[Oil and Gas, Natural Resources, and Energy Journal](https://digitalcommons.law.ou.edu/onej)

Volume 1 | Number 2

January 2015

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

Christopher S. Kulander
South Texas College of Law, ckulander@hcl.edu

Recommended Citation

Christopher S. Kulander, *Old Faves and New Raves: How Case Law Has Affected Form Joint Operating Agreements—Problems and Solutions (Part Two)*, 1 Oil & Gas, Nat. Resources & Energy J. 165 (2015), https://digitalcommons.law.ou.edu/onej/vol1/iss2/3

ONE J

Oil and Gas, Natural Resources, and Energy Journal

VOLUME 1 NUMBER 2

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

CHRISTOPHER S. KULANDER**

Table of Contents

* Due to considerations of length, this article is being published in two parts. The first part appeared in vol. 1, no. 1.

** Christopher Kulander, Of Counsel, Haynes and Boone, LLP, & Director, Harry L. Reed Oil & Gas Law Institute, South Texas College of Law. Licensed in New Mexico and Texas. B.S. (Geology) 1993, Wright State University; M.S. (Geophysics) 1995, Wright State University; Ph.D. (Geophysics—Petroleum Seismology) 1999, Texas A&M; J.D. 2005, University of Oklahoma College of Law. The author thanks the following people who assisted in various ways in the completion of this report: Owen Anderson, Buddy Clark, Michel Curry, James Franks, Donald Jackson, Byron Kulander, John Lowe, Riva Laughlin, Mark Mathews, John Reeves, Glynn Starling, Lucas Tanner, and Natalie Tarenko. Background portions of this paper, updated as necessary, appear in John Lowe, et al. CASES AND MATERIALS ON OIL AND GAS LAW (6th Ed. West 2012). Some case law descriptions included in this paper appear in Christopher Kulander, *Oil, Gas, and Energy Case Summaries*, TEX. J. OIL, GAS & ENERGY L., Vol. 9, No. 2 (2014).

I. Operator Liability, Removal, and Replacement

The Form JOAs contain remedies for operators against non-operators who fail to make timely payment of their share of expenses or otherwise default in their obligations. Non-operators typically face a steeper climb when challenging the operator, however, particularly when seeking redress under the provisions for removal of an operator for failure to carry out its duties. Removal of an operator is rightfully seen as a last resort in conflicts between operators and non-operators. Litigation over whether certain exploration and production activities of an operator constitute a violation of the "good and workmanlike" standard have often ended favorably for operators. However, questions related to the *financial obligations* of an operator are different.

A. Exculpatory Clauses

Exculpatory language in the Form JOAs can significantly limit the ability of nonoperators to hold the Operator liable or recover damages.[1] The operator acts on behalf of the non-operators subject to a "good and workmanlike" standard, but is only liable for its actions/omissions in its capacity as "Operator" as defined in the JOA only where it acts with "gross negligence or willful misconduct." Questions continue to arise as to exactly what conduct by the operator is subject to the exculpatory clause.

Problem: *In 1992, Mustaine Petroleum purchased a 55% working interest in the leases comprising the Cold Sweat Prospect from Freidman Petroleum, with same leases comprising the Contract Area of a 1982 Form JOA. Freidman Petroleum had been the operator of the Cold Sweat Prospect since 1952 and during the lifetime of the prospect over 1.6 million barrels of oil had been produced. Although required by the terms on the JOA, no vote to replace or approve the new operator was made. Not long after the assignment to the new de facto operator Mustaine Petroleum, however, the cost of operating the wells on the Contract Area rose dramatically, and production decreased due to maintenance problems. Some non-operators approached Mustaine Petroleum about purchasing its interest in the prospect. Meanwhile, Mustaine circulated an AFE to cover the costs of proposed maintenance on the wells. The circulation of this AFE triggered the 'consent/non-consent' option for the non-operators, possibly invoking a 300.00% penalty for non-consenters. Some non-operators did not consent, did not sign the subsequent AFE, and did not pay any of their proportionate shares of the proposed costs, nor even consented to Mustaine Petroleum being made the operator. Shortly thereafter, Mustaine Petroleum curtailed production to approximately one barrel per day—the minimum to hold the leases.*

In the following litigation, the trial court found that the non-operators had 1) waived their objection to Mustaine Petroleum being the operator by

1. *See e.g.*, Article V.A of the 1989 Form.

accepting the benefits of Mustaine Petroleum's performance (limited though those benefits were), and 2) that under the terms of the JOA, the operator was not allowed to start any single project costing over $30,000 unless that project was either connected to drilling, reworking, deepening, completing, recompleting, or plugging back of a well which had already been authorized pursuant to the JOA. The trial court also found that, despite Mustaine Petroleum's claim, the circulation of the AFE was a breach of contract because the work proposed in the AFE was not reworking and that due to the initiation of the consent/non-consent option through circulation of the AFE and its invocation of the 300% penalty to non-operators, the non-operators did in fact suffer damages. On appeal, Mustaine Petroleum claimed that even if it was liable for breach of contract, the exculpatory clause in Article V.A of the JOA limits its liability to gross negligence or willful misconduct. Does the exculpatory clause absolve Mustaine Petroleum of liability?

Perhaps the single most commonly cited operator removal/exculpatory clause case is *Abraxas Petroleum Corp. v. Hornburg*,[2] wherein the following exculpatory clause found in the 1977 and 1982 Form JOAs was considered by the El Paso Court of Appeals:

> "[Operator] …shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct."[3]

At the district court level, the jury failed to find that the appellant operator, Abraxas, had acted with gross negligence and/or willful misconduct and that Abraxas' liability sounded in contract law. The Texas Court of Appeals in El Paso, in examining the issue of whether Abraxas could therefore be found liable for exemplary damages, found that the exculpatory clause in the JOA applies to claims that the operator failed to act as a reasonably prudent operator but does not apply to contractual claims against the operator arising from failure to comply the terms of the JOAs.

In making this decision, the court of appeals first noted that the exculpatory clause was unambiguous and was found in an article that

2. *Abraxas*, 20 S.W.3d at 759.
3. *Id*.

concerned the operator's authority to conduct operations in the Contract Area, suggesting an intent by the drafters to limit its applicability to operational conduct. More significantly, in the court's eye, was the fact that the operator's limitation of liability was linked directly to imposition of the duty of the operator to act in a reasonably prudent manner—a duty strictly concerning the manner in which the operator conducted drilling and production operations on the lease. Therefore, the court concluded that the exculpatory clause was limited to claims based upon allegations that the operator failed to act as a reasonably prudent operator and does not apply to a claim that it breached the contractual terms of the JOA.[4]

Only a year removed from *Abraxas*, the Eastland Court of Appeals released its aforementioned *Cone* opinion, holding that the exculpatory clause in a 1982 Form only absolves claims that the operator had not acted in a good and workmanlike manner with regards to operations. [5] Contractual breaches of the terms of the JOA were not released. The court opined thusly:

> "In the operating agreement, the language which requires a showing of gross negligence and willful misconduct immediately follows the provision requiring the operator to conduct operations in a good and workmanlike manner. [Non-operator's] complaints did not allege the failure of [operator] to operate in a good and workmanlike manner. Rather, [Non-operator's] complaints alleged breaches of specific terms of the agreement and are in the nature of an accounting. . . . The gross negligence/willful misconduct requirement applies to any and all claims that the operator failed to conduct operations in a good and workmanlike manner. The court in *Abraxas Petroleum Corporation v. Hornburg* reached a similar result in interpreting this same clause."[6]

Further cases help define the issues of application of the exculpatory clause and the scope of gross negligence and willful misconduct. In 2003, the Houston [1st Dist.] Court of Appeals in Texas considered the standards required to show gross negligence and willful misconduct. Specifically, in *IP Petroleum Company, Inc. v. Wevanco Energy, L.L.C.*,[7] non-operator signatories to a 1956 Form sued in contract claiming that the operator failed to reach the target depth and that this constituted gross negligence and/or

4. *Id.*
5. *Cone*, 68 S.W.3d 147.
6. *Id*. at 155.
7. 116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

willful misconduct. The district court found that the operator's failure to reach the target depth was a result of gross negligence and/or willful misconduct.[8] The court of appeals reversed, holding that the evidence did not support the finding that the operator had acted with gross negligence and/or willful misconduct and that the exculpatory clause applied to any unworkmanlike activity of the operator. The court noted that gross negligence required a finding of great malfeasance, rather than just a series of smaller errors.

Also in 2003, another Texas Court of Appeals considered the exculpatory clause in Article V of the 1982 Form and opined on whether it was limited to claims involving actual operations or whether it also covered contractual breaches of the terms of the JOA. In *Castle Texas Production Ltd. Partnership v. The Long Trusts*,[9] the trial court found the operator liable for breach of contract. The court of appeals agreed, rejecting the operator's argument that the exculpatory clause exonerated any such breach, holding:

> "[Operator] attempts to entirely escape liability for breach of contract arguing that it cannot be held to have breached the JOAs absent proof that it was guilty of "gross negligence or willful misconduct," the standard of care prescribed by Article V.A. of the [1982 Form] JOAs. This clause, however, is limited to claims that [operator] failed to act as a reasonably prudent operator in its operations in the Contract Area and does not apply to a claim that it otherwise breached the JOAs."[10]

The exculpatory language in the 1989 Form is subtly different then that employed in the 1977 and 1982 Forms, possibly resulting in different interpretations as to application. Considering the following:

Problem: *Roth Oil and Anthony Gas were operator and non-operator, respectively, to a 1989 Form that covered the mineral interests comprising the Duster Unit in Texas. After state authorities broke up the unit for lack of production, Anthony Gas sued Roth Oil, claiming that it had failed to maintain production in paying quantities, causing oil and gas leases potentially worth millions of dollars to expire and the unit to be broken up. Roth Oil claimed that the exculpatory clause in Article V.A of the JOA absolves it of liability. Is Roth Oil correct?*

---

8. *Id*. at 896-7. (The case does not expressly state the vintage of the JOA form, but the language cited is suggestive of a 1956 Form.)

9. 134 S.W.3d 267 (Tex. App.—Tyler 2003, pet. denied).

10. 134 S.W.3d at 283-84.

In *Wendell Reeder v. Wood County Energy, LLC*,[11] a unanimous 2012 opinion issued by the Texas Supreme Court that compared the exculpatory language in the 1977 and 1982 Forms to the corresponding exculpatory language in Article V.A of the 1989 Form, the Court found that the operator was not liable for its activities under the JOA unless those activities involved gross negligence or willful misconduct. In other words, the claims of non-operators arising under allegations that the operator failed to conduct activities as contractually prescribed by the terms of the JOA was found to be precluded by the exculpatory clause.

In *Reeder*, the Court considered the case of an operator who faced claims by non-operators that it had failed to maintain production in paying quantities, causing leases potentially worth millions of dollars to expire and the Texas Railroad Commission (the "RRC") to break apart a unit and suspend operations therein. The operations were conducted pursuant to the 1989 Form. At trial, a jury found the operator had breached its duty to the non-operators by failing to maintain production in paying quantities. The court of appeals affirmed, and held that the exculpatory clause in the JOA at issue should not be applied to shield the operator from the claims of the non-operators because the clause did not apply to breach of contract claims like the ones before the court. Therefore, it was not necessary that the operator first be found to have behaved with either gross negligence or willful misconduct.

The Supreme Court of Texas first noted that, unlike the 1977 and 1982 Form JOAs that provide "[Operator] shall conduct *all such operations* in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct," the 1989 Form provides in Article V.A that "[Operator] shall conduct *its activities under this agreement* as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct." (emphasis added)

Drawing upon the difference between the exculpatory language of "its activities under this agreement" in the 1977 and 1982 Forms versus "all such operations" in the 1989 Form, and noting that some commentators[12]

11. 395 S.W.3d 789 (Tex. 2012).

12. *See* Robert Bledsoe, *The Operating Agreement: Matters Not Covered or Inadequately Covered*, 47 ROCKY MTN. MIN. L. INST. § 15.03[1] (2001); *see also* Wilson Woods, *The Effect of Exculpatory Clauses in Joint Operating Agreements*, 38 TEX. TECH. L. REV. 211, 214-15 (2005).

have concluded the 1989 Form provided for a more expansive exoneration of the operator, the Court held the 1989 Form's exculpatory language broadened the range of operator activities covered by the exculpatory clause outside of those strictly relating to operations under the JOA.

Specifically, this interpretation of the 1989 Form exculpatory clause yields that the clause covers not only basic oilfield operations but also all activities covered under the form JOA. The Court opined, "The [1989 form JOA exculpatory clause] implicates a broader scope of conduct following the language of the contract. The agreed standard exempts the operator from liability for its activities unless its liability-causing conduct is due to gross negligence or willful misconduct." After subsequently finding that the operator had not acted with gross negligence or willful misconduct, the Supreme Court reversed and ruled in favor of the operator.

The implication of *Reeder* is that application of the exculpatory clause to a failure by the operator to satisfy basic contractual obligations under the 1989 Form may render such breach not actionable unless the breach rises to the level of "gross negligence or willful misconduct," as determined by the fact-finder. It may now be that operators under a 1989 Form will be exempted from liability to non-operators if the operator acts with mere ordinary negligence.

B. Gross Negligence and Willful Misconduct

The definitions of "gross negligence" and "willful misconduct" have been heavily scrutinized. Gross negligence is, of course, heightened negligence. One commentator has opined that "[g]ross negligence is generally defined as the failure to use even slight care."[13] The Texas Supreme Court has defined it as "that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the rights or welfare of the person or persons to be affected by it."[14] In the oil and gas context, one court has required the plaintiff to show that a defendant "had actual subjective knowledge of an extreme risk of serious harm."[15] The risk is considered from a subjective point of view—what did the operator know or should have known about the

13. Andrew Derman, *Joint Operating Agreement: A Working Manual*, p. 27, White Paper, Thompson & Knight, LLP, *available at* http://www.tklaw.com/files/Publication/afd3af63-c4d4-429f-8884-9ef64167b148/Presentation/PublicationAttachment/a9271338-00f3-4c77-897f-d5a53776ca16/Joint%20Operating%20Agreement%20-%20Derman.pdf (last visited May 23, 2015).

