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Oil and Gas: A.A.P.L. Form 610 Model Form Operating Agreement: Imposing Limitations on the Operator's Ability to Require Contribution from Nondefaulting Nonoperators

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has expressed a desire that the owner be informed of the possible ramifications if the contractor, mechanics, or materialmen are not compensated.

The possibility of a falsified notice and such a notice's effect is a problem that must be resolved. Allowing a subcontractor, laborer, or materialman to rely on a falsified notice thwarts the intent of informing the owner of the possibility of a lien on the dwelling. At the same time, denying a good faith subcontractor, laborer, or materialman a valid lien simply because the notice on which they justifiably relied was false would be inequitable.

A possible resolution to this problem would be to negate liens based on a falsified notice (this would follow the intent of section 142.1 in protecting the owner-occupier), and require the invalidated lienholder to go against the provider of the falsified notice.

The written notice to an owner-occupier required by the amended statute must be made before a lien can be perfected. If this notice is not given, a trustee in bankruptcy may avoid the lien. Once the notice is given, though, whether correctly or incorrectly, the trustee cannot avoid the mechanic's or materialmen's liens until the statutory time allotment for perfecting such lien has passed.

While problems exist with the statutes that deal with notice to the owner in an owner-occupied dwelling, requiring such notice promotes openness between the owner and the contractor. The notice is an important element in educating the owner concerning the ramifications of contractors', subcontractors', mechanics', or materialmen's liens on his real property.

Tom Newby

Oil and Gas: A.A.P.L. Form 610 Model Form Operating Agreement: Imposing Limitations on the Operator's Ability to Require Contribution from Nondefaulting Nonoperators

Parties seeking to develop and produce oil and gas properties frequently find it advantageous, and in some cases necessary, to combine their resources with other such parties. The continuing demand for fossil fuels has driven the oil and gas industry to explore deeper and deeper into the earth's crust. Consequently, production operations have become capital-intensive, requiring expenditures that a single oil and gas developer may be unable or unwilling to make. Moreover, conservation statutes in many states limit the number of separate wells that may be drilled within a given geographical area. Because there probably will be more than one party within an area with an interest in oil and gas development, it is to the parties' mutual benefit to combine their resources and develop the property together.

Lessees wishing to combine their resources for the development of oil and gas underlying a given tract of land typically will do so by entering into an operating agreement. There are many forms of operating agreements available,

but the one most widely used in the industry today is the A.A.P.L. Form 610 Model Form Operating Agreement.[1] The Model Form Operating Agreement provides for the designation of an operator, who shall be in charge of all production operations, and nonoperators, who shall be liable for their proportionate share of the expenses incurred by the operator. In addition, the Model Form 610 (1977 version) provides that if a nonoperator does not pay its share of the expenses incurred by the operator, the operator may require all nondefaulting parties to pay the unpaid amounts in the proportion to the interest each nondefaulting party owns.[2] The Model Form also provides that each party paying its share of the unpaid expenses shall be subrogated to the security rights granted to the operator under the operating agreement.

The purpose of this note is to examine the effect of the above clause, to explore any rights and duties that might exist between the operator and nonoperators if the operator seeks to invoke this remedy, and to suggest arguments available to nonoperators to avoid additional assessments for expenses incurred under the operating agreement.

Purpose and History of the A.A.P.L. Form 610 Model Form Operating Agreement

The Model Form Operating Agreement seeks to define the rights and duties existing between the operator of an oil and gas well and its cotenant nonoperators. This contractual framework has been widely accepted in the oil and gas industry as a useful tool to forge a cooperative entity that can properly develop oil and gas property. A proper analysis of a specific clause within the Model Form Operating Agreement must be developed in light of the operating agreement as a whole, the history of its development, and the purposes it was developed to serve.

The use of an operating agreement in the oil and gas industry is not a recent development. Cotenants of oil and gas properties and their lessees realized that development and production of jointly owned mineral interests, in the absence of an agreement between the parties, was plagued with uncertainty. This uncertainty revolved around the concepts of "reasonable and necessary costs," the term of different oil and gas leases, and the assumption of the risk of dry holes.

It is the general rule that a cotenant has the right to enter on the land and produce his share of oil and gas.[3] However, the developing cotenant must

1. Wigley, *A.A.P.L. Form 610-1977 Model Form Operating Agreement,* 24 ROCKY MTN. MIN. L. INST. 693, 696 (1978): "The A.A.P.L. Model Form became, without question, the most widely accepted and most often used Form in the industry." Young, *Oil and Gas Operating Agreements: Producers 88 Operating Agreements, Selected Problems and Suggested Solutions,* 20 ROCKY MTN. MIN. L. INST. 197, 199 (1975): "It is presently believed that the Ross-Martin, now A.A.P.L. Form 610, has gained such general acceptance, even by major companies, that it may be considered a Standard Operating Agreement." A.A.P.L. refers to the American Association of Petroleum Landmen.

2. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. VII-B.

3. Earp v. Mid-Continent Pet. Corp., 167 Okla. 86, 27 P.2d 855 (1933); R. HEMINGWAY, OIL AND GAS § 5.1 (1971); E. KUNTZ, OIL AND GAS, § 5.3 (1962).

account to his co-owners for their proportionate share of the production less the reasonable and necessary costs of development, extraction, and marketing.[4] The concept of "reasonable and necessary" costs of development and production is not easily defined and can lead to considerable uncertainty. Oftentimes, a heated dispute develops between the developing cotenant and the nondeveloping cotenants.

Further uncertainty follows when cotenants in the same oil and gas property execute different oil and gas leases on their respective mineral interests. It is likely that the leases will have different primary terms and therefore will have different expiration dates. Although one lessee may be currently developing the property, his activity will not inure to the benefit of other lessees.[5] The drilling and production by one lessee will not serve to extend the leaseholds held by other cotenant lessees.[6] Consequently, a lessee may face the possibility of termination of his leasehold estate if he cannot begin his own drilling activity, even though the oil and gas property is already burdened by intensive drilling activity.

A developing cotenant also assumes the entire risk of a dry hole.[7] He cannot require contributions from his co-owners in the oil and gas property for any expenses attributable to the dry hole. A cotenant wishing to develop his proportionate interest in the mineral estate will be reluctant to engage in expensive drilling and exploration operations if he cannot spread the risk of loss among the concurrent owners.

The above uncertainties associated with unilateral development and exploration, along with exploration costs outstripping what a single lessee could bear, provided the impetus for joint development of concurrently owned oil and gas interests. Operating agreements were drafted by many oil companies to

4. Prairie Oil & Gas Co. v. Allen, 2 F.2d 566 (8th Cir. 1924); Earp v. Mid-Continent Pet. Corp., 167 Okla. 86, 27 P.2d 855 (1933); HEMINGWAY, *supra* note 3, at 165.

5. *See* Mattison v. Trotti, 262 F.2d 339 (5th Cir. 1964). *See also* Earp v. Mid-Continent Pet. Corp., 167 Okla. 86, 87, 27 P.2d 855, 856 (1933):

> The drilling by a lessee under a different lease obtained from a cotenant of the lessor does not operate to extend the term of the lease beyond the five years therein provided unless there exist between the two lessees some agreement with reference to the development of the common property which in effect makes the drilling, development and production the act of both lessees.

(Court syllabus.) *See also* Willson v. Superior Oil Co., 274 S.W.2d 947 (Tex. Civ. App. 1954), wherein the court stated that in the absence of an agreement to cooperate in the development of a common property "[e]ach owner in a co-tenancy acts for himself and no one is the agent for the other nor has any authority to bind the other merely because of the relationship unless authorized to do so."

6. Earp v. Mid-Continent Pet. Corp., 167 Okla. 86, 27 P.2d 855 (1933); Schank v. North American Royalties, Inc., 201 N.W.2d 419 (N.D. 1972); Hughes v. Cantwell, 540 S.W.2d 742 (Tex. Civ. App. 1976).

7. Prairie Oil & Gas Co. v. Allen, 2 F.2d 566 (8th Cir. 1924); Earp v. Mid-Continent Pet. Corp., 67 Okla. 86, 27 P.2d 855 (1933); White v. Smyth, 147 Tex. 272, 214 S.W.2d 967 (1948). *But see* Moody v. Wagner, 167 Okla. 99, 22 P.2d 633 (1933), which held that the operating cotenant is entitled to deduct the costs of a dry hole if it is part of the drilling scheme between the parties.

delineate the rights and obligations of the participants in a joint development operation. Unfortunately, these agreements were not uniform and the participants often quarreled over the terms of the operating agreement.[8] The Model Form Operating Agreement was developed to provide a uniform agreement for joint operations that could be generally accepted throughout the oil and gas industry.[9]

The Model Form Operating Agreement first appeared in 1956, with revisions occurring in 1977 and in 1982. All revisions of the Model Form Operating Agreement provide for the designation of an operator who "shall conduct and direct and have full control of all operations on the Contract Area [or "Unit Area" in the 1956 form] as permitted and required by, and within the limits of, this agreement."[10] The operator also has the responsibility of promptly paying all expenses incurred in the development and operation of the oil and gas lease covered by the agreement. The nonoperators are responsible for their proportionate share of the expenses incurred by the operator.[11]

