Annual Institute on Mineral Law

Volume 45 *The 45th Annual Institute on Mineral Law* Article 11

3-26-1998

# Joint Operating Agreement Issues

Patrick W. Gray

Follow this and additional works at: https://digitalcommons.law.lsu.edu/mli_proceedings

Part of the Oil, Gas, and Mineral Law Commons

Repository Citation

Gray, Patrick W. (1998) "Joint Operating Agreement Issues," *Annual Institute on Mineral Law*: Vol. 45 , Article 11.
Available at: https://digitalcommons.law.lsu.edu/mli_proceedings/vol45/iss1/11

This Paper is brought to you for free and open access by the Mineral Law Institute at LSU Law Digital Commons. It has been accepted for inclusion in Annual Institute on Mineral Law by an authorized editor of LSU Law Digital Commons. For more information, please contact kreed25@lsu.edu.

# Joint Operating Agreement Issues

**Patrick W. Gray**
*Liskow & Lewis*
*Lafayette, Louisiana*

## I. Introduction

This talk is technically entitled Joint Operating Agreement Issues. The title was an attempt by those behind the presentation of this year's Mineral Law Institute to provide subject matter that was sufficiently broad to allow the speaker to delve into selected areas covered by standard operating agreements. Accordingly, we will delve into the various ways operations are conducted between mineral producers involved in "Joint Exploration Activities." Joint Exploration Activities according to *Williams & Meyers* are:

> A term used "to describe the situation of a jointly owned lease or block of acreage which contemplates the exploration and drilling of multiple wells, each party paying for its own costs and being entitled to its pro rata share of income and operating expenses. *This joint form of oil and gas activity is primarily conducted via the form of a 'joint operating agreement'* . . ." [Emphasis added.]
>
> 8 Williams & Meyers, p. 540.

As the authors correctly point out, because of the risk involved, these activities are generally conducted under the auspices of a joint operating agreement. When they are not, it is often the result of a failure of the parties to agree on one because of competition in the area or some other like reason. We will later address the problems that might arise because of the failure to enter into a joint exploration or operating agreement.

Joint Operating Agreement is defined as follows:

> An agreement between or among interested parties for the operation of a tract or leasehold for oil, gas and other minerals. This type of agreement is frequently entered into before there has been any development. 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.* A joint operation may be carried on by a variety of means other than by a joint operating agreement, including the following: joint adventure, partnership, corporation or trust. [Emphasis added.]
>
> 8 Williams & Meyers, p. 541.

As indicated, the result of a joint operating agreement is the creation of



Published by LSU Law Digital Commons, 1996

a joint account that constitutes the funds available for the payment of obligations and that is amassed by the collection of money both by contributions from the parties and through the collection of proceeds from production in those cases where the operator does marketing. Note that under the agreement referenced by *Williams & Meyers*, lease ownership remains separate.

Operations to conduct exploration for minerals are often conducted under a written form of joint operating agreement developed for onshore operations by the American Association of Petroleum Landmen, (latest revision being Form 610-1989). In Louisiana, such an agreement must be in writing because it deals with the operation of mineral leases. *Hayes v. Muller*, 245 La. 356, 158 So.2d 191 (1963). The joint operating agreement is designed to set forth the rules under which the property will be developed and how the parties will share income going forward in the venture. Inasmuch as there are legal relationships that would naturally cause certain duties to arise, the content of this agreement is important. This paper will follow and discuss the format of the current standard form joint operating agreement and discuss case law affecting particular areas covered by such agreements.

## II. The Joint Operating Agreement

The AAPL Form 610-1989 is designed in a format that covers the basic necessities of operations and in some instances provides multiple choice or fill-in the blank options that create elections to accommodate specific needs or preferences.

### A. Article I - "Definitions"

The first section of the standard form operating agreement defines certain terms that are used and applied in the agreement. While seemingly terms are often self-defining to those who are familiar with oil and gas operations, one should nevertheless pay special attention to these terms and take pains to apply them consistently in any additions to the agreement as well as in any other writings dealing with or affecting the area covered by the agreement. Where necessary, one should also add additional definitions of terms of art. If a party is ever called upon to ask a court to decide the meaning of certain provisions of the joint operating agreement, farmout agreement, or any side letter, the court will pay close attention to how these terms are defined.

In a lawsuit about oil and gas matters such as these, more times than not the court will not have any experience with oil and gas matters, and these terms of art and will mean absolutely nothing to the court *except* insofar they are defined in the contract or in normal use. Recognizing these types of situations, Civil Code article 2047 provides that: "The words of a contract must be given their generally prevailing meaning. Words of art and technical terms must be given their technical meaning when the contract

involves a technical matter." This Code article will likely allow parol evidence about customary meanings in the industry, which means that a potential swearing match may develop among experts as to the meaning of terms.

To illustrate the point, reference is made to decision by Judge Clement of the United States District Court for the Eastern District of Louisiana, in *Louisiana Land & Exploration Co. v. Unocal Corporation,* 863 F. Supp. 306 (1994). There, the court struggled with terms of art used in a mineral instrument (in this case, a lease). The questions presented were (1) whether the term "value" in the royalty section providing that LL&E was to receive 27-1/2 percent of the value of liquid hydrocarbons was ambiguous and would require parol testimony, including testimony of an industry expert, and (2) whether the phrase "premiums or allowances" was ambiguous in the context of whether gathering charge reimbursements would be construed as allowances. In each case, the lawyers for LL&E argued forcefully that the terms were clear and unambiguous while the lawyers for Unocal argued that they were subject to special meaning in the industry which required further explanation. The court split on the two terms, saying the first was ambiguous and called for testimony of "professionals in the industry" as to the meaning of the word "value." However, no testimony was allowed on the meaning of the phrase "premiums or allowances" as section 110 of the NGPA, which allowed the gathering charge reimbursement, characterized the charge as an "allowance." Thus, in this instance, the court was able to locate a statutory definition. The sum and substance is that the courts, who do not deal with these concepts on a day-to-day basis, will not naturally adopt assumed industry definitions.

Even terms which are used that are commonplace and seemingly well-defined in the industry can be made subject to interpretation precisely because they are specialized industry terms. If the drafter is not careful to define terms and use them accordingly, an unintended meaning may be attached to the terminology even where the drafter assumes that the other contracting parties understand the terminology. For that reason, it is very important to use consistent terminology in all of the documents that both lead up to and more particularly, are employed in subsequent agreements, because conflicting definitions in earlier or later documents can be used to modify or define the rights and obligations of the agreement. Likewise, where appropriate the drafter should always take the trouble to fully define specialized industry terminology.

**B. Article II - "Exhibits"**

The "Exhibits" section of the joint operating agreement calls for supplementation of the main body of the agreement with those exhibits frequently attached to the agreement. Certain of the proposed attachments are commonly used and are significant. Those familiar with these agreements know that Exhibit "A" is in many ways more important than



Published by LSU Law Digital Commons, 1996

any provision in the body of the agreement. Exhibit "A" will define the lands and leases that are subject to the agreement, the percentage of ownership before and after payout of the participants, and other burdens that might exist against the leases covered by the agreement. In conjunction with Article III of the Joint Operating Agreement, Exhibit "A" will define the basis upon which expenses will be charged and revenues will be disbursed. Obviously, errors in Exhibit "A" could have drastic implications in the event that a third party was to rely upon the recorded agreement or an extract of the agreement.[1]

Exhibit "C" is styled "Accounting Procedure" and will generally contain the currently effective procedures developed by the Counsel of Petroleum Accountants Societies ("COPAS"), which will define how and when the charges to the joint account can be made as well as how and upon what basis credits will be given. Exhibit "E", Gas Balancing Agreement, is an optional attachment. There has been quite a bit if controversy throughout the industry about gas balancing in recent years (discussed briefly below). The gas balancing agreement is an optional attachment, but it is sufficiently important that the Louisiana Supreme Court has made reference to the fact that the one who does not enter into a gas balancing agreement either in connection with the joint operating agreement or otherwise does so at his or her own peril.[2]

**C. Article III - "Interest of the Parties"**

Article III, "Interest of the Parties", contains three sub-sections. Section III(A), "Oil and Gas Interests," deals with the situation in which one of the participants in the joint operating agreement also owns a fee interest. It determines how the fee interest will be treated. This Section is obviously of limited importance.