14. Burk Royalty Co. v. Walls, 616 S.W.2d 911, 920 (Tex.1981).

15. *IP Petroleum Co.*, 116 S.W.3d at 897.

magnitude of the risk—with said risk known to the defendant to likely result in "extraordinary harm, not the type of harm ordinarily associated with breaches of contract or even with bad faith denials of contract rights" but instead actual "'death, grievous physical injury, or financial ruin.'" Generally, evidence that the operator had actual subjective knowledge that there existed an extreme risk of significant harm but still chose to act must be present for a finding of gross negligence in the JOA context.[16]

"Willful misconduct" is similar to gross negligence and Texas courts, at least, have not much differentiated the two.[17] One commentator has suggested that willful misconduct might require a heightened element of intent.[18] Like gross negligence, a finding of willful misconduct typically requires some evidence of "a specific intent…to cause substantial injury…"[19]

Problem: *Ortega Oil, as operator, and Squier Gas, as non-operator, executed a 1956 Form covering the mineral interests comprising the Rock Me Tonite Video Prospect. The terms of the JOA required Ortega Oil to drill to a depth that would allow for testing of a certain prospective formation. Ortega Oil drilled to approximately the necessary depth but after a rather haphazard open hole completion of the well, it decided to plug and abandon the hole. The operator notified the non-operator of the abandonment and, per the terms of the JOA, offered to turn control of the well over to Squier Gas. Squier Gas, after inspection of the site, believed the Ortega Oil had acted with gross negligence and/or willful misconduct and brings suit. Is Squier Gas correct?*

In *IP Petroleum Co.*, a Texas court of appeals considered the boundary between mere negligence and gross negligence and/or willful misconduct. Before the case, the parties had executed a JOA Form requiring the operator to drill to a depth necessary to test a specified formation. When the borehole approached TD, however, the operator completed the well at what it thought was the required depth and announced its intention to plug and abandon the hole. Under the terms of the JOA, after this required notice of operator's intention to plug and abandon ("P&A") the hole, the non-operators could then either accept the decision or take over the well provided they agreed to take on P&A responsibility. The non-operators believed, however, that the operator had mis-completed the well and sued.

16. Transp. Ins. Co. v. Moriel, 879 S.W.2d 10, 22 (Tex. 1994).
17. *Id*. at 11-12, citing *IP Petroleum Co., Inc.*, 116 S.W.3d at 897.
18. Jeanine Feriancek, *Liability for Negligence?*, 11 NAT. RESOURCES & ENV'T 58, 60 (1996).
19. *IP Petroleum Co., Inc*., 116 S.W.3d at 898.

The trial court found the operator had acted with both gross negligence *and* willful misconduct. The court of appeals reserved, finding only ordinary negligence and thus the operator was relieved of liability by the JOA's exculpatory clause.

C. Operator Removal and JOAs with No Removal Provisions

Very generally speaking, the more recent the vintage Form JOA at issue, the greater the likelihood of success for operator removal, especially in connection with an operator's breach of financial obligations. Many custom JOAs do not directly address operator removal. Only when the operator resigns or sells all of its rights and interests in the Contract Area is replacement expressly provided for in the 1956 Form, for example, but the only self-help remedies for non-operators seeking to remove an operator would be through the courts. As one commentator has suggested, the dearth of case law regarding removal of an operator under the 1956 Form may suggest how difficult and impractical this avenue would be.[20]

Still, however, JOAs that do not expressly provide for the removal of an operator are occasionally litigated, often with non-operators losing. In *Cross Timbers Oil Co. v. Exxon Corporation*,[21] the Amarillo Court of Appeals considered a JOA executed in 1965 which did not cover operator removal. In the buildup to the case, the operator was voted out but refused to relinquish control. The court refused to overturn the summary judgment of the district court in favor of Exxon after finding no express provision in the JOA allowing for operator removal and no grounds to imply a right for removal.[22] The court reasoned that while the JOA gave some rights to the non-operators to determine the nature and scope of operations on the Contract Area of the JOA, the manner in which those operations were actually accomplished were determined solely by the operator. Thus, the court determined that allowing for the removal of the operator by the non-operators would grant the non-operator powers that were not stipulated or implied in the JOA.[23] One commentator believes that in the absence of a removal provision, a court is unlikely to imply one.[24]

---

20. Fabeńe Talbot, *Removal and Replacement of the Operator under the Model Forms of Joint Operating Agreement*, Texas Bar Journal, Vol. 64, April 2001.

21. 22 S.W.3d 24 (Tex. App.—Amarillo 2000, no pet.)

22. *Id*. at 28.

23. *Id*.

24. Ernest Smith & John Lowe, *The Operator: Liability to Non-operators, Resignation, Removal and Selection of a Successor*, Special Inst. on Operating Agreements, Rocky Mountain Mineral Law Foundation (2008).

D. Operator Removal and JOAs with Removal Provisions

Exculpatory clauses in the 1977, 1982, and 1989 Forms provide a measure of protection for operators. In operator removal cases, these clauses pay an important role because, if cause is necessary for operator removal, a showing that an operator was negligent (if the JOA contains no exculpatory clause) or acts in a grossly negligence manner and/or is guilty of willful misconduct (if the JOA does contain an exculpatory clause), the operator can be removed. The scope of the protection provided by exculpatory clauses has been litigated almost ceaselessly.

1. "Good Cause" for Removal

The 1977, 1982, and 1989 Forms all allow non-operators to remove an operator for cause provided some due process protocols are followed, with the 1977 and 1982 Forms being the most similar. The 1977 and 1982 Forms both dictate in Article V.B.1 that the "Operator may be removed if it *fails or refuses to carry out its duties hereunder*…or become insolvent" (emphasis added). Whether or not this phrase necessitates the non-operators to prove that the operator has been grossly negligent or guilty of willful misconduct remains a hotly contested question.

For example, Article V.A of the 1977 Form also states that the operator must conduct itself in a "good and workmanlike manner," but provides that the operator "shall have no liability as operator to the other parties for losses sustained or liabilities incurred, except as such may result from gross negligence or willful misconduct." The "good and workmanlike" standard, vague to begin with, is therefore fettered with this type of exculpatory clause from the 1977 Form forward, which seemingly raises the threshold of liability beyond just failing to meet the average workaday standards of the oilfield and into the realm of flagrant inattention or recklessness. This arguably eliminates mere allegations of breach of contract as grounds for removal under the 1977 or 1982 Forms.

Not surprisingly, most operator removal cases under Form JOAs involve difficult arguments over whether actions by an operator were contrary to its "good and workmanlike manner" duties—and exactly what those duties are. One commentator feels that the reference to "duties" is far wider than merely just operating in a "good and workmanlike manner."[25] Other commentators have noted that combining a "for clause" removal provision

25. Lowe, *supra* note 38 at 29.

with the exculpatory "gross negligence or willful misconduct" language in the 1977 and 1982 Forms makes an operator "virtually removal proof."[26]

Indeed, in Texas, many of these removal cases involving the 1977 and 1982 Form are now won by the operator, but not always. In *Stine v. Marathon Oil Co.*,[27] a federal court of appeals interpreted the 1977 Form[28] exculpatory clause, opining, "The clause at issue is sufficiently clear and unambiguous. The clause provides that the Operator 'shall conduct all such operations in a good and workmanlike manner, but it shall have no liability *as Operator to the other parties* ... except such as may result from gross negligence or willful misconduct.'[29] It is clear to us that the protection of the exculpatory clause extends not only to 'acts unique to the operator,' as the district court expressed it, but also to any acts done under the authority of the JOA 'as Operator.' This protection clearly extends to breaches of the JOA."[30] More significantly, in the court's eye, was the fact that the operator's limitation of liability was linked directly to imposition of the duty of the operator to act in a reasonably prudent manner—a duty strictly concerning the manner in which the operator conducted drilling and production operations on the lease. Therefore, the court concluded that the exculpatory clause was limited to claims based upon an allegation that the operator failed to act as a reasonably prudent operator and does not apply to a claim that it breached the contractual terms of the JOA.[31]

The 1989 Form further refines the operator's standard of conduct and allows a non-operator to seek removal "for good cause by the affirmative vote of non-operators owning a majority interest based on ownership…after excluding the voting interest of operator." The "fails or refuses to carry out its duties" language from the 1977 and 1982 Forms is removed. "Good cause" is defined to be "not only gross negligence or willful misconduct but also the material breach of or inability to meet the standards of operator contained in Article V.A or material failure or inability to perform its obligations under this Agreement."[32] While this has been interpreted by at

26. Brian Bjella, *Removing the Operator Under the Joint Operating Agreement: Breaking Up is Hard to Do*, 45 ROCKY MTN. MIN. L. INST. 11-1, 11-21 (1999).

27. 976 F.2d 254, 260 (5th Cir. 1992).

28. The case does not make certain whether the Form JOA being litigated was the 1977 or 1982 form, but since it was apparently executed in early to mid-1982 (*see Stine* at 256-7), before the 1982 Form JOA was in wide release, the author believes it to be the 1977 Form JOA. The language cited appears identical.

29. *Id*. at 260. (Emphasis in opinion.)

30. *Id.* at 261. (Interestingly, the AAPL 1989 Model Form language is very similar to the language cited by the *Stine* court.)

31. *Id.*

32. 1989 Form art. V.B.1.

least one court as an easier standard to meet in order to achieve operator removal than "gross negligence or willful misconduct,"[33] operator removal under the 1989 Form for "gross negligence or willful misconduct" can still be an uphill battle for most non-operators when the focus is on arguments related to "good and workmanlike manner."

2. Removal for Failure to Meet Financial Obligations

Article VII.D.1 of the 1989 Form provides that any party's rights under the JOA may be suspended for failure to meet *financial* obligations—and such failure is not expressly subject to any exculpatory clause. The right to suspend a party's rights under Article VII.D.1 can be exercised thirty (30) days after written notice of default. If, however, the defaulting party is the operator, the non-operators have the right by vote to appoint a new operator "effective immediately," without reference to a cure period for the operator's default.

Two cases in Texas involving operator removal that apply the terms of the Form JOAs illustrate a path to remove an operator who has failed to meet its financial obligations under the JOA. *Tri-Star Petroleum Company v. Tipperary Corporation*[34] was an accelerated appeal from a temporary injunction issued by the district court in Midland requiring Tri-Star to relinquish its status as operator and prohibited interference with the successor operator's assumption of control while the non-operators sought a final judicial determination regarding operator removal from a project in Australia covered with a 1977 Form.[35] Unhappy with both the operator's accounting and field activities, the non-operator had voted to remove the operator and then voted to replace it with new operator named Tipperary, who then obtained a temporary injunction requiring Tri-Star to pass operational control to it. Tri-Star filed an accelerated interlocutory appeal challenging the temporary injunction, arguing both that a judicial decision

33. R. & R. Resources Corporation v. Echelon Oil and Gas, L.L.C., 2006 Tex. App. LEXIS 326 (Tex. App.—Austin 2006, no pet.) No. 03–05–00479–CV 2006 WL 66458 (unreported opinion)

34. 101 S.W.3d 583 (Tex. App.—El Paso 2003, pet. denied). In the case underlying the injunction, non-operators originally sought operator removal from a project in Australia, alleging the operator had failed to (i) conduct operations in a good and workmanlike manner under Article V of the 1982 Form and (ii) fulfill its duties under Article VII.D by improperly assessing charges in the joint account of the JOA, commingling funds in the joint account, inexplicitly classifying and reclassifying amounts billed to the joint account, failing to provide timely and proper adjustments for surpluses in the foreign exchange account of the JOA, and double-charging non-operators on cash calls and billings.

35. *Tri-Star Petroleum* involved a Texas-based operator and Australian non-operators attempting to develop a 2.3 million acre coalbed methane project in Australia.

was a condition precedent to remove an operator and that the temporary injunction could not have been made without a showing that the operator had failed to perform its duties.

Temporary injunctions require the prevailing party to show a probable right to recovery and probable injury if relief is denied. The time that the injunction becomes effective is important because the positions of the parties will be frozen at that instance in time for the duration of the injunction. Injunctions are used to maintain the status quo at the last peaceable, non-contested moment in time. The injunction in *Tri-Star* had been granted by the district court thirty days after the non-operators voted to remove the operator due to its alleged failure to conduct operations in a good and workmanlike manner, assessing of improper charges, commingling of funds, and double-charging for cash calls. The court therefore found the last peaceable non-contested status was thirty days after the vote of the non-operators to replace the operator, despite litigation existing before the vote. This means the status quo enforced by the injunction was that point after the vote where the operator had been removed by the terms of the JOA. The injunction therefore did not remove the old operator—it made it recognize the new operator.

The court of appeals rejected the operator's defense that the gross negligence standard should apply, at least in the case of a temporary injunction for financial failures.[36] This reasoning maneuvers around what had been a significant hurdle in past operator removal cases—proving the operator had acted in a grossly negligent manner.

In *R. & R. Resources Corporation v. Echelon Oil and Gas, L.L.C.*,[37] the operator appealed the grant of a temporary injunction, disallowing it from opposing the designation of a new operator after being voted out for failing to meet financial obligations under Articles V.A and VII.D.1 of the 1989 Form. The non-operators were unhappy with the accounting and operations of operator. Three non-operators, allegedly representing a majority of the working interest covered by the JOA, voted to remove the operator for "good cause" and to appoint a new operator. The operator refused to step aside, causing the non-operators to obtain a temporary injunction against the operator.

On appeal by the operator, the court upheld the granting of a temporary injunction, citing both *Tipperary* and the 1989 Form for the rule that

36. *Id*. at 590.

37. *R. & R. Resources Corporation* concerned an operator that failed to meet its financial obligations because it was billing non-operators for expenses incurred at least two months earlier and delaying paying expenses for several months despite its ability to pay them when they were due.

"[f]ailure to make prompt adjustments to an operating account and improperly assessed charges … have been bases for finding that an operator 'failed or refused to carry out its duties.'"

This decision seemed to expand the definition of "good cause" under the JOA past mere gross negligence or willful misconduct to include a material breach of or the inability to perform the operator's duties described in the JOA. With regards to the facts presented, the court found the operator had made inappropriate charges to the operating account and had failed to account promptly for charges to the operating account.[38]

The *R. & R. Resources* case also highlights the importance of assignments of working interests while maintaining voting rights under the JOA. After the execution of the JOA, the three non-operators which voted to remove the operator assigned some of their working interest to other parties via participation and subscription agreements which stipulated that the voting authority under the JOA was retained by the assignors. The court first had to analyze the participation and subscription agreements and decide if the assignors had retained voting authority in the first place. The case would likely have been decided differently if the court had found that the voting rights had been assigned in addition to the working interest, because a majority of the working interest—after discounting the working interest of the operator—may not have been present, thus invalidating the vote.

