Joint Operating Agreement - Case Law Update and Other Matters of Interest

Michel E. Curry
OVERVIEW OF OPERATING AGREEMENT CASES

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JOINT OPERATING AGREEMENT – CASE LAW UPDATE AND OTHER MATTERS OF INTEREST

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I. INTRODUCTION

The joint operating agreement1 ("JOA") is one of the most commonly used documents in oil and gas exploration. As a basic tenet, the JOA is an agreement among the various owners of the oil and gas leasehold estate intended to govern the orderly development and operation of the jointly held property. During the negotiation phase of the agreement, the objectives of the parties, if not their interests, are more or less perfectly aligned. Each party sees clearly ahead the prospect of a union in which substantial mutual benefits are to be derived. As a result, more often than not agreement upon even the most contentious points occurs with little difficulty. However, at some point after operations commence, the perfectly aligned interests of the parties may begin to diverge and the relationship then becomes adversarial. Often, some or all of the disputing parties are successors to the original signatories. For the most part, the nature of those disputes fall into predictable and repeating areas of disagreement. This paper will explore the development of recent case law2 in the context of those areas commonly resulting in legal action among the participants.

II. NOTICE

One of the recurring themes resulting in litigation among parties to a JOA relates to giving and receiving notices.3 In its most fundamental essence, notice acts as a "trigger". Some type of notice must be provided in connection with any proposed operation other than the Initial Well provided for in Article VI.A. With respect to the Initial Well, the lion's share of communication occurs during the negotiation phase and no other notice is required. At the original execution point, a well has been proposed, a cost estimate furnished, and all of the parties have agreed to participate. However, as to subsequent operations, the elements of the notice content, the parties providing and receiving notice, and the timing of the notice are frequent subjects of dispute among JOA participants.

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1 For purposes of this paper, all references to particular operating agreement provisions shall be to the American Association of Professional Landmen Form 610—1989 Model Form Operating Agreement, unless clearly indicated otherwise.

2 Although this paper is presented to the Arkansas Bar 45th Annual Natural Resources Law Institute, the author practices and is licensed in Texas and New Mexico. Therefore, the case law discussion will emphasize Texas cases with the hope that the discussion of these matters will be useful in JOA analyses regardless of jurisdiction.

3 We purposely omit any discussion of notice in the context of the JOA preferential right to purchase provision as that is a topic unto itself and well beyond the limitations of this particular paper.

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A. ESTIMATED EXPENSES

For the most part, the JOA is a financial instrument. The operating agreement is filled with provisions allocating financial responsibility. Article VI.B.1 requires notice of estimated costs to be included in connection with proposals for subsequent operations. This is typically accomplished by the operator (or proposing party) furnishing an authority for expenditure, or "AFE" to the non-operators. AFE's are planning tools intended to communicate some detail as to the intended operation and to give the parties notice of the anticipated expenses. This area is one of the many points where "lore" and "law" part ways. Contrary to popular lore, AFE's do not limit expenditures - they are only an estimate of the anticipated costs associated with a proposed operation. Three provisions in particular point to the responsibility for well costs:

Art.III.B. "Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid ... by the parties as their interests are set forth in Exhibit "A".

Art. VI.A. "The drilling of the Initial Well and the participation therein by all parties is obligatory, subject to Article VI.C.1. as to participation in completion operations [casing point election] and Article VI.F. as to termination of operations and Article XI as to occurrence of force majeure."

Art. VI.C.1. "Consent to the drilling, Deepening or Sidetracking shall include:

Option No. 1: All necessary expenditures for the drilling, Deepening or Sidetracking, testing, Completing and equipping of the well, including necessary tankage and/or surface facilities.

Option No. 2: All necessary expenditures for the drilling, Deepening, Sidetracking and testing of the well." [here follows casing point election language relating to completing and equipping the well].

(emphasis added).

Clearly, all three of these key provisions relate that, once committed, each party electing to participate in an operation is obligated to pay its proportionate share of all expenses incurred in the operation.

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4 No cost estimate for drilling the Initial Well is required. Generally, a cost estimate of that well is furnished during negotiation and prior to execution of the JOA.

5 We should note here that preparing and furnishing AFE's may be customary, but is not required under the operating agreement. Article VI.B.1 only requires that the proposal specify "the estimated cost of the operation." Therefore, a drilling proposal specifying the location of the well, the target zone and the anticipated depth, together with a lump sum estimate of the total completed cost would be sufficient.

The only provision which actually requires that an AFE be furnished is contained in Article VI.D Other Operations, and states that, "If Operator prepares an AFE for its own use, Operator shall furnish any Non-Operator so requesting an information copy thereof for any single project costing in excess of _________ Dollars ($ ____ )."

Thus, the requirement for furnishing an AFE even under this provision is responsive in nature, is limited to information purposes only, and the failure to comply with this provision clearly does not adversely impact a notice of operations which otherwise complies with the requirements of Article VI.B.1.

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No mechanism in the model form operating agreement places a ceiling on the obligation to pay well costs once a party has elected to participate in the operation. Unless all of the participating parties agree to terminate an operation early, each party must pay its full share of the expenses incurred. This obligation is essential to the joint undertaking for several reasons. In the first instance, unless all participating parties are contractually bound to pay for their share of operations, no party could afford to serve as the operator. Second, unanticipated operational problems not caused by operator error, incompetence or waste, and which result in added expense, are risks inherent to the oil and gas industry. Nevertheless, many disputes arise out of costs that exceed either the original notice (AFE) or anticipated ongoing expenses.

