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Recommended Citation

John Lowe, "Some Recurring Issues in Operating Agreements and What AAPL's Drafting Committee Might Do About Them," 60 Proceedings of the Rocky Mountain Mineral L. Annual Inst. (2014)

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Chapter 27

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

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§ 27.01 Introduction* **

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

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

Furthermore, there are other important reasons for operating agreements, including limited liability and taxation. No investor wants to be jointly and severally liable for the torts and contracts of other co-investors. Structuring a venture as a corporation brings limited liability but subjects it to double taxation and may limit its ability to take advantage of tax

*Cite as John S. Lowe, “Some Recurring Issues in Operating Agreements and What AAPL’s Drafting Committee Might Do About Them,” 60 *Rocky Mt. Min. L. Inst.* 27-1 (2014).

**I gratefully acknowledge the assistance of Richard Booth; Tim Dowd; John Grace; Lynn Hendrix; Douglas Mills; Professor David Percy; my research assistant, Daniel C. Lunsford; my former students Ryan Johnson, James Murphy, Patrick Murphy, Randy Parcel, and R.J. Pathroff for their research and analysis, as well as Donna Gaubert, my SMU administrative assistant; and Margo MacDonnell and the Foundation staff for their editorial assistance. The opinions I express are my own, and do not reflect the opinions of Southern Methodist University, SMU’s Dedman School of Law, or the Hutchison Endowment.

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

losses.² Partnerships are ideal entities for oil and gas development for tax purposes since profits and losses flow through to the partners. But partners have fiduciary obligations to one another, and from a liability viewpoint, partnership is a disaster because partners are jointly and severally liable.³ Additionally, partnership interests are difficult to convey and relatively unmarketable.

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

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

²See Charles O. Galvin, “The ‘Ought’ and ‘Is’ of Oil-and-Gas Taxation,” 73 *Harv. L. Rev.* 1441, 1495-96 (1960).

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

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

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

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

Operating agreements are ubiquitous in the American oil and gas industry. There are nearly one million producing wells in the United States,⁷ most of which are subject to at least one operating agreement. Historically, oil companies developed their own operating agreement forms, which they then exchanged and negotiated over—sometimes not reaching agreement before the property in question stopped producing.⁸ The inherent inefficiency of reinventing the wheel for every drilling venture led to the development of the first American Association of Professional Landmen (AAPL) Form 610 Model Form Operating Agreement in 1956 (AAPL Form 610-1956).⁹ Revised forms followed in 1977, 1982, and 1989.¹⁰ The AAPL model forms have become the standard in the United States, and will be the focus of this chapter.

Interest owners may use a model form as their governing contract or, less frequently, as a tool to start the negotiating process to draft their own

⁷In 2009, there were 824,847 producing oil and gas wells in the United States, as compared to about 3,650 in Saudi Arabia. It has been estimated that more than 45,000 new wells will be drilled in the United States each year. Since 1950, 2.6 million wells have been drilled in the United States. See Webcast, World Oil, “Oil and Gas Forecast 2013” (Feb. 19, 2013).

⁸This author was once involved as an expert witness in a dispute in which an entire field was developed, produced, plugged, and abandoned, apparently without the parties ever agreeing on the terms of an operating agreement. See George W. Hazlett, “Drafting of Joint Operating Agreements,” 3 *Rocky Mt. Min. L. Inst.* 277, 277–78 (1957) (noting that joint operations were so frequent that almost every company developed its own form of agreement to state the rights and obligations of the participants, but these agreements were not uniform and the desire of each company to use its own form often created disputes that resulted in costly delay and animosity).

⁹The process of the development of the AAPL Form 610-1956, which was originally published as the “Ross-Martin” Model Form by Kraftbilt, in Tulsa, Oklahoma, is discussed at J. O. Young, “Oil and Gas Operating Agreements: Producers 88 Operating Agreements, Selected Problems and Suggested Solutions,” 20 *Rocky Mt. Min. L. Inst.* 197, 198–202 (1975). See also John R. Reeves & J. Matthew Thompson, “The Development of the Model Form Operating Agreement: An Interpretative Accounting,” 54 *Okla. L. Rev.* 211, 214–16 (2001). As noted below at note 23, however, the first organizationally generated model form was the Rocky Mountain Mineral Law Foundation’s (RMMLF) Rocky Mountain Unit Operating Agreement, Form 1 (Undivided Interest) (RMMLF Form 1), which was published by the Foundation in May 1954.

¹⁰There have also been occasional tweaks to the forms. In 1967, the AAPL Form 610-1956 received cosmetic changes, primarily to reflect that it had been endorsed by the American Association of Petroleum Landmen (now the American Association of *Professional* Landmen), and was no longer a “pure” commercial form. And in 2013, the 1989 model form was revised to include horizontal modifications. See Jeff Weems, “Changes Within the AAPL 610 - 1989 Model Form Operating Agreement: Horizontal Modifications and Other Developments,” 59 *Rocky Mt. Min. L. Inst.* 29-1 (2013).

operating agreement.¹¹ Parties to onshore oil and gas ventures in the United States almost always tailor one of the AAPL model forms;¹² relatively minor change is the norm, though all of the AAPL model forms provide space for additional provisions, which may be lengthy.¹³ Offshore in the United States, the parties typically use one of the AAPL forms designed for offshore use; there are two, one adopted in 2002 for Outer Continental Shelf use¹⁴ and an offshore deepwater version adopted in 2007.¹⁵

There are several justifications for the development and use of model forms. They provide parties with well-written and comprehensive agreements that reflect industry best practices, reduce negotiation and drafting expenses, and allow for efficient interpretation of agreements by developing interpretative precedents over time.¹⁶ But the fact remains that operating agreements are second only to leases as litigation generators.¹⁷ They are also second only to leases in the amount of commentary that they attract at meetings like this one.¹⁸

¹¹Michael D. Josephson, “Fundamentals of International Joint Operating Agreements,” 53 *Inst. on Oil & Gas L.* 17-1, 17-3 (Ctr. for Am. & Int’l L. 2002).

¹²While new drilling ventures in the United States generally use the AAPL Form 610-1989, it is common to see the older forms in use in areas where they were used during initial exploration and operations, in the interest of uniformity. Some small operators just use the forms that they have become accustomed to using, and some larger companies have refused to use the AAPL Form 610-1989, viewing it as insufficiently operator friendly. See Lynn P. Hendrix, “The New Model Operating Agreement Forms: Why Change the Rules in the Ninth Inning?” *Onshore Pooling and Unitization* 6-1 (Rocky Mt. Min. L. Fdn. 1997).

¹³See AAPL Form 610-1956, at art. 30; AAPL Form 610-1977, at art. XV; AAPL Form 610-1982, at art. XV; AAPL Form 610-1989, at art. XVI.

¹⁴AAPL Form 710-2002 Model Form Offshore Operating Agreement (2002 AAPL Offshore JOA).

¹⁵AAPL Form 810-2007 Model Form Deepwater Operating Agreement (2007 AAPL Deepwater JOA).

¹⁶See Andrew B. Derman & Isabel Amadeo, “The 1989 AAPL Model Form Operating Agreement—Why Are You Not Using It?” *Oil & Gas Agreements: Joint Operations* 16-1, 16-2 (Rocky Mt. Min. L. Fdn. 2008). See also A. Timothy Martin & J. Jay Park, “Global Petroleum Industry Model Contracts Revisited: *Higher, Faster, Stronger*,” 3 *J. World Energy L. & Bus.* 4, 8 (2010).

¹⁷The frequency of litigation reflects that the model forms are drafted by committees, whose members often disagree and ultimately compromise and move on, leaving language that may be unclear; that parties sometimes substantially and inartfully modify the terms of the model agreements; that “models” do not necessarily fit the circumstances in which they are used; and that there is lots of money at stake.

¹⁸A search of the Foundation’s Digital Library alone found more than 100 papers with “Operating” or “Operator” in the title.

The AAPL has begun the process of revising the AAPL Form 610-1989 Model Form Operating Agreement (AAPL Form 610-1989),¹⁹ and over the next couple of years everyone active in the industry likely will find themselves discussing what the drafting committee proposes or what the drafting committee ought to do. This chapter will consider some issues that commonly arise with operating agreements and suggest to the drafting committee some changes that they might consider. In particular, this chapter will focus on what we can learn from others, looking at some of the provisions in the Association of International Petroleum Negotiators (AIPN) 2012 Model International JOA (AIPN 2012 JOA),²⁰ the Canadian Association of Petroleum Landmen (CAPL) 2007 Operating Procedure (CAPL 2007 Operating Procedure),²¹ the Australian Mining and Petroleum Law Association (AMPLA) Model Petroleum Joint Operating Agreement (AMPLA 2011 JOA),²² the United Kingdom Offshore Operators Association (UKOOA) Model Form JOA (UKOOA 2009 JOA), and the model forms issued by the Rocky Mountain Mineral Law Foundation.²³

¹⁹The committee includes Fred MacDonald, Bob Duplantis, Jeff Weems, Mike Curry, Tom Daily, Dorsey Roach, Andy Rudderow, Worth Carlin, Dave Padgett, Jim Dewbre, and Dora Soria. See Worth Carlin & Jeff Weems, “Changes Within the AAPL 610 - 1989 Model Form Operating Agreement: Horizontal Modifications and Other Developments,” *Development Issues in Major Shale Plays: What’s on the Horizon?* 5-1 (Rocky Mt. Min. L. Fdn. 2014).

²⁰AIPN endorsed model forms in 1990, 1995, 2002, and 2012.

²¹In Canada, one typically sees one of the five model form operating procedures developed by the CAPL and issued in 1971, 1974, 1982, 1990, and 2007. See Douglas G. Mills, Carolyn A. Wright & Julie J.M. Inch, “Exploring the Balance of Power in the Operator/Non-Operator Relationship Under the CAPL Operating Procedure,” 48 *Alta. L. Rev.* 363 (2010).

²²In Australia, one typically sees either one of the AIPN forms or the model form published by AMPLA in 2011. See AMPLA Model Petroleum Joint Operating Agreement, Approved Version 1 (Dec. 9, 2011) (AMPLA 2011 JOA). See also John Grace, “The AMPLA Model Petroleum Joint Operating Agreement,” *AMPLA Yearbook* 204 (2011) (discussion of AMPLA 2011 JOA by its drafter).

²³There are three model form operating agreements published by the Foundation. RMMLF Form 1, the first organizationally generated model form, was issued by the Foundation in May 1954, predating Kraftbilt’s Form 610 by more than a year. RMMLF Form 1 was designed for use with undivided interests, i.e., where the parties to the agreement jointly owned interests in the same leases. It is not often used today. See Hendrix, *supra* note 12, at 6-4 to 6-5. In the Rocky Mountain area, where federal lands are involved, it is common to see the Foundation’s Rocky Mountain Unit Operating Agreement, Form 2 (Divided Interest) (RMMLF Form 2), which was published by the Foundation in 1980 and revised in 1985 and 1994. RMMLF Form 2 is designed for use with divided interests, i.e., where the parties to the agreement own interests in different leases subjected to the unit:

Under the [RMMLF] Form 2 the working interest owners participate in costs and production on the basis of “participating areas” (smaller areas within the unit approximating the area capable of producing unitized substances in paying quantities), in proportion to the committed acreage each owns in the participating areas. While participation is based upon acreage within participating areas,

This chapter will also examine the more recent AAPL drafting ventures for offshore operations, which the AAPL drafting committee might consider to address the recurring issues that will be discussed.²⁴ Due to time and space limitations, the focus will be on issues related to operators—particularly operator liability and operator removal.

There is a sharp contrast between the theory and the practice of being an operator. In theory, the operator serves as an accommodation to the non-operators, who are not the operator's partners, but lease or mineral-estate cotenants or separate lease owners working together under a contractual cotenancy created by the operating agreement. The basic scheme of operating agreements around the world is that the operator will be one of the working interest owners. Generally, the operator is either a large working interest owner or one that has equipment and personnel conveniently located to the property that serves the group of owners in the interest of efficiency, rather than to make a profit from charging fees for acting as operator.²⁵ The operator is not directly compensated for being the operator. The concept is that the operator will make its profits from its ownership of mineral rights and the sale of its percentage of production, just like the non-operators, rather than from fees paid by its co-owners.

