# CHAPTER 7

# Be Careful What You Ask For: Subsequent Operations Under the Model Form Operating Agreement

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Synopsis

## § 7.01 Introduction

### [1] Preface

This article examines the conditions pursuant to which parties customarily agree to develop mineral leases which are owned by more than one person or entity, pursuant to agreements customary in the industry. In Louisiana, a civil law system, this is called ownership "in indivision" and the owners of the mineral leases are called "co-owners." In the common law states, these owners are called "cotenants." For purposes of this article, these terms are

used interchangeably.[1] The author attempts to demonstrate the universality of certain principles by citing the laws of several oil and gas producing states.

### [2] Law of Co-ownership or Co-tenancy

By definition, an operating agreement typically exists, if at all, only in the circumstances where two or more persons or companies own one or more mineral leases in indivision.[2] Conversely, there is obviously no need for an operating agreement to exist if a mineral lease(s) is owned by one single person or company. One might best appreciate the import of an operating agreement if one understands what rules apply if no operating agreement exists among co-owners (cotenants) of a mineral lease.

In Louisiana, an analysis of the purpose and effect of an operating agreement begins with the observation that, unless modified by agreement, the administration and management of a thing owned in indivision (or in a regime of co-tenancy) requires the concurrence of all co-owners or cotenants.[3]

In Louisiana, an explicit rule pertains to mineral leases which are owned in indivision. Thus, Article 177 of the Louisiana Mineral Code provides that a "co-owner of the lessee's interest in a mineral lease may not independently conduct operations . . . without the consent of his co-owner. He may act to prevent waste, destruction, or termination of the lease and to protect the

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[1] Your author apologizes in advance if his "Louisiana bias" is evident.

[2] While an operating agreement might also exist where parties enter into a contract for the joint operation of separately or distinctly owned mineral leases, this paper is principally concerned with co-owned mineral leases.

[3] Louisiana: Article 801, Louisiana Revised Civil Code. ("The use and management of the thing held in indivision is determined by agreement of all the co-owners.").

Article 806, Louisiana Revised Civil Code, provides, in relevant part, as follows:

> A co-owner who on account of the thing held in indivision has incurred necessary expenses, expenses for ordinary maintenance and repairs, or necessary management expenses paid to a third person, is entitled to reimbursement from the other co-owners in proportion to their shares.

"Under this provision, a co-owner is responsible to his co-owners for his share of necessary management expenses paid to a third person. A co-owner is not allowed to receive anything for his own management of the thing that is held in indivision unless he is entitled to such a recovery under a management plan adopted by agreement of all the co-owners, by judgment, or under the law of unjust enrichment." Revision Comment (c) to Article 806, Louisiana Revised Civil Code.

interest of all, but cannot impose upon his co-owner liability for any costs or expenses except out of production."[4]

As will be seen, the "consent of his co-owner" is granted and manifested by an operating agreement.

In contrast to Louisiana, a different rule prevails in Texas and Oklahoma. A mineral cotenant (including a lessee) can proceed to develop the mineral estate without the consent or joinder of the other cotenants. He must account to the other cotenants for their share of production, less costs of extraction.[5]

### [3] Operating Agreements

These general principles are applicable unless modified by agreement of the co-owners or cotenants. As is customary, co-owners or cotenants of mineral leases often enter into an "operating agreement" which provides for the exploration, development, operation or production of jointly owned mineral leases.

The American Association of Professional Landmen (the "AAPL") has played an integral role in the development and refinement of operating agreements through the publication and promotion of its Model Form.[6]



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[4] La. Rev. Stat. Ann. 31:177. In Louisiana, the notion that (in the absence of a contrary agreement) unanimity among *all* co-owners of a mineral lease is required before operations may be conducted, is reinforced when one contrasts this article with Article 175 of the Louisiana Mineral Code which, under certain circumstances, allows a co-owner of a mineral servitude to operate if it has obtained the consent of not less than eighty (80%) per cent of the co-owners of such servitude.

[5] Texas: Byrom v. Pendley, 717 S.W.2d 602, 605 (Tex. 1986) ("It has long been the rule in Texas that a cotenant has the right to extract minerals from common property without first obtaining the consent of his cotenants; however, he must account to them on the basis of the value of any minerals taken, less the necessary and reasonable costs of production and marketing. Cox v. Davison, 397 S.W.2d 200, 201 (Tex. 1965); Burnham v. Hardy Oil Co., 147 S.W. 330, 334–35 (Tex. Civ. App.—San Antonio 1912), *aff'd on other grounds*, 195 S.W. 1139 (Tex. 1917). The rule announced in Burnham and reaffirmed in Cox is founded on the distinctive legal relationship existing between cotenants; that is, each cotenant has a right to enter upon the common estate and a corollary right to possession. Burnham v. Hardy Oil Co., 147 S.W. at 335."); Oklahoma: Mullins v. Ward, 1985 OK 109, ¶ 17, 712 P.2d 55 ("The owners of an undivided interest in a mineral estate are tenants in common. While each of the cotenants may explore for oil and gas on property owned in common without the consent of the other co-owners, none can do so to the exclusion of the other cotenants. When oil or gas is discovered, the producing cotenants must account to the nonproducing cotenants for the pro rata share of the latter in any net profits derived from the mineral exploration.").

[6] The most widely used form of operating agreement is the AAPL Form 610—Model Form Operating Agreement published by the AAPL. First introduced in 1956 at its Annual Meeting in Denver, Colorado, revised forms were issued by the AAPL in 1977, 1982 and

"Typically the agreement provides for the development of the premises by one of the parties for the joint account. The parties to the agreement share in the expenses of the operations and in the proceeds of development, but the agreement normally is not intended to affect the ownership of the minerals or the rights to produce, in which respects, among others, the joint operating agreement is to be distinguished from a unitization agreement and from a mining partnership."[7]

As characterized by a Texas court,[8] the operating agreement is not "an ordinary contract," describing it further, as follows:

> Joint Operating Agreements, standardized forms developed over years by the industry to govern ventures in the development of oil and gas properties, are simply not everyday fixtures of life. They govern operations involving immense financial risk and reward; the parties to J.O.A. are experienced and sophisticated and generally have balanced bargaining positions. These are agreements which involve liabilities and obligations unique to the legal and technical peculiarities of the oil and gas industry.

The doctrine of contractual freedom is fully operative in the matter of operating agreements.[9] As such, there are very few, if any, principles of public policy which delimit the matters as to which parties are free to contract. For this reason, it is always necessary to resort to the particular agreement in order to determine the relative rights and obligations of the parties.[10]

General principles of contractual interpretation apply to these contracts.[11]

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1989. Except where otherwise noted, this article focuses primarily on the 1982 Model Form.

[7] Williams and Meyers, *Manual of Oil and Gas Terms*. As stated by other respected Commentators, an operating agreement is a contract typical to the oil and gas industry whose function is to designate an "operator, describe the scope of the operator's authority, provide for the allocation of costs and production among the parties to the agreement, and provide for recourse among the parties if one or more default in their obligations." 3 Ernest E. Smith & Jacqueline L. Weaver, "Texas Law of Oil And Gas," § 17.3 at 17-7 (2d ed. 2006).

[8] Hill v. Heritage Resources, 964 S.W.2d 89, 112 (Tex. Civ. App.—El Paso 1997, pet. denied).

[9] In Louisiana, it is said that parties are "free to contract for any object that is lawful, possible, and determined or determinable." Article 1971, Louisiana Revised Civil Code. Alabama: Bankers & Shippers Ins. Co. v. Blackwell, 51 So. 2d 498 (Ala. 1951); Mississippi: Smith v. Simon, 224 So. 2d 565 (Miss. 1969); Oklahoma: Kincaid v. Black Angus Motel, Inc., 1999 OK 54, 983 P.2d 1016; Texas: Bethel v. Butler Drilling Co., 635 S.W.2d 834 (Tex. Civ. App.—Houston [14th Dist.] 1982).

[10] In fact, the Model Forms invite—or certainly contemplate—contractual modifications or additions in Article XV of the 1977 and 1982 Model Forms (Article XVI of the 1989 Model Form), entitled "Other Provisions."

[11] "However, the JOA is a contract and shall be construed like any other contract." Oxley

Additionally, the reported decisions considered herein do not always identify the particular version of the Model Form Operating Agreement involved. Although it is informative to consider the case law involving the interpretation of operating agreements, it is somewhat illusory to attempt to draw generalized conclusions therefrom, as the particular agreement in question must always be reviewed.[12]

### [4] Rationale for a "Subsequent Operations Clause"

In theory, if not in actual practice, there is unanimity among the parties concerning the drilling of the initial test well. After all, that is typically the primary consideration which motivates parties to enter an operating agreement in the first place. Either the operating agreement or an accompanying letter agreement will spell out the time, location, objective depth and parameters of that first well, including the parties responsible for costs.

But often, this is where unanimity of purpose ends. Whether because of budgetary constraints, market considerations, differences in development philosophy, other projects demanding a party's available funds, an assignment of a party's interest to a third party who does not share a similar interest in "spending money," disputes or disagreements among the parties, or other reasons, there is no assurance that a proposal for the conduct of operations subsequent to the initial well would be received by all parties with an equal level of enthusiasm as the initial test well. For reasons stated above, in the absence of some contractual mechanism to address this situation, a stalemate might arise which would impede development of the jointly owned leases. Enter the "subsequent operations clause." Whether from the viewpoint of the proposing party or the non-operator, this important clause encourages one to "be careful what you ask for."

## § 7.02 The Proposal to Conduct a Subsequent Operation

### [1] Determination of Contract Area

Virtually all forms of operating agreement between working interest owners contain a provision which governs the proposal of and participation in operations subsequent to the drilling of the initial test well "on the Contract Area."

The first consideration is to establish that an operation proposed by one

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v. General Atl. Resources, 1997 OK 46, 936 P.2d 943. *See also* Ottinger, "Principles of Contractual Interpretation," 60 La.L.Rev. 765 (Spring 2000).

[12] "Contracts have the effect of law for the parties and may be dissolved only through the consent of the parties or on grounds provided by law." Article 1983, Louisiana Revised Civil Code.

co-owner of the jointly owned leases is to be conducted "on the Contract Area" covered by the operating agreement under which it is to be proposed; self-evidently, the requirements of the operating agreement only relate to operations conducted "on" the Contract Area.[13]

In *Hill v. Heritage Resources, Inc.*,[14] the Contract Area of the operating agreement only extended to subsurface depths down to 20,000 feet, but not below. Notwithstanding this horizontal limitation at a vertical subsurface depth, Authorizations for Expenditure ("AFEs") proposing the drilling of the 22-3 well to a subsurface depth of 22,000 feet were circulated by the operator. The AFEs were signed by some, but not all, of the working interest parties. After the well was drilled, it was held that the supposed non-consent election by certain parties was *not* effective and, consequently, the supposed consenting parties—who thought that they had agreed to "carry" the non-consenting interests—never owned those interests and, thus, had no authority to sell them.

The court observed that, "[b]ecause the 22 J.O.A. did not govern the 22-3 well, there was no obligation by any of the working interest owners to make a consent or non-consent election when the 22-3 well was proposed by Heritage." Rejecting an alternative argument, the court held that the execution of the AFEs by less than all of the working interest owners was not effective to amend the operating agreement so as to extend the depth limitation of 20,000 feet to the deeper depth of 22,000 feet.

This holding is consonant with an earlier observation, of broader application, that:

> It is a common practice to conduct mineral development under a joint operating agreement, and while there are duties between the parties for the operations of the lands embraced by the written agreement, those duties do not extend to operations by one of the parties on other and different lands.[15]

### [2] Notice of Proposal to Conduct a Subsequent Operation

An example of a "subsequent operations clause" is Article VI.B.1 of the 1982 Model Form[16] which reads, as follows:

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[13] The "Contract Area" is defined in the Model Form as "all of the lands, oil and gas leasehold interests and oil and gas interests intended to be developed and operated for oil and gas purposes under this agreement." *See, e.g.*, Article I.D of the 1982 Model Form.

[14] 964 S.W.2d 89 (Tex. Civ. App.—El Paso 1997, pet. denied).

[15] Rankin v. Naftalis, 557 S.W.2d 940, 946 (Tex. 1977). *See also* McAlpin v. Sanchez, 858 S.W.2d 501 (Tex. Civ. App.—Corpus Christi 1993, writ denied).

[16] As stated by one member of the AAPL Special Forms Committee which drafted the

B. Subsequent Operations:

1. Proposed operations: Should any party hereto desire to drill any well on the Contract Area other than the well provided for in Article VI.A, or to rework, deepen or plug back a dry hole drilled at the joint expense of all parties or a well jointly owned by all the parties and not then producing in paying quantities, the party desiring to drill, rework, deepen or plug back such a well shall give the other parties written notice of the proposed operation, specifying the work to be performed, the location, proposed depth, objective formation and the estimated cost of the operation. The parties receiving such a notice shall have thirty (30) days after receipt of the notice within which to notify the party wishing to do the work whether they elect to participate in the cost of the proposed operation. If a drilling rig is on location, notice of a proposal to rework, plug back or drill deeper may be given by telephone and the response period shall be limited to forty-eight (48) hours, exclusive of Saturday, Sunday and legal holidays. Failure of a party receiving such notice to reply within the period above fixed shall constitute an election by that party not to participate in the cost of the proposed operation. Any notice or response given by telephone shall be promptly confirmed in writing.

The proposed operations may include the drilling of a well, or the reworking, deepening or plugging back of an existing well. Parties often add the word "sidetracking" if it does not already appear in the Model Form.

The "subsequent operations clause" has no application to the reworking, deepening or plugging back of the initial well unless that initial well was drilled as a dry hole or, "if initially completed for production, ceases to produce in paying quantities."[17] Moreover, "Article VI.B.1 expressly restricts reworking operations to wells that are not producing in paying quantity."[18]

Under the three Model Forms preceding the 1989 form, a subsequent operation (other than *drilling*) may be proposed to be conducted only in respect of a dry hole or "a well *not then* producing in paying quantities."[19] In contrast, the 1989 form permits the conduct of such operations in connection with a "well *no longer capable of* producing in paying quantities."[20] Because the 1989 form contains a definition of "Rework" which does



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1982 Model Form, "Section B [of Article VI of the 1982 Model Form] is one of the most important and least understood portions of the contract." Davis, "The Modern Operating Agreement—Implications for Landmen," The Landman, Vol. 28 No. 11, p. 23, 57 (November 1983).

[17] *See* Article VI.B.2 (lines 16–19 of Page 7) of the 1982 Model Form. *See also* LPCX Corp. v. Faulkner, 818 P.2d 431 (Okla. 1991).

[18] Abraxas Petroleum Corp. v. Hornburg, 20 S.W.3d 741 (Tex. Civ. App.—El Paso 2000, no pet.).

[19] *See* Article VI.B.1 (line 10 of Page 5) of the 1982 Model Form.

[20] *See* Article VI.B.1 (lines 71-2 of Page 5) of the 1989 Model Form.

not appear in the earlier versions, the change in the predicate from "not then producing," to "*no longer capable of* producing," presents an interesting dichotomy under the 1989 form.

Under the 1989 form, a "Rework" operation is defined as one designed to "secure, restore, or improve production in a Zone which is currently open to production in the wellbore."[21] If one may only propose a Reworking operation under the 1989 form if the well in question is "*no longer capable of* producing in paying quantities," how can an operation be proposed to "secure, restore, or improve production" if the well, by definition, has been determined to be "no longer capable of producing in paying quantities?" Said another way, does not the predicate determination that a well is "no longer capable" of producing in "paying quantities," necessarily negate the possibility of an operation to "Rework"—that is to say, to "secure, restore, or improve" production from—such a well?

Arguably, it is intended to be implicit in the 1989 Model Form that the well is to be deemed to be "no longer capable of production" *by reason of its present physical condition*. This view would find support in the case law in Texas that, for purposes of a "shut-in clause" of a mineral lease, a well is capable of production if it is capable of producing in "paying quantities" without additional equipment or repairs.[22]

That is, according to the Texas courts in cases involving shut-in wells, "capable of producing in paying quantities" means a well "that will produce in paying quantities if the well is turned 'on,' and it begins flowing, without additional equipment or repair."[23] "Conversely, a well would not be capable of producing in paying quantities if the well switch were turned 'on,' and the well did not flow, because of mechanical problems or because the well needs rods, tubing, or pumping equipment."[24]

Because the Model Form specifies particular types of activities which would constitute a "subsequent operation," other activities—not so listed—would not be governed by this clause. By way of illustration, the specification of the types of subsequent operations contemplated in the Model Form does not include the installation of a water flood operation, secondary or tertiary recovery operations, the conduct of seismic operations or the

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[21] *See* Article I.P of the 1989 Model Form.

[22] Anadarko Petroleum Corp. v. Thompson, 94 S.W.3d 550, 558 (Tex. 2002).

[23] Hydrocarbon Mgmt. v. Tracker Exploration, 861 S.W.2d 427, 433–434 (Tex. App.—Amarillo 1993).

[24] Hydrocarbon Mgmt. v. Tracker Exploration, 861 S.W.2d 427, 434.

laying of a pipeline (unless the latter is included within the scope of an approved operation). Not being covered by the "subsequent operations clause," projects of this nature would require the unanimous consent of all participants, except to the extent that the operator is contractually authorized to undertake the project pursuant to the "limitation on expenditure" provision (hereinafter discussed).[25]

### [3] Who May Issue a Proposal to Conduct an Operation

The Model Form provides that "any party" to the Operating Agreement may propose a subsequent operation. Thus, as a general proposition, any working interest owner who is not then in default and who is otherwise entitled to participate in subsequent operations has the right to propose that particular operations be conducted in the Contract Area.[26] The issue has arisen as to who may properly avail the provisions of the agreement.