To protect themselves from operator error, incompetence and waste resulting in significant additional expense, non-operators have only two avenues for legal relief. At the beginning of the venture, the parties can negotiate an additional provision to the operating agreement limiting their obligation to pay excessive expenditures to either a fixed sum or a percentage of the original AFE amount. Such a provision places all of the risk for added expenses on the operator and necessarily encourages the operator to build contingencies into the cost estimate.6

To be even-handed, if a cost limitation provision is included, the operator should have the ability to either terminate the operation or require the parties to re-elect with respect to continued participation when the threshold has been reached. The 1989 Model Form JOA contains a provision partially addressing this situation. Article VI.F allows consenting parties owning an agreed upon-percentage to terminate any operation. However, no provision specifically either (a) allows the consenting parties to re-elect, or (b) allows the operator, who is often in the position of advancing the cost of the project, to unilaterally terminate operations.7

6 Following is an example of a cost-overrun limitation provision:

In the event that the accumulated cost of any operation proposed under Article VI.B.1 or VI.C exceeds 125% of the estimated cost, Non-operators shall have no liability for payment of the excess costs, except such excess costs as may result directly from explosion, fire, flood or other sudden emergency, whether of the same or different nature, and Operator acts to take steps required to deal with the emergency to safeguard life and property.

The exception to non-liability for excess costs contained in this paragraph tracks the language of Article VI.D. The risks identified in this exception are inherent in all operations and should be shared by all parties. Additionally, insurance should be available to ameliorate all or part of the additional expense. Absent such an exception, the operator would become the de facto insuror of every operation.

7 Following is suggested language which can be added to the cost-overrun limitation language above:

If the accumulated cost of such an operation proposed under Article VI.B.1 or VI.C exceeds 125% of the estimated cost, Operator at its sole election may either (a) terminate the operation and all of the consenting parties shall be liable for and shall pay for the reasonably necessary costs incurred with such termination, including without limitation the cost of plugging and abandonment of the well in it’s then present state, or (b) shall require Non-operators to make an election to either continue with the operation or to become a Non-consenting Party pursuant to the provisions of Article VI.B.2 with respect to the remainder of the
The second avenue for relief from cost-overruns is to bring suit against the operator on the basis that it has failed to perform as a reasonable prudent operator, in a good and workmanlike manner, in accordance with good oilfield practice. However, because cost-overruns and excessive operating expenses generally result from operations conducted on the Contract Area, a non-operator will be required to show that the operator acted with gross negligence or willful misconduct in order to establish operator liability for added costs. Because the level of proof required for success of such a claim is in most extremely high, the likelihood of success is virtually none. Alternatively, substantial or repeated cost overruns in operations may establish a basis for operator removal, which will be discussed in more detail below.

B. TIMING

Before commencing any operation within the scope of Articles VI.B and VI.C, notice of the proposed operation must be given to all of the parties having the right to participate. Following such notice, the non-proposing parties have a period of time, usually thirty (30) days, in which to respond. In this context, notice acts as a “trigger”, following which the rights of the parties are determined. Those parties responding to the notice in the affirmative become obligated to pay for their proportionate share of all costs and expenses. Those parties who fail to respond or who affirmatively elect not to participate are deemed non-consenting parties and relinquish their interests in the operation until the recovery of the non-consent penalty provided for in Article VII.B.2(b).

However, whether the notice must be properly given according to the terms of the operating agreement and the response period must be allowed to run as a condition precedent to invoking the non-consent penalty was the central issue in the recent decision in Dorsett v. Valence. In this case, Valence owned 94% of the working interest and was the operator. Dorsett was a non-operator and owned only 4% of the working interest. Valence began constructing roads and drill sites, and as to some wells, set conductor pipe and was actually operation. In the event that the Operator determines to terminate the operation and to plug and abandon the well pursuant to this paragraph, such abandonment shall be governed by the provisions of Article VI.E.

Non-consent penalties are intended to compensate the consenting parties for assuming the risk of a particular operation and are generally calculated as a multiple of the cost for that risk. Typical non-consent penalties range from 300% to 500% for drilling and completion expenses, but are often limited to 100% of the cost of tangible surface equipment. Non-consent penalties are sometimes attacked on the basis that they constitute unenforceable liquidated damages clauses, but the courts are fairly uniform in allowing such penalties as reasonable compensation for risk. See, Dorsett v. Valance, 111 S.W.3d 224 (Tex. App.—Texarkana 2003). Recovery of the non-consent penalty is limited to the proceeds of production from successful operations.


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drilling beneath the surface before giving notice to Dorsett of proposed drilling operations. Valence notified Dorsett of the operations, Dorsett failed to respond within the thirty day notice period and was deemed non-consent and subject to substantial penalties. The Texarkana Court of Appeals characterized this notice as a condition precedent to invoking non-consent penalties. Under its ruling, failure to give notice in advance of the operation or commencing an otherwise properly proposed operation prior to expiration of the contractual notice period relieves the non-consenting parties of liability for penalties. This rationale results in a significant alteration of the operator/non-operator relationship. Without the imposition of non-consent penalties as provided for in Article VII.B of the JOA, the relationship between operator and non-operator is one of cotenants. As cotenants, the operator may recover from the nonparticipating party only the reasonable cost of the operation.