Many states have an agency that permits and keeps track of the status of operatorship. In Texas, removal of the operator requires the new operator to provide written notification to the RRC using a P-4 form acknowledging the new operator's responsibilities, which is also to be acknowledged by the former operator. If the former operator refuses to sign the P-4 form and the new operator wishes to assume official operatorship in the eyes of the RRC, the new operator can file the P-4, unsigned by the former operator, along with an explanatory letter and documents showing the right to operate the property. Prior to approval of such an application, the RRC will notify the last known operator of record of its right to be heard. As indicated in *R. & R. Resources*, if the current operator refuses to sign the P-4 or resign its operatorship, the RRC will most likely not decide the issue, but allow the matter to be decided by judicial determination.

At this point, litigation is most likely required to remove the current operator and resolve the dispute. A temporary restraining order or temporary injunction can be the first step. The injunctive relief sought can include both prohibiting the former operator from interfering with the

38. *R. & R. Resources* at 338.

successor operator's duties and from continuing to conduct operations under the JOA, among other prohibited actions. Under certain circumstances, the temporary relief can include incidental mandatory actions on the part of the former operator, such as allowing access to records of joint operations. As the court showed in *R. & R. Resources*, a trial court granting such temporary relief is acting within its reasonable discretion if it believes that operator's actions, including accounting and reporting practices with regards to the operating account, do not measure up to the "good cause" standard in the JOA.

3. Operator Removal for the 1977 and 1982 Forms vs. the 1989 Form

The 1977 and 1982 Forms both provide that the operator shall conduct operations in a good and workmanlike manner, but that it shall have no liability as operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.

Problem: *Dexter Gas, as operator, and Noodles Oil and K Petroleum, as non-operators, executed a 1977 Form JOA covering oil and gas leases comprising the Messed Up Prospect. Dexter Gas owned an undivided 70% of the prospect, while the non-operators each owned an undivided 15%. Later, Noodles Oil and K Petroleum sought to remove Dexter Gas as operator by vote. Are they successful?*

The 1977 and 1982 Forms vary slightly, however, in the voting procedures. Article V.B.1 of the 1977 Form requires for removal of operator "the affirmative vote of two (2) or more Non-operators owning a majority interest based on ownership as shown in Exhibit "A", and *not* on the number of parties remaining after excluding the voting interest of the Operator."[39] Article V.B.1 of the 1982 Form requires for removal of operator "the affirmative vote of two (2) or more Non-Operators owning a majority interest based on ownership as shown on Exhibit "A" remaining after excluding the voting interest of Operator."

In addition to the problem faced by a lone non-operator that cannot seek redress because of the two vote minimum, the difference in wording in the second clause between the 1977 and 1982 Forms was apparently meant to avoid allowing an operator with a majority interest to avoid completely a vote of removal, but the wording still is not completely clear.

Removal of an operator under Article V of the 1989 Form requires two votes, one for the removal of the operator and another to select a successor

39. AAPL 1977 Form art. V.B.1. Emphasis added.

operator. In practice, this might be accomplished by a combined ballot. Specifically, The operator may be removed, after notice or default and an opportunity to cure, by an affirmative vote of a majority in interest of the Non-operators based on the interests shown on Exhibit for "good cause."

The 1989 Form provides that a successor operator is selected by the affirmative vote of two or more parties that, between them, own a majority share of the assets as described in Exhibit A. A removed operator cannot vote to succeed itself, but that does not necessarily mean it cannot vote for a successor. If the operator owns a large interest or there are only two signatories to the JOA, then it may be impossible to select a successor operator, possibly necessitating a court order.[40] Until a successor operator is elected, the previous operator must continue in that role.

Industry practice seems to be that one non-operator with a small minority interest can remove an operator with a large majority interest, assuming it has a "good cause" and that there are no custom "other provisions" to the contrary. This potentially has some interesting results: consider the example of three parties to a JOA: an operator with 98.0% working interest, and two non-operators each with 1.0% working interests. The non-operators seek to remove the operator through the mechanisms of the Article V.B.1 of the 1989 Form. The non-operators could remove the operator as, after removing the 98% interest, the non-operators would own 100% of the remaining working interest. Given that this would mean the non-operating owners of very small interests could unilaterally remove an operator if their "good cause" argument stood, this could be an undesired result.

On the other hand, it could be argued that the change in wording does not go far enough and that the interest of the non-operators is not increased on a pro-rata basis after removing the working interest of the operator. No mention of a pro-rata or proportionate increase is made, unlike in other portions of the JOA where increases in the interest of parties after removal of interests of others in contemplated, such as in the calculations of the interest of consenting parties in Article VI.B.2.(a) of the 1982 and 1989 Form JOAs.

To the author's knowledge, no court has spoken to these interpretations, but a custom provision in Article XVI of the 1989 Form that makes clear the definition of "majority interest" as used in Article V.B.1 means either a fifty percent (50.0%) or more interest in all the working interests listed in Exhibit "A," including that of the operator, or that the interests of the non-

40. *See* Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd., 225 S.W.3d 577 (Tex. App.—El Paso 2005, pet. denied).

operators is proportionately increased in the event of a removal, may be considered.

4. Operator Removal When JOA is "Subject to" Other Agreements

What if the JOA provides for operator removal but is made expressly subject to another instrument, such as a farmout agreement, that does not contemplate removal? Consider the following scenario:

Problem: *After a contentious series of events, Ballamy Production was removed as operator under a Form JOA and replaced with Howard Oil. While removal was conducted correctly according to the express terms of the JOA, the entire project from which the JOA sprang originated from a farmout agreement that contained language that (1) named Ballamy Production as operator and (2) established primacy of the farmout in any event that the terms of the farmout and JOA conflicted.*

In *Inex Industries, Inc. v. Alpar Resources, Inc.*,[41] the Amarillo Court of Appeals considered whether operator removal may be precluded in instances where the JOA is expressly made subject to other agreements that do not provide for operator removal and that prevail in the event of a conflict of terms. *Inex* involved an operator that was granted a temporary injunction by the district court against a successor operator that wanted to take over operations.[42] In upholding the injunction, the court held that the original operator had furnished a probable right of recovery and agreed with the original operator that a farmout agreement that provided that the original operator "shall serve as Operator of the wells" and that the "this [farmout agreement] shall be controlling over the Operating Agreement in the event of conflicting provisions" overrode the operator removal clause in the JOA.[43]

5. Assignments by Operator and Operator Removal

Case law in Texas indicates that an election of a successor operator is triggered upon assignment of the current operator's interest.[44] Can the operator avoid removal by assigning a significant part of its working interest to a wholly owned subsidiary who will vote against removal?

41. 717 S.W.2d 685 (Tex. App.—Amarillo 1986, no writ).

42. *Id*. at 687.

43. *Id*.

44. *Abraxas*, 20 S.W.3d at 750 ("As found by the trial court, [operator's] sale of its interest to Abraxas resulted in its resignation as operator pursuant to Article V.B.1, thereby invoking Article V.B.2's requirement that a successor operator be selected from the parties owning an interest in the Contract Area.")

Problem: *Yorke Petroleum was the unit operator of the Creepy Project, which was comprised of leases joined together under a unit operating agreement. Greenwood Gas and O'Brien Oil were non-operators. The principles of Yorke Petroleum got news that the non-operators were planning on removing Yorke as operator. They decided to transfer almost all of Yorke Petroleum's interest to a new subsidiary, Selway Operating. The idea then was to have Selway Operating vote against operator removal, something Yorke was not allowed to do itself per the express terms of the JOA. Will such a maneuver work?*

In *Penmark Resources Co. v. Oklahoma Corporation Comm'n*,[45] the court ruled that the subsidiary was not an eligible working interest owner for operator removal voting purposes because it was controlled by the operator. The court opined that the working interest owners who were trying to remove the operator did not have to prove that the transfer of the working interest to the subsidiary was a sham transaction or that the subsidiary was the alter ego of its parent company.[46] The court focused instead on the corporate structure of the operator and subsidiary, pointing out that while the record showed that the legal formalities were observed in that separate tax numbers and tax payments were made by the operator and the new entity, overwhelming evidence existed that the subsidiary was an instrumentality of the existing operator.[47]

On a broader note then, can the assignee of the original operator vote at all when designating a subsequent operator? Consider the following scenario:

Problem: *Chamberlain Gas, operator, found itself at odds with non-operators Corgan Corporation and Iha Oil regarding the Chimera Prospect, a group of leases covered by a 1989 Form. Chamberlain Gas decided to step down as operator and to assign its interest to D'arcy Energy. Corgan Corporation and Iha Oil both wanted to be operator. In the subsequent vote to decide which company will be the new operator, can D'arcy Energy vote for one of the non-operators simply to keep the other from attaining operatorship? Can it vote for itself to be operator?*

---

45. 6 P.3d 1076 (Okla.Civ.App. 2000).

46. *Id*. at 181.

47. *Id*. at 182. (The court noted the two entities were created for the same purpose, had a common board of directors, common street address, and that the subsidiary had no employees but paid the parent company a monthly fee for using its employees, who were subject to the parent company's control.)

Little case law speaks to this, but Article V.B.2 of the 1989 Form JOA excludes the original operator's vote when the operator is removed *or* resigns—and provides that the successor operator must be picked from the parties owning an interest in the Contract Area at the time the successor is selected. On the other hand, two commentators believe that the successor owner of the operator's interest should be allowed to vote.[48] The timing of the operator's resignation, the assumption by the assignee of the interest, and the selection of the new operator by parties to the JOA is key. One possible way around this conundrum is that, as a condition of purchase, the (potential) successor owner of the original operator's interest requires that the original operator hold a vote *before* the assignment naming the successor owner the new operator.[49] Of course, such an issue could be addressed in the custom provisions of the JOA in the first place.

II. Liability for Costs Of Operations

Unless changed by other provisions in the JOA, all costs and liabilities incurred in operations under Form JOAs are typically borne and paid by the parties in the percentages of their ownership of the Contract Area.[50] The ownership percentages are typically listed in Exhibit A.[51] This ownership is sometimes parsed out with different percentages for "before payout" ("*BPO*") and "after payout" ("*APO*"). Often times, a broker or geologist will be carried at 0.0% ownership BPO and "back-in" at some ownership percentage APO, helping to avoid exploration and development costs. In the same manner, the operators and non-operators own all production, subject to payment of royalties and other burdens on production, by such percentages, typically regardless of which party has contributed a particular property or where a well is located.

48. C. Barry Osborne and Linda Featherstone. *12 Commonly Overlooked, Underappreciated and/or Screwed Up Transition Issues That Can Ruin Your Whole Day (or Deal)*, Paper #6 of the proceedings of the Rocky Mountain Mineral Law Institute annual symposium (2006).

49. *Id*.

50. *See, e.g.*, AAPL 1989 Form art. III.B.

51. Landman friends of the author pass along their wish for lawyers to always list and describe all properties in Exhibit A of JOAs (and other instruments, usually) with Exhibit A subdivided for various property types.

A. Limitations on Expenditures and Liabilities of the Parties

1. Limitations on Expenditures

The Form JOAs typically require updates on expenditures at regular intervals. For example, according to Article V.D.8 of the 1989 Form, the operator is required to send an estimate of both current and cumulative costs incurred at "reasonable" intervals. Often times, the estimated price on the AFE is exceeded, sometimes by a wide margin.

Problem: *Downing Oil and Tipton Gas agreed to drill a wildcat in the Judas prospect. Downing Oil, as the operator, circulated an AFE for the well. Tipton Gas received the AFE before operations were commenced. As drilling progressed, Tipton Gas grew concerned about the cost and time of development and eventually sent a letter to Downing Oil stating that it elected to "automatically" go non-consent when the estimated drilling costs in the AFE were reached by actual costs. Sure enough, the estimated costs of the AFE were reached by actual costs before the target depth was penetrated. Downing Oil continued drilling and accruing expenses, eventually reached the target horizon, and then—finding the hole dry—shut it in, accruing plugging and abandonment costs. Tipton Gas announced that it owed nothing after the point in time that it believed it had "automatically" gone non-consent. Downing Oil and the other working interest owners brought an action against Tipton Gas for its proportionate share of the costs that were accrued after Tipton Gas claimed it "automatically" went non-consent. What result?*

In *M&T, Inc. v. Fuel Resources Development Co.*,[52] M&T was an operator owning a 56.25% undivided interest in the Contract Area as defined in a 1956 Form executed in 1973, while non-operators McBride and Fuel Resources owned 18.75% and 25% undivided interests, respectively. While M&T was drilling a well in Jackson County, Colorado, Fuel Resources stopped paying its share of the development costs. M&T and McBride continued to pay while the hole was drilled to the targeted total depth, and plugged and abandoned in the Dakota-Lakota formation. $150,927 in costs were left unpaid by Fuel Resources. In response to M&T's subsequent claim, Fuel Resources argued that it did not agree to pay any overruns and could therefore go non-consent in the middle of operations as the drilling costs were too high because the AFE set a ceiling on operation costs. A Colorado court examined the tentative nature of joint operating agreements and opined:

52. 518 F.Supp. 285 (D.Colo.1981).

> "It is axiomatic that drilling costs cannot be estimated with certainty and that an AFE is at best a good-faith estimate. AFE's are usually exceeded, often by very substantial amounts…In the oil and gas industry, it is understood and accepted that when one signs an AFE, he is committed to his proportionate share of the necessary costs in drilling to the objectives specified in the AFE, unless the parties mutually agree to terminate drilling earlier or to attempt a completion at a shallower formation."[53]

The court went on to rule that an AFE does not set a cap and that the parties who sign an AFE are required to pay their proportionate share of the cost overruns.