In practice, being an operator brings with it many advantages that may translate to profit. The operator can keep its equipment gainfully employed and its employees maintaining and upgrading their skills, while obtaining financial and perhaps technical support from non-operators. Overhead rates provided for in the Council of Petroleum Accountants Societies, Inc. (COPAS) accounting procedures are often generous.²⁶ Most importantly,

the participating areas can expand or contract and each participant's share of costs and production in wells within a participating area can change based upon a number of factors, including the drilling of additional wells. This concept makes divided type units unique and some of the most complicated agreements in the oil and gas industry. The [RMMLF] Form 2 is the most widely used operating agreement for federal exploratory units.

Hendrix, *supra* note 12, at 6-5. The Foundation also publishes the Rocky Mountain Joint Operating Agreement, Form 3 (RMMLF Form 3), originally published in 1959 and again in 1968, which has largely been supplanted by versions of the AAPL model form. *See id.*

²⁴See 2007 AAPL Deepwater JOA; 2002 AAPL Offshore JOA.

²⁵Where the transaction is structured so that the operator makes a profit from being the operator, as are many investments sold from "boiler room" operations in the United States, investors and their lawyers may see these limitations as inappropriate. *See* John S. Lowe, *Oil and Gas Law in a Nutshell* 420 (6th ed. 2014).

²⁶See Robert C. Bledsoe, "Current Problems Between Operators and Nonoperators in Operating Agreements," 40 *Inst. on Oil & Gas L. & Tax'n* 8-1, 8-4 (Sw. Legal Fdn. 1989) ("The operator often has a substantial financial stake in remaining as operator, not to mention his pride.").

being an operator brings with it the ability to shape the overall operational plan and to control outright day-to-day operations, both of which provide protections to the operator's investment that the non-operators do not have.²⁷ Often, the question of who gets to be the operator is one of the most hotly debated issues as parties negotiate operating agreements.²⁸

But the freewheeling “wildcatting” culture of the North American oil and gas industry often leads an operator, once ensconced, to act as a virtual dictator, proposing and conducting operations with little or no consultation with non-operators.²⁹ Disputes between operators and non-operators are frequent. Operator liability and operator removal are recurring topics explored in this chapter.

§ 27.02 Operator Liability—Should an Operator Be Liable for Breach of the JOA in the Absence of Gross Negligence or Willful Misconduct?

The model form operating agreements make it hard for non-operators to recover damages from the operator. Exculpatory language in the model forms severely limits the ability of non-operators to hold the operator liable. The operator acts for the non-operators subject to a “good and workmanlike” standard, but it is liable for its actions as operator only where it is guilty of “gross negligence or willful misconduct.” The apparent contradiction in terms in fact makes perfect sense in the industry: the operator serves as an accommodation to the non-operators, rather than as a for-hire independent contractor or employee.³⁰ Since the operator is not

²⁷P. Sean Murphy & Jonathan Sutcliffe, “The Operator’s Limitation of Liability Under the 1995 AIPN Model Form International Operating Agreement—Have We Gone Too Far?” *Landman* 1, 9 (May/June 2002). Murphy and Sutcliffe were discussing one of the AIPN forms, but the principle applies to all operating agreements; “It’s good to be king,” as Mel Brooks said in the movie, *History of the World, Part I*.

²⁸The party to the agreement with the largest production interest is often the operator. It is usually considered imperative by the parties to an operating agreement that the operator have a substantial production interest in the contract area. See Michael D. Josephson, “How Far Does the CAPL Travel? A Comparative Overview of the CAPL Model Form Operating Procedure and the AIPN Model Form International Operating Agreement,” 41 *Alta. L. Rev.* 1, 3 (2003). It is often said that investors want the operator to have “skin in the game.”

²⁹Non-operators have limited duties under the JOA, the most important duty being providing funds to the operator. See Nkaepe Etteh, “Joint Operating Agreements: Which Issues are Likely to Be the Most Sensitive to the Parties and How Can a Good Contract Design Limit the Damage from Such Disputes?” at 4 (Univ. of Dundee Ctr. for Energy, Petroleum & Mineral L. & Pol’y 2010) (unpublished).

³⁰The AIPN 2012 JOA states that explicitly: the operator shall “neither gain a profit nor suffer a loss as a result of being the Operator” AIPN 2012 JOA, at art. 4.2.B.5. The AMPLA 2011 JOA and CAPL 2007 Operating Procedure have similar language at clause

paid directly for its services, it should be liable for its mistakes and failures only where they are gross or willful.

But the scope of the exculpatory language is an issue: does the “gross negligence or willful misconduct” limitation on liability apply to all breaches of the JOA?

[1] Provisions of the AAPL Model Forms

The issue developed in the context of changes in the AAPL model form. Article 5 of the AAPL Form 610-1956 provided that the operator

shall conduct and direct and have full control of all operations on the Unit Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, *but it shall have 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.*³¹

The language quoted plainly tied the liability limitation to lease operations and plainly permitted non-operators to recover damages for breach of the terms of the operating agreement.³² But in the 1977 and 1982 AAPL model form revisions, the language of the second sentence was changed to

6.3(c) and clause 5.2, respectively. The drafting committee should consider adding such language to the new AAPL model form, or perhaps drafting alternative provisions: one adopting the “no profit” position, and another stating forthrightly that the operator expects to make a profit from fees for providing services.

³¹AAPL Form 610-1956, at art. V (emphasis added). The exculpatory language of the other early model form, RMMLF Form 1, was not so plainly stated. It provided that the “Unit Operator shall not be liable to any other Party for anything done or omitted to be done by it in the conduct of operations hereunder except in case of bad faith,” thus interjecting the issue of the operator’s subjective state of mind. RMMLF Form 1, at art. 8.3. Similar language was in article 4.5 of RMMLF Form 3 and in the AIPN 1990 JOA, which defined “gross negligence” to exclude “any error of judgment or mistake made . . . in the exercise in good faith of any function, authority or discretion conferred . . . under this Agreement.” AIPN 1990 JOA, at art. 1.36. Subsequent AIPN versions dropped the reference, but it is maintained in the definitions of the UKOOA 2009 JOA in the event of “special circumstances”:

“*Wilful Misconduct*” means an intentional or reckless disregard by Senior Managerial Personnel of Good Oilfield Practice or any of the terms of this Agreement in utter disregard of avoidable and harmful consequences but *shall not include any act, omission, error of judgment or mistake made in the exercise in good faith of any function, authority or discretion vested in or exercisable by such Senior Managerial Personnel and which in the exercise of such good faith is justifiable by special circumstances*, including safeguarding of life, property or the environment and other emergencies.

UKOOA 2009 JOA, at cl. 1.1 (emphasis added).

³²See, e.g., *Lancaster v. Petroleum Corp. of Del.*, 491 So. 2d 768 (La. Ct. App. 1986) (an operator who resigned without giving the 90 days’ notice required by article 21 was held liable for loss of a non-operator’s interest).

[Operator] shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.³³

The drafters added “willful misconduct” and omitted “or from breach of the provisions of this agreement.”

Professor Ernest Smith argued that the intent of the language change was to expand the exculpatory language so that it applied to any cause of action that a non-operator might assert, whether for tortious conduct or a breach of contract.³⁴ Though a federal court applying Texas law held in *Stine v. Marathon Oil Co.*³⁵ that the changed exculpatory language was to be interpreted very broadly,³⁶ several courts, relying in part upon the analysis of Professor Gary Conine,³⁷ have held that the changes in fact limited the exculpatory language to non-operators’ claims relating to the conduct of operations; it is not necessary for a non-operator alleging that the operator has breached the operating agreement to show gross negligence or willful misconduct.³⁸ By this line of cases, referred to here as the “*Abraxus* line,” the exculpatory language applies only to the conduct of operations or breaches of express or implied obligations that relate to operations.

³³AAPL Form 610-1977, at art. V.A.; AAPL Form 610-1982, at art. V.A.

³⁴Ernest E. Smith, “Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners,” 32 *Rocky Mt. Min. L. Inst.* 12-1, 12-30 (1986).

³⁵976 F.2d 254 (5th Cir. 1992).

³⁶The court in *Stine* reasoned that:

The tenor of the wording of the exculpatory clause is that Marathon [the operator] is not liable for good faith performance of “duties under this agreement” Thus, in the present case, Marathon is not liable for any action taken in connection with the completion, testing or turnover, or any well drilled under the provisions of the JOA unless Stine [the non-operator] can prove that Marathon’s actions were grossly negligent or willful. This protection extends to Marathon’s various administrative and accounting duties, including the recovery of costs under the authority of the JOA.

It is clear to us that the protection of the exculpatory clause extends not only to “acts unique to the operator,” as the district court expressed it, but also to any acts done under the authority of the JOA “as Operator.” This protection clearly extends to breaches of the JOA.

Id. at 261 (citations omitted).

³⁷See Gary B. Conine, “The Prudent Operator Standard: Applications beyond the Oil and Gas Lease,” 41 *Nat. Res. J.* 23, 66–74 (2001).

³⁸See *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. App.—El Paso 2000, no pet.); *Cone v. Fagadau Energy Corp.*, 68 S.W.3d 147 (Tex. App.—Eastland 2001, pet. denied); *IP Petroleum Co. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. denied); *Castle Tex. Prod. Ltd. P’ship v. Long Trusts*, 134 S.W.3d 267

The AAPL Form 610-1989, which predated all of the cases that applied the “gross negligence or willful misconduct” limitation narrowly, appeared to move back toward the broad *Stine* interpretation, providing that:

Operator shall conduct its *activities under this agreement* as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulations, but *in no event* shall it 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.³⁹

That language was interpreted expansively by the Texas Supreme Court in *Reeder v. Wood County Energy, LLC*.⁴⁰ There, non-operators claimed damages because their operator had failed to maintain production in paying quantities, causing valuable leases to terminate and the Texas Railroad Commission to dissolve the unit and suspend operations. At trial, a jury found the operator had breached his duty to the non-operators by failing to maintain production in paying quantities and that the exculpatory clause did not exempt the operator from liability because his conduct rose “to the level of gross negligence or willful misconduct.”⁴¹ The court of appeals held that the exculpatory clause could not have protected the operator from the claims of the non-operators because it did not apply to breach-of-contract claims.⁴²

On appeal, the Texas Supreme Court focused on the change of the language of the model forms.⁴³ The supreme court noted that while the 1956, 1977, and 1982 model forms had linked the exculpatory language to the operator’s obligation to “conduct *all such operations* in a good and workmanlike manner,”⁴⁴ the 1989 form tied it to the operator’s duty to “conduct *its activities under this agreement* as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with

(Tex. App.—Tyler 2003, pet. denied); *Shell Rocky Mountain Prod., LLC v. Ultra Res., Inc.*, 415 F.3d 1158 (10th Cir. 2005). See also *PYR Energy Corp. v. Samson Res. Co.*, 470 F. Supp. 2d 709 (E.D. Tex. 2007) (discussion of whether in a diversity case a federal district court applying Texas law should follow *Stine* or the *Abraxas* line of cases in ruling on the scope of the JOA’s exculpatory clause).

³⁹ AAPL Form 610-1989, at art. V.A (emphasis added).

⁴⁰ 395 S.W.3d 789 (Tex. 2012).

⁴¹ *Id.* at 790.

⁴² *Id.* at 790–91.

⁴³ *Id.* at 794.

