HOW DOES THE JOA AFFECT TITLE?

July 18, 2019

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HOW DOES THE JOA AFFECT TITLE?[1]

By Martin Gibson
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I. AT WHAT WE ARE LOOKING.

There are lots of operating agreements out there. I refer here to the traditional oil and gas agreement governing the joint operation of oil and gas leases and interests for the purpose of finding and producing oil and gas, to be distinguished entirely from the "operating agreement" constituting the controlling document of a limited liability company. The most popular such operating agreements or "JOAs" have been those produced by the American Association of Petroleum Landmen. These are mostly onshore, United States, lower 48 forms promulgated in and designated 1956, 1977, 1982, 1989, 1989H, and the 2015. There is a form for the Continental Shelf (710), one for deepwater offshore (810), and various modifications to the forms for specific purposes. The Rocky Mountain Mineral Law Foundation and other organizations have their own forms as well. Since most of the issues are common, our examples will be from the AAPL Form 610 – 2015; unless otherwise noted, all citations to a particular provision of a JOA are to the 2015 form.

II. JOA STRUCTURE.

A. Contribution. Oil and gas leases and minerals are not "conveyed" with the execution of a JOA; ownership remains in the record owners thereof. Exhibit A does not control the ownership of the leases subject to the JOA; instead it is the figure upon which production and costs are shared among the parties to the JOA. While Exhibit A usually is based on the lease ownership at the time of its formation, it does not control lease ownership. The owners are agreeing contractually to share the costs and resulting production from the effort to develop the minerals. Consequently, the JOA is not, primarily, a title document. However, there are some provisions that actually control title, some that burden title with liens, and many that impose a burden on the attributes of ownership – and some that are frequently modified to do a number of these things. The 2015 JOA uses the word "contribute" 15 times; Black's Online Dictionary defines contribute as "to supply a share or proportional part of money or property towards the prosecution of a common enterprise or the discharge of a joint obligation." It is in this sense that the JOA uses "contribute" and not the older concept of "transfer"; thus the "contribution" contemplated by "contribute" is in the context of supplying a share of funds or of discharging an obligation. "Contribute" is not a word of conveyance in the JOA.

B. The Reach of the JOA. With certain exceptions, the JOA holds sway over the "Contract Area" but it is recognized that the agreement might require actions or operations outside the Contract Area so tweaks were made in the 2015 form to allow this but without implying that leases and minerals outside of the Contract Area might be brought in. For example, in Article III. B. this change was made:

> Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations ~~on the Contract Area~~ conducted under this agreement shall be owned, by the parties as their interests are set forth in Exhibit "A."

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[1] CREDIT WHERE IT'S DUE

"If I have seen further, it is by standing on the shoulders of Giants." Sir Isaac Newton

So it is in the prosaic world of Oil and Gas Operating Agreements. The seminal work in this area was done by Gary B. Conine in his 1988 article in the Texas Tech Law Review at Volume 19, Number 4 (Page 1264), Property Provisions of the Operating Agreement -- Interpretation, Validity, and Enforceability. This was amplified and expanded by Gary B. Conine and Bruce M. Kramer in Property Provisions of the Joint Operating Agreement published by the Rocky Mountain Mineral Law Institute's Seminar on Oil and Gas agreements – Joint Operations (March 2008), most recently culminating in Professor Alex Ritchie's update of the prior works, Property Provisions of the Joint Operating Agreement: An Update for the 2015 Form JOA published as part of the Joint Operations and the New AAPL Form 610-2015 Model Form Operating Agreement, jointly sponsored by RMMLF, AAPL and COPAS, November 3-4, 2016. References to this body of work are, throughout, to *Ritchie* at page xxx, except where the quote is not repeated in *Ritchie*, in which case the reference to the original Conine article is referenced as *Conine* at page xxx. I have also relied on Ernest Smith and Jacqueline's Weaver most invaluable resource of Texas Law of Oil and Gas as a frequent guidepost, not only for this paper but throughout the years. Some reliance is had on my presentation "A Critical Survey of the AAPL's 2015 JOA" most recently presented to the Energy Law section of the Tarrant County Bar Association (December, 2017).

C. The Contract Area. Five blank lines are provided on the cover page of the 2015 for the purpose of defining the Contract Area. However, Art. II.A. says that Exhibit "A" will include a description of lands subject to this agreement and a description of the oil and gas leases and interests that are subject to this agreement. The definition of "Contract Area" set out in Art. I.E. ties the term to Exhibit "A" but no mention is made of the effect of filling in the five blank lines on the cover page. It is suggested that the normal practice is to use a short-hand description on the cover page (something that makes you know you have the right JOA when you reach into the file and gives some minimal information) but to concentrate your efforts on describing the lands covered by your agreement and the oil and gas leases and interests covered in Exhibit "A". While many draw a map of the area, these maps frequently fail the test of the Statute of Frauds but sometimes even a poor copy of a map works.[2] Even if you use a map, you should list the lands covered by setting out the survey names and abstract numbers or the section, township and range.

D. Unleased Acreage. You have described your leases and the acreage covered. What if there is a lease or an unleased interest within the described acreage that is not described in Exhibit "A"? *Ritchie's* conclusion is that such lease or interest is not subject to the JOA, even if owned or acquired by a party to the JOA unless the JOA has an AMI.[3] In your author's humble view, the description of the Contract Areas as meaning the leases and lands "intended to be developed and operated for Oil and Gas purposes under this agreement" covers unleased interests in leased tracts, surrounded tracts and all depths even if some of the leases have a depth limitation; hence, I believe that, and absent contrary inserted language, if a party to the JOA acquires an interest within the Contract Area it will be subject to the JOA even if acquired after the date the JOA was signed.

III. JOA PROVISIONS DIRECTLY AFFECTING TITLE.

A. The Cross-Conveyance.

Of course, when starting with a hierarchy of title events, it's best to start with one that does not meet that requirement; this is one in which courts have decided to add language to the JOA. Thus, the Cross-Conveyance issue.

1. Some writers and courts believe that the description and stipulation of interests committed to the JOA create a cross-conveyance of interests under the JOA such that each owner holds legal title to its Exhibit A interest in each lease described in Exhibit A.[4] The relevant language:

> WHEREAS, the parties to this agreement are owners of Oil and Gas Leases and/or Oil and Gas Interest in the land identified in Exhibit "A," and the parties hereto have reached an agreement to explore and develop these leases and/or Oil and Gas Interests for the production of Oil and Gas to the extent and as hereinafter provided. Page 1, lines 6-8.
>
> ***
>
> Exhibit "A," shall include the following information:
>
> (1) Description of lands subject to this agreement,
>
> ***

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[2] *Coe v Chesapeake Exploration* 695 F.3d 311 (5th Cir. 2012).

[3] *Ritchie* at p. 5 citing *Clovelly Oil Co., LLC v Midstates Petroleum Co.*, 112 So.3d 187 and *Anderson Energy Corp. v Dominion Oklahoma Texas Exploration & Production, Inc.*, 469 S.W.3d 280 (Tex.App.—San Antonio 2015). In *Anderson*, the Operator argued that because the recitals in the JOA said that the parties are "owners" of the leases and the definition of oil and gas lease and interests are those "owned" by the parties, the parties only intended that the JOA apply to leases and interest owned as of the effective date, not to anything subsequently acquired. The court rejected this argument because the JOA contained an AMI. *Ritchie* also cites a Kansas case and a Colorado case for the opposite proposition even in the absence of an AMI: *Amoco Prod. Co. v Charles B. Wilson, Jr., Inc.*, 976 P.2d 941 (Kan. 1999), and *Kincaid v. Western Operating Co.*, 890 P.2d 249 (Colo.Ct.App. 1995).

[4] *Ritchie* at p. 11. While the article is referring to pooling and only by analogy to operating agreements, the conclusion "the courts of Texas, … have taken the position that pooling and unitization result in a cross-conveyance of interests among the parties" seems overbroad.

(4) Percentages or fractional interests of parties to this agreement,

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(5) Oil and Gas Leases and/or Oil and Gas Interests subject to this agreement …. Article II.A.

Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations ~~on the Contract Area~~ conducted under this agreement shall be owned, by the parties as their interests are set forth in Exhibit "A." In the same manner, the parties shall also own all production of Oil and Gas from the Contract Area subject, however, to the payment of royalties and other burdens on production as described hereafter. Art. III.B., lines 39-42 [the strikethrough is deleted 1989H language while the underline is added by the 2015].

On the other hand, see Art. III.B., lines 45-47 in the 2015 form:

"Nothing contained in this Article III.B. shall be deemed an assignment or cross-assignment of interests covered hereby, and in the event two or more parties contribute to this agreement jointly owned Leases, the parties' undivided interests in said Leaseholds shall be deemed separate leasehold interests for the purposes of this agreement."

2. Only one Texas case applied the cross-conveyance concept to the operating agreement. In *Gillring*[5] the JOA covered 401 acres which were subject to several leases. A gas well was drilled and a unit designation of 320 acres was filed; the 320 acre unit was entirely within the 401 acre Contract Area. If Gillring's interest was calculated based on the proportion that his contributed tract of an undivided 1/4 of 100 acres bore to the 320 acre unit his percentage would have been 7.8125%; his share of the 401 acre Contract Area was 6.6256%. The tracts not included in the unit were tracts in which Gillring owned no interest. Gillring sued to have production distributed on the basis of the parties' ownership in the unit rather than according to Exhibit A to the JOA. According to the Court of Appeals, "[Gillring's] working interest contribution under the operating agreement entitled it to a working interest in the 401 acre unit [citing cases], with income to be paid on the basis of each party's acreage contribution to the whole unit. [citing cases] Income is to be paid to each party according to his ownership in the entire tract. [citing cases] … By executing the operating agreement, [Gillring] had relinquished 75 percent of its ownership in the 25 acres in exchange for a 6.23 percent interest in each acre within the 401 acre unit."[6]

3. The JOA contractual language cited in support of this conclusion was "(A)ll costs and liabilities incurred in operations under this contract shall be borne and paid, and all equipment and material acquired in operations on the Unit Area shall be owned, by the parties as their interests are given in Exhibit 'A.' All production of oil and gas from the Unit Area, subject to the payment of lessor's royalties, shall also be owned by the parties in the same manner." The court did not say that the JOA in question was the 1956 AAPL form, but the quoted language is identical to it. The operating agreement was executed in July of 1976, before the promulgation of the 1977 AAPL form, so we believe the case is interpreting the 1956 AAPL form.

4. The predecessor language to that quoted above from Art. III.B., lines 42-44 (the non-cross conveyance language) was first seen in the 1977 form: "All production of oil and gas from the Contract Area, … shall also be owned by the parties in the same manner during the term hereof; provided, however, this shall not be deemed an assignment or cross-assignment of interests covered hereby."

5. The court used the term "ownership" and stated the effect of cross conveyance, "[b]y executing the operating agreement, appellant had relinquished 75% of its ownership in the 25 acres in exchange for an undivided 6.23 percent working interest in the entire 401 acre Operating Unit. Therefore, it had an undivided 6.23% interest in each acre …." Given the similar non-cross-conveyance language in the 1977, 1982 and 1989 AAPL Form 610, the lack of such

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[5] *Gillring Oil Co. v. Hughes* 618 S.W.2d 874 (Tex. Civ. App. -- Beaumont 1981, no writ). While cited several times since, it has only been cited for procedural matters and never for the substantive issue of whether the listing of leases in Exhibit A to the JOA creates a cross-conveyance.

[6] *Id*. at 876.

language in the 1956 form, and the lack of any language in the 1956 form stating that the leases themselves had been cross-assigned (the provision quoted, and relied upon, by the court stated only that "[a]ll production of oil and gas from the Unit Area … shall also be owned by the parties in the same manner [emphasis added]"), it is unlikely that a Texas court will conclude that the subsequent AAPL Form JOAs result in a cross-conveyance of interest in the Exhibit A leases.

6. However, in a situation in which the operating agreement has actually resulted in a cross-assignment of interest as, potentially, under properties still governed by the 1956 form, or where the parties have deleted the language denying cross-assignment, and assuming the courts are talking about ownership of the underlying leases and not just the production, there can be several implications:

a) All of the parties to the JOA are in privity of estate with each lessor which may make each party to the JOA liable for the performance of the covenants, express and implied, under each lease. Not addressed is the issue of whether the cross-assignment might be a sub-lease for IRS rules nor whether the putative cross-assignee is receiving an interest in a separate property for purposes of Rev. Rul. 77-176.

b) Include a conveyance of interest throughout the Contract Area; otherwise, a standard assignment ("I convey the B Lease to which I have record title to X subject to the JOA whose Contract Area covers 6 other leases") may result in the grant being interpreted as only conveying an interest in the original lease and not in the now-cross-conveyed other leases.

c) There is no case law on whether the implied cross-assignment violates a prohibition on assignment contained in a lease.

d) The state law based co-tenancy arrangement is substantially modified by the JOA.

e) A cross-conveyance changes the royalty obligation of the lessee/WIO. As discussed below, if one party to the JOA contributes leases with a low royalty burden and another contributes leases with a high royalty burden, the relative advantage/disadvantage of the royalty burden is maintained in Exhibit A because, on the same number of acres, the low burden contributor with have a higher net revenue interest on Exhibit A (but the same working interest share) than the high burden contributor. Upon a cross conveyance, each party to the JOA will own the identical interest in each lease so the high burden contributor loses its disadvantage and *vice versa*.

7. The issue of whether current Texas law holds that a pooling (not a JOA) constitutes a cross-conveyance is beyond the scope of this paper; it is also largely irrelevant to the JOA because, generally, none of the language required to authorize pooling is included in the JOA language. We note these items for your consideration:

a) George Snell is a strong proponent of the view that Texas does not treat pooling as a cross-conveyance.

b) Ritchie cites Texas as following the rule that pooling or unitization results in a cross-conveyance of the interests of the parties to the pooling agreement.[7] This conclusion is supported by a 2016 case.[8]

c) The court in the *Browning Oil Co. v. Luecke* case held that if the particular lease had not been validly pooled, then no cross-conveyance of the lessors' interests could occur.[9]

d) The court in *Puckett v. First City National Bank of Midland*[10] held that the pooling provision in a lease that contained language that the entire acreage pooled in a unit shall be treated for all purposes "except the payment of

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[7] *Ritchie*, supra at 1280.