The Texas Supreme Court reversed the Texarkana Court of Appeals and rendered judgment in favor of Valence. The supreme court implicitly approved the principle that notice of the proposed operation is a condition precedent to assessment of non-consent penalties. However, “Nothing in the Agreement forbids the operator from commencing work before the end of the notice period.” The effect of the time limits contained in the provision preserves the working interest owner’s right to a specified time period (usually 30 days) before making a decision and requires the operator to commence work not later than ninety days after the proposal. The risk of early commencement falls entirely on the operator. Regardless of the time operations are actually commenced, failure of the non-proposing party to consent within the prescribed time results in application of the non-consent penalty. Thus, in this context, notice of a proposed operation serves as a condition precedent to begin the response period but is not a limitation on commencement of operations.

C. TYPE OF OPERATION

In addition to the timing of notice with respect to the conduct of operations, the notice must relate to the operation actually conducted. In Stable Energy, L.P. v. Kachina Oil & Gas,

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12 Id. at 231.
13 Id. at 234.
14 Id. at 234.
15 Id. The analysis in this opinion clearly implicates a cotenancy relationship between the parties to an operating agreement in the absence of non-consent penalties. Because the drilling operations in the Dorsett case were successful, the court does not discuss this relationship at such length as to indicate that recovery is limited only to production obtained from successful operations. However, under either the cotenancy analysis or application of the operating agreement provisions, only successful operations should result in reimbursement of expenses to the participating parties.
17 Id., 164 S.W.3d at 662-63.
18 Id., 164 S.W.3d at 663.
In 19, the operator proposed a reworking operation in an effort to save a lease that was about to terminate for failure to produce in paying quantities. The proposal by Kachina, the operator, was to clean out and treat the existing zone in an effort to reestablish production. Twenty eight percent (28%) of the working interest elected not to participate in the operation. Stable consented to participate in the operation and agreed to assume the non-consent interest. However, after notice was given and the response time had lapsed, and before Kachina commenced operations, Stable and a subsidiary voted their interests plus the non-consent interests in an attempt to remove Kachina as operator. Following this vote, Stable’s subsidiary took over possession of the property and conducted a successful deepening operation.

However, the operation conducted was not the same as the operation contained in the notice by Kachina, which had been rejected by the 28% non-consenting interest owners. Completion of the well in a new formation was not substantially the same as the reworking operation contained in the original notice. The Austin Court of Appeals held that before non-consent penalties may be invoked, the operation conducted must be substantially the same as the operation contained in the notice and rejected by the non-consenting parties.

D. PROPER PARTIES & MAINTENANCE OF UNIFORM INTEREST

In the recent case of ExxonMobil Corp. v. Valence Oper. Co., the court assessed damages for breach of the JOA Maintenance of Interest provision predicated principally on ExxonMobil’s failure to give Valence notice of proposed drilling operations. ExxonMobil was the operator of a three well gas unit subject to a JOA containing a Maintenance of Interest provision. Although the provision was slightly modified from that contained in the printed form, the substantive portion was essentially unaffected. ExxonMobil farmed out its interest to Wagner & Brown who then proposed two wells to Valence. Both of the wells were proposed to

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20 Id. at 329-30.
21 Id. An additional aspect of this case is that the vote to remove Kachina as operator was ineffective. This court found that under the terms of the JOA, commencement of the non-consent operations was a condition precedent to relinquishment of the 28% non-consent interest. Because the operation contained in the original notice was never commenced, the non-consent interests were not effectively relinquished and Stable’s subsidiary company was not elected operator.
Because the operation was not conducted by the operator and was not otherwise allowed under the operating agreement, Stable was denied reimbursement for its costs in conducting the operation. This result seems inconsistent with a cotenancy analysis, and one must assume that the parties failed to plead and prove either cotenancy or quantum meruit.
23 ExxonMobil Corp. v. Valence Oper. Co., 173 S.W.3d 303 (Tex. App.— Houston [1st Dist.] 2004, application for petition pending). The exact language of the provision follows: “Notwithstanding any other provisions to the contrary, no party shall sell encumber, transfer or make other disposition of its interest in the leases embraced within the Contract Area and in the wells, equipment and production unless such disposition covers either:
1. the entire interest of the party in all leases and equipment and production; or
2. an equal undivided interest in all leases and equipment and production in the Contract Area.”
maintenance of uniform interest provision is to make certain that the interests of the parties remain consistent throughout the life of the lease. By farming out to Wagner & Brown, Exxon effectively realigned the interests of the parties without consent. Valence had an interest in continuing production from the Cotton Valley Lime and then using the existing wellbores to recover the behind-the-pipe reserves in the shallower formations. Wagner & Brown's sole interest was to maximize production from the shallower Cotton Valley Sand formation. By farming out its interest in the shallower formations, Exxon severed its interest from Valence's, caused Valence to incur extra costs associated with developing the shallow formations to recover reserves that could have been recovered through existing wells and thereby breached the JOA.27

III. OPERATOR REMOVAL

A. THE STANDARD

Operator removal probably results in more litigation, or threatened litigation, than any other facet of the operating relationship. However, there are very few reported cases dealing with removal. The removal provision of the 1989 model form was modified from the predecessor 1982 form. The language of the 1982 form is as follows:

Art. V.B. "... Operator may be removed if it fails or refuses to carry out its duties hereunder, or becomes insolvent, bankrupt or is placed in receivership, by the affirmative vote of two (2) or more Non-Operators owning a majority interest based on ownership as shown in Exhibit "A" remaining after excluding the voting interest of Operator."

