot of parties don't recognize this, but when you sign a JOA, you have essentially agreed that you will pay your proportionate share of costs to casing point in an initial exploratory well. In other words, you are contractually bound to ante-up your share of drilling costs if the operator chooses to drill the well.

AUTHORITY FOR EXPENDITURE (AFE)

What the heck is an AFE. and what significance does it have for the operator and non-operator?

Under the terms and conditions of the standard JOA, an operator will prepare an AFE which covers a dry hole and producing well estimate of expenditures, and typically the operator will forward the AFE to the non-operator who will execute same and return it. What purpose does it serve for the non-operator to execute an AFE and return to the operator? One scenario concerns advanced billings for 30 days of expenditures. The typical JOA will provide that operator can advance bill the non-operator for their percentage of anticipated costs for the next 30 days. Generally, most wells in Arkansas are drilled at least to casing point within a 30 day period. Obviously. in deep wells it would take longer, but as a general rule, the non-operator will be asked to forward their share of the dry hole costs after receipt of a billing. The typical AFE will have the dry hole estimates. and the non-operator will then forward their share of the anticipated dry hole drilling costs pursuant to the AFE. If the well is a completed producer, then it is typical for the billing to be sent to the non-operator for their share of anticipated completed well costs.

As stated above, the standard JOA provides that the operator may ask the non-operator to forward its proportionate share of costs for the succeeding thirty day period. Generally speaking, this results in the non-operator being forwarded an invoice, and the invoice provides for their share of the dry hole drilling costs. The manner in which the proportionate share of drilling costs is determined is based upon an authority for expenditures. What is the significance in a joint operating of an authority for expenditures? What happens if the operator exceeds the authority for expenditures? As a non-operator, whether it be an oil and gas company or a mineral owner, am I responsible for the excess costs? Possible answers:

a. Yes.
b. No.
c. Maybe.
d. I don't know.

In subsequent operations after casing point in the initial exploratory well, an AFE is sent by a proposing party to a non-proposing party, and the parties are either in or out (non-consent). This exercise in the machination of a JOA may be helpful to the practitioner or landman who is involved with mineral owners who may want to participate in the well. Even though it is rare, there are occasions wherein mineral owners participate in the drilling of wells, and they may or may not know what they are getting into. It is not uncommon for a non-sophisticated non-operator to think the AFE gives him a limitation on his exposure concerning the drilling of the well.

I remember an occasion when I was involved in drilling a well at the Prairie Grove Battle Field west of Fayetteville. A novice non-operator signed an JOA and AFE, and agreed to participate for a 50% working interest in the well. When he signed the JOA, he had no idea what he had signed. There were no lawyers in Fayetteville at that time who knew anything about joint operating agreements. and if they had read one, they would not have known what it meant.

What if there had been cost overruns on the well? What if the hole caved in, and the operator drilled the well at double the estimate? Is the non-operator liable for cost overruns? The answer is yes. This of course is assuming that there is not magic language contained in the JOA which enables the non-operator to go non-consent when certain monetary expenditures are exceeded. For example. 150% or 200%.

What if the operator has an incompetent engineering staff, and they make some extremely expensive errors when completing the well? I worked as a landman concerning the drilling of a deep gas well in the Anadarko basin in the early 80's. Our engineering staff was in over their heads. they actually made it to TD, and ran a log, but after that there were numerous problems. The anticipated completion well costs were well in excess of two million dollars, and they blew it. The non-operators who had signed AFEs were ecstatic, thought we had a producer, paid their anticipated share of costs. but then they refused to pay anymore bills. Is the non-operator liable? Maybe. Under the JOA. the operator has no liability to the non-operator unless its conduct was grossly negligent. What does gross negligence mean? This means whatever your expert says it means.

What standard needs to be considered? Generally, in Arkansas the operator must be reasonable and prudent. In Ashland Oil and Refinery Company v. Bond, 222 Ark. 696, 263 SW 2d 74 (1953), there was no JOA governing the parties. However, the parties did utilize an AFE. An AFE was forwarded to the non-operator by the operator, and the well was drilled and completed, but the expenditures greatly exceeded the authority for expenditures estimate.