In order to limit exposure to such overruns, a signatory of a JOA may want to either get such a limit agreed upon in writing before signing a particular AFE or to include in the custom terms of the JOA a clause that absolves non-operators who execute an AFE of the responsibility to pay further costs after the estimated costs of a project are exceeded by actual costs by a certain percentage, say 125%. In the absence of such contract modification, non-operators can typically challenge the costs assessed them by the operator only if the costs were incurred in bad faith or are excessive, unreasonable, or unauthorized by the AFE. In *True Oil Co. v. Sinclair Oil Corp.*,[54] the Wyoming Supreme Court rejected an argument that the operator was required to drill the well "at cost" and that the operator's affiliated companies were not entitled to profits for the services and equipment they had furnished. The court pointed out that the operator could have contracted out drilling and other services to nonaffiliated companies and in at least one instance had done so. "[C]ompetitive rates were what was mutually contemplated [under the parties' agreement]. Under these circumstances … the fiduciary duty to be met by True Oil [the operator] was to obtain drilling and related services at a reasonable cost as reflected by competitive rates."[55]

2. Cost Overruns

Problem: *Rabin Gas and Howe Operating were operator and non-operator, respectively, to a 1989 Form covering all the leaseholds in the Duster-in-the-Wind prospect. Rabin Gas proposed to drill a well. Howe Operating consented. Three years passed while Rabin Gas tried to get the necessary permits to drill. Finally, permits secured, Rabin Gas again*

53. *Id*. at 289.
54. 771 P.2d 781 (Wyo.1989).
55. *Id*. at 793.

proposed drilling the same well and Howe Operating again consented. The second proposal's estimate on drilling costs was higher than the first and assumed that Rabin Gas will conduct drilling and completion operations twenty-four hours a day. Soon, however, Howe Operating noticed that actual expenses were far more than the estimates it agreed to in the second proposal, primarily because Rabin Gas was only operating during daylight hours due to, it claims, equipment limitations. Howe Operating notified Rabin Gas that it was going non-consent and refused to pay any *costs associated with the present operation. A lawsuit followed, with Rabin Gas seeking foreclosure on Howe Operating's interest and with Howe Operating counter-claiming that Rabin Gas had materially breached the terms of the JOA, absolving it of the obligation to pay. Who prevails?*

In July 2013, the Tenth Circuit Court of Appeals decided *Elm Ridge Exploration Co., LLC v. Engle*,[56] a claim for the recovery of drilling expenses in New Mexico. Fred Engle was a non-operator to a Form JOA executed in 1992.[57] Through a series of assignments, Elm Ridge Exploration Company, LLC became successor operator under the JOA.

After a three year delay in acquiring the necessary permits in order to drill the well, Elm Ridge re-notified Engle of its intent to drill the well with a higher estimated cost. Engle again chose to participate. While the estimated cost of the well was calculated assuming that operations would proceed around the clock, the well was in fact drilled only during daylight hours, quickly increasing costs past the estimate. Engle refused to pay his share of the increased cost of the well. In response, Elm Ridge filed a complaint seeking foreclosure against Engle for allegedly defaulting on his obligation to pay his share of the drilling expenses in state court. Engle counterclaimed, alleging that, because Elm Ridge had breached the terms of the JOA, Engle should not have to pay for unauthorized expenses that Elm Ridge incurred. Engle removed the case to the U.S. District Court for the District of New Mexico.

The district court found that Engle was responsible for his share of the costs of the well that were not attributable to Elm Ridge's breach of the JOA terms and that Elm Ridge was entitled to a foreclosure order. Both Engle and Elm Ridge appealed to the Tenth Circuit wherein Engle contended that, when parties do not share fiduciary duties, excuse of performance should extend to a substantial (even if not material) breach of a contract by the other party. Therefore, Engle argued he should be excused from paying *any* share of the drilling expenses because Elm Ridge

56. 721 F.3d 1199 (10th Cir. 2013).
57. Language cited in the case suggests that a 1989 Form is at issue.

substantially breached the JOA when it resorted to the more expensive daylight-only operations without Engle's consent.

While Elm Ridge did not contest that it substantially breached the JOA because of the daylight-only operations, it contended that Engle was obligated to pay his share of the drilling expenses because the daylight operations had not harmed Engle. More specifically, Elm Ridge claimed that had it secured 24-hour rig operations pursuant to the cost estimate it had sent Engle, such operations would have been more expensive because of different permitting requirements. The court was not persuaded, noting testimony from trial showing that Elm Ridge could have waited for a 24-hour rig to become available without jeopardizing the drilling permit it had already obtained. Furthermore, the court noted that in the past, Elm Ridge would only spud wells using a daylight rig to preserve its drilling permit, finishing the well once a 24-hour rig was available.

Ultimately, the court affirmed that, although Elm Ridge had substantially breached the JOA, it did not materially breach the JOA.[58] Therefore, Engle's consent in participating in the drilling of the well and his implied acceptance of the drilling expenses were controlling. The court also affirmed, however, that Engle was only responsible for his share of the costs of the well that were not attributable to Elm Ridge's breach of the JOA.

B. Defenses to Claims for Payment

As seen above, parties typically are each obligated to pay their share of the costs of an operation to which they consented even if those costs significantly exceed original estimates. One reason for this prevailing view seems to be courts' recognition that parties to JOAs are (or should be) sophisticated enough to know that oil and gas operations involve risk and that sometimes projects end up costing (far) more than the estimates.[59] In certain circumstances, however, parties have successfully challenged this presumed obligation, particularly if the operator conducts operations in a way clearly different from the procedure prescribed in the approved AFE.

---

58. The court of appeals did not discuss the definitions of "substantially" and "materially" and how they differ, but noted both parties agreed to a jury instruction that a material breach by Elm Ridge would discharge Engle of performance but did not include discharge of performance for a substantial breach by Elm Ridge.

59. One commentator has suggested a sort of "rubes" defense" should exist where an operator that has heavily promoted a project to unsophisticated parties should only be able to collect the cost estimate in the AFE. *See* Robert Bledsoe, *Problem Areas in Drafting Operating Agreements—Some Suggested Solutions*, ADV. OIL, GAS & MIN. L. COURSE, State Bar of Texas (1981).

1. Breach of Terms of AFE

Problem: *Zander Gas, as operator, and Carlos Oil, as non-operator, executed a JOA covering the leaseholds and fee minerals comprising the Downer Prospect. Zander Gas sent out an AFE for drilling a well with terms that provided that drilling would be conducted under a turnkey drilling contract. Carlos Oil consented. The well was instead drilled with a day-rate contract and ended up costing much more than the estimate in the AFE. Carlos Oil refused to pay. Zander Gas sued. What result?*

The aforementioned *Haas* case[60] considered just such a scenario.[61] The court disallowed the operator to recover for the cost overage attributable to the change from, in that case, the footage basis provided for in the AFE to the day-rate cost used in reality.

2. Fraud and Misrepresentation

Problem: *Waters Oil convinced Gilmour Gas, Mason Production, and Wright Petroleum to invest in a water-flood scheme at the Sorrow Prospect. Waters Oil portrayed this investment as low risk and high yield, citing a nearby successful water-flood project (although no Waters Oil personnel had actually investigated the effort, expertise, geology, time involved, or details of the process that involved in the neighboring water-flood). Waters Oil claimed that the project would be conducted in a formation that has already proved its prospective nature. In a momentary lapse of reason, the other three companies invested in exchange for a 5.0% working interest in the leases, executed a 1989 Form that named Waters Oil as operator, and agreed to share costs and production. Sure enough, after two years of 'flooding,' the lease produced next to nothing except JIBs. Waters Oil decided to plug and abandon the well. The non-operators each refused to pay their share. Waters sued each for their proportionate share of the costs. What result?*

In *Barn v. Maloney*,[62] the court found that the operator's fraud induced the non-operators to participate. "After a careful consideration of the entire record before us, we are forced to the conclusion that [operator's] unqualified statements that 'We are working . . . on a sandbar development that has already proven its merit' and that 'Risk is minimal…' were false statements of material facts which, under the circumstances, amounted to fraud as defined above. We also conclude that his failure to mention the gas

60. Please see page 20 of Part One of this article.
61. *Haas*, 484 S.W.2d 127.
62. 516 P.2d 1328 (Okla. 1973).

cap and the possible necessity of filling it with water before flood effect would occur, as indicated by the 'experience record of Shell' which was common knowledge in the area and the failure to mention the unplugged wells in the immediate area that permitted loss of water and pressure, amounted to a concealment of material facts that he was bound under the circumstances to disclose."[63] The court held that under the circumstances, even if the operator had followed all the procedures of the JOA related to AFEs and JIBs, it could not charge for costs overruns because it deliberately understated projected drilling costs in order to induce the non-operators to consent to the project.

A brace of commentators have also suggested that an operator that negligently drafts an AFE so that the negligence can be shown to have resulted in an underestimation of costs may result in the challenging parties being excused from paying.[64] Litigating such an argument would seemingly be fact intensive and difficult.

3. Changes in the Operation

As discussed above, within both JOAs and AFEs are provisions that require the party or parties proposing subsequent operations to ask the other parties whether or not they would like to participate in the operation. As petroleum engineers and geologists know, however, projects specifics can quickly change as new information is made available. What happens when an operation is modified *after* requests for consents are sent out?

Problem: *Harris Oil, as operator, and Dickenson Gas, as non-operator, executed a JOA covering the leaseholds and fee minerals comprising the Alan Parsons Prospect. Along with the AFE, Harris Oil delivered to Dickenson Gas geologic maps detailing the location of nearby drilling sites and the proposed location of the new well. Also included was a cost estimate of one million dollars. Later—and without notice to Dickenson Gas—Harris Oil geologists decided that another site, about 1,500 feet from the first site, was a better location to drill. Upon drilling on the new site, however, the drillstem ran into a zone of unexpected metamorphic rock that drives up the actual costs to 1.5 million dollars—50% higher than the estimate. Dickenson Gas sought rescission of the JOA and the related exploration agreement reasoning that it was not informed of the new location before drilling and of the cost overruns after spudding. Harris Oil argued the original well location was just an estimate and that it could*

63. *Id.* at 1332.
64. SMITH AND WEAVER, TEXAS LAW OF OIL AND GAS, *supra* note 2 at § 17.3[C][1].

move the site a reasonable distance given a good scientific reason. Who wins?

In *Palace Exploration Company v. Petroleum Development Company*,[65] the non-operator/petitioner was an investor in an oil and gas well. The operator/respondent was an Oklahoma oil and gas exploration corporation. Both parties entered into an exploration agreement and JOA (form vintage unstated) to develop a prospect in Oklahoma. The operator faxed information of the two prospects to the investor, including the location of nearby wells and a proposed drilling site. An AFE was signed by the petitioner/investor estimating the cost of the project at $280,000. After determining that the geologic information on one of the maps sent to the investor was mistaken, the operator shifted the drilling location by 1,600 ft but did not mention the change to the investor. Upon drilling in the new location, the operator encountered more water-bearing strata than anticipated, requiring the use of specialized drilling mud that resulted in an increase in the estimated drilling costs to $378,057.

Petitioner brought an action seeking rescission of the JOA and the exploration agreement. One issue raised on appeal was whether sufficient evidence existed to establish that the operator had not committed constructive fraud under Oklahoma law when it failed to disclose a change in well location before commencement of drilling. The court ruled that evidence was sufficient to prove that the respondent had not committed constructive fraud. During the jury trial, an expert witness for the respondent had testified that the point that marked the drilling location on the geological structure map was only a tentative estimation of where the final drilling location would be. The court of appeals ruled that the jury's subsequent decision—finding that the changing of the drilling location by 1,600 ft from the position located on the map was not fraud—was reasonable based on the evidence and expert witness testimony presented at trial.

Article VI.B.1 of the 1989 Form requires any party in the JOA to notify all the other parties to the agreement of its intention to drill, rework, sidetrack, deepen, recomplete, or plug back any well within the Contract Area. The party proposing a new well is required to specify the work to be performed, the proposed depth, and the location of the hole. *Palace Exploration* suggests that the operator of the new operation continues to have considerable leeway concerning the location of the well, rework zone, or final production zone—at least if it has sound technical evidence to back up the location change. Therefore, if Article VI.B.1 (or a clause like it) does

65. 316 F.3d 1110 (10th Cir. 2003)

not pinpoint the exact location of the well as that laid out in the drilling proposal, those who want the location of the well to be the exact location of the proposed well might consider an addition provision either requiring a change in location to be approved by the participating parties or a clause simply disallowing a location change from that described in the drilling proposal.

4. Lack of Contractual Privity

Problem: *Cornell Oil and Cameron Gas were the non-operators and Sheppard Production the operator to a JOA over leaseholds and fee minerals comprising the Dusty Prospect. The JOA contained the following clause: "if the cost of drilling and completing the test well exceeds $355,000, Operator will bear all such excess costs." Another clause in the JOA provided that "It is not the intention of the parties to create, nor shall this agreement be construed as creating, a mining or other partnership or association, or to render the parties liable as partners." Sheppard Production then hired driller KlutzCo. to conduct a re-entry and sidetracking operation. KlutzCo. negligently damaged the hole, resulting in cost overruns and delays. The non-operators sued the driller and Sheppard Production, who counter-claimed against the non-operators for cost overruns not paid. Which side wins?*

In *Smith v. L.D. Burns Drilling Co.,*[66] the Texas Court of Appeals in Waco, considering clauses similar to the ones above in a JOA (form vintage unstated), held that no partnership was created by the JOA in question and because of this, the driller did not have privity with non-operators. Additionally, the non-operators only share privity with the operator and cannot recover from the driller. As the court explains, "Although the investors bore the risk of loss of their entire investment, [operator] expressly assumed the risks of all costs overruns. Because the investors' rights as working-interest owners were made completely derivative of [operator's] rights and obligations as the operator, the investors cannot individually pursue claims arising out of [operator's] relationship with [driller]."[67] Therefore, the express agreement places the risk of cost overruns, and the non-operators are not responsible for these expenses to either the driller or operator.)

66. 852 S.W.2d 40 (Tex. App.—Waco 1993).
67. *Id.* at 42.