By contract, Section III(B) is almost universally important. It is an adjunct to Exhibit "A" of the joint operating agreement and it essentially establishes that the costs and liabilities incurred in operations under the operating agreement shall be borne, and all equipment and material shall be owned, as the parties' interests are set forth in Exhibit "A." Similarly, it states that all oil and gas production from the contract area shall be owned

1 LSA-R.S. 9:2731 *et seq.* provide that a joint operating agreement will be effective as to third parties and establish a procedure by which third parties may be bound by the recordation of a declaration in lieu of the filing of the entire agreement.

2 In its opinion denying relief to owners seeking cash balancing in lieu of in kind balancing, the Louisiana Supreme Court declared:

The owners could easily have entered into a gas balancing agreement or inserted a provision addressing the issue of imbalances in a joint operating agreement. The owners involved in the instant case failed to do so, despite the existence of case law and commentary which clearly demonstrates that owners not covered by a joint operating agreement or a gas balancing agreement proceed at their own peril.

*Hunt Oil Co. v. Batchelor*, 644 So.2d 191 at 204-5 (La. 1994).

by the parties as their interest is set forth in Exhibit "A." Section III(B) also has a provision indicating that no party to the operating agreement shall ever be responsible on a price basis to any other party's lessor or royalty owner for a price higher than the price received by that party. In other words, if the price for products sold under the operating agreement is below what is owed under the mineral lease, then the party who contributed the mineral lease to the joint operations shall bear the additional royalty. Finally, this section states that the method of jointly operating these mineral interests does not establish a cross-conveyance of the mineral leases covered by the agreement. Rather, the parties continue with their separate ownership rights and obligations. The net effect of this is that if there is going to be joint ownership of the leases under the agreement, that will occur by virtue of ancillary agreements such as farmouts, subleases, or assignments.

Section III(C) of the operating agreement simply establishes that if a party creates additional burdens against a lease that has been contributed to the joint operating agreement, that party shall bear the additional burdens. The other parties are not responsible for it. It further establishes that any subsequently created interests shall be subject to those operators and non-operators' liens, which are established in Article VII of the joint operating agreement. Obviously, this would only be effective to the extent that one has properly recorded the joint operating agreement or a memorandum of operating agreement, which would put third parties who receive the subsequently created interest on notice of the agreements, restrictions, obligations and lien provisions.

**D. Article IV - "Titles"**

Article IV deals with "Titles." Section IV(A) is the "Title examination" provision: "Title examination shall be made on the Drillsite of any proposed well prior to commencement of drilling operations and in the event the Drilling Parties so request or Operator so elects, title examination shall be made on the entire Drilling Unit, or maximum anticipated Drilling Unit, of the well." Title examination is therefore *mandatory* for the drillsite on any well, and it is *mandatory* on the entire unit where a party requests it. Inasmuch as this is a mandatory provision, in the event that the operator fails to obtain a title examination, and title proves defective, the failure to obtain a title examination could conceivably constitute gross negligence on the part of the operator under Article V and cause the operator to be liable for the loss of the interest that could have been corrected by title curative work. Additionally, this failure could constitute a violation of the agreement and might make the operator liable for breach of contract even if the loss were not deemed to be the result of gross negligence.

These mandatory provisions provide serious legal responsibility questions that have not yet been resolved by the courts. This paper will



Published by LSU Law Digital Commons, 1996

discuss below the problems courts have had in applying the gross negligence standard to the actions of the operator in particular contexts, and those discussions will apply to each situation in which the operator is given a mandatory directive such as this one. In the author's view, the Article V standard should be applied to all activities conducted under the operating agreement by the operator such that the court should be compelled to find a breach of the agreement, and then find it to be as a result gross negligence or willful misconduct before awarding damages, but this has not always been done.

Section IV(A) further states that: "No well shall be drilled on the Contract Area until after (1) the title to the Drillsite or Drilling Unit, if appropriate, has been examined as above provided, and (2) the title has been approved by the examining attorney or title has been accepted by all of the Drilling Parties in such well." Again, this is mandatory. An operator needs approved title opinions or waivers on the drillsite (and potentially the entire unit) *before* any well is drilled. This could present a serious problem if drilling operations are begun before the title opinion and curative work are complete.

Section IV(B) deals with "Loss or Failure of Title." It is fairly comprehensive and provides that each party bears the burden of loss of any lease contributed by that party. Section VII(E) of the operating agreement, which calls for the party who contributed the leases to pay rentals, dovetails with this provision, so that the contributing party will protect that party's own leases. Often the operator will undertake to cure title, maintain leases and pay royalties, thereby confusing the respective duties of the parties. Any loss of title caused by the operator would presumably place the parties proportionately at risk, subject to whatever rights might be available against the operator under Article V.[3]

3 In *Huggs, Inc. v. LPC Energy, Inc.*, 889 F.2d 649 (5th Cir. 1989), the Fifth Circuit, Judge John Duhe, applying Louisiana law, was faced with a situation in which LPC, an operator, failed to pay delay rentals and lost two leases and let two others within a unit expire because they ceased producing and lapsed without an attempt either to maintain them by further operations, delay rentals, or assignment to the other participants, who would then be in a position to maintain the leases. The court found that the leases lost because of the failure to pay delay rentals did not warrant compensation because the applicable agreements excused the operator from liability from mistake or oversight in connection with the payment of delay rentals. However, with respect to those leases lost because they were not maintained by drilling operations or delay rentals, and were not assigned, the court found that the operator had committed gross negligence, had violated the duty expected of a prudent operator and as respects a third party overriding royalty owner committed a tort. There is no mention of the fact that gross negligence was stipulated as a standard in this case nor does it appear that a funding of such was either necessary or outcome determinative. Such a finding would certainly not be justify under the definition of gross negligence established by the jurisprudence, *i.e.*, "the want of even slight care . . . the want of that diligence which even careless men are accustomed to exercise." *State v. Vinzant*, 7 So.2d 917, 200 La. 301 (La. 1942); *First Commonwealth Corp. v. Hibernia Nat. Bank of New*

Section IV(B) provides that in the event of loss of a lease there will be no retroactive adjustment development costs nor operating expenses nor of revenues. However, where the contributing party has paid up drilling costs in a producing well there will be a reimbursement of those costs from production. There are also provisions establishing that if a contributing party or anyone acting on behalf of a contributing party acquires a lease interest within ninety (90) days of loss, the acquisition is attributed to the initial contributing party. This again dovetails with Section E of VII of the operating agreement, which addresses the effect of the lost acreage on the contributing party or the joint account.

**E. Article V - "Designation and Responsibilities of Operator"**

Article V of the operating agreement is the article that establishes the rights and duties of the operator. Section A talks about designation and responsibility of the operator, requires that the parties name the operator, and states that the operator shall "conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement." It also provides that the operator shall be an independent contractor, that the operator will not be or hold itself out as "agent" of non-operators, and that the operator "shall not have the authority to bind" the non-operators "to any obligation or liability assumed or incurred by Operator as to any third party." It further states that the operator must conduct its activities in a reasonably prudent manner in accordance with good oilfield practice and in compliance with applicable law and regulation, but goes on to provide that *"in no event shall [the operator] have any liability as operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct."* Article III of the operating agreement provides that the costs and liabilities under the operating agreement will be shared by the parties in accordance with their percentages. Thus, "losses sustained" here would seem to include all costs and liabilities expended for the joint account and would thereby subject all of the joint account expenditures to the gross negligence/willful misconduct standard. Similarly, the reference to "liabilities incurred" would have the same effect with respect to third-party liability, whether it be in tort or contract, for so long as it relates to joint operations.

There is a spectrum of standards of care which, if applied properly, should provide the rules by which one's conduct will be judged. The least burdensome to the actor is gross negligence or willful misconduct which properly applied, are practically equivalent. Gross negligence is defined as "the want of even slight care and diligence, it is the want of that diligence

*Orleans*, 891 F. Supp. 290, amended 896 F. Supp. 634 (E.D. La. 1995) *aff'd*, 5 F. 3d 622 (5th Cir. 1996).



Published by LSU Law Digital Commons, 1996

which even careless people are accustomed to exercising."[4] Alternatively, it is defined as fault which proceeds from inexcusable neglect or ignorance by Louisiana Civil Code article 3506(13). Next is normal negligence which is conduct which falls below the standard established by law for the protection of others against an "unreasonable risk of harm."[5] Next would be a fiduciary duty, pursuant to which one owes the highest degree of care and cannot place one's own interest above that of the party to whom the duty is owed.[6] While one might anticipate that problems might occur around the edges of those standards, the courts have had the most trouble determining when to apply which standard, even in view of the stipulation stating that the operator will be liable only for those losses sustained by gross fault.[7] The appropriate standard for judging the operator's conduct -- gross negligence -- has sometimes been blurred as courts look to the relationship formed by the joint operating agreement.