Because the burden is on the operator to discharge liabilities owed to third parties, the Model Form Operating Agreement grants several rights and remedies to the operator to ensure reimbursement from the nonoperators. In addition to the operator's right to a breach of contract action against defaulting nonoperators, the operator is given a lien upon each nonoperator's interest covered by the agreement, a security interest in the nonoperator's share of oil and gas produced and in all equipment, and the right to collect directly from the purchaser of the oil and gas the proceeds from the sale of the nonoperator's share of oil and gas produced until the amount owed by the nonoperator, plus interest, has been paid.[12]

Although at first glance the above remedies may appear adequate to protect the operator, in today's climate of restricted cash flow and endemic bankruptcy among oil and gas producers, the operator often finds himself in an unsatisfactory position when trying to obtain reimbursement from the defaulting nonoperator. The operator's rights to a security interest in production or to collect directly from the purchaser of such production are completely ineffective if the operations result in a dry hole. Additionally, the foreclosure of the liens granted to the operator against the interests of the defaulting nonoperator can be costly and time-consuming. If a nonoperator has repeatedly ignored demands made by the operator to secure payment of the nonoperator's proportionate share of costs, it usually is an indication that the nonoperator is in serious financial difficulty. The operator attempting to foreclose his lien may find himself competing against other third-party creditors for the assets of the nonoperator. The apparent effectiveness of these remedies

8. Hazlett, *Drafting of Joint Operating Agreements*, 3 ROCKY MTN. MIN. L. INST. 277, 278 (1957).

9. *See generally* Wigley, *supra* note 1.

10. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. V.

11. *Id.*, art. VII-A.

12. *Id.*, art. VII-B.

may be undermined by the uncertainties involved in establishing priority of interests in the nonoperator's assets and in meeting the requirements of the Uniform Commercial Code for a security interest in personal property.[13]

The drafters of the Model Form Operating Agreement apparently recognized the infirmities of the aforementioned remedies granted to the operator and consequently included another remedy. However, this specific remedy seldom was invoked prior to the difficult times the industry faces today. This remedy grants the operator the power to require contribution from the nondefaulting nonoperators for the payment of the debts of other defaulting nonoperators. Article VII-B of the 1977 version of the Model Form Operating Agreement provides:

> If any party fails or is unable to pay its share of expense within sixty (60) days after rendition of a statement therefore by Operator, the non-defaulting parties, including Operator, shall, upon request by Operator, pay the unpaid amount in the proportion that the interest of each such party bears to the interest of all such parties.[14]

On its face, this clause gives the operator great leverage against all nonoperators, whether in default or not. The operator may avail himself of the solvency of other nonoperators to reduce greatly any risk of loss attributable to the insolvency of other nonoperators.

Under this clause, the liability of each nondefaulting party for the expenses attributable to a defaulting party is limited "in the proportion that the interest of each such party bears to the interest of all such parties." A close reading of the clause will reveal that "all such parties" refers to the class of nondefaulting parties. Unfortunately, it is not uncommon today for many of the parties to an operating agreement to be in serious financial straits and unable to meet their proportionate share of expenses. As the class of nondefaulting parties gets smaller, a nondefaulting party will be liable under this clause for a larger percentage of the total cost of the operations. It is conceivable that the operator could also fall into the class of defaulting parties

13. It might be advisable for the operator to file a U.C.C. financing statement that has been executed by each of the nonoperators, but this does not appear to be a common practice in the oil and gas industry.

14. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. VII-B. The 1956 version of the Model Form Operating Agreement contains substantially different wording:

> In the event of the neglect or failure of any non-operating party to promptly pay its proportionate part of the cost and expense of development and operation when due, the other non-operating parties and Operator, within thirty (30) days after the rendition of statements therefor by Operator, shall proportionately contribute to the payment of such delinquent indebtedness and the non-operating parties so contributing shall be entitled to the same lien rights as are granted to Operator in this section.

Id. ¶ 9.

The effect of this clause is essentially the same as article VII-B in the 1977 and 1982 versions. One difference, however, is that under the 1956 version, a nondefaulting party's liability to contribute to the payment of a delinquent indebtedness may be limited to the proportion that the party's interest bears to the interest of all parties, defaulting and nondefaulting.

and one nonoperator become liable for the entire cost of production, regardless of how small his interest is in proportion to the entire contract area.

From the dearth of cases concerning operating agreements in general, and the clause in article VII-B in particular, it is apparent that this clause has lain dormant. However, economic conditions within the oil and gas industry have pressured operators to seek new methods to protect their interests, and it is likely that this clause will soon be added to the operator's regular arsenal against the nonoperators to secure payment for expenses incurred in the operation of the wells drilled under the agreement. Nonoperators who receive additional assessments from the operator under the authority of this clause should view their liability in light of the relationship between the operator and the nonoperator.