[8] *Avery et al. v. Hoskings, Inc. et al.*, 493 S.W.3d 684 (Tex.App. – San Antonio 2016), at 698.

[9] *Browning Oil Co. v. Luecke* 38 S.W.3d 625 (Tex.App. -- Austin 2000) at 645-46.

[10] *Puckett v. First City National Bank of Midland* 702 S.W.2d 232 (Tex.App.—Eastland 1985). The quotes at the end of this subparagraph (d) are at page 237.

royalties on production from the pooled unit" showed "an express intent not to effect a cross conveyance as to payments of royalty.

e) The court in *Samson Lone Star, Limited Partnership v. Charles G. Hooks*, et al.[11] found that pooling effects a cross conveyance.

f) A relatively recent case[12] held that "when a lease contains language that prevents a cross-conveyance of the lessor's minerals to the other who own the minerals being pooled, the lessor does not own a percentage of the minerals associated with the other tracts placed into the pool.

g) One possible point of analysis is whether the cases cited above might be interpreted to apply to a cross-conveyance of production and not the underlying minerals, though the language is certainly broad enough to cover both.

B. The Deemed Lease.

1. Section III.A. of the 2015 JOA provides as follows:

> If any party owns an Oil and Gas Interest in the Contract Area, that Interest shall be treated for all purposes of this agreement and during the term hereof as if it were covered by the form of Oil and Gas Lease attached hereto as Exhibit "B," and the owner thereof shall be deemed to own both royalty interest in such lease and the interest of the lessee thereunder.

2. This provision is not optional so if any participant in the JOA owns an unleased mineral interest that Owner is treated as if the Owner had executed a lease. The owner has not actually executed a lease but is treated as if a lease were executed so that the royalty is free of costs imposed by the JOA and the leased interest bears its share of costs. For tax purposes, this should work (no authorities on point) because there is a written, binding agreement protecting the deemed royalty from costs and burdening the remaining interest with all costs. For other purposes, I am not sure; it is not executed and delivered nor is it recorded and most recording memorandums do not mention it.

3. In a 2011 case,[13] ARCO contributed a 25% mineral interest to a JOA signed in 1967. While the JOA form was not identified, Article 3 provided

> "If it develops that any interest owned and contributed by a party hereto is an unleased interest in the oil and gas rights, then such unleased interest shall be treated for all purposes of this agreement as if it were an oil and gas lease covering such unleased interest on a form providing for the usual and customary one-eighth royalty…."

Note that no lease form was required as it has been since the 1956 AAPL form JOA.[14] The other 75% was covered by leases containing 60 day continuous operations clauses. During the June to August 2001 period, there was a 71 day period when no well was producing and no operations were being conducted. It turns out that gas has been flared during that period but the argument that flaring constituted operations was not pursued on appeal. Article 10 provided that the JOA:

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[11] *Samson Lone Star, Limited Partnership v. Charles G. Hooks. et al.*, 389 S.W.3d 409 (Tex.App.—Houston [1 Dist.] 2012, at page 431, reversed on other grounds 457 S.W.3d 52 (Tex. 2015). The lower court case holds that "pooling effects a cross-conveyance among the owners of the minerals under the various tracts in the pool so cotenants own undivided interests under the unitized tract in the proportion that their contribution bears to the unitized tract" citing *Montgomery v. Rittersbacher*, 424 S.W.2d 210, 213 (Tex. 1968).

[12] *Haider et al. v Jefferson County Appraisal District et al.*, 282 S.W.3d 419 (Tex. 2008), at 422.

[13] *Prize Energy Resources, L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537 (San Antonio 2011 no pet.).

[14] See Section 3 of the 1956 JOA.

> shall remain in full force and effect for as long as any of the oil and gas leases subjected to this agreement remain or are continued in force as to any part of the Unit Area….[15]

Lease termination occurred and the question was whether the ARCO deemed lease was an oil and gas lease "subjected to this agreement." Apparently, there was no attempt to impose the 60 day continuous operations clause on the ARCO deemed lease. The court concluded that the leases covering the 75% were "the only leases subject to this agreement" because those were the only leases that were contributed to the JOA; ARCO had contributed a mineral interest. Therefore, the leases expired causing the JOA to expire and the 25% mineral interest to revert to ARCO.

4. The ubiquitous problem with Article III.A. is that most parties fail to attach a form of lease or, when they do, it is not filled in and may not be sufficient to comply with the Statute of Frauds.[16] Sometimes, a JOA may be negotiated before the leasing begins and the parties may be reluctant to set the terms of the lease before the terms upon which leases are being granted are known. In this event, it is not possible to describe the lease terms based on the terms of leases already taken.[17] One lease term that should always be considered is one making the Exhibit B lease expire, generally, when the other leases in the Contract Area expire.

5. There is no requirement that Exhibit B lease be recorded. Obviously, it is prudent to do so under the Recording Acts. Nonetheless, the agreement to a "deemed" lease is likely to be binding on the parties to the JOA even if it is never recorded. As a further complication, the language does not require the mineral interest owner to sign the lease, using instead the terms "shall be treated for all purposes … as if it were covered by the form …" and "shall be deemed to own both royalty … and the interest of the lessee…." Strictly speaking, there is no way to file the lease unless it is included in a filing of the entire JOA or in a memorandum of JOA but, as a practical matter, executing the Exhibit B lease as suggested in (e) below, should suffice but that will turn it into a real lease and not a "deemed" lease.

6. We are not aware of a case dealing with whether the other parties to the JOA can be bona fide purchasers of the Exhibit B lease. Obviously notice of all matters related to the JOA would be imparted to the other parties, but it would still be possible for the other parties to be BFPs with respect to the leasehold interest. With no obvious case law on point, the question of whether possible lack of cash consideration for the Exhibit B lease might operate to eliminate the BFP status for the other parties, is open.[18]

7. The design of Exhibit B seems to be that it will not be signed unless property to be deemed subject to the lease is going to be surrendered or a well is proposed to be abandoned and some parties wish to retain operating rights or continue operations. We recommend that the Exhibit B lease be signed as a separate document at the time the JOA is executed and the covered mineral interests be described and that it be amended or a new one executed when a party acquires a mineral interest so as to avoid subjecting the mineral interest to the obligations and liabilities under the JOA.

8. While not necessarily an Exhibit B issue, one should keep in mind the peculiar *Sheppard* case.[19] The Texas Supreme Court held that the termination of Sheppard's lease did not terminate her participation in the unit. The Texas

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[15] This language is identical to that in Article 10 of the 1956 JOA.

[16] Tex. Bus. & Com. Code §26.01. Generally, failing to include the essential terms of the lease (royalty, term, etc.) may result in a court finding that the parties never bound themselves to the contract. A similar issue not provided for in the JOA is that no separate consideration for the lease is provided; however, no consideration is usually stated for entering into the JOA to begin with and the subjecting of one's leases to the limitations of the JOA in return for a participation right in a larger area may well satisfy the necessity for consideration. With respect to the Statute of Frauds issue, the description covers any Oil and Gas Interest owned by a party in the Contract Area; if properly done, both terms should be sufficient to overcome a claim that the description fails to sufficiently identify the property.

[17] We have had some success with saying that the royalty would be the highest rate provided for in leases covering approximately the same acreage (did not say net mineral acreage) at the time the interest was acquired or the date of the JOA, whichever was later. We have also tried taking the average royalty on all leases covering the acreage category into which the Oil and Gas Interest fits: 0-10 acres, 11-50 acres, 51-100 acres, 101 to 500 acres, and over 500 acres. This differentiation recognizes that larger tracts may garner better terms.

[18] *LaFon v. Grimes,* 86 F.2d 809 (5th Cir. 1936). Under Texas law, the burden to prove adequate consideration would be upon the other parties to the JOA. *Turner v. Cochran*, 61 S.W. 923 (Tex. 1901). The recital in the Exhibit B lease form would not be sufficient. *Davidson v. Ryle*, 124 S.W. 616, 619 (Tex. 1910).

[19] *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419 (Tex. 2008), cited most often for the proposition that oil and gas leases and pooling clauses are a matter of contract.

Supreme Court noted that a lease is not necessarily required for pooling. Both Sheppard's lease and the unit agreement pooled certain "premises" and "lands," not just their leased interests. Sheppard's lease allowed the actual Sheppard tract to be pooled rather than just the lease. The termination of the lease had no effect on the lands committed to the unit, and it did not cause the unit to terminate because it was a pooling of the lands, not just leases. The lesson here is to add a provision to your Exhibit B lease, which an E&P company might not want to add to leases taken from third parties, that denies that the pooling provision of the lease would ever apply to the reversionary interest of the lessor.

C. Contract Area Obligations.

Your Contract Area consists of 640 acres, 600 of which has been leased by the parties to the JOA and contributed to the JOA. 40 acres is unleased but is within the description of the Contract Area. One of the parties to the JOA acquires a lease on that 40 acres. Is that lease now subject to the JOA? Does it matter whether the JOA contained an Area of Mutual Interest (AMI) provision?

1. Ritchie believes that "[I]n the absence of an AMI provision, leases and interests acquired after the effective date are not usually contemplated by the parties to be covered by the JOA."[20] In support, he cited a Louisiana case[21] which held that the preprinted JOA language referred to leases and interests owned by the parties at the time the agreement was executed explaining that the parties could have included an AMI if they intended the JOA to apply to future leases. Then he cited a Texas case[22] which held that an operator who acquired leases and interests in the contract area without subjecting them to the JOA, had breached the JOA, even in the face of the argument that prevailed in the Louisiana case[23] because the lands and leases subject to the JOA included the subsequently acquired leases and interests and the JOA contained an AMI.

The effect of an AMI agreement and treating the after acquired lease as owned by the party who acquired it have completely different economic effects. An AMI requires sharing proportionately with all owners while saying the interest, so long as it is within the Contract Area, is owned by the acquirer results only in an adjustment to that owner's Exhibit A interest. It is likely that a court might look at the AMI as added language and impose the anti-harmonizing canon that the non-printed prevails over the printed[24] and apply the AMI provision over the individual ownership provision.

The interpretation referenced above requires the insertion of implied, limiting language so that the contribution of leases is applied only to leases owned *at the time of the signing of the JOA* while the inclusion of a subsequent acquisition requires insertion of implied language so that the contribution of leases applies to leases owned at the time of signing as well as to *subsequently acquired leases and interests*. Which points to the drafting tip for solving this problem. You could insert a clause in one of the Exhibit "A" references, like this: "which includes any interest in any lease or any Oil and Gas Interest in the Contract Area, even if subsequently acquired." It may also depend on what you include in Exhibit "A". If you include only the described leases and the lands they cover then nothing will include that unleased 40 acres in the Contract Area. With respect to an unleased, undivided interest in a tract described by an extant lease, then it is within the Contract Area and should be covered regardless of when acquired unless your AMI indicates to the contrary.

2. The JOA language is relatively meager:

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[20] Ritchie at 5.

[21] *Clovelly Oil Co., LLC v Midstates Petroleum Co.* 112 So.3d 187 (La.2013).

[22] *Anderson Energy Corp. v. Dominion Oklahoma Texas Exploration & Production, Inc.*, 469 S.W.3d 280 (Tex. App.—San Antonio 2015)

[23] *Clovelly*, supra.

[24] In *Producers Oil Co. v Snyder*, 190 S.W. 514, 515-516, the court stated:

> It is a well-recognized rule of construction that where a part of a contract is written, or typewritten, and a part is printed, and the written and printed part are apparently inconsistent, or there is reasonable doubt as to the sense and the meaning of the hole, the words in the writing will control the construction of the contract.

See Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 Texas Tech Law Review 1 (1993).

> WHEREAS, the parties to this agreement are owners of Oil and Gas Leases and/or Oil and Gas Interests in the land identified in Exhibit "A," and the parties hereto have reached an agreement to explore and develop these Leases and/or Oil and Gas Interests for the production of Oil and Gas to the extent and as hereinafter provided.[25]
>
> E. The term "Contract Area" shall mean all of the lands, Oil and Gas Leases and/or Oil and Gas Interests intended to be developed and operated for Oil and Gas purposes under this agreement. Such lands, Oil and Gas Leases and Oil and Gas Interests are described in Exhibit "A."[26]

If the land (the 40 acres in our initial example) is included within the Contract Area either by description of the entire 640 acres or by inclusion on the map often set out to reflect the Contract Area, then it seems relative certain that the parties elected to include the 40 acres in what was expected to be explored and developed.

D. Surrender of Leases.

1. Art. VIII.A. keeps the owner of a lease contributed to the JOA from surrendering the lease until the other parties have been notified and, should any of them wish to acquire the lease then the owner must assign it to the electing parties, without express or implied warranty of title, its interest in the lease. The original, assigning owner retains all liabilities previously accrued but retains no further interest in the assigned lease, and is released from future obligations. The acquiring party(s) must pay the original owner the difference between the value of "all salvable materials and equipment less the estimated cost of salvaging, P&A, and restoration." If the value is less than the Exhibit "C" costs, then the original owner must pay the deficit.

Such an assignment does not change the assigning party's Exhibit "A" interest and the assigned interest becomes free and clear of the JOA but subject to another JOA in the same form as the original JOA.

E. Surrender of Interest by Non-Consent.

1. As noted in Part V below, the non-consent to operations provision generally suspends the owner's right to receive revenues until some multiple of revenue has been recovered by the consenting parties. Unless those provisions are modified to specify a loss of title to a lease instead of just loss of production, they are not, strictly speaking, a title provision. Yet if they have been so modified, the examiner should be cognizant of Art. VII.D.3. which allows the enforcing parties to treat a failure to pay as a "deemed non-consent" and thereby invoke the provisions applicable to an election not to consent – which may include a title remedy.

2. The deemed non-consent is not available for all operations under the JOA but is limited to the costs relating to the drilling of a well, plugging back, sidetracking, reworking, deepening, completion or recompletion and only with respect to cost associated with such listed operations.

3. An Operator who invokes the deemed non-consent election provision waives the right to sue the defaulting Non-operator for unpaid well costs but does not waive any of the other specific remedies available under the 1989 JOA.[27]

F. Waiver of Right to Partition.

1. If two or more parties own an interest in the same lease they are cotenants. Cotenants have an absolute right to partition the property (divide it so as to own a part separately or force its sale and division of the proceeds).[28] The owners of such interest can waive the right to partition. Such a division of the leases and interests contributed to the

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[25] Page 2, line 6 of the 2015 JOA
[26] Ibid., Section I.E.
[27] *Allen Drilling Acquisition Co. v. Crimson Exploration Inc.*, 558 S.W.3d 761 (Tex. App.—Waco 2018, pet. filed, Jan. 22, 2019).
[28] *Daven Corp. v Tarh E&P Holdings, L.P.*, 441 S.W.3d 770, 777 (Tex. App. – San Antonio 2014, pet. den'd).