**Fiduciary Duties and Third-Party Contractual Liability**

There has been quite a lot of litigation over the issue of whether the joint operating agreement confers partnership or joint venture status.[8] If the assignment asserted is a partnership or joint venture, the participants may owe each other heightened standards of conduct, *i.e.* fiduciary obligations. Louisiana Civil Code article 2801 defines partnership as follows:

Art. 2801. Partnership; definition.

> A partnership is a juridical person, distinct from its partners, created by a contract between two or more persons to combine their efforts or resources in determined proportions and to collaborate at mutual risk for their common profit or commercial benefit.
>
> Trustees and succession representatives, in their capacities as such, and unincorporated associations may be partners.

Louisiana Civil Code article 2809 provides:

4 State v. Vinzant, 7 So.2d 917, 200 La. 301 (La. 1942); First Commonwealth Corp. v. Hibernia Nat. Bank of New Orleans, 891 F. Supp. 290, amended 896 F. Supp. 634 (E.D. La. 1995) aff'd, 5 F. 3d 622 (5th Cir. 1996), Huggs, Inc. v. LPC Energy, Inc., 889 F.2d 649 (5th Cir. 1989).

5 Gross v. Exxon Corp., 885 F. Supp. 899 (M.D. La. 1994).

6 Grand Isle Campsites, Inc. v. Cheek, 262 La. 5, 262 So.2d 350 (1972).

7 Louisiana Civil Code article 2004 provides, in part, that: "any clause is null that, in advance, excludes or limits the liability of one party for intentional or gross fault that causes damage to the other party." This clause does not contradict the stipulation that limits liability for either slight fault or normal negligence, and this the limitation of liability for those losses caused by anything other than gross negligence or willful misconduct should be applied globally to those acts governed by the operating agreement.

8 Joint ventures are generally governed by the same rules as a partnership. Cajun Elec. Power Coop., Inc. v. McNamara, 452 So.2d 212 (La. App. 1st Cir. 1984). The difference is that the joint venture is generally for a limited duration or purpose. Riddle v. Simmons, 589 So.2d 89 (La. App. 2d Cir. 1991), cert. denied, 592 So.2d 1316 (1992).

Art. 2809. Fiduciary duty; activities prejudicial to the partnership.

A partner owes a fiduciary duty to the partnership and to his partners. He may not conduct any activity, for himself or on behalf of a third person, that is contrary to his fiduciary duty and is prejudicial to the partnership. If he does so, he must account to the partnership and to his partners for the resulting profits.

Louisiana Civil Code articles 2814-2816 read as follows:

Art. 2814. Partner as mandatary of the partnership.

A partner is a mandatary of the partnership for all matters in the ordinary course of its business other than the alienation, lease, or encumbrance of its immovables. A provision that a partner is not a mandatary does not affect third persons who in good faith transact business with the partner. Except as provided in the articles of partnership, any person authorized to execute a mortgage or security agreement on behalf of a partnership shall, for purposes of executory process, have authority to execute a confession of judgment in the act of mortgage or security agreement without execution of the articles of partnership by authentic act.

Art. 2815. Effect of loss stipulation on third persons.

A provision that a partner shall not participate in losses does not affect third persons.

Art. 2816. Contract by partner in his own name; effect on the partnership.

An obligation contracted for the partnership by a partner in his own name binds the partnership if the partnership benefits by the transaction or the transaction involves matters in the ordinary course of its business. If the partnership is so bound, it can enforce the contract in its own name.

As can be seen, the significance of the partnership or joint venture finding is that partners or joint venturers are fiduciaries who owe one another the highest degree of care in the transaction of the affairs of the entity. *Grand Isle Campsites, Inc. v. Cheek,* 262 La. 5, 262 So.2d 350 (1972). Inasmuch as the entity seems to fit the classical definition of a partnership, litigation has arisen involving both third party liability and the liability of the partners *inter se*. Historically, under the case law the courts looked at the nature of the venture and identified it as what it appeared to be, and in doing so, often ignored self-serving language in the document trying to negate the existence of a partnership. Joint operating agreements have typically contained language to the effect that they are not to be construed as creating partnerships or joint venturers. As demonstrated in the decisions discussed below, joint operating agreement participants are generally at arms' length, do not require special protection, and thus the courts will not be inclined to find those fiduciary duties generally arising



Published by LSU Law Digital Commons, 1996

from partnership or joint venturer status. In a Colorado case styled *Dime Box Petroleum Corp. v. Louisiana Land and Exploration Co.*, 717 F. Supp. 717 (D. Co. 1989); *aff'd* 938 F.2d 1144 (10th Cir. 1991), Dime Box, a non-operator, claimed that LL&E, the operator, owed a fiduciary duty and was liable because it obtained some purchasing advantages that it did not share with the venture. The court found that this was an area in which a fiduciary relationship could conceivably be imposed, but because the parties were both sophisticated and of equal bargaining rank, because the operating agreement had disavowed a joint undertaking, and because the parties had specifically stated that the measure of operator's liability would be "gross negligence or willful misconduct," the court found there was no joint venture and no fiduciary relationship.

In *Caddo Oil Co., Inc. v. O'Brien*, 908 F.2d 13 (5th Cir. 1990), O'Brien claimed that Caddo, as operator, owed a fiduciary duty and an accounting. The accounting obligation would effectively have shifted the burden from O'Brien to disprove the correctness of operating charges, to Caddo, who would have to account for and justify all charges. The court held:

> O'Brien is incorrect. Caddo was under no duty to provide O'Brien with an accounting. Rather, the onus was on O'Brien to conduct an audit if he believed one necessary. Under the terms of the Operating Agreement, the Operator is liable to the Owners only in cases of the Operator's willful misconduct. The terms of the Operating Agreement control, and Caddo's actions are to be judged by a prudent operator standard, not by that of a fiduciary.

*Id.* at 17. It seems clear that the operation of the agreement is such that the parties will act at arms' length, and the duty will be that set forth in the operating agreement, not the more stringent duty owed by a fiduciary.

The other aspect of a finding of partnership or joint venture status, is that such a finding would call for liability of the non-operators as partners or joint venturers for obligations contracted by the operator. In this area, the courts have been more inclined to ignore self-serving stipulations and analyze the venture based upon how it is structured rather than what the parties choose to call it.[9] Thus, in *Posey v. Fargo*, 187 La. 122, 174 So. 175 (La. 1937); *Duncan v. Gill*, 227 So.2d 376 (La. App. 4th Cir. 1969), *cert. denied*, 255 La. 338, 230 So.2d 834 and *cert. denied*, 397 U.S. 1074, 25 L. Ed. 2d 809 (1970); and *Young v. Reed*, 192 So. 780 (La. App. 2d Cir. 1939), the courts have held that joint oil and gas operations constituted a joint venture causing liability of all participants to third parties. It follows that an agreement to jointly operate leases could be construed as a joint venture or partnership under these principles of Louisiana law, creating joint liability to third persons in spite of the stipulation to the contrary

9 Cajun Elec. Power Coop., Inc. v. McNamara, 452 So.2d at 212.

contained in the operating agreement.

Fortunately, this problem has been obviated by the enactment of Mineral Code article 215, which provides:

> A written contract for the joint exploration, development, or operation of mineral rights does not create a partnership unless the contract expressly so provides.

There is no case law applying the article, but it obviously specifically addresses the joint operating agreement situation and negates the existence of a partnership (or joint venture), absent a specific declaration creating the partnership.

A related avenue for liability to third-parties would seem to be *via* mandate or apparent authority. The model joint operating agreement contains a specific disclaimer as to the ability of the operator to act as agent for the non-operators. However, Louisiana Civil Code article 2814 states that: "A provision that a partner is not a mandatary does not affect third persons who in good faith transact business with the partner." It would appear that the agreement, specifically denying the existence of agency, if properly recorded, would take care of both the mandate and apparent authority issues both by virtue of the provisions of Mineral Code article 215, negating partnership, and the "good faith" requirement of article 2814, because good faith could not be argued in view of the existence of a properly recorded joint operating agreement. The reason that these provisions are important is that in the event of insolvency of the operator, there will often be an attempt to hold the non-operators liable for the debts contracted by the operator. It would appear that absent an affirmative act on the part of the non-operator which would suggest responsibility, the non-operators should not be personally liable for those debts.