⁴⁴ *Id.* at 793 (emphasis added) (quoting *Reeder v. Wood Cnty. Energy, LLC*, 320 S.W.3d 433, 444 (Tex. App.—Tyler 2010)).

good oilfield practice . . .”⁴⁵ Based upon the language differences—“its activities under this agreement” rather than “all such operations”—and noting that some commentators had concluded the AAPL Form 610-1989 provided for a broader exculpation of the operator, the Texas Supreme Court held that the 1989 model form exculpatory language protected the operator against liability for mere negligence not just in the conduct of basic oilfield operations but arising out of its conduct of all activities under the operating agreement.⁴⁶

Where “gross negligence or willful misconduct” is the standard for an operator’s liability, the bar for non-operators is high. “Gross negligence is generally defined as the failure to use even slight care.”⁴⁷ To prove gross negligence, a non-operator must show much more than mere negligence. The key aspect of gross negligence is the “conscious indifference” to a known risk.⁴⁸ There must be evidence that the operator had actual subjective knowledge of an extreme risk of serious harm and nonetheless proceeded to act.⁴⁹ Also, there must be some extraordinary harm foreseeable, not the type of harm ordinarily associated with breaches of contract or even with bad-faith denials of contract rights; harm such as “death, grievous physical injury, or financial ruin” is necessary.⁵⁰ Willful misconduct is a similarly high standard; Texas courts have held that there is little

⁴⁵*Id.* (emphasis added).

⁴⁶*Id.* at 794–95 (citing Robert C. Bledsoe, “The Operating Agreement: Matters Not Covered or Inadequately Covered,” 47 *Rocky Mt. Min. L. Inst.* 15-1, 15-9 (2001); Wilson Woods, Comment, “The Effect of Exculpatory Clauses in Joint Operating Agreements: What Protections Do Operators Really Have in the Oil Patch?” 38 *Tex. Tech. L. Rev.* 211, 214–15 (2005)). After finding that the operator had not acted with gross negligence or willful misconduct, the Texas Supreme Court reversed and ruled in favor of the operator. *Id.* at 797.

⁴⁷Andrew B. Derman, *The New and Improved 1989 Joint Operating Agreement: A Working Manual* 27 (1991).

⁴⁸Robert L. Theriot, “Disputes Between Operators and Non-Operators: Judicial Application of Joint Operating Agreements,” 30 *Oil, Gas & Energy Res. L. Sec. Rep.*, No. 3, at 95 (State Bar of Tex. 2006) (citing *Flye v. City of Waco*, 50 S.W.3d 645 (Tex. App.—Waco 2001, no pet.)).

⁴⁹*Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10, 22 (Tex. 1994), *superseded by statute*, 2003 Tex. Sess. L. Serv. ch. 204, § 13 (raised the standard to require clear and convincing evidence), *as recognized in U-Haul Int’l, Inc. v. Waldrip*, 380 S.W.3d 118, 140 (Tex. 2012).

⁵⁰879 S.W.2d at 24.

distinction between it and gross negligence.⁵¹ If there is a distinction, it is that willful misconduct may require a higher element of intent.⁵²

In sum, an operator is grossly negligent if it either knowingly does something contrary to good oilfield practice, realizing that its action could result in extraordinary harm or financial ruin to the non-operators, or refuses to act when it is so required by the JOA or other contracts and the failure results in financial ruin to the non-operators' property.⁵³ An operator engages in willful misconduct if it acts or refuses to act with a specific intent to harm the non-operators.

Whether the operator's actions or inactions constitute gross negligence is a question of fact. The court in *IP Petroleum Co. v. Wevenco Energy, L.L.C.*⁵⁴ required a finding of great misconduct, rather than a series of errors. There, the operator had no written drilling plan for the well; failed to use drilling mud so that the drill bit became stuck, adding more than \$100,000 to drilling costs; ran no drill-stem test on the well; did not inform the non-operators that setting pipe would prevent well deepening; and permitted the farmout agreement under which it was operating to expire while it was still engaged in drilling operations.⁵⁵ The court said that these failures were "legally sufficient evidence of negligence," but did not "rise to the level of gross negligence . . ."⁵⁶

Many think that the *Reeder* case goes too far, and that the drafting committee may move back to the language of the 1977 and 1982 agreements or state plainly in the new AAPL form that the exculpatory language does not apply to breaches of contract.⁵⁷ But the divergence of the commentators

⁵¹See *IP Petroleum Co. v. Wevenco Energy, L.L.C.*, 116 S.W.3d 888, 898 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (citing *Marshall Indep. Sch. Dist. v. U.S. Gypsum Co.*, 790 F. Supp. 1291 (E.D. Tex. 1992)).

⁵²See Jeanine Feriancek, "Operator Liability for Negligence?" 11 *Nat. Resources & Env't* 58, 60 (1996).

⁵³*Id.*

⁵⁴116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

⁵⁵*Id.* at 897–98.

⁵⁶*Id.* at 898. *But see* *Hamilton v. Tex. Oil & Gas Corp.*, 648 S.W.2d 316, 323 (Tex. App.—El Paso 1982) (holding that an operator might be held liable under the operating agreement for drilling a well at other than the agreed location without even giving notice to the non-operator and stating that "[s]everal connected acts of simple negligence may support a jury's finding of gross negligence").

⁵⁷See *Carlin & Weems*, *supra* note 19, at 5-50 (discussing recent JOA modifications affecting horizontal drilling in shale plays, the speakers stated that the provision was currently being rewritten to distinguish "the standards of conduct from the limitations of liability").

and the cases raises the question of how broad the operator's liability limitation should be.

[2] Provisions of Other Model Forms

Other model forms give little guidance regarding any industry "norm": the scope of the liability exclusion apparently varies.

The AIPN 2012 JOA likely gives an operator protection broader than any of the AAPL model forms. It begins with a release of liability for "performing (or failing to perform) the duties and functions of Operator," including liability for gross negligence or willful misconduct:

neither Operator nor any other Operator Indemnitee shall bear (except as a Party to the extent of its Participating Interest share) any damage, loss, cost, or liability resulting from performing (or failing to perform) the duties and functions of Operator, and the Operator Indemnitees⁵⁸ are hereby released from liability to Non-Operators for any and all damages, losses, costs, and liabilities arising out of, incident to or resulting from such performance or failure to perform, even though caused in whole or in part by a pre-existing defect, or the negligence (whether sole, joint or concurrent), gross negligence, willful misconduct, strict liability or other legal fault of Operator (or any other Operator Indemnitee).⁵⁹

The AIPN 2012 JOA follows with an indemnification promise from the non-operators that also extends to gross negligence and willful misconduct:

the Parties shall (in proportion to their Participating Interests) defend and indemnify Operator Indemnitees from any damages, losses, costs (including reasonable legal costs, expenses and attorneys' fees), and liabilities incident to claims, demands or causes of action brought by or for any person or entity, which claims, demands or causes of action arise out of, are incident to or result from Joint Operations, even though caused in whole or in part by a pre-existing defect, or the negligence (whether sole, joint or concurrent), gross negligence, willful misconduct, strict liability or other legal fault of Operator (or any other Operator Indemnitee).⁶⁰

The AIPN 2012 JOA contains an option, however, which the parties usually choose, that extends the possibility of liability for gross negligence or willful misconduct. But in comparison to the language of the AAPL model forms, it only narrowly opens the window to operator liability:

⁵⁸"Operator Indemnitee" is defined as "any of the Operator, its Affiliates, or their respective directors, officers, and employees. Operator Indemnitees means all of them." AIPN 2012 JOA, at art. 1.1.

⁵⁹*Id.* at art. 4.6.A (emphasis added).

⁶⁰*Id.* at art. 4.6.B (emphasis added).

Despite Article 4.6.A or 4.6.B, if any Senior Supervisory Personnel^[61] of Operator or its Affiliates engage in Gross Negligence/Willful Misconduct^[62] that proximately causes the Parties to incur damage, loss, cost, or liability for claims, demands or causes of action referred to in Article 4.6.A or 4.6.B, then, in addition to its Participating Interest share:

ALTERNATIVE PROVISION, CHOOSE ONE

ALTERNATIVE #1 - NO LIMITATION

Operator shall bear all such damages, losses, costs, and liabilities.

ALTERNATIVE #2 - JOINT PROPERTY LIMITATION

Operator shall bear only the actual damage, loss, cost, and liability to repair, replace and/or remove Joint Property^[63] so damaged or lost, if any.

ALTERNATIVE #3 - FINANCIAL LIMITATION

Operator shall bear only the first [_____ U.S. dollars] of such damages, losses, costs, and liabilities.⁶⁴

While the AIPN 2012 JOA definition of gross negligence/willful misconduct is probably much the same as the common law meaning, the optional provision offers non-operators less recourse than any of the AAPL model forms. The AIPN clause requires that the liability-triggering action or omission be that of a supervisor, usually a relatively high-level supervisor. Further, the actual liability of the operator may be limited by the nature of

⁶¹“Senior Supervisory Personnel means, with respect to a Party, any director or officer of such Party, and any individual who functions for such Party or one of its Affiliates at a management level equivalent or superior to any individual functioning as such Party’s . . .” *Id.* at art. 1.1. The parties entering into the agreement can choose from one of the five tiers of supervisory duties, ranging from field supervisors to county managers. *See id.* Generally, the parties choose Alternative No. 4 (senior managers reporting directly to the county manager) or Alternative No. 5 (county manager).

⁶²“Gross Negligence/Willful Misconduct” is defined as

any act or failure to act (whether sole, joint or concurrent) by any person or entity that was intended to cause, or was in reckless disregard of or wanton indifference to, harmful consequences such person or entity knew, or should have known, such act or failure would have on the safety or property of another person or entity.

Id.

⁶³“Joint Property means, at any point in time, all wells, facilities, equipment, materials, information, funds, and property (other than Hydrocarbons) held for use in Joint Operations.” *Id.* It does not include either damage to the formation or environmental damage.

⁶⁴AIPN 2012 JOA, at art. 4.6.D.

the damage, the amount, or both. Some have criticized the AIPN forms for the breadth of the exculpatory language.⁶⁵

The structure of the CAPL, AMPLA, and UKOOA model forms is similar to that of the AAPL forms; an operator that is grossly negligent or engages in willful misconduct is subject to full liability for damages. But the scope of the exculpatory language in the three forms is different. Clause 3.04 of the CAPL 2007 Operating Procedure provides that:

The Operator will manage all Joint Property and conduct all Joint Operations diligently, in a good and workmanlike manner, in compliance with the Title Documents and the Regulations and in accordance with good oilfield practice, including prudent reservoir management and conservation principles. Insofar as the Operator hires contractors hereunder, it will supervise them as is reasonable. Notwithstanding the preceding portion of this Clause, a breach of the obligations contained in this Clause will not result in any form of liability (whether in tort, contract or otherwise) of the Operator to the Parties, except insofar as the conduct

⁶⁵Murphy & Sutcliffe, *supra* note 27, at 9; Philip Weems & Michael Bolton, King & Spalding LLP, “Highlights of Key Revisions—2002 AIPN Model Form International Operating Agreement,” at 4 (2002). Interestingly, the final draft of the AIPN 2012 JOA included another optional provision that would have made the operator liable for administrative failures:

OPTIONAL PROVISION, CHOOSE, IF DESIRED. IF NOT CHOSEN CHECK CROSS-REFERENCES.

- 4.6.E Despite Article 4.6.D, Operator (i) shall not be released from or indemnified for, and (ii) shall bear all, damages, losses, costs, and/or liabilities arising out of, incident to, or resulting from:
- 4.6.E.1 Operator’s indemnity obligation under Article 20.1;
- 4.6.E.2 A final adjudication, or an admission or settlement of allegations, that Operator, its Affiliates, or any of their personnel misappropriated or embezzled funds paid to or held by the Operator under this Agreement;
- 4.6.E.3 A final adjudication, or an admission or settlement of allegations, that Operator, its Affiliates, or any of their personnel engaged in Gross Negligence / Willful Misconduct that proximately caused Operator not to properly perform one or more of the following administrative, accounting, financial, or procedural duties or functions:
- (a) adherence to approved Work Programs and Budgets and AFE’s under Article 4.2.B.1;
 - (b) receipt, payment, and accounting of funds under Article 4.2.B.3 and the Accounting Procedure;
 - (c) supplying data and filing reports under Article 4.4.A;
 - (d) procurement and maintenance of insurance under Article 4.7;
 - (e) compliance with contract award requirements under Articles 4.2.B.16 and 6.6; and/or
 - (f) compliance with over-expenditure limitations and approvals under Article 6.8.