Pursuant to explicit language granting to a consenting party "the non-consenting party's right . . . to propose . . . development wells," it was held in one case that a party consenting to the initial exploratory well had no duty to propose a development well to the party non-consenting that initial operation.[27]

In *ExxonMobil Corp. v. Valence Operating Co.*,[28] ExxonMobil (who was the operator) farmed out all of its interest in the joint leases, limited to certain subsurface depths, to Wagner & Brown, Ltd., and C. W. Resources. The farmees proposed the drilling of wells to the non-operator, Valence. The non-operator—being unaware of the farmout—considered the proposing parties to be "strangers" to the operating agreement and, hence, did not respond to it. The wells were drilled successfully and the proposing parties treated Valence as a non-consenting party.

Valence sued ExxonMobil, contending that the assignment to the farmees

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[25] *See* Article VII.D.3 of the 1982 Model Form. *See* text at § 7.02[5] herein. As stated by one commentator, "[u]nder this provision, one party can frustrate the objectives of the overwhelming majority by refusing to approve a proposed operation." Boigon, "The Joint Operating Agreement in a Hostile Environment," *38th Oil & Gas Inst. 5-1, § 5.05[3][a]* (Matthew-Bender 1987).

[26] Some operating agreements expressly provide that a party who is in default is not allowed either to propose an operation or to vote on a proposal submitted by another party. See, *e.g.*, Pittencrieff Resources v. Firstland Offshore Exploration Co., 942 F. Supp. 271 (E.D. La. 1996).

[27] Exxon Corp. v. Crosby-Mississippi Resources, 154 F.3d 202 (5th Cir. 1998).

[28] 174 S.W.3d 303 (Tex. App.—Houston [1st Dist.] 2005, pet. filed).

was a violation of the uniform maintenance of interest provision of the operating agreement.[29] The court so held.

As to the issue of whether Valence was a non-consenting party, the court held that "Valence's failure to consent to the drilling operation 'cannot result in the imposition of any of the contractual penalties because the obligation to give timely notice of consent is triggered *only* by the required notice of proposed operations.' "[30]

In affirming a trial court judgment awarding Valence recovery of the non-consent penalties, the court stated its rationale, as follows:

> It is not enough that WB and CW—non-parties to the JOA—notified Valence of *their* proposal to drill new wells in the Cotton Valley Sand formation to capture the same reserves that could have been accessed from the existing wellbores. Such "notice" from strangers to the JOA, coming after the farmout agreement had already been executed, entirely failed to satisfy the purpose of the notice requirement, namely, that Valence be given the opportunity to consent, or not, to a proposal made by a party to the JOA who had agreed to all its terms and conditions—not by strangers to the JOA with different interests. We hold, therefore, that the trial court correctly concluded that ExxonMobil's breach of the notice provision of the JOA relieved Valence of the burden of paying non-consent penalties. (Emphasis added.).

### [4] Multiple Proposals to Conduct a Subsequent Operation

With the exception of the 1989 version,[31] the Model Form does not by express terms preclude the possibility that several different proposals might be initiated or outstanding at the same time; the fact that one party has proposed a subsequent operation does not mean that another party may not immediately propose a different operation. Because the efficient or prudent development of the leases comprising the Contract Area is seldom promoted by a race to the post office to initiate the first proposal for the conduct of a subsequent operation, multiple proposals are not always in the best interest of the parties.

In order to avoid the circumstance that a party is "under the gun" to "pick and choose" among several disparate proposals, with the concomitant financial responsibility associated therewith, some operating agreements include a provision which disallows multiple proposals to be outstanding at one time ("first come, first served") or which regulates the priority order of

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[29] *See* Article VIII.D (lines 9–45 of Page 12) of the 1982 Model Form.

[30] The court of appeals cited El Paso Prod. Co. v. Valence Operating Co., 112 S.W.3d 616 (Tex. App.— Houston [1st Dist.] 2003, pet. denied).

[31] *See* Article VI.B.6 of the 1989 Model Form. While this provision does not preclude the possibility of multiple proposals (in fact, it admits that possibility), it does attempt to regulate the "order of preference of operations."

multiple proposals, if such are permitted. In the current climate of downsizing and consolidation, such a provision is of particular importance to the operator who will be responsible for the conduct of the several operations, but who might not have sufficient staff to execute several different operations at the same time.

### [5] "Limitation on Expenditure Clause"

Relevant to the issue of an operator's right to conduct operations without the consent of the non-operator—or, viewed in the converse, the duty of a non-operator to bear the consequences of any activity to which it has not explicitly consented—is the "limitation on expenditure clause."[32] This clause states that, "[w]ithout the consent of all parties, Operator shall not undertake any single project reasonably estimated to require an expenditure in excess _____ of Dollars ($_____) *except in connection with a well, the drilling, reworking, deepening, completing, recompleting, or plugging back of which has been previously authorized by or pursuant to this agreement.*"[33]

As seen, an "Operator shall not undertake any single project" if the costs of such "project" are "reasonably estimated" to exceed a stated amount, except that this limitation on expenditure does not restrict the right of the operator to conduct an operation if the operation is "in connection with a well, the drilling, reworking, deepening, completing, recompleting, or plugging back of which has been previously authorized by or pursuant to this agreement."

Stated differently, a proposed operation which has *not* been "previously authorized" pursuant to the agreement is, self-evidently, a separate and distinct operation which requires the concurrence of the non-operators if the costs thereof are "reasonably estimated" to exceed a stated amount.

The tension created by the interplay between the "limitation on expenditure clause" and the "subsequent operations clause" is obvious. Indeed, a conflict between such clauses was considered by the Wyoming Supreme Court in *Roemer Oil Company v. Aztec Gas & Oil Corporation*.[34] The operating agreement obligated the operator to obtain the consent of the other

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[32] *See, e.g.*, Article VII.D.3 of the 1982 Model Form.

[33] An operator would obviously desire that the monetary figure be as high as possible so that it has unfettered flexibility in conducting "any single project" without the necessity to "go back" to the non-operators. Conversely, a non-operator would want this figure to be a lower threshold so that its concurrence must be obtained before the project may be undertaken.

[34] 886 P.2d 259 (Wyo. 1994).

parties before "reworking" a well, if the proposed operation constituted a "single project reasonably estimated to require an expenditure in excess of Five Thousand and No/100 Dollars ($5,000.00)." The operator "determined that four . . . wells were capable of being produced economically and returned three of the wells to production," but did not consider the work to be "reworking" and, hence, did not seek the approval of the non-operator.

After the non-operator refused to pay its share of the expenses, the operator sued and obtained a summary judgment. On appeal, the Supreme Court of Wyoming found that the term "reworking" was ambiguous and "has no precise meaning." The court therefore found issues of fact as to the meaning of the term "reworking" and reversed the summary judgment.

Similarly, unless it is proposed pursuant to the "subsequent operations clause," no well can be reworked or plugged back without the consent of all of the parties.[35] The explicit necessity for the "consent of all parties" was affirmed in a case where the operator proposed a fracture stimulation operation to which a non-operator objected and as to which it declined to consent.[36]

One court has expressed a rather unique view of the "limitation on expenditure clause" as constituting a "limitation [which] is only for accounting purposes[,]" but which otherwise "does not alter the common-law rule of unilateral extraction and development of minerals by cotenants."[37] In *Cone*, the cotenants of a designated Contract Area were operating under the 1982 Model Form. The operator proposed the conduct of a water flood operation which was estimated to cost approximately $950,000. That type of operation was not within the ambit of the "subsequent operations clause." Cone, a non-operator, withheld his consent. The operator and the consenting parties proceeded with the operation, which was successful in that "production from the unit increased significantly as a result of the water flood."

Litigation ensued after Cone challenged charges which, he contended, "were improperly assessed to his account in light of his nonparticipation in the water flood." At issue was whether the operator could install the water flood operation without Cone's consent, where the anticipated costs ex-

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[35] *See, e.g.*, Article VII.D.2 of the 1982 Model Form.

[36] Texstar N. Am. v. Ladd Petroleum Corp., 809 S.W.2d 672 (Tex. Civ. App.—Corpus Christi 1991, writ denied).

[37] Cone v. Fagadau Energy Corp., 68 S.W.3d 147 (Tex. App.—Eastland 2001, pet. denied).

ceeded the $15,000 threshold set forth in the "limitation on expenditure clause."[38]

Rejecting the non-consenting owner's contention that, without his consent, the operator could not conduct a water flood operation, the court observed that the "relationship between Cone and the other working interest owners of the contract area was that of cotenants of the various leaseholds which comprise the contract area." From this premise, the court then recited the well-known principle that a "cotenant has the right to extract minerals from common property without first obtaining the consent of his cotenants."[39]

Concerning the "limitation on expenditure clause," the court stated, as follows:

> This provision applies to expenditures which the operator may charge to the other owners for activities conducted on the contract area. It provides a means of protecting a non-operating owner being charged for a large expenditure that exceeds a predetermined amount by essentially giving the non-operator owner veto power over the proposed charge. While this provision appears to limit activities on the contract area, the limitation is only for accounting purposes. This provision does not alter the common-law rule of unilateral extraction and development of minerals by cotenants. The provision does not restrict production activities which may be undertaken by the operator on the contract area. This provision is a limitation on the non-operator's exposure to liability for expenses incurred by the operator. This provision does not allow the non-operator to prohibit operations by withholding his consent. Accordingly, the operating agreement did not forbid [the operator] from installing the water flood without [the non-operator's] consent.

The fallacy in the court's reasoning resides in its failure to appreciate that the "default" rules of cotenancy apply only in the absence of an agreement between the parties. The operating agreement is, if anything, a comprehensive contractual undertaking which regulates, to the exclusion of the "default" rules on which the court relied, the relationship between cotenants.[40]

### [6] Content of Notice of Proposed Subsequent Operation

As indicated above,[41] in order to propose the conduct of a subsequent

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[38] *See* Article VII.D.3 of the 1982 Model Form.

[39] The court cited Byrom v. Pendley, 717 S.W.2d 602, 605 (Tex. 1986) and other cases for this proposition.

[40] *See* cases and other authorities cited at footnote 3, *supra*. The Texas Supreme Court denied the Petition for Review, thereby leaving the Court of Appeals Opinion intact. The *Cone* case represents a significant departure from this well-established rule.

[41] *See* § 7.02[2] herein.

operation, the proposing party must give all other parties "written notice of the proposed operation, specifying the work to be performed, the location, proposed depth, objective formation and the estimated cost of the operation."

Customarily, this information is transmitted by the proposing party along with a "Well Procedure" or "Well Prognosis" which describes in detail the engineering steps involved in the operation and, in order to provide "the estimated cost of the operation," an AFE setting forth the costs and expenses which are anticipated to be incurred in connection with the proposed operation.

The intended purpose of this requisite notice is to afford the working interest owner the opportunity to make a considered and meaningful decision as to whether or not it wishes to participate in the risk and expense of the proposed operation.

More often than not, the subsequent operation is proposed by the operator who, by reason of its unique position, has first hand knowledge of and more immediate access to all information necessary to evaluate the merits of the proposed operation.

In contrast, a non-operator who receives a proposal is not always in the same position as the operator in terms of access to such information. It is for this reason that the notice must contain information in sufficient detail to enable a less knowledgeable or informed participant to understand the nature and objective of the proposed operation so that it might make an informed decision with respect thereto.

As previously observed, an operating agreement is, of course, a contract to which apply general principles of contract law.[42] Thus, depending upon the circumstances, traditional defenses of waiver, estoppel and detrimental reliance might, in a proper case, be applicable to preclude, after the successful conduct of a non-consented operation, a complaint by a non-consenting party who did not object to a supposed deficiency in the consenting party's notice of the proposed operation.[43]

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[42] *See* footnote 11, *supra*.

[43] These defenses, and others, are "affirmative defenses" which must be specially plead by the defendant, failing which no evidence may be introduced to establish such defenses. *See* Rule 8(c)(1), Federal Rules of Civil Procedure; Louisiana: Article 1005, Louisiana Code of Civil Procedure; Oklahoma: Section 122008C, Code of Civil Procedure of the State of Oklahoma; Texas: Rule 94, Texas Rules of Civil Procedure.

For example, in a Texas case,[44] a party was held liable to the operator for its proportionate share of drilling costs, notwithstanding the failure of the operator to give the non-operator ten (10) days' notice before commencing operations, as expressly required by the operating agreement. Because the non-operator had actual knowledge of the proposed operations, and did not object, the court held that it had waived its right to complain about the failure of the operator to give contractual notice.

Additionally, because the giving of the requisite notice is a condition precedent to its conduct, an operator which fails to give the requisite notice before conducting a reworking operation may be denied recovery of costs associated with the operation.[45]

Because of the importance of the consequences to be attributed to a party's election in response to a proposal, the proposing party should be certain to obtain documentary evidence which manifests the fact and date of receipt of such proposal at the proper address of the notified party, as set forth in the operating agreement.[46] Unless the proposing party can prove the date of receipt of the notice,[47] a party who has not timely responded to the proposal (and whom the operator consequently considers to have "gone non-consent") might be able to contend, after the operation is successful, that it did not receive the requisite notice and that, if it had, it would have elected to participate in the cost and risk of the proposed operation.



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[44] Bluebonnet Oil & Gas Co. v. Panuco Oil Leases, Inc., 323 S.W.2d 334 (Tex. Civ. App.—San Antonio 1959, *writ ref'd n.r.e.*). A failure of a non-operator to timely object to the excessiveness of costs incurred by an operator at the time the cost was incurred, might result in a waiver of such right to object at a later date. Buttes Gas & Oil Co. v. Willard Pease Drilling Co., 467 F.2d 281 (10th Cir. 1972).

[45] LPCX Corp. v. Faulkner, 818 P.2d 431 (Okla. 1991). *See also* El Paso Prod. Co. v. Valence Operating Co., 112 S.W.3d 616 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (operator that, based upon its belief that the non-operator no longer owned an interest, did not offer the non-operator the opportunity to participate in a proposed workover and that treated the non-operator as a non-consenting party to that operation, held not entitled to impose non-consent recoupment factor. "There was no provision in the JOA for the imposition of the penalty if the initial required notice was not given.").

[46] *See* Article XII (lines 35–41 of Page 13) of the 1982 Model Form.

[47] Although there is authority for the proposition that "there is the legal presumption that a letter properly addressed, stamped, and mailed reaches its destination in due time," Pure Oil Operating Co. v. Gulf Refining Co., 78 So. 560 (La. 1918), even this (rebuttable) presumption does not supply the critical date of receipt. Texas: Southland Life Ins. Co. v. Greenwade, 159 S.W.2d 854 (Tex. 1942).

### [7] Proper Characterization of the Proposed Operation

Caution should be exercised by the operator in the characterization of the proposed operation as being one within the ambit of the "subsequent operations clause." In particular, an issue may arise as to whether a proposed operation is, by its nature, a "reworking" operation (to which the "subsequent operations clause" would be applicable) or mere maintenance or "routine repairs" (governed by the "limitation on expenditure" provision).[48]

One court has held that the operator had breached the operating agreement where it issued an AFE to which the non-operators—considering the proposed operation to be "routine repairs" rather than a "reworking" operation as characterized by the operator—did not respond.[49] Contending that the failure of the non-operators to respond to the notice gave rise to the imposition of the 300% non-consent recoupment factor, the operator deemed the non-operators to have relinquished their interest and thus applied the revenue to itself. The jury found the proposed operation to be "routine repairs," rather than a "reworking" operation as to which an election to participate or not was necessary, and awarded damages to the non-operators.

The operator argued that "the mere sending of the AFE letter did not result in any damages to [the non-operators]." The court rejected this contention, saying:

> However, the sending of the AFE letter triggered Appellees' contractual obligation to elect whether to participate in the cost of the proposed operations or suffer the 300 percent penalty specified in the JOA. When Appellees did not respond to the AFE, Abraxas immediately seized Appellees' interests in the Cleo Smith lease and began appropriating their earnings. Abraxas continued to withhold the earnings even though it did not complete the operations as specified in the AFE. Still further, Abraxas retained their interests until the lease had no value. Consequently, the evidence is both legally and factually sufficient to establish that sending the AFE resulted in damages to Appellees.

The court also rejected the operator's contention that its actions were protected by the "exculpatory" clause contained in the operating agreement,[50] finding that such clause "is limited to claims based upon an allegation that [the operator] failed to act as a reasonably prudent operator and does not apply to a claim that [the operator] breached the JOA."[51]

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[48] *See* § 7.02[5] herein.

[49] Abraxas Petroleum Corp. v. Hornburg, 20 S.W.3d 741 (Tex. Civ. App.—El Paso 2000).

[50] *See* Article V.A (lines 8–10 of Page 4) of the 1982 Model Form.

[51] Said the *Abraxas* court, "We have found no cases discussing exculpatory clauses exempting a party from liability for breach of contract." Abraxas Petroleum Corp. v.

In another case,[52] the operator sued the non-operators "to recover overpayment of revenues [which non-operators] received from production, after they elected to non-consent to the proposed reworking operations on the well." The non-operators having gone "non-consent," it was error for the operator to continue to pay revenues to the non-operators. At issue was the nature of the operator's claim for recovery of the undue, erroneously paid proceeds as Texas law has a four-year statute of limitations on a contract claim, but a two-year limitation period on a claim of unjust enrichment.