For the same reasons as it serves to protect against third party liabilities, Mineral Code article 215 should also prevent those fiduciary obligation claims between the participants that have arisen from time to time in Louisiana, which we discussed earlier and which have been successful in other states. See *e.g., TXO v. Hawkins Oil & Gas, Inc.,* 668 S.W.2d 16 (Ark. 1984).

**The Stipulated Gross-Negligence Standard**

At law, the naturally applying standard would be normal negligence, but the gross negligence stipulation, if effective, would change the standard. By implication, Louisiana Civil Code article 2004 allows such a change in the standard. That article provides: "Any clause is null that, in advance, excludes or limits the liability of one party for intentional or gross fault that causes damage to the other party." Article 2004 does not permit absolution from gross fault, but clearly permits the raising of the standard of liability to gross fault or intentional misconduct.

*Massey v. Decca Drilling Company, Inc.*, 647 So.2d 1196 (La. App. 2d

Cir.) *writ denied*, 653 So.2d 563 (1995), addresses the application of Article 2004. There, an operator hired an investors' drilling company to drill an earning well under a series of farmouts. Massey, the operator, did not like the progress of the drilling and stopped the well short of its intended depth, whereupon a disgruntled employee of the driller threw tools and junk down the hole. The well was cleaned up at a cost of $44,000 and produced about 9,500 barrels of oil, but liens were filed and the well was plugged. A jury found that the plaintiff had been damaged by the drilling company in the amount of nineteen million dollars; most of which was lost mineral production. In order to find that Decca was responsible, the court had to do two things. First, it had to negate the consequential damages provision of the drilling contract, and second, it had to find Decca responsible for the intentional act of its employee. The court did both. It found that Decca was vicariously liable for its employee's intentional tort and that the consequential damages limitation did not apply because of Article 2004.

The case is very troubling from the standpoint of controlling exposure to the joint account. What would be the result if an operator's employee destroyed equipment? Presumably, this would be one instance in which the operator would be responsible for those actions and liable to the non-operators. Outside of the context of this subject matter, the case is as troubling from the standpoint of proof of what had to be the most speculative of damages. It's inconceivable that a well produced 9,500 barrels of oil before being plugged could be shown to have, more likely than not, produced minerals valued at over sixteen million dollars to the farmoutee.

**Tort Immunity for Non-Operators**

In recent years, personal injury plaintiffs in oilfield cases have sometimes pursued the non-operating interests. These cases have generally failed. In those cases arising in the Outer Continental Shelf, courts have generally held that the joint operating interests constitute a "joint venture" for purposes of the Longshore and Harbor Worker's Compensation Act (the "LHWCA"), the compensation scheme that generally governs mineral operations on the Shelf, and have held that the non-operators, as "joint venturers," are immune under the LHWCA. See, *e.g., Heavin v. Mobil Oil Exploration and Producing Southeast, Inc.*, 913 F.2d 178 (5th Cir. 1990); *Davidson v. Enstar Corp.*, 860 F.2d 167 (5th Cir. 1988). The irony of the non-operators arguing that they were joint venturers for the purposes of the LHWCA, but could not be held liable as joint venturers otherwise, has been frequently challenged. However, the federal courts, as in *Heavin* and *Davidson,* have routinely held that despite a stipulation to the effect that no partnership or joint venture exists, and despite the dictates of LSA-R.S. 31:215, the substance of the relationship and dictates that the operating agreement creates a joint venture for the purposes of LHWCA. In non-Shelf cases, courts have immunized the non-operators under the Louisiana

worker's compensation law because those non-operators were considered "statutory employers." See, *e.g.*, *Rosskamp v. Phillips Petroleum Co.*, 992 F.2d 557, 558-59 (5th Cir. 1993). Recent legislative action may, however, have partially eroded the statutory employment defense under standard operating agreements.

In Act 315 of the 1997 session, the legislature limited the statutory employer defense somewhat. Under the revision, a defendant cannot take advantage of the "trade, business, or occupation" theory of statutory employment -- a theory typically relied upon by non-operators -- "unless there is a written contract between the principal and a contractor which is the employee's immediate employer or his statutory employer, which recognizes the principal as a statutory employer." In other words, to use the broadest form of the statutory employer defense, the joint operating agreement must recognize the non-operators as the statutory employer of the operator's employees. This may turn out to be a small problem, however, as the available tort theories against non-operators [*e.g.* strict liability] have also been limited in recent legislative actions. Nonetheless, it may be wise to include the "statutory employer" declaration in the operating agreement in order to protect non-operators against suits by the operator's employees.

**Withdrawal and Removal of Operator**

Section V(B) provides for the resignation or removal of Operator and selection of successor. It states that the operator can resign at any time by giving written notice to the non-operators, but it further provides that the resignation will not be effective for ninety (90) days. The significance of the timing of the withdrawal of an operator was underscored in the case of *Lancaster v. Petroleum Corp. of Delaware*, 491 So.2d 768 (La. App. 3d Cir. 1986). There, Petroleum was an operator of a well that blew out during drilling. Petroleum recommended the plugging and abandonment of the well, and as evidence of its conviction in its recommendation, resigned and threatened to plug the well that day unless another operator took over that day. Lancaster found another operator by agreeing to give the substitute operator a substantial portion of his back-in interest. The court found that Petroleum had breached the operating agreement by failing to honor the ninety (90) day notice of resignation provision[10] and awarded damages based upon the rights that were given up to the entice the new operator into taking over operations. This case seems to suggest that with a breach of the express provisions of an operating agreement, the gross negligence standard contained in Article V will not apply.

In addition to the provisions containing the procedure for voluntary

10 Arguably, the withdrawal would have been actionable even absent a specific ninety-day notice provision. *See Tabco Exploration, Inc. v. Tadlock Pipe & Equipment, Inc.*, 617 So.2d 606 (La. App. 3d Cir. 1993).



Published by LSU Law Digital Commons, 1996

withdrawal of an operator, Section V(B) also provides the procedure by which an operator may be removed by the other non-operators. This procedure requires (1) good cause; (2) an affirmative vote of the non-operators who own the majority interest remaining if the operator's interest is excluded; (3) delivery of notice of the vote and the written notice of any alleged default, and a period of time within which to cure the default, either thirty (30) days or forty-eight (48) hours depending on whether or not the default concerns operations then being conducted. The operator can then be removed by vote in the event of a failure to cure the default. "Good cause," as defined in the agreement, means gross negligence, willful misconduct, or a material breach of or an inability to meet the standards of good and workmanlike performance set forth in the agreement. Thus, while the mechanism for removal of an operator is available, it will be difficult to remove the operator. Assuming, as one must, that the operator will not agree that it has performed badly or has failed to cure any default in performance, there is no remedy available for removal of the operator outside of litigation. Even in the context of litigation, the existence of those required specific notices, non-compliance and proof of valid cause will constitute formidable obstacles to removing the operator.

In the event of the resignation or removal of an operator, Section V(B) establishes a procedure to determine how a successor operator will be selected. The successor operator shall be selected from the parties owning an interest at the time that the successor operator is selected. The operator "shall be selected by an affirmative vote of *two (2) or more parties owning a majority interest,* as shown in Exhibit A." In this vote, the operator is not entitled to vote for itself. This clause apparently does not provide a remedy in the event that less than two parties remain once the operator is excluded. However, that is apparently covered by the subsequent clause which provides that if the former operator does not vote or votes to reinstate itself, "the successor operator shall be selected by the affirmative vote of the party or parties owning a majority interest based on ownership as shown on Exhibit 'A' remaining after excluding the voting interest of the operator that was removed or resigned." So, if there are only two parties to an operating agreement, and one is operator, the remaining party (whether or not a majority interest owner) may vote to appoint itself operator. Similarly, with multiple parties, those parties may elect an operator even through they do not own an actual majority interest when the ownership interest of the operator is considered.

Section V(B) also addresses the rights and duties of the operators, how the operator is bound to obtain competitive rates, discharge expenses, protect from liens, and hold the money for the account of non-operators separate from its own. It also provides that the operator shall provide cost estimates for operations, shall keep the non-operators advised as to operations, and shall provide insurance for the joint account. These

provisions, while self-explanatory, are mandatory, and the failure of the operator to comply can make it liable to the non-operators for errors or non-performance. *See Forest Oil Corp. v. Superior Oil Co.*, 338 So.2d 758 (La. App. 4th Cir. 1976).

