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Chapter 12

The New Horizontal Modified Operating Agreement and Additional Drafting Considerations

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Synopsis

§ 12.01. Introduction and History of the American Association of Professional Landmen Form Operating Agreements.*

The American Association of Professional Landmen (AAPL) issued its first AAPL Form 610 Model Form Operating Agreement in 1956 in an attempt to streamline the process of negotiating and drafting an effective joint operating agreement by means of a standardized form.[1] It was an immediate success and quickly became the standard for the American oil and gas industry ("Industry").

As the Industry has evolved, so has the AAPL Model Form Operating Agreement. The AAPL released its first revision to the Model Form Operating Agreement in 1977 and the Model Form Operating Agreement was revised again in 1982 ("1982 JOA").[2]

Oil prices slumped over the next several years and the Industry suffered hard times. In 1989, the AAPL released another revision to the Model Form Operating Agreement ("1989 JOA") with a number of revisions addressing issues of solvency and adequate funding by reforming payments, default mechanisms, and security liens.[3]

Since the 1989 JOA was introduced, previously inaccessible oil and gas deposits have been opened to successful exploration and development through the combination of horizontal drilling and hydraulic fracturing. The rise of horizontal drilling has been swift and dramatic. In 1987, only about 50 horizontal wells existed.[4] Horizontal drilling has come to dominate the modern drilling landscape. Current estimates place the proportion

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* The authors would like to thank Cassy E. Romano for her invaluable assistance in the drafting and editing of this chapter. Also, capitalized terms used herein and not otherwise defined in this chapter have the meanings given to them in the 1989 Joint Operating Agreement (JOA) and the Horizontal JOA, as applicable.

1 David M. Patton, "Issues Raised by a Distressed Economy with Respect to Joint Operating Agreements and Other Common Oil and Gas Exploration and Development Agreements," *Financial Distress in the Oil & Gas Industry*, ch. 4 (Feb. 2010) (providing that the AAPL's name changed from the American Association of Petroleum Landmen to the American Association of Professional Landmen).

2 Model Form Operating Agreement, AAPL Form 610 – 1982.

3 Model Form Operating Agreement, AAPL Form 610 – 1989.

4 Kathy Shirley, "Horizontal Wells Now Common," *Explorer* (Sept. 2000), http://archives.aapg.org/explorer/2000/09sep/horiz_drill.cfm.

of total land-based drilling rigs in the United States engaged in horizontal drilling at 70 percent.[5] However, because none of the AAPL Model Forms addresses the concept of horizontal drilling, parties have had to incorporate provisions into their chosen Model Forms on an ad hoc basis to effectively address the relevant issues.

The AAPL recognized that the Industry would benefit from a standard form joint operating agreement with horizontal drilling and development modifications. As it had in the past, the AAPL formed a committee to review Industry needs and draft provisions responsive to those needs.[6]

Based upon the recommendations of this committee, the AAPL recently released a 1989 JOA that was modified for horizontal drilling and development ("Horizontal JOA").[7] A number of the revisions modify or add definitions to address issues relevant to horizontal drilling. New provisions have also been added to address certain operational matters that are specific to horizontal wells. The AAPL's modifications, however, are generally limited to horizontal drilling, and further modification is needed to address topics that are generally addressed by the Industry in joint operating agreements.

§ 12.02. Revisions to Definitions.

To address the needs of horizontal drilling, several definitions of the 1989 JOA were modified and added to the Horizontal JOA. Each revision and addition is addressed below in alphabetical order, with any new language denoted by underlined text.

[1] — Authority for Expenditure.

Operators distribute an Authority for Expenditure (AFE) in advance of operations to apprise the Non-Operators of the estimated cost thereof, as well as to provide sufficient information to allow the parties to determine

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5 Baker Hughes, *North America Rotary Rig Count*, Baker Hughes (June 13, 2014), phx.corporate-ir.net/phoenix.zhtml?c=79687 & p=rol-reportsother.

6 *See* Jeff Weems and Amy Tellegen, *The New Horizontal Agreement and the Prospect of an Entirely New Form*, Porter Hedges LLP, http://www.porterhedges.com/ portalresource/lookup/wosid/cp-base-430302/media.name=/2013-0923%20New%20 Horizontal%20Agreement%20and%20Prospect%20of%20New%20Form.pdf (last visited June 16, 2014).

7 Model Form Operating Agreement – Horizontal Modifications, AAPL Form 610 – 1989.

whether or not to participate in the operations.[8] Due to litigation regarding whether an AFE set a ceiling upon the expenditures to which the parties gave consent, the AAPL clarified in the 1989 JOA that an AFE is prepared for the purpose of estimating the costs to be incurred by the parties.[9] Horizontal well development is costly and the costs thereof often exceed the costs of developing a Vertical Well by a factor of two or more.[10] As relatively costly horizontal drilling operations have become increasingly commonplace, the risk of litigation when actual costs exceed AFE-projected costs has also risen; the revised AFE definition reiterates that AFEs are simply estimates and are not to be considered a contractual commitment:

> The term "AFE" shall mean an Authority for Expenditure prepared by a party to this agreement for the purpose of estimating the costs to be incurred in conducting an operation hereunder. An AFE is not a contractual commitment. Rather it is only an estimate, made in good faith.[11]

Although the intent behind the revised definition of AFE in the Horizontal JOA appears quite clear, further modification to this definition should be considered. As drafted, the definition of AFE provides that the AFE is not a contractual commitment, but, as drafted, this statement could lead to (or bolster) an argument that approval of an AFE by a Non-Operator is not a binding contractual commitment to pay its proportionate share of the necessary costs to perform operations set forth in the AFE.[12] Further clarification is likely necessary and prudent to avoid such an argument or a conflict with the language of Article IV.B.1. of the 1989 JOA and Horizontal JOA (providing that an election to participate in a proposal is a contractual commitment).[13]

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8 Williams & Meyers, *Manual of Oil and Gas Terms* 8-A (Patrick H. Martin and Bruce M. Kramer eds., 15th ed. 2013).