The well was a producer. Does the non-operator get his share of the proceeds after deducting only the AFE costs, and thus does the operator have to eat the excess? In the Ashland case, an AFE was forwarded to the non-operator, and the operator then made expenditures. The expenditures were approximately five times that of the original estimate. The non-operator complained that it should not be responsible for those excess costs because they didn't approve them. The Arkansas Supreme Court stated "when one tenant in common has drilled a producing well upon the common property, he must be given credit for his reasonable expenses upon being required to account to his co-tenant for the oil withdrawn for the oil withdrawn from the land".

For purposes of this paper, additional language contained in the Ashland opinion merits some discussion. It seems that R.E. Adair (we don't know if this was Red Adair a/k/a John Wayne or not) testified that an ordinary prudent operator would have done the same work in similar circumstances. The non-operator had complained that the operator could only recover those expenses contained in the AFE. However, in this case, there was no challenge to the reasonableness of the operator's expenditures, and it appears under Arkansas law that if your expenditures under an AFE are reasonable, the non-operator is liable for those expenses, and must pay its proportionate share of costs after consenting to the operation.

Under Arkansas law, the Arkansas Supreme Court, in essence, has held that lessees who don't own all the lessees may recover oil and gas from the property, but are required to account to the other non-participating parties, and the operator gets to recoup "reasonable costs of producing the minerals at the surface". See Fife v. Thompson, 288 Ark. 620, 708 SW 2d 611 (1986).

In summation, if you enter into a JOA, you are responsible for the reasonable expenses incurred by the operator regardless of whether or not the AFE is exceeded. This assumes there is no special language contained in the JOA which limit the non-operator's liability or exposure.

LIABILITY OF NON-OPERATORS TO THIRD PARTIES IF OPERATOR DOESN'T PAY THE BILLS, OR IF SOMETHING BAD HAPPENS

Hypothetical. Operator has a carried working interest to the tanks or wellhead. The non-operator pays all the costs to casing point, or to the tanks, or to the wellhead, and the operator fails to pay third party service or supply companies, or there is a huge blowout with damage that exceeds insurance benefits. The operator declares bankruptcy after the non-operator has made payment, and operator skips out without paying the third party suppliers. Do the non-operators have exposure or liability?

We have already established the fact that mineral lessees are co-tenants when there is no JOA, but what do we call the legal relationship to the parties governed by a JOA? Certainly an argument can be made that these co-tenants are partners in a joint venture. Here is the language contained in an 1989 JOA which attempts to limit the liability of non-operators:

> *The liability of the parties shall be several, not joint or collective. Each party shall be responsible only for its obligations, and shall be liable only for its proportionate share of the cots of developing and operating the Contract Area.* Accordingly, the liens granted among the parties in Article VII.5 are given to secure only the debts of each severally and no party shall have any liability to third parties hereunder to satisfy the default of any other party in the payment of any expense or obligation hereunder. *It is not the intention of the parties to create, nor shall this agreement be construed as creating a mining or other partnership, joint venture, agency relationship or association, or to render the parties liable as partners, co-venturers, or principals.* In their relations with each other under this agreement, the parties shall not be considered fiduciaries or to have established a confidential relationship but rather shall be free to act on arm's-length basis in accordance with their own respective self-interest, subject, however, to the obligation of the parties to act in good faith in their dealings with each other with respect to activities hereunder.

On the surface, it appears this paragraph limits the non-operator's liability, and makes the parties other than partners, but does this paragraph effectively end the discussion? In Davidson v. Enstar Corporation, 848 5th 2d 574 (Fifth Circuit 1988), and Heavin v. Mobil Oil Exploration and Producing (1990), several major oil companies were involved in the operation of two offshore platforms. Language contained in the JOA supposedly rendered the parties independent contractors with the operator calling the shots, and the non-operator essentially investing monies in the operation.