The court granted summary judgment to the operator on its alternative unjust enrichment claim, limiting recovery to a two-year period preceding the filing of suit. The court rejected the operator's claim for recovery for a four-year period of time, finding that the operator's suit did not sound in contract because "the operating agreement did not place an obligation on appellees to take action to suspend payments." "The mere receipt of money

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Hornburg, 20 S.W.3d 741, 759 (Tex. App. 2000). Inexplicably, the court did not consider Stine v. Marathon Oil Co., 976 F.2d 254 (5th Cir. 1992) wherein the Fifth Circuit, applying Texas law, extended the protection of the exculpatory clause to alleged breaches of contract, including particularly the accounting and administrative duties performed by the operator under the operating agreement. Other cases on the exculpatory clause: *Applies to breach contract claims* (following *Stine*)—IP Petroleum Co. v. Wevanco Energy, L.L.C., 116 S.W.3d 888 (Tex. App.—Houston [1 Dist.] 2003, pet. denied) (". . . the exculpatory clauses in the JOA applied, and the plaintiffs had to establish that IP was grossly negligent or acted with wilful misconduct when it breached the contract."); Palace Exploration Co. v. Petroleum Dev. Co., 316 F.3d 1110 (10th Cir. 2003) ("Palace did not articulate any theory of recovery whereby it could recover legal damages based on breach on contract, for the above-referenced exculpatory clause limited PDC's potential liability to willful acts or acts that resulted from gross negligence.") and PYR Energy Corp. v. Samson Res. Co., 470 F. Supp. 2d 709 (E.D. Tex. 2007) (while questioning the correctness of Stine, nevertheless "the preconditions for departing from *Stine* are not shown to exist in this case."). *Does not apply to breach contract claims* (not following *Stine*)—Cone v. Fagadau Energy Corp., 68 S.W.3d 147 (Tex. App.—Eastland 2001, pet. denied) ("The gross negligence/willful misconduct requirement applies to any and all claims that the operator failed to conduct operations in a good and workmanlike manner," but not to claims of "alleged breaches of specific terms of the agreement and [which] are in the nature of an accounting."); Castle Tex. Prod. Ltd. P'ship v. Long Trusts, 134 S.W.3d 267 (Tex. App. 2003) (the exculpatory clause "is limited to claims that Castle failed to act as a reasonably prudent operator in its operations in the contract area and does not apply to a claim that it otherwise breached the JOAs."); Shell Rocky Mt. Prod., LLC v. Ultra Res., Inc., 415 F.3d 1158 (10th Cir. 2005) ("While a higher standard for breach might apply to drilling, extraction, and other risky operations because most operators have the same incentive as non-operators to do well in physical operations, it is nonsensical to apply such a standard to administrative and accounting duties where the operator can profit by cheating, or simply overcharging, its working interest owners").

[52] Mobil Producing Tex. & N.M., Inc. v. Cantor, 93 S.W.3d 916 (Tex. Civ. App.—Corpus Christi 2002, no writ).

they were not entitled to does not constitute a breach."

## § 7.03 The Election to Participate or Not in a Subsequent Operation

### [1] Election in Response to Notice of Proposed Subsequent Operation

Upon receipt of the requisite notice and attendant information, the receiving party has a period of thirty (30) days within which to make an election. However, for obvious reasons related to cost, if a drilling rig is "on location" at the time of the issuance of the notice, this period is usually reduced to a shorter period of time, customarily forty-eight (48) hours. Presumably, the drilling rig must be "on location" pursuant to other lawful agreements or proposals, and cannot be brought on to the location merely for the purpose of reducing the period of time within which parties must respond to a notice of a proposed operation—"bootstrapping" is seldom condoned by the courts.

A case illustrative of this is *Chisos, Ltd. v. JKM Energy, L.L.C.*[53] The plaintiff was the operator and gave notice of a proposed reworking operation on the HL2 Well to JKM, the non-operator. "The letter, which purported to give JKM forty-eight hours to make its decision, was faxed late on a Friday afternoon and required JKM to commit almost $170,000 or elect not to participate. The forty-eight-hour deadline was based on a provision of the JOA that allowed for a reduced deadline if a drilling rig was on the premises. The letter claimed that this provision applied because a 'drilling/workover' rig was on the premises."

In litigation to, among other things, determine JKM's status in the HL2 Well, the court found that "Chisos did not provide the required notice, but instead 'made a disingenuous and bad faith attempt to force JKM to opt out of the operations in regard to HL2, and contrary to the JOA, gave JKM only [forty-eight] hours to commit to the expenditure of $170,000.' " This, according to the court, was in bad faith. The court further explained, as follows:

> For two months, it did not give JKM the thirty-day notice required by the JOA. However, during that time it did arrange for a workover rig to be sent to the well.
>
> Once the rig was in place, it attempted to pass the workover rig off as a "drilling/workover" rig that would trigger the forty-eight-hour notice provision in the JOA applicable to drilling rigs. Chisos knew that the rig was not a drilling rig. Chisos also knew that JKM asserted ownership of the HL2 well. And, despite the fact that the rig was on site earlier in the week, Chisos sent the letter late on a Friday. These facts are substantial evidence supporting a finding of bad faith.

[53] 2011-NMCA-26, 150 N.M. 315, 258 P.3d 1107.

As a remedy, the court ordered the operator to account to JKM and afford it a retroactive opportunity to elect to participate in the successful rework of the HL2 Well.

An agreement which provided that a party must notify the proposing party of its election to participate "in writing . . . not less than fifteen (15) days after receipt of such notice" was interpreted so as to allow as timely an election made nineteen (19) days after the proposal. The court rejected the contention that the election was required to be made "within" fifteen (15) days after receipt of the notice.[54]

A failure to respond timely to a proper notice is tantamount to an election to not participate in the proposed operation.[55] Thus, in order to elect to participate, a party must timely and affirmatively respond in the manner contemplated by the agreement.

A party who elects to participate in the cost, risk and expense of a proposed operation is called a "consenting party" while a party who does not affirmatively elect to participate therein is called a "non-consenting party."

An election must be unequivocal and cannot be conditional. A conditional election—that is, an election purporting to add or delete conditions to the circumstances under which the respondent would be agreeable to participating in the proposed operation—is tantamount to no timely election at all. Accordingly, the conditionally responding party would be a non-consenting party unless, of course, the proposing party (and, presumably, all other consenting parties) would waive this position and be agreeable to the conditions sought to be imposed by the respondent.

Although admittedly arising in a different context, one court held that AMI parties who made an "equivocal" election to an offering under an "area of mutual interest" provision were not entitled to participate because they "did not unequivocally accept [the offering party]'s offer within the required period and are not now entitled to accept.[56]

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[54] GeoSouthern Energy Corp. v. Chesapeake Operating Inc., 274 F.3d 1017 (5th Cir. 2001), *cert. denied*, 537 U.S. 814, 123 S.Ct. 75, 154 L.Ed.2d 17 (2002).

[55] Colorado Springs Nat'l Bank v. Ferebee, 486 P.2d 456 (Colo. Ct. App. 1971).

[56] J-O'B Operating Co. v. Newmont Oil Co., 560 So. 2d 852 (La. Ct. App.), *writ denied*, 565 So. 2d 449 (La. 1990) ("The AMI agreement does not authorize a conditional election to participate in an acquired interest nor does our law sanction such practice."). Citing Professor Litvinoff, *47 La.L.Rev. 699, 737* (1987), the court observed that, "[i]f the acceptance limits, conditions, or modifies the offer, it is itself considered a new offer and gives the one who made the original offer the right to withdraw it." In the interest of full disclosure, your author was counsel to one of the parties to this case.

If any party elects to "go non-consent," the operating agreement requires the operator to notify the consenting parties of this fact and to afford each consenting party the opportunity to elect (a) to participate in the proposed operation only to the extent of its original interest or (b) to take a proportionate part of the non-consenting party's interest. In the latter instance, a party who elects to take a proportionate part of the non-consenting party's interest is often said to have "enhanced" its interest."

The requirement of this election notice was first added to the 1977 version of the Model Form Operating Agreement in order to avoid the holding of a case which had held that, in the absence of such a provision, the operator was *not* required to notify the consenting parties that not all parties were participating.[57] Obviously, in the absence of this second notice and the concomitant opportunity to elect to "stand" on its original interest or to "enhance," a consenting party has no way of knowing in advance the extent of its obligation to bear costs and to assume risk. Thus, in the case giving rise to this requirement, each party who signed the original AFE (which reflected that *all* parties would participate) was held liable for its proportionate part of the interest of the parties who did not in fact participate, in addition to its original interest.

In one case,[58] a dispute arose as to whether a farmee under a farmout agreement executed by a farmor whose working interest was subject to the operating agreement, "held" or "owned" an interest in the Contract Area sufficient to be considered in the tally of elections. The operating agreement provided for one consequence to a non-consenting party—a 1000% non-consent recoupment factor—if the consenting parties represented a *minority*-in-interest of the working interest participants, and another consequence—a relinquishment of interest in a specified geographical area—if the consenting parties constituted a *majority*-in-interest of the working interest participants.

On rehearing, the Wyoming Supreme Court held that "the majority-minority interest determination must be made upon the expiration of the ten-day 'second election' period as provided" in the operating agreement. At that point in time, the farmee who had actually proposed the operation (and, hence, who had consented to its conduct) did not "own" an interest in the Contract Area (for the reason that it had not yet "earned" any interest pursuant to the farmout agreement by the drilling of the yet-to-be-drilled

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[57] French v. Joseph E. Seagram & Sons, Inc., 439 S.W.2d 448 (Tex. Civ. App. 1969).

[58] Moncrief v. Louisiana Land & Exploration Co., 861 P.2d 500 (Wyo.), rev'd on rehearing 861 P.2d 516 (Wyo. 1993).

well) and, consequently, its vote being excluded, the consenting parties represented a *minority*-in-interest and the non-consenting parties thereby incurred a 1000% non-consent recoupment factor, and not a forfeiture of interest.

Without the consent of all other parties, a party may not partially non-consent a proposed operation, but must make a single election as to the entirety of its interest.[59]

### [2] Right of a Party to Change its Initial Election in Response to Notice of Proposed Subsequent Operation

A party who failed to respond within the thirty (30) day period was held to have elected to not participate in the well which was the subject of the proposal.[60] Moreover, having elected to "go non-consent," the operating agreement "provides no opportunity for the non-consenting party to change its election between the end of the thirty day notice period and actual commencement of operations."[61]

*XTO Energy Inc. v. Smith Production Inc.*[62] presented the issue of whether a party, having timely elected to "go non-consent," could change its election prior to the expiration of the thirty (30) day period and thereby assert a right to participate in the proposed operation. The court held in the negative, saying:

> Under the unambiguous language of each of the JOAs,[63] if, after proper notice of a proposal to drill an additional well under Article VI.B.1., a party to the JOA timely and properly gives notice to the proposing party as to whether it elects to participate in the cost of the proposed operation, then that party may not change its election, even if it purports to do so within thirty days after receipt of the notice of the proposed operation and regardless of whether the other parties have materially changed their positions in reliance on the initial election.

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[59] General American Oil Co. v. Superior Oil Co., 416 So. 2d 251 (La. Ct. App.), *writ denied*, 421 So. 2d 908 (La. 1982) ("There is no provision in the JOA . . . that allows a party to partially non-consent to a certain operation."). *See also* Viking Petroleum v. Oil Conservation Comm'n, 100 N.M. 451, 672 P.2d 280 (1983) (upholding Oil Conservation Commission's denial of non-operator's request to partially participate in unitized operation.).

[60] Nearburg v. Yates Petroleum Corporation, 1997-NMCA-69, 123 N.M. 526, 943 P.2d 560, *cert. denied*, 123 N.M. 446, 942 P.2d 189 (1997).

[61] Nearburg v. Yates Petroleum Corporation, 1997-NMCA-69, 123 N.M. 526, 943 P.2d 560, 568.

[62] 282 S.W.3d 672 (Tex. Civ. App.—Houston [14th Dist.] 2009).

[63] The case involved the 1982 Model Form.

### [3] Implied Duty to Participate in Proposed Subsequent Operation

In recognition of the detailed nature of the provisions of the operating agreement relative to the circumstances under which subsequent operations might be proposed and conducted, consideration should be given to the issue of whether such explicit provisions might be overridden or ameliorated by an *implied* duty of good faith or mutual cooperation. Stated differently, can it be successfully contended that a party who makes a proper election to "go non-consent" has nevertheless breached an *implied* duty of cooperation in the development of the commonly owned leases?

The Texas courts which have considered the issue tend to answer this question in the negative. A concurring opinion in *English v. Fischer*[64] set in motion attempts by imaginative litigants to recover punitive damages in breach of contract cases arising out of a variety of contractual relationships. Although the Supreme Court of Texas rejected a claim for punitive damages for breach of contract, the author of a concurring opinion noted that, in certain situations, punitive damages might be recoverable for breach of contract; the concurring opinion identified certain instances where parties have incurred a duty of good faith and fair dealing because Texas courts "read" such duties into contractually-based transactions arising from a "special relationship" between the parties.[65]

In *Exxon Corporation v. Atlantic Richfield Company*,[66] a party to an operating agreement resisted the termination of the agreement by the vote of the majority of the cotenants. The termination was effected in accordance with an express provision in the operating agreement. The party who opposed termination contended that "the contract contained an implied covenant of non-termination." The Texas Supreme Court held that there "can be no implied covenant as to a matter specifically covered by the written terms of the contract." The court stated further:

> The agreement made by the parties and embodied in the contract itself cannot be varied by an implied good-faith-and-fair-dealing covenant.

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[64] 660 S.W.2d 521 (Tex. 1983). This non-oil and gas case involved a suit by a homeowner against the mortgagee for failure to turn over the proceeds of a fire insurance policy in order to aid the homeowner in rebuilding after the fire.

[65] Concurring, Justice Spears stated that a "special relationship either arises from the element of trust necessary to accomplish the goals of the undertaking, or has been imposed by the courts because of an imbalance of bargaining power." 660 S.W.2d 521, 524 (Tex. 1983).

[66] 678 S.W.2d 944 (Tex. 1984).

* * *

All parties agreed upon the termination clause. These clauses expressly and unambiguously set out the terms under which the contract could be terminated. There can be no implied covenant to the contrary.

This issue was considered in the context of a dispute involving an operating agreement in *Texstar North America, Inc. v. Ladd Petroleum Corporation*.[67] Texstar, as operator, proposed a fracture stimulation operation in order to increase production. The operating agreement required unanimous consent before a well could be reworked; Ladd, a non-operator, withheld its consent. The operator sued the non-consenting cotenant, alleging that, by withholding its consent, Ladd had breached a duty of good faith. The court rejected Texstar's contention and stated that, in view of the express requirement of the operating agreement that unanimous consent was required, there was no implied duty of good faith and fair dealing between parties to an operating agreement. The court found that an operating agreement does not give rise to a "special relationship" sufficient to impose a duty of good faith and fair dealing.

In *Hondo Oil and Gas Company v. Texas Crude Operator, Inc.*,[68] the Fifth Circuit, applying Texas law, found no "special relationship . . . establishing any fiduciary duty" between non-operators under an operating agreement.

Oklahoma law appears to be to the same effect.[69]

## § 7.04 The Conduct of the Subsequent Operation

### [1] Commencement of Proposed Subsequent Operation

Once a party proposes a subsequent operation, the issue of whether it may thereafter elect to not proceed with its implementation depends upon the elections made in response thereto. Under the 1982 Model Form, if all parties elect to participate therein, the operator is obligated to "actually commence the proposed operation" within ninety (90) days after expiration of the notice period.[70] However, the operator has the unilateral right, by giving written notice to the other parties, to extend this period by thirty (30) days if necessary for certain stated reasons.[71]

The fact that all parties have consented to the proposed operation gives

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[67] 809 S.W.2d 672 (Tex. Civ. App.—Corpus Christi 1991, writ denied).

[68] 970 F.2d 1433, 1438 (5th Cir. 1992).

[69] Davis v. TXO Production Corp., 929 F.2d 1515 (10th Cir. 1991).

[70] *See* Article VI.B.1 (lines 21–30 of Page 5) of the 1982 Model Form.

[71] *Id.*

rise to an obligation—and not a mere option—that the operator "*shall* . . . actually commence" the operation. Hence, if a consenting party has dedicated monies to cover its responsibilities for a proposed operation and, in so doing, has diverted funds which it would have otherwise used on another project which it must thereby forego, it might have a cause of action against the operator who fails to undertake the operation to which all parties have consented.[72] Presumably, under these circumstances, the operator may elect to forego the proposed operation only with the concurrence of all consenting parties.[73]

If the operation is not timely commenced, the notice procedure must be initiated again in order to impose the non-consent recoupment factor.[74]

For example, in *Valence Operating Company v. Anadarko Petroleum Company*,[75] Valence, as non-operator, proposed the "immediate drilling" of four wells on the Contract Area. Anadarko, as operator, did not consent, and "Valence became the operator for the purpose of its proposal, and was mandated to 'actually commence work on the proposed operation' by March 17, 2000."

After Anadarko challenged the imposition of a non-consent recoupment factor on the basis of its election to not participate, the court reviewed the "things [Valence did] before the deadline." None of the cited activities involved actual on-site drilling. Rather, the court observed that the "preliminary activities conducted by Valence in advance of the deadline consisted mostly of acts that are sometimes characterized in the industry as 'back-room preparations' and securing drilling permits with no on-site activity except a preliminary staking of wells." "These preliminary activities were not sufficient to constitute, as a matter of law, the actual commencement of work on the proposed operation within the meaning of Article VI.B.2 of the Joint Operating Agreement." The court upheld the jury's finding that Valence failed to comply with the temporal requirement that operations must be actually commenced "within sixty (60) days after the expiration of the notice

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[72] Presumably, the operator may be protected by the "exculpatory" clause of the operating agreement. *See* Article V.A (lines 8–10 of Page 4) of the 1982 Model Form. However, *see* footnotes 50–51, *supra*, and the accompanying text concerning the issue of the applicability of the "exculpatory" clause to a breach of contract.