It was not included in the final version of the AIPN 2012 JOA.

*to which the breach pertains constitutes Gross Negligence or Wilful Misconduct*⁶⁶ for which the Operator is solely responsible under Article 4.00.⁶⁷

This language would appear to provide protection for an operator similar to the *Abraxus* line of cases. The exculpatory language extends only to the “breach of the obligations contained in this Clause,” and the clause imposes obligations relating to “management of Joint Property” and the “conduct of Joint Operations.”⁶⁸ Thus, non-operators could recover damages for breaches of the contract other than a breach of “good oilfield practice,”⁶⁹ a breach of the health, safety, and environmental risks provision,⁷⁰ and a breach of the title maintenance provisions.⁷¹

The AMPLA 2011 JOA, on the other hand, appears to extend the exculpatory language to all of the operator’s activities, as does *Reeder*. The AMPLA 2011 JOA does not use the term “gross negligence,” but defines “Wilful Misconduct” to mean “any act or failure to act which was intended to cause, or was in reckless disregard or wanton indifference to, the foreseeable consequences of such action or failure to act.”⁷² Clause 6.5 then continues:

Except as a Participant to the extent of its Percentage Share, the Operator *is not liable to the Participants for any loss sustained or liability incurred in connection with the Joint Venture*, even if arising from the negligence of the Operator or any person for whom the Operator may be vicariously liable, *except where, in*

⁶⁶The CAPL 2007 Operating Procedure defines “Gross Negligence or Wilful Misconduct” as:

any act, omission or failure to act (whether sole, joint or concurrent) by a person that was intended to cause, or was in reckless disregard of, or wanton indifference to, the harmful consequences to the safety or property of another person or to the environment which the person acting or failing to act knew (or should have known) would result from such act, omission or failure to act. However, Gross Negligence or Wilful Misconduct does not include any act, omission or failure to act insofar as it: (i) constituted mere ordinary negligence; or (ii) was done or omitted in accordance with the express instructions or approval of all Parties, insofar as the act, omission or failure to act otherwise constituting Gross Negligence or Wilful Misconduct was inherent in those instructions or that approval.

CAPL 2007 Operating Procedure, at cl. 1.2.

⁶⁷*Id.* at cl. 3.04 (emphasis added).

⁶⁸*Id.*

⁶⁹*Id.*

⁷⁰*Id.* at cl. 3.05A.

⁷¹*Id.* at cl. 3.10A. This is the conclusion of Mills, Wright & Inch, *supra* note 21, at 375.

⁷²AMPLA 2011 JOA, at cl. 1.1.

*a particular case, the Operator (or that person) has committed fraud or Wilful Misconduct.*⁷³

The reference to “in connection with the Joint Venture” is broader than “breach of the obligations contained in this Clause.”

Similarly, the UKOOA 2009 JOA uses language that probably would be interpreted consistently with the *Reeder* interpretation:

The Operator shall not be liable for and each Participant (including for the avoidance of doubt the Participant designated as Operator) shall defend, indemnify and hold the Operator harmless:

- (a) to the extent of the indemnifying Participant’s Percentage Interest from and against any loss, damage or claim by or liability to any person, whether a Participant or not, (including any award of damages and any legal or other costs and expenses incurred in respect of such claim or liability) which arises, whether directly or indirectly, out of the performance, non-performance or misperformance by the Operator of any of its duties or obligations as Operator hereunder . . . , irrespective of negligence and/or breach of duty (whether statutory or otherwise) on the part of the Operator, except only for any loss, damage, claim or liability resulting from or arising out of:
 - (i) the Wilful Misconduct of the Operator; or
 - (ii) the failure of the Operator to obtain or maintain any insurance which it is required to obtain and maintain . . . , except where the Operator has used all reasonable endeavours to obtain or maintain any such insurance but has been unable to do so and has promptly notified the Participants participating or proposing to participate therein⁷⁴

The exculpatory language extends to losses that arise “whether directly or indirectly, out of the performance, non-performance or misperformance by the Operator of any of its duties or obligations as Operator hereunder”⁷⁵

The AAPL offshore model forms show a similar split. The AAPL Form 710-2002 Model Form Offshore Operating Agreement (2002 AAPL Offshore JOA) limits the liability for gross negligence or willful misconduct to “operations.”⁷⁶ But the AAPL Form 810-2007 Model Form Deepwater Operating Agreement (2007 AAPL Deepwater JOA) requires gross negligence or willful misconduct to impose liability for either “activities or operations” under the JOA or affecting the lease, which would appear to apply to breaches of contract.⁷⁷

⁷³*Id.* at cl. 6.5 (emphasis added).

⁷⁴UKOOA 2009 JOA, at cl. 6.2.4.

⁷⁵*Id.* at cl. 6.2.4(a).

⁷⁶2002 AAPL Offshore JOA, at art. 5.2. The form uses the phrase “activities and operations” in several other articles.

⁷⁷2007 AAPL Deepwater JOA, at art. 5.2.

On balance, the *Abraxus* line of cases, limiting the scope of the “gross negligence or willful misconduct” exclusion to the conduct of operations or breaches of express or implied obligations that relate to operations, is a more workable result, though Professor Smith’s analysis of the purpose of the language changes is compelling.⁷⁸ As stated by the Tenth Circuit in *Shell Rocky Mountain Production, LLC v. Ultra Resources, Inc.*,⁷⁹ requiring a showing of gross negligence or willful misconduct to impose liability on an operator makes sense for physical operations because the interests of the operator and the non-operators are aligned, but “it is nonsensical to apply such a standard to administrative and accounting duties where the operator can profit by cheating, or simply overcharging, its working interest owners.”⁸⁰ Oil and gas operations are indeed risky, but we should expect that all the parties, including operators, will perform the promises of their contracts.

Perhaps the best approach for the drafting committee is to let the parties make the choice. A new model form should give the parties the options to decide to make the operator liable only for gross negligence or willful misconduct for both the conduct of operations and for breaches of contract, give the operator the protection of the exculpatory language only for operations, or subject the operator to full liability for both negligence and breach of contract.

[3] Suggestions for the Drafters

[a] Provide Cost Overrun Options

However broadly their exculpatory provisions are interpreted, several of the model forms contain provisions that potentially take the edge off the limitation of the operator’s liability and that the drafting committee should consider offering as options in the context of cost overruns, which

⁷⁸Not everyone will agree.

While the courts’ construction of the JOA in *Abraxas* and *Fagadau* is reasonable, it arguably imposes an unfair burden of liability on the operator for contract performance. Unlike many contracts where profit is the main goal of performance, the operator’s performance under the JOA does not entail the normal expectation of operation for profit.

Arthur J. Wright, “Joint Operating Agreements—Common Amendments and Mistakes,” 50 *Rocky Mt. Min. L. Inst.* 7-1, 7-9 (2004).

⁷⁹415 F.3d 1158 (10th Cir. 2005).

⁸⁰*Id.* at 1171.

are probably the most common source of disputes between operators and non-operators.⁸¹ The AIPN 2012 JOA provides that:

- 6.9.A For commitments and expenditures with respect to any line item of an approved Work Program and Budget, *Operator shall be entitled to incur in connection with the corresponding Joint Operation without further approval of the Operating Committee a combined over-commitment and over-expenditure for such line item up to ten percent (10%) of the authorized amount for such line item; provided that the cumulative total of all over-commitments and over-expenditures for a Calendar Year shall not exceed five percent (5%) of the total annual Work Program and Budget in question.*
- 6.9.B At such time Operator reasonably anticipates that the total amount of the commitments and expenditures actually incurred plus the commitments to be incurred with respect to such line item exceeds the limits of Article 6.9.A, *Operator shall furnish to the Operating Committee Operator's reasonably detailed estimate of the total commitments and expenditures required to carry out the Joint Operation corresponding to such line item, together with supporting information.*⁸²

In other words, if the operator's cost overruns exceed 10% of any line item or 5% of the annual work program and budget, it must provide the operating committee an authority for expenditure (AFE). The AIPN 2012 JOA allows alternatives as to whether the AFE is informational only, or is a supplemental expenditure that the operating committee must approve and reflect in a revised work program and budget.⁸³ If the supplemental-expenditure alternative is chosen, it is clear "that the overexpenditures approved by the Operating Committee are to be included in the relevant Work Program & Budget used to determine Operator's authority to subsequently incur overexpenditures without Operating Committee approval."⁸⁴

⁸¹Operations under a JOA are typically based upon an authority for expenditure (AFE), which is usually prepared and circulated by the operator. There is no standard form for an AFE, and often non-operators are unhappy with the amount of detail the operator provides. Regardless of the amount of detail an operator gives, however, the case law is clear that an AFE is nothing but a device to implement the JOA by facilitating decision making, and that its estimates of the cost of proposed operations are just that—estimates. A non-operator that agrees to participate in an operation under a JOA is responsible for its share of cost overruns, and can successfully challenge them only if the operator has incurred them in bad faith, or they are excessive, unreasonable, or unauthorized by the AFE or JOA. *See, e.g., M & T, Inc. v. Fuel Res. Dev. Co.*, 518 F. Supp. 285 (D. Colo. 1981) (actual costs of drilling a well were nearly twice what the AFE showed). There have been much worse cost overruns. *See Parejo Ltd. 1981 v. Getty Oil Co.*, Nos. CV F-85-150, CV F-85-217, 1991 WL 260436 (E.D. Cal. May 28, 1991) (an AFE of \$4.4 million was followed by a well that cost at least \$18 million).

⁸²AIPN 2012 JOA, at art. 6.9 (emphasis added).

⁸³*Id.*

⁸⁴Weems & Bolton, *supra* note 65, at 11.

But what if the operating committee does not approve the operator's supplementary AFE? The AIPN provision on cost overruns neither expressly caps the liability of the non-operators nor imposes liability for excessive overruns on the operator, but merely opens the door for the participation of the operating committee.⁸⁵

The Canadian and Australian JOA model counterparts contain similar provisions. The CAPL 2007 Operating Procedure provides:

AFE Overexpenditures—A Party's approval of an AFE constitutes its approval of all expenditures necessary to conduct the Operation described therein, subject to the limitations or charges prescribed by the Accounting Procedure and Articles 8.00 and 9.00 for Horizontal Wells and a Casing Point election respectively. However, the Operator will, *for informational purposes only*, promptly notify the Non-Operators if it incurs or expects to incur expenditures for a Joint Operation that exceeds the total amount estimated in the applicable AFE by more than the greater of \$50,000 or 10%. *It will include in that notice its explanation for that overexpenditure and its revised cost estimate for that Joint Operation.* If that Joint Operation relates to a well, the Operator will then provide estimates of current and cumulative costs incurred therefor on a daily basis where practicable and weekly estimates of forecast costs until that Joint Operation is completed.⁸⁶

The AMPLA 2011 JOA merely states that “if the Operator expects there will be a cost overrun in carrying out an Approved Programme which cannot be avoided by Good Australian Oilfield Practice, the Operator may exceed a current Approved Budget by not more than 10%,” and requires that the operator report any unbudgeted expenditure to the participants.⁸⁷ It also authorizes the operating committee to decide whether to approve cost overruns, but does not expressly address the liability of the operator if the operating committee does not approve.⁸⁸

⁸⁵The final draft of the AIPN 2012 JOA included an optional provision at article 4.6.E.3(f) that would have made an operator liable where “Gross Negligence/Willful Misconduct” caused the failure to comply “with over-expenditure limitations and approvals under Article 6.8.” *See supra* note 65. It was not included in the final version.

⁸⁶CAPL 2007 Operating Procedure, at cl. 3.2C (emphasis added).

⁸⁷AMPLA 2011 JOA, at cl. 8.4(a)(ii).

⁸⁸*Id.* at cl. 5.2(c). John Grace, the principal drafter of the AMPLA 2011 JOA, commented as follows:

On the question of non-approval in Australia of more than 10% cost overrun, if the Operator has committed to the expenditure without authority/approval (whether actual or ostensible, or by AFE whether prospective or retrospective) it must carry the cost itself. It is a useful restraining mechanism. This is not expressly stated but is the logical legal conclusion.