Under this provision, the operator may be removed only in two instances: (a) failure or refusal to carry out its duties, or (b) insolvency, bankruptcy or receivership.28 Article V.A, Designation and Responsibilities of the Operator, states only that the operator "shall conduct and direct and have full control of all operations on the contract area" and that "[i]t shall conduct all such operations in a good and workmanlike manner."

Aside from having the duty to conduct and direct operations on the contract area, the operator has very few express duties under the operating agreement.

Article V.B of the 1989 model form operating agreement has been expanded from its earlier counterpart to provide"

"... Operator may be removed only for good cause by the affirmative vote of Non-Operators owning a majority interest based on ownership as shown on Exhibit "A" remaining after excluding the voting interest of Operator; ... For purposes hereof, ‘good

27 Id. In addition, although not addressed, substitution of ExxonMobil's farmee as operator of the farmout wells is arguably not sanctioned by the terms of the JOA.

28 A discussion of bankruptcy laws and application of the automatic stay to the operating agreement is covered in other writings and, therefore, outside the scope of this paper. Happily, this writer will confine our inquiry to an examination of the operator's failure or refusal to carry out its duties under the operating agreement.
cause’ shall mean not only gross negligence or willful misconduct but also the material breach of or inability to meet the standards of operation contained in Article V.A. or material failure or inability to perform its obligations under this agreement.”

Unlike its predecessor, the 1989 form provides that the operator may be removed only for good cause. Good cause includes only (a) gross negligence or willful misconduct, and (b) a material breach or inability to perform its obligations. Article V.A. of the 1989 form, sets out the standard of the operator's performance and provides that “Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation, ....”

Unlike later forms, the 1956 model form operating agreement contains no provision for removing the operator. Although that form was originally issued nearly fifty years ago, many properties continue to be operated subject to its terms. Operator removal under this early form must be accomplished through voluntary means, although it seems that in an extreme case other relief should be available. We are unaware of a reported case involving the 1956 model form in which a removal was attempted. Perhaps the lack of case law confirms the operator's position under this form.

B. OPERATOR'S DUTIES & OBLIGATIONS

All of the issues raised by these provisions can be summed up in two rather succinct questions: (1) What are the duties or obligations of the operator, and (2) who gets to decide if the operator has “failed or refused” to carry out its duties and, in the case of the 1989 form, whether such failure or refusal is material?

Determining the express duties or obligations of the operator requires an examination of the entire operating agreement. Aside from directing operations, the operator is expressly charged with paying expenses as they come due and maintaining related accounting records, filing regulatory reports, forwarding notice of non-operator proposed operations, maintaining gas balancing accounts, settling claims within its delegated dollar authority, and providing the insurance required by Exhibit “D”. No other activities under the JOA are delegated exclusively to the operator. Of the operator’s express duties, all except the control and direction of operations are essentially clerical in nature and require no exercise of discretion.

Under the 1982 form, the complete failure of the operator to provide the noted accounting and clerical services should serve as grounds for removal. Under the 1989 form, such failure must be material and the operator is allowed notice and an opportunity to cure its malfeasance before removal might be accomplished. Although the 1989 form is more detailed than the 1982 form in its description of the standard to which the operator is held, as to control and

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29 Article V.B.1. “...such vote shall not be deemed effective until a written notice has been delivered to Operator by a Non-Operator detailing the alleged default and Operator has failed to cure the default within thirty (30) days from its receipt of the notice or, if the default concerns an operation then being conducted, within forty-eight (48) hours of its receipt of the notice.”
direction of operations both describe a simple negligence standard: good and workmanlike. However, the 1989 form injects additional elements of materiality, notice and opportunity for cure. Neither of the provisions address the essential question of who gets to decide whether the operator has failed or refused to carry out its duties and whether its malfeasance was material.

C. WHO DECIDES?

This issue was essential to the El Paso Court of Appeals’ decision in Tri-Star Petr. Co. v. Tipperary Corp.\textsuperscript{30} The Tipperary case involved a 1982 form of agreement. Tri-Star was the original operator and Tipperary was a non-operator. Tipperary’s complaint included allegations that Tri-Star had failed to conduct operations in a good and workmanlike manner and had failed and refused to carry out its duties under the JOA.\textsuperscript{31} The non-operators alleged and there was some evidence that Tri-Star had improperly charged the joint account, improperly commingled funds, failed to provide proper billing adjustments, overcharged the non-operators, failed to provide reasonable information requested by the non-operators, failed to sustain required volumes of gas, and allowed acreage to prematurely expire.\textsuperscript{32} Of these allegations, all except the loss of acreage and failure to meet production requirements fall within the operator’s accounting and clerical duties. Tipperary and other non-operators conducted a vote to remove Tri-Star as operator and substitute Tipperary. Tri-Star refused to step down and turn operations over to Tipperary as successor operator, claiming that a judicial determination was a condition precedent to a vote to remove an operator by the non-operators.\textsuperscript{33}

The trial court found that “the non-operators voting to remove Tri-Star as operator made the determination under Article V.B [of the JOA] that Tri-Star had failed and refused to carry out its duties under the JOA; and ... upon the effective date of the removal vote, Tipperary became the duly elected successor operator ....”\textsuperscript{34} Thus, the trial court disagreed with Tri-Star’s argument that a judicial determination of the operator’s “failure or refusal” was a condition precedent to removal and allowed the non-operators to determine whether or not the operator met the standards of the JOA. Initially, the non-operators get to decide whether the operator has failed or refused to perform according to the required standard and presumptively, whether such failure was material.

