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Some Recurring Issues in Operating Agreements and What AAPL'S Drafting Committee Might Do About Them

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Chapter 27
SOME RECURRING ISSUES IN OPERATING AGREEMENTS AND WHAT AAPL'S DRAFTING COMMITTEE MIGHT DO ABOUT THEM

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Synopsis

§ 27.01 Introduction[*][**]

Joint operations are the norm in oil and gas ventures around the world. Oil and gas exploration and development are expensive and highly risky, so investors seek to minimize individual risks by sharing them with others. Further, in the United States, leases covering a production area are likely to be held by several owners because mineral titles have been fragmented historically. For these reasons, it is common to see dozens of working interest owners in a single well in this country.

Joint operations are usually conducted under the terms of an operating agreement, a written contract between cotenants or separate owners of oil and gas interests setting out their agreement to operate their interests or leases as one "contract area." Practicality is one reason to use an operating agreement. The common law defining the rights and obligations of the owners of working interests in oil and gas operations is complicated, confusing, and incomplete. Sometimes the law of cotenancy applies, but often it does not.[1] And when the law of cotenancy applies, its hoary principles may not "fit" the modern oil and gas industry.

Furthermore, there are other important reasons for operating agreements, including limited liability and taxation. No investor wants to be jointly and severally liable for the torts and contracts of other co-investors. Structuring a venture as a corporation brings limited liability but subjects it to double taxation and may limit its ability to take advantage of tax losses.[2] Partnerships are ideal entities for oil and gas development for tax purposes since profits and losses flow through to the partners. But partners have fiduciary obligations to one another, and from a liability viewpoint, partnership is a disaster because

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[1] If working interest owners own undivided interests in the same lease(s), they are cotenants. But if they own interests in different leases, they are not cotenants, even if the leases are in the same spacing unit. *See* Come Big or Stay Home, LLC v. EOG Res., Inc., 2012 ND 91, ¶ 19, 816 N.W.2d 80, 87.

[2] *See* Charles O. Galvin, "The 'Ought' and 'Is' of Oil-and-Gas Taxation," 73 *Harv. L. Rev.* 1441, 1495–96 (1960).

partners are jointly and severally liable.[3] Additionally, partnership interests are difficult to convey and relatively unmarketable.

Concurrent ownership is traditionally the favored structure for oil and gas operations, and it is facilitated by an operating agreement. Under the operating agreement, each party owns separate property for tax purposes, and the tax results are approximately the same as they are for partners. But the liabilities of the non-operating parties are effectively limited to the amount of their investments. The operator is an independent contractor, liable for its own torts and contractual obligations, not a partner of the non-operators.[4]

Effectively, an operating agreement "pools" leases and fractional interests in leases or mineral rights within the defined contract area under the day-to-day direction of an individual or corporation designated as the "operator." This brings additional expertise to the venture and spreads the risks of drilling and the cost of operations.[5] An operating agreement provides a decision-making process, a risk-allocation mechanism, and a financial instrument for the parties involved in exploration and production operations within the contract area.[6]

Operating agreements are ubiquitous in the American oil and gas industry. There are nearly one million producing wells in the United States,[7] most of which are subject to at least one operating

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[3] *See* Howard L. Boigon & Christine L. Murphy, "Liabilities of Nonoperating Mineral Interest Owners," 51 *U. Colo. L. Rev.* 153, 157 (1980) (citing Dana v. Searight, 47 F.2d 38 (10th Cir. 1931); Riss v. Harvey, 354 P.2d 594 (Colo. 1960); Mikel Drilling Co. v. Dunkin, 1957 OK 226, 318 P.2d 435).

[4] While operating agreements are popularly referred to as "*joint* operating agreements" or "JOAs," they are structured to avoid classification as partnerships. *See id.* at 161 ("It is well settled that one co-tenant cannot do anything with respect to the common property binding upon his co-tenants unless they may have authorized or ratified his act. No agency by implication arises out of his act merely from the relationship of co-tenancy." (quoting Tungsten Prods., Inc. v. Kimmel, 105 P.2d 822, 823–24 (Wash. 1940))). *See also* Taylor v. Brindley, 164 F.2d 235, 240 (10th Cir. 1947); Myers v. Crenshaw, 116 S.W.2d 1125, 1129 (Tex. Civ. App. 1938), *aff'd*, 137 S.W.2d 7 (Tex. Comm'n App. 1940)).

[5] *See* Alexander J. Black & Hew R. Dundas, "Joint Operating Agreements: An International Comparison from Petroleum Law," 8 *J. Nat. Resources & Envtl. L.* 49, 49–50 (1992).

[6] *See* David E. Pierce, "Transactional Evolution of Operating Agreements in the Oil and Gas Industry," *Oil and Gas Agreements: Joint Operations* 1-1, 1-10 (Rocky Mt. Min. L. Fdn. 2008).

[7] In 2009, there were 824,847 producing oil and gas wells in the United States, as compared to about 3,650 in Saudi Arabia. It has been estimated that more than 45,000 new wells will be drilled in the