These cases are essentially worker's compensation cases. The injured employee on both platforms sued for big bucks. What did the majors do? They defended on the grounds that the parties were joint venturers despite a JOA which said they were not. Why? In this situation, there is federal legalization which limits relief under a worker's compensation scenario, and the injured employees did not have the ability to sue the non-operators because they were joint venturers, and thus they were immune. Some language cited in Heavin needs some scrutiny. The Plaintiff contended the non-operators had nothing to do with the supervision of the employees, nor did the non-operators work with the other employees. Essentially, the language in the offshore JOA was compared to the language to the JOAs in Arkansas in regard to the issue of individual versus joint liability. The operator calls the shots, and the non-operators invest monies. The Court found "these facts do nothing more than demonstrate the allocation of responsibility among the joint venturers". In Davidson, the Court found that despite the magic limiting language, operators and non-operators were engaged in a joint venture partnership as a matter of law.

Last year, I was involved in litigation wherein I represented a entity who provided services to an operator, and there was a concern the operator would not have the ability to pay the bills, so the third party brought the non-operators in, in part, under the JOA. The JOA specifies a legal relationship between the operator and non-operator. The following facts should be noted concerning the boilerplate JOA:

A. The parties jointly own oil and gas leases which have been pooled in the contract area as specified in the JOA. In other words, the parties are tenants in common concerning jointly owned leases.

B. One party is designated as the operator, and the other parties are non-operators.

C. Non-operators receive daily progress reports, and get to make a casing point election.

D. The operator can be replaced by any of the non-operators based upon certain circumstances. Any of the parties may be voted in as operator based upon operator's resignation, if the operator decided not to participate in a proposed operation in the contract area, or insolvency.

E. Each of the parties are obligated in the initial well to pay their proportionate share of costs in drilling the well. The execution of the JOA makes the payment of drilling costs for the initial well obligatory. Each party, including the operator, can individually elect whether or not to participate in completing the initial well, drill another well, or any other operation in the contract area after the initial well reaches total depth.

F. If any party, including the operator, fails to pay its proportionate share of the costs, the other parties are obligated to pay for the non-paying parties' costs.

G. The operator is required to carry insurance for the benefit of the joint account of the parties as outlined in the JOA.

H. Under the terms and conditions of the JOA, the operator may settle an uninsured third party damage claim or suit arising from operations if the expenditure does not exceed a certain amount. The typical JOA will contain the figure of $5,000.00 - $10,000.00. The operator and non-operators shall assume and take over the further handling of the claim or suit unless the authority is delegated to the operator. All costs associated in handling or otherwise discharging such a claim or suit shall be at the joint expense of the parties participating in the operation from which the claim arises.

I. A review of the JOA reveals numerous references to the word "joint property". The non-operators have the right to audit the operator's account, the operator has the ability to provide materials for the joint account, and non-operators have the right to furnish the materials suitable for use and acceptable by operator. Under a JOA, a joint account is established to keep track of income and expenses.

Even though the JOA states the parties are not partners, an argument can be made that the parties are joint venturers or partners concerning the drilling of the initial well. What makes the parties partners or joint venturers? Clearly, the parties own a joint interest in oil and gas leases. Clearly, the parties will share profits and losses in the venture. If the initial well becomes a producer, the operator and non-operators will share in their proportionate share of the revenues. The contra argument is that the non-operators have no lack of mutual control, that all of the responsibility is on that of the operator, and that the non-operators are not involved in any of the decisions. Generally, the non-operators receive daily drilling reports about the progress of the well. The non-operators are notified, consulted, and agree on whether or not to complete the well.

Under Arkansas law, if you are representing a third party who is attempting to get at the non-operators based upon the operator's insolvency or upon a tort claim, in order to defeat the language contained in the JOA, you need to establish the parties are joint venturers or partners.