9 *Id*.; *see* Art. I.A. of the 1989 JOA; s*ee also* Weems and Tellegen, *supra* note 6, at 5; M & T, Inc. v. Fuel Res. Dev. Co., 518 F. Supp. 285 (D. Colo. 1981).

10 *See, e.g*., Lonnie Barker, *Will Horizontal Wells Become Conventional in Oil and Gas?*, Siemens Global Weblogs (Jan. 18, 2013), https://blogs.siemens.com/measuring success/stories/688/ (placing the cost for Vertical Wells between $1 and 3 million and for Horizontal Wells between $5 and 8 million).

11 Art. I.A. of the Horizontal JOA.

12 *Id*.

13 *See* Art. VI.B.1. of the Horizontal JOA; *see also* Art. VI.B.1. of the 1989 JOA.

[2] — Deepen.

The concept of Deepening a Vertical Well involves extending the borehole to a greater overall depth. For Horizontal Wells, the concept applies to extending the length of the Lateral rather than drilling to a deeper Zone or formation. The revised definition captures this difference as follows:

> The term "Deepen" shall mean a single operation whereby a well is drilled to an objective Zone below the deepest Zone in which the well was previously drilled, or below the Deepest Zone proposed in the associated AFE, whichever is the lesser. When used in connection with a Horizontal Well, the term "Deepen" shall mean an operation whereby a Lateral is drilled to a Displacement greater than (i) the Displacement contained in the proposal for such operation approved by the Consenting Parties, or (ii) to the Displacement to which the Lateral was drilled pursuant to a previous proposal.[14]

[3] — Displacement (New Definition).

The Displacement of a Horizontal Well refers to the length of its Lateral. Because some states have defined the term with respect to wells under their jurisdiction,[15] the definition explicitly defers to the states that have done so and provides the customary definition for those that have not.

> The term "Displacement" shall have the same meaning as the term defined by the state regulatory agency having jurisdiction over the Contract Area, in the absence of which the term shall otherwise mean the length of a Lateral.[16]

[4] — Drillsite.

Under the 1989 JOA, the Drillsite was defined as the Oil and Gas Lease or Interest upon which the well will be located, which would not include

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14 *See* Art. I.D. of the Horizontal JOA.

15 *See, e.g.*, 16 Tex. Admin. Code § 3.86(a)(3) (2014) ("Horizontal drainhole displacement [means] [t]he calculated horizontal displacement of the horizontal drainhole from the penetration point to the terminus."). Note that "terminus," "horizontal drainhole" and "penetration point" are all defined terms under § 3.86(a).

16 Art. I.E. of the Horizontal JOA.

the Lateral(s) of a Horizontal Well.[17] In the context of Horizontal Wells, the definition of Drillsite was also inadequate because the title review required under Article IV.A. of the 1989 JOA only applied to the Drillsite (unless otherwise elected by a majority in interest of the Drilling Parties).[18] Thus, the title to the Lateral(s) and the Leases penetrated thereby would not be subject to title review. To address Horizontal Wells, the definition of Drillsite has been modified to cover the area penetrated by a Lateral of a Horizontal Well.

> The term "Drillsite" shall mean the Oil and Gas Lease or Oil and Gas Interest on which a proposed well is to be located. When used in connection with a Horizontal Well, the term "Drillsite" shall mean (i) the surface hole location, and (ii) the Oil and Gas Leases or Oil and Gas Interests within the Drilling Unit on or under which the wellbore, including the Lateral, is located.[19]

It should be noted that Article IV.A. of the 1989 JOA was often modified to include the area penetrated by a Lateral of a Horizontal Well, but such a change is no longer necessary given the revised definition of Drillsite in the Horizontal JOA.[20]

[5] — Horizontal Rig Move-On Period (New Definition).

Many Horizontal Wells are drilled in two distinct phases. The first phase involves the use of a "Spudder Rig." Spudder Rigs are relatively small rigs that are used for drilling the wellbore vertically down to the kickoff point.[21] The second phase uses a larger rig to Complete the Lateral portion of the well. This two-phase approach often saves on drilling costs and can allow drilling operations to commence more quickly than would occur

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17 Art. I.G. of the 1989 JOA.

18 Art. IV.A. of the 1989 JOA.

19 Art. I.H. of the Horizontal JOA.

20 Lamont C. Larsen, "Suggested Changes to the 1989 AAPL Form Operating Agreement to Address Horizontal Development," *Rocky Mtn. Min. L. Found.*, *Horizontal Oil & Gas Development*, Paper No. 8, 7 (Nov. 2012).

21 For another view on this particular revision, see Thomas A. Daily, "Horizontal Modifications to the AAPL 610 JOA—A Focus Upon the 610-1982 Form," *Oil, Gas & Min. L. Inst.* 7 (Mar. 28, 2014), https://utcle.org/ecourses/OC4925/get-asset-file/asset_id/32307.

if only a single rig were used; however, it requires a time delay—at times significant—between the Spudder Rig's Completion of its operation and the arrival of the second rig. The Horizontal JOA uses the following defined term in connection with this time delay:

> The term "Horizontal Rig Move-On Period" shall mean the number of days after the date of rig release of a Spudder Rig until the date a rig capable of drilling a Horizontal Well to its Total Measured Depth has moved on to location.[22]

[6] — Horizontal Well (New Definition).