5. Laches

Problem: *In June 2003, Frisk Corporation, as operator, and Lightfoot Energy, as sole non-operator, executed a 1989 Form covering the Subterranean Prospect. The JOA required the operator to notify the non-operator of any lease development activities and to obtain the non-operator's consent for certain expenditures. Additionally, the operator is required to bill the non-operator on a monthly basis for its share of expenses via JIBs. The JOA applied to successors and assignors but gave the non-operator the right to contest and audit the JIBs within two years.*

In May 2004, Lightfoot Energy assigned its interest to Dylan Energy Corporation, and on September 1, 2004, Frisk Corporation assigned its interest to Winters Oil. In January 2005, Winter Oil began sending JIBs to Dylan Energy Corporation that included lease expenses. Dylan Energy Corporation failed to pay any JIBs, and Winters Oil filed suit in 2007. Dylan Energy Corporation subsequently declared bankruptcy in 2008, having never paid Winters Oil. In December of 2009, Winters Oil sent a demand letter to Lightfoot Energy, claiming that Lightfoot Energy was responsible for paying the JIBs that Dylan Energy Corporation failed to pay. Lightfoot Energy refuses to pay the JIBs, and Winters Oil filed a breach of contract claim against Lightfoot Energy.

Lightfoot Energy raised the defense of laches, noting truthfully that it had not been able to examine the JIBs for errors and was not allowed to participate in the decision making regarding the operations of the wells. Lightfoot Energy was also not able to protect its interests, or review the JIBs to make sure the costs themselves were legitimate. Additionally, Winters Oil waited to sue Lightfoot Energy until Dylan Energy Corporation was long bankrupt, leaving Lightfoot Energy with no way of seeking subrogation or indemnification from Dylan Energy Corporation. Do these defenses help?

In *Windsor Energy Group v. Noble Energy*,[68] the Wyoming Supreme Court examined a situation very similar to the preceding tale and held that the doctrine of laches was an available defense for a breach of an oil and gas contract, even though the statute of limitations had not expired. The Court noted that, in order to successfully invoke the equitable defense of laches, a non-operator had to demonstrate that an operator's delay in asserting its claim was both inexcusable and that the defendant (or others) suffered injury, prejudice, or a disadvantage as a result. Delays in sending JIBs and subsequent notices that JIBs had not been paid, a lack of

68. 2014 WY 96 (2014).

opportunity of inspect and challenge bills, a lack of opportunity to participate in the planning of the operations giving rise to unpaid JIBs, and the fact that the prior non-operator was being held accountable for a successor deadbeat were all addressed as elements shoring up the laches defense. *Windsor* raises the interest question of predecessor/successor liability for operations under the JOA, addressed in Section VII of this article.

C. Claims of Lessors to Non-consenting Lessees

The parties who agree to undertake additional operations generally must bear the entire cost of the operation. Depending upon the terms of the agreement, the party who refuses its consent to such operations may lose all interest in the new or deeper portion of the well. This is, indeed, quite often the case with horizontal wells that are lengthened or when laterals are drilled. With vertical wells, it is more common, as is indicated above, to provide that the nonconsenting party acquires a carried interest[69] subject to a non-consent penalty. These costs include "all production, severance, excise, gathering and other taxes, and all royalties, overriding royalties and other burdens applicable to the non-consenting party's share of production." In either case, lessors may receive either no royalty or royalty only after the penalty is reached.

Problem: *Gibbons Gas declared that it was going non-consent to an operation that later yielded a productive well. According to the terms of Article VI.B.2.(b) of the 1989 Form covering the project, Gibbons Gas faced a 300% non-consent penalty, during which time it will receive no proceeds and, therefore, no royalty will be passed to its lessor, Farmer Beard. Farmer Beard sued, claiming to be a third-party beneficiary to the JOA and therefore owed royalty. Can the lessor get a share of royalty?*

The Texas Supreme Court in *Tawes v. Barnes*[70] ruled that the lessor of a non-consenting lessee was not a third-party beneficiary of the JOA and could not sue the consenting lessees for the royalty that would otherwise be

69. The term "carried interest" has no fixed meaning, but varies in accordance with the terms of the agreement involved. In the case of a party "who goes nonconsent," the term means that the nonconsenting party "will receive none of the proceeds of the production until the parties who put up the money to 'carry' his interest receive some multiple of the costs they have expended with respect to the carried interest." JOHN S. LOWE, Ch. 3.H., OIL AND GAS LAW IN A NUTSHELL (West 6th ed. 2003). If a party is carried "to the casing point," it is free of the costs of drilling and testing, but is liable for its share of the costs of completing, equipping, and producing. A party who is carried "to the tanks or pipeline" will be free of the equipment and completion costs, and liable only for the costs of operation. *Id.*

70. 340 S.W.3d 419 (Tex. 2011).

owed by her lessee. The court reasoned that the JOA did not contain any statement or indication of intent to make the lessor of a lessee that goes non-consent a third-party beneficiary of the consenting parties' obligation to pay royalty.

D. Default and Remedies

Form JOAs provide remedies against deadbeat parties. For example, Articles VII.B-D. of the 1989 Form address what happens when a non-operator refuses to make prompt payments of its share of costs. Execution of these remedies can conflict with remedies being taken by creditors outside the scope of the JOA.

Problem: *Staley Gas (as operator) and Cantrell Oil (as a non-operator) were signatories to a 1989 Form covering the leaseholds and fee minerals comprising the Boggy prospect in Texas. Cantrell Oil failed to make timely payment of its proportionate share of operating costs. In accordance Article VII.B of the JOA, Staley Gas placed a lien on Cantrell Oil's interests in leaseholds, minerals, produced hydrocarbons, and proceeds in the Contract Area. Cantrell Oil had previously taken out a loan from Starr Bank. As a result, a deed of trust was executed in favor of Starr Bank against Cantrell Oil's leasehold and mineral interests in the Contract Area, and other properties, as security for the loan. The JOA itself was unrecorded and no memorandum of JOA had been recorded. However, recorded copies of the deeds and assignments of the mineral and leasehold interests to Cantrell Oil all contained references to the JOA. Sure enough, Cantrell Oil defaulted on the deed of trust and Starr Bank attempted to foreclose. A primacy question arose in litigation. Does the deed of trust or the liens provided for in the JOA prevail?*

In *MBank Abilene, N.A. v. Westwood Energy, Inc.*,[71] Westwood was an operator of a JOA covering two leases. SEI was non-operator. The JOA granted a lien to the operator covering the non-operator's working interest, produced hydrocarbons, and proceeds. Outside of the JOA, SEI also incurred debt and gave a deed of trust to MBank. SEI later defaulted on both its financial obligations to Westwood and MBank. In the subsequent litigious tug-of-war between the bank and the operator over the financial carcass of SEI, MBank argued it had no notice of the cross-liens in the JOA.

The trial court ruled for Westwood and the Eastland Court of Civil Appeals affirmed, holding that the bank took the working interest subject to

71. 723 S.W.2d 246 (Tex. App.—Eastland 1986, no writ).

the operator's lien, because the bank was put on notice of the lien due to references to the JOA in the chain of title in the non-operator's working interest.[72] This result would not have been likely in states like Louisiana that do not recognize inquiry notice being passed by references to unrecorded documents in the chain of title.

Problem: *Mullins Oil was designated the operator of the Dead Man Project, which was covered by a unit agreement creating cross liens among the signatories. Clayton Gas and other non-operators consented to share in proportionate costs and production. Mullins Oil drilled the Initial Well (as defined in the unit agreement) that turned out dry. Mullins Oil sent the non-operators JIBs for their expenses. Clayton Gas, unhappy with the way things had gone, refused to pay. Mullins Oil initiated a lien on Clayton Gas' interest and foreclosed. However, the Dead Man Project was now considered entirely unprospective and Clayton Gas' interest was essentially worthless. Can Clayton Gas be held personally liable for his debt to Mullins Oil?*

In *Tiger Flats Prod. Co. v. Oklahoma Petroleum Extracting Co.*,[73] Tiger Flats Prod. Co. was designated operator at the Dutcher Unit. Several non-operators, including the optimistically-named OPEC, watched while Tiger Flats drilled a dry first well. OPEC refused to pay its share and Tiger Flats initiated a lien on OPEC's WI and foreclosed. As is very common in such suits, OPEC counterclaimed that Tiger failed to operate in a prudent manner. OPEC's leaseholds, however, were now nearly worthless. The Plan of Unitization for the Dutcher Unit expressly created cross-liens and provided that the liens could be foreclosed at any time in the same manner and with the same effect as mechanics and materialmen's liens. The Oklahoma Supreme Court held that the non-operator may be held personally liable "in the event that the amount derived from the value of foreclosure of lien on the leasehold interest is insufficient to pay the claim."[74]

72. *See* Enduro Oil Co. v. Parish & Ellison, 834 S.W.2d 547 (Tex. App.—Houston [14th Dist.] 1992, writ denied) (As in *MBank*, the court in *Enduro* recognized the operator lien in a JOA as being prior in right to a subsequent lien when the owner of the subsequent lien took its security interest with inquiry notice of the operator's lien.)

73. 711 P.2d 106 (Okla. 1985).

74. *Id.* at 107.

III. Successor Liability and Bankruptcy

A. Successor Liability

Perhaps the most important purpose of a JOA is to provide a contractual framework to efficiently develop oil and gas leaseholds and fee interests while protecting against the imputed liability associated with mining partnerships and joint ventures.[75]

Oil and gas practice and usage support the proposition that, even before the metastasizing of Form JOAs, operating agreements generally do not provide for continuing liability to shadow a party once that signatory had assigned its interest.[76] Relatively recently, however, the Supreme Court of Texas, in a poorly reasoned and decided case, opened the door on assignor liability with regard to leasehold interests included in the Contract Area of an offshore model form JOA[77] with the decision of *Seagull v. Eland*.[78] *Seagull v. Eland* involved two JOAs wherein a non-operator, Eland Energy, Inc., assigned its working interest to Nor-Tex Gas Corporation, which subsequently went bankrupt. Seagull Energy Exploration & Production, Inc., co-lessee, was operator under both JOAs, and went after Eland for its assignee's debt. Citing several landlord-tenant cases and contractual litigation—but no actual oil and gas cases—the Supreme Court imposed

---

75. *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 Youngstown Sheet & Tube Co. v. Penn, 363 S.W.2d 230 (Tex. 1962). *See also* SMITH AND WEAVER, TEXAS LAW OF OIL AND GAS, *supra* note 2 at § 17.3[A][2].

76. *See* 2 Howard Williams & Charles Meyers, OIL AND GAS LAW § 503.2, at 582 (Patrick Martin & Bruce Kramer eds., 2007) (1959); Fabeńe 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, 521-522 (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 intent of the parties); Intratex Gas Co. v. Puckett, 886 S.W.2d 274, 277-78 (Tex. App.—El Paso 1994, no writ) (when interpreting an unambiguous contractual term, the commercial context behind the contract should be considered, along with industry practice).

77. The AAPL has crafted and released for public use multiple Form JOAs specifically designed for offshore work, including the Model Form 2000 Offshore (Shallow Water), Operating Agreement, Offshore (Deep Water), and Offshore (Deep Water) Operating Agreement 2006.

78. *Seagull*, 207 S.W.3d 342. For an extensive description of this misguided case and its ramifications, *see* Christopher Kulander and David Lauritzen, *A Flock of Trouble: Liability Under Oil and Gas Joint Operating Agreements After* Seagull v. Eland, 14 TEX. WESLEYAN L. REV. 212 (2008).

liability under the two JOAs to the prior non-operating working interest owner Eland who had assigned its interest to the current defaulting non-operator years earlier.

That such an interpretation of JOAs is against the intent of the original parties to the agreement—and to the oil and gas industry as a whole—is axiomatic to every commentator found.[79] The functional point is that the Court considered the form language of the JOA insufficient to absolve assignors of their leasehold interests within the Contract Area of the JOA from liability. Contrary to the expectation of most, who assume that by assigning all their interest in the oil and gas leaseholds that comprise a portion of the Contract Area of the JOA they have removed themselves from further liability for subsequent actions by the assignees, such liability could indeed live on if the lease assignment does not clearly remove the spectre of continuing liability.

As a result of *Seagull*, language is sometimes added to the additional provisions portion of JOAs to protect predecessors in title from being targeted for non-payment of amounts owed by their successors in title. To limit such liability, consider using language similar to the following in the custom provisions:

"Upon and after the Effective Date of this [JOA], no Operator or Non-operator shall be liable for, or bear any responsibility for any costs, debts, claims, judgments, fines, levies, obligations or services subsequently incurred and arising from or related to operations under this [JOA], or for any AFE, JIB, Drilling Unit agreement or other agreements that may now or in the future encumber the Contract Area or, if applicable, any AMI that now or in the future encompass all or a portion of the leasehold and/or borehole interests and/or other interests in the Contract Area after the effective date of the leasehold interest of any Operator or Non-operator encompassed by this Agreement. Any subsequent transferee of such an ownership interest in any leasehold and/or borehole interest assigned shall effect a novation of the transferor as to any costs attributable to this [JOA] and any unit agreement, unitization agreements, pooling agreements, or

79. *See* 2 Williams & Meyers, *Oil & Gas Law* § 503.2 (2005) citing the appellate decision overturned by the Texas Supreme court; Welch, *supra* note 175; Michel Curry, *A Look at the Maintenance of Uniform Interest in Joint Operating Provisions*, 24TH ANNUAL ADVANCED OIL, GAS AND ENERGY RESOURCES LAW COURSE, State Bar of Texas (2006); *see also* Kulander and Lauritzen, *supra* note 176.

other agreements that may encompass all or a portion of the Contract Area."[80]

B. Accrual of Plugging and Abandonment Liabilities

Timing of accrual of expenses for plugging and abandonment costs is important when considering whether the potential liability for associated costs was assigned or not, even in light of language designed to elude the pitfall set up by *Seagull* as described immediately above. If the costs accrue *before* the assignment, such costs still might come back to haunt the original assignor of the leasehold.

Problem: *Garcia Gas, operator, and Mydland Energy, non-operator, were parties to a 1989 Form. After signing the JOA, five wells were drilled within the JOA's Contract Area after the required drilling permits were issued from the state oil and gas commission. Through a series of mense conveyances, Garcia Gas's interest ended up in the possession of Hunter Oil while Mydland Energy's interest ended up in the possession of Pigpen Petroleum. The five wells then ceased production. Immediately after, Pigpen Petroleum filed for bankruptcy protection, preventing Hunter Oil from getting Pigpen's proportionate share of the plugging and abandonment costs of the five wells. Hunter Oil then sued Mydland Energy, going up the assignment chain, for Pigpen's portion of the plugging costs. The JOA contained the exculpatory language suggested above arising from the* Seagull *case as an additional provision in Article XVI. Does this language prevent liability for Pigpen's portion of the plugging and abandonment costs from attaching to Mydland?*

In *GOM Shelf, LLC v. Sun Operating Limited Partnership*,[81] the court held that the obligations to plug and abandon a wellbore on a federal lease accrued at the time the party who later assigned their leasehold rights became either a lessee or an owner of the operating rights. Therefore, a practitioner drafting language in an assignment of oil and gas properties should consider adding language that expressly relieves the assignor of all costs and liabilities associated with plugging, abandonment and remediation of any wells then existing or thereafter drilled on the assigned leaseholds.