JOINT VENTURE

Under Arkansas law, in order for a business enterprise to constitute a joint venture, two or more persons must combine a joint business venture for their mutual benefit. There must be a right of mutual control or management of a venture, and there is an express or implied understanding that they are to share in the profits or losses of the venture. Tacket v. Gilmer, 496 SW 2d 368 Ark. (1973). There appears to be no dispute that the operator and non-operators jointly own leases in the contract area, and there is no dispute they share in the profits and losses in the well. Each party is to receive their share of revenues if the well is productive, and they all pay their proportionate share of drilling costs. One issue that can be argued is whether or not there was is a right of mutual control. In Spangler v. Comer Lumber and Supply Co., 439 SW 2d 792 Ark. (1969), the Supreme Court of Arkansas found there was substantial evidence to sustain a finding that the parties were joint venturers and were liable for oil well drilling supplies furnished to one party. In Spangler, the argument was made that there was no evidence of a right to direct and govern the movements of the operator in respect to the joint venturer, but the Court found it significant there was evidence that the parties advanced substantial sums of money in the drilling of the well even though they contend they had no legal responsibility to do so, and they also received progress reports.

Non-operators will place significance on the fact that the parties have no control over the operation. If the operator were simply standing on its own with no communication between the non-operators, perhaps the argument could be made there was no right of mutual control, but their discussions and consultation in the above referenced matters indicate they "may" have the right of mutual control. It is important to remember that the JOA provides a mechanism wherein a non-operator becomes the operator.

A contra argument can be made by virtue of a case styled Stone v. Riggs, 163 Ark. 211 259 SW 2d 412 (1924). Stone stands for the proposition that the parties were not joint venturers in developing the oil and gas lease. Stone is distinguishable from Spangler in that the Stone Court stated "where one is only interested in the profits of a business as a means of compensation for services rendered by himself, or for the rent or hire of property furnished by him in the prosecution of the business, he's not a partner." The Court in Stone further stated "where the profits are merely a measure of compensation, no partnership is created.". In Stone, two cases are cited, Beebe v. Olentine, 97 Ark. 390, 134 SW 936, and Hayes-Thomas Grain Co. v. Wilcox, 144 Ark. 621, 223 SW 357 which are worth mentioning. In Beebe, the parties jointly purchased land for the purpose of speculation, and each party was to pay an equal amount of the purchase price, and to share equally in the final profits arising from future sales even though only one party was responsible for running the joint venture. The Court held that this showed an intention on their part to form a partnership for the purpose and sale of timberlands. The parties, by their contract, engaged in a joint enterprise, and shared the profits and losses equally. In Hayes-Thomas Grain Co., the Arkansas Supreme Court held there was a partnership where the parties had entered into a community of interest between a construction company and contracting company, and the Court found that there were all the elements of a joint enterprise and a joint contribution to a common end in the sharing of profits. This created a partnership between the contracting company and the construction company.

JOINT OPERATING AGREEMENT PROVISIONS

A non-operator will argue that the limiting language does not deem them joint venturers or partners because of the stated intent. However, the following language is noteworthy:

> Liability of Parties: The liability of the parties shall be several, not joint or collective. *Each party shall be responsible only for its obligations, and shall be liable only for its proportionate share of the costs of developing and operating the Contract Area.*

There are numerous inconsistencies in a JOA which may be utilized by parties attempting to heap liability upon non-operators. For example, all the parties agree that the non-operators are obligated to pay for their share of the costs. If a non-operator fails to pay, then an operator could sue the non-operators for their share of costs. On the other hand, if an operator did not pay for its share of costs, the non-operators could sue the operator. The result is the non-operators must argue that each of the parties is obligated for their share of costs, but only to each other, and not to a third party. A third party will argue that each of the parties are obligated for their proportionate share of costs to a third party who supplies services to one of the drilling operations.

There are numerous references contained in the accounting procedure attached to the JOA to "joint owners, joint operations, and joint property". The non-operators clearly have the right to inspect or audit the books of operator concerning joint operations. Operator has to submit to an audit of these properties. There are extensive accounting procedures included in the JOA for the operator to follow in the handling of both income and expenses. Non-operators may claim operator is not their agent. Non-operators are bound by the decisions operator makes in regard to financial expenditures, and thus, is operator their agent?

The operator has ability to settle a lawsuit when there is a claim of a specified amount under the JOA. However, the consent of the non-operators is required prior to settling a claim in excess of this amount.