Because a Vertical Well and a Horizontal Well are, and need to be, treated differently in many respects, Horizontal Well and Vertical Well are both defined in the Horizontal JOA.[23] In drafting a definition of Horizontal Well, the AAPL committee was cognizant that many states have already defined the concept of Horizontal Wells within their jurisdictions.[24] Thus, the definition of Horizontal Well explicitly defers to the states that have defined Horizontal Well while providing a definition for use in those states that have not yet defined this concept.

> The term "Horizontal Well" shall have the same meaning as the term defined by the state regulatory agency having jurisdiction

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22 Art. I.I. of the Horizontal JOA.

23 *See* Arts. I.J., I.Y. of the Horizontal JOA.

24 *See, e.g.*, 16 Tex. Admin. Code § 3.86(a)(4) (2014) ("Horizontal drainhole well [means] [a]ny well that is developed with one or more horizontal drainholes having a horizontal drainhole displacement of at least 100 feet."); N.D. Cent. Code § 57-51.1-01(4) (2013) ("'Horizontal Well' means a well with a horizontal displacement of the wellbore drilled at an angle of at least eighty degrees within the productive formation of at least three hundred feet [91.44 meters]."); Ohio Rev. Code Ann. § 1509.01(GG) (2013) (" 'Horizontal Well' means a well that is drilled for the production of oil or gas in which the wellbore reaches a horizontal or near horizontal position in the Point Pleasant, Utica or Marcellus formation and the well is stimulated."); Mont. Admin R. 36.22.302(41) (2014) (" 'Horizontal Well' means: (a) a well with one or more horizontal drainholes; and (b) any other well classified by the board as a horizontal well."); Wyo. Admin. Code Oil Gen Ch. 1 § 2(y) (2013) ("Horizontal well shall mean a wellbore drilled laterally at an angle of at least eighty degrees (80°) to the vertical and with a horizontal projection exceeding one hundred feet (100') measured from the initial point of penetration into the productive formation through the terminus of the lateral in the same common source of hydrocarbon supply").

> over the Contract Area, in the absence of which the term shall mean a well containing one or more Laterals which are drilled, Completed or Recompleted in a manner in which the horizontal component of the Completion interval (1) extends at least one hundred feet (100') in the objective formation(s) and (2) exceeds the vertical component of the Completion interval in the objective formation(s).[25]

[7] — Lateral (New Definition).

Because the concept of a Lateral is a large component of a Horizontal Well, a new definition was added to the Horizontal JOA to address this concept.

> The term "Lateral" shall mean that portion of a wellbore that deviates from approximate vertical orientation to approximate horizontal orientation and all wellbore beyond such deviation to Total Measured Depth.[26]

[8] — Plug Back.

The traditional concept of a "Plug Back" is essentially the opposite of Deepening operations. That is, a Plug Back operation in a Vertical Well involves plugging the well back to a certain depth in order to produce from a shallower formation. To apply this concept to Horizontal Wells, this definition was modified in the Horizontal JOA as follows:

> The term "Plug Back" shall mean a single operation whereby a deeper Zone is abandoned in order to attempt a Completion in a shallower Zone. <u>When used in connection with a Horizontal Well, the term "Plug Back" shall mean an operation to test or Complete the well at a stratigraphically shallower Zone in which the operation has been or is being Completed and which is not in an existing Lateral</u>.[27]

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25 Art. I.J. of the Horizontal JOA.
26 Art. I.L. of the Horizontal JOA.
27 Art. I.R. of the Horizontal JOA.

[9] — Sidetrack.

For Vertical Wells, the term "Sidetrack" means "the directional control and intentional deviation of a well from vertical so as to change the bottom hole location unless done to straighten the hole or drill around junk in the hole or to overcome other mechanical difficulties."[28] The very purpose of a Horizontal Well is to deviate the intended point of termination from the vertical point of entry, which makes the conventional idea of sidetracking moot. The Horizontal JOA extends the "Sidetrack" concept for application to Horizontal Wells by defining it as a change along the vertical or horizontal axis of the well's Lateral.

> When used in connection with a Horizontal Well, the term "Sidetrack" shall mean the directional control and deviation of a well outside the existing Lateral(s) so as to change the Zone or the direction of a Lateral from the approved proposal unless done to straighten the hole or drill around junk in the hole or to overcome other mechanical difficulties.[29]

[10] — Spudder Rig (New Definition).

The definition of Spudder Rig clarifies what should or should not be classified as a Spudder Rig. This new definition also works in conjunction with the definition of "Horizontal Rig Move-On Period" and Article VI.B.9. of the Horizontal JOA (see Section 12.03[5] of this chapter regarding the new Spudder Rig concept added under Article VI.B.9. of the Horizontal JOA).[30]

> The term "Spudder Rig" shall mean a drilling rig utilized only for drilling all or part of the vertical component of a Horizontal Well; a rig used only for setting conductor pipe shall not be considered a Spudder Rig.[31]

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28 Art. I.Q. of the 1989 JOA.
29 Art. I.U. of the Horizontal JOA.
30 Arts. I.I., VI.B.9. of the Horizontal JOA.
31 Art. I.V. of the Horizontal JOA.

[11] — Terminus (New Definition).

"Terminus" is another term which many states have already defined within their jurisdictions.[32] This definition defers to those states which have already defined the term and adds a customary definition for those states that have not.

> The term "Terminus" shall have the same meaning as the term defined by the state regulatory agency having jurisdiction over the Contract Area, in the absence of which the term shall mean the furthest point drilled in the Lateral.[33]

[12] — Total Measured Depth (New Definition).