However there is also an unwritten rule in Australia that, once you appoint the Operator you support it through thick and thin—hell or high water—in all reasonable circumstances including those that may not necessarily be Good Operating Practice, so long as it was not Wilful Misconduct. So it would be rare for an

Logical though it may be that an operator that incurs costs in excess of the contract limits without prior or subsequent approval of the non-operators should have to bear those costs, an express statement in the contract of the effect of excessive cost overruns is preferable. Professors Smith and Weaver have suggested that a JOA might include a clause putting the “entire risk” of excessive cost overruns on the operator or, alternatively, requiring that the operator circulate a new AFE that the non-operators can approve or disapprove.⁸⁹ Either structure poses a dilemma for an operator. “Given the nature of the oil and gas industry, an operator may not reasonably know that the overexpenditure limits have been exceeded until the operation is completed and the overexpenditure has been incurred.”⁹⁰

But several of the model forms contain provisions similar to those suggested by Professors Smith and Weaver.⁹¹ Both the 2002 AAPL Offshore JOA and the 2007 AAPL Deepwater JOA contain provisions requiring a supplemental AFE and election to participate in the event that the operator exceeds overexpenditure limits, though using somewhat different terms. Article 8.7 of the 2002 AAPL Offshore JOA, an optional provision, states:

If Operator determines that the Overexpenditure will exceed the Allowable Variance,^[92] Operator shall submit a new AFE for the current operation (“Supplemental AFE”) for approval of the Participating Parties. The Participating

Operating Committee not to approve a greater than 10% cost overrun, provided it was reasonable within fairly flexible parameters. There would of course be much huffing and puffing before this position was reached.

Email from John Grace to John Lowe (May 27, 2014).

⁸⁹See Ernest E. Smith & Jacqueline Lang Weaver, 3 *Tex. L. of Oil & Gas* § 17.3[C][1] (2d ed. 2006).

⁹⁰Josephson, *supra* note 11, at 17-18. Further, drafting a functional excessive-cost clause may be hard to do. In *Pegasus Energy Group, Inc. v. Cheyenne Petroleum Co.*, 3 S.W.3d 112 (Tex. App.—Corpus Christie 1999, pet. denied), the court held that an exploration agreement that required the non-operators to approve “any expenditures which exceed the AFEs attached hereto by ten percent (10.00%) or more,” required the operator to obtain approval for drilling costs that exceeded its AFEs by 10% on a well-by-well basis, rather than on a line-by-line or item-by-item basis. *Id.* at 122.

⁹¹Some drafts of the AAPL Form 610-1989 had such a provision that was not adopted in the final version. See Derman, *supra* note 47, at 183–84.

⁹²The “Allowable Variance” is defined as an

Overexpenditure . . . no more than the greater of _____ Dollars (\$_____) or _____ percent (____%), or in the case of an operation involving the design, construction, and installation of a Platform, or Development Facilities, no more than the greater of _____ Dollars (\$_____) or _____ percent (____%) . . .

2002 AAPL Offshore JOA, at art. 8.7.

Parties may then elect whether to continue to participate within _____ (____) days or _____ (____) hours if a rig is on location, [] **inclusive** [] **exclusive** of Saturdays, Sundays, and federal holidays, after receipt of the Supplemental AFE. If fewer than all, but one (1) or more Participating Parties elect to continue to participate in the current operation and agree to pay and bear one hundred percent (100%) of the costs and risks of conducting it, Operator shall continue to conduct the current operation. Otherwise, the operation shall cease.⁹³

The 2007 AAPL Deepwater JOA provides that:

Except as provided in Article 6.2.3 (*Further Operations During a Force Majeure*), if it appears (based upon the Operator's reasonable estimate) that the actual Costs associated with an original AFE or its approved supplemental AFEs will exceed the relevant permitted over-expenditure set forth below,^[94] the Operator shall promptly submit a supplemental AFE to the Participating Parties. A supplemental AFE shall include the dollar amount of the permitted over-expenditure from the previously approved AFE as part of the dollar amount of that supplemental AFE. Subject to Article 8.6.1 (*Well Proposals, Recompletions, and Workovers*), after receipt of the supplemental AFE each Participating Party has the right to make an Election as to its further participation in the approved activity or operation.⁹⁵

The UKOOA 2009 JOA does not permit a non-operator to elect not to participate further, but affirmatively requires the overspending operator to seek “prior approval” of the operating committee to incur additional expenses, which makes it easier to conclude that an operator that does not do so is financially responsible:

The Operator shall use reasonable endeavours not to exceed the approved exploration and/or appraisal Budget but shall be entitled without prior approval of the Joint Operating Committee to incur expenditure:

- (a) in excess of an approved AFE up to the lesser of ten per cent (10%) of the amount of the approved AFE and [] Pounds (£[]); and
- (b) subject to (a) above, in excess of an approved exploration and/or appraisal Budget up to [] per cent ([]%) of the amount of the approved Budget.

Whenever it appears to the Operator that the over-expenditure for any item will exceed the amount authorised under this clause 10.5, the Operator shall revise the appropriate AFE and/or Budget and will seek the prior approval of the Joint Operating Committee to incur the additional expenditure prior to entering into any further commitment.⁹⁶

⁹³*Id.*

⁹⁴The “permitted over-expenditure” is the lesser of a percentage of the AFE amount or a dollar amount, both of which are negotiated and may be different for different kinds of operations. See 2007 AAPL Deepwater JOA, at arts. 6.2.2.1–4.

⁹⁵*Id.* at art. 6.2.2.

⁹⁶UKOOA 2009 JOA, at cl. 10.5.

But the clearest statement found was that of the final draft of the AIPN 2012 JOA, which included an optional provision that was dropped from the final version of the form:

4.6.E Despite Article 4.6.D, Operator (i) shall not be released from or indemnified for, and (ii) shall bear all, damages, losses, costs, and/or liabilities arising out of, incident to, or resulting from:

....

(f) compliance with over-expenditure limitations and approvals under Article 6.8.⁹⁷

For better or worse, limitation of the operator's liability by reference to gross negligence or willful misconduct or both is a part of operating agreements around the world. Some protection for the operator is generally justifiable, given the risks of the oil business. But the most common source of dispute—cost overruns—should be expressly addressed in a revised AAPL form using the approaches illustrated by the contract language quoted above as options.

[b] Provide an Option for an Operating Committee

Perhaps my most controversial suggestion will be that the drafting committee should also include in the new model form an option for an operating committee. Andrew Derman and James Barnes argued at the Rocky Mountain Mineral Law Foundation *Annual Institute* in 1996 that offshore and international operations were better conducted using an operating committee than the traditional U.S./Canadian onshore structure:

Historically, the first model form operating agreements were drafted to address the drilling of onshore wells primarily in the United States, where individual autonomy is a prized tradition. These agreements were conceived to deal with relatively unsophisticated technology, low cost wells, high margin prices, and small lease areas held under a property ownership system that fosters unilateral initiative. Under the circumstances, it was not unreasonable for the parties to delegate broad authority to one of them to organize the drilling of an exploratory well and to develop the field.⁹⁸

They urged that in offshore and international operations, an operating committee was a more efficient structure because of the large contract

⁹⁷ See *supra* note 65.

⁹⁸ Andrew B. Derman & James Barnes, "Autonomy Versus Alliance: An Examination of the Management and Control Provisions of Joint Operating Agreements," 42 *Rocky Mt. Min. L. Inst.* 4-1, 4-12 (1996). See also *id.* at 4-6 ("The rationale generally given for this structure of autonomy and non-association is to avoid adverse U.S. tax effects and to limit liability among the co-adventurers. . . . A corollary consequence is the creation of a structure that reserves maximum autonomy to each individual co-adventurer and contemplates minimum cooperative action among the co-adventurers.").

areas, sophisticated technology, and expensive drilling and development involved; non-operators simply cannot afford to be “passive investors” in offshore and international operations.⁹⁹

Derman and Barnes could have been writing about shale development and other operations involving horizontal drilling and hydraulic fracturing, which are fast becoming the normal drilling and completing techniques. Horizontal drilling now accounts for more than 60% of all rig activity in the United States.¹⁰⁰ And 90% of oil and gas wells in the United States undergo hydraulic fracturing to stimulate production.¹⁰¹ With advanced technology come higher costs. “Horizontal well costs are generally 20% to 25% higher than vertical well costs”¹⁰² More expensive rigs needed for horizontal drilling coupled with more fracking has raised costs “from \$2 million to \$5–6 million per well in the Woodford Shale of Southeast Oklahoma.”¹⁰³ “A typical Bakken well costs \$8–10 million with about \$1.5–2.5 million in fracking cost.”¹⁰⁴ And a single Marcellus well may have direct costs of more than \$7.6 million.¹⁰⁵ In the context of complicated and expensive technologies, it is in the interests of both operators and non-operators that the JOA include an option for a process that brings all the parties—non-operators and the operator—together periodically to discuss and analyze projects and the technologies to perform them.

The AIPN, AMPLA, and UKOOA model forms all provide for operating committees.¹⁰⁶ Neither the CAPL 2007 Operating Procedure nor the AAPL forms do, but RMMLF Form 1 and RMMLF Form 2 state that operations “shall be subject to supervision and control by the Parties,”¹⁰⁷ and require

⁹⁹*Id.*

¹⁰⁰See Independent Petroleum Ass’n of Am. (IPAA), “U.S. Oil Technology Revolutionizing Development,” <http://oilindependents.org/u-s-oil-technology-revolutionizing-development/>.

¹⁰¹See IPAA, “Hydraulic Fracturing: Effects on Energy Supply, the Economy, and the Environment” (Apr. 2008).

¹⁰²U.S. Envtl. Prot. Agency, “Directional Drilling Technology,” at 6 (Dec. 10, 2012).

¹⁰³Timothy Fitzgerald, “Frackonomics: Some Economics of Hydraulic Fracturing,” 63 *Case W. Res. L. Rev.* 1337, 1353 (2013).

¹⁰⁴*Id.* at 1352.

¹⁰⁵William E. Hefley et al., “The Economic Impact of the Value Chain of a Marcellus Shale Well,” at 65 tbl.12 (Pitt. Bus. Working Paper Aug. 30 2011).

¹⁰⁶See AIPN 2012 JOA, at arts. 5.1–.13; AMPLA 2011 JOA, at cl. 5.1–.8; UKOOA 2009 JOA, at cl. 9.1–.10.

¹⁰⁷RMMLF Form 1, at art. 7.1; RMMLF Form 2, at art. 14.1.

that “a meeting shall be called by Unit Operator upon written request of any Party”¹⁰⁸

Using an operating committee undoubtedly raises the risk that an operator will be held to have a fiduciary obligation to the non-operators, which no operator wants, as well as the risk that the operator and non-operators will be jointly and severally liable to third parties.¹⁰⁹ The greater the control of the non-operators is, the greater the risk is that the parties will not be treated as cotenants.¹¹⁰ To some degree, this risk can be minimized by careful drafting; all of the model forms contain similar provisions disclaiming the existence of a partnership, denying the intention to create a joint venture or mining partnership, and purporting to negate any fiduciary relationship.¹¹¹ But whatever the risk of being classified as joint venturers or mining partners, the changes in the technologies and economics of the industry may require more cooperative decision making than the current AAPL forms provide for. Including an option for an operating committee in the new model form is one way to open the door to more cooperation.

[c] Provide for Consultation

Alternatively, AAPL’s drafting committee should consider imposing a consultation obligation on the operator. While any interaction between the operator and non-operators may give support to third-party claims of joint and several liability, the exposure from consultation is minimal.

Several of the model forms contain mandatory-consultation language. The CAPL 2007 Operating Procedure, which contains no provision for an operating committee, nonetheless provides for mandatory consultation:

¹⁰⁸RMMLF Form 1, at art. 7.3; RMMLF Form 2, at art. 14.3. RMMLF Form 1 provides for a negotiated percentage of participating interest to make the call, while RMMLF Form 2 states that “any Party having voting power on any matter to be considered” may call for a meeting.