In regard to insurance, the following language is contained:

Operator shall carry or provide insurance for the benefit of the joint account of the parties.

If the drilling of the well was not a joint venture, why then would the operator be required to carry insurance for a joint account when only the operator is liable?

Non-operators cite disclaimers contained in the JOA which may be interpreted that non-operators would never be obligated to any third party the operator failed to pay. The disclaimers contained in the JOA may not be controlling based upon the acts of the parties. The intent of the parties is to jointly drill a well to a specified depth with the operator carrying on the day to day activities. It can be argued the JOA does nothing more than spell out division of duties or responsibilities. Under Arkansas law, if the parties are not joint venturers or partners, what would their relationship be called?

Under the terms and conditions of the JOA, each of the parties grant a security interest to the other parties concerning payment. Each of the parties executed a financing statement granting a security interest in the well to operator. This is further evidence of the relationship between the parties.

If a Court finds the parties are not joint venturers or partners, at a minimum, each of the non-operators may be responsible for their proportionate share of the costs.

QUASI-CONTRACT

As stated above, pursuant to the Ashland case, the Supreme Court of Arkansas held that a co-tenant was responsible for his fair share of costs despite cost overruns. The joint ownership of oil and gas leases legally makes the parties tenants in common in regard to those leases, and each party is responsible to account to the other party if any revenues are received in the well regardless of whether or not a joint operating agreement is in existence.

In a situation wherein a third-party supplier has not been paid by the operator, there is one other theory that should be considered concerning a cause of action against the non-operator. Dews v. Haliburton Industries, Inc., 708 SW 2d 67, 288 Ark. 532 (1986) concerns recovery by suppliers against non-operators for costs associated with drilling a well. The Court sustained a cause of action for recovery under a quasi-contract theory wherein services had been performed for the benefit of another party in drilling the well.

Under the theory of quasi-contract, a third party could recover for the services rendered in drilling the well. If no liability could be attached to the non-operators, this would essentially mean that the non-operators would receive benefits from drilling a well for which they have not paid all the expenses. In Dews, the Court found that there were valuable materials placed in the well, and that one of the parties would have been unjustly enriched if he were not required to pay for the work. In Dews, various companies responsible for drilling the well filed suit against the operator in an attempt to collect monies owed to them. Dews was joined as a third party defendant who received the benefit of the well being drilled, and Dews argued there was no contract between him and the other parties, he had no legal responsibility to pay for same. Quasi-contracts or contracts implied in law are legal fictions created by the law to do justice. They do not rest upon the express or implied consent of the parties. Rather, the underlying principles that one should not unjustly enrich himself at the expense of another. Dunn v. Phoenix Village, Inc., 213 Fed. Supp. 936 Wd Ark. (1963). In Dews, testimony at trial demonstrated that Dews was aware that the companies were performing valuable services for the well. The Court found that Dews would not be allowed to standby and watch the companies perform services without being liable in some form. The Court found that the company suing Dews in good faith had performed services on the well, and that Dews, as the owner of the majority of the working interest of the producing well, had accepted and used their services. The Court therefore found that the companies providing services to the well could recover from Dews.

JOA PROBLEMS WORTH MENTIONING AND POSSIBLE SOLUTIONS

Problem:

1. Non-operators don't pay the bills on time. What are operator's remedies?
2. Operator forwards AFE, non-operator signs AFE and returns same to operator. Operator sends thirty (30) day advance billing, and non-operator doesn't pay on time. What are operator's remedies?
3. Non-operators say operator is incompetent, and has been billed for expenses which are not recoverable under the JOA. What are non-operator's remedies?

Suggestions:

1. Don't do business with non-operators or operators you don't trust.
2. Set up escrow accounts.
3. Limit exposure and operations to a percentage of anticipated costs. (150-200%)
4. Carry lots of insurance on the joint account.

CONCLUSION

The insolvency of major companies makes the old way of business very risky. Do you remember the day when Texaco filed for bankruptcy protection following the Getty Oil-Pennzoil case? Anybody heard of a company named Enron?