The Total Measured Depth is the full measure of the distance traveled by the wellbore.[34] Some Horizontal Wells called "multilateral wells" have multiple Laterals extending from a single vertical wellbore.[35] A number of multilateral configurations are possible, including multiple Laterals emanating from the vertical wellbore at roughly equivalent depths or multiple Laterals at different depths, which are designed to penetrate entirely different Zones or formations.[36] The Horizontal JOA captures all concepts with the following language:

> The term "Total Measured Depth," when used in connection with a Horizontal Well, shall mean the distance from the surface of the ground to the Terminus, as measured along and including the vertical component of the well and Lateral(s). When the proposed operation(s) is the drilling of, or operation on, a Horizontal Well, the terms "depth" and "total depth" wherever used in this agree-

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32 16 Tex. Admin. Code § 3.86(a)(6) (2014) ("Terminus [means] [t]he farthest point required to be surveyed along the horizontal drainhole from the penetration point and within the correlative interval."); Mont. Admin R. 36.22.302(40) (2014) ("Horizontal drainhole end point' means the terminus of a horizontal drainhole.").

33 Art. I.W. of the Horizontal JOA.

34 Weems and Tellegen, *supra* note 6, at 9.

35 For an overview of multilateral wells, Steve Bosworth *et al*., "Key Issues in Multilateral Technology," 10 *Oilfield Rev.* 14 (1998), *available at* https://www.slb.com/~/media/Files/resources/oilfield_review/ors98/win98/key.pdf.

36 *Id*.

ment shall be deemed to read "Total Measured Depth" insofar as it applies to such well.[37]

[13] — Vertical Well (New Definition).

This definition was previously unnecessary as all Model Form Operating Agreements prior to the Horizontal JOA only contemplated Vertical Wells. Now that Horizontal Wells are also contemplated, the following definition has been added:

> The term "Vertical Well" shall mean a well drilled, Completed or Recompleted other than a Horizontal Well.[38]

§ 12.03. Revisions to Article VI. — Drilling and Development.

[1] — Article VI.A. — Initial Well.

Article VI.A. of the 1989 JOA was modified to accommodate an Initial Well that is a Horizontal Well. This was accomplished by adding a requirement to specify the surface hole location and the Terminus of each Lateral, along with the horizontal length of each Lateral.[39] While these changes are minor and non-controversial, Section 12.06[4] of this chapter sets forth additional considerations for drafting Article VI.A. of either the Horizontal JOA or 1989 JOA.

[2] — Article VI.B.1. — Subsequent Operations, Proposed Operations.

Article VI.B.1. of the 1989 JOA was revised in two main respects. First, subsequent proposals for Sidetracking and Deepening are clearly limited to the Consenting Parties for a Horizontal Well, but Non-Consenting Parties can still elect to participate in Sidetracking or Deepening a Vertical Well.[40] This change is consistent with the revisions made to Articles VI.B.4. and VI.B.5. of the 1989 JOA restricting the applicability of those provisions to Vertical Wells (*see* Sections 12.03[3] and [4] of this chapter regarding the

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37 Art. I.X. of the Horizontal JOA.
38 Art. I.Y. of the Horizontal JOA.
39 Art. VI.A. of the Horizontal JOA.
40 Art. VI.B.1. of the Horizontal JOA.

revisions made to Articles VI.B.4. and VI.B.5. in the Horizontal JOA). Parties who are negotiating a joint operating agreement based upon the Horizontal JOA should be cognizant of this revision to Article VI.B.1. in the Horizontal JOA because any modifications to Articles VI.B.4. and VI.B.5. regarding Horizontal Wells will need to be reflected in this chapter as well.

The second change made to Article VI.B.1. of the 1989 JOA sets forth the information required to be provided in a proposal for a Horizontal Well.[41] Those requirements are:

(1) state that the proposed operation is a Horizontal Well operation;

(2) include drilling and Completion specifying the proposed:

(i) Total Measured Depth(s),

(ii) surface hole location(s),

(iii) Terminus/Termini,

(iv) Displacement(s),

(v) utilization and scheduling of rig(s) (Spudder Rig, drilling and Completion), and

(vi) stimulation operations, staging and estimated drilling and Completion costs as set forth in an AFE.[42]

Although arguably implied under (v) above, Article VI.B.1. of the Horizontal JOA does not specifically provide that the Horizontal Rig Move-On Period must be specified in the proposal for a Horizontal Well if a Spudder Rig is to be used. For clarity, it would be beneficial to expressly require the inclusion of the Horizontal Rig Move-On Period in the proposal for a Horizontal Well if a Spudder Rig is to be used. The parties should also consider whether there is any additional information that should be required to be included in proposals for Horizontal Wells, and if so, those items should be specified in Article VI.B.1. of the Horizontal JOA.

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41 *Id.*

42 *Id.*

[3] — Article VI.B.4. — Subsequent Operations, Deepening.

Article VI.B.4. of the 1989 JOA was revised to apply only to Vertical Wells.[43] This change precludes a Non-Consenting Party from electing to participate in a proposal to Deepen a Horizontal Well. Under Article VI.B.4. of the 1989 JOA, (and under the Horizontal JOA for Vertical Wells), a Non-Consenting Party is permitted to elect to participate in Deepening operations by reimbursing the Consenting Parties for its proportionate share of costs and expenses for the original well. One reason for treating Horizontal Wells differently in this regard is the fact that Deepening a Horizontal Well (extending a Lateral in the existing formation) is fundamentally different from Deepening a Vertical Well.[44] Note that it is possible that Deepening a Horizontal Well could require substantial new drilling and consequently the Non-Consenting Parties should be permitted to elect to participate.[45] The parties negotiating a joint operating agreement based upon the Horizontal JOA should consider if this revision is appropriate, and if Non-Consenting Parties should be prevented from only some, but not all, Deepening operations.