---

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

81. 2008 U.S. Dist. LEXIS 25636 (S.D. Tex. Mar. 31, 2008).

C. Bankruptcy

Often, looming behind a recalcitrant operator or other contentious relationship among parties to a JOA is the specter of bankruptcy. For example, if an operator is not replaced prior to bankruptcy, the automatic stay of bankruptcy may suspend rights normally held by to non-operators and contractors. Bankruptcy courts largely agree that JOAs are executory contracts. In *Wilson v. TXO Production Corporation*,[82] the court held that both parties had continuing obligations under an operating agreement so long as oil and gas was being produced from the wells subject to the operating agreement. Even if no further exploration or production activities were conducted under the JOA, the JOA was still considered an executory contract that could be disavowed.

Specifically, executory contracts are subject to the provisions of 11 U.S.C. § 365. Section 365(a) states that, subject to the approval of the bankruptcy court, a trustee may assume or reject any executory contract. Section 365(d)(2) provides that "the [bankruptcy] trustee may assume or reject an executory contract…at any time before the confirmation of a [reorganization] plan." Since typically no such reorganization plan exists with regard to curing defaults or providing compensation for the default—even any adequate assurance of future performance under the executory contract—the debtor or its trustee can decide whether to disavow the JOA.

Therefore, since the JOA is executory, the trustee may reject it. If rejected, the operator and the bankrupt non-operator become co-tenants, with the bankrupt entity as an owner of part of the working interest unaffected by the JOA.[83] In essence, the acreage of the debtor drops out of the acreage covered by the JOA. If producing wells are on acreage leased exclusively by the debtor, the non-bankrupt JOA signatories can then join the scrum of unsecured creditors at the bankruptcy court seeking their cut of production and personal property associated with production—platforms, tank batteries and gathering systems. Also, if the JOA acreage is held by production exclusively located on acreage entirely leased by a bankrupt debtor that disavows the JOA, the non-bankrupt co-tenants may be left scrambling to keep their own leases through the Continuous Operation clauses of their own leases or some other contrivance.

If the operator files for bankruptcy, Form JOAs typically provide that the filing doubles as a resignation of the operatorship. This automatic resignation, however, could possibly be ruled a violation of the automatic

82. 69 B.R. 960, 963 (Bankr. N.D.Tex. 1987).

83. *Id.* at 964; Shaw & Estes v. Texas Consolidated Oils, 299 S.W.2d 307 (Tex.Civ.App.—Galveston (1957), writ ref'd n.r.e.).

stay that is triggered under federal bankruptcy laws. Recognizing this, JOAs typically provide that should an operator file for bankruptcy protection, the operator and non-operators will together comprise an interim operating committee until that time when the operator either accepts or rejects the JOA. Some Form JOAs provide that the interim operating committee must approve actions by an affirmative vote of two or more parties owning a majority interest based on the interests shown on Exhibit A.

Even if the debtor does not reject the JOA, problems exist. Parties in bankruptcy typically have either a trustee appointed by the court or a chief restructuring officer appointed on recommendation of the debtor if a recovery plan is presented to and accepted by the bankruptcy court. Convincing a bankruptcy trustee or a chief restructuring officer to accept the risks associated with reworking or deepening a well, to say nothing of entirely new or prospective operations, is different than dealing with an oil and gas businessman.

Bankruptcy laws are largely immune to certain contractual stipulations. Even if the JOA is not rejected, contractual agreements to disallow a party to enter bankruptcy have been found unenforceable.[84] Bankruptcy courts may unwind as a preference AFEs in some cases of alleged favoritism if they were made within ninety days of the bankruptcy filing as provided by United States Bankruptcy Code 11 U.S.C. § 547, or even further back if the AFE could be argued to somehow benefit certain "insiders" such as family members and close business contacts of the debtor, at the expense of other creditors.

IV. Gas Balancing and Sales

Each party to a JOA typically owns a share of production in accordance with its proportionate interests in the Contract Area and "shall take in kind or separately dispose of its proportionate share."[85] Most controversies over marketing have arisen where a party has failed to dispose of its share of natural gas or, more rarely, oil. JOAs typically acknowledge this contingency by authorizing the operator to purchase the non-operator's share or to sell it for the account of the non-marketing party "at the best price obtainable in the area." If gas is involved, the operator may also have the right to treat all undisposed production as belonging to it, in which

84. In re. Madison, 184 B.R. 686, 691 (Bank. E.D. Pa. 1995).

85. AAPL 1989 Form art. VI.G (Options 1 or 2). Some exceptions, of course, exist, such as when a party goes non-consent as to additional drilling or to lengthening a horizontal lateral.

event the operator will need to make adjustments (or "balance") at a later date.

Because JOAs typically do not clearly address the most crucial issues that arise in imbalance situations, parties to an operating agreement frequently enter into a separate gas balancing agreement that is added as an attachment to the JOA. A gas balancing agreement sets out the rights of the parties if one or more happens to not dispose of its entire share of the gas production. Such agreements typically draw upon one of three methods for balancing: (1) balancing-in-kind, where the under-produced party takes a certain percentage of the overproduced parties' gas until the imbalance has been made up; (2) periodic cash balancing, where the underproduced party receives cash at various times during production to pay for the underproduction; and (3) cash balancing upon reservoir depletion, where the well is immediately brought to balance via a cash payment at the end of the well's lifespan, with the payment equal to all the value of the total underproduction. Cash balancing upon reservoir depletion requires keeping records for the life of the well. Some courts have viewed the gas balancing agreement as the exclusive determinant of the parties' gas balancing rights, and in several instances where the parties have provided for balancing-in-kind, courts have refused to grant cash balancing, even though the reservoir became depleted before the underproduced party could exercise its make-up rights.[86]

A. Marketing Rights of Parties in the Absence of a Gas Balancing Agreement

The rights of the parties related to the disposition of gas is either determined by the gas balancing agreement or, absent that, the operating agreement. The 1989 Form provides, in various sections of Article VI.G, options to be used if a desired gas balancing form is not completed separately. Gas balancing is only necessary if one party, typically the operator, asserts to sell all—or a higher percentage than its real interest—of the gas as its own. If the non-operators' gas has been purchased directly by the operator or sold by the operator on behalf of the non-operators, then the non-operator simply is entitled to its share of the sales price. If no gas balancing agreement is used, the JOA's terms are enacted and they are considerably sparser and less clear, causing the courts to invoke contract law or common law and equitable precepts to fill the gaps.

86. *See, e.g.*, Amoco Production Co. v. Fina Oil & Chemical Co., 670 So.2d 502 (La.App. 1996) and Chevron U.S.A., Inc. v. Belco Petroleum Corp., 755 F.2d 1151 (5th Cir. La. 1985).

1. Rights of Underproduced Parties

Problems have arisen in the past concerning the balance of rights between non-operators who enter into a gas sale contract after a JOA has been signed and the designated operator who has the right to commit non-marketing parties' gas for the accepted "reasonable period" of time. While the non-marketing parties certainly have the right of termination, the operator will want to have some reasonable advance notice of termination so as to cover previous obligations to third parties. Whether or not a gas balancing agreement is attached to the operating form, the 1989 Form (Article VI.G, options 1 and 2) attempts to handle this tension point by requiring non-operators who want to enter into a gas sales contract for gas the operator has previously marketed to provide at least ten days written notice.

Problem: *Collins Oil was a non-operator signatory to a JOA under the terms of which the operator, Gabriel Gas, had both done all the marketing of natural gas and overproduced its share of the total interest as described in Exhibit A to the JOA. Natural gas prices then rose dramatically. After the rise in prices, Collins Oil decided to market its own share of the natural gas and demanded a cash accounting of the natural gas Gabriel Gas had hitherto overproduced as calculated by either (1) the current "fair market price" of the gas or by (2) an accounting in kind. Gabriel Gas responded that it would rather pay a cash payment based on the price it actually received for the overproduced gas when it sold it before. Lawsuits fly. What price must Gabriel Gas use to account to Collins Oil?*

In *United Petroleum Exploration, Inc. v. Premier Resources, Ltd.*,[87] the underproduced non-operator sought either an accounting in kind or cash accounting based on a price the non-operator put forth as the current "fair market value" in the region. The court said accounting in kind could not be ordered because the non-operator had not provided any facilities to market the gas. Furthermore, cash accounting on the current price was denied because the court was hesitant to equate non-operator's argued "fair market value" with the higher price non-operator's subsidiary pipeline would have (allegedly) paid for the gas. The court instead ordered cash balancing based on the price actually received by the operator.

While in kind balancing is feasible when the imbalance is small, cash payments are probably necessary for larger imbalances. The timing of when the cash balancing should take place is important and potentially contentious. If the underproduced party deliberately waits to market its

87. 511 F. Supp. 127 (W.D. Okla. 1980).

natural gas until gas prices rise, and then demands cash balancing at the current higher prices, then it can be argued that the underproduced party has violated its obligation under most JOAs to a take and dispose of its share of production and should not be able to compel immediate cash payments at the current high prices. Any JOA party that forsakes a present sale in an effort to make a sale later at a higher price would also seem to have violated the general good faith and fair dealing standard implied in contracts.

In addition, Smith and Weaver, in the JOA portion of *Texas Law of Oil & Gas*, argue that cash balancing upon reservoir depletion may be undesirable, particularly if equities in the case favor the non-operators.[88] For example, if the operator operated the well in such a way that inhibited the non-operator(s) from being able to make up the unbalance production in-kind or if the non-operator(s) could not—despite good faith efforts—find a buyer for their gas.

No simple rule on how the cash payment is to be calculated can possibly cover all the possibilities when cash balancing is demanded. The price an underproduced party would have received, the price actual received, and the ability of both the operators and the non-operators to mitigate the imbalance are all factors that must be considered.

2. Split-Stream Sales and Royalty

Gas balancing problems can also arise when gas from a single well is sold to different pipeline companies via different gathering lines under the control of the various parties to the JOAs. The balancing factors that must be examined when parties have failed to market gas can also apply to split-stream sales.

Problem: *Rabin Oil entered into a 1956 Form with Squire Gas in which each party to the agreement was to market its own gas from a field experiencing declining production. At one point, Rabin Oil's natural gas purchaser could not take all the gas that Rabin sent to it and thus a gas imbalance occurred. Rabin switched natural gas purchasers and then brought a court action seeking to rectify the gas imbalance through gas balancing-in-kind. Squire Gas counter claimed, saying that cash balancing at the current price was in order. What result?*

In *Beren v. Harper Oil Co.*,[89] five parties entered into a 1956 Form under which the parties were required to "take in kind or separately dispose of" its share of gas. Under the agreement, each party reserved the right to market

88. SMITH AND WEAVER, TEXAS LAW OF OIL AND GAS, *supra* note 2 at 17.6[A].
89. 546 P.2d 1356 (Okla. Ct. App. 1975).

its respective portion of the unit production. An imbalance developed between two parties to the JOA because the first purchaser of production for one party to the JOA had a high-pressure line that could not take all the natural gas that party could send it. Later, after the under-produced party terminated its contact with the high-pressure line and switched to another line that could take much more of the produced gas, the under-produced party brought an action to restore the balance by balancing-in-kind. The court ruled against balancing-in-kind, however, in favor of immediate cash balancing because the reservoir was depleting and the underproduced party may never had made up its portion. In addition, if the cost of gas was rising, in-kind balancing was thought by the court to be inequitable to the overproduced parties.

Royalty payable on split-stream sales can be problematic in Oklahoma, where royalty owners are entitled to payment based on the weighted average of gas sales from a well. Significant accounting problems are posed when parties to a JOA sell gas under different contracts for different prices or do not sell their shares of production at all for an extended period. The Oklahoma Production Revenue Sharing Act[90] places the responsibility for accounting to royalty owners on the unit operator, rather than on the purchasers of production, and requires each working interest owner that is marketing natural gas to pay the royalty share of proceeds to the operator every month. The operator then distributes the royalty proceeds and is protected against liability if it properly distributes all proceeds paid to it by the various working interest owners. Alternatively, a working interest owner who is concerned that the operator might not properly distribute royalty payments has the option to pay all royalty owners within the Contract Area directly.

3. Triggering Events and Balancing Without a Gas Balancing Agreement

Unless a gas balancing agreement or another source of pertinent terms, such as a custom provision in a Form JOA, provides otherwise, demands for gas balancing by an under-produced party may not be successful until some triggering event occurs that could result in a derogation of the position of the under-produced party to subsequently achieve balance. Exactly what constitutes such an event could be contentious.

Problem: *Edge Oil owned a 50% percent interest in the mature Flanders field while another non-operating interest owner, Pinder Petroleum, owned 5% of the field and took its percentage of production in kind. The minerals and leasehold interests comprising the field were*

90. Okla. Stat. tit. 52, § 570.1.

covered by a 1956 Form. Edge Oil sold its interest to Lodge Gas, who in turn sold that entire interest to Thomas Oil three years later. After the second sale, Pinder Petroleum brought suit, demanding an immediate cash-balancing payment to balance the differences in production due each of the signatories of the JOA. Edge Oil retorted that Pinder Petroleum's position had not changed and that the statute of limitations only begins to run when one of the co-tenants ousts another co-tenant. Therefore, since Thomas Oil had assumed liability for balancing and had honored Pinder Petroleum's right to take in kind, no cash balancing was in order, particularly since balancing-in-kind is preferred in the industry. At the time of Pinder's claim, Edge, Lodge, and Thomas were all solvent and no other evidence of any possible deterioration of Pinder's position to successfully claim future balancing-in-kind or eventual cash-balancing upon reservoir depletion was apparent. Will Pinder be successful in its claim?