The court of appeals found that Tipperary had a reasonable basis upon which to make its determination and upheld the trial court ruling.\textsuperscript{35} This case is hugely important to non-operators.


\textsuperscript{31} Id. at 590.

\textsuperscript{32} Id. at 590.

\textsuperscript{33} Id. at 595.

\textsuperscript{34} Id. at 595.

\textsuperscript{35} Id. at 598, 603-04. (ruling that Tipperary presented sufficient evidence that it has a probable right of recovery, upholding the trial court’s finding of a threat of irreparable injury, and affirming the trial court’s issuance of a temporary injunction preventing Tri-Star from interfering with Tipperary’s assumption of operations).
If the non-operators can make the initial determination as to the operator’s failure or refusal to perform its duties and its failure or inability to comply with the standards of the JOA, and there is a reasonable basis for such determination, a removal vote by the non-operators is enforceable through temporary injunction. Although *Tipperary* involved 1982 removal language, the analysis under the 1989 model form has been found to be similar. This decision has the potential to move non-operators from the disenfranchised to the empowered. Of course, removal of the operator on this basis may still be challenged at the trial on the merits to establish a permanent injunction.36

The rationale of the *Tipperary* Court was confirmed in the January 2006 decision by the Austin Court of Appeals in *R & R Resources Corp. v. Echelon Oil & Gas, LLC.*37 This recent case involved operator removal under a 1989 form of JOA. The principal complaint by the non-operators related to accounting procedures and excess operating expenditures. The non-operators voted to remove R&R as operator for “good cause” and demanded that it relinquish operations in favor of Leexus Oil & Gas as the duly elected successor operator. R&R refused to relinquish operations and the non-operators obtained a temporary injunction. The trial court found that (1) the non-operators had affirmatively voted to remove R&R as operator, (2) R&R’s improper accounting procedures and operating practices constituted a material breach of the standards of operation and a failure or inability to perform its obligations under the JOA, thereby constituting “good cause”, and (3) refusal to relinquish operator status was a breach of the JOA.38 On appeal, the Austin Court of Appeals confirmed the trial court finding that “Failure to make prompt adjustments to an operating account and improperly assessed charges—similar to the allegations in this case—have been bases for finding that an operator ‘failed or refused to carry out its duties,’ which would support the entry of a temporary injunction.”39 On the strength of the decisions in *Tipperary* and *R&R Resources*, it seems that the non-operators are authorized to decide the basic removal issues and, if such decision reasonably complies with the plain language of the governing JOA, the non-operators will be entitled to enforce that decision through injunctive relief.

D. DOES GROSS NEGLIGENCE OR WILLFUL MISCONDUCT APPLY TO REMOVAL?

In the *Tipperary* case, Tri-Star argued that removal of the operator requires application of the gross negligence and willful misconduct standard.40 This is another area where lore and law diverge. Common perception among industry participants is that the exculpatory clause relates

36 Id. at 605. “A ruling on temporary injunctive relief may not be used to obtain an advance ruling on the merits.” (citing, *Iranian Muslim Org. v. City of San Antonio*, 615 S.W.2d 202, 208, 24 Tex. Sup. Ct. J. 399 (Tex. 1981)).


38 Id.

39 Id., (citing the *Tipperary* decision).

40 *Tri-Star v. Tipperary*, 101 S.W.3d at 596.
to removal. In both the 1982 and 1989 model forms, the exculpatory clause appears in Article V.A Designation and Responsibilities of Operator. The language contained in each version is practically identical: "... but in no event shall [Operator] 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."\(^{41}\) Nothing contained in the plain language of this clause relates to removal of the operator. The only matter addressed by the exculpatory clause is the lack of responsibility by the operator to the non-operators for losses and liabilities. These matters are financial in nature and have little or nothing to do, at least directly, with the operator's performance of its duties. Although the court of appeals did not discuss whether the gross negligence or willful misconduct standard applies, its support of Tipperary's temporary injunction on other bases substantiates the principle that establishing gross negligence or willful misconduct is not a predicate to operator removal.\(^{42}\) Had either the trial or appellate courts applied the gross negligence or willful misconduct standard, it is probable that Tri-Star would have survived.

However, in the \textit{R&R Resources} decision, R&R specifically argued that the exculpatory clause prevented the non-operators from removing R&R as operator.\(^{43}\) In this connection, the appellate court stated that R&R was without "any authority supporting application of an exculpatory clause that concerns the manner in which an operator conducts drilling operations ... to equitable claims that do not involve R & R Resources' 'liability' for damages, or to claims for damages that are not based on drilling operations."\(^{44}\) Thus, it seems that there is little, if any, support for application of the exculpatory clause to removal issues in general, particularly where there is no claim concerning operations conducted on the contract area.