JOA could terminate the JOA or, at least, make operations extremely difficult. Accordingly, beginning with the 1977 JOA, a waiver of the right of partition within the Contract Area has been included.

2. What if the waiver of the right to partition has been deleted or you are dealing with a custom form that lacks the waiver? Oklahoma and Kansas say there is no implied bar to partition even if one party is given exclusive management and even if there are pref rights and non-consent penalties.[29] An early Texas case[30] followed the same approach as Oklahoma and Kansas but subsequent cases find an implied waiver of partition where the agreement kept the JOA alive as long as any of the leases were in effect.[31] The crucial element required to imply a waiver of the right of partition seems to be if partition would result in one party avoiding responsibility under a contract.

3. The provision itself is in Art. VIII.E.

> If permitted by the laws of the state or states in which the property covered hereby is located, each party hereto owning an undivided interest in the Contract Area waives any and all rights it may have to partition and have set aside to it in severalty its undivided interest therein.

G. <u>Preferential Right to Purchase</u>.

1. Article VIII.F. of the 2015 JOA sets forth what Professor Ritchie has deemed the most controversial provision of the operating agreement - the Preferential Right of Purchase clause. Here's the relevant language:

> "Should any party desire to sell all or any part of its interests under this agreement, or its rights and interests in the Contract Area, it shall promptly give written notice to the other parties, with full information concerning its proposed disposition, which shall include the name and address of the prospective transferee (who must be ready, willing and able to purchase), the purchase price, a legal description sufficient to identify the property, and all other terms of the offer. The other parties shall then have an optional prior right, for a period of ten (10) days after the notice is delivered, to purchase for the stated consideration on the same terms and conditions the interest which the other party proposes to sell; and, if this optional right is exercised, the purchasing parties shall share the purchased interest in the proportions that the interest of each bears to the total interest of all purchasing parties. However, there shall be no preferential right to purchase in those cases where any party wishes to mortgage interests, or to transfer title to its interests to its mortgagee in lieu of or pursuant to foreclosure of a mortgage of its interests, to dispose of its interests by merger, reorganization, consolidation, or by sale of all or substantially all of its Oil and Gas assets any party, or by transfer of its interests to a subsidiary or parent company or to a subsidiary of a parent company, or to any company in which such party owns a majority of the stock."

2. The preferential right to purchase, also known as a right of first refusal or a pre-emptive right, is distinguished from an option because the preferential right does not grant a right to purchase unless the seller has decided to sell. One court calls it a dormant option that ripens into an option when an interest is offered in connection with a sale.[32]

3. Due to its disfavored status, it is often deleted (at least so sayeth our experience and Smith & Weaver).

While disfavored, it certainly appears in many operating agreements and has been the focus of much litigation. Following Smith & Weaver's lead, we organize our thoughts into three primary issues - the first is the problem of the types of interest that it captures and the second is the problem of package sales.[33] The third is the problem of the reluctant objector having its rights waived.

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[29] *Ritchie*, at 25.
[30] *Warrner v Winn*, 191 S.W.2d 747 (Tex. Civ. App. 1945)
[31] *Sibley v. Hill*, 331 S.W. 2d 227 (Tex. Civ. App. 1960) and *Dimock v. Kadane*, 100 S.W.3d 602 (Tex. App. 2003).
[32] *McMillan v. Dooley*, 144 S.W.3d 159, 171 (Tex. App. – Eastland 2004, pet. den'd).
[33] We do not delve into the intricacies of the reluctant objector and how an oil and gas company can have its rights waived or have its right to object estopped for its failure to object to a constant violation of the preferential right provision except in subparagraph 6. We do want to highlight the issue and direct you to the right place. See Smith & Weaver, § 17.3[F][3].

4. Interest Type - One such issue is the type of interest to which the clause applies; clearly it applies to the working or expense bearing interest, but does it also apply to an override, a production payment or other interests? The language itself applies “all or any part of its interests under this agreement”; hence one would think that if the interest were created after the date of contribution to the JOA, the preferential purchase right would apply but if created prior to the JOA and not subjected to the JOA, it would not apply. The Dallas Appeals Court in 2007 found that a sale of an overriding royalty interest would be captured and be subject to the preferential right.[34] That case seems correctly decided based on the intent of the parties. However, consider the following. Company X owns 25% of the leases in a contract area. It wishes to sell half of its interest and has found a buyer to consummate the transaction. Company X forms Sub Z, which is wholly-owned by Company X and transfer 12.5% of the properties to Sub Z. Company X then sells the equity interest of Sub Z to Buyer A. Buyer A then transfers the assets from Sub Z to Buyer A. Situations like this need to be considered and the creativity of the attorneys needs to rival that of our creative oil and gas clients in order to carefully consider what is and what is not allowed under these types of provisions.

5. Package Sales - Package deals are the bane of pref rights and their application. How do you value specific properties under a certain JOA when the purchase price of an acquisition includes both JOA properties and non-JOA properties? Per Smith & Weaver, “[t]he sale price if often not allocated to individual properties; and even if such an allocation is made, it is often difficult, if not impossible, to determine whether the party that attempts to exercise its option is doing so ‘on the same terms and conditions . . . which the other party proposes to sell.’”[35] The cases provide some rules:

(a) The selling party must offer the properties to the holder of the pref right, even if the package includes properties that are not subject to the pref right.[36] The rightholder “does not have the privilege to negotiate with the seller regarding the terms of the third-party offer.[37]

(b) The selling party was not precluded from offering the subject interest as part of a package deal, but the holder of the right was not required to accept the other interests in the package in order to exercise his right of purchase.[38] It is important to note that the pref right at issue in this case was not contained in a JOA but the principle of law should still be the same.

(c) Upon receiving notice, the pref right holder must give the selling party notice of its intent to exercise his right, subject to his objection to the inclusion of the other properties.[39]

6. Ignoring the Right. One court[40] has held that continuously disregarding the preferential purchase right may cause the JOA owners to be estopped to assert a breach of the clause. Another court[41] found that failing to exercise the right when partial assignments are made does not constitute a waiver of the preferential purchase right when the entire interest is later offered for sale.

H. Assignment and Maintenance of Uniform Interest.

1. Maintenance of Uniform Interests.

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[34] See *El Paso Production Co. v. GeoMet, Inc.*, 228 S.W.3d 178 (Tex. App.-Dallas 2007) (governed by Alabama law). See also *Boldrick v BTA Oil Producers*, 222 S.W.3d 672 (Tex. App. Eastland 2007) holding that an ORRI assigned subject to a JOA could have costs charged against it.
[35] Smith & Weaver, §17.3[F][3].
[36] See *Navasota Resources, L.P. v. First Source Texas, Inc.*, 249 S.W.3d 526 (Tex. App.—Waco 2008 pet den’d); for a list of other cases reaching the same conclusion see footnote 26 of *B&R Oil Company, Inc., et al. v. Stoler, et al.*, 77 N.E.3d 823 (Ind.App. 2017). But see *FWT, Inc. v Haskin Wallace Mason Property Management, L.L.P.* 301 S.W.3d 787 (Tex. App. – Fort Worth 2009 pet den’d) where the court, in a non-oil and gas case held that a requirement for FTC approval was a condition that had to be met by the party holding the preferential purchase right. This case has been subsequently distinguished by other cases.
[37] *Hicks v. Castille*, 313 S.W.3d 874 (Tex.App. – Amarillo 2010) at 882 and *FWT, Inc. v Haskin Wallace Property Management, L.L.P. supra*.
[38] *McMillan v. Dooley*, 144 S.W.3d 159 (Tex. App.—Eastland 2004, pet. Denied).
[39] Id.
[40] *Mulvey v Mobil Producing Texas and New Mexico Inc*., 147 S.W.3d 594 (Tex. App. – Corpus Christi 2004).
[41] *McMillan v. Dooley*, supra at 171.

Article VIII.D. of the 2015 JOA sets forth the provision typically referred to as the Maintenance of Uniform Interest clause. This provision raises numerous title issues. Here's the relevant language:

"For the purpose of maintaining uniformity of ownership in the Contract Area in the Oil and Gas Leases, Oil and Gas Interests[42], wells, equipment and production covered by this agreement no party shall sell, encumber, transfer or make other disposition of its interest in the Oil and Gas Leases and Oil and Gas Interests embraced within the Contract Area or in wells, equipment and production unless such disposition covers either:

1. the entire interest of the party in all Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production; or

2. an equal undivided percent of the party's present interest in all Oil and Gas Leases, Oil and Gas Interests, wells, equipment and production in the Contract Area."

2. Our experience has been that this provision is commonly overlooked by oil and gas companies after an operating agreement has been entered into. How does this happen? What are the common problems? Consider the following:

a) Oil Company X and Oil Company Y are each 50% owners under the operating agreement of a contract area that is 1000 acres. Oil Company Y acquired its interest from Small Oil Company A and per the terms of their agreement, Small Company A receives a back-in carried interest of 5% for the first five wells that are drilled on the 1000 acres. Oil Company Y makes an assignment of forty acres for each of the first five wells. Oil Company X and Oil Company Y go on to drill ten more wells on the 1000 acres.

b) Oil Company X, looking to partially monetize its interest in the 1000 acres, sells a net profits interest to Financial Fund Z in five existing wells and all future wells located on the 1000 acres.

Per the terms of the Maintenance of Uniform Interest clause, neither of these partial divestures are allowable under the operating agreement. However, what rights and what damages would all these parties have against each other? Trying to piece together the parties' rights is a daunting endeavor for any person trying to examine title and seeking to understand the impact of the operating agreement on these transactions.

3. We are unaware of any cases where a non-party to the operating agreement has attempted to use this provision to unwind its transaction, which is not surprising since the triggers to unwind the transaction should be in the documentation related to the non-party's disallowed acquisition. The same is true for a party to the operating agreement attempting to unwind its disallowed transaction with a non-party to the operating agreement -- again with the same theory that the triggers to unwind the transaction should be in the documentation of the disallowed acquisition. As such, many of these transactions are never challenged and become parts of the development of an acreage block.

4. However, for such challenges by a party to an operating agreement, there is no designated remedy in the operating agreement for an aggrieved party to enforce and attempting to assess damages.[43] The aggrieved party must be able to show damages in order to receive any relief. It is here that the particulars of the aggrieved party's complaint come into play to determine what relief is appropriate.

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[42] The inclusion of Oil and Gas Interests in the 1989 form, removed one of the primary ambiguities in the earlier forms since it confirmed that a uniform maintenance of ownership requirement applied to contributed mineral interests as well as leases.

[43] See Vol. no. 3 Ernest E. Smith & Jacqueline Lang Weaver, Texas Law of Oil and Gas § 17.3[F][5] (LexisNexis Matthew Bender 2012) ("Smith & Weaver")

5. There are some reported challenges of parties violating the Maintenance of Uniform Interest Clause.[44] In a Houston appeals court case from 2005, ExxonMobil and Valence Operating were successors in interest to a joint operating agreement with the standard maintenance of uniform interest clause.[45] ExxonMobil farmed out the right to drill a certain formation to two other companies, whereby the companies could earn an assignment to the depths that included that formation upon drilling a successful test well as well as meeting other conditions.[46] The two new companies proposed wells into this formation and Valence elected not to consent to these operations, which put Valence into the penalty provisions in the subsequent operations clauses of the operating agreement.[47] Valence challenged the farmout, indicating that ExxonMobil violated the Maintenance of Uniform Interest Clause.[48] At the trial court, ExxonMobil's breach of the Maintenance of Uniform Interest Clause was found to have caused Valence to be subject to additional expense of drilling wells in producing formations already accessible from existing wells, resulting in damages to Valence of $310,867.28 and caused Valence to be subjected to the non-consent provisions of the JOA, resulting in damages of $523,432.[49] The Houston Appeal Court upheld the trial court's findings, holding that there was sufficient evidence to support a claim that the formation explored by the new parties could have been explored from existing wells and that Valence would not have suffered non-consent penalties from these new wells but for ExxonMobil's farmout.[50]

IV. JOA PROVISIONS IMPOSING LIENS.

A. Operator's Duty. Article V.D.3. of the 2015 JOA requires the Operator to keep the Contract Area free from liens and encumbrances except for those resulting from a bona fide dispute as to services rendered or materials supplied.

B. Liability of Parties. Art. VII.A. of the 2015 JOA says that the liens granted under the JOA (more below) are to secure the debts of each severally and "no party shall have any liability to third parties hereunder to satisfy the default of any other party in the payment of any expense or obligation hereunder." While the IRS recognizes this treatment by allowing the parties to opt out of treatment as a partnership under Subchapter K of the Internal Revenue Code, the Texas Comptroller of Public Accounts has recently obscured like treatment under the Texas business income (franchise) tax. In a private letter ruling,[51] the Comptroller found that owners under a JOA that did not opt out of partnership tax treatment, created a taxable entity for Texas franchise tax purposes; the ruling did not mention the disclaimer of partnership, or joint venture set out in Art. VII.A. as follows:

> It is not the intention of the parties to create, nor shall this agreement be construed as creating, a mining or other partnership, joint venture, agency relationship or association, or to render the parties liable as partners, co-venturers, or principals. In their relations with each other under this agreement, the parties shall not be considered fiduciaries or to have established a confidential relationship but rather shall be free to act on an arm's-length basis in accordance with their own respective self-interest, subject, however, to the obligation of the parties to act in good faith in their dealings with each other with respect to activities hereunder.

C. Reciprocal Liens Granted. Art. VII.B. grants reciprocal liens as follows:

1. Each party grants to the other parties hereto a lien upon any interest it now owns or hereafter acquires in Oil and Gas Leases and Oil and Gas Interests in the Contract Area, and a security interest and/or purchase money security

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[44] Excluded is a discussion of two cases related to solving the conundrum of having the operator violate this provision and then determining who the operator may be of the assigned acreage and the unassigned acreage. These cases are interesting however and may be useful to review when looking at this issue. See generally, *Pitco Production Co. v. Chaparral Energy, Inc.*, 63 P.3d 541 (Okla. 2003) and *TransTexas Gas Corp. v. Forcenergy Onshore, Inc.*, 2004 Tex. App. LEXIS 7877 (Tex. App.-Corpus Christi, Aug. 26 2004 pet den'd).