From a drafting perspective, it should also be noted that the Horizontal JOA does not clarify that Non-Consenting Parties regain the right to participate in Deepening operations under Article VI.B.2(c) once the Consenting Parties recoup their expenses under Article VI.B.2.(b).[46] This appears to simply be an oversight because Non-Consenting Parties can participate in Reworking, Recompleting and Plugging Back a Horizontal Well once such expenses are recouped, and Deepening and Sidetracking are not listed in

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43 Art. VI.B.4. of the Horizontal JOA.

44 Lamont C. Larsen, "Horizontal Drafting: Why Your Form JOA May Not Be Adequate for Your Company's Horizontal Drilling Program," 48 *Rocky Mtn. Min. L. Found.* J. 51 (2011); s*ee also* Weems and Tellegen, *supra* note 6, at 11–12.

45 Larsen, *supra* note 44; *see also* Weems and Tellegen, *supra* note 6, at 12; Larsen, *supra* note 20 at 11-12. (An interesting concept to consider that is proposed by Larsen is whether Plugging Back operations should be treated differently for Horizontal Wells due to the rationale that Non-Consenting Parties should be granted an election to participate when there is substantial new drilling. In the context of a Horizontal Well, a Plug Back operation in which a new Lateral is drilled at a shallower depth could require substantial new drilling, which is fundamentally different from Plugging Back a Vertical Well.

46 Art. VI.B.2.(b), (c) of the Horizontal JOA.

Article VI.B.2.(c) because of the ability of Non-Consenting Parties to elect to participate in those operations under Articles VI.B.4. and VI.B.5. This language can easily be clarified by adding Deepening and Sidetracking (in connection with a Horizontal Well) to Article VI.B.2.(c).

[4] — Article VI.B.5. — Subsequent Operations, Sidetracking.

Similar to Article VI.B.4., Article VI.B.5. of the Horizontal JOA precludes a Non-Consenting Party from electing to participate in Sidetracking operations for a Horizontal Well.[47] Similar to the rationale behind the revisions made to Article VI.B.4., one reason for treating Horizontal Wells differently than Vertical Wells is that Sidetracking a Horizontal Well is fundamentally different.[48] This argument, however, is less persuasive in the context of Sidetracking operations. Sidetracking, in the context of a Vertical Well, is a deviation of a well to change the bottom hole location, but it is not required that a new depth or strata be targeted.[49] In the context of a Horizontal Well, Sidetracking would similarly involve a deviation of the well to hit a new location that would likely be in the same formation or strata as the original well. A more persuasive rationale is that Horizontal Wells are more expensive, and the initial drilling is much riskier (depending upon the extent to which the Contract Area has been de-risked by prior development). Also, as noted above in Section 12.02[3] of this chapter, Article VI.B.2.(c) should be clarified to include Sidetracking if the construct of the Horizontal JOA in Article VI.B.5. is left unchanged.

[5] — Article VI.B.9. — Subsequent Operations, Spudder Rigs (New Provision).

The Horizontal JOA includes a new Article VI.B.9. addressing the use of Spudder Rigs, including cost allocation and the timing between the release of the Spudder Rig and moving a rig capable of drilling the Horizontal

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47 Art. VI.B.5. of the Horizontal JOA.

48 Weems and Tellegen, *supra* note 6, at 12.

49 Art. I.U. of the Horizontal JOA.

Well on location.[50] Although the use of Spudder Rigs is not a new concept, Spudder Rigs are now specifically addressed in the Horizontal JOA, and the timing between the release of the Spudder Rig and moving a rig capable of drilling the Horizontal Well on location appears to the primary focus of Article VI.B.9.[51] Article VI.B.9. provides that (i) the Operator can request one or more extensions to the Horizontal Rig Move-On Period, (ii) the Operator can propose the use of a Spudder Rig for an approved Horizontal Well if the approval of such well did not provide for the use of a Spudder Rig, and (iii) the Operator will re-propose the well for which the Horizontal Rig Move-On Period was not met (unless the Consenting Parties elect to abandon the operation).[52]

As defined in the Horizontal JOA, the "Horizontal Rig Move-On Period" is "the number of days *after the date of rig release* of a Spudder Rig until the date a rig capable of drilling a Horizontal Well to its Total Measured Depth has moved on to location."[53] As noted above, Article VI.B.9. allows for the Horizontal Rig Move-On Period to be extended too.[54] One potential issue that is apparent in the definition of Horizontal Rig Move-On Period is that this period is not triggered until the Spudder Rig is released, which provides little certainty as to either when the Spudder Rig will be released (as this is in the Operator's control) or when the requirement to provide a rig capable of drilling the Horizontal Well will be triggered. Although timing may need to be flexible, the parties should be careful and confirm the Horizontal Rig Move-On Period so that it does not allow for unfettered delay by the Operator at the Consenting Parties' expense.

In addition to the conceptual and drafting considerations raised above, there are also potential pitfalls to using Spudder Rigs. First, the parties should consider the terms of the applicable Leases and state law to determine if a Spudder Rig is capable of holding a Lease past its primary term

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50 *See* Weems and Tellegen, *supra* note 6, at 12–15 (discussing Article VI.B.9. of the Horizontal JOA in more detail).

51 Art. VI.B.9. of the Horizontal JOA.

52 *Id*. Note the parties specify the required percentage in interest of the Consenting Parties required to consent for each option under Article VI.B.9. of the Horizontal JOA.

53 *Id*. (emphasis added).