\section*{E. VOTING}

The 1982 and 1989 model forms agree that the vote to remove an operator shall be conducted by the non-operators owning a majority interest based on ownership as shown on Exhibit "A" to the JOA. Both versions similarly provide that the successor operator shall be selected by the vote of two or more parties owning a majority interest based upon the ownership shown on Exhibit "A" to the JOA.\(^{45}\) Further, the model forms are consistent that an operator who is the subject of an involuntary removal may not vote for itself as successor operator.\(^{46}\) The plain language indicates that all parties are entitled vote except that a removed operator is only

\(^{41}\) Article V.A., A.A.P.L. Form 610—Model Form Operating Agreement – 1989.

\(^{42}\) \textit{Tri-Star v. Tipperary}, 101 S.W.3d at 597-98. "The trial court in a temporary injunction hearing is only required to find that Tipperary and Interveners have a probable right of recovery with respect to their claim of non-compliance with the removal vote ...."

\(^{43}\) \textit{R & R Resources Corp. v. Echelon Oil & Gas, LLC.}, 2006 WL 66458 (Tex. App.—Austin Jan. 10, 2006, no pet. hist.) (Memorandum Opinion not reported in S.W.3d).

\(^{44}\) Id. (citing \textit{Abraxas Petr. Corp. v. Hornburg}, 20 S.W.3d 147, 155 (Tex. App.—Eastland 2001, pet. denied).

\(^{45}\) \textit{Tri-Star v. Tipperary}, 101 S.W.3d at 597-98.

\(^{46}\) Article V.B.2, A.A.P.L. Form 610—Model Form Operating Agreement – 1989 and 1982 versions.
allowed to vote for or against any other party. In *Fasken Land and Minerals, Ltd. v. Occidental Permian Ltd.*, a case involving a unit operating agreement similar in form to the API model form, the removed operator's vote against the nominated successor was effective to prevent any party from being elected to succeed Occidental Permian as unit operator.\(^{47}\)

Neither form of operating agreement contains a provision directly stating whether a non-consenting party is or is not entitled to vote for a successor operator. Many industry participants believe that a non-consenting party relinquishes its right to vote on most operating agreement issues.\(^{48}\) However, whether parties who have relinquished their interest pursuant to the non-consent provision of the JOA are entitled to vote is likely one more area where lore and law do not coincide.

Article VI.B.2.b of the 1989 form states that a non-consenting party shall be deemed to have relinquished its interest "in the well and share of production therefrom." Likewise, the consenting parties shall be entitled to receive only the interest relinquished. The obvious result of this language is that the effect of the non-consent election is limited to a specific well, or even a particular operation. Thus, a party can participate in one well, elect non-consent status in drilling the next, and participate in the drilling and completion but not the re-work of a third.\(^{49}\) At the end of the day, the division of interest may vary significantly from well to well and will change as payout occurs and the non-consenting parties regain possession of the relinquished interests. In such an event, must the parties vote on the successor operator well-by-well, with potentially conflicting results, or are votes to be calculated on a weighted average basis?\(^{50}\)

The voting provision of the JOA simply states that the parties' votes are to be weighed according to the ownership displayed on Exhibit "A". We are not instructed to consider any variation in interests from well to well, nor are we asked to determine voting percentages after

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\(^{48}\) See, e.g., *Stable Energy, L.P. v. Kachina Oil & Gas, Inc.*, 52 S.W.3d 327 (Tex. App.—Austin 2001, no pet.). This case illustrates the general feeling in the industry that a party who assumes a non-consenting interest owner's responsibility for costs is entitled to vote those interests in an operator removal and selection case. Stable had agreed to participate and to assume the costs attributable to an aggregate 28% non-consent interest. Because the non-consent operation was never commenced, the interests were not relinquished and Stable was not entitled to vote the non-consent interests. The court does not address whether Stable would have been entitled to vote the non-consent interests had they been relinquished.

\(^{49}\) For a good illustration of this point, see Article VII.B.4 Deepening, which provides that, where less than all of the parties have participated in drilling, sidetracking or deepening a particular well, the non-consent provisions apply only to the lesser of the total depth drilled or the objective zone identified in the notice of proposed operation and the well shall not be deepened beyond the initial objective without first affording the non-consent parties an opportunity to participate in the deepening operation.

\(^{50}\) See, *Journey Oper., LLC v. Pogo Prod. Co.*, 2004 WL 258122 (Tex. App.—El Paso 2004) (Memorandum Opinion). In this case, the successor operator attempted to utilize a weighted average approach. Even with this approach, Journey did not receive a majority in interest and it was unnecessary for the court to address the appropriateness Journey's method.
taking into account whether a party is non-consent in a single operation or all of the wells.\textsuperscript{51} The operator is placed in control of the contract area, not just a single well. Even where the contract area is limited to a single spacing unit, unless it is also limited to a single formation, having control of the contract area can result in responsibility for one or more wells which may be completed at more than one depth. All Parties have a continuing interest in selecting the operator. Thus, allocating voting percentages based upon the interests shown in Exhibit “A”, without regard to non-consent issues, makes basic good sense, simplifies the procedure and protects the interests of all parties.

IV. CONCLUSION

In the preceding pages, we have discussed various facets of the operating agreement and examined a number of recent cases related to those particular issues. Some of those cases are not completely resolved as they are pending final decision before the next higher court. Regardless of the outcome of any individual case, one thing is certain, with the increase in recent oil and gas industry activity and record-high commodity prices, the stakes are sufficiently high that we will see many new decisions involving the JOA in months to come.\textsuperscript{52}

\textsuperscript{51} Actually, a party should not be non-consent in all wells unless either the JOA provides for a casing point election or a subsequent operation has been proposed in the Initial Well. There is no non-consent provision with respect to drilling the initial well.