[73] In an unreported decision, an Oklahoma court held that an operator could avoid the duty to drill the well under Article VI.A by resigning as operator. Magic Circle Energy Corp. v. Slawson, 61,136 (Okla. App. 10/30/84).

[74] *See* text accompanying footnote 138, *infra*.

[75] 303 S.W.3d 435 (Tex. Civ. App.—Texarkana 2010, no pet. h.).

period" specified in the operating agreement.

An operating agreement has been interpreted as to not obligate the operator to drill the proposed well if any party elects to not participate in the proposed operation.[76] Consequently, if less than all of the parties elect to participate, the proposing party "may withdraw such proposal if there is insufficient participation."[77]

Under the Model Form, the operator shall conduct the operation for the account of the consenting parties.[78] If the operator has elected to not participate in the risk and expense of the subsequent operation, the operator shall nonetheless conduct the operation for the account of the consenting parties unless the consenting parties designate one of the consenting parties to conduct the operation, in which latter event the party actually conducting the operations shall comply with the terms and provisions of the operating agreement.[79]

Where a non-operator conducted reworking operations under the belief that it had succeeded to operatorship, and such belief was later rejected, its demand for reimbursement of the costs of the operation was disallowed.[80] The court denied recovery because the "operator alone is entitled to perform operations on behalf of the consenting parties and bill them accordingly."[81]



### [2] "Jumping the Gun"—Premature Commencement of Proposed Subsequent Operation

Not only must the operator commence the operation *within* ninety (90) days after expiration of the notice period (the failure to do which would necessitate the re-institution of the notice and election procedure), the question has arisen as to whether it may commence the operation *before* the expiration of the first notice period, if it wishes to impose the non-consent recoupment factor against a non-consenting party.

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[76] Frankfort Oil Co. v. Snakard, 279 F.2d 436 (10th Cir. 1960).

[77] *See* Article VI.B.1 (lines 53–4 of Page 5) of the 1982 Model Form.

[78] Under the 1990 Canadian Model Form, the proposing party has the absolute right to be the operator of the "independent operation" which it proposes. *See* Clause 1004 of the 1990 CAPL.

[79] *See* Article VI.B.2 of the 1982 and 1989 Model Forms.

[80] Stable Energy, L.P. v. Kachina Oil & Gas, Inc., 52 S.W.3d 327 (Tex. Civ. App.—Austin 2001, no writ).

[81] Stable Energy, L.P. v. Kachina Oil & Gas, Inc., 52 S.W.3d 327, 335.

In *Dorsett v. Valence Operating Company*,[82] the operator issued a series of notices proposing subsequent operations, but was found to have actually commenced operations *before* the elapse of thirty (30) days from receipt by the non-operator of the proposal. In fact, in several instances, work on the well had already begun by the time the notice of proposed operation was issued. When the non-operator failed to respond, she was held by the operator to have "gone non-consent," and the operator enforced the non-consent recoupment factor against the non-operator.

The non-operator sued the operator, claiming that, "[s]ince she did not receive timely notice of the proposals . . . , her duty to elect to participate was never triggered and, thus, her failure to elect could not render her a non-consenting party subject to the nonconsent penalty."[83]

The operator contended that the operating agreement (which was the 1977 Form) "requires only that an operator give a nonoperator notice of a proposed operation and then allow a thirty-day election period."[84] Further, the operator argued that the operator "can commence work at any time before or after notice is given to the nonoperating parties, as long as it allows the parties thirty days to make their election."[85]

Taking a rather liberal view of the point in time at which work is deemed to have "commenced,"[86] the appellate court reversed the judgment in favor of the operator, and held that the non-operator had not incurred any non-consent recoupment factor. The appellate court "read the contract to require that the operator provide parties notice of proposed operations and allow thirty days for the parties to elect to participate before the operator commences work on the operation."[87] Because the operator "jumped the gun," the appellate court held that the "nonconsent penalty was never triggered and is not enforceable against" the non-operator.[88]

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[82] 111 S.W.3d 224 (Tex. Civ. App.—Texarkana 2003).

[83] 111 S.W.3d 224, 228.

[84] 111 S.W.3d 224, 228.

[85] 111 S.W.3d 224, 228.

[86] The court invoked the line of cases holding that, for purposes of lease maintenance, preparatory work conducted in good faith is sufficient to constitute "commencement" of drilling operations. See, *e.g.*, Petersen v. Robinson Oil & Gas Co., 356 S.W.2d 217 (Tex. Civ. App.—Houston 1962, no writ). *Louisiana*: Breaux v. Apache Oil Corp., 240 So. 2d 589 (La. Ct. App. 1970); *Mississippi*: Exxon Corp. v. Crosby-Mississippi Resources, 154 F.3d 202 (5th Cir. 1998); *Oklahoma*: Smith v. Gypsy Oil Co., 265 P. 647 (Okla. 1928).

[87] 111 S.W.3d at 235.

[88] 111 S.W.3d at 235.

In a unanimous decision, the Texas Supreme Court reversed the appellate court and reinstated the judgment of the trial court.[89] Referring to the notice provision, the court stated that it "places no temporal limitation on [the operator's] ability to commence work on the proposed projects." "It places no restrictions on when [the operator] may commence drilling or preparations for drilling." Said the court:

> In short, the thirty-day notice period sets a deadline for [the non-operator] to decide whether to participate in proposed operations. Nothing in the language of the Agreement forbids the operator from commencing work before the end of the notice period.

In *Bonn Operating Company v. Devon Energy Production Company, L.P.*,[90] the Fifth Circuit affirmed a district court decision which relied upon *Valence Operating Company v. Dorsett*, and held that a non-consent recoupment factor was appropriately applied where the non-operator made an express election to "go non-consent" after the wells were drilled. Rejecting the non-operator's contention that the operator had violated the operating agreement by proposing the wells after they were drilled and completed, the court also found this election constituted a waiver under Texas law.

### [3] Deviation from Scope of Proposed Subsequent Operation

As noted above, the purpose of the first notice is to enable a party to make a reasoned determination as to whether or not it desires to participate in the risk and expense of the described operation. The operator will only be successful in enforcing contribution from the consenting parties if it actually conducted the operation as fairly described in the AFE. Hence, any material deviation from the operation as described in the Well Procedure or AFE might relieve the party from the consequences of its election based thereon.

In *Haas v. Gulf Coast Natural Gas Company*,[91] parties executed an AFE agreeing to participate in the drilling of a well on a footage basis,[92] as disclosed by the AFE. After the operator was unable to contract for the drilling of the well on a footage basis, it secured a drilling contractor to drill the well on a daywork basis, but did not apprise the consenting parties of this change in the plans. When the daywork costs exceeded the amount reflected in the AFE, the consenting parties refused to pay, asserting that the change in the plans (to which they had not consented) relieved them of liability for

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[89] Valence Operating Co. v. Dorsett, 164 S.W.3d 656 (Tex. 2005).

[90] 613 F.3d 532 (5th Cir. 2010).

[91] 484 S.W.2d 127 (Tex. Civ. App. 1972).

[92] *See* Ottinger, "Drilling Contracts," 38 *L.S.U. Min. L. Inst.* 99 (1991).

the costs. The appellate court reversed the trial court's decision in favor of the operator and indicated that the fact that the plaintiff-operator changed the plans without securing the consent of the non-operators was a valid defense to the operator's demand for the payment of costs. In essence, the deviation from the plans disclosed in the AFE, coupled with the fact that the operator did not advise the participants that the well would be drilled on a basis different than disclosed in the proposal, was viewed by the appellate court as significant (if not dispositive).

In another instance,[93] the operator proposed the drilling of a test well at a certain location as particularly designated in the AFE. A non-operator declined to participate in the drilling of the well as described therein. The operator later changed the specifications for the well, but did not afford the non-operator another opportunity to elect to participate in the drilling at the revised location. The operator drilled the well, which was successful. It was held that, because the well was drilled at a location and to a depth which was not specified in a proper notice to the non-operator (as required by the operating agreement), the non-operator had not forfeited its interest in the well.

In a Canadian case,[94] an operator was denied recovery against the non-operators for the additional costs of directionally drilling a well where the AFE did not disclose that the "well was anything other than a [true vertical] conventional well." The court found that the operator's "personnel were not forthright with the [non-operators], suggesting a lack of agreement." The court was also struck with the fact that the operator "did not have the good corporate manners to find the time to discuss the additional expenses," but was "only interested in payment, not discussion and certainly not niceties."[95]

The demand of a non-consenting party for relief from its election to not participate because the well was drilled at a different location than specified in the notice, was denied in a case arising in New Mexico.[96] The non-consenting party argued that it was not subject to the recoupment factor because the well which was drilled (and successfully completed) "was not at

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[93] Acadienergy, Inc. v. McCord Exploration Co., 596 So. 2d 1334 (La. Ct. App. 1992).

[94] Passburg Petroleums v. San Antonio Explorations Ltd., [1988] 2 W.W.R. 645, 57 Alta L.R. (2d) 57 (Q.B.).

[95] Passburg Petroleums v. San Antonio Explorations Ltd., [1988] 2 W.W.R. 645, 57 Alta L.R. (2d) 57 (Q.B.).

[96] Matrix Prod. Co. v. Ricks Exploration, Inc., 2004-NMCA-135, 136 N.M. 593, 102 P.3d 1285 (*cert. denied*).

the exact location where the operator had proposed to drill and which had been stated in the notice." "The well had been drilled approximately 500 feet from its intended location." The court noted that the non-operator had "produced no evidence that Defendants knew of the mistake" prior to drilling, *i.e.*, that the error was not intentional.

The court, affirming a motion for summary judgment in the operator's favor, held that the operator "gave [the non-operator] notice of the drilling operation, as required by the JOA, and that any subsequent error that occurred was in performing the drilling operation itself," and not in the notice.[97]

As succinctly stated by one court, "if non-consenting parties are going to forfeit their interests, it is essential that the operation triggering that forfeiture is the same one the parties rejected."[98]

The rationale of these cases is that, while a party may make a certain election—to participate or not participate—with regard to an operation as described in the well prognosis and companion AFE, it does not necessarily follow that such party would have made the same decision if the parameters of the original proposal were different or are later changed. Thus, in order to enforce against a non-consenting party the provisions relative to a relinquishment of interest, it is imperative that the proposing party shall have complied with the requirements of the operating agreement pertaining to notice and an opportunity to make a meaningful election.

Consequently, where a change is made to the original proposal, it is incumbent upon the proposing party to resubmit the revised proposal. Failing this, the non-consenting party may not be subject to a relinquishment and a consenting party may not be liable for any costs. A wake-up call? Yes, but, this is so because the operation which is actually conducted is a different operation than that disclosed by the required notice and as to which the parties had made an election.



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[97] Matrix Prod. Co. v. Ricks Exploration, Inc., 2004-NMCA-135, 136 N.M. 593, 102 P.3d 1285 1289. The court also stated that it did "agree with the trial court that '[t]he facts are undisputed that the discrepancy in the location of the Burrus #3 well resulted from an honest, unintended, non-negligent mistake during operations that does not rise to the level of gross negligence or willful misconduct.' Matrix presented no evidence supporting an alternative conclusion. We therefore hold the trial court correctly concluded that Ricks is shielded by the exculpatory clause from liability for any losses caused during operations." Gulf Coast Natural Gas Company.

[98] Stable Energy, L.P. v. Kachina Oil & Gas, Inc., 52 S.W.3d 327 (Tex. Civ. App.—Austin 2001, no writ).

As it relates to a party who elected to "go non-consent," this rule is consistent with the well-established principle that forfeitures are not favored.[99] However, as stated by one court, "the fact that forfeitures are not favored in our law does not mean that contractual provisions calling for forfeitures are to be ignored."[100]

### [4] Modification of Operation Being Conducted

Even if a party consents to a proposed operation, an issue may arise as to whether a modification of that approved operation, during or after its conduct, constitutes a "continuation" of the original operation (for the costs of which the consenting party is obligated by reason of its original consent) or a "new" or "other" operation (for the costs of which the consenting party is not obligated in the absence of further or supplemental consent).

In a case illustrative of this proposition,[101] an operator instituted suit against a consenting non-operator to recover drilling costs incurred in connection with the initial well drilled under an operating agreement and a sidetrack well made necessary by downhole problems in the initial well. The non-operator resisted the operator's demand by contending that the sidetrack operations amounted to a "subsequent operation" which had not been proposed in accordance with the operating agreement. Because the non-operator had not approved the expenses of the sidetrack in advance, the non-operator denied liability. Finding the terms "initial well," "subsequent wells" and "other operations" to be ambiguous, the trial judge submitted to the jury the question, *viz.*, "Do you find that the Campbell sidetrack was a continuation of the original Campbell 1 well as distinct from subsequent or other operations as defined in the Operating Agreement?" The Fifth Circuit

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[99] Alabama: Protective Life Insurance Co. v. Thomas, 134 So. 488 (Ala. 1931) ("Forfeitures are looked upon by the courts with disfavor, and it is a rule of general application that stipulations in contracts intended to work a forfeiture of a conceded right will not only be strictly construed, but strict compliance therewith by the party claiming the forfeiture will be exacted."); Colorado: Sung v. McCullough, 651 P.2d 447 (Colo. Ct. App. 1982) ("Forfeitures are looked upon with disfavor."); Louisiana: Schultz v. Texas & P. R. Co., 186 So. 49, 52 (La. 1938) ("Forfeitures are not favored; they are strictly construed, and will not be maintained unless it is plain that every reasonable requirement of the contract has been followed."); Mississippi: Maxey v. Glindmeyer, 379 So. 2d 297 (Miss. 1980); Texas: Reilly v. Rangers Management, Inc., 727 S.W.2d 527 (Tex. 1987); Ohio: Miraldi v. Life Ins. Co., 48 Ohio App.2d 278, 356 N.E.2d 1234 (1971); Oklahoma: City of Tulsa v. Air Tulsa, Inc., 851 P.2d 519 (Okla. 1993).

[100] Bender v. Louisiana & A. R. Co., 255 So. 2d 849, 851 (La. Ct. App. 1971).

[101] Holt Oil & Gas Corp. v. Harvey, 801 F.2d 773 (5th Cir. 1986), *cert. denied*, 481 U.S. 1015, 107 S.Ct. 1892, 95 L.Ed.2d 499 (1987).

upheld the trial court's ruling on ambiguity and the jury's determination that this sidetracking operation was merely a continuation of the initial test well for the costs of which the consenting party was liable.

In cases such as this, the issue is whether the operation which is conducted is the same operation as was actually disclosed by the AFE (or was a justifiable revision thereof) or is a discrete, new or different operation which was not fairly disclosed by the AFE. These cases often involve expert testimony by petroleum engineers or other professionals involved in the industry, offered in order to explain to the trier of fact the precise nature and purpose of the work performed as contrasted with the proposal.

For example, if an AFE proposes the reworking and recompletion of a well in a specified zone (say, 10,500 feet) and if the operator, after the designated operation is unsuccessful, proceeds without additional authority or concurrence from the non-operators to plug-back and attempt a completion in a different zone (say, 8,500 feet), the latter operation cannot be said to be the "same" operation or a justifiable revision of the operation specified in the AFE. In such a case, the non-operator should be able to deny liability for the costs associated with the unauthorized operation.[102]



An operation may be terminated prior to its completion if all parties agree to do so.[103] However, because of the absence of the "requisite consent of the other mineral interest owners who were parties to the operating agreement," an operator was held to have breached the operating agreement when it "threatened to plug and abandon" a well after it reached its objective depth.[104]

## § 7.05 Responsibility for Costs of the Subsequent Operation

### [1] Commitment to Pay Costs of Proposed Subsequent Operation

Unless the agreement of the parties provides otherwise, a party's execution of an AFE is a commitment to pay its proportionate share of the costs and expenses incurred in the operation, even if the costs and expenses

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[102] To hold otherwise might enable an unscrupulous operator to propose a certain (relatively inexpensive but, as an engineering matter, unreasonable or imprudent) reworking operation (knowing that the non-operators would not consent thereto) and, having rendered the non-operators into a non-consenting posture "in the well," to then conduct the proposed operation and, after its commercial failure, immediately proceed to conduct another or different operation than was disclosed by the AFE (with a higher prospect of success) and then take the position that the non-operators are non-consent "in the well."

[103] Arkla Exploration Co. v. Boren, 411 F.2d 879 (8th Cir. 1969).

[104] Lancaster v. Petroleum Corp., 491 So. 2d 768, 777 (La. Ct. App. 1986).

are in excess of the anticipated costs and expenses as reflected in the AFE.[105]

It has been held that the execution of an AFE by one who has not executed an operating agreement does not thereby obligate such party to pay for the drilling of the well.[106] In another case, however, liability was found where a non-operator did not sign the operating agreement but did sign an AFE, did request blow-out insurance and did pay the first drilling cost invoice after signing the AFE.[107]

In order to avoid the "open-ended" responsibility associated with an otherwise unlimited AFE, parties might place a ceiling on the authorized expenditures under an AFE to the end that, if that ceiling is reached, the operator is required to secure the further consent of the other parties to exceed that ceiling amount.[108] A contract which required written approval "for any expenditures which exceed the AFEs . . . by ten percent (10.00%) or more" was interpreted as referring "to the total AFE" and not, as contended by the non-operator, "on a line-by-line, item-by-item basis."[109]

One appellate court found the "contract provisions [of an operating agreement] regarding consent [to be] unambiguous," as a consequence of which the court affirmed the refusal of the trial judge to receive testimony

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[105] M & T, Inc. v. Fuel Resources Dev. Co., 518 F. Supp. 285 (D. Colo. 1981) ("It is axiomatic that drilling costs cannot be established with certainty and that an AFE is at best a good-faith estimate. AFE's are usually exceeded, often by very substantial amounts . . . . In the oil and gas industry, it is understood and accepted that when one signs an AFE, he is committed to his proportionate share of the necessary costs in drilling to the objective specified in the AFE, unless the parties mutually agree to terminate drilling earlier or to attempt a completion at a shallower formation."). The avoidance of the "open-ended" liability is often a significant reason why parties secure a turnkey drilling contract.