54 *Id*.

when the rig itself is not capable of drilling the well.[55] For instance, a Lease may require that once commenced, drilling operations must be diligently prosecuted to maintain the Lease, and the lack of resources needed to Complete the well, even once spudded, can result in the expiration of a Lease.[56] Additionally, it could be argued that operations were not commenced in good faith so as to hold a Lease when the rig or equipment used is not capable of drilling the well. For example, in *Geier-Jackson, Inc. v. James*, the court held that the use of a drilling rig incapable of reaching the depths needed to produce from the expected reservoirs was not commencing operations in good faith.[57] For tight shale formations in which horizontal drilling is a must to produce from the expected horizon, the same logic could apply to find that a Spudder Rig incapable of drilling the Lateral needed is not adequate to hold the Lease. In *Bunnell Farms Co. v. Samuel Gary, Jr. & Associates*, however, the commencement of drilling operations by a rig incapable of drilling to the target depth was held by the court to be commencing operations in good faith so as to hold the Lease in force.[58]

Although the two cases discussed above involved drilling rigs incapable of drilling to the depth needed, an analogy could be made between those fact patterns and the use of a Spudder Rig incapable of drilling a Lateral for a formation in which drilling a Lateral is required to economically produce hydrocarbons. Also, even though both of the cases discussed above reached different results, the determination of what constitutes commencement of operations in good faith was a fact specific determination, and as such, demonstrates that this issue is ripe for litigation. The provisions of the applicable Leases should be reviewed to determine what actions constitute commencement of operations, and if the terms of the Leases are uncertain, state law should be examined and considered in connection with imple-

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55 Bruce M. Kramer, "Keeping Leases Alive in the Era of Horizontal Drilling and Hydraulic Fracturing: Are the Old Workhorses (Shut-in, Continuous Operations, and Pooling Provisions) Up to the Task?," 49 *Washburn L.J.* 283, 297 (2010).

56 *Id.*; *see also* 3-6 Williams & Meyers, *Oil and Gas Law* § 606 (2013).

57 Kramer, *supra* note 55, at 283 (citing Geier-Jackson, Inc. v. James, 160 F. Supp. 524, 529–30 (E.D. Tex. 1958)).

58 Kramer, *supra* note 55, at 283 (citing Bunnell Farms Co. v. Samuel Gary, Jr. & Assocs., 47 P.3d 804, 807 (Kan. Ct. App. 2002)).

menting a Spudder Rig (or providing for a significantly delayed Horizontal Rig Move-On Date).

[6] — Article VI.B.10. — Subsequent Operations, Multi-Well Pads (New Provision).

Another addition made by the Horizontal JOA is Article VI.B.10. regarding the cost allocation of multi-well pads.[59] Article VI.B.10. provides "[i]f multiple Horizontal Wells are drilled or proposed to be drilled from a single pad or location, the costs of such pad or location shall be allocated, and/or reallocated as necessary, to the Consenting Parties of each of the wells thereon."[60] This new provision addresses the increased use of multi-well pads, and acknowledges that costs will need to be allocated, however, the new language does not address a method to allocate the costs. Such clarification may be necessary to avoid arguments amongst the parties. In addition to clarifying how costs will be allocated, the parties should also consider mechanically how the reimbursed costs will be handled, and if applicable, how long the Operator will have to tender those reimbursements. Additionally, as one author notes, the parties to a Horizontal JOA should consider whether the Counsel of Petroleum Accountants Societies ("COPAS") Accounting Procedure conflicts with the Operator's ability to reallocate costs under Article VI.B.10. (as such reallocation may be made after some time); changes to the COPAS Accounting Procedure may be necessary if the use of Article VI.B.10. is anticipated.[61]

[7] — Article VI.C.1. — Completion of Wells: Completion (Casing Point Election).

Article VI.C.1. of the 1989 JOA provides that the parties can elect to either (i) include the costs to drill, test and complete the proposed well in the initial AFE (under Option No. 1), or (ii) give each Consenting Party the right to elect whether or not to participate in the Completion of the well after the wells has been drilled and tested (under Option No. 2).[62] The

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59 Art. VI.B.10. of the Horizontal JOA.

60 *Id*.

61 Weems and Tellegen, *supra* note 6, at 15.

62 *See* Art. VI.C.1. of the 1989 JOA.

1989 JOA, when modified for horizontal development by producers, often applied Option 1 to all Horizontal Wells, because the drilling of the Lateral in the target formation does not provide an election point as would be needed under Option No. 2. The Horizontal JOA modified Article VI.C.1. to be consistent with Industry practice and provide that Option No. 1 applies to Horizontal Wells. An additional change to consider is to clarify that hydraulic fracturing is included in the definition of "Completion," to add certainty that such costs will be included under Option No. 1, and that these costs will be included in the proposal under Article VI.B.1. of the Horizontal JOA.

§ 12.04. Revisions to Article XV.A.

Provided that the Operator has executed the 1989 JOA, Article XV.A. makes the joint operating agreement binding upon each Non-Operator immediately upon signing.[63] This introduces the possibility of operations commencing under the joint operating agreement prior to execution by all of the anticipated parties. The 1989 JOA addresses this possibility by allowing the Operator to unilaterally terminate the agreement prior to spudding the Initial Well if it determines there is insufficient participation to justify the start of operations.[64] If the Operator chooses to proceed with drilling the Initial Well, it must indemnify each Non-Operator for costs that would have been charged to the non-executing persons.[65] In exchange, the revenue that would have gone to the non-executing persons goes instead to the Operator.[66]

The Horizontal JOA retains the forgoing provision as an option under Article XV.A. and adds a second option for the parties to consider.[67] Under this second option, the Operator advises the parties of the total interest held by the executing parties and offers each party three methods for dealing with the remaining interest.[68] The first method allows the party to remain

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63 *See* Art. XV.A. of the 1989 JOA.
64 *Id.*
65 *Id.*
66 *Id.*
67 *Id.* Art. XV.A.
68 *Id.*

at its designated interest.[69] The second method allows the party to succeed to its proportionate share of the interest that would have been held by the non-executing persons.[70] The third method allows the party to both succeed to the interest described in the second option as well as all or part of its proportionate share in any interest the other parties elected not to take.[71] If a party fails to make an election within forty-eight hours, it is deemed to have elected to remain at its designated interest.[72]

§ 12.05. Revisions to Article XVI.

