

Oil and Gas Joint Operating and Farmout Agreements

Crafting Instruments That Address Modern Exploration and Production Challenges

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Today's faculty features:

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OPERATING AGREEMENTS -- PRINCIPLES AND PROBLEMS

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I. EXPLORATION AND DEVELOPMENT WITHOUT AN AGREEMENT

In order to understand the place of operating agreements, we will first review the rights of owners who do not have such an agreement. Then we will focus on the particulars of this important document.

Joint Ownership

- **Basic issues of property law and the need for cooperation arise when different parties own an interest in a mineral estate or an oil and gas leasehold. Most states have laws which deal with operations where there are no joint development or exploration agreements.**

Joint Ownership

▶ **Attributes of Joint Ownership**

- ▶ Each has the right to lease, sell or otherwise dispose of her interest without consent from the other. Joint tenancy may become tenancy-in-common if one joint tenant acts without the consent of the other.
- ▶ Subject to the duty to account, each has the right to develop the property without consent from the other.
- ▶ A joint tenant's interest passes to the other joint tenant upon death. The interest of each tenant-in-common will pass according to a will or laws of intestacy.

Disputes Involving Joint Ownership

Partition

- ▶ Most states have partition statutes which allow the following:
 - ▶ Physical division of a parcel of land to allocate among the co-owners. This is not practical where only a mineral interest is at issue because of the difficulty in equitably dividing a mineral estate.
 - ▶ Forced sale of property to a third-party as an alternative.

Effect of Force Pooling Statutes

- ▶ Pooling statutes are “pro-development” and provide a mechanism to force co-owners or lessees to “put up or shut up”. Applies to fee owner or lessee who doesn’t want to participate in an oil and gas operation. Each owner is given the option to commit its interest and pay share of costs. Remedies vary for nonjoinder, depending upon whether the nonconsenting party is a lessee or unleased mineral owner.

Obligations of Co-Owners to Third Parties – Mining Partnerships

- ▶ Mining partnerships are a creature of the court system. They are a legal fiction with sobering consequences. If a mining partnership is found to exist, each co-venturer is liable for 100% of the venture's obligation.
 - ▶ Normal rule is that each owner is responsible for only *pro rata* share. *Carter Baron Drilling v. Excel Energy Corporation*, 581 F.Supp. 592 (D.Colo. 1984).
 - ▶ But see *Blocker Exploration v. Frontier Exploration*, 740 P.2d 983 (Colo. 1987) (joint ownership, agreement to show profits and losses, and joint operation control).

Duties Owed to Co-Owners.

- While a fiduciary relationship does not typically exist among co-owners, a fiduciary duty may be created where a person creates the duty to act on another's behalf, especially if one party occupies a "superior position" relative to another. *Dime Box Petroleum v. Louisiana Land & Exploration*, 938 F.2d 1144 (10th Cir. 1991) and *Atlantic Richfield v. Farm Credit Bank*, 226 F.3d 1138 (10th Cir. 2000).
 - Fiduciary duty requires that a party "act primarily for the benefit of another in matters connected with the undertaking."
 - How has the oil and gas industry addressed these uncertainties?

ANALYSIS OF A.A.P.L. FORM OPERATING AGREEMENT – 1989 FORM

- Standard operating agreements – JOA's – deal with the problems that arise when mineral interests are owned by many.

How JOA's are used.

- ▶ Operating agreements can stand on their own or are used as an exhibit or an attachment to another agreement, such as a farmout agreement.

Versions.

- ▶ There have been several versions of the Standard Operating Agreement; 1956, 1977, 1982, 1989. This presentation focuses on the 1989 form; however, do not assume that all provisions in the different forms are the same.
- ▶ Operating Agreements involving federal leases use a federal form, which has some similarities.

Recording the Operating Agreement.

- ▶ A basic principle in most states is that an interest in real property is not effective against third parties who later purchase the same interest and who do not have notice of the interest, unless constructive notice of the interest is recorded in the public records of the county in which the property is located.

Recording the Operating Agreement.

- ▶ Types of property interest which are created or affected by an operating agreement:
 - ▶ Operating agreement may create security interests, the right to file liens or allow preferential rights that trump the BFP's rights.
 - ▶ When in doubt, record. Example is A.A.P.L. Form 610 RS – recording supplement. Include property description, names of parties, description of potential security interests and preferential rights, and how copy can be obtained.

Article I – Definitions.

- “Contract area”.
- Distinctions between:
 - Drilling.
 - Deepening.
 - Sidetracking.
 - Reworking.
 - Recompleting.
 - Plugging Back.
- Many other terms defined.

Article II – Exhibits

- Exhibit “A” describes, among other things:
 - Lands and Formations
 - Parties
 - Percentage or Fractional Interests
 - What if there is a conflict with record title ownership?

Article II – Exhibits.