¹⁰⁹As discussed in § 27.01, *supra*, one of the reasons for using an operating agreement is to minimize the risk of the parties being regarded as a joint venture, owing fiduciary duties to each other and being jointly and severally liable to others. See Ernest E. Smith, “The Operator: Liability to Non-Operators, Resignation, Removal and Selection of a Successor,” *Oil & Gas Agreements: Joint Operations 2-1, 2-4* (Rocky Mt. Min. L. Fdn. 2008).

¹¹⁰Boigon & Murphy, *supra* note 3, at 159 (noting that in mining partnership cases, mutual control often proves most important in determining whether an enterprise constitutes a joint venture).

¹¹¹See AAPL Form 610-1989, at arts. V.A, VII.A; AIPN 2012 JOA, at art. 14.1; AMPLA 2011 JOA, at cl. 3.3(f), 3.4(d); CAPL 2007 Operating Procedure, at cl. 1.5; RMMLF Form 2, at art. 28.2; UKOOA 2009 JOA, at cl. 22.2.1; 2002 AAPL Offshore JOA, at art. 19.1; 2007 AAPL Deepwater JOA, at art. 22.1. See also Smith, *supra* note 109, at 2-4; Pierce, *supra* note 6, at 1-20 to 1-21.

The Operator will consult with the Parties periodically about the exploration, development and operation of the Joint Lands, the construction, installation and operation of any Production Facility and management of the Joint Property. It will keep them informed in a timely manner about Joint Operations planned or conducted by it. Subject to this Agreement, the Parties delegate to the Operator, on their behalf, management of the exploration, development and operation of the Joint Lands and management of the other Joint Property.¹¹²

And both the 2002 AAPL Offshore JOA and the 2007 AAPL Deepwater JOA contain a similar, but more general provision: “unless otherwise provided in this agreement, the operator shall consult with the non-operating parties and keep them informed of important matters.”¹¹³ RMMLF Form 2 also has similar language:

In the conduct of operations hereunder, Unit Operator shall: . . . Consult freely with the Parties within the area affected by any operation hereunder and keep them advised of all matters arising in operations hereunder which Unit Operator deems important, in the exercise of its best judgment.¹¹⁴

[d] Provide an Option for Secondment

Another concept adopted in the AIPN model forms in the 2002 and 2012 versions that the AAPL drafting committee should include as an option in a new model form is secondment. “Secondment” means “placement . . . of an employee of a Non-Operator or its Affiliate in Operator’s organization . . .”¹¹⁵ Under the AIPN forms, it is limited in use to “situations requiring particular expertise or involving projects of a technical, operational or economically challenging nature.”¹¹⁶

[T]he concept of Secondment [is that] Non-Operator personnel with particular expertise and experience are integrated into the Operator’s organization for the limited purpose of conducting a particularly complex Joint Operation . . . [as] a way to enhance the Operator’s technical capabilities without diluting overall accountability and the Operator’s responsibility for Joint Operations.¹¹⁷

Secondment also provides non-operators “inside information” about the joint operations, though it is usual to restrict confidential information to that to which the non-operator is entitled under the JOA, and may facilitate a smoother working relationship between the operator and non-operators. The AMPLA 2011 JOA contains a broader secondment provision in clause

¹¹²CAPL 2007 Operating Procedure, at cl. 3.2A. The UKOOA 2009 JOA has consultation language at clause 6.9 in addition to the provision for an operating committee.

¹¹³2002 AAPL Offshore JOA, at art. 5.2; 2007 AAPL Deepwater JOA, at art. 5.2.

¹¹⁴RMMLF Form 2, at art. 16.1.D. RMMLF Form 1 has similar language at article 9.1.C.

¹¹⁵AIPN 2012 JOA, at art. 1.1 [Alternative No. 3].

¹¹⁶*Id.* at art. 4.3.C.

¹¹⁷Weems & Bolton, *supra* note 65, at 3.

7.8, which permits the operator to request or a non-operator to nominate “suitable management and technical personnel for particular Joint Operations,” though neither the operator nor a non-operator is required to accept or provide any proposed secondees.¹¹⁸ The UKOOA 2009 JOA is particularly well formulated and flexible, in this author’s opinion:

Secondment

6.11.1 The Participants agree that in certain circumstances a collaborative effort between them may be beneficial to Joint Operations. Such collaborative effort may include the secondment by a Non-Operator of personnel to the Operator’s organisation:

- (a) to work on a term assignment as a member of a project team; or
- (b) to fill organisational positions;

in respect of Joint Operations. The length of any assignment shall be agreed between the Non-Operator and the Operator. Notwithstanding the foregoing, the Non-Operator shall have the right on giving three (3) months notice, to withdraw its employee from any such assignment.

The Operator shall have the right to require the removal of any person seconded to its organisation for reasonable cause.

6.11.2 In respect of any person seconded to the Operator’s organisation under clause 6.11.1 for the period of such secondment:

- (a) such person shall remain the employee of the Participant which seconded him and such Participant shall remain responsible for all the legal obligations of an employer associated with such employment;
- (b) all costs associated with the employment of such person (including salary and employee benefits) and all costs associated with his secondment to the organisation of the Operator shall be chargeable to the Joint Account; and
- (c) all work undertaken by such person shall be Joint Operations and accordingly the Operator shall retain overall responsibility for such work and such person (and the Participant which seconded him) shall benefit from all indemnities and limitations of liability applying to the Operator hereunder, including those set forth in clause 6.2.4 in relation to such work.¹¹⁹

§ 27.03 Operator Removal—Is Gross Negligence or Willful Misconduct Necessary to Justify Removal?

The practical remedy provided to non-operators by all the model form operating agreements for bad behavior by an operator is operator removal.

¹¹⁸AMPLA 2011 JOA, at cl. 7.8(b).

¹¹⁹UKOOA 2009 JOA, at cl. 6.11.

But under the model forms, once a party has been designated as operator, it is not easily removed. Difficulty of removal, like limited liability, follows from the relationship of the operator and non-operators. The operator serves to facilitate the goals of the economic partnership of the working interest owners, rather than as a for-hire administrator. The operator does not make a profit or collect fees as operator. The operator is at risk, just like everybody else involved in the venture. So the operator ought to be protected against removal, as well as liability, except in unusual circumstances.

[1] Provisions of the AAPL Model Forms

The first AAPL model form, AAPL Form 610-1956, provided for change of operator only when the operator sold all of its interest in the Contract Area or resigned; under the 1956 model form, once a working interest owner was elected operator it remained operator as long as it owned *any* interest in the Unit Area, unless it chose to resign. Many thought that the 1956 form was too rigid, that some provision for operator removal was desirable.¹²⁰

The three later versions of the AAPL model form permit non-operators to remove the operator, but only for cause and after process. The 1977 and 1982 model forms provided in article V.B.1 that “Operator may be removed if it fails or refuses to carry out its duties hereunder.”¹²¹ As Robert Bledsoe commented, “[f]ailure or refusal to carry out [its] duties’ is a fertile area for evidentiary development”¹²²

An interpretative problem with the 1977 and 1982 forms was whether the reference to “fails or refuses to carry out its duties” requires non-operators to show that the operator has been grossly negligent or guilty of willful misconduct in order to justify removal. To this author, the reference to “duties” is broader than the obligation imposed to conduct operations in a “good and workmanlike manner,” to which the terms of the exculpatory language apply, but the argument was raised in operator-removal

¹²⁰See, e.g., Young, *supra* note 9, at 219. The Foundation’s first form, RMMLF Form 1, had no operator-removal provision either.

¹²¹The 1977 and 1982 forms differed as to the percentage the non-operators had to control. The 1977 form required “the affirmative vote of two (2) or more Non-Operators owning a majority interest based on ownership as shown on Exhibit ‘A,’ and not on the number of parties remaining after excluding the voting interest of Operator.” AAPL Form 610-1977, at art. V.B.1. The 1982 form provided for “the affirmative vote of two (2) or more Non-Operators owning a majority interest based on ownership as shown on Exhibit ‘A’ remaining after excluding the voting interest of Operator.” AAPL Form 610-1982, at art. V.B.1.

¹²²Bledsoe, *supra* note 26, at 8-5.

litigation,¹²³ and several commentators have noted it: “[t]he combination of ‘for cause’ removal clauses along with such a high standard of liability under the AAPL 1977 and 1982 forms makes an operator virtually removal proof”¹²⁴

AAPL Form 610-1989 clarified the standards and process for for-cause removal of the operator by requiring notice and an opportunity for cure, and by replacing the “fails or refuses to carry out its duties” language with removal for “good cause,” which is defined broadly, to make it clear that the operator-removal standard was a lower threshold than “gross negligence or willful misconduct”:

Operator may be removed only for good cause by the affirmative vote of Non-Operators owning a majority interest based on ownership as shown on Exhibit “A” remaining after excluding the voting interest of Operator; such vote shall not be deemed effective until a written notice has been delivered to the Operator by a Non-Operator detailing the alleged default and Operator has failed to cure the default within thirty (30) days from its receipt of the notice or, if the default concerns an operation then being conducted, within forty-eight (48) hours of its receipt of the notice. For purposes hereof, “good cause” shall mean not only gross negligence or willful misconduct but also the material breach of or inability to meet the standards of operation contained in Article V.A. or material failure or inability to perform its obligations under this agreement.¹²⁵

[2] Provisions of Other Model Forms

Several of the model forms address the issue of whether operator removal requires a showing of gross negligence or willful misconduct, at least indirectly. RMMLF Form 2’s language relating to operator removal is similar to that in the 1977 and 1982 AAPL model forms, but authorizes removal for breach of “duties or obligations,” rather than just “duties,” which may be sufficient to avoid the issue of whether the breach must rise to the level of “gross negligence or willful misconduct”:

Upon default or failure in performance of its *duties or obligations* under the Unit Agreement, Unit Operator may be removed by the Approval of the Parties after excluding the voting interest of the Unit Operator, and the Parties shall, or any

¹²³See *Tri-Star Petroleum Co. v. Tipperary Corp.*, 101 S.W.3d. 583, 589–90 (Tex. App.—El Paso 2003, pet. denied); *R & R Res. Corp. v. Echelon Oil & Gas, L.L.C.*, No. 03-05-00479-CV, 2006 WL 66458, at *8 (Tex. App.—Austin Jan. 10, 2006) (mem. op.).

¹²⁴Brian R. Bjella, “Removing the Operator Under the Joint Operating Agreement: Breaking Up Is Hard to Do,” 45 *Rocky Mt. Min. L. Inst.* 11-1, 11-21 (1999) (citing Milam Randolph Pharo, “Duties and Obligations Revisited—Who Bears What Risk of Loss?” *The Oil and Gas Joint Operating Agreement* 4-1, 4-16 (Rocky Mt. Min. L. Fdn. 1990)).

¹²⁵AAPL Form 610-1989, at art. V.B.1 (emphasis added). Article V.D lists rights and duties of the operator, and article XV.D also provides that “the failure of any party to this agreement to comply with all of its financial obligations provided herein shall be a material default.” That failure to pay bills is a material breach is implicit in all the JOA forms, though it is best made express.

Party may, promptly give written notice to the Unit Operator of such Approval of the Parties to remove the Unit Operator detailing the default or failure in performance.¹²⁶

The 2002 AAPL Offshore JOA permits operator removal where there is a “substantial breach of a material provision,”¹²⁷ undoubtedly on the theory that gross negligence or willful misconduct would meet that standard, while “substantial breach of a material provision” would not require gross negligence or willful misconduct. The provisions of the CAPL 2007 Operating Procedure and the AMPLA 2011 JOA are similar. The CAPL 2007 Operating Procedure provides that:

The Operator will be replaced and another Operator appointed . . . if:

. . . .