In *Harrell v. Samson Resources Co.*,[91] Conoco was an operator to a 1956 Form that did not include a gas balancing agreement and that covered land in Oklahoma. Conoco and non-operator Harrell had separate gas purchase agreements, both with purchaser/transporter Producer's Gas, while non-operator Samson entered into a gas purchase agreement with El Paso Natural Gas. An imbalance later occurred when Producer's Gas triggered a force majeure clause in its gas purchase agreement with Harrell and stopped taking natural gas from Nov. 11, 1982 to Nov. 1984. Still later, Harrell called for an accounting because Samson was planning on selling its interest in the Contract Area. A disagreement ensued over whether the proposed sale was a triggering event allowing an accounting and, if so, what kind of accounting would be allowed.

In the subsequent litigation, the trial court allowed pre-depletion gas balancing on the weighted average price actually received. The court of appeals reversed. The Oklahoma Supreme Court allowed accounting and then interpreted the take-in-kind provisions of the 1956 Form, holding that the provisions created "a co-tenant-like relationship" between the parties in the operating agreement. At the same time, the Court opined that since the JOA provided that each well owner was to take its share of production in kind and separately dispose of it, the JOA was "contradictory with respect to the legal relationship between the parties."[92]

The Court approved the lower court's ruling that pre-depletion cash balancing of the underproduced parties' interests was warranted because balancing-in-kind was not practical given the uncertain amount of reserves

91. 980 P.2d 99 (Okla. 1998).
92. *Id*. at 103, citing Anderson v. Dyco Petroleum Corp., 782 P.2d 1367 (Okla.1989).

in the field. It found that in order to reconcile the conundrum of co-tenancy with the necessity of taking and disposing of their share of production, the Court ruled that "the ownership clause creates a co-tenant-lie relationship between the parties as to the gas sold, but that each owner has the right to separately take and market its own share, subject only to a duty to account to the other owners."

4. Farmout Agreements and Assignments

Farmouts and assignments of interests to new parties are often triggers for balancing disputes. One key consideration is the solvency of the purchasers and whether the previous owner has tried to shift its trust responsibilities for accounting to the new co-tenant. Reconsidering the preceding example, what might happen if the reserves estimates of the Flanders field were very speculative? What if instead of being solvent, Thomas Oil was teetering on bankruptcy and evidence existed that its operation of the Flanders field has resulted in waste?

In *Unit Petroleum Company v. Mobil Exploration*,[93] two signatories to a 1956 JOA were Mobil Exploration and Unit Petroleum, who had 52.9% and 6.3% interests, respectively, in the Contract Area. Mobil then assigned its interest to Amoco, who in turn assigned its interest to Gothic Energy. At the time of Mobil's assignment to Amoco, Mobil's interest was overproduced by at least 158,101 mcf, and Unit's was underproduced by at least 50,425 mcf. The JOA contained no separate gas balancing agreement but did contain an ownership clause that stated in relevant part:

> "Unless changed by other provision, all costs and liabilities incurred in operation under this contract shall be borne and paid, and all operations on the Unit Area shall be owned, by the parties as their interests are given in Exhibit "A." All production of oil and gas from the Unit Area, subject to the payment of lessor's royalties, shall also be owned by the parties in the same manner."

Effectively, in order for Unit to have been able to successfully demand partial-depletion cash balancing, Unit needed to show that the sale of Mobil's interest somehow derogated its rights to a co-tenant accounting of profits. The trial court refused to order cash balancing, finding that "there was no act in derogation of Unit's rights triggering cash balancing."[94] Furthermore, tolling of the statute of limitations was found to occur when

93. 79 P.3d 1238 (OK Civ. App. 2003).
94. *Id*. at 1241.

derogation of the underproducer's rights occurred. The Oklahoma Court of Civil Appeals agreed that mere assignment of Mobil's interest did not represent a derogation of Unit's rights, but remanded the case anyway so that the trial court could analyze the circumstances and equities of the case to make sure that Unit's rights had not been derogated.

V. Preferential Rights to Purchase & Maintenance of Interests

A. Preferential Rights to Purchase

The "Preferential Right to Purchase" clause in the Form JOAs has stoked much litigation. "Pref right" or "right of first refusal" clauses typically require that any party to the JOA that wishes to assign all or part of its interests covered by the JOA must first provide the other signatory parties notice of the pending assignment and a chance to acquire the property. Some such clauses, however, such as the 1989 Form's Article VIII.F, exclude mortgages/deeds of trust, foreclosures of same, or assignments made necessary by corporate structure changes from the scope of the pref right.[95]

Problem: *Townes Oil and Nelson Gas owned undivided interests in leases covered by a 1989 Form. Article VIII.F is in effect in the form. Townes Oil transferred all its interest in the Contract Area to Ely Oil, an affiliate entirely owned by Townes Oil, and then sold the equity of Ely Oil to an unrelated third company, Lafave Petroleum. Can Nelson Gas enforce the preferential right to purchase?*

In *Tenneco Inc. v. Enterprise Products Co.*,[96] owners of a natural gas liquids fractionation plant, entered into a "Restated Operating Agreement" containing a provision that plant owners had a preferential right of purchase if one of the co-owners proposed to sell its interest. Tenneco, a plant co-owner, transferred its interest to a wholly owned subsidiary and then sold all of its stock in the subsidiary to Enron. The other co-owners wanted the preferential right clause to apply and brought suit, alleging (among other causes of action) that the transfer violated the preferential right provision. Specifically, the other co-owners alleged that the transaction, when coupled with the sale of the subsidiary's assets to Enron, invoked the right of first refusal clause that entitled the plaintiffs to purchase the subsidiary's stock on the same terms as offered by Enron. The Supreme Court of Texas

95. AAPL 1989 Form art. VIII.F specifically excludes interests that are transferred "by merger, reorganization, consolidation, or by sale of all substantially all of a company's assets" from coverage of the pref right.

96. 925 S.W.2d 640 (Tex. 1996).

rejected the co-owners' argument that the nature of the transactions should be determined by looking to the intent of the parties to the stock sale. The Court instead ruled that rights-of-first-refusal should be narrowly construed and that in any event the language of the disputed provision in the Restated Operating Agreement referred only to a change in ownership.

Not all courts would agree with the result of *Tenneco*. In *Williams Gas Processing-Wamskutter Co. v. Union Pacific Resources Co.*,[97] two companies that jointly owned a gas processing plant had an agreement containing a pref right clause that applied if any co-owner proposed to sell all or a part of its interest to a non-affiliate. One of the parties transferred its entire interest in the plant to a subsidiary, and then created a holding company to which all of the stock of the subsidiary was transferred. The holding company then merged with a third, unrelated company. The Wyoming Supreme Court rejected the argument that the latter transaction was a "merger" rather than a sale and held that it triggered the preferential right of the other co-owner.

One commentator has suggested that pref right clauses are intended to reward risk by giving the JOA participants the opportunity to enlarge their interests within the Contract Area in preference to a third party who did not share in the initial risks. In addition, the pref right enables the parties to exclude new and possibly undesirable participants who may be financially weak or have management styles or philosophies that conflict with those of the original participants.[98]

B. Limitations on Sales and Purchase Obligations

Problem: *Simmons Oil wanted to sell a wholly-owned subsidiary, Frehley Production, to independent third party Criss Gas. The package of properties and assets comprising the subsidiary included all the stock in Frehley Production, a group of oil and gas leases, an AMI agreement that Frehley had entered into covering properties in several counties, fee mineral interests, cash, and a plethora of purchase contracts and service agreements. The purchase price of Frehley Production was split into separate components and the value of each portion of Frehley Production was allocated and agreed upon by Simmons Oil and Criss Gas. A portion of the oil and gas leases—but none covered by the AMI agreement—were subject to a preferential right to purchase clause held by Stanley Exploration. Stanley Exploration, after receiving notice of the sale, informed Simmons Oil that it wanted to exercise its pref right. Simmons Oil*

97. 25 P.3d 1064, 163 O & G Rep. 926 (Wyo. 2001).
98. Conine, *supra* note 9 at 1317.

responded to Stanley Exploration that if it wanted to exercise the pref right, it must purchase all *the assets and properties comprising Frehley Production. Furthermore, Simmons Oil claimed that the price to be paid should be the same as it allocated with Criss Gas. Stanley Exploration sues, arguing it should only have to buy the leases covered by the pref right and that the price should be the market value as determined by the court. Does Stanley Exploration have to buy the whole package? What price should it be required to pay?*

In *Navasota Resources, L.P. v. First Source Texas, Inc.*,[99] a Texas court of appeals considered the pref right in the 1989 Form as applied to a package sale. The holder of the pref right, Navasota Resources, L.P., covering a Contract Area referred to as the "Hilltop Prospect" sued the working interest owners and the purchasers of a portion of the working interest to enforce the pref right.

Under the terms of the proposed transaction between the seller, Chesapeake, and the potential buyer, the buyer would (1) purchase a percentage of outstanding shares of common stock of Chesapeake's subsidiary, Gastar, (2) enter into a thirteen-county AMI agreement with Gastar, (3) pay $5,012,933.00 for 1/3 of Gastar's net leasehold acreage that was subject to the pref right in a 1989 Form JOA, and (4) pay 44% of the costs through casing point on certain test wells in the Contract Area of the JOA in order to earn a 33.33% working interest. After receiving notice of the sale, Navasota notified the seller that it wanted to exercise its option. Chesapeake responded that in order for Navasota to exercise its pref right, it must comply with every aspect of the agreement by buying all the stock, entering the AMI agreement, pay the cash price, and pay for the promoted carry. Navasota refused and brought suit, arguing it only had to buy the property.

Chesapeake argued that the AMI and stock purchase were part of the "terms and conditions" of the Hilltop Prospect, while Navasota argued these items were separate transactions. After considering the applicable case law, the court found that "virtually every authority of which we are aware agrees that the holder of a preferential right cannot be compelled to purchase assets beyond those included within the scope of the agreement subject to the preferential right in order to exercise that right."[100] The court held that Chesapeake could not require Navasota to purchase shares of common stock or enter into the AMI agreement order to exercise its pref right.

99. 249 S.W.3d 526 (Tex. App.–Waco 2008, pet. denied).
100. *Id*. at 535.

When the portion of the properties covered by a pref right is part of a larger sale, the value of the portion covered by the pref right can be difficult to ascertain. Typically, a company selling a panoply of properties will allocate values to each component of the sale. The *Navasota* court noted that Texas requires that a seller be held to the allocated price absent evidence that the property was worth a different value or was purposely under- or overvalued. Other states require the court to determine the "true value" or fair market value of the properties covered by the pref right.[101]

Preferential right clauses typically allow a party holding the right to buy the covered interest but the right must be exercised exactly as stated and cannot require preferential right holder to purchase any other unrelated items—stock, other lands, equipment, etc. Typically, in order to utilize the preferential right to purchase, the parties must be willing "to purchase the stated consideration on the same terms and conditions the interest which the other party proposes to sell."[102]

C. Maintenance of Interest Provisions

The 1989 Form's maintenance provision (Article VIII.D) states that if any party should sell, encumber, transfer any of the production, leases, wells, pumps, rigs or other equipment inside the JOA's Contract Area to a third party, such disposition must cover either all of that party's interest in the Contract Area or an equal undivided interest in the Contact Area.

Problem: *Elton Exploration owned a working interest in a lease that was subject to a maintenance of interest provision in a 1989 Form. Elton Exploration wanted to drill a well pursuant to the JOA, but before proposing the well, Elton Exploration entered farmout agreements with two other investors who were non-operating parties to the JOA. The other non-operators sued to have the maintenance provision enforced, which would allow them to participate with their proportionate shares pursuant to the non-consent provisions of the JOA. What result?*

In the unpublished opinion, *Medallion Petroleum, Inc. v. Unit Petroleum Company, et al.*,[103] the court upheld application of the maintenance of interest clause in just such a scenario. In its opinion, the court noted the similarities between the maintenance of interest clause and forced pooling, opining:

---

101. For further discussion of *Navasota, see* Christopher Kulander and Kirk Worley, Navasota v. First Source Texas *and Its Effects on Packaged Sales and Preferential Rights to Purchase Clauses*, 52 S. TEX. L. REV. 233 (2011).

102. *Navasota*, 249 S.W.3d at 529-530.

103. No. C 90-484, Dist. Ct., Grady County, OK (1990).

> "In *Amoco Production v. Corporation Commission of the State of Oklahoma*, the court held that the Oklahoma Corporation Commission cannot force pool by wellbore instead of by drilling and spacing unit. In so ruling, the court reasoned that the original risk capital investors have a right to rely on the original election of participation, and that it was unfair to alter the positions of the parties after the initial well was drilled….Joint operating agreements, such as the one involved in this case, achieve by contract the same objectives that force pooling and unitization seek to accomplish by statute."[104]

If this unpublished opinion is any suggestion about how a court might address maintenance of interest provisions in the future, parties should consider acquiring a waiver from all other parties to a JOA before acquiring any beneficial interest in properties within that JOA's Contract Area from any particular signatory.

VI. Area of Mutual Interest Exhibit/Provision

To avoid allegedly unequal, complicated, unfair or just plain difficult distributions of benefits acquired or generated by one party due partially or wholly from joint operations, many JOAs provide that any cash, fee mineral, or leasehold acreage received under an assignment, conveyance, bill of sale, bottom hole agreement, acreage contribution, or other support agreement must be distributed proportionately for the benefit of all parties of the JOA. An area of mutual interest clause or agreement, often referred to as an "*AMI*" agreement or clause, typically provides that all parties to the AMI agreement will share in any future interests that any party acquires within (or partially within) a defined geographical area. AMI agreements are commonly included as a separate exhibit to the JOA.

Courts have held that AMI agreements can be enforced against successor parties as a covenant running with the land.[105] AMI agreements may not always apply, however, to properties acquired inside or outside the Contract Area that are unrelated to drilling or other joint operations. As noted by one commentator, this situation can leave the parties free to engage in competitive lease acquisitions based on information obtained from joint operations.[106] Outside of questions of whether an AMI agreement is

---

104. *Id*.

105. *See e.g.* Westland Oil Development Corp. v. Gulf Oil Corp., 637 S.W.2d 903 (Tex. 1982) (The clause dealt with land other than that assigned to the defendants.)