- **Exhibit “B” – Form of Lease.**
 - Exhibit “B” to the JOA should be a form lease for unleased interests which may be acquired within the Contract Area. Parties need to attach.
- **Exhibit “C” – COPAS.**
 - Detailed accounting provisions and agreements regarding compensation of the operator; expenses for operations, purchase of material, etc.
 - Note section 4- Two-year limitation on adjustments.
- **Exhibit “E” – Gas Balancing Agreement.**
 - Allows parties to equal out their interests in production either through gas balancing or cash balancing if product is sold to more than one buyer.

Article III – Interests of Parties

- Parties agree to share costs and liabilities in proportion to their interests as set forth in Exhibit A.

Article IV – Titles

- Article IVA. Requires that there be a title examination of the drillsite for any proposed well.
- The 1989 Form incorporates a change that allows only the Drilling Parties (*i.e.*, those who pay) to receive title information.
 - Is the title opinion protected by the attorney-client privilege? Yes, if state recognizes “common interest rule”. *Skaggs v. Conoco, Inc.* 957 P.2d 526 (N.M.App. 1998).

Article IV – Titles

- ▶ Title defects losses – Article IV.B
 - ▶ “Failure of title” is not borne jointly by the parties, but solely by the party who contributed the oil and gas lease, (example, lessor didn’t own the property).
 - ▶ Party who is required to make lease payment and fails to make payment bears entire loss of lease interest and has its rights reduced in the contract area.
 - ▶ Party responsible for loss has 90 days to cure defect and to acquire a new lease.

Article IV – Titles

- All other title losses are joint losses borne by the parties in proportion to their interest in Exhibit A, such as leases that expire or are cancelled for breach of implied covenants.

Article V – Operator

- Why would anyone want to be the Operator?
 - Usually owns majority interest.
 - Can control pace, location and who performs the operations.
- Operator Liability. Article V.A. designates the operator and limits its liability with respect to the other parties. The basic standard of care is as follows:

Article V – Operator

- ▶ “Operator shall conduct its activities under this agreement as a reasonable, prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oil field practice, and in compliance with applicable laws and regulations, but in no event shall it have any liability as operator to other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.”

Article V – Operator

- ▶ Authorities split on whether operators may be sued for “simple breach of contract.” Compare *Shell Rocky Mountain Production LLC v. Ultra Resources, Inc.*, 415 F.3d 1158 (10th Cir. 2005) (exculpatory clause in Art.V.A. does not insulate operator for simple breach), with *Stine v. Marathon Oil Co.*, 976 F.2d 254 (5th Cir. 1992) (operator not liable for any act taken as operator – including breach of express duties -- unless there is gross negligence or willful misconduct).

Article V – Operator

- Operator may be removed only for “good cause” by affirmative vote of majority of non-operators after excluding voting interest of Operator. “Good Cause” is not limited to gross negligence or willful misconduct by Operator. Thus, may be able to remove Operator even though it cannot be sued for poor performance. Article V.B.

Article V – Operator

- “[C]hange of corporate name or structure of operator or transfer of Operator’s interest to any single subsidiary, parent or successor corporation shall not be the basis for removal of Operator.” Art. V.B.1.

Article V – Operator

- Some of the Rights and Duties of Operator.
 - Art. V.D.I. states that wells must be drilled at “competitive rates”. *Shell v. Ultra, supra*.
 - Operator must pay bills and keep operations free of liens. Art. V.D. 2, 3.
 - Fiduciary duty only when accounting for funds. Compare Arts. V.D.4 and VII.A.
 - Provide access to books and records. Art. V.D.5.

Article V – Operator

- 1989 Form requires periodic updates on expenditures. Under Article V.D. 8., the Operator must furnish an estimate of current and cumulative costs incurred for the joint account at reasonable intervals during the course of any operation, if a request is made. No liability if estimate made in “good faith”.
- Cost overruns where there is an AFE. AFE’s are just “estimates” and consenting parties are liable for share of overruns. *M & T, Inc. v. Fuel Resources Dev. Co.*, 518 F.Supp. 285 (D.Colo. 1981).

Article VI – Drilling and Development

- ▶ **Initial Well.**
 - ▶ No right to go non-consent on initial well in 1989 Form.

Article VI – Drilling and Development

- ▶ Subsequent operations and operations by less than all parties. Art. VI.B.2.
 - ▶ Any party may propose a subsequent operation.
 - ▶ If less than all parties consent to participate in a subsequent operation, then the Operator shall give consenting parties right to limit participation or acquire a proportionate share of the non-consenting parties' interest. Art. VI.B.2.a. Proposal can be withdrawn if less than 100% participation.

Article VI – Drilling and Development

- ▶ Article VI.B. describes the interest of a non-consenting party in any subsequent operations (“nonconsent penalties”). Penalties for nonparticipation must be severe enough to encourage maximum participation and prevent “free ride”. Typically:
 - ▶ 100 – 200% for equipment
 - ▶ 300-500% for costs of drilling which pose a greater risk
- ▶ Competing proposals. 15 days to submit alternative proposal. Decided by majority vote of voting parties. If tied, initial proposal prevails. Art. VI.B.6.