[45] *ExxonMobil Corp. v. Valence Operating Co.*, 174 S.W.3d 303, 307 (Tex. App.-Houston [1st Dist] 2005 pet den'd).

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.* at 315

[50] *Id.* at 316-18.

[51] Texas Comptroller of Public Accounts, Private Letter Ruling No. 201010157, December 11, 2017.

interest in any interest it now owns or hereafter acquires in the personal property and fixtures on or used or obtained for use in connection therewith, to secure performance of all of its obligations under this agreement including but not limited to payment of expense, interest and fees, the proper disbursement of all monies paid hereunder, the assignment or relinquishment of interest in Oil and Gas Leases as required hereunder, and the proper performance of operations hereunder. Such lien and security interest granted by each party hereto shall include such party's leasehold interests, working interests, operating rights, and royalty and overriding royalty interests in the Contract Area now owned or hereafter acquired and in lands pooled or unitized therewith or otherwise becoming subject to this agreement, the Oil and Gas when extracted therefrom and equipment situated thereon or used or obtained for use in connection therewith (including, without limitation, all wells, tools, and tubular goods), and accounts (including, without limitation, accounts arising from gas imbalances or from the sale of Oil and/or Gas at the wellhead), contract rights, inventory and general intangibles relating thereto or arising therefrom, and all proceeds and products of the foregoing.

> To perfect the lien and security agreement provided herein, each party hereto shall execute and acknowledge the recording supplement and/or any financing statement prepared and submitted by any party hereto in conjunction herewith or at any time following execution hereof, and Operator is authorized to file this agreement or the recording supplement executed herewith as a lien or mortgage in the applicable real estate records and as a financing statement with the proper officer under the Uniform Commercial Code in the state in which the Contract Area is situated and such other states as Operator shall deem appropriate to perfect the security interest granted hereunder. Any party may file this agreement, the recording supplement executed herewith, or such other documents as it deems necessary as a lien or mortgage in the applicable real estate records and/or a financing statement with the proper officer under the Uniform Commercial Code.
>
> Each party represents and warrants to the other parties hereto that the lien and security interest granted by such party to the other parties shall be a first and prior lien, and each party hereby agrees to maintain the priority of said lien and security interest against all persons acquiring an interest in Oil and Gas Leases and Interests covered by this agreement by, through or under such party. All parties acquiring an interest in Oil and Gas Leases and Oil and Gas Interests covered by this agreement, whether by assignment, merger, mortgage, operation of law, or otherwise, shall be deemed to have taken subject to the lien and security interest granted by this Article VII.B. as to all obligations attributable to such interest hereunder whether or not such obligations arise before or after such interest is acquired.
>
> To the extent that parties have a security interest under the Uniform Commercial Code of the state in which the Contract Area is situated, they shall be entitled to exercise the rights and remedies of a secured party under the Code. The bringing of a suit and the obtaining of judgment by a party for the secured indebtedness shall not be deemed an election of remedies or otherwise affect the lien rights or security interest as security for the payment thereof.

2. Generally, such liens are upheld, prevailing over a deed of trust where the mortgage was taken subject to the lien even though the JOA was unrecorded[52], and giving the operator priority over creditors who had received an assignment of production from the debtor non-operator with respect to suspense funds.[53]

3. While the lien may still be imposed absent recording or filing, it seems clear that such unrecorded contractual liens will not be recognized in a bankruptcy proceeding.

D. <u>Claims that Never Die</u>.

1. The oil and gas industry has generally treated a selling owner as no longer liable under the JOA once all of its interest is transferred (except as to liabilities already incurred). However, *Seagull*[54], held that a prior working interest owner, which had assigned and sold its working interest to a third party, was still liable to reimburse the operator for

[52] *MBank Abilene, N.A. v. Westwood Energy, Inc.*, 723 S.W.2d 246 (Tex. App. – Eastland 1986, no writ).
[53] *Enduro Oil Co. v. Parish & Ellison*, 834 S.W.2d 547 (Tex. App. – Houston [14th Dist.] 1992, writ denied).
[54] *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342 (Tex. 2006)

the proportion of costs associated with its assigned interest when the assignee failed to pay. Seagull Energy E & P, Inc. ("Seagull") was the operator under two similar operating agreements in which Eland Energy, Inc. ("Eland") was a working interest owner. Eland later assigned and sold its interest in the leases included within the operating agreement to Nor-Tex Gas Corporation ("Nor-Tex") and also assigned to Nor-Tex its rights and obligations under the operating agreement. When Nor-Tex failed to reimburse Seagull for the costs incurred with operating the leases (actually imminent plugging and abandonment liabilities), Seagull filed suit against both Nor-Tex and Eland. Eland contended that it no longer had any obligations under the operating agreement as it had transferred all of its interest to Nor-Tex. However, the Supreme Court of Texas, after reviewing the language of the operating agreement, held that Eland was still liable for the share of costs attributable to the working interest assigned to Nor-Tex by Eland.

2. The Court's ruling hinged on the issue of express release. As neither the express terms of the operating agreement nor the express actions of the operator released Eland from its financial obligations under the operating agreement, the transfer of Eland's interest to Nor-Tex did not act as a novation, and therefore Eland was still bound by the terms of the agreement. Specifically, the Court noted that this particular operating agreement did not set forth the consequences of an assignment of a working interest to a third party, and therefore, without an express release, Eland could not unilaterally terminate its obligations under the operating agreement through a transfer of its interest to a third party.

3. Nevertheless, the holding set forth in Seagull Energy may not apply to some other operating agreements, in particular the 1989 operating agreement and the 2015, primarily because of hoped for efficacy of revised language. The operating agreement in Seagull was a customized offshore form.

4. Article VIII, Section D of the 2015 JOA provides the following (redlines retained to show changes from the 1989 JOA):

> "Every sale, encumbrance, transfer or other disposition made by any party shall be made expressly subject to this agreement and shall be made without prejudice to the right of the other parties, and any transferee of an ownership interest in any Oil and Gas Lease or Interest shall be deemed a party to this agreement as to the interest conveyed from and after the effective date of the transfer of ownership; provided, however, that the other parties shall not be required to recognize any such sale, encumbrance, transfer or other disposition for any purpose hereunder until thirty (30) days after ~~they have~~ Operator has received a copy of the instrument of transfer or other satisfactory evidence thereof in writing from the transferor or transferee. Except as otherwise provided herein, any transfer by a party shall relieve the transferor from liability for the cost and expense of operations attributable to the transferred interest which are conducted after the expiration of the 30-day period above provided; provided that, ~~No~~ no assignment or other disposition of interest by a party shall relieve such party of obligations previously incurred by such party hereunder with respect to the interest transferred, including without limitation the obligation of a party to pay all costs and expenses attributable to an approved operation conducted hereunder, in which such party has agreed to participate ~~prior to making such assignment~~, and the lien and security interest granted by Article VII.B. shall continue to burden the interest transferred to secure payment of any such obligations. The transferee shall be jointly and severally liable with its transferor for payment of its share of all costs and expenses attributable to an approved operation conducted hereunder in which its transferor had agreed to participate.

5. From the language in the 1989 JOA (the above without the changes), an argument exists that the express recognition of the sale or transfer granted by the other parties upon thirty days' notice could be deemed an express release of the transferring party's obligations, especially since the transferee is deemed to have become a "party" to the 1989 AAPL JOA. This language, buttressed by the confirmation that the transferor is still liable for any obligations incurred prior to the transfer, implies that the transferor is no longer liable for obligations incurred after the transfer has occurred. Nevertheless, this section also stated that "no assignment … shall relieve such party of obligation previously incurred … including … the obligation of a party to pay all costs attributable to an operation conducted hereunder in which such party has agreed to participate prior to such assignment". This language implies that a transferor may be still be liable for costs incurred post-transfer so long as the transferor consented to those costs pre-

transfer. Accordingly, an argument to harmonize these provisions is that a transferor is liable for any and all obligations that such transferor agreed to participate prior to the transfer of its interest, but is not liable for any later agreed to operations, unless of course the other parties expressly release the transferor from these obligations.

6. Of course, the 2015 JOA language begs the question of what operations were "approved" for the purpose of continuing liability. Does it have to be formally approved as in signing an AFE or will this become fertile ground for oral and implied agreements? For most leases, the plugging and abandonment liability does not accrue until it is time to P&A the wells. However, there is some argument that P&A liability begins to accrue from first production on offshore leases; therefore, as seen in the next paragraph, P&A may be an approved offshore operation, without an AFE, to which the selling non-operator is "deemed" to have agreed.

7. A later case[55], perhaps, obviated some of the concern about the *Seagull* case. The form was the 1989 Model Form. Trotter, an individual was originally a party to the JOA with Bishop Petroleum as Operator. In 2002, Trotter assigned all of his working interest to his company, Indian Oil, and so informed Bishop. The issue involved reworking of the well in 2007 which exceeded the AFE, substantially over-ran the anticipated costs, and did not result in production. Bishop sued Trotter, based on the broad language in Seagull, for Indian Oil's share of the costs. The court rejected the notion that Seagull stands for the proposition that "Trotter automatically is liable for all expenses at issue in this case notwithstanding the 2002 assignment of Trotter's working interest to Indian Oil [emphasis in original]." The court explain that, unlike Seagull, "the joint operating agreement at issue here is not silent on the key issue." Much as is suggested under subparagraph 5 above, the court relied on Article VIII.D. which says that "[n]o assignment or other disposition of interest by a party shall relieve such party of obligations previously incurred by such party hereunder with respect to the interest transferred, including without limitation the obligation of a party to pay all the costs attributable to an operation conducted hereunder in which such party has agreed to participate prior to making such assignments." According to the court, Trotter is liable for previously incurred obligations prior to the assignment but "[n]othing in this record suggests that the obligation to pay for the workover under the July [2007] AFE is an obligation previously incurred by Trotter before the 2002 assignment." Nonetheless, Trotter admitted that he is individually liable, even after the assignment, for plugging and abandonment expenses and monthly operating expenses, and the court so held. So, *Seagull* maintains currency for obligations previously agreed to (operating expenses, P&A costs, and, specific, previously agreed to AFEs) but not for AFEs approved by its assignee after the assignment. However, and only as to pre-2015 JOAs, there is no express provision for a release and the obligations at issue do not meet Restatement criterion for release of obligations.[56]

8. For a discussion of whether successive owners of the transferred lease have joint or several liability under *Seagull*, see Smith & Weaver, §17.3[C][3].

V. JOA PROVISIONS IMPOSING BURDENS BUT NOT NECESSARILY TITLE ISSUES.

A. Surrender of Interest by Non-Consent or for Failure to Pay.

1. Non-Consenting Parties. The parties to a JOA usually agree to participate in the Initial Well to be drilled in the Contract Area. The parties may elect, however, whether to participate in subsequent operations in the Contract Area. This election process is outlined in Article VI of the JOA. All the parties, the Operator included, are given an opportunity to participate or not participate in each subsequent operation after the Initial Well. Art. VI.B.1 and VI.B.2.(a). Those electing not to participate are subject to a "penalty" for not consenting to such operations and, under the 2015 JOA, that penalty is relinquishment of the Non-Consenting Party's "interest in the well and its share of production therefrom" for a drilling operation but in the case of another listed operation it is the "interest in the production obtained from the operation …."

2. Relinquishment of Interest for Non-Participation. The entire cost and risk of conducting such operations shall be borne by the Consenting Parties in the proportions they have elected to bear same under the terms of the preceding

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[55] *Indian Oil Company, LLC et al. v Bishop Petroleum Inc.*, 406 S.W.3d 644 (Tex.App.—Houston [14 Dist.] 2013, pet. den'd)

[56] Restatement of Property § 538, quoted with approval in *Seagull*, supra at 347.

paragraph. Consenting Parties shall keep the leasehold estates involved in such operations free and clear of all liens and encumbrances of every kind created by or arising from the operations of the Consenting Parties. If such an operation results in a dry hole, then subject to Articles VI.B.6. and VI.E.3., the Consenting Parties shall plug and abandon the well and restore the surface location at their sole cost, risk and expense; provided, however, that those Non-Consenting Parties that participated in the drilling, Deepening or Sidetracking of the well shall remain liable for, and shall pay, their proportionate shares of the cost of plugging and abandoning the well and restoring the surface location insofar only as those costs were not increased by the subsequent operations of the Consenting Parties. If any well drilled, Reworked, Sidetracked, Deepened, Recompleted or Plugged Back under the provisions of this Article results in a well capable of producing Oil and/or Gas in paying quantities, the Consenting Parties shall Complete and equip the well to produce at their sole cost and risk, and the well shall then be turned over to Operator (if the Operator did not conduct the operation) and shall be operated by it at the expense and for the account of the Consenting Parties. Upon commencement of operations for the drilling, Reworking, Sidetracking, Recompleting, Deepening or Plugging Back of any such well by Consenting Parties in accordance with the provisions of this Article, each Non-Consenting Party shall be deemed to have relinquished to Consenting Parties, and the Consenting Parties shall own and be entitled to receive, in proportion to their respective interests, all of such Non-Consenting Party's interest in the well and share of production therefrom or, in the case of a Reworking, Sidetracking, Deepening, Recompleting or Plugging Back, or a Completion pursuant to Article VI.C.1. Option No. 2, all of such Non- Consenting Party's interest in the production obtained from the operation in which the Non-Consenting Party did not elect to participate…Art. VI.B.2(b)

3. Duration. Although some parties may structure a JOA with a more Draconian "sit out-fall out" participation requirement, whereby not consenting to an operation results in the permanent relinquishment of the Non-Consenting Party's interest in the well, the leases, and associated production therefrom, the AAPL form JOA is structured such that the relinquishment continues only until the proceeds from the sale of production attributable to the Non-Consenting Party's interest (after deducting taxes and other lease burdens associated with such interest) equals a percentage of the costs incurred with respect to both (i) surface equipment and operating expenses, and (ii) the costs and expenses of drilling and the equipment in the well. Art. VI.B.2(b)(i) and (i). The pertinent language:

> Such relinquishment shall be effective until the proceeds of the sale of such share, calculated at the well, or market value thereof if such share is not sold (after deducting applicable ad valorem, production, severance, and excise taxes, royalty, overriding royalty and other interests not excepted by Article III.C. payable out of or measured by the production from such well accruing with respect to such interest until it reverts), shall equal the total of the following:
>
> (i) _____% of each such Non-Consenting Party's share of the cost of any newly acquired surface equipment beyond the wellhead connections (including but not limited to stock tanks, separators, treaters, pumping equipment and piping), plus 100% of each such Non-Consenting Party's share of the cost of operation of the well commencing with first production and continuing until each such Non-Consenting Party's relinquished interest shall revert to it under other provisions of this Article, it being agreed that each Non-Consenting Party's share of such costs and equipment will be that interest which would have been chargeable to such Non-Consenting Party had it participated in the well from the beginning of the operations; and
>
> (ii) _____% of (a) that portion of the costs and expenses of drilling, Reworking, Sidetracking, Deepening, Plugging Back, testing, Completing, and Recompleting, after deducting any cash contributions received under Article VIII.C., and of (b) that portion of the cost of newly acquired equipment in the well (to and including the wellhead connections), which would have been chargeable to such Non-Consenting Party if it had participated therein. Art. VI.B.2(b)(i) and (ii).