106. Gary Conine, *Property Provisions of the Operating Agreement/Interpretation, Validity, and Enforceability*, 19 TEX. TECH L.REV. at 1345–48 (1988).

included in a JOA (see Section II above) or questions regarding interests acquired because of joint operations **without** an AMI agreement, AMIs generate considerable litigation, often focused on the tensions points of the legal description of the physical extent of the AMI's coverage, conflicts between the terms of the JOA and the included AMI agreement, and whether AMIs (and pref rights) cover only those interests owned at the time of execution of the JOA or all subsequent acquisitions as well.

A. Description of Contract Area/AMI

Underlying most conflicts regarding AMI agreements, consent to assign provisions, preferential rights to purchase clauses, and rights of first refusal provisions is a desire by one party to remove itself from any obligation to transfer all or a portion of an acquired asset. Scrutiny of property descriptions is often the first step taken by parties hopeful of releasing themselves from coverage by AMI agreements, assignment consents, and purchase preference clauses. Therefore, one of the most common worries regarding JOA Contract Areas and AMI agreement exhibits is providing a sufficient legal description as JOA Contract Areas, AMI agreements, and similar provisions that do not contain an adequate legal description are potentially void.

Problem: *Cash Oil and Jennings Gas were operator and non-operator, respectively, in a prospect comprised of several leaseholds and covered by a JOA that included an AMI agreement. A dispute erupted over a lease acquired by Cash Oil that Jennings Gas claimed was located within the Contract Area as described in the AMI. The property description in the AMI was composed of a survey with no scale. Furthermore, the Contract Area was outlined with a thick black border that did not show the size of the tract or the number of acres in the Contract Area. Finally, the AMI plat contained no reference to recorded deeds or other instruments. Does the property description in the AMI meet the requirements for a legally sufficient property description as required by the Statute of Frauds?*

A description of properties in a JOA or AMI—instruments that affect an interest in real property—must contain a valid legal description or they are void.[107] Therefore, knowing what constitutes a legally sufficient property description and then measuring up to that standard in a JOA and its exhibits is crucial. The description "must furnish within itself, or by reference to some other existing writing the means or data by which the particular land

107. *See e.g.*, UCC BUS. & C. CODE § 26.01 (Vernon 2002).

may be identified with reasonable certainty."[108] In practice, a threshold question when considering whether a particular description meets this standard is: could a surveyor go out and easily reconstitute the legal description boundary with the information contained in the description without drawing upon any intrinsic knowledge?

The case law of the state where the properties are located in any conflict will document scenarios that bracket whether or not a particular description meets this standard. For example, in Texas, a series of documents in an exhibit that was expressly incorporated into an AMI agreement included a plat on which the acreage in question was circled by a black line and a commonly-used commercial map that included abstract numbers, survey information and block identification was held to comprise a valid legal description.[109] On the other hand, a survey with no scale with a parcel outlined with a thick black border[110] that did not show size of the tract or number of acres and contained no reference to recorded deeds or other instruments was found to not meet the requirements of a valid legal description.[111] Remember: *such instruments are void as a matter of law.*

Often times, the easiest and cheapest method used by those attempting to draft a legally sufficient property description without using a prior metes and bound survey (or conducting one themselves) is to follow survey/block or township/range boundaries, other man-made boundaries such as roads, powerlines, or (least desirable) natural boundaries—typically a river or stream.[112] On the plat, care should be taken to make boundary lines describing the outer boundary of the Contract Area thin and precise and to include all survey/block or township/range names and abstract numbers.[113]

B. Conflict Between Printed Form and AMI Exhibit or Provision

Care also must be taken so that the language of an exhibit, supplement, or JOA exhibit such as an AMI agreement does not result in ambiguity when it conflicts with the pre-printed language in the JOA. Expensive legal battles arise over such ambiguities.

108. Wilson v. Fisher, 188 S.W.2d 150, 152 (Tex. 1952.

109. MTrust Corp. N.A. v. LJH Corp., 837 S.W.2d 250, 252-3 (Tex. App.—Fort Worth 1992, writ denied).

110. Probably drawn by a geologist with a wide-point Sharpie.

111. Guenther v. Amer-Tex Const. Co., 534 S.W.2d 396 (Tex.Civ.App.—Austin 1976, no writ).

112. Randy Browne, Certified Professional Landman, Haynes and Boone, LLP, Personal Interview, Apr. 2, 2014.

113. *Id*.

Problem: *A 1956 Form was executed by several parties in Our Lady of Blessed Acceleration Parish, Louisiana that included typewritten "addition provisions." One of the additional provisions provided that the terms of the JOA would cover all oil and gas leases located entirely or partially within a Contract Area thereafter defined. In the form portion of the JOA, however, was found a clause whereby the terms of the JOA were stated to apply only to leases owned as of the Effective Date as defined in the JOA.*

Much later and through several mense conveyances, Bloom Oil and Lanier Gas acquired undivided portions of the leaseholds comprising the Contract Area of the JOA. Lanier Gas then acquired 100% of one new oil & gas lease located partially within the Contract Area. Bloom Oil claimed that it was due an assignment of an undivided portion of the new lease per the terms of the typewritten portion of the JOA. Lanier Gas pointed to the printed portion of the JOA, however, and argued the contractual duty to assign only applied to leases owned by the original signatories upon the Effective Date of the JOA. Litigation ensues. What result?

In *Clovelly Oil Co., LLC v. Midstates Petroleum Co., LLC,*[114] the Louisiana Supreme Court considered the applicability of the 1956 Model Form Joint Operating Agreement to leases obtained in the future. In the case, a non-operating working interest owner Midstates Petroleum Co. allegedly breached the terms of the JOA with operator Clovelly Oil Co. by not allowing Clovelly to claim a working interest in the new mineral lease Midstates had acquired in 2008. Through separate chains of assignments, Clovelly and Midstates became partners to the JOA, which was executed in 1972. The JOA contained both a printed portion and a typewritten addendum.

In the opinion, the Supreme Court of Louisiana first cited to *Amend v. McCabe*[115] regarding the canon of interpretation whereby any particular portion of a contract is viewed in light of all other parts so that, if possible, harmonization of all the various parts to the contract is achieved. In reading the printed portion and typewritten addendum of the JOA together, the Court did not find any express conflict or ambiguity between the two. Specifically, the Court found that, while the typewritten addendum described the geographic area to which the agreement would apply, the printed terms of the JOA expressly limited the agreement to the leases the parties owned at the time they executed the agreement.

---

114. 112 So.3d 187 (La. 2013).
115. 95-0316 (La. 12/1/95); 664 So.2d 1183, 1187.

Next, the Court distinguished *Amend* from *Amoco Production Co. v. Charles B. Wilson, Jr., Inc.*,[116] the Kansas Supreme Court case upon which the court of appeals relied. In the Kansas case, at the time one of the parties entered into the applicable JOA, that party knowingly misrepresented that it held a lease covering a particular tract, when it actually only held rights to an undivided portion of the tract. As the parties in *Amoco* clearly intended the particular area to be covered in its entirety by the JOA, and since *Amend* involved no such misrepresentation of lease ownership, the Court found that *Amoco Production Co*. provided no direction to deciding *Amend*.

Finally, the Court noted that parties signing a JOA commonly also enter into an AMI agreement, which typically provides that the JOA will apply to any future leases the parties may obtain within the Contract Area as defined in the JOA. In *Clovelly*, however, the parties had not entered into an AMI. Ultimately, the Louisiana Supreme Court reversed the court of appeals, siding instead with the trial court in holding that the AMI agreement did not extend to the new lease. This case also implies that, at least in Louisiana, if no AMI agreement exists, an addendum describing a specific geographic area to which the agreement would apply may be preempted by any printed terms of the form JOA that expressly limits the agreement to the leases the parties own at the time they execute the agreement.

C. AMI Application to Subsequently Acquired Interests

If no clear language makes interests acquired by one of the JOA signatories after the effective date of a Form JOA subject to a typewritten AMI clause, what is the scope of the "Contract Area"? Does it cover future acquisitions or just those owned by the signatory parties on the effective date?

Problem: *Tucker Oil and Reed Gas were the original operator and non-operator, respectively, in the Run Run Run prospect that was comprised of several leaseholds and covered by a 1977 Form that included a typewritten AMI provision governing future acquisition of interests that were subject to the JOA. A plat in Exhibit A contained the notation "AMI" on the hash marked boundary drawn thereon but not the actual words "Area of Mutual Interest." The JOA did not contain language that expressly made subsequent acquisitions by JOA parties subject to the AMI clause. Years later and through several mesne conveyances, Tucker Oil and Reed Gas' interests were assigned to Nico Production and Cale Operating, respectively.*

116. 266 Kan. 1084, 976 P.2d 941 (1999).

Cale Operating had acquired minerals and leases within the area geographically described by the plat in Exhibit A. Nico Production sought a judicial determination that the interests acquired by Cale Operating were subject the AMI clause, arguing that future acquisitions were covered within the broad language used in the Article I definition of "Contract Area" (that referred to "all of the lands" described in Exhibit A) and the broad description of Exhibit A of the covered lands, the same being "all interest of the parties in the land located within the areas outlined" on the plat. Nico Production also argued the presence of the typewritten AMI clause illustrated clear intent that the JOA would apply to interests acquired after 1980. Cale Operating countered (1) that the present tense used in the JOA's recitals and in the definitions of "oil and gas leases" and "oil and gas interests" (stating that the signatory parties "are owners") and (2) the lack of the phrase "area of mutual interest" and any reference to any future acquisitions in Exhibit A, meant the JOA did not apply to interests acquired after execution. Which party prevails?

In *Clovelly*, described above, the lack of an included AMI agreement was crucial in leading the Louisiana Supreme Court to hold that the JOA's preprinted language limited Exhibit A's definition of the Contract Area to only leases and unleased mineral interests owned by the signatory parties at the time the agreement was executed. This case was later cited by a Texas Court of Appeals in *Anderson Energy Corporation v. Dominion Oklahoma Texas Exploration & Production, Inc*.[117] in its ruling on a dispute with facts much like the problem above. The court held that the terms of an AMI clause included within a 1977 Form did extend to interests subsequently acquired within the boundaries of an area described in Exhibit A.

The *Anderson* court first noted that it construed the Contact Area of a JOA not just by isolated words or phrases within the JOA and instruments it may reference, but by considering the language used in the context of the entire JOA and related documents. After noting Kansas case law that discounted the recital tense argument,[118] the court also highlighted Colorado case law that noted it was standard practice in the oil and gas industry for parties to enter into JOAs with terms that would apply to interests to be acquired in the future.[119] Ultimately, the court overturned the trial court's decision and determined that the drafters had intended that the Contract Area would include the lands marked "AMI" in the Exhibit A plat,

117. 2015 Tex. App. LEXIS 6659 (Tex. App.—San Antonio 2015).
118. Amoco Prod. Co. v. Wilson, 976 P.2d 941 (Kan. 1999).
119. Kincaid v. W. Operating Co., 890 P.2d 249 (Colo. App. 1994).

thus making the later-acquired properties within the hashed boundary of the plat subject to the terms of the typewritten AMI clause.

D. Interests Acquired Because of Joint Operations without an AMI

If the acquisition was made possible by information obtained through joint operations, should the party acquiring the interest be compelled to share it with the other parties even in the absence of an express AMI clause? Consider the following.

Problem: *Laing Gas, operator, and non-operators Pappalardi Petroleum and West Oil were parties to a Form JOA covering the leases and fee mineral interests comprising the Hard Times prospect. After the cross-conveyances provided for in the JOA occurred, each party owned an undivided one-third working interest in the prospect. While operating the prospect, Laing Gas learned of the presence of a prospective geologic feature adjacent to the Contract Area as described in the JOA. Specifically, the feature was an extension of the structural high targeted by Laing Gas in the Initial Well and it was identified using geological information and bottom hole pressure test data gleaned during the drilling and testing of the Initial Well, an operation that the two non-operators had enthusiastically supported. The Initial Well was located on a lease originally owned entirely by West Oil. The JOA did not contain an AMI agreement.*

After completing the Initial Well, Laing Gas acquired a lease over the adjacent tract. The non-operators demanded an assignment of undivided portions of the new lease in the same percentage as their interests in the Hard Times prospect, arguing that Laing Gas only discovered the prospectivity of the neighboring tract as a result of their contributions to the prospect. Laing Gas pointed to the lack of any AMI in the JOA, and claimed it had no such obligation and that all parties had access to the well information it used. What result?

Not having an AMI agreement can put parties seeking a mandatory assignment in a difficult spot. On the other hand, some case law suggests that prospect data, like the geological and bottom hole pressure data described above, are a product of joint operations and should belong to all JOA parties.[120] It follows then, that if one party had special access to the data and used it to obtain the acreage outside the Contract Area, the other parties should be allowed to participate upon paying a proportionate share of the acquisition costs.[121] However, if the information was available to all

120. *See* Kaye v. Smitherman, 225 F.2d 583 (10th Cir.Kan.1955); Foley v. Phillips, 508 P.2d 975 (Kan. 1973); and Smith v. Bolin, 271 S.W.2d 93 (Tex. 1954).

121. *Id*.

parties and only one took advantage of it, it is difficult to see that the others have any claim.

VII. Conclusion

Since the beginning of the oil and gas industry, mineral properties have been jointly developed by owners of undivided mineral interests. Joint operations spur better efficiency in oil and gas development as resources and expertise are pooled.[122] JOAs began to be widely used in the 1920-30s, often in co-tenant situations.[123] JOA have been recognized as a necessary set of rules for the parties to coordinate their activities and hence Form JOAs have become, after the oil and gas lease itself, the most common instrument seen in the upstream oil and gas industry.[124]

Like most complex contractual arrangements, the JOA contains provisions dealing with a wide variety of specific subjects, can potentially include many ancillary agreements, and may reference and incorporate the terms of other unrecorded agreements. Many provisions deal with the property interests of the participants and govern such matters as maintenance of title, liens and encumbrances, and the acquisition or transfers of interests. Close attention must therefore be paid to new case law as it appears so that not only are new JOAs reflective of the changing legal landscape, but also so that existing JOAs do not become problematic at the most inopportune times before remedial measures, such as a clarifying amendment, can be taken without the threat of immediate litigation limiting such options or hurrying their promulgation.

---

122. Conine, *supra* note 9 at 1223.

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

124. 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 9 at 1264-65.