The Nature of the Relationship Between the Operator and the Nonoperator

The nature of the relationship between the operator and the nonoperator is unclear, and it is even more unclear how the relationship between the operator and the nonoperator affects the application of the clause in article VII-B. Although the language of article VII-B is relatively clear, there is some ambiguity concerning the extent to which an operator must establish that a nonoperator "fails or is unable to pay its share of expenses." However, the clause does clearly establish the contractual right in the operator to require nondefaulting nonoperators to contribute payments to cover the default. The nonoperator who wishes to avoid liability under the clause must therefore premise his argument on the duties, whether implied in law or equity, imposed upon the operator arising out of the relationship between the operator and the nonoperator. This relationship can be characterized as a (1) joint venture, (2) cotenancy, or (3) "cotenancy plus."

The Operating Agreement as a Joint Venture

The relationship between the operator and the nonoperator created by the operating agreement closely resembles a joint venture. The requirements for a joint venture have been stated as follows:

(1) A contribution by the parties of money, property, effort, knowledge, skill or other asset to a common undertaking;
(2) A joint property interest in the subject matter of the venture;
(3) A right of mutual control or management of the enterprise;
(4) Expectation of profit, or the presence of "adventure," as it is sometimes called;
(5) A right to participate in the profits;
(6) Most usually, limitation of the objective to a single undertaking or ad hoc enterprise.[15]

15. W. JAEGER, WILLISTON ON CONTRACTS, § 318 at 563-65 (3d ed. 1959). These elements are discussed in Stott, *Legal and Tax Consequences of Mining Joint Venture Agreements*, 18 ROCKY MTN. MIN. L. INST. 189, 195-97 (1973).

The Model Form Operating Agreement contains many of these elements. The parties to the agreement are required to contribute their share of expenses, are frequently working interest owners in the property covered by the operating agreement and thus have a property interest in the subject matter of the venture, and have the right to participate in the profits from the well.[16] Additionally, the operating agreement only obligates the parties to the operation of a single designate initial well, thereby meeting the requirement of a "single or *ad hoc* enterprise."[17] Any further drilling operations conducted by a party to the agreement require additional consent from the other parties to the agreement before they become obligated to participate in the costs of the well.[18]

If the Model Form Operating Agreement is found to create a joint venture, certain obligations and duties exist between the parties to the joint venture. "The most important characteristic of a joint venture is that a fiduciary relationship of trust and confidence arises therefrom. Each party has the right to demand and expect from his associates full, fair, open, and honest disclosure of everything affecting the relationship."[19] The operator thus owes the nonoperators certain fiducial duties that must be fulfilled before the operator may resort to his contractual right under article VII-B against the nondefaulting nonoperators. These duties include the duty of loyalty toward the interests of the nonoperators and the duty of openness and full disclosure.

The fiducial duties of a joint venturer are essentially the same as in a general or limited partnership.[20] A joint venturer, as a partner, is under a duty of loyalty and honor toward his fellow venturers and may not act at their expense.[21] Specific constraints on the activities of a joint venturer flow from this general duty of loyalty. Thus, a joint venturer may not compete with the joint venture within the scope of its business nor exploit knowledge acquired through the joint venture for personal gain.[22] If the Model Form Operating Agreement is held to constitute a joint venture, then the operator must excercise its powers with due regard to the fiducial duties owed to the nonoperator.

The operator may be subject to an even higher duty of loyalty than the typical joint venturer. "Loyalty to co-partners is required from all partners. However, if one partner is in a position to exert greater control over partner-

16. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. VII-A provides: "Each party shall be responsible only for its obligations, and shall be liable only for its proportionate share of the costs of developing and operating the Contract Area." Article III-B provides that the production from oil and gas will be owned by the parties to the agreement according to their stipulated fractional interests under the operating agreement.

17. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. VI-A.

18. *Id.*, art. VI-B.

19. Williams, *The Fiduciary Principle in the Law of Oil and Gas*, 13th INST. ON OIL AND GAS LAW AND TAX. 261 (Sw. Legal Fdn. 1962). *See also* Blackstock Oil Co. v. Caston, 184 Okla. 489, 491, 87 P.2d 1087, 1089 (1939): "The relation between the parties to a joint adventure is fiduciary in its character, and requires the utmost good faith in all the dealings of the parties with each other."

20. J. CRANE & A. BROMBERG, PARTNERSHIP § 68 at 389 (1968).

21. Note, *Fiduciary Duties of Partners*, 48 IOWA L. REV. 902 (1963).

22. CRANE & BROMBERG, *supra* note 20, at 390-95.

ship affairs than can be exercised by his co-partners, the court will require an even higher degree of loyalty from this partner."[23] Given the virtually exclusive managerial powers granted to the operator under the Model Form Operating Agreement and the resulting high duty of loyalty and honor to the nonoperators, there is an even stronger emphasis on the limitations placed upon the operator's exercise of powers that may adversely affect the interests of a nonoperator.