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JOINT OPERATING AGREEMENT
CASE LAW UPDATE
&
OTHER MATTERS OF INTEREST

Arkansas Bar Association
45th Natural Resources Institute

Michel E. Curry
Cotton, Bledsoe, Tighe & Dawson
Midland & Houston, TX
Operating Agreements

- NOT JUST “ANOTHER CONTRACT”
Operating Agreements

■ NOT JUST “ANOTHER CONTRACT”
  ■ Facilitates O&G development among co-owners
Operating Agreements

- NOT JUST “ANOTHER CONTRACT”
  - Facilitates O&G development among co-owners
  - May be in effect for a very long time
Operating Agreements

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  - Facilitates O&G development among co-owners
  - May be in effect for a very long time
  - Runs with the land: Parties to JOA not original parties
    - Disagreements in interpretation
Operating Agreements

- NOT JUST “ANOTHER CONTRACT”
  - Facilitates O&G development among co-owners
  - May be in effect for a very long time
  - Runs with the land: Parties to JOA not original parties
    - Disagreements in interpretation
  - Relates to specialized body of property law
Operating Agreements

- AAPL MODEL FORM
  - 1956
  - 1977
  - 1982
  - 1989

- API MODEL FORM
  - Field wide units
Operating Agreements

- **COMMON AREAS OF DISPUTE**
  - Expense Estimates
  - Notice
  - Operator Removal
The Operating Agreement is primarily a financial instrument.

Disagreements relating to cost & expenses lead to many (if not most) JOA disputes.

Reported cases often address cost disputes as damages issues.
EXPENSE ESTIMATES

- Three provisions point to responsibility for well costs:
  - Art. III.B.
  - Art. VI.A.
  - Art. VI.C.1.
EXPENSE ESTIMATES

The essence of the JOA is contained in Article III.B.

“... all costs and liabilities incurred in operations under this agreement shall be borne and paid ... by the parties as their interests are set forth on Exhibit ‘A’.”
EXPENSE ESTIMATES

- Art. VI.A. “The drilling of the Initial Well and the participation therein by all parties is obligatory …”

- This is the project that got everyone interested in the first place.

- We knew what the costs would be before we signed up.
EXPENSE ESTIMATES

Art.VI.C.1. “Consent to the drilling, Deepening or Sidetracking shall include:

- **Option No. 1:** All necessary expenditures for drilling, … testing, … Completing & equipping

- **Option No. 2:** All necessary expenditures for drilling, … and testing. [casing point election]
EXPENSE ESTIMATES

- Each participant has clearly consented to pay for its share of expenses.

- SO, WHAT’S THE PROBLEM?
The dispute arises when actual expenses exceed expectations.
EXPENSE ESTIMATES

“LORE v. LAW”

Lore:
- The AFE limits the amount an operator can spend on an operation.

Law:
- Agreement to pay all necessary expenses related to an operation.
EXPENSE ESTIMATES

- AFE
  - Estimate of Anticipated Expenses
  - Planning tool
- No mechanism in Model Form to limit well costs unless:
  - All parties agree to terminate the operation.
  - 1989 Art. VI.F. agreed upon % can terminate.
EXPENSE ESTIMATES

- What can non-operators do?
  - Sue the Operator for failure to perform its duties.
    - Operations on the Contract Area = Exculpatory clause protection.

- Drafting Solutions
  - Limitation on costs exceeding AFE.
    - No non-operator liability for excess costs.
    - Places all risk for overrun on Operator.
EXPENSE ESTIMATES

What can Operators do?

Drafting Solutions

- Sole authority to terminate the operation.
  - All participants remain liable for termination cost.
- Require parties to re-elect consent/non-consent status.
  - Distributes risk of cost overrun to all the parties.
FAILURE TO PAY COSTS

- The converse of cost-overruns.
- Affects primarily the operator.
- Operator becomes an involuntary lender.
- Non-operator has consented to the operation, therefore non-consent penalties do not apply.
FAILURE TO PAY COSTS

- Limited Remedies for Operator
  - Charge interest.
  - “Net-check” expenses – sufficient revenue stream
  - Sue to collect unpaid JIB’s – counterclaim
  - 1982 Model Form: Foreclose Operator’s Lien.
  - Advance payment (preventive solution).
FAILURE TO PAY COSTS

- Limited Remedies for Operator
- 1989 Model Form
  - Deemed non-consent.
  - Suspension of rights.
    - Withhold information.
    - Participation in new operations
NOTICE

BASIC ELEMENTS

Notice is a “Trigger” that affects the rights of the parties.

- TIMING
- TYPE OF OPERATION
- PROPER PARTIES
NOTICE

TIMING

- When must notice be given?

  *Dorsett v. Valence (Ct. Appeals)*

  - Before any operation is commenced.
  - Def.: “Commence Operations”
  - No commencement before initial response period expires.
  - Condition Precedent to non-consent penalties.
NOTICE

TIMING

When?

Valence v. Dorsett (Supreme Ct.)