[106] Sonat Exploration Co. v. Mann, 785 F.2d 1232 (5th Cir. 1986) (applying Mississippi law) ("The Authorization for Expenditure form utilized by Sonat contains no language which may be taken as a promise by Mann to pay a part of the reflected costs."). Liability has been found even where the non-operator signed neither an operating agreement nor an AFE, based upon the conduct of the parties. Lammerts v. Humble Oil & Refining Co., 489 P.2d 485 (Okla. 1970).

[107] G.H.K. Co. v. Janco Invest., Inc., 748 P.2d 45 (Okla. Civ. App. 1987) (approved for publication by Court of Appeal but not by Supreme Court).

[108] These are called "supplemental AFEs." See, *e.g.*, Forest Oil Corp. v. Superior Oil Co., 338 So. 2d 758 (La. Ct. App. 1976) (AFE provided that, "without the further consent of Non-Operators, expenditures may not be made in excess of one hundred fifty percent (150%) of the original estimated cost of the well consented to, as set out in the AFE issued by the Operator.").

[109] Pegasus Energy Group, Inc. v. Cheyenne Petroleum Co., 3 S.W.3d 112 (Tex. Civ. App.—Corpus Christi 2000).

proffered by a party who had not signed an AFE as to an "industry practice" "to the effect that the consent requirements of the operating agreements . . . had to be evidenced in writing by means of AFEs."[110] The court stated that the "contracts clearly require consent, but they do not specify that any particular form of consent is required." "Moreover, the contract plainly does not state that consent is invalid or ineffective if it is not confirmed in writing."[111]

Moreover, a party who failed to timely respond to a notice of a proposed operation and who was late in paying his bills, was nonetheless held to have not suffered a forfeiture of his interest where the operator ultimately accepted the party's funds, which were utilized and never returned.[112] The court found it significant that "matters" between the parties "were handled very loosely."[113]

### [2] Special Remedies to Protect the Operator Who Incurs Costs for the Joint Account

Notwithstanding a consenting party's commitment to pay its proportionate part of the costs and expenses incurred in the operation, it is the unfortunate experience of some operators that a consenting party might nevertheless fail or refuse to pay its bills during the conduct of the operation. Because it has timely and properly elected to participate in the proposed operation (and thereby avoided a "deemed" relinquishment of its interest), the 1977 and 1982 Model Forms do not otherwise provide any serious disincentive to a consenting party to fail to pay its bills timely.[114]



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[110] C & C Partners v. Sun Exploration & Production Co., 783 S.W.2d 707 (Tex. Civ. App.—El Paso 1989, writ ref'd).

[111] Although the reported decision does not indicate which version of the Model Form was involved, the language quoted in the decision is identical to the language in the 1977 Model Form. The court did not mention the notice provision of the Model Form which provides that "[a]ll notices authorized or required between the parties and required by any of the provisions of this agreement, unless otherwise specifically provided, shall be given in writing . . . ." See, *e.g.*, Article XII of the 1977 Model Form. Indeed, another Texas court disagreed with *C & C Partners* by finding that the operating agreement "plainly require[s] written consent or non-consent to a proposal to drill a subsequent well." Hill v. Heritage Resources, 964 S.W.2d 89, 134 (Tex. Civ. App.—El Paso 1997, pet. denied).

[112] Cresent Drilling & Dev., Inc. v. Sealexco, Inc., 570 So. 2d 151 (La. Ct. App. 1990), *writ denied*, 575 So. 2d 373 (La. 1991).

[113] Cresent Drilling & Dev., Inc. v. Sealexco, Inc., 570 So. 2d 151, 155 (La. Ct. App. 1990).

[114] The 1989 Model Form does contain a provision which creates an incentive for a non-operator to pay its bills. *See* Article VII.D of the 1989 Model Form.

To address this circumstance, some operating agreements contain special provisions which stipulate that, notwithstanding a timely election, a consenting party who thereafter fails to pay its share of costs may, at the election of the operator, be deemed to have "gone non-consent." Such provisions typically require the issuance of a notice of default with a cure period before the retroactive imposition of such a severe consequence.

An operating agreement might contain a special provision which authorizes other collection remedies, such as a "cash call" which allows the operator to require a consenting party to pay in advance its proportionate share of the estimated costs to be incurred in the operation during the next calendar month.[115] A "cash call" provision will typically provide for the consequences to a party who fails to timely honor the call by paying its share of costs. Being purely contractual, these consequences might range from an enhanced interest rate, denial of access to the rig floor or to well data, a deemed, retroactive "non-consent," or the forfeiture of the interest of the defaulting party.[116]

It might also be provided that a consenting party will be required to post some form of security in order to protect the operator who actually incurs the expenses of the operation on behalf of the joint account. Such security might be in the form of a letter of credit, a personal guaranty or other form of financial assurance.

In the absence of such collection mechanisms, the operator must incur the totality of the costs and expenses of the operation and be relegated to invoicing the consenting parties and hoping that its bills are honored. As one of my clients has stated on more than one occasion: "I have an understanding with my banker—I don't loan money and he doesn't drill wells!"

While an operator has the right to assert and enforce a lien on the interest

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[115] *See* Article VII.C of the 1982 and 1989 Model Forms. *See also* Part I.3 of the COPAS—Accounting Procedure (Joint Operations) which is customarily attached as Exhibit "C" to the Model Form Operating Agreement.

[116] For example, in Alpha Resources, Inc. v. Rose Energy, Ltd., Civil Action No. 01-3492, United States District Court, Eastern Division of Louisiana (J. Feldman, Order and Reasons, March 7, 2002), the court enforced the express language of the parties' agreement and held that the non-operator which did not pay its share of costs in response to a "cash call" had forfeited its interest to the operator. The court relied on J-O'B Operating Company v. Newmont Oil Company, cited at footnote 56, supra, as authority for its ruling. *See also* McKendrick v. Lyle Cashion Co., 104 So. 2d 295 (Miss.), suggestion of error, overruled, 105 So. 2d 480 (Miss. 1958).

of the defaulting party, this might be a hollow remedy if the operations are unsuccessful.[117]

### [3] Relinquishment of Interest

While the non-consenting party is not personally liable for the costs of the proposed operation, its interest will be subject to the recoupment factor stipulated in the operating agreement.[118] The applicable provision which governs the relative rights and obligations of the parties in respect of an election to not participate in a subsequent operation in both the 1977 and 1982 Model Forms is Article VI.B.2 which reads, as follows:

> Upon commencement of operations for the drilling, reworking, deepening or plugging back of any such well by Consenting Parties in accordance with the provisions of this Article, each Non-Consenting Party shall be deemed to have relinquished to Consenting Parties, and the Consenting Parties shall own and be entitled to receive, in proportion to their respective interests, all of such Non-Consenting Party's interest in the well and share of production therefrom until the proceeds of the sale of such share, calculated at the well, or market value thereof if such share is not sold, (after deducting production taxes, royalty, overriding royalty and other interests existing on the effective date hereof, payable out of or measured by the production from such well accruing with respect to such interest until it reverts) shall equal the total of the following:
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> (a) 100% of each such Non-Consenting Party's share of the cost of any newly acquired surface equipment beyond the wellhead connections (including, but not limited to, stock tanks, separators, treaters, pumping equipment and piping), plus



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[117] *See* Article VII.B of the 1982 Model Form. In Louisiana, "[p]rivilege can be claimed only for those debts to which it is expressly granted in this Code." Article 3185, Louisiana Revised Civil Code. Hence, the so-called "operator's lien" provided for in the Model Form is unenforceable in Louisiana as constituting an impermissible consensual privilege (lien). However, both the operator and the non-operator have a reciprocal right of privilege (lien) under La. Rev. Stat. Ann. 9:4881 through 4889 enacted by Act No. 1040 of the 1997 Louisiana Legislature.

[118] Although the Model Form does not characterize it as such, the jargon of the industry often speaks of the recoupment factor as a non-consent "penalty." See, *e.g.*, Jicarilla Apache Tribe v. Supron Energy Corp., 479 F. Supp. 536, 546 n.7 (D.N.M. 1979), *affirmed*, 728 F.2d 1555 (10th Cir. 1984) ("Non-consent indicates the unwillingness of a joint lessee to share in the risk of any particular drilling operation. The joint lessee who drills does so at his own risk. If production is secured, the non-participating lessee suffers a financial *penalty* to the benefit of the lessee who drilled before being permitted to share in the proceeds of well production."). *See also* Andrau v. Michigan Wisconsin Pipe Line Co., 712 P.2d 372 (Wyo. 1986). *See* text accompanying footnote 156, *infra*. A concurring opinion in Valence Operating Co. v. Dorsett, 164 S.W.3d 656, 664 (Tex. 2005) was written in order to explain why "[c]asual readers may not understand how a court could possibly hold that a 'non-consent penalty' is not a 'penalty.' " "The contract also provides unambiguously that those who do not consent nevertheless get additional revenues (after recoupment by those who do), for which they pay nothing. This is not a penalty but a bonus."

100% of each such Non-Consenting Party's share of the cost of operation of the well commencing with first production and continuing until each such Non-Consenting Party's relinquished interest shall revert to it under other provisions of this Article, it being agreed that each Non-Consenting Party's share of such costs and equipment will be that interest which would have been chargeable to each Non-Consenting Party had it participated in the well from the beginning of the operation; and

(b) _____% of that portion of the costs and expenses of drilling, reworking, deepening or plugging back, testing and completing, after deducting any cash contributions received under Article VIII.C., and _____% of that portion of the cost of newly acquired equipment in the well (to and including the wellhead connections), which would have been chargeable to such Non-Consenting Party if it had participated therein.[119]

As a consequence of this provision, the non-consenting party relinquishes its interest "in the well," including the non-consenting party's rights to participate in production obtained from the well, until the consenting party has received the stipulated multiple of the costs attributable to the interest of the non-consenting party out of production. "Payout" of the stipulated multiple of costs occurs when that net portion of the revenue stream otherwise allocable to the interest of the non-consenting party (after deducting taxes and existing burdens allocable thereto) equals the applicable multiple of costs. This mechanism "is designed to ensure that nonparticipating owners do not benefit from the successful outcome of risks they do not take."[120] Conversely, from the viewpoint of the parties bearing the cost and risk, it is used in order to compensate the consenting parties for the risk which each assumes.[121]

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[119] By way of contrast, under the 1956 Model Form, the non-consenting party "shall be deemed to have relinquished to Consenting Parties, and the Consenting Parties shall own and be entitled to receive, . . . all of such Non-Consenting Party's interest in the well, [and] its leasehold operating rights" until the non-consent recoupment factor is discharged or satisfied. Each of the 1977 and 1982 Model Forms is to the same general effect, except that the reference to the non-operator's "leasehold operating rights" is omitted.

[120] In re Sam Oil, 817 P.2d 299, 302 (Utah 1991).

[121] *See also* Conine, "Rights and Liabilities of Carried Interest and Nonconsent Parties in Oil and Gas Operations," *37th Oil & Gas Inst. 3-1, § 3.04[3][b]* (Matthew-Bender 1986) ("The cost and risk of the operation are borne by the consenting parties in proportion to the interest they have elected to bear. In order to compensate for the transfer of risks and liabilities attributable to the declining parties' interests, the consenting parties are granted some form of benefit upon commencement of the operation."). *See also* Dimock v. Kadane, 100 S.W.3d 602, 606 (Tex. Civ. App.—Eastland 2003) (a non-consenting party is subjected "to a substantial penalty if the proposed operation results in a producing well.") and General American Oil Co. v. Superior Oil Co., 416 So. 2d 251, 258 n.6 (La. Ct. App. ), *writ denied*,

Because no mention of contractual interest is made in the Model Form, and since the non-consenting party has no personal liability for the payment of the non-consent factor, it would not appear that interest should accrue on the unrecouped portion of the applicable multiple of costs.[122]

"When a party to an operating agreement elects to go non-consent, their (sic) interest is called a carried interest, and the non-consenting party a carried party."[123]

A non-consenting party is "deemed to have relinquished" its interest "in the well," *not* in the Joint Leases independent of "the well." As a consequence, while a non-consenting party has no right to participate in subsequent operations "in the well" prior to discharge or satisfaction of the applicable recoupment factor, the Model Form does not envision that it is to be denied the opportunity to participate in other operations on the Joint Leases not involving the "well" in question, such as the drilling of another well. In fact, a party who elects to not participate in the risk of a well, which is thereafter drilled by the consenting parties and completed as a dry hole, would nevertheless seemingly benefit from that well to the extent that geologic information from that dry hole might "set up" a second well in which such party should be afforded the opportunity to participate. Even if the operating agreement, by its terms, denies a non-consenting party access to the logs or other well data from a well in which it did not participate, the consenting parties will evaluate such data and formulate a geological profile to justify the second well. In auto racing, this is called "drafting."

As seen above, the relinquishment of the interest of the non-consenting party is "deemed" to be effectuated "upon commencement of operations" by



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421 So. 2d 908 (La. 1982) ("The non-consent provision referred to essentially provides that a party could elect not to participate in certain operations undertaken by another party to the agreement by simply remaining silent for a certain period of time after being notified by the other party of the actions it planned to take along with certain other information. If the action was undertaken and the well eventually produced hydrocarbons, the party performing the operation was allowed to keep an increased share of the production as a penalty against the party who had non-consented.").

[122] *Cf.* Phillips Oil Co. v. OKC Corp., 812 F.2d 265 (5th Cir.), *cert. denied*, 484 U.S. 851, 108 S.Ct. 152, , 98 L.Ed.2d 107 (1987) (expert testimony properly admitted to assist court in interpreting accounting procedure in farmout agreement; court concludes interest not recoverable where it was not specifically designated as a chargeable item). In Louisiana, conventional interest "must be fixed in writing; testimonial proof of it is not admitted in any case." La. Rev. Stat. Ann. 9:3500C(1).

[123] Texaco Inc. v. Berry Petroleum Corp., 869 F. Supp. 1523, 1529 (W.D. Okla. 1994), citing Williams and Meyers, *Manual of Oil and Gas Terms.*

the designated operator.[124] The timing of this relinquishment—and the consequences resulting therefrom—has been the subject of litigation.

In *Stable Energy, L.P. v. Kachina Oil & Gas, Inc.*,[125] Kachina, the designated operator—which owned no interest in the Contract Area—issued an AFE which proposed a reworking operation to clean the wellbore of an existing well. Stable owned a 33% interest in the well and elected to participate. When certain parties, owning an approximate 28% interest, elected to not participate, Stable agreed to enhance its interest to the full extent of the interest of the non-consenting parties. Stable sent a check to Kachina with instructions that the proceeds should only be applied to the costs associated with the 28% enhanced interest which it assumed. Because Stable was in default by having failed to pay outstanding JIBs, Kachina held the funds in escrow

Considering itself the majority owner (33% plus 28%, or 61%), and reminiscent of Napoleon crowning himself as Emperor, Stable asserted that it consequently was the operator and undertook operations on the well through its affiliated company. It did this by cutting the locks from the gate, "self-help" rarely (if ever) condoned by the courts.[126] Stable's affiliate conducted an acid workover operation in the well. After Kachina withdrew the original AFE, a dispute arose as to operatorship. Stable filed suit for an injunction, seeking to confirm its claim to operatorship.

Stable asserted that it became the majority interest owner (approximately 61%) when it tendered its check to Kachina to cover costs of the enhanced interest.

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[124] See, *e.g.*, Article VI.B.2 of the 1982 Model Form.

[125] 52 S.W.3d 327 (Tex. Civ. App.—Austin 2001, no writ).

[126] Most typically presented in lease disputes, judicial repugnance to "self-help"—or to the disregard of judicial processes—was early recognized by the courts of Louisiana. There is probably no greater judicial expression of the disdain toward "self-help" than that expressed in Thayer v. Littlejohn, 1 Rob. 140, 141 (La. 1841), where the court observed:

> "While we regret the obligation we are under of recording in our judgment a resort to force and violence by any of the inhabitants of the State, instead of an application to courts of justice, in redressing their grievances, we are much gratified by the opportunity of expressing our approbation of the due sense which those of our fellow citizens who constituted the jury in the district court, manifested of their duty to prevent the recurrence of acts showing such disregard of the law, and all attempts to seek redress through violence and force, by persons who fancy themselves injured, or are really so. And we are surprised that the defendants should have conceived the idea that they could excite our sympathy or commiseration. We would have cheerfully granted damages for the frivolous appeal, if they had been asked, or if we thought ourselves authorized to grant them when not demanded."

The court held that, under the explicit terms of the JOA, relinquishment of the non-consenting owner's interest occurs upon the "commencement" of the *proposed* operation. Since Kachina withdrew its proposal, and since actual commencement of the operation as proposed by Kachina did not occur, the event which would effectuate the transfer or relinquishment of interest never occurred.

The court also rejected Stable's argument that the operation was commenced—and, hence, that the relinquishment occurred—when Stable's affiliate began its workover operation. The court held that, because the operation conducted by the affiliate was "substantially different" from the operation as disclosed in Kachina's AFE, and was not conducted by the duly selected operator (Kachina), the commencement of those operations could not be the event which would effect the relinquishment of interest.[127] "Only actual commencement of Kachina's proposed project could have triggered relinquishment of the non-consent interests."[128] Finally, the court did not accept Stable's argument that it had voted itself as operator, noting that, since the interest of the non-operators was never relinquished to Stable, it never became the majority owner and, therefore, it never possessed a sufficient interest to vote out Kachina.