The operator's managerial authority over the joint venture also gives rise to an accentuated duty of openness and full disclosure.[24] Although it is not required by the terms of the Model Form Operating Agreement, the operator should notify the nonoperators of any delinquency or pending default on the part of any other nonoperator. To do otherwise would not be consistent with the operator's "accentuated duty" of disclosure of all matters affecting the joint venture.[25]

It is urged that the duties imposed upon a joint venturer in the position of the operator under the Model Form Operating Agreement logically require the operator to attempt foreclosure of the liens and security interests granted to it under the operating agreement against a defaulting nonoperator before resorting to its remedy against the nondefaulting nonoperators under article VII-B. Otherwise, the operator would be able to avail itself freely of the solvency of the nondefaulting nonoperators without any obligation on the part of the operator to protect and preserve the nonoperators' expectations of profit from the joint venture. Such conduct would be manifestly inconsistent with the operator's high duty of loyalty owed to the other members of the joint venture.

All of the above duties are premised on the conclusion that the Model Form Operating Agreement establishes a joint venture among the parties to the agreement. Although many of the elements for a joint venture certainly exist, the weight of authority appears to be that the relationship created is not a joint venture.[26] The few cases that have addressed the issue have arrived at the conclusion that there is insufficient mutual control between the operator and the nonoperator to satisfy the requirements for a joint venture.[27]

23. Note, *supra* note 21, at 908. *See* C.H. Codding & Sons v. Armour & Co., 404 F.2d 1 (10th Cir. 1968); Bosworth v. Eason Oil Co., 202 Okla. 359, 213 P.2d 548 (1949).

24. C.H. Codding & Sons v. Armour & Co., 404 F.2d 1 (10th Cir. 1968); CRANE & BROMBERG, *supra* note 20, § 67.

25. Uniform Partnership Act § 20 provides: "Partners shall render on demand true and full information of all things affecting the partnership to any partner or to the legal representative of any deceased partner or partner under a legal disability." 6 U.L.A. 256 (1969).

26. Prentice v. Amax Pet. Corp., 220 So. 2d 783 (La. App. 1969); Luling Oil and Gas Co. v. Humble Oil & Refining Co., 144 Tex. 445, 191 S.W.2d 716 (1945); Youngstown Sheet & Tube Co. v. Penn, 355 S.W.2d 239 (Tex. Civ. App. 1962), *modified and aff'd on app.* 363 S.W.2d 230 (Tex. 1962); Berchelmann v. Western Co., 363 S.W.2d 875 (Tex. Civ. App. 1962); U.S. Truck Lines v. Texaco, Inc., 337 S.W.2d 497 (Tex. Civ. App. 1960).

27. *E.g.*, Berchelmann v. Western Co., 363 S.W.2d 875 (Tex. Civ. App. 1962). *See* Bledsoe, *Selected Creditor Problems—Joint Interest Operations*, 23d INST. ON OIL AND GAS LAW AND TAX. 215, 219 (Sw. Legal Fdn. 1972); Jones, *Problems Presented by Joint Ownership of Oil, Gas and Other Minerals*, 32 TEX. L. REV. 697, 719 (1954).

In *Youngstown Sheet & Tube Co. v. Penn*,[28] the Texas Supreme Court decided that the operating agreement before it did not establish a joint venture. Although it is clear from the opinion that the operating agreement signed by the parties was not the Model Form Operating Agreement, there appears to be basic similarities between the language cited by the court and the language of the Model Form. The agreement in *Youngstown* provided that the operator would have "exclusive charge, control and supervision of all operations of every kind" in the development of the lease.[29] The operator also had the authority to bill each nonoperator for its proportionate share of the costs and expenses incurred by the operator, and the operator was granted a lien on the nonoperator's interest to secure payment. In addition, the operating agreement contained an express disclaimer of any intent by the parties to create a partnership venture. *Youngstown* decided as a matter of law that the operating agreement did not create a partnership relation between the operator and the nonoperators "for the reason that it does not establish joint operation of the leases nor mutual agency of the parties."[30] It is apparent from the court's decision that the level of control left in the nonoperators did not rise to the level of "joint operation" required to establish a joint venture.[31]

A comparison between the language of the operating agreement in *Youngstown* and the Model Form Operating Agreement shows the precedential value of the *Youngstown* decision. The Model Form (1977 version) provides that the operator "shall conduct and direct and have full control of all operations . . . ."[32] The operator also has the power to charge each of the parties to the agreement with their proportionate share of the expenses and to exercise the liens and security interests granted under article VII-B. And finally, as in *Youngstown*, the Model Form provides: "It is not the intention of the parties to create, nor shall this agreement be construed as creating, a mining or other partnership or association, or to render the parties liable as partners."[33] The basic similarity of language and structure between the Model Form and the *Youngstown* agreement indicates that the Model Form Operating Agreement does not create a joint venture. A nonoperator seeking to impose a duty of loyalty upon the operator arising out of a joint venture relationship may be building such obligations on a precarious foundation.