The Horizontal JOA contains three new additional provisions in Article XVI.

[1] — Article XVI.A. — Conflict of Terms (New Provision).

This provision provides for the dominance of Article XVI. provisions with respect to provisions contained in other articles.[73] It does so by declaring that, in the event of conflict between an Article XVI. provision and a non-Article XVI. provision, the former is to govern.[74]

[2] — Article XVI.B. — Operator's Duty (New Provision).

One of the goals of the AAPL committee in creating the Horizontal JOA appears to be balancing the need for Operator accountability against the Operator's need for flexibility with respect to operations.[75] The Horizontal JOA attempts to strike this balance with respect to Operator accountability for horizontal drilling by requiring the Operator to drill to, and place the Lateral in, the objective zone.[76] These requirements are balanced by giving the Operator flexibility with respect to Lateral Displacement by re-

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69 *Id.*
70 *Id.*
71 *Id.*
72 *Id.*
73 Art. XVI.A. of the Horizontal JOA.
74 *Id.*
75 Weems and Tellegen, *supra* note 6, at 13 ("[An] overarching concept applicable to Model Forms, and the Horizontal Form in particular, [is] that the Operator should have as much flexibility and leeway as is practicable.").
76 Art. XVI.B. of the Horizontal JOA.

quiring the Operator to drill only so far as a prudent Operator would deem further drilling is neither justified nor required.[77]

[3] — Article XVI.C. — Priority of Operations, Horizontal Wells (New Provision).

In some instances, the parties may not agree about the operation or operations that should be conducted once a Horizontal Well has been drilled to the objective Displacement. This article of the Horizontal JOA addresses the issue by establishing a default order of operations that can be used to proceed in the event of such conflict.[78] Operations are numbered below in their respective order of precedence.[79]

First:	Testing, coring or logging;
Second:	Complete drilling operations;
Third:	Extend or deepen a Lateral;
Fourth:	Kick out and drill an additional Lateral in the same Zone;
Fifth:	Plug back the well to a Zone above the Zone in which a Lateral was drilled; if there is more than one proposal to Plug Back, the proposal to Plug Back to the next deepest prospective Zone shall have priority over a proposal to Plug Back to a shallower prospective Zone;
Sixth:	Sidetrack; and
Seventh:	Plug and abandon as provided for in Article VI.E.

The drafters of the Horizontal JOA recognized that each situation is unique and that the circumstances of a particular well may cause any of the foregoing operations to be inappropriate in certain situations.[80] The provi-

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77 *Id.*
78 Art. XVI.C. of the Horizontal JOA.
79 *Id.*
80 *Id.*

sion grants a degree of operational flexibility by allowing the Operator to eliminate any of the foregoing operations if a reasonably prudent Operator would not conduct the operation given the conditions of the hole.[81] Please note that Article XVI.C. sets forth a priority of operations for Horizontal Wells only, and the parties may wish to add a similar detailed priority of operations for Vertical Wells to Article XVI.

§ 12.06. Additional Drafting Considerations.[82]

[1] — Additional Definitions.

In addition to the horizontal specific defined terms (which were generally addressed by the AAPL committee in the Horizontal JOA), additional defined terms are often included in joint operating agreements to add clarity. Additional defined terms to consider are "affiliate," "control," and "governmental agency".[83] The definition of "affiliate," (and "control," which is often used in connection with the definition of "affiliate") can provide clarity under Article V.D.1. of the 1989 JOA (Competitive Rates and Use of Affiliates). This is because Article V.D.1. of the 1989 JOA contains a vague reference to "affiliates *or related parties*."[84] In addition to defining "affiliate," the phrase "or related parties" should be struck from Article V.D.1. of the 1989 JOA to clarify this article and to avoid confusion or arguments over who is and is not a related party.

If the term "affiliate" is defined in the joint operating agreement, the parties to the joint operating agreement should consider how broad of a definition should be used and whether private equity sponsors or other investors should be excluded from this definition. Depending upon whether any party has (or may later have) a private equity sponsor or other investor, this could create unintended consequences in the future depending upon the

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81 *Id.*

82 Unless provided otherwise, references to the 1989 JOA in this section of the chapter are generally applicable to both the 1989 JOA and the Horizontal JOA.

83 Art. XV. for the 1982 JOA.

84 Art. V.D.1. of the 1989 JOA (emphasis added). Additionally, affiliate is a defined term in the 2005 COPAS Accounting Procedure, which also touches upon the subject matter of Article V.D.1.; as such, consistency between the accounting procedure and the joint operating agreement should be considered.

terms of the joint operating agreement and any additional requirements or restrictions on affiliates. It is not uncommon for private equity sponsors or other investors to invest in multiple exploration and production companies within an area, as well as midstream, service and downstream companies; as such, the parties revising a joint operating agreement should consider the breadth of the definition of "affiliate," and how this definition will affect the parties going forward.

[2] — Article IV.A. — Title.

Under Article IV.A. of the 1989 JOA, title examination of the Drillsite is required of any proposed well prior to commencing drilling operations, and, if a majority in interest of the Drilling Parties request (or the Operator so elects), the title examination will be made as to the entire Drilling Unit.[85] To address Horizontal Wells, the definition of Drillsite has been modified by the AAPL committee in the Horizontal JOA to cover the area penetrated by a Lateral of a Horizontal Well (see Section 12.01[4] of this chapter). Subsequent operations such as Deepening a well (which does require a proposal under the joint operating agreement), however, do not clearly require title examination under Article IV.A. as it is currently drafted. Due to the nature of Horizontal Wells, title examination should be expanded to apply to subsequent operations such as Deepening (and possibly Sidetracking) as such operations expand the Drillsite (as defined under the joint operating agreement) or possibly the Drilling Unit. This revision, if made, follows the reasoning behind examining title to the Drillsite as defined in the Horizontal JOA and applying such review to all areas penetrated by the Lateral(s). Admittedly this clarification to Article IV.A. is not all that common and prudence often dictates that Operators perform the necessary title examination, but it is important to understand there are some limitations to Article IV.A. in this regard.