Although the position of the enhanced party (Stable) relative to operatorship was not sustained, the mere fact that it was advanced merits comment. Except in the case of an "in or out" provision, the non-consenting party incurs only a "deemed" relinquishment of its interest; the relinquishment is temporary, not permanent, subject to recoupment of the stipulated non-consent recoupment factor. Hence, the transfer of interest resulting from a consenting party "enhancing" its interest should not ordinarily give rise to the occasion to change operators.[129]

### [4] Recoupment of Costs of the Subsequent Operation

#### [a] Preface

As mentioned previously, a non-consenting party is not personally liable for the costs and expenses of the operation. All costs and expenses incurred

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[127] "[T]he [affiliate's] operation was designed to open new productive zones, rather than to merely clean existing perforations, as Kachina had planned." 52 S.W.3d at 332.

[128] 52 S.W.3d 327, 332 (Tex. App. 2001).

[129] The only occasion to change operators as envisioned by the operating agreement is if the operator "goes non-consent" on a subsequent operation proposed by a non-operator, unless a drilling rig is on location. *See* Article VI.B.2 of the 1982 (lines 38–43 of Page 5) and 1989 (lines 32-9 of Page 6) Model Forms.

in the operation are borne by each of the consenting parties in proportion to the interest of all consenting parties who participate in the operation.

The interest of the non-consenting party is subject to the *in rem* obligation to discharge or bear the allocated costs and the applicable non-consent recoupment factor. If the well does not produce sufficient quantities of product to discharge the *in rem* responsibility, the non-consenting party is not liable "out of pocket" for any deficiency.

### [b] "Subsequently Created Interests"

Under the 1982 Model Form, the revenue stream otherwise accruing to the non-consenting party—which is diverted to the account of the consenting party during the recoupment period—is exclusive of "overriding royalty and other interests not excepted by Article III.D."[130] Article III.D of the 1982 Model Form regulates "subsequently created interests" and, in essence, is designed to ensure that the proceeds attributable to the interest of the non-consenting party will not be less than that existing on the date of confection of the operating agreement. This, in turn, is only effectuated if all legitimate and existing burdens are expressly disclosed in the exhibits to the operating agreement. Obviously, the worth or efficacy to the consenting party of the recoupment feature of the "subsequent operations clause" is a direct function of the fullness of the revenue stream as a meaningful device to remunerate the consenting party for assuming additional risk. While the entitlement of the consenting party is not to be diminished by the creation of "subsequently created interests," the non-consenting party who created that burden would (in the absence of other agreements) be obligated to indemnify the consenting party with respect to "claims and demands for payment asserted by owners of the subsequently created interest."[131]

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[130] *See* Article VI.B.2 (lines 6–8 of Page 6) of the 1982 Model Form.

[131] *See* Article III.D.1 of the 1982 Model Form. A party creating an overriding royalty interest and who desires to protect itself from a claim by the overriding royalty interest owner in the event that, at a later date, it "goes non-consent" in a proposed operation might include a clause such as the following in the instrument creating the overriding royalty interest, to-wit:

> If, at any time and from time to time, the interest of Assignor in and to the Said Leases (or any of them) and the right of Assignor to receive production or proceeds thereunder or allocable thereto shall, pursuant to the terms of any Joint Operating Agreement, contract or other agreement, be suspended or deferred until the achievement or occurrence of payout or any other event or condition (including, by way of illustration, the satisfaction or discharge or satisfaction of any non-consent recoupment factor), then, in that event, the overriding royalty interest conveyed and assigned hereby shall also be suspended or deferred and the owner thereof shall not be entitled to receive production

In *Boldrick v. BTA Oil Producers*,[132] working interest owners entered into an operating agreement and, thereafter, BTA assigned an overriding royalty interest to the predecessor-in-interest of the plaintiff, Boldrick. Chevron proposed a well and BTA elected to not participate; the well was successfully completed. Chevron initially made payments to the plaintiff, but later ceased making such payments, and demanded that Boldrick return monies previously paid. Boldrick sued BTA and others, alleging breach of contract, unjust enrichment and conversion. Plaintiff relied on the language in the assignment of overriding royalty interest that such interest was to be "free and clear of all costs of development and operation."

The court found the overriding royalty interest to be a "subsequently created interest" which, under the terms of the operating agreement, was "chargeable with a pro rata portion of all costs and expenses under the operating agreement in the same manner as if it were a working interest." The court specifically stated, as follows:

> Inasmuch as the use of the proceeds that would have come to Boldrick under his overriding royalty to meet the costs and expenses under the operating agreement is mandated by the operating agreement, such a use could not constitute a breach of contract between Boldrick and BTA that was subject to the operating agreement and could not constitute unjust enrichment or conversion.

The fact that the consenting party is entitled to be protected from "overriding royalty and other interests not excepted by Article III.D" does not, of itself, compel the conclusion that the owner of the overriding royalty interest is not entitled to be paid. Unless provided otherwise in the contract creating the overriding royalty interest, or some other contract to which the owner of overriding royalty interest is a party or by which it is bound, the party owning the overriding royalty is entitled to be paid by the party owing such interest, even if the latter has to pay "out of pocket."[133]

By the very nature of the grant (or reservation) of the overriding royalty

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> or proceeds allocable thereto for the same period of time and under the same circumstances as the interest of Assignor is subject to such suspending circumstance. Assignor shall have no duty or obligation to pay any production or proceeds allocable to such overriding royalty interest during any period of time that Assignor is not receiving or entitled to receive production or proceeds under such circumstance.

[132] 222 S.W.3d 672 (Tex. App.—Eastland 2007, no pet.).

[133] *Cf.* Gulf Explorer, LLC v. Clayton Williams Energy, Inc., 2006-1949 (La. App. 1 Cir. 6/8/07), 964 So. 2d 1042, a case which considered Louisiana's Risk Fee Statute and in which the court held that the operator "is entitled to recover its costs out of the production attributable to [plaintiff]'s tract or 'continuous expanse of land' and not merely the amounts attributable to that tract *minus* the royalties and overriding royalties [plaintiff] is obligated to pay pursuant to its contract with third parties."

interest, the working interest owner has conferred upon the overriding royalty owner the right to participate in production, free of drilling and production costs.[134]

When there *is* production in fact and the party creating or responsible for the overriding royalty interest is not receiving any share of the production because it went "non-consent," the overriding royalty owner is being denied its right to participate; it is being denied the essential benefit of its bargain.

The grant (or reservation) of the overriding royalty interest, unless qualified, would carry an implied warranty of delivery to the overriding royalty interest owner, and such owner should have a basis to complain if it is denied its right to participate in production because of actions or inactions of its grantor.[135]

As stated by one Louisiana court (albeit in a different context), "[t]he principle is sound that a seller should not be allowed to obligate himself to deliver and to warrant title and peaceable possession to a buyer of a thing and then by his own act or claim to derogate from, or to assert rights to the thing contrary to, his own obligations."[136]

### [c] Gas Marketing

If the parties have entered into separate contracts for the sale of gas, and if the sales price applicable to the gas attributable to the non-consenting party is at significant variance from that allocable to the consenting party, the consequences of such a "split-stream" must be considered. Under whose contract is the "non-consent gas" to be sold? This would obviously have an impact on the rate of achievement of payout, as the costs and the pertinent recoupment factor are recovered at a faster or slower rate, depending upon the pricing applicable thereto; obviously, gas sold at, say, $4 per Mcf will "payout" the recoupment account in half the time as "payout" based on $2

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[134] "An overriding royalty is an interest severed out of the working interest or lessee's share of the oil, free of the expenses of development operation and production." Williams and Meyers, "Oil and Gas Law," § 418 (1991).

[135] Louisiana: "The seller is bound to deliver the thing sold and to warrant to the buyer ownership and peaceful possession of, and the absence of hidden defects in, that thing. The seller also warrants that the thing sold is fit for its intended use." Article 2475, Louisiana Revised Civil Code. Texas: Guyer v. Rose, 601 S.W.2d 205 (Tex. Civ. App.—Dallas 1980) (purchaser's right of possession to land "could not be defeated by the seller's failure to perform his obligations under the contract.").

[136] Tealwood Props., LLC v. Graves, 45,975 (La. App. 3 Cir. 04/27/11), 64 So. 3d 397, 403.

per Mcf.[137]

The Model Form does not address this situation, and the typical gas balancing agreement which is often attached as Exhibit "E" to the Model Form Operating Agreement is not relevant here since the gas being produced and sold during the recoupment period is not gas to which the non-consenting party is entitled, by reason of its election. Said another way, there is no gas being "left in the ground," the marketed gas being attributable to the consenting party. This is so because the consenting party has received "title" to the "non-consent gas" during the recoupment period and, therefore, its marketing arrangements should control. Because of this, prudence would suggest that a party entering a gas sales contract should attempt to modify or limit its contractual warranty or delivery commitment to its purchaser in order to avoid liability in the circumstance that it suffers a deemed relinquishment of its interest during the term of the sales contract.

### [d] Non-Consent Recoupment Factor

As noted above,[138] the operator is not generally obligated to actually conduct the proposed operation if less than all of the parties elect to participate therein. Nevertheless, in order to impose the stipulated non-consent recoupment factor, the proposed operation must be commenced within the time period specified in the agreement. If it is not timely commenced, no non-consent recoupment factor may be imposed until the contractual requirements of notice and election are again followed.[139]

The distinction is risk-based: The risk assumed by consenting parties is in the *conduct* of the operation; it is only if that operation is successful, and, hence, when that risk has been removed or successfully managed, that the second class of expenditures is incurred (such as the installation of surface equipment to accommodate production for the now successful well). The low-risk dollars are being spent at "happy time."

Where a non-consenting party challenged the enforceability of a 400% non-consent recoupment factor as constituting an unenforceable "penalty," the court disposed of this contention and stated that, "[i]n view of the substantial financial risks suffered by consenting parties and in view of the fact that *the percentage is to be paid only from production*, we believe the

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[137] *Cf.* State ex rel. Superior Oil Co. v. Texas Gas Transmission Corp., 136 So. 2d 55 (La. 1962).

[138] *See* text accompanying footnote 73, *supra.*

[139] *See* text accompanying footnote 74, *supra.*

400% provision of Section 12 of the J.O.A. is valid and enforceable."[140]

During the period of time that the consenting parties are recouping their costs and the stipulated recoupment factor out of production, it is said that the interest of the non-consenting party has been "relinquished" to the consenting parties. Notwithstanding this relinquishment, and the fact that the non-consenting party is not personally liable for the costs and expenses of the operation as to which it declined to participate, it has been held that a non-consenting party may be held liable to a regulatory authority for the costs of plugging a blow-out well if the operator either cannot be located or has inadequate resources.[141] However, in a private suit between the parties to an operating agreement (not involving direct regulatory enforcement), non-consenting parties were held "not responsible for damages emanating where they held no interest."[142]

### [5] Accounting for Non-Consent Account

In order to enable the non-consenting party to "track payout" of the non-consent recoupment factor to which it is subject, the party conducting the operation is obligated to provide certain cost and revenue information to the non-consenting party starting sixty (60) days after the operation is completed and monthly thereafter.[143]

Although beyond the scope of this presentation, the manner in which the operator allocates operating expenses among various wells in a field—a matter governed in large part by the COPAS Accounting Procedure

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[140] Hamilton v. Texas Oil & Gas Corp., 648 S.W.2d 316 (Tex. Civ. App.—El Paso 1982, writ ref'd n.r.e.). The *Hamilton* court characterized the non-consent penalty as a "liquidated damages provisions." However, the Supreme Court of Texas has noted that, "[w]hile *Hamilton* reached the correct result, we disapprove of its treatment of the non-consent penalty as a liquidated damages provision." Valence Operating Co. v. Dorsett, 164 S.W.3d 656, 664 (Tex. 2005). *See* text accompanying footnote 173, *infra*. *See also* Nearburg, cited at footnote 60, *supra* ("We note preliminarily that, although we follow custom by referring to the operating agreement provisions at issue as a 'penalty,' they do not meet the definition of a penalty as set forth in" relevant treatises.).

[141] Railroad Com. of Texas v. Olin Corp., 690 S.W.2d 628 (Tex. Civ. App.—Austin), *writ ref'd n.r.e. per curiam* 701 S.W.2d 641 (Tex. 1985). A similar rule also prevails in Louisiana by administrative policy of the Louisiana Office of Conservation. *See Enforcement Policy—Abandoned Wells & Pits*, Memorandum by J. Patrick Batchelor, Commissioner of Conservation, dated July 24, 1990. Yet to be litigated in Louisiana is the issue of whether a non-consenting party can be considered as a "legally responsible" party under La. Rev. Stat. Ann. 30:29, enacted by Act No. 312 of 2006.

[142] Texaco Inc. v. Berry Petroleum Corp., 869 F. Supp. 1523 (W.D. Okla. 1994).

[143] *See* Article VI.B.2 (lines 53—65 of Page 6) of the 1982 Model Form.

customarily attached to an operating agreement[144]—has, in some instances, created an opportunity for mischief. In particular, the allocation of lease operating expenses as between non-consented wells (in which a party is subject to a recoupment factor) and other wells (in which all parties participate) can be problematic.

For example, an operator was found to have committed fraud by systematically misallocating to one certain well (in which the plaintiffs had "gone non-consent") expenses which should have been equitably prorated among numerous wells in the field, including wells in which the plaintiffs had participated. By so allocating costs exclusively to the non-consent well, the operator enjoyed, in the words of the court, a maximization of the "receipt of nonconsent penalties." A punitive damages award of $4.8 million was reduced on appeal to $1 million, but was otherwise affirmed.[145]

When the non-consenting party senses that the operator views a non-consent account as a "profit center" to be exploited, alarm bells should sound.

Article V.D of the 1982 Model Form requires that "[a]ll wells drilled on the Contract Area shall be drilled on a competitive contract basis at the usual rates prevailing in the area." The issue has arisen as to whether a non-consenting party has standing to complain about the costs incurred by the operator in conducting the non-consent operation.

In *Shell Rocky Mountain Production, LLC v. Ultra Resources, Inc.*,[146] Ultra, a non-operator, elected to not participate in certain operations, based in part on its belief that the costs disclosed in the operator's AFE were excessive. Suit followed where Ultra complained about excessive costs.

Among other defenses, Shell, the operator, challenged the standing of Ultra since it elected to "go non-consent." The court rejected this contention, as follows:

> Shell also contends that Ultra has no standing to complain about well costs because it chose not to participate in the wells once it was made aware of Shell's cost estimate. We disagree. A party that refuses to consent does not forever relinquish its interest in the well to the consenting parties. Relinquishment lasts only until "payout," the point at which the consenting parties have recovered a percentage—here 300%—of the well's cost. This percentage is commonly referred to as the "nonconsent penalty" and is found in Article VI, section B(2) of the JOAs. Once payout is reached, nonconsenting parties are entitled to

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[144] *See* Jolly and Buck, "Joint Interest Accounting: Petroleum Industry Practice" (Professional Development Institute, North Texas State University 1988).

[145] Grynberg v. Citation Oil & Gas Corp., 573 N.W.2d 493, 1997 SD 121.

[146] 415 F.3d 1158 (10th Cir. 2003).

begin receiving production revenue commensurate with their ownership interest. It therefore follows that if Shell is incurring excessive costs, as alleged by Ultra, both the amount of revenue and the date at which Ultra will receive any revenue are directly affected. Thus, Ultra has standing to sue for breach of the competitive rate provision of the JOAs.

### [6] Enforcement of Non-Consent Account Against Third Parties Acquiring from a Non-Consenting Party

In the experience of the author, it is not the usual practice to actually confect and file for record a "conditional" or "term" assignment of the non-consenting party's relinquished interest to the consenting party. Rather, the recoupment is more commonly treated as an "off-record" accounting matter. Thus, during the period of time that the interest of the non-consenting party is "deemed" to have been relinquished to the consenting party pending recoupment of the stipulated multiple of costs, the interest remains vested of record in the name of the non-consenting party.

Because operating agreements are frequently not recorded, the consenting party—in whose favor the recoupment is occurring—is consequently at the mercy of the non-consenting party, whose recorded interest might become burdened by an assignment, lien, deed of trust, mortgage or other encumbrance to the potential detriment of the consenting party.

The Model Form provides that every "sale, encumbrance, transfer or other disposition made by any party shall be made expressly subject to this agreement and shall be made without prejudice to the right of the other parties."[147] Nevertheless, if the operating agreement is not recorded, and unless, under applicable local law, a third party is charged with notice in the absence of recordation, one who acquires the interest of the non-consenting party in the Joint Leases would take free and clear of the operating agreement (including the obligations thereof pertinent to the non-consent recoupment factor).

If, at the time of the assignment, there is an open recoupment account bearing against the non-consenting party's interest in the assigned leases, the question arises as to the rights and remedies of the consenting parties as against the non-consenting party who, by assigning to the third party without complying with the requirement to make the assignment "subject to" the operating agreement, thereby deprived the consenting parties of their "benefit of the bargain."[148] Being a personal, not a real,[149] obligation, a third

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[147] *See* Article VIII.D of the 1982 Model Form.