Other authorities have stressed that although the operator's scope of authority under an operating agreement is usually limited to drilling one well according to the parameters of the agreement, this fact does not give the

28. 355 S.W.2d 239 (Tex. Civ. App. 1962), *modified and aff'd on app.* 363 S.W.2d 230 (Tex. 1962).

29. 355 S.W.2d at 241.

30. 355 S.W.2d at 245.

31. The court in *Youngstown* relied upon U.S. Truck Lines v. Texaco, Inc., 337 S.W.2d 497 (Tex. Civ. App. 1960), which held that joint operations were an essential element of a mining partnership. The operator's exclusive control of development and exploration negated a finding of a partnership. *See* Bledsoe, *supra* note 27.

32. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. V-A.

33. *Id.*, VII-A.

nonoperators any control over the operations.[34] The limitations on the operator's conduct should not be construed as establishing joint control over the operations. Concomitantly, the limitation of the nonoperators' rights to approvals, audits, and inspections should also not be construed as establishing joint control over the operations.

On the other hand, in *Oklahoma Co. v. O'Neil*,[35] the Supreme Court of Oklahoma stated that one of the requirements for a joint venture was "acts or conduct reflecting cooperation in the project."[36] The court decided that the operating agreement established a joint venture between the parties. In the opinion the court did not focus upon the language of the agreement. Instead, it emphasized that the nonoperators had little knowledge or skill with which to assist the operator in the development of the leases. The court then stated: "Recognizing this state of affairs the defendants [the nonoperators] left the management and operation of the leases to the plaintiff [the operator]. This conduct amounted to cooperation under these circumstances."[37] Thus, the Oklahoma court appears to adopt a very liberal standard when measuring the conduct necessary to establish a joint venture. Under this decision, the limited powers of the nonoperators under the Model Form Operating Agreement, coupled with inability or ignorance on the part of the individual nonoperators involved, may prove sufficient to satisfy the Oklahoma court's standard of "acts or conduct reflecting cooperation in the project."[38]

As a practical matter, if a nonoperator is arguing that the Model Form Operating Agreement constitutes a joint venture so the court will find that a fiducial relationship existed, and that there were fiduciary duties owed to the nonoperator that must be fulfilled before equity will allow the operator to resort to his article VII-B remedy, the nonoperator will face vehement opposition from the oil and gas industry. One of the most onerous characteristics of a joint venture is joint and several liability between all members of the venture.[39] One of the reasons the oil and gas industry has accepted the Model Form Operating Agreement as an effective contractual framework for joint operations is that its structure will likely avoid joint and

34. Jones, *supra* note 27.

35. 440 P.2d 978 (Okla. 1968).

36. *Id.* at 984. The court in *O'Neil* listed three requirements for a joint venture: (1) a joint interest in the property involved, (2) an agreement, express or implied, to share in the profits or losses, and (3) acts or conduct reflecting cooperation in the project.

37. *Id.* at 985.

38. The court in *O'Neil* did not require an affirmative act on the part of the nonoperators in order to constitute "cooperation." However, in Jenkins v. Pappas, 383 P.2d 645 (Okla. 1963), the court had stated that "cooperation in the project" contains an element of *active conduct*. Each party must actively join in the promotion, conduct, or management of the joint venture. This language indicates that a passive compliance with the acts of the operator is not sufficient to establish "cooperation." *See also* Edwards v. Hardwick, 350 P.2d 495 (Okla. 1960). It is unclear whether it was the Oklahoma court's intention in *O'Neil* to broaden its definition of "cooperation" to include relatively *passive* conduct on the part of the nonoperators.

39. Bergen, *Liabilities of Nonoperating Investor in Oil and Gas Leases Under Various Types of Investor Agreements*, 17th INST. ON OIL AND GAS LAW AND TAX. 185 (Sw. Legal Fdn. 1966).

several liability. Thus, the nonoperator may wish to base his claim of a fiducial relationship upon a theory not burdened with such an unattractive result.