- Declined comment: “Commence Operations”
- Notice triggers initial response period.
- Condition Precedent to non-consent penalties.
- Not a requirement to commence operations.
NOTICE

TYPE OF OPERATION & EST. COST

- Art. VI.B.1 requires notice of the proposed operation and the estimated cost.
  - No AFE is required.
  - Cost estimate could be as simple as $X in a well developed area.
NOTICE

TYPE OF OPERATION

- Operation proposed must be substantially the same as the operation conducted.
- Condition precedent to non-consent penalties.

Stable Energy, L.P. v Kachina
NOTICE

PROPER PARTIES

- Any party to the JOA may propose an operation.

- The proposing party must be a party to the JOA.

*ExxonMobil Corp. v Valence Oper. Co.*
NOTICE

PROPER PARTIES

*ExxonMobil Corp. v Valence Oper. Co.*

- This case involves both Notice and the Maintenance of Uniform Interest provision
Exxon Mobil Corp. v. Valence Operating Co.

- ExxonMobil
  - owned 82% WI
  - Operator of the Gladewater Gas Unit
  - Production from the Cotton Valley Lime

- Valence
  - owned 16% WI
NOTICE

*Exxon Mobil Corp. v. Valence Operating Co.*

- JOA: slightly modified Maintenance of Interest provision
  - No party may sell, encumber, transfer or otherwise dispose of its interest in the leases or wells unless such disposition covers either the entire interest in all leases, equip. & production, or an equal undivided interest in all leases, equip., & production.
Exxon Mobil Corp. v. Valence Operating Co.

- ExxonMobil
  - Farmout to Wagner & Brown
  - Cotton Valley Sand test
  - Shallower than existing production

- Wagner & Brown
  - 2 well proposal to Valence
NOTICE

Exxon Mobil Corp. v. Valence Operating Co.

- Valence
  - Ignored well proposals from W&B (stranger)
  - Later was informed of the FOA

- Wagner & Brown
  - Deemed Valence non-consent in 1st 2 wells
  - Proposed 3 additional wells
EXxon Mobil Corp. v. Valence Operating Co.

- Valence
  - Elected to participate in additional wells under protest
  - Sued ExxonMobil on the basis that the FOA breached the JOA Maintenance of Interest provision
**NOTICE**

*Exxon Mobil Corp. v. Valence Operating Co.*

- Valences’s Position:
  - Exxon’s FOA violated the MUI provision
  - Valence’s failure to timely consent was a result of Exxon’s breach.
  - The shallower formations were accessible from existing wells
  - Damages are equal to the Non-consent penalties, plus added drilling cost, plus attorneys fees.
Exxon Mobil Corp. v. Valence Operating Co.

- Exxon Mobil’s defense:
  - Deletion of the word “uniform” allowed partial transfers.
  - The provision only applied to sale of an interest in both the leases and the wells …
  - Exxon did not transfer the wells, therefore no violation.
  - Valence failed to timely respond, their own fault
NOTICE

*Exxon Mobil Corp. v. Valence Operating Co.*

- Trial Court:
  - Judgment for Valence
  - $834,299 damages
  - $166,250 attorneys fees
EXXON MOBIL CORP. v. VALENCE OPERATING CO.

- Court of Appeals
- MUI provision clearly prohibits partial transfers
- The Exxon-Wagner & Brown FOA was a breach of the operating agreement
NOTICE

Exxon Mobil Corp. v. Valence Operating Co.

PROPER PARTIES

- No duty to respond to notice from someone not a party to the agreement.
Exxon Mobil Corp. v. Valence Operating Co.

Court of Appeals – Original Opinion

- Damages for additional drilling expense vacated.
  - Valence sought to recover for “lost opportunity”
  - No existing or prior proposal to complete shallow zones
  - No competing proposals provision in the JOA
  - Therefore, loss was speculative
NOTICE

Exxon Mobil Corp. v. Valence Operating Co.

- Court of Appeals – Substituted Opinion
  - Damages Awarded for Breach of MOI: incremental cost of drilling to recover reserves that could be produced through existing wells
  - First case directly on this point
  - Appeal to Texas Supreme Court pending
Frequent dispute among operators and non-operators.

Very few reported cases.
OPERATOR REMOVAL

- **STANDARD**
  - Defined by the JOA
  - No longer owns an interest
  - Insolvency
  - Gross negligence, willful misconduct
  - Fails or refuses to carry out its duties
OPERATOR REMOVAL

- Fails or refuses to carry out its duties.
  - Control and direct operations.
  - Pay expenses.
  - Regulatory compliance.
  - Keep financial and other records.
- 1989 JOA requires
  - materiality
  - notice & opportunity for cure
OPERATOR REMOVAL

- Who decides?

_Tri-Star Petr. Corp. v. Tipperary Corp._

- Non-operators get to decide.
- Reasonable basis for determination.
- Enforceable by temporary injunction.
OPERATOR REMOVAL

Does the exculpatory clause protect the operator from removal?

- No.
- Exculpatory clause relates to liability of the operator, not removal.

R&R Res. Corp. v. Echelon Oil & Gas LLC
OPERATOR REMOVAL

Voting

- Not well addressed by the Model Form.
- Several cases discuss, but none decide issue.
- How are votes calculated when the ownership is different from well to well?
  - according to the ownership on Exhibit “A”.
- Do non-consenting parties get to vote?
  - Probably.
Arkansas Bar
45th Natural Resources Institute