The non-consent penalty is used to reward the parties who assume the Non-Consenting Party's interests and reward the Consenting Parties for accepting additional risk with respect to the proposed operations. While the appropriate penalties are beyond the scope of this paper, it is worth noting that the larger the risk, the higher the appropriate penalty percentage, and the lower the chance that the

Non-Consenting Party's interest will ever revert back to the Non-Consenting Party. The question is, what are the title implications of this relinquishment?

4. With respect to those jurisdictions which regard unitization/pooling and the JOA as a simple contractual arrangement (rather than a cross-conveyance), the non-consent provision is characterized not as a cross-conveyance but rather as "nothing more than a rearrangement of contractual rights and obligations of the partners as to specific operations within the enterprise as a whole."[57] While the party is not participating in the operation in question, and is therefore not subject to the benefits and obligations with respect thereto, the Non-Consenting Party is still a party to the JOA in general and entitled to the rights and subject to the obligations with respect thereto. Conine points out that while a party's degree of control in the Contract Area might be reduced, the party remains a party to the overall venture.[58]

5. In situations in which the parties are co-owners of the lease or leases, whether originally or by a cross-conveyance under the JOA, the title implications are more uncertain. The Non-Consenting Party "relinquishes" its interest in the well and its related production and present ownership is vested in the Consenting Parties until the non-consent penalties have been satisfied.[59] Conine focuses his analysis on the type of interest being transferred. The Non-Consenting Party's interest is a "carried interest," of which three basic forms have been identified (based on and named for the tax cases that identified them):

> *Abercrombie*--the carried party retains a portion of the working interest subject to a mortgage to secure advances for operating costs made by the carrying party.[60]
>
> *Herndon*--the carrying party (himself an owner of a working interest) becomes obligated to advance costs on behalf of the carried party and in return is assigned a production payment carved out of an burdening the carried interest.[61]
>
> *Manahan*--the carried party assigns all or a part of its working interest to the carrying party subject to a reversion in favor of the carried party and after the carrying party recovers a portion of its costs advanced the working interest returns to the carried party.[62]

Conine argues that in those cases in which the non-consent provision clearly calls for a conveyance of the working interest during the period of relinquishment, an actual transfer of an interest in the leasehold is intended and the Non-Consenting Party loses its possessory rights in the property, and retaining a future interest in the form of a possibility of reverter.[63] As such, the carried interest is a *Manahan*-type interest. A Texas court has previously agreed with this characterization.[64] In *Olin* the court was required to determine whether Non-Consenting Parties were liable for plugging obligations under RRC regulations as "non-operators." The *Olin* court found that under RRC rules, a Non-Consenting Party is responsible for plugging and abandoning a well, even if production from the well has yet to recoup the non-consent penalties. The parties, and the court, agreed that the relinquished interest was a *Monahan*-type carried interest. However, the Non-Consenting Parties urged the court to hold that the working interest was held entirely by the Consenting Parties until the non-consent penalties had been satisfied and the interest reverted to the Non-Consenting Parties. The court disagreed, holding that the ownership of a "future" interest in the well was still a working interest resulting in liability for plugging and abandonment even though the Non-Consenting Party wasn't currently bearing its working interest in the well.[65] Conine notes that there is plenty of authority to permit a court

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[57] Conine at 1290.
[58] *Id*., citing *Shell Oil Co. v Prestidge*, 249 F.2d 413 (9th Cir. 1957).
[59] Conine at 1291.
[60] *J.S. Abercrombie Co. v. Commissioner*, 7 T.C. 120 (1946), *aff'd*, 162 F.2d 338 (5th Cir. 1947).
[61] *Herndon Drilling C. v. Commissioner*, 6 T.C. 628 (1946).
[62] *Manahan Oil Co. v. Commissioner*, 8 T.C. 1159 (1947).
[63] Conine at 1292-1293.
[64] *Railroad Commission v. Olin Corp.*, 690 S.W.2d, 628 (Tex. Civ. App.), writ ref'd n.r.e. per curiam, 701 S.W.2d 641 (Tex. 1985).
[65] *Ritchie* at 13.

accepting the cross-conveyance theory to apply the theory to the non-consent provisions and construct a *Manahan*-type carried interest.[66]

However, Ritchie goes on to argue that there are three significant differences in the rights of the parties to a pooling/unitization agreement and parties to a non-consent provision which compel the rejection of any implication of cross-conveyancing in a non-consent temporary relinquishment of interests:[67]

> There is uncertainty over how much of the leasehold working interest is affected by the relinquishment, if any. The non-consent provision makes no reference to the transfer of working interest in the lease on which the well is located or in the drilling or proration unit. The Non-Consenting Parties will be permitted to participate in future wells, regardless of proximity to the relinquished well and such parties may even be permitted to participate in the sidetracking the well to a new bottom-hole location. No re-conveyance occurs, yet all parties may participate fully.
>
> A substantial degree of control over operations remains vested in the Non-Consenting Party, even with respect to the subsequent operation in which it has elected not to participate. The Non-Consenting Party may still access the entire Contract Area, obtain information about all operations, vote on the surrender of leases, vote on the removal/replacement of the Operator. These are contrary to an implied reassignment of working interest under a non-consent provision.
>
> A cross-conveyance is not necessary to achieve the intent of the non-consent provision. The obligation to bear costs, the right to production, and the power to determine the objectives of the proposed operation are the only interests which are redistributed. The relinquishment should be viewed as a temporary transfer of rights in production and as an accounting device to compensate those assuming obligations for drilling the well.
>
> These factors cause Conine to argue that the arrangement between consenting and non-consenting parties to a JOA most closely resembles a *Herndon*-type carried interest.[68] The Consenting Parties and the Non-Consenting Parties may remain co-owners with respect to the leasehold working interest, with the Non-Consenting Parties' interest subject to a production payment in favor of the Consenting Parties who are contractually entitled and obligated (for the time being) to operate the well and pay all costs and expenses incurred with respect to the well. The Non-Consenting Party, as a concurrent owner in the leasehold working interest, may also continue to be liable to the public as a property owner with a possessory interest, which is consistent with the result in the *Olin* case. Relatedly, Mr. Derman suggests that, in appropriate circumstances a Non-Consenting Party should consider selling its reversionary interest to a party who can assume any and all future liabilities with respect to the well in which it is relinquishing an interest.[69]

B. <u>Failure to Pay; Deemed Non-Consent</u>.

1. Article VII of the JOA contains penalties which may be imposed on the parties for defaulting in their financial obligations under the JOA. Included in the penalties is a "deemed" non-consent and relinquishment of interest:

> The non-defaulting party may deliver a written Notice of Non-Consent Election to the defaulting party at any time after the expiration of the thirty-day cure period following delivery of the Notice of Default, in which event if the billing is for the drilling a new well or the Plugging Back, Sidetracking, Reworking or Deepening of a well which is to be or has been plugged as a dry hole, or for the Completion or Recompletion of any well, the defaulting party will be conclusively deemed to have elected not to participate in the operation and to be a Non-Consenting Party with respect thereto under Article VI.B. or VI.C., as the case may be, to the extent of

[66] Conine at 1294.
[67] Conine at 1294-1296.
[68] *Ritchie* at 11.
[69] Derman, Andrew B, "The New and Improved 1989 Joint Operating Agreement: a Working Manual" Volume 19 of the Monograph Series published by the Section of Natural Resources, Energy, and Environmental Law of the ABA, at 51.

the costs unpaid by such party, notwithstanding any election to participate theretofore made. If election is made to proceed under this provision, then the non-defaulting parties may not elect to sue for the unpaid amount pursuant to Article VII.D.3., lines 28-34.

Until the delivery of such Notice of Non-Consent Election to the defaulting party, such party shall have the right to cure its default by paying its unpaid share of costs plus interest at the rate set forth in Exhibit "C," provided, however, such payment shall not prejudice the rights of the non-defaulting parties to pursue remedies for damages incurred by the non-defaulting parties as a result of the default. Any interest relinquished pursuant to this Article VII.D.3. shall be offered to the non-defaulting parties in proportion to their interests, and the non-defaulting parties electing to participate in the ownership of such interest shall be required to contribute their shares of the defaulted amount upon their election to participate therein. Art. VII.D.3., lines 35-40.

2. This is a special remedy in the event that the default is related to billing for the drilling of a new well or the Plugging Back, Sidetracking, Reworking, Deepening or Recompletion of any well. If a party defaults in the payment of such obligations then, following the applicable cure period, the party will be "conclusively deemed" to have elected not to participate in the operation and to be a Non-Consenting Party with respect thereto under Article VI.B. or VI.C. to the extent of the costs unpaid by such party. This provision acts as a sort of retroactive election not to consent to an operation. Thereafter, the non-consent provisions and title implications thereof described above will control the relinquishment and recovery of the "deemed" Non-Consenting Party's interest.

C. What happens when Article III.A. is deleted?

1. The reconciliation of the term "Oil and Gas Interests" or "Interests" with other terms in the JOA can be problematic. While the form JOA does not include an Area of Mutual Interest (AMI) provision, it is one of the most often added provisions. Usually it is cut and pasted from a prior agreement and often will use the term "Oil and Gas Interests" or "Interests" in a manner wholly unrelated to its use in the JOA. The definition in the form of the JOA is limited to "unleased fee and mineral interests" in the Contract Area and "owned by parties to" the JOA. The like term in an AMI may well be intended to apply to leasehold as well as mineral interests and to many variations thereof. Make sure you use a different, distinguishable term to describe the rights to which the AMI applies.

2. It can be deleted because the owner of the mineral interest (the Oil and Gas Interest) simply does not want its mineral interest covered by the JOA. Most often this is seen where a promoting party simply does not wish to share its minerals with the other owners and would rather they not know about them. Unfortunately such deletion puts the mineral owner in an advantageous position with respect to the other non-operators; for example, the mineral owner can choose to be treated as an unleased mineral owner and thus claim a full ownership interest in production (after the recovery of costs). We have previously requested a sworn statement that the parties to the JOA do not own any unleased mineral interest in the Contract Area, as a way to create a detrimental reliance argument.

3. At one time, the federal tax law imposed disparate tax treatment on royalties versus working interests (part of the "windfall" profits tax). In these situations, some parties to the JOA elected to treat their mineral interests entirely as working interests with no division of the interest into royalty and working interests by the use of Exhibit B. In any situation in which a party to the JOA is contributing its entire mineral interest as a working interest, it would behoove that party to secure an exemption from the lien provisions of Article VII.B. for what would have been the royalty portion of the interest. At the very least, such an owner should exempt a reversionary interest in the mineral interest (when production ceases and the JOA expires, I get my minerals back), otherwise a foreclosure on the mineral interest will result in a complete loss of the interest, not just the working interest portion.

D. Allocations of Interests.

1. Article III.B., lines 5 – 6 provides for the sharing of costs and liabilities incurred in connection with operations conducted under the JOA (so operations off the Contract Area can be covered) according to the interests set out in Exhibit "A." Production from the Contract Area is shared on the same basis. While the ownership of the leases in the

Contract Area may not change upon the signing of the JOA (see the cross-conveyance discussion in III.A., above), the rights to production and revenues and liabilities for costs are modified by contract.

2. Amongst the working interest owners, each is responsible for its share of costs in the Joint Account as established by Article V.B.2., but this is solely with respect to the other parties to the JOA. With respect to the lease contributed to the Contract Area, the lessee remains liable directly to the lessor for compliance with the lease terms.

3. Article III.B., lines 5 - 6 also provides for the ownership of "all equipment and materials acquired in operations on the Contract Area" by the parties according to Exhibit "A."

4. Under the printed form, the AAPL carefully avoided implying that Exhibit "A" could change the underlying lease ownership interests.

5. The 2015 JOA, in Article III.B., lines 10 – 28, a method of changing Exhibit "A" is set out; no such provision is in previous forms. Without setting it out in full, the Operator has a duty to amend Exhibit "A" from time to time to correct mistakes or to reflect ownership changes in the Contract Area. The Operator must seek consent of each party whose interest would change; if a party fails to consent, then, and based on an attorney's opinion (cannot be an employee of any affected party nor an employee of an Affiliate of such party) the Operator can make the change anyway and must furnish each party (not just affected parties) with a copy of the new Exhibit "A" and the title opinion on which it is based. A non-consenting party may then litigate the issue and must join all affected parties. If the objector wins, the Operator must re-amend Exhibit "A" to reflect the decision.

E. Royalty Burdens.

1. One issue for the title examiner is the burden that the working interest lessee must bear when the lease becomes subject to the JOA. The issue is best illustrated by reference to the difficulty Texas courts have had in allocating lease burdens in voluntary units.

2. On one side is the weighted average approach as exemplified in *TXO v. Prickette*.[70] In *Prickette*, a lessee of one lease in the unit had not been able to sell its gas for 21 months; the court held that the unit operator was required to pay royalties to the lessors of the non-selling lessee from the date of first production. The court based the decision on the pooling clause which gave the lessor a pro rata share of production from the unit. Though not so articulated, this applies a weighted average approach which requires the party selling gas to pay royalties on production throughout the unit. However, the *Prickette* case was distinguished in the *Puckett* case (below) as the court said that the *Prickette* case was a venue case, the issue was whether the Plaintiff has established a cause of action, and that the issue was not the calculation of royalties when the gas was being sold by two working interest owners at different prices to different purchasers.

