Judicial Interpretation of the Operating Agreement

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PRIVATE AND INDEPENDENT SINCE 1923.

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Coverage of Topics

- Life without a JOA
- Expiration/termination of the JOA
- The Exculpatory Clause
- Operator Removal
- Continuing Liability
- Form Clauses vs. Custom Clauses

Joint Operations Without a Joint Operating Agreement

Prairie Oil & Gas Co. v. Allen

2 F.2d 566 (8th Cir. 1924)

- Owner of WI not included in JOA. What then?
  - Lizzie Allen owned a 1/10th working interest in a tract. Co-tenant(s), owners of the other 9/10ths working interest, drilled a well and began producing without her input.
  - She sued for waste, trespass, and for 1/10th of the value of production (free of cost).
  - Court held that "[the 1/10th working interest owner] is entitled to an accounting from [the operator] Skelly Company for the market value of the oil produced less the reasonable and necessary expense of developing, extracting and marketing the same."

Joint Operations Without a Joint Operating Agreement (1b)

State v. Harrington 407 S.W.2d 467 (1966)

- Oral agreement to drill a well among co-tenants
  - Texas Supreme Court found a mining partnership existed between defendants where they orally agreed to own a proportionate share of a well.
  - "All of the elements of a mining partnership–joint ownership, joint operations, sharing of profits, community of interest and mutual agency representing the mining partnership in management and operation—were proved without dispute…"

Joint Operations Without a Joint Operating Agreement

- ***Tabco Exploration v. Tadlock Pipe & Equip*.**
  617 So.2d 606 (1993)
- Background:
  - Oral agreement for some money disposal project called the Buster-Bake No. 1 Well in East Texas
  - Tadlock to supply pipe and rig and pay all expenses; to be reimbursed upon completion
  - Workover rig to be provided by Tabco, but wasn't. Bust!
  - Tabco sues for pipe costs, Tadlock counters for costs
- Biggest Issue
  - Whether or not the oral agreement between the partnership and Tadlock Properties is valid

Joint Operations Without a Joint Operating Agreement

- ***Tabco Exploration v. Tadlock Pipe & Equip*.** 617 So.2d 606 (1993)
- Partnership?
  - Court found that "a partnership was created by an oral agreement" and on later that the non-operator was liable for half of the expenses incurred. So…
  - The joint and several liability seen in the above scenario is the primary reason that the Form JOAs have express clauses disclaiming joint and several liability and any fiduciary duty among the parties.

Anderson Energy Corporation v. Dominion Oklahoma Texas E&P, Inc.

2015 Tex. App. LEXIS 6659 (Tex. App.—San Antonio, Jun. 30, 2015).

- Questions considered:
  - Is coverage of a JOA limited to the interests owned by the original parties at the time of execution?
  - Is a JOA terminable at will if it has no expiration date?
- Background:
  - Anderson and Dominion owned interests covered by a 1977 JOA with a typewritten AMI outlining an area for future development ***and*** a preferential right to purchase for any sale of a parties' interests.
  - JOA did not contain language that expressly made subsequent acquisitions by JOA parties subject to the AMI clause nor any specific expiration date.
  - A plat in Exhibit A of the JOA contained the notation "AMI" on the hash marked boundary drawn thereon but not the actual words "Area of Mutual Interest."

Anderson Energy Corporation v. Dominion Oklahoma Texas E&P, Inc.

2015 Tex. App. LEXIS 6659 (Tex. App.—San Antonio, Jun. 30, 2015).

- Chain of title: Perlman -> Sun Oil -> Anderson; Perlman -> Dominion -> HighMount (?)
- Before the sale, Anderson sought a judicial determination that the interests acquired by Dominion were subject to the AMI clause
  - future acquisitions covered within the broad language used in the JOA's Article I definition of "Contract Area"
    - (that referred to "all of the lands" described in included Exhibit A)
  - …and the broad description in Exhibit A of the said lands, the same being "all interest of the parties in the land located within the areas outlined" on the included plat.
  - Anderson also argued the presence of the typewritten AMI clause illustrated clear intent that the JOA would apply to interests acquired after 1980.

Anderson Energy Corporation v. Dominion Oklahoma Texas E & P, Inc.

2015 Tex. App. LEXIS 6659 (Tex. App.—San Antonio, Jun. 30, 2015).

- Dominion countered
  - (1) that the present tense used in the JOA's recitals and in the definitions of "oil and gas leases" and "oil and gas interests" (stating that the signatory parties "are owners") and
  - (2) the lack of the phrase "area of mutual interest" and any reference to any future acquisitions in *Exhibit A*, meant the JOA did not apply to interests acquired after execution of the JOA.