Operator and Nonoperator as Cotenants

Owners of undivided interests in oil and gas rights are tenants in common.[40] Lessees of the owners of the undivided interests are also tenants in common.[41] Normally, the operator will also be a lessee of a mineral owner within the tract of land covered by the operating agreement. As a lessee, the operator is also a cotenant with the nonoperators. A nonoperator may thus argue that a cotenant owes certain duties to his fellow cotenants. If an operator is to require nondefaulting nonoperators to bear costs in excess of their proportionate share, then the nonoperator may argue that courts of equity should require the operator to first honor his duties to his cotenant nonoperators. These duties include the duty to protect the interests of other cotenants and to deal fairly by fully disclosing all facts that will affect the interests of other cotenants.

That the operator and the nonoperator are tenants in common is "insufficient reason for saying that each has a full complement of fiduciary relationships with his other cotenants."[42] However, this does not mean that cotenants are entirely free of any obligations toward concurrent owners. The Oklahoma Supreme Court has stated: "Cotenant owners of an estate in lands stand in a relation of mutual trust and confidence to each other, and neither will be permitted to act in hostility to the other in reference to such joint estate."[43] The nonoperator may reasonably argue that this relation of "mutual trust and confidence" imposes upon the operator a duty to pursue other available remedies against a defaulting nonoperator before imposing additional burdens upon nondefaulting nonoperators under article VII-B of the operating agreement. Otherwise the operator could place a heavy burden on the ability of the nonoperator to reap any benefits from his oil and gas rights when it was within the power of the operator to pursue other potentially effective remedies that would not adversely affect the nonoperator.

A corollary to the relationship of "mutual trust and confidence" between cotenants is the general duty of fair dealing owed to other cotenants. Powell has noted that courts will find a breach of a fiduciary relationship between cotenants where one cotenant has made "an agreement with the other cotenants, in which some advantage is gained by 'overreaching' the others."[44] Obviously, the courts seek to prevent one party from taking unfair advantage of another party. This principle should be applied to the relationship between the operator and the nonoperator. Thus, before an operator is allowed to invoke its remedy against nondefaulting nonoperators, the facts should show

40. KUNTZ, *supra* note 3, § 5.1 at 104.

41. HEMINGWAY, *supra* note 3, § 5.1 at 164.

42. 4A POWELL, REAL PROPERTY ¶ 605 (1954). *See* Britton v. Green, 325 F.2d 377 (10th Cir. 1963).

43. Ellis v. Williams, 297 P.2d 916 (Okla. 1952)

44. POWELL, *supra* note 42, ¶ 605 at 619.

that the operator has not persuaded his cotenants to enter into the operating agreement by misstating facts or by concealing facts that should have been revealed.[45]

"Cotenancy Plus"

The cotenancy relationship gives rise to only limited fiducial duties between the cotenants. Consequently, cotenants in oil and gas interests often function with relatively few constraints on their conduct toward their fellow cotenants.[46] It is contended, however, that given the operator's position as a cotenant as well as the designee of broad managerial powers under the operating agreement, it is more consistent with fundamental fiduciary principles to impose a higher duty of care and loyalty upon the operator's conduct toward its fellow nonoperators. Specifically, the operator, because of its unique position under the operating agreement, is under a minimum obligation to pursue all reasonable alternatives to recover payment from a defaulting nonoperator before invoking its remedy against nondefaulting nonoperators.

The Model Form Operating Agreement substantially alters the normal cotenancy relationship. Although the operator assumes the primary responsibility of discharging all debts incurred in oil and gas exploration, the nonoperators relinquish all control over the conduct of the operations. The nonoperators also vest all of their rights to conduct exploration operations (at least as far as the initial well is concerned) in the operator. The operating agreement also grants the operator the power to exercise the remedies created under the operating agreement at its own discretion. Thus the operator has become a "cotenant plus"; that is, the operator is raised to a position of special advantage over the nonoperators by virtue of the concentration of exploration and development rights vested in it under the operating agreement and the substantial rights and remedies granted to the operator to secure payment of expenses incurred.

Basic fiduciary principles can easily be applied to this "cotenancy plus" relationship. In an excellent article on fiduciary principles in the oil and gas field, Howard Williams made the following generalization:

> Wherever the owner of an interest in oil and gas has a *power* with respect to another person's interest in oil and gas, the courts are quick to imply a *duty* in connection with the exercise of such power. Power begets responsibilities and duties. A fiduciary principle becomes applicable. The person having the power is restricted in his conduct; he is not permitted to base his conduct exclusively on self-interest. He must give consideration to the effect of his conduct upon the interest owned by another with regard to which he has a power.[47]

45. Blackstock v. Caston, 184 Okla. 489, 87 P.2d 1087 (1939); POWELL, *supra* note 42, ¶ 605 at 624.

46. *See* Williams, *supra* note 19.

47. *Id.* at 274.

It is apparent that the terms of the Model Form Operating Agreement grant the operator substantial power over the nonoperators' oil and gas interests. The operator's status as a cotenant dictates certain obligations toward the nonoperators. Moreover, the operator's position of power should also dictate the existence of limitations upon the exercise of that power.