3. On the other side is the tract allocation approach is *Puckett*.[71] Here, the lessee was receiving a lower price (the interstate price) for its production while others in the unit were receiving a higher price because their gas was sold in the intrastate market. The court found that the parties to the unit agreement, except for the plaintiff's immediate lessee, had no contractual obligation to the plaintiff; i.e. the plaintiff lessors could only look to the price received by their lessee to determine the basis for their royalty payment. To get there the court had to narrowly construe the cases holding that a pooling constitutes a cross-conveyance by holding that none of the cross-conveyance cases involved the question of royalty allocation.[72]

4. The JOA language in Article III.B. attempts to walk a thin line between a tract allocation and a weighted average by providing two options. The first option retains the language of the 1989 JOA and continues to leave a blank for a maximum royalty burden:

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[70] *TXO Production Corp. v. Pickette*, 653 S.W.2d 642 (Tex. App. -- Waco 1983, no writ).
[71] *Puckett v. First City National Bank*, 702 S.W.2d 232 (Tex. App. -- Eastland 1985, writ ref'd n.r.e.).
[72] *Id.* at 237-38.

> Regardless of which party has contributed any Oil and Gas Lease or Oil and Gas Interest on which royalty or other burdens may be payable and except as otherwise expressly provided in this agreement, each party shall pay or deliver, or cause to be paid or delivered, all burdens on its share of the production from the Contract Area up to, but not in excess of _______________ and shall indemnify, defend and hold the other parties free from any liability therefor. Article III.B., lines 14-17.

5. This provision (Option No. 1) allows the parties to choose the lowest royalty figure and, in essence, distribute this portion of the royalty payment on a weighted average basis. We do not believe this creates a cross-conveyance; it is just a contractual agreement about how to allocate a base amount of royalty. Why is the blank inserted? That allows the majority of the royalty to be distributed on a weighted average basis but preserves the economic advantage of the party who contributed leases with lower royalties as is shown by the following (applicable only if Option No. 1 is chosen):

> Except as otherwise expressly provided in this agreement, if any party has contributed hereto any lease or Interest which is burdened with any royalty, overriding royalty, production payment or other burden on production in excess of the amounts stipulated above, such party so burdened shall assume and alone bear all such excess obligations and shall indemnify, defend and hold the other parties hereto harmless from any and all claims attributable to such excess burden.[73] .

6. This provision allows a royalty in excess of the amount listed in the preceding blank to be changed against the party to the JOA who contributed that lease to the Contract Area.

7. The 2015 JOA added a new Option No. 2 which reads, "all burdens on its share of production from the Contract Area except Subsequently Created Interests of other parties to this agreement." Under this provision all royalties are borne on a weighted average basis.

8. The 2015 JOA retained the obligation each party has to pay its lessors (though, in fact, most are paid by the purchaser of production) with this language.

> Notwithstanding anything set forth in this Article III.B. above, as long as the Drilling Unit for the productive Zone(s) is identical with the Contract Area, each party shall pay or deliver, or cause to be paid or delivered, all burdens on production from the Contract Area due under the terms of the Oil and Gas Lease(s) which such party has contributed to this agreement, and shall indemnify, defend and hold the other parties free from any liability therefor.[74]

9. Mr. Derman referred to the above quoted sentence as a "curious sentence" and concluded that it was intended to protect "a party for agreeing to insert an amount in the blank which exceeds its burdens. Such a sentence is not necessary."[75] Were that the intent, then it is difficult to see why that protection is not extended to the Contract Area containing more than one Drilling Unit.[76] Perhaps the reason for this sentence is to recognize the chance that royalty differentials are more likely to arise in multiple unit situations, though that answer still fails to satisfy. What a Drilling Unit is, as set out in the definitions on page 1, is "the area fixed for the drilling of one well by order or rule of any state or federal body having authority." So, as long as there is but one Drilling Unit in the Contract Area, the production from the unit is, for royalty purposes, treated as if it were on a weighted average basis.

10. In a similar vein, Article III.B., lines 42-44 tell us that, notwithstanding the rest of Article III.B., a lessee party to the JOA is never liable for paying royalty on a price basis higher than the price received by the party lessee and if

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[73] Article III.B., lines 32-35 of the 2015 JOA.
[74] Article III.B., lines 38-41 of the 2015 JOA.
[75] Derman at 15.
[76] The Drilling Unit for the JOA is not to be confused with the Drilling Unit prescribed by state rules. For example, the Texas Railroad Commission, Rule 38, defines a Drilling unit as "the acreage assigned to a well for drilling purposes," while a proration unit is "the acreage assigned to a well for the purpose of assigning allowable and allocating allowable production to the well."

someone else's lessor makes a claim against the lessee party, that other party's lessee will hold the first party lessee harmless. This is one of several indemnifications by JOA parties to other JOA parties appearing in Article III.

11. The 1982 JOA, in Article III.B., in lines 15 - 19 referred to the "payment of royalties" and to paying that party's share of "the royalty amount stipulated." The 2015 JOA, in Article III.B, in Option No. 1, lines 32 - 34 refers to "burdens" and, in line 33 defines such burdens to include "royalty, overriding royalty, production payment or other burden on production." While we are not aware of a case in which a party attempted to claim that it could create additional burdens (other than royalties) and force them upon the other parties, to prevent such an occurrence is certainly why the 2015 JOA language has been broadened.

12. What's to keep a party to the JOA from adding burdens for the other parties to bear after the JOA is executed? That is found in Article III.C., "Subsequently Created Interests."

a) The first clause of the first sentence of Article III.C. (lines 49-50 and lines 1 and 2 on the next page) treats a pre-JOA burdening of contributed leases by a mortgage by a party to the JOA as a "subsequently created interest":

b) "If any party has contributed hereto a Lease or Interest that is burdened with an assignment of production given as security for the payment of money … such burden shall be deemed a 'Subsequently Created Interest.'"[77]

> We can only speculate as to why the AAPL chose not to call it a mortgage but in all likelihood it is because, in an Article devoted to the sharing of costs and production, it is only the "assignment of production" provision in the standard mortgage that immediately impacts the sharing of production. While it seems highly unlikely, it is possible that a party might grant a mortgage on the leases and not grant an assignment of production in the leases. In this unusual situation, once a default occurs and the lender forecloses on the lease, after the lease is actually sold at the foreclosure sale, the purchaser at the foreclosure sale would then have the right to receive the revenues attributable to the lease but the mortgage might never have been considered a Subsequently Created Interest, thus erasing the indemnity provided to the other parties to the JOA against Subsequently Created Interests. However, in the normal case, the party who mortgaged the interest will end up indemnifying the other parties against any claim by the mortgagee.

13. The balance of the first sentence of Article III.C. (lines 49-50 and line 1-2) defines a Subsequently Created Interest as one that was created after the date of the JOA and is not shown on Exhibit "A", including the following: "royalty, overriding royalty, production payment, net profits interests, or other burden payable out of production attributable to its working interest hereunder, such burden shall be deemed a "Subsequently Created Interest."

14. The JOA then creates a second category of Subsequently Created Interest:

> "… if any party has contributed hereto a Lease or Interest burdened with an overriding royalty, production payment, net profits interests, or other burden payable out of production created prior to the date of this agreement, and such burden is not shown on Exhibit 'A,' such burden also shall be deemed a Subsequently Created Interest to the extent such burden causes the burdens on such party's Lease or Interest to exceed the amount stipulated in Article III.B. above" [emphasis added].
>
> So, if a party owns a royalty or override (or any other benefit burdening a contributed lease) then

a) If that burden is NOT shown on Exhibit A, and

b) That burden was created prior to the date of the JOA, then

c) That burden is a Subsequently Created Interest but only to the extent the burden causes the burdens on the lease or interest to exceed the amount in the blank in Article III.B, line 31.

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[77] Article III.C., lines 33-34.

Under earlier JOAs, one could have the issue of whether this burden is the one that causes the burdens to exceed the amount in the blank but, most likely, the burden the contributing party created will be tallied last; however, under the 2015 form, the above language applies if Option No. 1 was selected but only to the extent the burden causes the burdens on the lease to exceed the amount shown in the blank in Option No. 1. This means that a person contributing leases can increase the burdens (cut an override, for example) up to the amount in the blank without falling into the Subsequently Created Interest. Note also that the addition of Option No. 2 means that the contributing party will bear all burdens, even if newly created, except for other parties' Subsequently Created Interests.

d) There are three consequences to an interest being a Subsequently Created Interest ("SCI"):

1. The Burdened Party assumes all liability for the SCI and indemnifies all of the other parties against any liability for the SCI.

2. "… the Burdened Party[78] shall assume and alone bear, pay and discharge the Subsequently Created Interest and shall indemnify, defend and hold harmless the other parties from and against any liability therefor.

3. The SCI is subject to all of the Article VII.B. enforcement rights that the other parties (including the Operator) have against the Burdened Party:

> "… if the Burdened Party fails to pay, when due, its share of expenses chargeable hereunder, all provisions of Article VII.B shall be enforceable against the Subsequently Created Interest …."

4. The issue here is whether, assuming the inability to collect under the indemnification described in (1) above, the other parties can enforce these provisions against the holder of the SCI.

Mr. Derman rightfully questions whether this provision, without more, is sufficient to bind the third party holder of the SCI.[79] Under a race-notice recordation statute, which Texas has,[80] if the subsequent instrument is executed and delivered before the prior instrument is filed for record and if the subsequent purchaser or lienholder pays value and has no notice of the prior instrument, then the subsequent instrument prevails regardless of whether the prior instrument is filed for record before the subsequent instrument.[81] There are at least two approaches to this problem:

(1) One approach is to require that any party assigning an SCI notify the assignee that the interest is subject to the JOA; one way is to require any assignment of an interest to be made subject to the JOA. This is already required by Article VIII.D., lines 11-14 but if the document creating the SCI is filed before the JOA is signed, the provision does not help:

> "Every sale, encumbrance, transfer or other disposition made by any party shall be made expressly subject to this agreement and shall be made without prejudice to the right of the other parties, and any transferee of an ownership interest in any Oil and Gas Lease or Interest shall be deemed a party to this agreement as to the interest conveyed from and after the effective date of the transfer of ownership …."

5. There is also the issue of whether a non-operating working interest owner bent on transferring interests free of the JOA will be intimidated by this requirement. If the other parties are already trying to collect and are now turning to an SCI to get there, it's not likely that the assigning owner will be deterred by a further breach of the agreement.

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[78] Being the party "whose interest is burdened with the Subsequently Created Interest." Article III.C., line 7.

[79] Derman, *supra*, at 19.

[80] Tex. Prop. Code Ann. §13.001

[81] *Houston Oil Co. v. Kimball*, 122 S.W. 533 (Tex. 1910); a subsequent case rightly pointed out that the recording statute had changed since Kimball and a junior claimant had to show that the junior grantee was a purchaser for value, without notice, but did not change the principle for which Kimball is cited here. *Raposa v. Johnson*, 693 S.W.2d 43 (Tex.App. – Fort Worth 1985) at 48.

6. The traditional way to protect oneself is to put something of record. The AAPL also publishes a memorandum of operating agreement which is often attached as Exhibit H. However the only reference to the memorandum in the JOA is in Article XIII, line 57:

> "Upon termination of this agreement and the satisfaction of all obligations hereunder, in the event a memorandum of this Operating Agreement has been filed of record, Operator is authorized to file of record in all necessary recording offices a notice of termination and each party hereto agrees to execute such a notice of termination as to Operator's interest, upon request of Operator, if Operator has satisfied all its financial obligations."

7. The biggest practical problem to the protection afforded by the Memorandum of Operating Agreement is that, in most JOAs, the Memorandum is never executed and, when it is, the parties sign the exhibit, not a separate document, and never file it of record.

8. If the burdened party is required to assign its interest say, pursuant to a non-consent penalty, the burdened party must deliver the interest free of the SCI.

> "If the Burdened Party is required under this agreement to assign or relinquish to any other party, or parties, all or a portion of its working interest in/or the production attributable thereto, said other party, or parties, shall receive said assignment and/or production free and clear of said Subsequently Created Interest, and the Burdened Party shall indemnify, defend and hold harmless said other party, or parties, from any and all claims and demands for payment asserted by owners of the Subsequently Created Interest."[82]

F. Titles.

1. The Operator under a JOA is required to have title examined on the "Drillsite", or on the Unit if the parties or the Operator so decide, of any proposed well prior to commencement of drilling operations.[83] A drillsite means "the Oil and Gas Lease or Oil and Gas Interest on which a proposed well is to be located."[84] The 2015 continued the 1989H addition of the following: "[w]hen used in connection with a Horizontal Well, the term 'Drillsite' shall mean (i) the surface hold location, and (ii) the Oil and Gas Leases or Oil and Gas Interests within the Drilling Unit or under which the wellbore, including the Lateral is located."[85] The force of this provision used to be that a well could not be drilled until the titles had been approved by an examiner or accepted by the parties; since, generally, no one sought approval of title and title attorneys, generally, do not "approve" title, the 2015 left the alternative of approval by the examining attorney but changed the other alternative to that of the Operator and no longer requires approval of the consenting parties.[86]

2. Generally we do not see a title attorney say "approve" in a title opinion. Subject to the usual mountain of requirements, exceptions and exclusions, we do not know why that could not be done but suspect it is because, in the event of a title failure, regardless of whether all requirements had been met, a disgruntled working interest owner would say, "well, you *approved* it." There is merit is in this concern; for example, in *Rogers v. Ricane*,[87] the court appeared to find that the purchaser of production was justified in ignoring a requirement in the title opinion to cure a conveyance in the chain of title based on testimony that the title defect was not "imminent," that the purchaser of production had relied on two years of production without notice of an adverse claim, and it was the Lessee's obligation, not the purchaser's obligation to meet title requirements.[88] However, the fact that the Operator is entitled to use its in-house staff to run the title (but cannot charge for staff attorney, staff landmen or other personnel), in essence gives the Operator

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[82] Article III.C., lines 15-18.
[83] Article IV.A.
[84] Article I.I.
[85] Article I.I. of the 2015.
[86] Article IV.A., page 3.
[87] *Rogers v. Ricane Enterprises, Inc.*, 930 S.W.2d 157 (Tex. App. -- Amarillo 1996).
[88] *Id.*, at 175.

the right to approve title. To be clear, copies of all title opinions are still required to be provided to the Consenting Parties (no longer called Drilling Parties) but approval by the Consenting parties is no longer required.