Anderson Energy Corporation v. Dominion Oklahoma Texas Exploration & Production, Inc.

2015 Tex. App. LEXIS 6659 (Tex. App.—San Antonio, Jun. 30, 2015).

- Court holds subsequent interests covered
- JOA "Contact Area" not just defined by isolated words or phrases in the JOA but by considering the language used in the context of entire JOA.
- KS/CO CL discounts tense argument—industry practice that AMI covers subsequent interest
- AMI provision was the "most telling indicator"
- Also! Duration is "reasonable time" Remand:
  - at-will duration is not practical, fair or customary in the oil and gas industry

Scope of Operator's Authority

- ***Abraxas Petroleum Corp. v. Hornburg*** 20 S.W.3d 741 (El Paso, 2000)
- Background? What form JOA? Exculpatory clause?
  - 1977/1982 form AAPL JOA
  - Exculpatory Clause: "[Operator] …shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such *operations* in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct."

Scope of Operator's Authority

- ***Abraxas Petroleum Corp. v. Hornburg*** 20 S.W.3d 741 (El Paso, 2000)
- Was clause ambiguous?
  - No. The court of appeals found that the exculpatory clause was unambiguous and noted that it was found in an article which concerned the operator's authority to conduct *operations* in the contract area.
- Did clause cover contract issues?
  - The operator's limitation of liability was linked directly to imposition of the duty of the operator to act in a reasonably prudent manner—a duty strictly concerning the manner in which the operator conducted *drilling operations on the lease*. So…

Scope of Operator's Authority

- Was the operator's action seen as a "K claim" breach or an "operation"?
  - the court concluded that the exculpatory clause was limited to claims based upon an allegation that the operator failed to act as a reasonably prudent operator and *did not* apply to a claim that it breached the JOA K terms.

Exculpatory Clause: *Wendell Reeder v. Wood County Energy, LLC*

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

- Questions Considered:
  - Are there differences between the operator exculpatory clauses in the '89 vs. the '82 & '77 form JOAs?
  - How does exculpatory language in the form JOAs cover breach of contractual terms?
- Facts:
  - Operator accused of failure to maintain production on leases which then expired, causing RRC to breakup unit
  - Trial court: operator breached duty under '89 JOA.
  - CoA: Clause does not apply to breach of contract claims

Wendell Reeder v. Wood County Energy, LLC

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

- Texas Supreme Court:
  - Case law: exculpatory clause of '77 & '82 forms only applies to actual work, not to K breaches
  - Parse language of the JOAs:
    - '77 and '82: "all such operations"
    - '89: "its activities under this agreement"
  - TSC finds '89 language broadens ranges of activities under the exculpatory clause—K breaches
  - So…with no evidence of gross negligence or willful misconduct, '89 clause shields operator

Wendell Reeder v. Wood County Energy, LLC

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

- Implication:
  - '89 form JOA exculpatory clause may protect operator from contractual claim breach
    - Unless gross negligence/willful misconduct plays a role
    - Could be hard to prove
  - Interesting interpretation of '89 form by TSC:
    - "[Operator] shall conduct *its activities under this agreement* as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice,…"

2015 JOA Exculpatory Clause

- 2015 Form Article V.A.:
  - 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 regulations**.** However, in no event shall it have any liability as operator to the other parties for losses sustained or liabilities incurred in connection with authorized or approved operations under this agreement except such as may result from gross negligence or willful misconduct

<- two sentences!

<- new language!

Operator's Ability to Set Rates

***Hamilton v. Texas Oil & Gas Corp*.** Background?
648 S.W.2d 316 (Tex.Civ.App.—El Paso, 1982)

- What about expert's opinion on site movement?
  - Court held that an expert's opinion that "the costs of site preparation would increase four or five times due to the change in location" was sufficient evidence to support the jury's finding that non-operator was not liable for his proportionate share of the *increased* cost of preparation.
- How did gross negligence play into the holding?
  - The court's holding was dependent upon the finding that there was sufficient evidence to support the jury's finding of gross negligence.

Operator's Ability to Set Rates

- ***Argos Resources, Inc. v. May Petroleum, Inc.*** **693 S.W.2d 663 (1985)**
- Background:
  - JOA dated October 21, 1981. The agreement provided that May, the operator, would commence drilling of a well on or before December 31, 1981.
  - Argos was required to pay 15% of the costs and liabilities May incurred in drilling the well.
  - On or about December 31, 1981, Argos paid May $32,925.00, 15% of the AFE's estimated drilling cost. But…
  - May actually did not begin drilling the well until January 24, 1982.
  - Fifteen percent of the actual cost of drilling the well turned out to be $49,735.66, **$16,810.66 more** than the amount Argos had already paid.
  - May sued Argos for what it considered the balance due for the actual drilling costs. Trial court?
  - The trial court entered a judgment awarding May $16,810.66.