**Correlative Duties of the Participants**

Finally, *Estis v. Monte Carlo Exploration, Inc.*, 558 So.2d 341 (La. App. 3d Cir.), *cert. denied*, 563 So.2d 879 (1990), involved a case in which the Plaintiff lessor was awarded lease cancellation because the ninety (90) day drilling clause was not satisfied. The lessee sought to hold the operator liable. The standard applied by the court was that of a reasonable and prudent operator. It turns out that the lease expired because the Office of Conservation would not let the operator sell oil until certain operational improvements were done. The court found that because the operator was not provided sufficient funds from the non-operators to perform the services, the operator could not held responsible for the resulting loss. The sum and substance here is that the obligations are reciprocal between the operators and the non-operators.

**F. Article VI - "Drilling and Development"**

Article VI discusses the initial well under the agreement and the deadline for drilling. It establishes that the first well is mandatory, then attempts to cover all of the situations of subsequent operations after the initial well's completion, reworking, plugging back, other operations, or well abandonment. It also provides a procedure with respect to subsequent wells under which may choose to participate or may decline to participate in operations beyond the drilling of the initial well.

**Elections**

The protocol after the first well is drilled is that any of the parties will be allowed to propose additional operations, whether it be drilling, reworking, recompleting or plugging the well. Thereafter, the other participants are required to elect to participate or not to participate in the operation within a time frame established by the agreement, which is generally forty-eight (48) hours if a rig is on location, and thirty (30) days if not. The failure to respond will constitute an election not to participate. A notice shall be written and shall give the parties with an interest under the agreement details on the (1) work to be performed; (2) the location; (3) the proposed depth; (4) the objective horizon; and, (5) the estimated cost of the operation. This section states that non-consenting parties shall not have to pay for any part of the operation, but shall have no interest in the operation until certain percentages subject to selection by the participants to the agreement have been paid.

The election clauses raises the question of how detailed the proposal for subsequent operations must be and how stringent the courts will be about the process. In this context, a discussion of the case law is



Published by LSU Law Digital Commons, 1996

illustrative. What the cases generally reveal is that the courts will not honor form over substance, and that they will treat these procedures as strictly as the parties do. The first case is *J-O'B Operating Co. v. Newmont Oil Co.*, 560 So.2d 852 (La. App. 3d Cir.), *cert. denied,* 565 So.2d 449 (1990). The case involved what appeared to be an operating agreement with Area of Mutual Interest ("AMI") language that allowed the participants, by election, to share in leases acquired within the confines of the AMI upon paying a share of the costs. The agreement affected state lands under lease to Texaco. Newmont had apparently committed at least verbally to both the State Mineral Board and to Texaco that it would conduct seismic operations as partial consideration for the sublease from Texaco, and for the State's deferral of further development on the lease.

Under the operating agreement, the participants, including J-O'B, had the right to participate in any sublease upon agreement to pay acquisition costs within 15 days of receipt of notice of the acquisition and its cost. Newmont offered the sublease based upon reimbursement of seismic costs and other expenses. J-O'B agreed to pay all expenses, other than seismic costs, which were substantial. Newmont took the position thereafter that J-O'B had waived its right to participate and proceeded with its plans to drill on the farmout acreage. Apparently because of the view that J-O'B did not participate in the acreage, J-O'B was not offered an election to participate in the well.

Trial was held after the well was drilled, and the trial court held that J-O'B was entitled to participate in the well, but because the seismic work was a part of the acquisition cost, J-O'B had to pay its share. The court of appeal reversed, holding that the agreement did not allow an electing party "the right to contest the necessity for or the extent of any consideration paid by the acquirer for a lease . . . . Newmont had no obligation to structure the agreement so as to satisfy any AMI party, its only obligation being to offer participation on the terms finally agreed upon." *Id.* at 859. The court went further:

> Although unnecessary to our decision, we consider that an obvious inequity would result were we to decide otherwise. As a result of the equivocal responses from appellees . . . Newmont, together with the AMI parties who agreed to bear the acquisition cost . . . shouldered the entire burden . . . Appellees who bore neither the expense nor the risk of the venture now seek to participate in the proceeds from a highly successful well.

*Id.* at 860. The court was holding the parties to the letter of the agreement because of its perception of the risk/reward balance that drives the oil industry, and would not allow an equivocal election to constitute a retroactive acceptance after a successful well had been drilled.

The decision in *Crescent Drilling and Development, Inc. v. Sealexco, Inc.*, 570 So.2d 151 (La. App. 3d Cir. 1990), *cert. denied,* 575 So.2d 373

(1991), also illustrates the courts' treatment of election provisions. The case involved, among other things, a claim that one of the non-operators had forfeited a mineral interest because it failed to tender a share of drilling costs. The court made the following observation about how the operator, Sealexco, managed the joint account:

> [T]he record reflects that matters between Sealexco and its operating partners . . . were handled very loosely . . . . Further the record reflects that Sealexco, as a matter of practice, allowed its participants to make elections late, they were allowed to pay prospect fees and other obligations untimely, and were never penalized . . . . Ben Seale's obligation for his share of the cost of the . . . well, although perhaps tendered untimely, was accepted by Sealexco, utilized and never returned.

*Id.* at 155. The obvious implication is that if the provisions of an agreement are not *followed* strictly, they will not be *applied* strictly by the courts.

The decision in *Acadienergy, Inc. v. McCord Exploration Company*, 596 So.2d 1334 (La. App. 3d Cir. 1992), stands in contrast. There the parties entered into a drilling agreement and an ancillary operating agreement. Those agreements applied only to acreage unitized around the initial well drilled under the agreements. After an initial well was drilled by the operator, Acadienergy, a non-operator, Westover, proposed an additional well. Acadienergy responded that it did not like the location and would not participate. McCord then began corresponding with Westover about revising the well location. They apparently reached agreement and advised Acadienergy of the fact that they had "refined" the bottom hole location. Acadienergy requested detail on the "refinement," but the detail was never provided. In deciding that Acadienergy had not been given a proper election, and thus did not forfeit its rights to participate in the well which was already producing, the court noted the following requirements of a notice of a proposed operation: "As indicated by the terms of the Operating Agreement, there are five facts of which a party must be given written notice. These facts are the work to be performed, the location, the proposed depth, the objective formation, and the estimated cost of operation." *Id.* at 1342. Westover argued substantial compliance with these requirements, but the court of appeal found that because of the "refinement" of the bottom hole location and the refusal of Westover and McCord to provide information on it, the election provisions of the operating agreement were not complied with. Thus, Acadienergy was allowed to participate in the well.

This result is a bit more harsh and less in keeping with the *J-O'B Operating* decision's deference to the risk/reward equities, which would require an affirmative indication of participation in the risk of the well prior to drilling. Perhaps the distinction is that the court was not convinced that Acadienergy was a potentially willing participant who was not given a fair

opportunity to participate, whereas *J-O'B* had been more direct in its refusal to agree to bear the necessary expenses to participate in the venture.

**Spacing**

Section VI(B)(7) of the AAPL Form 610-1989 provides that "no well shall be proposed to be drilled or Completed from a Zone in which a well located elsewhere on a Contract Area is producing, unless such well conforms to the then existing spacing pattern for such Zone." This is apparently a provision which is causing great controversy, as it would appear to prevent an alternate unit well and would prevent application of the consent provisions and non-consent penalties under the agreement. However, the designation by the Office of Conservation of the well as an alternate unit well may obviate this problem.

**Marketing Obligations**

Generally, the operator is under no obligation to take production and sell it for the account of the non-operator, but many times does. Several cases have addressed both the marketing obligation and gas balancing in the absence of an agreement. In the area of marketing obligations, courts are willing to honor the terms of the operating agreements insofar as the agreement might superimpose an obligation that protects the operator from more stringent liability standards. But the courts, however, are not consistent on the application of those liability standards.