- (b) the Operator defaults in performance of *any* of its duties or obligations hereunder . . . and does not begin to remedy diligently that default within 30 days after receiving a *bona fide* notice from Parties holding a majority of the Working Interests (excluding those of the Operator and any of its Affiliates that are Parties), specifying the default in sufficient detail to enable the Operator to understand its nature and requiring the Operator to remedy it, provided that the Operator will be replaced immediately by an interim Operator . . . if those duties or obligations must be fulfilled sooner to protect life, property or the environment¹²⁸

The counterpart provision in the AMPLA 2011 JOA addresses operator removal in terms of the duration of the operator’s appointment. It states that the operator’s appointment ends when “the Operator commits a Breach Default Event and fails to remedy the default within 60 days of receipt of a written notice of default served by a Participant.”¹²⁹

Better to be sure. The 2007 AAPL Deepwater JOA avoids the issue by making *either* a finding of gross negligence or willful misconduct or “substantial breach of a material provision” of the contract that is not timely cured cause for removal.¹³⁰ And the UKOOA 2009 JOA provides both that the joint operating committee may remove the operator at the end of any month if “the Operator has committed any material breach of, or failed to observe or perform any material obligation on its part contained

¹²⁶RMMLF Form 2, at art 17.2.B (emphasis added).

¹²⁷2002 AAPL Offshore JOA, at art. 4.4(c).

¹²⁸CAPL 2007 Operating Procedure, at cl. 2.3B (emphasis added). As discussed below, even the reference to default of “any” of the operator’s duties or obligations will require the showing of a material breach.

¹²⁹AMPLA 2011 JOA, at cl. 6.2(d). “Breach Default Event” is defined to include the “Operator committing a material breach of any of its material obligations under this agreement” *Id.* at cl. 1.1.

¹³⁰See 2007 AAPL Deepwater JOA, at art. 4.4.2(a), (b).

in, this Agreement,”¹³¹ and for an option for immediate removal for “Wilful Misconduct.”¹³² Additionally, there is a note that “if these words [the option for immediate removal] are deleted then any Wilful Misconduct is assumed also to be a breach of the Operator’s obligations under the JOA which would justify removal under 5.3.1,” which makes clear that material breach of a material obligation need not rise to willful misconduct.

[3] The Operator-Removal Process

Ultimately, whether there is “cause” for operator removal is a fact question.¹³³ Under the usual principles of contract interpretation, to support removal of an operator by non-operators, the operator’s breach must be material—a failure to conduct operations in a “good and workmanlike manner,” a significant breach of contract duties, or some tortious conduct. Further, materiality must be judged in context, considering the particular breach in light of all of circumstances, including the totality of the operator’s duties under the agreement. The operating agreement specifies many of the duties of the operator, but it also provides that the operator has the duty to “conduct and direct and have full control of all operations” and that “it shall conduct all such operations in a good and workmanlike manner.” A single act might be so egregious that it would constitute grounds for removal, for instance, if the operator committed an outright act of theft. On the other hand, insignificant breaches of the operating agreement, such as sending out billing statements a few days late, would not constitute grounds for removal. Whether there is cause for operator removal is a question of the materiality of the breach when considered in light of all of the functions performed by the operator in furthering the goals of the project and in carrying out its contractual duties. As Howard Boigon has observed, what those seeking to remove an operator must do is “prove that the operator’s conduct is not within the latitude normally accepted by the industry.”¹³⁴

Proof of the failure or refusal of an operator to perform its duties under the operating agreement, particularly in light of the operator’s obligation

¹³¹UKOOA 2009 JOA, at cl. 5.3.1(a).

¹³²*Id.* at cl. 5.3.2(i).

¹³³See Robert C. Bledsoe, “Operating Agreements from the Standpoint of the Nonoperator,” *Advanced Oil, Gas & Mineral L. Inst.* (State Bar of Tex. Oct. 1985) (“[The meaning of ‘failure or refusal to carry out duties’] presents a fact issue . . .”). See also Bledsoe, *supra* note 26, at § 8.02.

¹³⁴Howard L. Boigon, “The Joint Operating Agreement in a Hostile Environment,” 38 *Inst. on Oil & Gas L. & Tax’n* 5-1, 5-28 (Sw. Legal Fdn. 1987). Boigon was a principal drafter of the AAPL Form 610-1989.

to perform in a “good and workmanlike manner,” generally requires testimony of industry norm and custom. Whether or not the operator has adhered to the standard of performance reasonably expected of operators under similar circumstances is not a matter within the common understanding of a jury.

Many have thought that the standard for operator removal is objective, ultimately to be determined by a court, rather than by the subjective determination of the non-operators. *Tri-Star Petroleum Co. v. Tipperary Corp.*¹³⁵ is to the contrary, however. There a Texas-based operator, Tri-Star Petroleum Company (Tri-Star), and Australian non-operators used the AAPL Form 610-1977 with a COPAS Model Form Accounting Procedure to operate a 2.3-million-acre coalbed gas project in Queensland, Australia. The non-operators voted to remove Tri-Star, alleging both accounting and operational defaults. Tri-Star refused to step aside. Tipperary, the newly elected operator, went to court in Texas and obtained a temporary injunction requiring Tri-Star to hand over operations. Tri-Star then filed an accelerated interlocutory appeal. One of Tri-Star’s arguments was that the trial court had erred by granting a temporary injunction without determining that Tri-Star had failed or refused to perform its duties as operator under the JOA.¹³⁶ Tri-Star argued that a judicial determination was a condition precedent to the removal of an operator.¹³⁷ The appellate court considered the evidence that had been presented to the trial court, including both accounting and operational defaults, perhaps the worst of which was that Tri-Star’s failures had required the venturers to relinquish parts of the “Authority to Prospect” from Queensland. The appellate court stated that “the trial court could [properly] conclude that the JOA provisions were unambiguous and thus its terms should be given their plain, ordinary, and generally accepted meaning.”¹³⁸ Effectively, the court interpreted the AAPL Form 610-1977 provisions to permit the non-operators to determine whether cause existed for operator removal.¹³⁹

¹³⁵101 S.W.3d. 583 (Tex. App.—El Paso 2003, pet. denied).

¹³⁶*Id.* at 590.

¹³⁷*Id.*

¹³⁸*Id.*

¹³⁹Brad Moody has characterized the two positions as “will of the court” and “will of the majority.” See M. Bradford Moody, “Removing An Uncooperative Operator Under the Model 610 Form Operating Agreement,” 34 *Oil, Gas & Energy Res. L. Sec. Rep.* 39, 50 (State Bar of Tex. 2010).

The underlying logic of *Tri-Star* is attractive: the parties who enter into one of the model forms contractually agree that non-operators have the right to determine whether cause exists under the circumstances. So long as there is no indication that the non-operators have acted in bad faith or unreasonably, there is no reason that judicial confirmation of their action should be necessary. The fact remains, however, that there is no express obligation under any of the AAPL model forms that the operator give up operational control if it does not agree that cause existed for the removal vote, so that operator-removal votes are likely to end up before the courts, as was the case in *Tri-Star*. Until a court has ruled, the operator generally continues to function in that capacity.¹⁴⁰

And when courts rule, they often find in favor of the operator. *Gifford Operating Co. v. Indrex, Inc.*¹⁴¹ illustrates the point.¹⁴² There, non-operators owning a majority of the working interest voted to remove the operator.¹⁴³ The opinion notes operational defects alleged by the non-operators.¹⁴⁴ The court observed that the operator “must be free to exercise [its] good judgment”¹⁴⁵ and can be removed only if it “has failed to operate the well in a good and workmanlike manner.”¹⁴⁶ The court found that the operator had operated the well in a good and workmanlike manner and thus could not be removed, notwithstanding the majority vote of the working interest owners who had asserted they had grounds for removal.¹⁴⁷

Whether or not there is cause for removal, the process can be bloody, as *Tri-Star* illustrates. “A vote to remove an operator will likely result in a declaratory judgment action that will not be satisfactory to either party.”¹⁴⁸

¹⁴⁰The reason may be pride. But it may also be economics. An operator has a financial interest in continuing as operator, as discussed at § 27.01, *supra*.

¹⁴¹No. 2:89-CV-0189, 1992 U.S. Dist. LEXIS 22505 (N.D. Tex. Aug. 7, 1992) (unreported).

¹⁴²So does *Tri-Star*. Even though the court found that the non-operators had properly removed the operator, the operator continued to operate until the court ruled.

¹⁴³*Gifford*, 1992 U.S. Dist. LEXIS 22505, at *4–5.

¹⁴⁴See *id.* at *3–4 (alleging negligence in the design and execution of the fracture treatment).

¹⁴⁵*Id.* at *3.

¹⁴⁶*Id.* at *4.

¹⁴⁷*Id.* at *5.

¹⁴⁸Bjella, *supra* note 124, at 11-21 (citing Pharo, *supra* note 124, at 4-17).

Even if non-operators seek expedited injunctive relief, the litigation may take years and cost a lot of money to resolve.¹⁴⁹

[4] Suggestions for the Drafters

[a] Make the Operator-Removal Provisions More Certain

A possible expediting solution would be to include a provision in the operating agreement that follows the court's reasoning in *Tri-Star*, making it clearer that determination whether good cause exists to remove an operator is an appropriate function of the non-operators acting in good faith. Arthur Wright has suggested that non-operators should insert language in article V.B.1 of the operating agreement that reads:

A judicial determination that good cause exists for removal of the Operator shall not be a condition precedent to the removal of the Operator for good cause becoming effective, provided that an Operator removed for good cause shall be deemed reinstated as Operator if and when a valid judgment, which holds that good cause did not exist for such removal, becomes final and non-appealable. The Non-Operators would suffer irreparable harm if the removal of an Operator for good cause is not made effective as provided above and the Non-Operators shall be entitled to injunctive relief or other equitable relief to enforce any such removal of Operator.¹⁵⁰

Wright also suggests that the “good cause” definition in article V.B.1 be modified to include “material failure or inability to perform its obligations, duties, or responsibilities under this agreement.”¹⁵¹ That change would more clearly include the “duties” of the operator listed in article V.D of the AAPL Form 610-1989.¹⁵² Both changes would discourage litigation over how the operator-removal process is supposed to work.

Finally, the drafting committee should consider providing specifically that non-operators who seek to remove an operator will face no liability.¹⁵³ The CAPL 2007 Operating Procedure has such a provision:

¹⁴⁹The non-operators' vote to remove *Tri-Star* was in 1999. The decision of the court of appeals was in 2003.

Professor Bruce Kramer and I once spent three days sequestered in a federal court house waiting to testify (for opposing parties) in an operator-removal case. Killing time, we calculated that the total of the likely charges for the lawyers and experts involved in the case substantially exceeded any damages.

¹⁵⁰Wright, *supra* note 78, at 7-16.

¹⁵¹*Id.* at 7-17.

¹⁵²“Rights and Duties’ might be considered to be different from ‘obligations.’” Moody, *supra* note 139, at 42.

¹⁵³In *Tri-Star Petroleum Co. v. Tipperary Corp.*, 101 S.W.3d. 583 (Tex. App.—El Paso 2003, pet. denied), *Tri-Star* asserted a barrage of claims against those who sought to remove it.

No Recourse For Removal-An Operator that resigns or is replaced in accordance with this Article will not have any claim or recourse against the other Parties because of its resignation or replacement.¹⁵⁴

[b] Provide an Option for Removal Without Cause

An alternative that AAPL's drafting committee should consider is to give non-operators the option to remove the operator without cause. Many model forms include such an option, though it may be used infrequently and the details of how it works differ. The first draft of what became the AAPL Form 610-1989 included an optional provision providing that non-operators might remove an operator without cause by a majority vote, which was roundly criticized by large companies and dropped from the final version.¹⁵⁵ A removal-without-cause provision is included in the 2007 CAPL Operating Procedure, however, keyed to non-operators owning at least 60% of the working interest:

Delayed Replacement-The Operator will be replaced and another Operator appointed . . . if:

- (a) at least two Parties holding at least 60% of the Working Interests agree, by notice to the other Parties (including as a single Party for this purpose any Affiliate thereof that is a Party), to replace the Operator, provided that a single Party holding at least a 60% Working Interest may, by notice to the other Parties, become the Operator hereunder, unless it: (i) would then be subject to immediate replacement under Subclause 2.02A¹⁵⁶; or (ii) is then subject to a *bona fide* notice of default under Clause 5.05.¹⁵⁷

¹⁵⁴CAPL 2007 Operating Procedure, at cl. 2.6F. So does the UKOOA 2009 JOA:

The Operator shall have no claim against the Participants as a consequence of the . . . removal of the Operator but such . . . removal shall be without prejudice to any rights, obligations or liabilities which accrued during the period when the Operator acted as such.