The principle that "power begets responsibilities and duties" was previously reflected in the propensity of the courts to impose a higher duty of loyalty and care upon a partner or joint venturer who possesses the ability to exercise greater control over the affairs of the venture than is possessed by the other venturers.[48] The operator is in an analogous position as a cotenant in possession of greater managerial authority over the development of an oil and gas interest than that possessed by the co-owners. The operating agreement grants the operator "full control of all operations."[49] The operator thus has almost exclusive managerial control over the daily prosecution of operations. The operator is also allowed to use its own employees, tools, and drilling equipment in the operation of the initial well, subject to the basic limitation that the operator's charges for such drilling equipment "shall not exceed the prevailing rates in the area."[50] The operator also has the discretion to require contribution from nondefaulting nonoperators.[51] The operator is vested with a power to impose a liability for expenses on a nonoperator that could greatly exceed that nonoperator's interest in the oil and gas property. This power can virtually destroy a nonoperator's ability to reap a profit from its oil and gas interests. Given the managerial and discretionary powers granted to the operator, it would be a small step to impose fiduciary obligations on the operator to protect the interests of the nonoperators.

A fiduciary has been defined as "a person who undertakes to act in the interests of another person."[52] This too indicates that the managerial and discretionary powers granted the operator under the operating agreement dictate the imposition of fiducial limitations on the exercise of those powers. The primary purpose of the operating agreement is to facilitate the development of jointly owned oil and gas interests by appointing a single developer who will engage in exploration activity for every cotenant's interest simultaneously.[53] It is an affirmative undertaking on the part of the operator to develop jointly owned oil and gas property efficiently for the mutual benefit of all parties to the operating agreement within a contractual framework that reduces the uncertainties attached to development by a single cotenant.

In summary, a nonoperator may premise the existence of fiducial limitation upon the operator's conduct as a "cotenant plus" on the concentration of managerial and discretionary powers in the operator, the operator's "undertaking" to act in the interests of the nonoperators, and the operator's

48. *E.g.*, C.H. Codding & Sons v. Armour & Co., 404 F.2d 1 (10th Cir. 1968).
49. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. V-A.
50. *Id.*, V-D.
51. *Id.*, art. VII-B.
52. Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 521, 540 (1949).
53. Wigley, *supra* note 1.

basic duties as a cotenant. Whether the operator is held to "the punctilio of an honor the most sensitive,"[54] or only required to refrain from interfering with the nonoperator's enjoyment of its property interests, basic fiduciary principles logically require the imposition of certain minimum limitations on the operator's ability to assess additional charges against a nondefaulting nonoperator under article VII-B. The fiduciary principle arising from the "cotenancy plus" relationship requires the operator to govern his conduct in light of the interests of the nonoperators rather than exclusively in light of its own economic interests.[55] Therefore, at the very least the operator should be under an obligation to "exhaust its remedies" against the defaulting nonoperator before resorting to remedies detrimental to other concurrent interests.

It was previously noted that if a nondefaulting party is required to contribute additional funds to cover a defaulting party's expenses, that nonoperator is subrogated to the rights of the operator.[56] The operator thus may argue that no damage is done to the nonoperator's interest because the nonoperator has an effective remedy against the defaulting party. Yet these remedies may prove to be as ineffective for the nonoperator as they often prove to be for the operator. The operator, in effect, has shifted much of the risk of loss resulting from the ineffectiveness of these remedies to the nonoperator. The operator would not be complying with its fiduciary obligations as a "cotenant plus" if it extracted payments from its cotenant nonoperators under article VII-B of the operating agreement and then placed on them the costly and time-consuming burden of pursuing the foreclosure of a lien or establishing the priority of a security interest in the assets of a defaulting nonoperator.

Conclusion

The Model Form Operating Agreement is widely used throughout the oil and gas industry and provides an effective contractual framework to establish the rights and duties between the operator and the nonoperators. Because of the depressed economic conditions in the oil and gas industry today, operators are resorting to little-used remedies to secure payment from nonoperators. One of these is the right of contribution from nondefaulting nonoperators. The application of this remedy is sure to cause dissension between the operator and the nonoperator, with ensuing litigation.

It is contended that courts should not look at the language creating this remedy in a vacuum. The unique relationship created by the operating agreement creates fiduciary duties owed by the operator to the nonoperator. Courts should recognize these duties and impose certain minimum standards of conduct that must be met before the operator may resort to this harsh remedy.

Randall Wood

54. Meinhard v. Salmond, 249 N.Y. 458, 164 N.E. 545 (1928).
55. *See* Williams, *supra* note 19.
56. A.A.P.L. Form 610-1977 Model Form Operating Agreement, art. VII-B.