*Grace-Cajun Oil Co. No. Two v. Damson Oil Corp.*, 897 F.2d 1364 (5th Cir. 1990), involved a situation in which Damson acted as operator in marketing its own and Grace Cajun's gas. The operating agreement provided that Damson had "no liability as Operator to the other parties for losses sustained, or liabilities incurred, except such as may result from gross negligence or from breach of the provisions of this agreement." *Id.* at 1366. Damson sold the gas to Louisiana Intrastate Gas Corporation ("LIG") at a NGPA § 102 price, which it was not entitled to absent the filing and approval of a well status application with the Louisiana Department of Natural Resources. Because the well status application was not filed, LIG recouped the difference between the § 103 price which it paid and the § 109 price that Damson was entitled to in the absence of the application. Grace-Cajun ultimately sued Damson for its loss. The court did not find gross negligence or a breach of the operating agreement, saying: "It is not necessary to resolve whether the district court applied an improper standard to its determination of Damson's liability under the operating agreement. The gas purchase contract clearly defines Damson's duty." *Id.* at 1367. The court was not impressed with Damson's argument that Grace-Cajun was not a party to the gas sales agreement with LIG, and found Damson liable for the difference between what was collected and what Grace-Cajun could have ultimately received had Damson filed for and obtained a well status determination.

The court's initial premise here was that under the operating agreement, Grace Cajun had the right either to market its own gas or to allow Damson, as operator, to market it. Clearly, this was production contemplated by the operating agreement and was a central part of that agreement. It is unfathomable that the court could not conclude that the gas here was produced and sold subject to the rights, grants and conditions of that agreement, and for that reason the court's refusal to analyze the decision under the standards set forth in the operating agreement is incorrect.

In *LL&E v. Unocal*, 1997 WL 756597 (E.D. La.), LL&E had two separate relationships with Unocal. At Lake Pagie, LL&E had granted several mineral leases to Unocal. After demand, LL&E sued Unocal to collect for underpayments of royalties as a result of improper pricing of liquids, non-payment for reimbursed gathering charges and improper gas pricing because of certain settlements which Unocal had entered into which reduced the pricing Unocal had received for gas. Unocal counterclaimed for sums which it had paid to settle an oil pricing claim by the Department of Energy affecting the Caillou Island Oil Field. Unlike Lake Pagie, at Caillou Island, Unocal and LL&E were co-working interest owners of several state leases. The case is interesting and unique because it relates to a lessee/operator's marketing obligations under two different scenarios -- one involving a mineral lease and the other an operating agreement.

With regard to the lease issue, the Court found as had been held in *Frey v. Amoco*, 603 So.2d 166 (La. 1992), that despite the lessee's duty to market, the lessee, Unocal, was prudent to renegotiate the gas sales contract during the gas sales crisis. The court made specific reference to the duty set forth in the mineral code, *i.e.* the prudent operator standard under Mineral Code article 122.

With respect to the joint operating agreement, the court found that the rights and obligations governing the actions of the parties were contained in the two operating agreements at issue, which were identical. The operating agreements provided that Unocal had "exclusive control" over operations on the state leases. The agreements further provided that the operator was "free to exercise its own best judgment in conducting the operations." Under those agreements Unocal was to market production in the event that LL&E failed to do so and would be in full control of those operations. The issue was whether Unocal should have unitized certain wells in order to ensure higher pricing under Department of Energy rules in order to establish that the production could be classified as "new oil" under the regulations providing higher price incentives for such new oil.

Despite the differing standards in the *Grace-Cajun* operating agreement (gross negligence or breach of agreement versus best judgment), the court found that "Unocal took on the same responsibilities as the operator in *Grace* and that the unitizing of the properties in question was



Published by LSU Law Digital Commons, 1996

Unocal's responsibility." *LL&E v. Unocal*, 1997 WL 756597 (E.D. La.) at 7. The court also found that Unocal chose to ignore the advice on whether to unitize because of concerns that the formation of units would provoke development demands resulting in the release of non-unitized acreage back to the State, as lessor. The court found that because Unocal was negligent in not unitizing the properties, it could not collect reimbursement against LL&E. Stated another way, the court apparently applied a negligence standard and ignored the "best judgment" standard written into the agreement.

**Well Costs**

The next area of discussion relates to operating agreement responsibilities only indirectly in that it deals with cost adjustments in the event that operations involving those leases subject to the provisions of the operating agreement are unitized with those not subject to any agreement. With regard to drilling wells not subject to reimbursement provisions of a joint operating agreement, problems generally arise when an operator drills a well into a unitized horizon or into one that is subsequently unitized and includes acreage not under lease to the joint interests. In those situations different rules apply depending upon whether or not the acreage is under lease to a third party or not subject to a mineral lease. LSA-R.S. 30:10. The "Risk Fee Bill" provides a mechanism by which the operator, on behalf of the joint account, can recover those costs incurred in the "drilling, testing, completing, equipping, and operating the unit well." The owner/driller can recover those expenses out of the non-participating owners share of production, as well as a charge for supervision, plus an additional "risk charge" of one hundred percent of the drilling and completion costs.

There is a procedure developed to enable the operator to collect the risk charge. It requires notice, *via* certified mail, to others in the unit of the estimated cost of the well, its location, its proposed depth and logs and other non-public test data. The recipient of this information is then entitled to elect to participate that is, the recipient can agree to pay a share of the drilling cost. In the event that this information is not forwarded in accordance with the statute, the "risk charge" is unavailable. Similarly, in the event that the tract is not subject to a lease, the risk charge is similarly unavailable, but well costs are properly chargeable, subject to compliance with the dictates of LSA-R.S. 103.2 requiring a detailed itemized statement of the cost of drilling, upon request by registered mail and the passage of ninety days from the formation of the unit. [11]

---

11 The statute is viewed as punitive and therefore subject to strict construction. On this basis, it was held in *Browning v. Exxon*, 848 F. Supp. 1241 (M.D. La. 1994) that because the statute required certified mail, a notice by registered mail would not suffice. Thus, while the statute's 15 day response period is stringent, the court's application of it's punitive provisions is properly lenient.

The risk fee bill envisions a situation where one is drilling an undrilled unit or is drilling a substitute unit well, and thus knows the unit configuration and can ascertain the property ownership and leasehold situation, and can notify the non-participants. In those occasions in which the unit is not yet formed at the time that the well is drilled, and is not formed until after some production has accrued, an adjustment of well costs will be required. In that case, the non-participating owner is given the same election, with the same results, except that the chargeable costs are "reduced in the same proportion as the recoverable reserves in the unitized pool have been recovered by production." This same rule applies to units which are revised to include extra acreage not under lease to the operator, and the reverse applies, that is, credits are given to acreage that is excluded from a unit *via* a revision of the unit. The method applied effects a change in the law with respect to the method of achieving such an adjustment. *Desormeaux v. Inexco Oil Co.*, 298 So.2d 897 (La. App. 3d Cir.), *writ refused*, 302 So.2d 37 (La. 1974), mandated a dollar for dollar method of reduction of well costs. This method was applied recently in the case of *Tex Con Oil and Gas Co. v. Batchelor*, 634 So.2d 902 (La. App. 1st Cir. 1993), *cert. denied*, 635 So.2d 1102 (1994). The "new" method added by Act No. 595 of 1991, has been called the "unit of production depreciated well cost method." *Id.* at 907. The former method provided a direct credit for revenues received for production, while the currently applicable method requires that the cost of the well be reduced in accordance with its loss of utility, so as to make the reduction commensurate with the lost value, and the costs due and owning relate to the future utility and value of the well. This statute explicitly does not apply to those situations in which written agreements deal with the same subject matter *i.e.,* operating agreements.

In *Acadienergy, Inc. v. McCord Exploration Co., supra,* the drilling agreement was accompanied by an operating agreement, which provided for a set percentage contribution of well costs, subject to a well cost adjustment based upon voluntary or compulsory unitization affecting the initial well. The well was included in a Commissioner's unit, which was revised twice. The question was whether there would be subsequent adjustment upon unit revisions. The court found that the portion of the agreement providing for well cost adjustments was ambiguous, and construed it against the drafting party, Acadienergy. Further, the court found that, equitably, the parties' revenue interest did not increase with the unit revision, and therefore, neither should its well cost liability, and thus denied the request for an adjustment.

**Allocation of Production and Balancing**

With regard to production attributable to those within the unit who do not have an agreement with the operator, the applicable law varies depending upon whether the tract is leased or unleased. Unleased interest owners are entitled to a share of the proceeds from production attributable

to the tract's interest in production, for which the operator is liable. LSA-R.S. 30:10(A)(3). The working interest owner under a mineral lease is entitled to receive production. In the event that the working interest owner does not take production as it is produced, it is now resolved that "in-kind" balancing is the norm. *Hunt Oil Co. v. Batchelor*, 644 So.2d 191 (La. 1994). In the event that the well depletes before in-kind balancing can be done, a cash accounting by the operator is in order. The operator would then be forced to collect the overpayments to the non-operator caused by the imbalance. *King v. Strohe*, 673 So.2d 1329 (La. App. 3d Cir. 1996) suggests that these collection efforts could be governed by the doctrine of payment of a thing not owed, to the extent that no provision specifically permits collection from overbalanced parties after depletion.