Operator's Ability to Set Rates

Argos Resources, Inc. v. May Petroleum, Inc. 693 S.W.2d 663 (1985)

Regarding time-of-the-essence clause, Argos argues?

- since May failed to begin drilling by December 31, 1981, May cannot recover, given that when time is of the essence in a K a party must perform in strict compliance within the time prescribed to be entitled to any relief.

- Court says:
  - "[T]he operating agreement in the present case falls under the two general rules that (i) time is ordinarily not of the essence and (ii) that a [operator] need only prove substantial performance to recover on his contract."
  - "We conclude further that time was not of the essence in the operating agreement before us and that [operator] consequently did not forfeit its rights under the agreement when it failed to begin drilling on or before [the date specified in the J.O.A."].

Other Problems: Liability after Assignment

- A, nonoperator, under JOA assigns its interest to X.
- X did not pay the debts incurred after the assignment.
- Operator sued A.
- Is assignor liable under even though it no longer owns an interest in the contract area?

1989 ARTICLE III. INTERESTS OF THE PARTIES

B. Interests of Parties in Costs and Production: Unless changed by other provisions, **all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations on the Contract Area shall be owned, by the parties as their interests are set forth in Exhibit "A"**...

1989 ARTICLE VII -- EXPENDITURES AND LIABILITY OF PARTIES

A. Liability of Parties: The liability of the parties shall be several, not joint . . . **. 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**. . . .

1989 Article XV.B. Successors and Assigns

- **This agreement shall be binding upon** and shall inure to the benefit of the parties hereto and their respective … **successors and assigns, and** the terms hereof shall **be deemed to run with the Leases or Interests** included within the Contract Area.

Transfer of Interests: *Successor Liability*

- Problem: The Texas Supreme Court in *Seagull v. Eland*,* considered the form JOA insufficient to absolve assignors from liability.
  - Therefore, such liability could live on if the lease assignment did not clearly remove the specter of continuing liability.
- Obviously, against custom/practice of the biz. Some of the confusion arose from the earlier Model Form JOA's use of the phrase "obligations previously incurred by such party" to describe the responsibility that remained with the transferor party. *E.g.,* 1989 Model Form JOA at VIII.D.

***Seagull v. Eland*, 207 S.W.d3d 342 (Tex. 2006)**

Transfer of Interests: *Successor Liability*

- Former Solution: Add provision to Article XVI stopping such continued liability.
  - "Upon and after the Effective Date of this Joint Operating Agreement, no Operator or Non-operator shall be liable for, or bear any responsibility for any costs, debts, claims, judgments, fines, levies, obligations or services subsequently incurred and arising from or related to operations under this Agreement."

2015 JOA: Successor Liability

- *Seagull* probably goes the other way now…
- Article VIII.D now provides that an assignment of a party's interest in the Contract Area is not effective until 30 days following the operator's receipt of the transfer instrument.
- Article VIII.D now provides that after such 30-day period, **the transferor is relieved of liability for costs and expenses occurring after the 30-day period.**
  - An exception to this release occurs if, prior to the assignment of its interest, the assignor **approves an operation** from which the costs and expenses arise.
  - Leads instead to joint and several liable for the costs and expenses attributable to this previously approved operation.

Article VI.E—Transfer of Interests: *Accrual of P&A Liabilities*

- Problem: Plugging and abandonment costs may incurred when the well permit is issued by the appropriate authority. That means *Surprise!* liability for plugging orphaned wells may fall back on parties who assigned the well while it was still producing.
- Solution: Add language to Article XVI that expressly relieves any assignor of Contract Area interest of all costs and liabilities associated with plugging, abandonment and remediation of any wells then existing or thereafter drilled on the assigned leaseholds.