UKOOA 2009 JOA, at cl. 5.4.

¹⁵⁵See Derman, *supra* note 47, at 185; John Burritt McArthur, "Coming of Age: Initiating the Oilfield into Performance Disclosure," 50 *SMU L. Rev.* 663, 748 (1997).

¹⁵⁶Clause 2.02A provides for immediate replacement of a bankrupt or insolvent operator. Unlike the counterpart provision in the AAPL model contracts, it defines insolvency, as being "unable to pay its debts as they fall due in the usual course of business or if it does not have sufficient assets to satisfy its cumulative liabilities in full." CAPL 2007 Operating Procedure, at cl. 2.3A(a). In *Tri-Star Resources Ltd. v. J.C. International Petroleum Ltd.* (1986), 48 Alta. L.R. 2d 355, [1987] 2 W.W.R. 141 (Can. Alta. Q.B.), the court found that the appointment of a receiver for the operator was sufficient to trigger the automatic removal provisions of an earlier version of the CAPL form. But a definition of "insolvency" is preferable, and should be added by the drafting committee.

¹⁵⁷CAPL 2007 Operating Procedure, at cl. 2.3B. Clause 5.05 provides for interest, suspension from the venture, and ultimate removal of a defaulting non-operator.

The UKOOA 2009 JOA has a similar provision, but the percentage of ownership necessary to replace an operator is negotiated.¹⁵⁸ The AIPN 2012 JOA straightforwardly provides an optional provision that an

Operator may be removed at any time without cause by the affirmative vote of _____ (_____) or more of the total number of Non-Operators, excluding Affiliates of the Operator, holding at least _____ percent (____%) of the combined Participating Interest of such Non-Operators.¹⁵⁹

The 2002 AAPL Offshore JOA and the 2007 AAPL Deepwater JOA permit operator removal when the operator no longer owns the largest interest.

If the Operator assigns part of its Working Interest (excluding an interest assigned to an Affiliate) and the assignment reduces the Operator's Working Interest to less than the Working Interest of a Non-Operating Party, whether accomplished by one or more assignments, then the removal of the Operator requires approval by Vote.¹⁶⁰

The removal-without-cause option is rarely chosen in international operations because host-government agreements commonly require government approval for a change of operator,¹⁶¹ and often the operator is the only investor party to the host-government contract to have experience, personnel, and equipment in the country. But removal without cause has a place in domestic operations, where mineral-owner-approval requirements are unusual and operational logistics are easier. An optional provision for operator removal without cause should be included in the AAPL Form 610 revision for the same reasons that it is included in the AIPN 2012 JOA. First, it is logical: “if one can intellectually conclude, or make the leap of faith, that an Operator should be working for the benefit of all of the co-adventurers, why should the Non-Operators not have the power to remove their Operator?”¹⁶² Second, where chosen, the possibility of removal of the operator without cause will help establish a cooperative relationship between operator and non-operators: “the authority to remove will tend to restrain the Operator from becoming too creative in charging its internal costs, and will tend to cause the Operator to be attentive to the balance of its wants and needs with those of the Non-Operators.”¹⁶³ The mere pres-

¹⁵⁸UKOOA 2009 JOA, at cl. 5.3.1(b).

¹⁵⁹AIPN 2012 JOA, at art. 4.10.E.

¹⁶⁰2007 AAPL Deepwater JOA, at art. 4.4.1. *See also* 2002 AAPL Offshore JOA, at art. 4.4(c).

¹⁶¹*See* Ernest E. Smith et al., *International Petroleum Transactions* 615 (Rocky Mt. Min. L. Fdn. 3d ed. 2010). Investors rarely want to rock the investment boat by asking for government approval of an operator change.

¹⁶²Derman & Barnes, *supra* note 98, at 4-39.

¹⁶³*Id.*

ence of the option in the model form may help set a healthier tone for the relationship of operator and non-operator.

Additionally, providing the non-operators with an option to remove an operator whose interest falls below an agreed percentage of the whole makes good sense; it is in every participant's interest that the operator has "skin in the game."¹⁶⁴

[c] Provide Options to Facilitate Renegotiation of the Operating Agreement

There are several practical problems with the remedy of operator removal. One is that it is often not feasible for the non-operators to take over operations or to locate a competent contract operator; change of operator is likely to be an expensive process, particularly if it is done with short notice and in the midst of disagreements. Second, because oil and gas exploration and development is risky as well as expensive, the working interest owners share an interest in continuity in operations with the operator; change may bring mistakes and raise costs for everyone. And third, as discussed above, an operator removed for cause often will dispute the existence of cause and simply refuse to go, throwing the issue into the courts.

In this context, the drafting committee should also consider provisions that might facilitate adjustment of operations short of operator removal, by permitting renegotiation of provisions of the operating agreement that may strain relations between the operator and the non-operators. Oil and gas production may last for decades, and there is a strong possibility that within that time there will be changes in company ownership, culture, operating circumstances, or economics that will make the parties' original agreement unsatisfactory to at least some of the parties.

There are two provisions in the CAPL 2007 Operating Procedure that are particularly attractive in that they permit adjustment of the terms of the operating agreement and, potentially, a change of operator. The first is the operator-challenge process, which permits a non-operator to replace an operator in situations in which the terms the parties have agreed upon turn out to be unattractive to the non-operators. The CAPL 2007 Operating Procedure provides that:

- A. *Challenge Notice*-At any time *after* a Party has been the Operator for a continuous period of at least 2 years, any Non-Operator may give notice (the "Challenge Notice") to the other Parties that it is prepared to conduct Joint Operations on more favourable terms and conditions. It will include in the Challenge Notice sufficient detail to enable the other Parties to evaluate the nature of the Challenge Notice and the effect the revised terms and conditions would have on Joint Operations. Within 60 days after receipt of

¹⁶⁴See *supra* note 28.

the Challenge Notice, the Operator will notify the Parties if it is prepared to operate on the terms and conditions set out therein. If it is, it will promptly proceed to do so, and Subclause 2.03B [dealing with removal for cause] will apply to it, *mutatis mutandis*. If it is not, it will resign as Operator effective not later than 45 days after that 60 day period. The Operator will be deemed to resign if it fails to deliver such a notice within that 60 day period.

- B. *Successor Operates Under Challenge Notice*-If the Operator resigns under Subclause 2.03A, a successor will be appointed under Clause 2.06, provided that the Party that served the Challenge Notice will become the new Operator if no other Party is prepared to operate on the terms and conditions set out herein. The new Operator will conduct Joint Operations on the basis set forth in the Challenge Notice. Any costs in excess of those set out therein in the 2 year period after becoming the Operator will be for its sole account. Notwithstanding Clause 2.04 (but subject to Clause 2.09), the new Operator may not resign until it has acted as Operator for at least 2 years.¹⁶⁵

In other words, a non-operator that successfully challenges an operator must “put up or pay up”; it is responsible for all excessive costs for the next two years.

The second provision, a counterbalance to the operator-challenge provision, permits the operator to request modification of the terms and conditions of the operating procedure to its advantage and to the disadvantage of the non-operators:

A Party that has been the Operator for a continuous period of 2 years may give notice (“Operator’s Notice”) to the NonOperators of the revised terms and conditions on which it would continue as Operator, provided that an Operator operating under a previous Operator’s Notice may not serve another Operator’s Notice until the previous one has been effective for at least 2 years. Within 60 days after receipt of the Operator’s Notice, each Non-Operator will notify the Operator if it agrees to the Operator operating under those revised terms and conditions. A Non-Operator that fails to respond within that period will be deemed to agree to those revised terms and conditions. A Non-Operator that does not agree must give notice (“CounterProposal”) to the other Parties of the terms and conditions upon which it would serve as the Operator. Any such CounterProposal will be deemed to be a challenge of the Operator. Clause 2.03 will apply, *mutatis mutandis*, as if it were a Challenge Notice, except that the Counter-Proposal will be compared to the terms and conditions proposed in the Operator’s Notice. If no Party serves a Counter-Proposal, the Operator will thereafter operate under the Operator’s Notice, with any excess costs for its sole account. Notwithstanding Clause 2.04 (but subject to Clause 2.09), it may not resign until it has operated for at least 2 years under any Operator’s Notice that becomes effective.¹⁶⁶

Taken together, these two provisions are similar to the “Push/Pull” provisions sometimes found in partnership agreements, or “baseball arbitration.”

A fair criticism of these provisions is that they are unlikely to be helpful to non-operators with small interests. But the reality is that it is large

¹⁶⁵CAPL 2007 Operating Procedure, at cl. 2.4.

¹⁶⁶*Id.* at cl. 2.5.

interest owners that are likely to be operators, and to implement the provisions. The parties to any contract can always renegotiate that contract, but making renegotiation a contract right brings a salutary certainty to the process.

§ 27.04 Conclusion

The analysis above teaches several lessons. One is that the structure of model form operating agreements around the world is surprisingly uniform. That should not be surprising, for though local law and culture may require tweaks in the details, the purposes of an operating agreement and the problems investors confront finding and producing oil and gas are much the same wherever exploration and production occur. A second lesson is that AAPL's onshore model forms are "dated"; they have been overtaken by both precedents and changes in technology and business structures.¹⁶⁷ It is high time to consider changes.¹⁶⁸ And third, the analysis shows that some of the newer model forms, in particular, contain useful ideas—and even more importantly, language to implement them—that might be embraced by AAPL's drafting committee. It may be true that there is "nothing new under the sun" when it comes to the structure and drafting of operating agreements.¹⁶⁹ But we can learn from what others have done, and the comparative analysis above demonstrates vividly that different words or word structures may make a difference in meaning.

Operating agreements, like leases and deeds, are instruments of private law. While the words parties choose to express their intent will always be subject to interpretation in the context of the circumstances of the agreement,¹⁷⁰ there is no good reason for courts to intervene to rewrite

¹⁶⁷A thoughtful and incisive analysis of changes in the business structure caused by the development of unconventional resources is found at David H. Sweeney et al., "Fracturing Relationships—The Impact of Risk and Risk Allocation on Unconventional Oil & Gas Projects," 65 *Inst. on Oil & Gas L.* 6-1 (Ctr. for Am. & Int'l L. 2014).

¹⁶⁸There are many "recurring issues" in operating agreements. As I noted in my presentation at the *Annual Institute*, I began this chapter thinking I could review a long list, quickly cut it to five, and end by writing about just two, due to time and space constraints.

¹⁶⁹Ecclesiastes 1:4-11. For example, the operator-challenge provisions from the CAPL model form that I discussed favorably in the last section were called "'challenge' or 'flip-flop' clauses" by Joe Young when he wrote more than 40 years ago. Young, *supra* note 9, at 219.

¹⁷⁰See Oliver Wendell Holmes, "The Theory of Legal Interpretation," 12 *Harv. L. Rev.* 417, 417-18 (1899).

the agreements of the parties.¹⁷¹ The challenge for the model form drafters, then, is to understand clearly what effects they seek to attain, and then to pick words that clearly express those results. That is particularly true of committee-drafted contracts, which may lack the focus of drafters negotiating head-to-head, and an important reason to consider including alternative provisions as options; let the parties make the final decisions.

¹⁷¹This is a common theme in oil and gas jurisprudence. See *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 131 (Tex. 1996) (an important case involving interpretation of a lease royalty clause) (citing *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 245 (Tex. 1981); *Tex. Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968)). See also *Foster v. Atl. Ref. Co.*, 329 F.2d 485, 490 (5th Cir. 1964).