An under-produced party who has entered into a joint operating agreement which allows but does not require them to take production in-kind, but have not entered into a gas balancing agreement would, according to the Louisiana Second Circuit Court of Appeal, be entitled to a cash balancing upon depletion. *Ellwood Oil Co. v. Anderson*, 655 So.2d 694 (La. App. 2d Cir.), *writ denied*, 661 So.2d 466 (1995). However, in *Amoco Production Co. v. Fina Oil & Chemical Co.*, 670 So.2d 502 (La. App. 1st Cir.) *writ denied*, 673 So.2d 1037 (1996), the First Circuit held that in the event that the parties had addressed balancing, but did not provide a method of correcting imbalances upon depletion, there would be no cash balancing. The 1989 AAPL form contains language similar to that employed in the *Ellwood* case and would presumably call for the same result.

**G. Article VII - "Liability of Parties"**

Article VII discusses liabilities of the parties and what happens in the event of default by parties. This section establishes that the liabilities shall be several and not joint or collective and then it restates the notion that "each party shall be responsible only for its obligations, and shall be liable only for its proportionate share of the costs of developing and operating the Contract Area." It goes on to say:

> [N]o party shall have any liability to third parties hereunder to satisfy the default of any other party in the payment of any expense or obligation hereunder. It is not the intention of the parties to create, nor shall this agreement be construed as creating, a mining or other partnership, joint venture, agency relationship or association, or to render the parties liable as partners, co-venturers, or principals.

It also conveys that the parties are not fiduciaries with one another and thus are free to act in their own self interest "subject, however, to the obligations of the parties to act in good faith in their dealings with each other with respect to activities hereunder."

**Mutual Liens**

Section VII(B) is important in that it is the section which iterates the

liens and security interests purportedly granted by the operating agreement. In these days of constant reorganization and commitment to ever-changing strategic objectives by the larger companies, parties are called upon to deal with total strangers under operating agreements created by other parties. It is not unusual for a company to find itself at odds with another company not only in areas of operational philosophy, which creates problems in other areas, but also in the area of financial responsibility. If the operator has financial problems, the non-operators may face agency and partnership claims (previously discussed) as well as lien claims by creditors. As between the parties, the operators and non-operators liens have become important.

We begin this area with the premise that liens may not be created by agreement between debtor and creditor unless there is a statute declaring that such a contract shall create a lien. *Blasingame v. Anderson*, 108 So.2d 105, 236 La. 505 (La. 1959). Nevertheless, in *Kenmore Oil Co. v. Delacroix*, 316 So.2d 468 (La. App. 1st Cir. 1975), the court recognized an operator's lien, noting that one was provided for in an operating agreement, but not otherwise defining the source. Since that time, operator's liens have become commonplace, with little analysis regarding their source. There have been various suggestions that the operator's lien was created by subrogation, because the operator paid the bills of the suppliers on behalf of the non-operator, which supplier was entitled to his own lien, or that it was granted by a broad reading of this statute. See *Compadres, Inc. v. Johnson Oil and Gas Corp.*, 547 So.2d 382 (La. App. 3d Cir. 1989).

Those familiar with the various forms of operating agreements are aware that the form has always provided for an operator's lien, and many of the more modern forms grant a lien to the non-operator. It does not appear that *any* of the arguments advanced in favor of the operator's lien could even arguably support the non-operator's lien, as it could neither be supported by the legal subrogation theory nor the "broad language" of the old lien act.

Fortunately, this problem was rectified by the passage of Act 1040 in the 1997 Regular Session of the legislature, which established privileges in favor of both the operator and the non-operator. These statutory cross-liens are contained in LSA-R.S. 9:4881 *et seq.* Neither lien is dependent upon the existence of an agreement. This is established by the fact that 4881(2) defines a non-operator as "a lessee other than the operator," and 4881(3) defines the operator as "a lessee who is conducting operations with respect to a well." The fact that these *in rem* obligations are statute-based and not dependent upon any agreement raises issues relating to well costs, marketing and balancing.

The operator, under 4882(A) is granted a privilege "to secure payment of *all* obligations incurred in the conduct of operations which the non-operator is *personally* bound to pay or reimburse." [Emphasis added.] In



Published by LSU Law Digital Commons, 1996

contrast, pursuant to 4882(B), the non-operator is given a privilege "to secure payment of all obligations owed to him by the operator from the sale or other disposition of hydrocarbons of the non-operator produced from the well." Thus, the operator obtains a lien covering all personal obligations, while the non-operator's lien only secures payments for production.

Although, arguably, the claim for collection of the well costs is quasi-contractual,[12] presumably non-operators who do not provoke unitization are not "personally bound" to reimburse well and operating costs. [13] Thus, to the extent that the non-operator, without an agreement, is not personally bound, the operator does not obtain a lien on production. However, because the operator is allowed a direct recoupment from production, the lien may not be essential for collection of drilling or operating costs.

The non-operator's reciprocal lien pertains to amounts "owed" to the non-operator from sale of hydrocarbons. At first glance, this provision would seem to strengthen the position of the non-operator in a unit who has no agreement with the operator. However, a closer look reveals that, because the non-operator is not due anything but an in-kind balancing, and the act only covers obligations owed, the lien is not granted in an under-balanced situation. After depletion, the non-operator is entitled to a cash balancing, and LSA-R.S. 9:4883(6) gives the non-operator a lien on the proceeds received by, and obligations owed to the operator. This remedy would seem to prove somewhat thin given the narrow time frame that the "obligations owed" might exist, and the difficulty in tracking the liened "proceeds." The result that the lien is not as significant, ultimately, as the personal claim for a cash balancing. These issues point up to the fact that these reciprocal liens are best suited for application in connection with an operating agreement that establishes the "personal obligations," which give rise to the privilege.

The lien granted by Section VII(B) of the operating agreement is similar to the statutory lien in that it is on the mineral leases, other interests, and personal property. Unlike the statutory lien, however, this privilege does not appear to be limited to operations in connection with any particular well, whereas the statutory lien has historically and is currently based upon operations on a particular well. It also appears to cover royalty and overriding royalty interests, which are excluded under the statutory lien. As a practical matter, however, one might question the wisdom of seizing royalty proceeds and placing the lease in jeopardy.

---

12 The right to collect is based upon LSA-R.S. 30:10 and arguably constitute a "personal" obligation, similar to the operators quasi-contractual obligation to account to unleased owners. See *Taylor v. Woodpecker Corp.*, 633 So.2d 1308, 1312-3 (La. App. 1st Cir. 1994).

13 The non-operating working interest owner is "personally" liable only in the event that he would "ratify and consent" to the drilling operations per *Superior Oil Co. v. Humble Oil & Refining Co.*, 165 So.2d 905 (La. App. 4th Cir.), *cert. denied*, 246 La. 842, 167 So 2d 668 (1964); *Davis Oil Co. v. Steamboat Petroleum Corp.*, 583 So.2d 1139 (1991).

Third-party mortgagees of the interest owners may claim priority over the liens in the operating agreement. The lender will claim priority either because of the public records doctrine or because of the express ranking provisions of LSA-R.S. 9:4888. A recent decision from the Sixth Circuit, construing Louisiana law, addressed these issues. See *In Re Century Offshore Management Corp.*, 119 F.3d 409 (6th Cir. 1997). In that case, the lending agreement was made "subject to" the operating agreement. The court strongly suggested that the mortgage would otherwise have primed the operating agreement's liens. But by making the mortgage "subject to" the operating agreement, the lender subordinated its security interest to those created by the operating agreement, even though the operating agreement was unrecorded. The result is the same without reliance upon the "subject to" language. The Fifth Circuit has held that a bank's otherwise superior mortgage interest and pledge of production must bear drilling costs attributable to the mortgagor, because the non-operator's interest was so limited. *Grace Cajun Oil Co. No. 3 v. Federal Deposit Ins. Corp.*, 882 F.2d 1008 (5th Cir. 1989). The court's unstated logic, to the effect that the mortgagee's right to receive production proceeds is limited by what the mortgagor was entitled to, seems both equitable and rational.