[148] This hypothetical situation obviously presupposes that the non-consenting party is not contractually precluded from assigning its interest, such as by the preferential right to

party purchaser of the interest of the non-consenting party would not be obligated to honor the recoupment account, unless the third party expressly assumes that obligation.[150]

Case law in Texas indicates that a bank's liens on a borrower's leases created under a recorded deed of trust may be subordinate to liens covering the same leases created under an unrecorded operating agreement to which the borrower was a party because the assignment under which the borrower claimed its interests in the leases made reference to the operating agreement.[151]

However, in a pure "race to the courthouse" state, a third person is not bound by unrecorded agreements, even with actual notice thereof.[152] Although the obligation to suffer the non-consent recoupment factor is an *in rem*—not personalo—bligation (in that the discharge or satisfaction of the non-consent recoupment factor is only exigible to the extent that production from the non-consented well is sufficient to do so, but is not otherwise payable "out-of-pocket"), the non-consenting party who fails to protect the consenting parties, might be liable to the consenting parties for damages for breach of contract. The calculation of monetary damages based upon the



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purchase provision or other provision of the operating agreement that might restrict the free assignability of the interest.

[149] "A real obligation is a duty correlative and incidental to a real right." Article 1763, Louisiana Revised Civil Code. This civil law notion is akin to the "covenant running with the land" in common law jurisdictions. See, *e.g.*, Vulcan Materials Co. v. Miller, 691 So. 2d 908 (Miss. 1997); McGuffy v. Weil, 125 So. 2d 154, 158 (La. 1960) ("The contract, under consideration, explicitly declares that the restriction 'shall constitute a covenant running with the land and shall be binding upon . . . all subsequent owners . . .' The recitals of the contract leave no doubt that a real obligation was created.").

[150] For example, in Louisiana, "[a]n obligor and a third person may agree to an assumption by the latter of an obligation of the former. To be enforceable by this obligee against the third person, the agreement must be made in writing." Article 1821, Louisiana Revised Civil Code.

[151] MBank Abilene, N.A. v. Westwood Energy, Inc., 723 S.W.2d 246 (Tex. Civ. App.—Eastland 1986, no writ).

[152] The law of Louisiana illustrates this proposition. La. Rev. Stat. Ann. 9:2721A (repealed by Act No. 169 of 2005, replaced by Article 3338, Louisiana Revised Civil Code); McDuffie v. Walker, 51 So. 100 (La. 1909); Louisiana Gaming Corp. v. JDH Ltd., 31,722 (La. App. 2 Cir. 03/31/99), 736 So. 2d 940, 942 ("Pursuant to the public records doctrine, whatever is not recorded is not effective except as between the parties, and a third person's actual knowledge of unrecorded interests is immaterial."). However, *see also* Southwest Gas Producing Co. v. Creslenn Oil Co., 181 So. 2d 63 (La. Ct. App. 1965), *writ denied*, 182 So. 2d 77 (La. 1966) (public records doctrine did not apply where the mortgage made express reference to the operating agreement).

future productivity of that well might, in large part, be quite speculative,[153] particularly since a money judgment would represent an expanded liability (exigible against all of the judgment debtor's non-exempt assets) where only an in rem responsibility previously existed.[154] To avoid these consequences, the parties might consider placing something of record in order to protect the consenting party against loss of this interest.[155]

### [7] Enforcement of Non-Consent Recoupment Factor in Bankruptcy

As noted above,[156] while the Model Form does not characterize it as such, industry participants often refer to the recoupment factor incurred by a non-consenting party as a non-consent "penalty." Such a characterization may give rise to arguments and concerns relative to its enforceability, particularly in bankruptcy. Indeed, a bankruptcy proceeding involving a debtor who is a party to an operating agreement gives rise to a variety of issues concerning the enforceability of the provisions of such agreement.

Section 365(a) of the Bankruptcy Code[157] provides, in pertinent part, that "the trustee,[158] subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."

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[153] See, *e.g.*, McCoy v. Arkansas Natural Gas Co., 165 So. 632 (La. 1936) ("A review of the cases on that subject-matter shows that damages were not allowed because of the uncertain and speculative nature of the loss complained of. One of the reasons which we assigned in this case when it was previously before us for sustaining the exceptions of no cause and no right of action was that 'the loss complained of was, manifestly, more a matter of uncertainty and speculation than of fact or estimate'.").

[154] *Cf.* Shanks v. Exxon Corp., 95-2164 (La.App. 1 Cir. 05/10/96), 674 So. 2d 473, *writ denied*, 96-1475 (La. 09/20/96), 679 So. 2d 436 (lessee which released lease on lands in a producing unit—based upon its belief that unit well would never payout—held not liable for well costs in favor of former lessor whose lands, by reason of the release, were rendered unleased—and post-release production was being withheld by operator to apply to payout—where lessor sued former lessee, contending that, because the well costs were incurred while lease in effect, lessee should remain liable for such well costs, notwithstanding release). *See* Ottinger, "After the Lessee Walks Away—The Rights and Obligations of the Unleased Mineral Owner in a Producing Unit," 55 *L.S.U. Min. L. Inst.* 59 (2008).

[155] There is specific statutory authority in Louisiana for the filing of a "declaration" of an operating agreement in lieu of the agreement itself. La. Rev. Stat. Ann. 31:217.

[156] *See* footnote 118, *supra*.

[157] 11 U.S.C.A. § 365(a).

[158] As a general proposition, in a case in which no trustee has been appointed, a debtor-in-possession enjoys all of the rights granted by the Code to a trustee. 11 U.S.C.A. § 1107.

Much litigation under Section 365 is concerned with what constitutes an "executory contract." It appears that the definition most widely accepted by the courts is that articulated by Professor Countryman: "A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[159]

The standard to be applied in determining whether or not the contract should be rejected appears to be the "business judgment test," although some courts have adhered to a rule which requires a determination that the contract be "clearly burdensome" to the estate.[160]

An operating agreement has been held to constitute an "executory contract," susceptible to treatment under Section 365 of the Bankruptcy Code.[161] In *Wilson*, it was held that an operating agreement was an executory contract under 11 U.S.C.A § 365 and that, during the pendency of the bankruptcy case, and until such time as the contract is assumed, the terms of the operating agreement were suspended and unenforceable, and that during this "suspension" period, the relation of the parties was that of tenants in common or co-owners.[162] If the contract is assumed, its provisions would be applicable.

If the debtor is a non-consenting party, the enforceability of the "penalty" is determined by whether the operation giving rise to its imposition occurred pre- or post-petition. Clearly, the treatment described above would apply where the operator's notice proposing the conduct of a subsequent operation is initiated after the bankruptcy case is filed. It could be argued that it would also apply where the bankruptcy case is filed after the dispatch of the notice, but before the expiration of the election deadline. If the non-consent has been incurred prior to the institution of the case, sound arguments could be made that the non-consent provision is effective.

The issue is presented as to whether the operator may set-off or recoup the non-consent recoupment factor from proceeds of production if the non-

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[159] Countryman, "Executory Contracts in Bankruptcy," 57 Minn. L. Rev. 439 (1973).

[160] Group of Institutional Investors v. Chicago, M., S. P. & P. R. Co., 318 U.S. 523, 550, 63 S.Ct. 727, 743, 87 L. Ed. 959 (1943) ("Thus, the question whether a lease should be rejected and if not on what terms it should be assumed is one of business judgment."); In re Minges, 602 F.2d 38 (2d Cir. 1979).

[161] In re Wilson, 69 B.R. 960 (Bankr. N.D. Tex. 1987).

[162] *See* text accompanying footnotes 3 and 4, *supra*.

consent is in place before the case is filed. In this regard, it is necessary to distinguish between a case under Chapter 7 and under Chapter 11. Sections 724(a) and 726(a)(4) of Bankruptcy Code authorize a trustee to avoid a lien securing a "penalty."[163] For example, a claim for 200% recoupment against the interest of a non-participating bankrupt party was denied as an attempt to enforce a "penalty" in In Re Sierra Trading Corporation.[164]

### [8] Personal Responsibility of a Consenting Party for the Payment of Royalties to Lessor of a Non-consenting Party

If a lessee commits its mineral lease to an operating agreement and subsequently "goes non-consent," the issue is presented as to who is responsible for the payment of royalties on production from the well drilled by the consenting parties. If the lessor of a non-consenting party is not paid the royalties to which it is due, to whom may it look for performance of the duty to pay royalties?

The 1982 Model Form[165] provides, as follows:

> During the period of time Consenting Parties are entitled to receive Non-Consenting Party's share of production, or the proceeds therefrom, Consenting Parties shall be responsible for the payment of all production, severance, excise, gathering and other taxes, and all royalty, overriding royalty and other burdens applicable to Non-Consenting Party's share of production not excepted by Article III.D.

In a case coming to it on appeal from a district court decision which affirmed a decision of a bankruptcy court,[166] the United States Fifth Circuit certified three questions to the Texas Supreme Court, including the following question, to-wit:

> Does Barnes have any right [to] enforce the [Dominion-Moose Agreements]—the WIUA and JOA—between Dominion, Moose . . . and the Moose Assignees, including Tawes, to recover unpaid royalties, between the date of first production and February 2002, of Baker-Barnes Nos. 1 & 2 wells under what we have called the "Royalty Provision" of the JOA, either as a third-party beneficiary of the WIUA and JOA or by virtue of having privity of estate with Tawes?

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[163] 11 U.S.C.A. §§ 724(a) and 726(a)(4). These sections apply only to Chapter 7 cases. *See* Section 507(a)(8)(G) of the Bankruptcy Code in Chapter 11 cases.

[164] 482 F.2d 333 (10th Cir. 1973) ("Although we do not attach great significance to it, we note, as did the district court, that the claimant in its billings to the debtor corporation referred to the 200% provision as a 'penalty.' Such characterization is of course not binding on the claimant. It may only have been a layman's incorrect use of a legal word of art. On the other hand, it may coincidentally have been a correct choice of words."). *Id.* at 337.

[165] *See* Article VI.B.2 (lines 39–42 of Page 6) of the 1982 Model Form.

[166] Tawes v. Barnes (In re Moose Oil & Gas Co.), 613 F.3d 521, 531 (5th Cir. 2010).

In this case, Barnes was the lessor under a mineral lease owned by Dominion who "went non-consent" on the drilling of the Baker-Barnes Nos. 1 & 2 wells. Since Dominion "went non-consent," Moose became the operator, but later filed for bankruptcy protection. Barnes sued several parties, including Tawes, who was a consenting party but who owned no interest in the Barnes lease. Barnes' suit was based upon its contention that it was a third party beneficiary under the operating agreement based upon the clause cited above, which the court referred to as the "Royalty Provision."

The Texas Supreme Court accepted the certification and issued its opinion, responding only to the first question certified.[167] Conducting a thorough review of Texas law on third party beneficiaries and privity of contract, the Supreme Court concluded that "any benefit Barnes derived by way of the JOA Royalty Provision was merely incidental and not enough to entitle her to the third-party beneficiary status she seeks." Addressing the contended privity status, the Court rejected such contention, noting that, "[b]ecause Tawes, as a consenting party, did not permanently acquire Dominion's interest in the non-consent wells, and because Tawes did not otherwise contractually assume a duty to pay royalties accruing on production from the non-consent wells directly to Barnes, we hold that the parties do not share any privity which allows Barnes to enforce the Dominion-Moose Agreements to recover her unpaid royalties from Tawes."[168]

## § 7.06 Miscellaneous Issues Concerning the Subsequent Operation

### [1] Alternate Arrangements Concerning a Non-Consent Election

Some operating agreements provide for the total relinquishment of the interest of a non-consenting party (rather than mere deferral pending discharge or satisfaction of a percentage recoupment factor) if the proposed operation is "necessary" to earn an interest or maintain leasehold rights. These are sometimes called "in or out" or (in a proper case) "blackout"[169] provisions and the operations giving rise to their application are often said

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[167] Tawes v. Barnes, 340 S.W.3d 419 (Tex. 2011).

[168] On June 27, 2011, the Fifth Circuit reversed the judgment of the District Court, which had affirmed the judgment of the Bankruptcy Court in favor of Barnes and against Tawes, and remanded the cause to the District Court "with directions to remand to the Bankruptcy Court, with directions to the Bankruptcy Court to render judgment that Barnes take nothing in her action against Tawes."

[169] "A term which has been applied to a provision in a joint operating agreement that a party electing not to participate in the drilling of a well shall assign its interest in the drillsite and in other drillsites directly and diagonally offsetting the drilling unit." Williams and Meyers, *Manual of Oil and Gas Terms*.

to be "necessary" or "required" operations. A provision stipulating a forfeiture of acreage for non-consenting an operation was judicially enforced, notwithstanding that it had been characterized by the parties as a "preliminary" agreement.[170]

Many clauses of this type define a "required operation" (sometimes called a "lease saving operation") as one which is "necessary" in order to maintain any lease which, if the operation were not conducted, would otherwise terminate on or before a date of less than a stated period of time thereafter, usually not more than six months.

Care should be taken in the formulation of this provision. On more than one occasion, the author has reviewed a version of such a clause wherein the notion was stated that "operations shall be deemed necessary *if proposed* on or before sixty (60) days prior to the date on which any such lease would expire in the event the operations are not performed." Under this arguably "backwards" formulation, many unintended wells might be considered as "necessary." To give an admittedly extreme example, an operation *proposed* for the drilling of a well on a paid-up lease with a ten-year primary term would arguably satisfy this definition, even if the proposal were made early in the lease term—the well is being proposed "on or before" the end of the lease's term and, hence, "on or *before* sixty (60) days *prior* to the date on which . . . such lease would expire in the event the operations are not performed."

Because the verbiage focuses on the date of the *proposal* rather than on the date of *expiration* of the lease, it might be said to be "backwards." The better formulation measures time in respect of the otherwise termination date (a matter over which the proposing party has no control) rather than in reference to the date of the proposal. It might be more precisely written by requiring a certain minimum notice and then saying that "such operations shall be deemed necessary if, in the absence of their conduct, a lease would expire within _____ days of the date of the notice." In view of the drastic consequences of an election to not participate, parties should endeavor to clearly define "necessary" or "required" operations.

In a Canadian case,[171] a dispute arose as to whether a well which was drilled by less than all of the parties was a "well required to preserve

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[170] Chevron U.S.A., Inc. v. Martin Exploration Co., 447 So. 2d 469 (La. 1984). In the interest of full disclosure, your author was counsel to one of the parties to this case.

[171] APL Oil & Gas Ltd. v. Amoco Canada Resources Ltd., 16 Alta. L. R. (3d) 95 (Q.B. 1993).

title"—as to which a non-consenting party forfeits its interest—or an "independent operation"—as to which a non-consenting party incurs a 300% non-consent recoupment factor. The court held that the determination of the status of the operation depended upon the intention of the parties at the time the well was drilled, *not* when the election was required to be made. Based upon the evidence submitted, the well was held to be an "independent operation," rather than a "well required to preserve title." Under the court's analysis, "a party may be required to elect whether or not to participate before it knows what the consequence of its non-election will be, notwithstanding that such consequences may well influence the election it will make."[172]

it were to be accepted as the prevailing view, the holding of this case—that the determination as to the status of a proposed well, as being a "lease saving operation" (giving rise to an absolute forfeiture of the interest of a non-consenting party under an operating agreement so providing) or otherwise, is to be made at the time a well is drilled, rather than when it is proposed—could be a trap for the unknowing. To illustrate, assume that a well ("Well A") is producing on a lease and, after the expiration of the primary term, a party proposes the drilling of a second well on the same leased premises ("Well B"). At the time of proposing the drilling of Well B, it is not a "required operation" because Well A was then producing, thereby maintaining the lease in force and effect pursuant to the usual "habendum clause." If a party fails to affirmatively elect to participate within the thirty (30) days contemplated by the operating agreement, that party is a non-consenting party if the drilling of Well B is later actually commenced. If, on some date not less than thirty (30) days after the expiration of the notice period, Well A ceases to produce and a decision is made that it cannot be successfully reworked, and if the lease is not being otherwise maintained, the drilling of Well B is, all of a sudden, a "lease saving operation."

When Well B was proposed, it was *not* a well "necessary to maintain the lease" since the lease was then being maintained by production from Well A. However, at the time Well B is spud-in, it *is* a "necessary" well as the lease would otherwise expire in the absence of further operations or production. The non-consenting party who thought it would (only) suffer a "deemed" relinquishment of its interest until a multiple of costs was paid-out is now, all of a sudden and without the further opportunity to change its election, subject to a total and absolute forfeiture of its interest. The *character* of the

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[172] Bonney and Park, "Recent Judicial Developments of Interest to Oil and Gas Lawyers," 33 Alberta Law Review 368 (1994–5).

subsequent operation—the drilling of Well B—did not change, but the contractual *consequences* of the non-consenting party's earlier election have changed dramatically.

To avoid this circumstance, and in order to provide certainty and understanding as to the consequences of an election, the parties might include a clause such as the following in the "required operation" provision of the operating agreement, to-wit:

> The determination of whether a proposed operation is a "required operation" (as defined hereinabove) shall be made on the basis of the relevant facts and circumstances as they exist on the date of the notice proposing such operation, even if such facts and circumstances should change or are different as of the date of actual commencement or completion of the proposed operation. The written notice proposing a "required operation" shall (i) expressly state that the proposing party considers the operation to be a "required operation"; (ii) make express reference to the provisions of this Article, and (iii) include, in addition to the information required by Article VI.B.1 hereof, a fair, reasonable and concise summary of the facts and circumstances which, in the view of the proposing party, necessitate the subsequent operation so proposed in order to maintain leasehold rights or earn any interest (but without any liability or responsibility on the proposing party in the event that any such fact or circumstance so included is not correct or complete).

In a recent case,[173] a non-consenting party challenged the validity of an "in or out" provision in an operating agreement on several theories, all of which were rejected.

First, the non-operator contended that the provision (contained in Article XV—Other Provisions, of the 1982 Model Form) violated the Texas statute of frauds. The contention was that "there is no designation or description of the assignor or assignees, that there is an insufficient description of the interests in the leases to be released and assigned, and that there is no reference to an extrinsic writing sufficient to supply the missing information." The court rejected this argument, finding that, because the Contract Area "is sufficiently described, the agreement does not violate the statute of frauds."