3. Honored more in its breach, it is rare that the Operator delays drilling until title has been accepted by all of the participating parties; however, the Operator frequently provides a copy of the drillsite title opinion to the participating parties and, hearing no objection assumes the acceptance of title by the recipients; that caution seem no longer required by the 2015 JOA.

4. The advent of horizontal drilling has changed the circumstances surrounding this provision. The *Browning Oil* case [89] tells us that each tract expected to be penetrated by the wellbore will be considered a drillsite. This provision, Article IV, therefore requires title to be examined for each tract to be penetrated plus any other tracts that will be within the minimum distances to lease lines. The option of approving title to the entire unit,[90] as advocated by Mr. Derman,[91] is very nearly realized.

5. If you are not using the 1989H and you are planning to drill a horizontal well, you may want to add the following to the definition of "Drillsite" when a horizontal well is contemplated:

> The term "Drillsite," when used in connection with a Horizontal or Multi-lateral Well, means the surface location on the Contract Area (or surface lands in proximity of adjacent thereto) plus the Oil and Gas Lease or Oil and Gas Interests on which wellbores, including all Laterals, are located.[92]

6. Failure of Title. Article IV.B. provides extensive guidance as to what happens when title fails.

a) Traditionally, Operators have been quite careful to confirm title on the drillsite tract in a vertical well. Most title failures, then, have been with respect to other tracts in the unit and not with respect to the drillsite. However, with the advent of horizontal drilling, and since horizontal wells in shale or tight formations do not permit drainage except from the portion of the formation hit by the frac, almost all tracts included in a unit for a horizontal shale well will be drillsite tracts. Thus, title will be reviewed as to each such tract before drilling.

b) In a bid to clarify when a title failure occurs, Article IV.B.1. of the 2015 JOA says that a title failure occurs when a contributed interest is determined to be invalid as of the effective date of the JOA or during the term if appropriate.

c) Article IV.B.1 also provides that a title failure includes when an interest covers a lesser interest or less lands (as to aerial extent or Zones) unless such limitations are disclosed on Exhibit "A". This has raised the question of whether a Pugh clause (whether vertical or horizontal) has to be listed separately on Exhibit "A". While the answer should be "no", the exculpation for letting leases expire for failure to develop or because "express or implied covenants have not been performed" or by operation of an express term in the interest or by the expiration of the primary term, all under Article IV.B.3, starts out with an exclusion from exculpation of the losses in Article IV.B.1. and B.2. It seems clear that AAPL did not intend this result so a scrivener using the 2015 JOA might modify Article IV.B.3 to provide that a title loss occasioned by the operation of a specific term of a lease (like a Pugh clause) will still be a joint loss and that a depth limitation in a lease, so long as the limitation is set out in the lease will not be considered a title failure.

d) The first curative step in Article IV.B. is to allow the party who contributed the lease to have 90 days to acquire a new lease or otherwise cure the failure:

> Should any Oil and Gas Interest or Oil and Gas Lease be lost through failure of title, which results in a reduction of interest from that shown on Exhibit 'A,' the party credited with contributing the affected Lease or Interest

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[89] *Browning Oil Co., v Luecke* 38 S.W.3d 625 (Tex. App. -- Austin 2000).
[90] Article IV.A..
[91] Derman, *supra*, at 21.
[92] *See*, Gibson, "Modifying Oil & Gas Documents for Horizontal Drilling," February 22, 2013, Live Oak CLE, Midland, Texas, at 10.

(including, if applicable, a successor in interest to such party) shall have ninety (90) days from final determination of title failure to acquire a new lease or other instrument curing the entirety of the title failure, which acquisition will not be subject to Article VIII.B. [providing for renewal and extension of leases], and failing to do so, this agreement, nevertheless, shall continue in force as to all remaining Oil and Gas Leases and Interests.[93]

e) Presumably, but not explicitly, the party whose lease title failed is given this right exclusively, and, if the cure is not accomplished within the 90 days, any acquisition of a lease on the lost acreage would be acquired under Article VIII.B., i.e. each party to the JOA would be entitled to its proportionate share (assuming the Exhibit A interests have been adjusted for the lost lease).

f) The first consequence of the title failure is that the party who contributed the lease bears the entire loss and cannot charge the Operator or another party with any of its costs previously paid or incurred:

> "The party credited with contributing the Oil and Gas Lease or Interest affected by the title failure (including, if applicable, a successor in interest to such party) shall bear alone the entire loss and it shall not be entitled to recover from Operator or the other parties any development or operating costs which it may have previously paid or incurred, but there shall be no additional liability on its part to the other parties hereto by reason of such title failure."[94]

7. The crux here is "shall bear alone the entire loss…." One would think that the phrase is limited to the loss of the lease, but the language is not that restrictive. Why does it matter?

a) In *Luecke*,[95] Browning and other lessees had leases, granted in 1979, covering lands in Fayette County, Texas. Each lease was substantially the same and contained the following language:

> Lessee, at its option, is hereby given the right and power to pool or combine the acreage covered by this lease or any portion thereof as to oil and gas, or either of them, with any other land covered by this lease, and/or with any other land, lease or leases in the immediate vicinity thereof to the extent hereinafter stipulated . . . . For the purposes of computing the royalties to which owners of royalties and payments out of production and each of them shall be entitled on production of oil and gas, or either of them, from the pooled unit, there shall be allocated to the land covered by this lease and included in said unit ... a pro rata portion of the oil and gas, or either of them, produced from the pooled unit after deducting that used for operations on the pooled unit. Such allocation shall be on an acreage basis--that is to say, there shall be allocated to the acreage covered by this lease and included in the pooled unit . . . that pro rata portion of the oil and gas, or either of them, produced from the pooled unit which the number of surface acres covered by this lease . . . and included in the pooled unit bears to the total number of surface acres included in the pooled unit. Royalties hereunder shall be computed on the portion of such production, whether it be oil and gas, or either of them, so allocated to the land covered by this lease and included in the unit just as though such production were from such land.
>
> ****
>
> Notwithstanding paragraph number four (4) hereof, if any pooled unit is created with respect to any well drilled on the land covered hereby, at least sixty percent (60%) of such pooled unit shall consist of the land covered hereby.
>
> ****
>
> In the event a well is drilled on a tract of insufficient size to contribute sixty percent (60%) of the unit acreage, Lessee will pool all of the drillsite leased acreage and when available, will pool only acreage

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[93] Article IV.B.1., lines 7-12.
[94] Article IV.B.1.(a).
[95] *Browning Oil Co., Inc. v. Luecke,* 38 S.W.3d 625 (Tex.App. -- Austin 2000).

> from other Lessor owned land under lease to Lessee, provided however, that Lessee may pool other acreage not owned by Lessor if required to meet established field rules. In this event, only that acreage necessary to make the unit meet the applicable field rules will be included.
>
> In the event that Lessee shall have an option to utilize a greater or lesser spacing requirement with respect to any producing well and or producing formation or horizon, then Lessee affirmatively covenants and agrees to utilize the lesser spacing requirement. For example, in the event that the field rules specify that in connection with the production from the Chalk Formation, the Lessee may utilize either a One Hundred Sixty (160) acre spacing requirement and/or an optional Eighty (80) acre spacing requirement, then Lessee shall utilize the lesser Eighty (80) acre spacing requirement.[96]

b) In 1994, the lessee requested this modification of the pooling provisions:

In addition to the provisions for pooling, combining or unitizing as contained in Paragraph 4 of the Lease, in the event Lessee, its successors or assigns, should exercise its right and power, in its sole option and discretion, to pool, unitize or combine the lease premises or any portion thereof with other lands in order to form a unit or pooled unit containing a well with a horizontal drainhole, as defined herein, such unit or pooled unit may, within the discretion of Lessee, its successors or assigns, contain the greatest acreage allowable to the extent prescribed or permitted by the Railroad Commission of Texas or other governmental authority having jurisdiction, including, without limitation, Statewide Rule 86 . . . and any amendments or supplements thereto . . . . For the purposes of the lease and for the purpose of exercising the above described rights, a horizontal well or horizontal drainhole is defined as any well in which the horizontal component of the gross completion interval is, at a minimum, one hundred (100) feet.[97]

The Lueckes refused to agree to this modification. In spite of such rejection, the lessee proceeded to drill and complete two horizontal wells traversing the Lueckes' land. The Jennifer Medusa Well No. 1 crossed seven separate tracts of land, only one of which belonged to the Lueckes; however, the vertical portion of the well and part of the horizontal drainhole were physically located on the Lueckes' tract. The P-12 showed a unit of 839 acres, 268 of which were Lueckes tracts. The Lueckes tract with a wellbore consisted of 10% of the total unit acreage.[98]

The lessee drilled a second horizontal well, the Weyand-Hays Unit Well No. 1, and portions of the wellbore crossed two of the Lueckes' tracts. The P-12 reflected 346 acres, including seventy-eight acres from one Lueckes' tracts and thirty-six acres from another, for an aggregate of about 30% of the unit.

The Lueckes sued. The trial court ruled that the lessees had breached the pooling provisions. Damages were reserved for determination by the jury. The Lueckes claimed royalty on all production from the two units and, with respect to the wellbores actually crossing the tracts, they claimed a double royalty on the total production from that well. The lessees proposed a royalty based the share of production from the wells that could be attributed to the Lueckes' tracts. The trial court awarded damages of $833,256 plus prejudgment interest generally in accord with Lueckes contention and $75,000 in attorneys' fees.

c) On appeal, the lessee made three arguments:

(1) Lessee did not have to comply with the pooling provisions;

(2) The Lueckes presented no evidence of damages or that proof was insufficient; and

(3) The trial court failed to submit the proper measure of damages.

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[96] *Id.* at 637-38.
[97] *Id.* at 638.
[98] *Id.*

The court of appeals recognized that parties to oil and gas leases must strictly comply with its terms and that such compliance applies to pooling clauses. The court then concluded that there was no implied general exception for horizontal wells. The lessee argued that the applicable field rules precluded the formation of pooled units in accordance with the lease's anti-dilution provisions. The court examined previous decisions and found no holdings mandating the inclusion of acreage from existing units when designating a new adjacent unit, but that, even if they had, the lessees were required to heed the provision mandating that 60% of each unit consist of Luecke land.

8. However, the court disagreed with the consequence of the breach of the pooling provisions. The court, instead, held that the breach "rendered the pooled units invalid with respect to the Lueckes' land. Absent valid pooling, there is no cross-conveyance, and the Lueckes are not entitled to royalties on oil and gas produced from land they do not own." The court found that the trial court had failed to give the jury sufficient guidance on determining the damages.

9. The court went on to hold as follows:

> Without valid pooled units, the leases do not and cannot award the Lueckes royalties on oil and gas produced from tracts they do not own.
>
> But the rule of capture, which is premised on drainage, does not support [the Lueckes'] entitlement to royalties on all production from a horizontal well, precisely because (1) the geophysical characteristics of the formation actually inhibit the natural drainage underlying the rule of capture, (2) production from multiple drillsite tracts is involved, and (3) the fractures contributing to production are not all adjacent to any single drillsite.
>
> Absent the ability to naturally drain neighboring tracts, the Lueckes are not entitled to production from other lessors' tracts unless there has been a cross-conveyance of property interests. Because the purported units were invalid, there has been no cross-conveyance of interests, and the Lueckes are not entitled to royalties on production from lands they do not own. Although the Lueckes' tracts are drillsite tracts, they cannot claim royalties for total production when they have no legal claim to oil and gas recovered from other lessors' drillsite tracts."[99]

The court decided that it had to balance two competing interests: (1) the lessee should not be allowed to ignore anti-dilution provisions with impunity and (2) the immense benefits that have accompanied the advent of horizontal drilling, including the reduction of waste and the more efficient recovery of hydrocarbons:

> Draconian punitive damages for a lessee's failure to comply with applicable pooling provisions could result in the curtailment of horizontal drilling. We decline to apply legal principles appropriate to vertical wells that are so blatantly inappropriate to horizontal wells and would discourage the use of this promising technology. The better remedy is to allow the offended lessors to recover royalties as specified in the lease, compelling a determination of what production can be attributed to their tracts with reasonable probability.[100]

On this basis, the court remanded for a new trial on damages.

10. While the result in *Browning* may well limit the damages caused by a failure of title in a JOA context, the question is whether any payments to the Lueckes, over and above what they would have received under the unit allocation formula, will be charged to the joint account or to the party who contributed the failed lease under Article IV.B.1.(a).

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[99] *Id*. at 645-46 (citations omitted).
[100] *Id*. at 647.

11. While the issue in (10) is of sufficient concern, there is, lurking in the background, the risk of applying the doctrine of "Confusion of Goods" to the situation of an unleased interest or failed title. Note that the following is applied in situations analogous to horizontal well situations but no cases we have found actually apply these concepts to horizontal wells.

In the case of Humble Oil and Refining Company,[101] West was the Lessor of certain tracts and Humble was the Lessee. Humble decided to convert the field to a gas storage reservoir. The conversion was approved by the Texas Railroad Commission. Humble injected gas into the reservoir; there was still native gas (gas in place) in the reservoir. West's suit for an injunction to prohibit injection was rejected. West then argued that it was entitled to royalty in all production from the reservoir (including injected gas) because the lease said West was entitled to royalties "on oil gas and other minerals which may be produced and saved from the lands hereby conveyed." Having previously rejected the notion that injected gas was, once again, subject to the rule of capture,[102] the court applied the "confusion of goods" theory[103]:

. . . [T]he confusion of good theory attaches only when the commingled goods of different parties are so confused that the property of each cannot be distinguished. Where the mixture is homogeneous, the good being similar in nature and value, and if the portion of each may be property show, each party may claim his aliquot share of the mass. [citing cases] Additionally, the burden is on the one commingling the goods to properly identify the aliquot share of each owner; thus, if good are so confused as to render the mixture incapable of proper division according to the pre-existing rights of the parties, the loss must fall on the one who occasioned the mixture. [Citing cases] Stated differently, since Humble is responsible for, and is possessed with peculiar knowledge of the gas injection, it is under the burden of establishing the aliquot shares with reasonable certainty [emphasis added]. [Citing cases and other sources].[104]

So, Humble's burden was as follows:

. . . [I]t is our view that the act of commingling native and extraneous gas did not impose upon Humble the obligation of paying royalties on all gas thereafter produced from the reservoir, if the evidence establishes with reasonable certainty the volume of gas reserves upon which the Wests would have been entitled to royalties, absent injection of extraneous [the term for gas that has become personal property and then re-injected] gas. The burden of this showing devolves upon Humble after proof by the Wests of their royalty interests, together with proof of Humble commingling of extraneous and native gas. The threshold question for determination is whether the requisite computation of reserves is capable of establishment with reasonable certainty; and, if so, the further question to be resolved is whether burden defined above is discharged by Humble under the evidence.[105]

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[101] *Humble Oil & Refining Company v. West*, 508 S.W.2d 812 (Tex. 1974).