**Other Non-Performance Remedies**

The operator does have the ability to demand advanced payment for the next month's expenses from the non-operators in anticipation of operations under Section VII(C). Thus, the operator does not have to fund operations for the benefit of the non-operators. This call for an advance would create an "obligation" under the liens clause, or an obligation incurred under the lien act and could allow an operator's lien to secure payment, but the timing is so tight as to make it impractical.

Next, Section VII(D), "Defaults and Remedies," provides remedies in the event that one of the parties is in default of its obligations of the agreement. One option afforded the operator is the ability to call upon the other parties to make up that defaulting party's share, thus reducing the burden upon the operator. There is a subsection which provides that any party to the agreement can deliver to a party in default a notice of default and specify the actions required to cure the default. If not cured within thirty days, then "all of the rights of the defaulting party granting by this agreement may upon notice be suspended until default is cured." If the operator is the defaulting party then the operator who does not cure a default can be removed by a vote of the non-operators owning a majority interest.

The rights suspended for the defaulting party include the right to receive information and to participate in operations, even those operations in which they are currently participating. The suspended rights also include the right to receive proceeds for production. *Pittencrieff Resources, Inc. v. Firstland Offshore Exploration Co.*, 942 F. Supp. 271 (E.D. La. 1996) is a case dealing with an offshore platform and purportedly applying Alabama



Published by LSU Law Digital Commons, 1996

law, although it is readily apparent that the choice of law selection was not outcome determinative. The result would have been the same under Louisiana law. The case involved an offshore exploration agreement which was not on a "standard" form, although its provisions, and the problems created, are not atypical. The operating agreement provided at Section 9.1 that no well that had once produced could be abandoned without the consent of all parties owning an interest in the platform. Section VI(E)(2) of the AAPL Model Form 610-1989 has a similar provision. The agreements also have similar provisions regarding reimbursement for the abandonment costs net of salvage value. The issue presented revolved around the fact that Firstland had an desire to take over the platform and operate it, while Unocal and others wanted it abandoned. The operating agreement did allow any non-operator an election to take over the platform, in the event that abandonment was proposed. The concern, unexpressed in the opinion, was about Firstland's ability to conduct operations in such a manner as to not expose Unocal and other owners to additional exposure as a result of those operations, because Unocal could retain potential liability as a result of Firstland's continued operations both to the MMS, as a former lease owner and operator, and to third parties, under some theory of pre-transfer negligence. Section VI(E)(2) of the standard form contains language to the effect that the party taking over operations shall indemnify the former owners, but, as is evident, an indemnity is only as strong as the party providing it. It further provides that the party taking over operations shall prove their ability to "conduct operations" on the well, but again, the ability to "conduct operations" may not provide sufficient relief, in that it arguably did not require the demonstration of an ability to stand the type of losses that can arise due to unforeseen environmental or other catastrophes which might occur in oilfield operations.

Faced with the prospect of giving up its interest in a platform and wells and possibly retaining exposure, Unocal and several non-operators took the position that since no non-operator was current on its bills, no non-operator was entitled to participate in operations or vote. Inasmuch as the exercising the option to take over the platform and wells required an "election," the question became whether a party which could not vote, could nevertheless exercise an election to take over the platform. The court equated electing with voting and held that a party in default could not elect to take over the platform and wells. The court was initially concerned about the fact that the loss of voting rights would affect an unintended forfeiture of the parties' interest in the property. Ultimately, court concluded that the provisions preventing voting by a defaulted party were intended to limit rights, even if the effect was a forfeiture of property.

It would appear that the limitations on the rights of a party in default in *Pittencrieff* are similar to the restrictions contained in VIII(D)(1), that is, a party in default cannot receive information, cannot participate in Section

VI(B) operations, or in the right to receive proceeds. There is no limitation expressed as to voting on procedures other than those under Section VI(B), so it is an open question whether the standard form would allow a party in default to take over operations of a well after an abandonment proposal. In any event, one would hope that the Section VI(E) language concerning the ability of the defaulting party to "conduct operations" would provide sufficient protection.

Section VII(D) also contains an interesting provision that states that the non-defaulting parties can sue the defaulting parties or operator may sue a joint account expense to collect amounts due, and then provides "[n]othing herein shall prevent any party from suing any defaulting party to collect consequential damages accruing to such party as a result of the default." Part 3 provides that the non-defaulting parties can eliminate the ability of a defaulting party to consent to any future operations. This cures the problem that had existed in the past under certain operating agreements in which a party might be in default, but might contractually consent to operations and take the chance of being bailed out by a good well. This basically hampered the ability of the joint account to continue operating. Section VII(E) refers to payment of rentals and as discussed earlier, those rentals and these obligations are taken care of by the party who contributes the leases although the operator is bound to notify these parties when a rental might be due or shut-in type rental might be due. In the event the operator does not do that, the loss is shared by the joint account rather than borne by the contributing party.

**H. Article VIII - "Acquisition Maintenance or Transfer of Interest"**

Section A of Article VIII, entitled "Surrender of Leases," provides that: "the leases covered by this agreement, insofar as they embrace acreage in the contract area, shall not be surrendered in whole or in part unless all parties consent thereto." This section then goes on to establish a procedure of thirty (30) days notice by which parties notify another party of the potential surrender of leases. When the parties want to surrender, they must notify other parties, who have an opportunity to pick up those leases. This section also addresses assignment of the obligations under the leases and also an assignment of equipment and production. Under the agreement, the assigning party shall be relieved of further obligations, and the assignee shall pay the reasonable salvage value of the assignor's interest. Of course, the payment provisions are governed by the accounting procedures that establishes values. Part B governs renewals and extensions and how they will be owned.

**I. Articles IX-XVI**

The remainder of the operating agreement contains Article IX, "Internal Revenue Code Election." This section enables parties to create partnership for income tax purposes. Article X talks about how claims and lawsuits will be handled and gives the operator authority to settle disputes



Published by LSU Law Digital Commons, 1996

up to a specified amount. It provides that the parties shall share an expense of any claims. Article XI, "Force Majeure," provides what happens if parties are prevented from operating for any unavoidable reason. Article XII deals with notices. Article XIII provides for the term of the agreement. Article XIV talks about laws, regulations, what laws will govern, and allows the parties to select the governing law. Article XV contains miscellaneous provisions, including how the agreement will be executed and its effect on successors and assigns. Article XVI is "Other Provisions" and allows the parties to create special conditions and provisions.

**J. Restrictions on Transfer**

Joint operating agreements commonly restrict transfer of interests covered by the agreement, typically through a preferential rights provision. Yet under a recent decision, *Fina Oil and Chemical Co. v. Amoco Prod. Co.*, 673 So.2d 668 (La. App. 1st Cir. 1996), *cert. denied,* 679 So.2d 1353 (1996), it may be possible, intentionally or otherwise, to circumvent these provisions.

In this case, Amoco spun off a number of lease interests to MW, a newly formed and wholly owned subsidiary, as part of a reorganization. Amoco then sold all the stock of MW to Apache. Fina, a working interest owner in the three joint operating agreements involved, took exception, and sued Amoco. Fina contended that Amoco's action triggered the preferential right to purchase provisions. The court disagreed. It found that the transfer from Amoco to MW was part of a legitimate reorganization. Under standard agreements, where restrictions on transfer do exist, a transfer by "merger, reorganization, consolidation" is exempt from the preferential rights provisions. As for the sale of stock by Amoco to Apache, the court found no restriction in stock transfers in the joint operating agreement. Accordingly, in effect, Amoco was allowed to transfer all of its interest in the joint operating agreement to another, unrelated party without triggering the preferential rights provisions.

**K. Prescription**

Arguably, because billings are rendered periodically on a revolving basis, the charges due under the operating agreement will be governed by the three year prescriptive period governing open accounts. However, that is not the case according to the jurisprudence, which holds that the ten (10) year period governing general contracts is applicable. *Caddo v. O'Brien*, 908 F.2d 13 (5th Cir. 1990).

## III. Conclusion

There is currently quite a bit more litigation over operating agreements and co-ownership issues than has historically existed. This trend is likely to continue given the lack of cohesiveness in the industry. The case law has indicated that an attempt will be made to honor the language and intent of those operating agreements, and actually encourages such agreements,

particularly to resolve theory issues like production allocation. Although the results of the court's decisions on these agreements are not always easy to reconcile, the courts will attempt to follow the intent of the parties to an agreement, and thus it behooves parties to enter into agreements fully defining rights and obligations, where possible.

ꙮꙮꙮꙮ - ꙮꙮꙮꙮ