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Fundamentals of Joint Operating Agreements

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(an expansion of Weems) – by Christopher Kulander

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INTRODUCTION

by Christopher Kulander[∞]

Joint ownership of oil and gas exploration and production rights—whether held through fee mineral ownership or ownership of an oil and gas lease—arise in many ways. Cotenants of a mineral estate may each lease to different companies, or companies leasing adjacent acreage may be required to pool their leases to form a drilling unit. Individual leases may be jointly held by several lessees. Farmout agreements may give rise to co-ownership of working interest once, for example, payout is achieved. Mineral title also tends to become increasingly fragmented over time, leaving many working interest owners with undivided leasehold interests covering a production area or even a single well. Other times, joint ownership is the result of a deliberate decision to spread the cost and risk of drilling and development. The nature of the petroleum industry makes such decisions increasingly necessary. Even where oil or gas is known to exist in large quantities in the United States, such as in shale formations, the hydrocarbons can frequently be recovered only by the use of highly expensive technology, such as horizontal drilling coupled with a hydraulic fracturing operation. Companies may not want to assume the entire risk or entire cost of such expensive and risky undertakings. Hence a lessee with a promising "prospect" may farm out part of its acreage, or it may do the drilling itself, but only after selling interests in the leasehold to investors or to other companies. Alternatively, several companies that already have leases in the area may agree to combine their efforts for exploratory and developmental purposes.

Regardless of how joint ownership arises, an agreement should be reached on a variety of matters including initial drilling, payment of expenses, operation of the well, division of production, and further development of the property. The joint operating agreement ("***JOA***") serves this function. A JOA describes the geographic area it covers and specifies the fractional interests owned in this area by the various parties having working interests in the area. Typically, one of these parties is designated the "operator" with authority to incur expenses and make operational decisions. Occasionally, a party, such as a lease owner who has assigned all of its lease interests to investors, is named as a "contract" operator. A contract operator has standing to enforce the JOA and may bring suit on behalf of the participants, even though it lacks any interest in the area covered by the JOA.[1] The other contracting parties are referred to as "non-operators." Each non-operator's share of both costs and production is usually based on its fractional interest in the JOA's area. A typical JOA is a lengthy agreement that addresses many issues, including whether and how different combinations of parties can develop the area and how the operator will incur costs and bill the non-operators for their share of costs. A JOA also addresses how production is to be physically divided among the parties in accordance with each party's interest in the area or well.[2] A JOA almost always provides the operator with ample remedies against non-

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∞ Professor, South Texas College of Law Houston. Much of this paper draws from the work of Jeff Weems' *Fundamentals of Joint Operating Agreements*, Proceedings of the 44th Annual Ernest E. Smith Oil, Gas and Mineral Law Institute, Apr. 19-20, Houston, Texas (used with permission).

1 *See* Basic Energy Service, Inc. v. D-S-B Properties, Inc., 367. S.W.3d 254 (Tex. App. 2011, no pet.); Long v. Rim Operating, Inc., 345 S.W.3d 79 (Tex. App.—2011, pet. denied).

2 ERNEST SMITH & JACQUELINE WEAVER, TEXAS LAW OF OIL AND GAS § 17.3(A)(1) (Matthew Bender 2007) (2d ed. 1998).

operators who do not pay their share of operating expenses.[3]

History of Joint Operations and Form JOAs

The need for JOAs began to arise in the early-mid 1900s for a number of reasons. Spacing and density conservation laws arose, requiring the pooling of leases. Also, as wells were drilled deeper and thus became more expensive, joint investment to spread risk became more appealing. As mineral ownership became more fragmented and, consequently, as more and different lessees found themselves sharing leaseholds over the same, overlapping, or adjacent tracts, joint operations became more necessary. In addition, as described below, concerns about joint-and-several liability arose. The owners of undivided mineral interests, and their lessees, found that some of the common law rules of co-tenancy and mining partnerships did not sit comfortably with their oil and gas development plans.

At first, many operators had their own preferred form of operating agreement, leading to delay as negotiations and "form wars" occurred between potential co-developers. In the 1950s, starting in Oklahoma, industry negotiators, landmen, and lawyers began to conceive of a model form for joint operations.[4] Eventually, the Ross Martin Company in Tulsa published the "Kraftbilt Form 610" JOA in 1956, the first widespread form JOA.[5] Approximately ten years later, the American Association of Petroleum Landmen ("***AAPL***") assumed control of the 1956 form, renaming it the "AAPL Model Form 610 JOA," (the "***1956 Form***").[6]

Descendants of the 1956 Form are now the most popular form JOAs in use.[7] While one may encounter other JOA forms, most have evolved, in part, from one of the forms developed by the AAPL, including offshore domestic JOAs.[8] "As a result, judicial and academic concepts developed in the context of one JOA or one dispute are increasingly viewed as generally applicable to all JOAs."[9] Nevertheless, as will be illustrated throughout this article, individual words and phrases make a difference. Thus, a small change in a JOA provision from one form to the next may fundamentally alter the substance and effect of the provision.

The AAPL has promulgated several revisions of the 1956 form: the 1977 AAPL 610 Form JOA (the "***1977 Form***"), in the 1982 AAPL 610 Form JOA (the "***1982 Form***"), the 1989 AAPL 610 Form JOA (the "***1989 Form***"), and the 2015 AAPL 610 Form JOA (the "***2015 Form***").

The 1989 Form was revised during the bleakness of the mid and late 1980s, when oil prices sank, banks failed, and bankruptcies in the oil and gas business washed over upstream operations,

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3 *Id*.

4 Paul Yale, *The AAPL Operating Agreement and the Deadbeat Non-Operator*, Proceedings of the 27th Annual Energy Law Institute for Attorneys and Landmen at page D-5, South Texas College of Law, Houston, Aug. 27-28, 2014.

5 *Id*.

6 *Id*. American Association of Petroleum Landmen, http://www.landman.org/.

7 Gary Conine, *Property Provisions of the Operating Agreement—Interpretation, Validity and Enforceability*, 19 TEX. TECH L. REV. 1263, 1273-74 (1988).

8 Ernest Smith, *The Future of Oil and Gas Jurisprudence, Joint Operating Agreement Jurisprudence*, 33 WASHBURN L.J. 834, 835 (Summer 1994).

9 *Id*.

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