[102] *Lone Star Gas Co. v. Murchison*, 353 S.W.2d 870 (Tex. Civ. App. -- Dallas 1962, *writ ref'd n.r.e.*). This case adopted the reasoning that gas, once extracted, becomes personal property referring to *White v. New York State Natural Gas Corp.*, 190 F. Supp. 342 (W.D. Pa. 1960) instead of the Kentucky conclusion that injected gas becomes subject to the doctrine of *animas ferae naturae. Hammonds v. Central Kentucky Natural Gas Company,* 255 Ky. 685, 75 S.W.2d 204 (1934).

[103] The case of *W.L. Lindemann Operating Co., Inc. v. Strange,* 256 S.W.3d 766 (Tex. App. - Fort Worth 2008), at 781, explains the concept further: "Commingling is also referred to as confusion of goods; 'as a general rule the confusion of goods theory attaches only when the commingled goods of different parties are so confused that the property of each cannot be distinguished.' [citing cases] 'One who wrongfully permits the property of another to become so intermingled and confused with his own property as to render it impossible to identify the goods of each is under the burden of disclosing such facts as will insure a fair division, and if he fails or refuses to do so, the combined property or its value will be awarded to the injured party [emphasis added].' [citing cases]. In applying the commingling rule, we hold one who willfully commingles to a strict burden . . . ."

[104] *Humble Oil & Refining Company v. West*, supra at 818.

[105] *Id.*, at 819

The court remanded the case to the trial court for further proceeding in accordance with the opinion.[106]

Another case involves itself in allocation production between properties. *Springer Ranch, Ltd. v. O.F. Jones III et al.*,[107] involved a large tract of land which was leased in 1956; the tract was divided by will among the heirs of the original lessor in 1990 and an agreement was entered into among the heirs in 1993 which provided, in part that "all royalties payable under the above described Oil and Gas Lease [the 1956 lease] from any well or wells … shall be paid to the owner of the surface estate on which such well or wells are situated, without reference to any production unit on which such well or wells are located." At that time there were two vertical wells on each tract. In 2013 the operator drilled a horizontal well that penetrated two of the three tracts. The owner of the surface location insisted that the agreement's allocation to the surface owner meant that she was entitled to 100% of the production; the other owner contested this claim. Concluding that the wellbore is situated on more than one surface estate, the court held as follows:

> The uncontroverted and only evidence before us shows the productive portion of the [horizontal] … well under the Springer Ranch's property is the length of the well between the first takepoint and the property line. The productive portion under Sullivan's property is the length of the well between the property line and the last takepoint. The portion of the royalties to which Springer Ranch and Sullivan are entitled is determined by the ratio of the productive portions of the … well on their respective properties to the entire length of the well, multiplied by the one-eighth lease royalty. The same proration of royalties shall apply to future horizontal wells on the parties' properties.

In Pennsylvania, there is, perhaps, no ability on the part of the lessee to provide testimony as to the amount of the commingled gas to which the lessor is entitled. In *Pomposini v. T.W. Phillips Gas and Oil Co.*,[108] Pomposini leased to Phillips. The lease provided for royalties based on a sliding pressure scale:

> [On gas] at the rate of two hundred dollars per year while the well shows a pressure of 200 or more lbs. per square inch upon being shut in five minutes in two inch pipe or thirty minutes in larger pipe; at the rate of one hundred dollars per year while the well shows a pressure of 100 or more lbs. per square inch upon being shut in five minutes in two inch pipe or thirty minutes in larger pipe; at the rate of fifty dollars per year while the well shows a pressure of less than 100 lbs. per square inch upon being shut in five minutes in two inch pipe or thirty minutes in larger pipe; to be paid quarterly from completion until abandonment of well.

Here, the reservoir was being used as a gas storage reservoir; lessor had not granted the right to store gas (apparently the lessor was also the surface owner) but was being paid $75 per year. The court, recognizing that both native and extraneous gas were in the reservoir, held that the royalties were to be determined by the pressures exerted by the native gas; however, because of the commingling, the gas injected into the well could not be separated with certainty from the amount of natural gas produced and stored. Under these circumstances, the lessor was entitled to royalties based on the pressure exerted by the gas without regard to whether the gas therein was native or injected from a foreign source. (Citing *Humble Oil Refining Co. v. West*). The Pennsylvania Superior Court sent the case back to the trial court but without, apparently, disturbing the lessor's rights to royalties based on the aggregate pressure.

Whether the Texas Supreme Court will adopt the confusion of goods doctrine with respect to horizontal wells is open. The *Browning v. Luecke* case was decided after the *Humble Oil & Refining* case in which the confusion of goods doctrine is articulated, and Browning expressly rejected the theory that the lessors in Browning might

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[106] The retrial of the issue of the amount of native gas occurred in *Exxon Corp. v West,* 543 S.W.2d 667 (Tex. Civ. App. -- Houston 1976). In essence, Exxon's expert witnesses analyzed all information in the reservoir and made every assumption in favor of West up to the "bounds of reason." The court stated as follows: "In making his geological interpretation for the Maximum Reserve Study, [the expert] picked the highest point on the log for the ceiling of the reservoir, the deepest point for the gas/water contact and the most eastern area location for the fault; all of these points being extended, in the witnesses opinion, to the 'bounds of reason.'"

[107] *Springer Ranch, Ltd. v. O.F. Jones III et al.,* 421 S.W.3d 273 (Tex.App.—San Antonio 2013)

[108] *Pomposini v. T.W. Phillips Gas and Oil Co.*, 397 Pa.Super. 564, 580 A.2d 776 (Pa.Super 1990).

be entitled to share in production from other tracts. On the other hand, Humble is a Texas Supreme Court case, but did not deal with horizontal wells, and Browning is a well-reasoned Court of Appeals case dealing specifically with horizontal wells.

The point of all of the above is, when a party whose lease has failed for title reasons, and the party is obligated to "bear alone the entire loss…" does that loss include the production liabilities and, if so, will that include liability under the *Browning* case and under the *Humble* case or would the horizontal drillers prefer to insert a clause limiting the loss?

12. But what if the Operator is the one that contributed the failed lease? If the Operator is the party who contributed the lease, then you may have to deal with an expansive interpretation of the exculpatory clause recently handed down by the Texas Supreme Court. In *Reeder*,[109] Wendell Reeder, an individual, was the operator under a 1989 form of JOA, which covered existing, producing wellbores located in Wood County, Texas. Reeder did not own any working interest in the wellbores personally, but he did own a percentage interest in a limited partnership which held 87.5% of the working interest in the wellbores covered by the JOA. Individuals and estates held the remaining 12.5% of the working interest in the wellbores. The wells covered by the JOA needed expensive repairs but the working interest owners ("WIOs"), including the limited partnership (which was not controlled by Reeder), refused to pay. Reeder, as operator, spent his own money trying to preserve the wells but, ultimately, the RRC suspended production from the wells. The WIOs sued Reeder for damages for failing to maintain production in paying quantities, for lost leases and loss of the unit.

In the trial court, the jury found that Reeder had breached is duty as operator by failing to maintain production in paying quantities or other operations in the field and that the exculpatory clause above applied to the breach of contract claim. The court of appeals disagreed and held that the gross negligence and willful misconduct instruction should *not* have been included in the jury charge. Reeder then appealed to the Texas Supreme Court.

The Court started by asking whether the exculpatory clause in the JOA sets the standard to adjudicate breach of contract claims. The Court then compared the language to prior cases analyzing the exculpatory clause. A similar clause was found in *Castle Tex. Prod. Ltd. P'ship v. Long Trusts*, 134 S.W.3d 267 (Tex. App. – Tyler 2003, pet denied):

> [Operator] . . . shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It 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.

The court of appeals noted the difference between the phrase "its activities under this agreement" contained in the *Reeder* JOA and the phrase "all such operations" contained in the *Long Trusts* case. Nevertheless, the court of appeals held that the exculpatory clause applied only to claims that Reeder breached his duties *in operations* not that he breached the JOA more generally. In several prior cases, courts of appeal had construed the phrase "all such operations" to apply the exculpatory clause only to claims that the operator had failed to act as a reasonably prudent operator for operations in the field and not for other breaches of the JOA.

The AAPL changed the exculpatory clause in the 1989 Model Form Operating Agreement to cover "activities under [the JOA]" whereas the 1977 and 1982 forms' exculpatory clause covered "all such operations [under the JOA]…." The state and federal cases limiting the scope of the exculpatory clause in JOAs were interpreting the 1977 and 1982 forms of JOA. In the *Reeder* case, the parties had used the 1989 form of JOA which refers to operator's "activities under this agreement" instead of "all such operations."

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[109] *Reeder v. Wood County Energy, LLC* 10-0887 (Tex. 2012).

The court found the change significant and broadened the protection of operators. The court found that "agreed standard *exempts the operator from liability for its activities* unless its liability-causing conduct is due to gross negligence or willful misconduct." Finding that Reeder did not act with gross negligence or willful misconduct, the court rendered judgment in favor of operator (Reeder) on the contract claims.

The court did not address the meaning of "activities" and, thus, sets the stage for additional lawsuits. In fact "activities" is used in the 1989 JOA in the exculpatory clause and in only two other provisions; once in Article IV.A. where costs for hearings on spacing or pooling applications are allowed if "necessary and proper for the activities … under this agreement," and once in Article VII where the parties are obliged to "act in good faith in their dealings with each other with respect to activities hereunder."

Thus, for determining the reach of Article IV.B.1.(a), the parties to the JOA must consider that, if the lease upon which title failed was contributed by the Operator, the expansive language of *Reeder* may render the obligation to "bear alone the entire loss" meaningless. This result can be obviated by clarifying the exculpatory clause.

VI. MISCELLANEOUS.[110]

A. The Date.

The failure to enter into a JOA at all or the commencement of operations before a JOA is entered into can have stunning consequences, the most dramatic of which is the possibility that the parties have formed a Mining Partnership. The consequences of being in a Mining Partnership are Draconian: the parties are general partners with joint and several liability. The JOA must be entered into prior to the date operations are commenced -- not back dated, but actually formed by agreement before there are any operations.[111]

1. The date following Article XVI, page 18, line 1 probably controls and should be the same as the date on the cover page. The JOA provides for a date for each signature and all signatures should carry a date prior to the commencement of operations.

2. The date following Article XVI should be earlier than the date for the initial well in Article VI.A., otherwise the Operator may not be obligated to drill the Initial Well.

3. The date following Article XVI sets the date before which a lease burden will not be considered a Subsequently Created Interest in Article III.[112]

B. Forcenergy.

The *Forcenergy* case had a subsequent iteration[113] which contains some interesting title-related holdings:

1. The language in Article XVI of the 1982 version ("This instrument shall be binding upon and shall inure to the benefit of the parties hereto and to their respective, heirs, devisees, legal representatives, successors and assigns.") operates to make the JOA "run with the land."

2. The JOA is a "farmout" under § 541 of the bankruptcy code. "The statute which defines the term 'farmout,' has been interpreted more broadly than is typical in the oil and gas industry… The definition of farmout requires that there be a written agreement in which the owners of a right to drill, produce, or operate … hydrocarbons on property

[110] This is a collection of JOA matters that largely have nothing to do with title.

[111] Godfrey, Cullen M., "Mining Partnerships: Liability Based on Joint Ownership and Operations in Texas," The Landman, November/December 1993, page 35 at 36. There are 5 elements of a Mining Partnership, and it is formed by law without a written agreement: (i) joint ownership, (ii) joint operations, (iii) sharing of profits and losses, (iv) community of interests, and (v) mutual agency.

[112] Subject, obviously, to the exception for assignment of production as described in Section V.E. above.

[113] *TransTexas Gas Corp. v Forcenergy Onshore* 13-10-00446 (Tex.App.—Corpus Christi 2012, pet. denied)

agrees to transfer or assign an oil and gas interest that includes … defined operations upon the property. The interests transferred under such an agreement will not be property of the estate under section 541 (b)(4)(A)." This may apply to a non-consent interest; that is, the interest transferred to the consenting parties when a party goes non-consent because the court concluded: "Under article VI, section B.2 of the [JOA] … TransTexas agreed to transfer its rights to the wells and production to the consenting parties …. TransTexas's title was subject to the … September 1982 join operating agreement … [so it is] a 'farmout agreement' under the [Bankruptcy Code]. Any oil and gas interests that TransTexas claimed to include in the bankruptcy were excluded from TransTexas's bankruptcy estate."

3. The rejection of the JOA by the bankrupt had no effect on the non-bankrupt's ownership of relinquished interests because of the exclusion explained in 2. above.

C. Albert.

Also to be considered is the *David Albert* case.[114] There, the court obviated a horizontal Pugh clause, in part because of the leased tract's inclusion in a Unit. Certain trusts and individuals signed a lease in 1995 that contained a horizontal Pugh clause which said that, at the end of the primary term, the lease "also shall expire as to all depths below the deepest depth drilled theretofore established in a well located on lands covered by this lease." Before the expiration of the primary term, the lessee and the lessors executed a pooling declaration which pooled the production from gas wells "as to all depths covered by the leases." The crux of the dispute was whether the Pugh clause effectively terminated the lease as to depths below the deepest depth drilled (the court did not decide whether that means total vertical depth or total measured depth). ABX/Albert said it did; Dunlap said it did not. The court found that the lessees "executed the pooling agreement during the primary term … when all depths continued to be covered by the lease," and "[w]e agree with Dunlap that the depth limitations of the horizontal Pugh clause were never triggered because the first production from the unit occurred before the primary term of the … lease ended. In this regard, the lessors agreed to the terms of the pooling agreement and its resulting modification of the … lease by their execution of the pooling agreement."

[114] *David Albert d/b/a David Albert Oil & Gas et al. v. Dunlap Exploration, Inc.*, 457 S.W.3d 554 (Tex.App.—Eastland 2015)