Article VI – Drilling and Development

- ▶ Well abandonment and termination of operations.
 - ▶ Decision to abandon dry hole belongs to parties who consented to the operation. Art. VI.E.1.
 - ▶ Parties opposing abandonment must provide satisfactory evidence of financial capability to conduct operations, or Operator has authority to plug and abandon wells. Art. VI.E.1.

Article VI – Drilling and Development

- ▶ **Taking production-in-kind.**
 - ▶ The Operator typically acts as the agent of all parties to sell production from a well. Sometimes each owner will “take in kind” and sell its share of the production. Each party must execute necessary division orders and contracts for the sale of its interest in production if it is sold by the Operator. The authority of the Operator may be revoked. Art. VI.G.

Article VII – Expenditures And Liabilities Of Parties

- Article VII.A. negates concept of joint liability, as well as the notion that the parties are fiduciaries or partners.
 - All rights and obligations are several, not joint. “Good faith” still required in dealings with each other. What does that mean?

Article VII – Expenditures And Liabilities Of Parties

- ▶ Article VII.B. creates lien rights and security interests among the parties to secure performance of their obligations.
 - ▶ Operator has right to suspend payment of revenues to defaulting parties, bring suit, make party non-consent, require advance payment, etc.
 - ▶ All performing parties have lien and security interests against defaulting party to assure payment. See Article VII.B. and *Andrau v. Michigan Wisconsin Pipeline Co.*, 712 P.2d 372 (Wyo. 1986).

Article VIII – Acquisition, Maintenance Or Transfer Of Interests

- Leases may not be surrendered unless all parties consent. Art. VIII.A.
- Right of partition is waived. Art. VIII.E.
- Preferential Right to Purchase. Art. VIII.F.
Parties have right to impose a preferential right to purchase by checking the box. Consideration needs to be given to the potential benefits and burdens of “pref. rights.”

Article VIII – Acquisition, Maintenance Or Transfer Of Interests

- Under the 1989 Form, a preferential right is not triggered by mortgages, transfers to subsidiary or parent companies, by a disposition of interests by “merger, reorganization, consolidation, or by sale of all or substantially all of the Oil and Gas assets” of a party.
 - A sale of the company’s stock generally did not trigger the right. *Rainbow Oil Co. v. Christmann*, 656 P.2d 538 (Wyo. 1982)
 - Preferential rights were not triggered by intercompany transfers. *Questa Energy Corporation v. Vantage Point Energy*, 887 S.W.2d 217 (Tex.App.- Amarillo 1994)

Article VIII – Acquisition, Maintenance Or Transfer Of Interests

- ▶ **Practical Problems with Preferential Rights.**
 - ▶ Uncertainty generated by a package sale.
 - ▶ Allocate value where there is more than one asset involved.
 - ▶ Diminishment of value of burdened interest.
 - ▶ Disputes.
 - ▶ Remedies for breach of preferential right to purchase.
 - ▶ Wrongful exercise of preferential right.
 - ▶ Conclusion. Carefully weigh the benefits and burdens before checking the box.

Article XIII – Term of Agreement

- ▶ Two choices. Option No. 1 continues JOA as long as any lease is in effect. Option No. 2 continues JOA as long as any well drilled under JOA is capable of producing in paying quantities.
- ▶ Option No. may be longer if there is more than one lease.

Article XVI – Miscellaneous Additional Provisions

- ▶ Consider inserting language to the effect that the operating agreement controls in the event of a conflict with any other agreement among the parties.
- ▶ Consider alternative dispute resolution, such as mediation, arbitration. Especially useful where there is a deadlock over change of operator, conduct of operations, or alleged breach of duty by operator.

JOINT OPERATING AGREEMENTS, FARMOUT AGREEMENTS AND OTHER MATERIAL AGREEMENTS

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FARMOUTS AND RELATED AGREEMENTS

- A farmout agreement is a transaction wherein the owner of an oil and gas lease (farmor) agrees to an assignment of a part of a lease to a party (farmee) who agrees, as consideration for the assignment, to drill a well to a certain depth or condition.

- The farmout agreement allows that the farmee “earns” its interest upon either drilling.

- ❑ Under a drill to earn farmout, the farmee earns the interest under the Farmout Agreement once drilling commences or reaches the contracted depth.
- ❑ Under a produce to earn farmout, the farmee must, generally, drill a well that produces in paying quarterly to earn the interest in the farmout acreage.

- It is common for the farmor to retain a non-operating interest in the farmed out acreage.

- ❑ Few farmout agreements are recorded. However, once an agreement has been fully performed, the farmee is entitled to a recordable assignment of interest. It is important that the terms of the farmout agreement and the terms of the assignment do not conflict, or a dispute may arise as to which prevails.

- A frequent reason for a discrepancy between record title as shown in the County Clerk's records and the interest shown to be paid in the deed is the absence of an executed assignment pursuant to a farmout agreement.

Term Assignments

- ▣ Companies have frequently turned to term assignments instead of farmout agreements.

- The term assignments convey an interest from the assignor/farmor to the assignee/farmee for a specific term. The assigned interest is to revert to the assignor if the assignee doesn't drill a producing well to a certain depth by a certain date.