GOM Shelf, LLC v. Sun Operating Limited Partnership

Authorization for Expenditures (AFEs)

- ***Hill v. Heritage Resources, Inc.**** Background?
  - Operator circulates a JOA to all WI owners to cover the proposed drilling of wells to a certain depth or top of a particular formation, whichever is less.
  - All parties assent and execute the JOA.
  - One well, 22-2, is drilled under the "Initial Well" provision and is a success. 19,062' feet!
  - Some time after the JOA is executed, Heritage circulates another AFE to cover costs to a 2nd well, 22-3, and other "subsequent wells."
  - This AFE is not executed. However, several non-operators contribute their proportionate share of the costs. Two non-operators who are signatories to the JOA do not assent or sign the second AFE and do not contribute their proportionate share to cover the costs of 22-3. Is 22-3 in the JOA's contract area?
  - Operator drills 22-3 and brings in a producing well. With respect to 22-3, Operator treats nonpaying non-operators as non-consent working interest owners under the terms of the JOA.

*964 S.W.2d 89 (El Paso 1997)

Authorization for Expenditures (AFEs)

Hill v. Heritage Resources, Inc.

Does modification of JOA require mutual assent of all the parties? Potentially new consideration?

- "…any modification of the contract would require the mutual assent of all the parties."
- Court held that additional consideration was needed to modify the JOA.

- Was there any evidence of intent to modify JOA?
  - the court found that "there is no evidence of a clear intent on behalf of the parties to modify the J.O.A. [and further that] formal modification of the…J.O.A. was never expressly addressed or requested."

Authorization for Expenditures (AFEs)

- The takeaways:
  - after execution of a JOA, an operator cannot unilaterally modify the JOA just through the circulation of an AFE.
  - However, unless the terms of the AFE or the work done under the AFE contradict or leave the domain covered by the JOA, once signed, the terms can be binding even if the costs rise above the estimate of the AFE.

2015 JOA modification/amendments

- New terms in Article III.B grant operator the right to correct mistakes or address changes in ownership in Exhibit A's Contract Area, but…
  - …must inform the non-operator(s) with docs and…
  - …get permission from affected non-operator(s)…
  - …or get a title opinion issued by an unaffiliated licensed attorney.

Clovelly Oil Co., LLC v. Midstates Petroleum Co., LLC

112 So.3d 187 (La. 2013)

- Question considered: favor reading two clauses together or allow an "addendum clause" to preempt a "form clause"?
- Background:
  - Through separate chains of assignments, Clovelly and Midstates became partners to 1956 form JOA, executed in 1972.
    - The JOA contained both a printed portion and a typewritten addendum.
  - Midstates acquired a lease that Clovelly claimed was within an area described in an (addendum) clause giving Clovelly claim to % of WI
- Trial Court:
  - Clovelly and Midstates both moved the trial court for SJ on whether the JOA applied to the disputed lease
  - Court granted SJ in favor of Midstates, holding that the JOA could not apply to new leases obtained thirty-five years after the agreement had been originally executed.

Clovelly Oil Co., LLC v. Midstates Petroleum Co., LLC

112 So.3d 187 (La. 2013)

- Court of Appeals: Reversed—
  - JOA terms applied to the disputed lease because it was well within the area delineated in the typewritten addendum of JOA. Ignore printed term.
- LA Supreme Court: Reversed—
  - While the typewritten addendum described the area to which the agreement would apply, form JOA terms expressly limited the agreement to leases the parties owned at the time they executed the agreement
    - In reading the printed portion and typewritten addendum together, the Court did not find any express conflict or ambiguity between the two.
    - Must embody what the contract suggests in its entirety—courts in LA (and TX!) will not read out any term

Clovelly Oil Co., LLC v. Midstates Petroleum Co., LLC

112 So.3d 187 (La. 2013)

- Court noted that parties commonly enter into AMI agreements, which would cause their JOA to apply to future leases the parties may obtain.
  - In this case, the parties had not entered into an AMI.
- Ultimately, the Louisiana Supreme Court reversed the CoA and reinstated the ruling of the trial court.
- *Clovelly* implies that in Louisiana, if no AMI exists, a mere addendum describing a specific area to which the agreement would apply would not be enough
  - May be preempted by any printed terms of the form JOA that expressly limit the agreement to the leases the parties own at the time they execute the agreement

Unsigned Components—do they belong in the documents comprising "the JOA"?

- Separate doc must be "sufficiently related" to the document for which incorporation is sought.
  - Main agreement must reference unsigned one
  - Main agreement must reference existing doc
  - Oral testimony or mere estoppel claim not enough to prove up unsigned, non-existent or incomplete agreement
    - For example: AMI agreement*

- A unrecorded, unsigned hand-drawn plat does not provide cause for equitable estoppel to enforce the AMI
  - Estoppel is not a cause of action but a defense*

*Crowder v. Tri-C Resources, Inc. 821 S.W.2d 393 (Tex.App.—Houston [1st Dist.] 1991, no writ)

Thanks for Listening!

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