Next, the non-operator contended that the "in or out" provision "creates an unenforceable penalty or forfeiture." Citing prior authority,[174] the court noted that "nonconsent penalties are not liquidated damages," but, rather, "are an incentive for the risk takers by allowing reasonable compensation for agreeing to participate in new wells." The court concluded that, "[b]ecause the consenting owners agreed to this risk and because [the non-consenting party] is in no different position than he would be if the Lindsey Leases had

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[173] Long v. Rim Operating, Inc., 345 S.W.3d 79 (Tex. App.—Eastland 2011).

[174] Valence Operating Co. v. Dorsett, 164 S.W.3d 656 (Tex. 2005).

not been maintained, Article XV.K. is not an unenforceable penalty or forfeiture."

A conflict between Article VI.B (subsequent operations) and Article VI.E.2 (abandonment of wells that have produced) was resolved in *Jackhill Oil Company v. Powell Production, Inc.*[175] A proposal was made to redrill a "well to a different bottom hole, as the original well had become unprofitable." Viewing the proposal as one under Article VI.B, two parties agreed to participate in the proposed redrilling, but one party refused and "objected to what it characterized as 'the plugging and abandonment of the Flick 7-16 Well.' " This objecting party asserted that the proposed operation was governed by Article VI.E.2 since, according to this party, the proposal involved the plugging and abandonment of a well. Article VI.E.2 provided that any party not in agreement with the plugging and abandonment of a well was entitled to purchase the interest of the other parties. This objecting party tendered the salvage value to the other parties, which was refused. The court found as fact that the participating parties "did not intend to plug and abandon the well" which was "in actuality plugged but not abandoned." The court held that Article VI.B (and not Article VI.E.2) applied because the proposed sidetrack operation involved the plugging, but not the abandonment, of the well.

In the exercise of the right of freedom of contract, some operating agreements provide that, in lieu of the interest of a non-consenting party being subject to the non-consent recoupment factor, the interest will be "farmed-out" to the consenting parties pursuant to predetermined terms, with the non-consenting party retaining an overriding royalty interest. One case considered such a special clause and determined that the "farmed-out" interest did not constitute an acreage contribution which had to be shared with all Drilling Parties.[176] Because this alternate approach is set forth in the operating agreement, it would seem to avoid the problem encountered in the *Moncrief* case discussed above.[177]

### [2] Proposal of a Subsequent Operation Before Discharge or Satisfaction of Outstanding Account

It is not uncommon for a subsequent operation to be proposed prior to the full discharge or satisfaction of an outstanding non-consent recoupment

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[175] 210 Mich. App. 114, 532 N.W.2d 866 (1995).

[176] Harper Oil Co. v. Yates Petroleum Corp., 105 N.M. 430, 733 P.2d 1313 (1987) [apparently involving Article VIII(C) of the 1977 Model Form].

[177] *See* text accompanying footnote 58, *supra*.

factor applicable to the same well. An illustrative example of this scenario would the following:

> An operator proposes the drilling of a well on the Contract Area which is governed by the 1977 Model Form. One non-operator goes "non-consent" while another non-operator participates in the well. The cost and risk of the well are borne by the consenting parties while the interest of the non-consenting party is subject to the non-consent recoupment factor stipulated in the operating agreement. The well produced for a period of time, but did not achieve payout (and certainly did not discharge the 500% non-consent recoupment factor to which the non-consenting party was subject under the terms of the controlling 1977 Model Form operating agreement). After production from that well terminates, the consenting parties desire to plug-back the well to a shallower zone and attempt a completion in that shallower zone.

Several issues are presented by this hypothetical situation, such as:

- Can the plug-back recompletion operation even be conducted without the consent of the non-consenting party?
- What are the rights of a non-operator in a well in which it "went non-consent," prior to the discharge or satisfaction of the applicable non-consent recoupment factor?
- If so, to what non-consent recoupment factor, if any, are the costs of the plug-back recompletion of the well subject?

As a threshold issue, can the plug-back recompletion operation be conducted in the first instance without the non-consenting party's consent? One respected commentator has expressed the view that, under the circumstances described above (governed by the 1977 Model Form), the operation cannot be conducted without the consent of all working interest owners, including a party whose interest is subject to a non-consent recoupment factor.[178] In contrasting the 1982 Model Form to the 1977 version, the commentator stated that "[t]he proposal provisions of Article VI.B.1. [of the 1977 Model Form] are not applicable to . . . a non-consent well completed as a producing well but not producing in paying quantities if recoupment of penalty costs has not yet occurred. Thus, without the consent of all parties, there can be no reworking, deepening, plugging-back or sidetracking of such a well."

Relevant to an inquiry as to the status of the non-consenting party is Article VI.B.2 (lines 1–6 of Page 7) of 1977 Model Form,[179] to-wit:

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[178] Hardwick, "The 1982 Model Form Operating Agreement: Changes and Continuing Concerns," *Oil and Gas Agreements, Paper No. 8* (Rocky Mt. Min. L. Fdn. 1983).

[179] A functionally similar, although not identical, provision also appears in the 1956 Model Form on Page 6 thereof. The 1982 Model Form is identical.

> **If and when** the Consenting Parties recover from a Non-Consenting Party's relinquished interest the amounts provided for above, the relinquished interests of such Non-Consenting Party shall automatically revert to it, and, **from and after such reversion**, such Non-Consenting Party shall own the same interest in such well, the material and equipment in or pertaining thereto, and the production therefrom as such Non-Consenting Party would have been entitled to had it participated in the drilling, reworking, deepening or plugging back of said well. **Thereafter**, such Non-Consenting Party shall be charged with and shall pay its proportionate part of the further costs of the operation of said well in accordance with the terms of this agreement and the Accounting Procedure, attached hereto. (Emphasis added).

Based upon the explicit language of the operating agreement, since the non-consenting party went "non-consent" with respect to the drilling of the first well, it would relinquish its interest in that well and would have no further rights or interest therein until the stated non-consent recoupment factor is recouped in full. If the operation is unsuccessful, the non-consenting party would continue to be in a relinquished mode and would relinquish the right to propose or participate in any further operations on the well.[180]

It is a rule of contractual interpretation that penalties are generally to be strictly construed against the party seeking to impose the penalty.[181] Nevertheless, the reference in the operating agreement to a relinquishment of the interest of the non-consenting party "in the well" is rather clear, even if arguably harsh under certain circumstances. It is often said that a non-consenting party is penalized for being correct in its election to not participate in the operation.

Having concluded that the non-consenting party is not "in the well" until the stated non-consent recoupment factor is recouped in full, the question arises as to whether or not the non-consenting party would be subject to a non-consent recoupment factor with respect to costs to be incurred in the plug-back recompletion of the well and, if so, what non-consent recoupment factor would apply? If the non-consent recoupment factor for tangible

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[180] Obviously, a non-consenting party would be free to make any proposal to the other parties and, if they agreed with respect thereto, the terms of the operating agreement could be waived or modified to that extent, but it would take the express concurrence of *all* of the consenting parties before any such modification could become effective. In the absence of some agreed modification of the operating agreement, a non-consenting party's interest in the subject well would remain relinquished until the recoupment factor is discharged or satisfied.

[181] Louisiana: Scurlock Oil Co. v. Getty Oil Co., 324 So. 2d 870 (La. Ct. App. 1975) (well cost reporting statute, being penal, "should be construed strictly against the party seeking to impose the penalty."); Texas: Pope v. State, 86 S.W.2d 475 (Tex. Civ. App.—El Paso, 1935).

equipment and operations is 100% and the non-consent recoupment factor for the intangibles—drilling, reworking, deepening or plugging-back costs—is 500%, to which of these factors, if any, is the non-consenting party subject in respect of the operation conducted without the participation of the non-consenting party?

The general principles of co-ownership or co-tenancy (which are applicable unless modified by agreement of the parties) establish the rule that, while a co-owner or cotenant who manages the commonly owned asset is entitled to reimbursement of the actual expenses incurred in the maintenance of the asset, it is entitled to no more than those costs.[182] Of course, reference must be made to the operating agreement in order to determine whether one co-owner or cotenant might charge in excess of the actual costs incurred; that is, if the consenting parties can charge a non-consent recoupment factor or are limited to a recoupment of the actual costs incurred.

In support of an argument that the higher recoupment factor applies, one might anticipate that the proposing party would rely on the following language from its operating agreement which stipulates the percentage recoupment factor to which a non-consenting party is subject, as follows:

> 500% of that portion of the costs and expenses of drilling, reworking, deepening, or *plugging back*, testing and completing, . . .

The proposing party (who seeks to impose the higher multiple) might argue that the reference to "costs and expenses of . . . reworking, . . . or plugging back," means that the costs of reworking or plugging-back under these circumstances are to be subject to the 500% non-consent recoupment factor.

Your author would disagree, believing that the better view is that the "string" of words used in this provision ("drilling, reworking, deepening, or plugging back") mean that the 500% non-consent recoupment factor applies to those costs incurred in those particular operations as to which a party "went non-consent" in the first instance because the pertinent operation was proposed as such.

In other words, if, prior to the non-consenting party going non-consent, the proposed operation is a *drilling* operation, and if the non-consenting party elects to not participate therein, then the non-consent recoupment factor applies to the costs incurred in that *drilling* operation.

If, however, the operation proposed is a *reworking* operation, then the

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[182] Louisiana: Article 806, Louisiana Revised Civil Code; Texas: Neeley v. Intercity Management Corp., 732 S.W.2d 644 (Tex. Civ. App.—Corpus Christi 1987).

non-consent recoupment factor applies to the costs incurred in that *reworking* operation, and so on.[183]

The use of the "string" of words should not be viewed as a license, in a non-consented drilling operation, to allow the consenting parties to conduct the other mentioned operations at a later date and thereby subject the non-consenting parties to the non-consent recoupment factor therein stated. If that were the correct interpretation, a necessary construction would arguably be that, if the first operation were a (relatively inexpensive) *reworking* operation, and a party "went non-consent" with respect thereto, then, at a later date, but prior to discharge or satisfaction of the non-consent recoupment factor assessed against the non-consenting party, the consenting parties, without any notice to or approval of the non-consenting party, could *deepen* that well and subject the non-consenting party to a 500% non-consent recoupment factor as to the *deepening* costs of an operation which was never proposed. This would be illogical and certainly extreme, an interpretation not generally countenanced by the law.[184]

As observed by one commentator, "[t]he '56 and '77 Agreements did not address this and therefore left it unclear as to how to deal with such subsequent costs incurred in a non-consent well."[185] However, this situation is rather clearly treated in the 1982 Model Form[186] where it is provided, as follows:

An election not to participate in the drilling . . . of a well shall be deemed an election not

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[183] To illustrate more clearly what should be the proper interpretation of the clause in question, under this hypothetical situation, it might be rewritten (with the italicized words added for clarity), as follows:

> 500% of that portion of the costs and expenses of drilling *(if the drilling of a well is the proposed operation as to which a party "went non-consent")*, or of reworking *(if the reworking of a well is the proposed operation as to which a party "went non-consent")*, or of deepening *(if the deepening of a well is the proposed operation as to which a party "went non-consent")*, or of plugging back *(if the plugging back of a well is the proposed operation as to which a party "went non-consent")*, . . .

[184] In Louisiana, it is the rule that, "[w]hen the words of a contract are clear and explicit and lead to no absurd consequences, no further interpretation may be made in search of the parties' intent." Article 2046, Louisiana Revised Civil Code. *Accord*: Reilly v. Rangers Management, Inc., 727 S.W.2d 527 (Tex. 1987).

[185] Ellis, "An Overview of Article VI—The Drilling and Development Article of the A.A.P.L. Form 610-1989 Model Form Operating Agreement," *The Oil and Gas Joint Operating Agreement, Paper No. 3* (Rocky Mt. Min. L. Fdn. 1990).

[186] Article VI.B.2 (lines 28-35 of Page 6) of the 1982 Model Form. *See also* Article VI.B.2(c) (lines 27-39 of Page 7) of the 1989 Model Form.

to participate in any reworking or plugging back operation proposed in such a well, or portion thereof, to which the initial Non-Consent election applied that is conducted at any time prior to full recovery by the Consenting Parties of the Non-Consenting Party's recoupment account. Any such reworking or plugging back operation conducted during the recoupment period shall be deemed part of the cost of operation of said well and there shall be added to the sums to be recouped by the Consenting Parties one hundred percent (100%) of that portion of the costs of the reworking or plugging back operation which would have been chargeable to such Non-Consenting Party had it participated therein.

In commenting on the addition of this paragraph to the 1982 Model Form, a member of the AAPL Special Forms Committee has stated that a "new paragraph has been inserted in order to clarify that any reworking or plugging back operation conducted during the recoupment period for a prior non-consent election is intended to be treated as part of the cost of operating the affected well. Accordingly, only the actual cost of such reworking or plugging back operation will be subject to recoupment."[187]

To be noted is the fact that, even under the explicit language of the 1982 Model Form (which language does not exist in the 1977 version), the costs are only subject to a 100%—or "dollar-for-dollar"—recoupment. It would seem rather incongruous if, as might be argued for by the consenting parties under this hypothetical situation, the 1977 Model Form would impose (albeit not explicitly) a 500% non-consent recoupment factor and that such factor would be explicitly reduced in the 1982 Model Form to a 100% recoupment.

One final observation on the last quoted clause in the 1982 Model Form: Its text mentions, as a next-subsequent operation, a "reworking" and a "plugging back" operation, but makes no reference to a "deepening" operation as being the next-subsequent operation after a "drilling" operation. Article VI.B.4 of the 1982 Model Form essentially brings a "sidetracking" operation within the ambit of a "deepening" operation, but, again, the latter is not explicitly included within Article VI.B.2 as the next-subsequent operation.[188] As a consequence, unless the parties modify this article to include a reference to a "deepening" operation, it would seem that a "deepening" (and, by definition, "sidetracking") operation could not be conducted, under the hypothetical circumstances here considered, without the consent of all parties, including a party who originally went "non-consent" in the proposed "drilling" operation, and whose applicable non-consent recoupment factor has not been discharged or satisfied.

The 1989 Model Form provides that those "parties that did not participate

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[187] Davis, "The Modern Operating Agreement—Implications for Landmen," The Landman, Vol. 28 No. 11, p. 23, 59 (November 1983).

[188] *See* Article VI.B.2 (lines 28–35 of Page 6) of the 1982 Model Form.

in the drilling of a well for which a proposal to Deepen or Sidetrack is made hereunder shall, if such parties desire to participate in the proposed Deepening or Sidetracking operation, reimburse the Drilling Parties in accordance with Article VI.B.4. in the event of a Deepening operation and in accordance with Article VI.B.5. in the event of a Sidetracking Operation."[189] Of course, parties are free to alter this so as to impose some sort of recoupment factor or even deny the right to participate in such subsequent operations.

Thus, the non-consenting party under the 1977 Model Form should not be subject to the higher (under this hypothetical situation, 500%) non-consent recoupment factor with respect to costs to be incurred in the plug-back reworking operation. However, the non-consenting party would be subject to the 100% recoupment stipulated in Article VI.B.2(a) of the operating agreement as being pertinent to the "cost of operation" of the well.

While the cost of a reworking operation may admittedly not normally be considered to be a LOE-type expense (at least for certain purposes),[190] this is consistent with the explicit treatment of such costs under such circumstances as set forth in the 1982 Model Form. Of course, the unrecouped costs of the initial drilling operation would still be subject to the original 500% non-consent recoupment factor, but the newly incurred costs of reworking should not be subject to that higher recoupment factor.

This interpretation is consistent with general co-ownership principles and with the rule of interpretation that penalties are generally to be strictly construed against the party seeking to impose the penalty.[191] Under the doctrine of strict construction, it has been said that one must be able to "put his finger" on the provision which authorized the imposition of a penalty.[192]

It is beyond debate that the joint participation of multiple parties in the development of mineral properties serves valid and legitimate commercial purposes: The spreading of risk and, concomitantly, the promotion of the drilling of more wells.

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[189] *See* Article VI.B.1 (lines 22-5 of Page 6) of the 1989 Model Form.

[190] For example, reworking costs—if designed to find or establish production—may be characterized as capital or extraordinary costs for purposes of lease maintenance under the doctrine of production in "paying quantities." Lege v. Lea Exploration Co., 93-605 (La. App. 3 Cir. 2/2/94), 631 So. 2d 716, *writ denied*, 94-0450 (La. 4/4/94), 635 So. 2d 1112. *See also* Pshigoda v. Texaco, Inc., 703 S.W.2d 416 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.).

[191] *See* footnote 181, *supra*.

[192] Blasingame v. Anderson, 108 So. 2d 105 (La. 1959).

It is the nature of the industry that the conduct of a given operation will give rise to a variety of circumstances—often unanticipated—that will necessitate additional expenditures in order to prudently develop and exploit mineral reserves or to perpetuate leasehold rights. These subsequent operations may not always be viewed by the co-owners with the same level of enthusiasm.

The "subsequent operations clause" of the operating agreement is designed to resolve disputes between the parties and to avoid the stalemate which might otherwise result among cotenants. The very important four letter word—"risk"—is at the heart of the clause considered herein. Risk can only be evaluated and managed if parties are provided both the information necessary to make an informed decision about the expenditure of capital and the time within which to do so.

At the same time, a party who is willing to assume such risk should not be precluded from doing so by the contrary view of another party, particularly where a risk-reward mechanism is provided to ameliorate the consequences of such disagreement.

The important notions of contractual certainty and of commercial predictability are advanced when the parties to an operating agreement clearly understand the rules which govern the conduct of subsequent operations.