Also, it should be noted that Article IV.A. of the 1989 JOA is often modified by deleting the limitation on charging in-house legal fees to the joint account.[86] As one commentator noted, the ability to charge in-house

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85 Art. IV.A. of the 1989 JOA. Please note that *all* Drilling Parties are required to consent to a Drilling Unit title review under the 1982 JOA.

86 Andrew B. Derman, *The New and Improved 1989 Joint Operating Agreement: A Working Manual* 19 (1991), *available at* http://www.tklaw.com/files/Publication/ ef72d02f-

counsel expenses should not be treated differently than the ability to charge outside counsel.[87] The current limitation on charging in-house counsel fees creates an incentive for the Operator to use more expensive outside counsel whose fees are chargeable to the joint account. Section II.9. of the 2005 COPAS Accounting Procedure also addresses what legal fees can be charged to the joint account.[88] For purposes of consistency, the accounting procedure should be revised to be consistent with Article IV.A. of the 1989 JOA and should incorporate any changes made to Article IV.A. of the 1989 JOA permitting charges to the joint account for title or regulatory work by in-house counsel.

[3] — Article V. — Operator.

[a] — Standard of Operatorship; Indemnification of Operator.

Under Article V.A. of the 1989 JOA, the Operator is required to conduct its activities under the agreement as "a reasonably prudent operator in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice and in compliance with applicable law and regulation."[89] If a joint operating agreement has been entered into pursuant to a joint development agreement (or similar joint venture arrangement), the parties should confirm that the Operator's standard under Article V.A. of the 1989 JOA is consistent with what is required under these underlying agreements (and the same applies for provisions regarding the removal and replacement of the Operator under Article V.B. of the 1989 JOA, as discussed in Section 12.05[3][b] of this chapter).

Under Article V.A. of the 1989 JOA, the Operator is also indemnified against losses sustained or liabilities incurred except for those resulting from the Operator's gross negligence or willful misconduct. Several states

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06e2-490f-8806-747ea801df05/Presentation/PublicationAttachment/7719816f-42b1-47ff-9a57-afa788bb4aef/New%20and%20Improved%20-%20Derman.pdf.

87 *Id.*

88 The corresponding section in the 1984 COPAS Accounting Procedure is Section II.10. Please note Section II.10. of the 1984 COPAS Accounting Procedure conflicts with Article IV.A. of the 1989 JOA regarding charges for outside counsel.

89 Art. V.A. of the 1989 JOA.

have enacted anti-indemnity statutes prohibiting an indemnity from covering the indemnitee's negligence, but some states such as Texas and Louisiana have specifically excluded joint operating agreements from the application of these statutes.[90]

[b] — Removal of Operator.

Article V.B.1. of the 1989 JOA provides that an Operator can only be removed for "good cause" as defined in that article.[91] As noted above, if there is a joint development agreement (or similar agreement regarding joint development), the parties should confirm that there is not a conflict between that agreement and the JOA regarding the removal or replacement of an Operator.

[c] — Contract Rates and Use of Affiliates.

Under Article V.D.1. of the 1989 JOA, contract rates are required to be at the "usual rates prevailing in the area." Due to the use of long term contracts and fluctuations in drilling and service costs, it may be prudent to add a right to enter into long-term contracts for the Operator to address the situation in which an Operator has entered into a long-term contract and the agreed upon rates are no longer market. Or, this language can be clarified to expressly provide that the requirement regarding contract rates applies at the time of entry into the contract, or any extension or renewal thereof.

Also, Article V.D.1. of the 1989 JOA permits the Operator to use its own equipment under "the same terms and conditions as are customary and usual in the area." It is unclear what the difference is between "usual rates prevailing in the area" and "customary and usual," but arguably these are different standards (although this difference may be minimal and unintentional). Additionally, Section II.6. of the 2005 COPAS Accounting Proce-

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90 Joint operating agreements are excluded from the definition of "agreement pertaining to a well for oil, gas, or water or to a mine for a mineral" to which the statute applies. Tex. Civ. Prac. & Rem. Code Ann. §§ 127.001–127.002 (2013). Joint Operating Agreement is defined as "an agreement between or among holders of working interests or operating rights for the joint exploration, development, operation, or production of minerals." § 127.001(2); *see also* La. Rev. Stat. Ann. 9:2780(D) (2014) (defining operating agreement according to Louisiana statute).

91 Art. V.B.1. of the 1989 JOA.

dure addresses the rates that can be charged by the Operator for use of its equipment. Section II.6. of the 2005 COPAS Accounting Procedure also provides the Operator the option of charging costs "commensurate with costs of ownership and operation" subject to a rate to allow for maintenance, depreciation, taxes and other items, or to charge the "commercial rates prevailing in the immediate area" minus 20 percent Section II.6. of the 2005 COPAS Accounting Procedure should be modified to be consistent with Article V.D.1.

Similarly, Article V.D.1. of the 1989 JOA provides that work performed by affiliates or related parties of the Operator must be provided at "competitive rates, pursuant to written agreement, and in accordance with customs and standards prevailing in the industry."[92] Section II.7. of the 2005 COPAS Accounting Procedure also addresses the use of affiliates by the Operator. Under Section II.7. of the 2005 COPAS Accounting Procedure, the cost of goods or services provided by an affiliate of the Operator shall not exceed "average commercial rates prevailing in the area." Again, it is unclear what distinction can be made between "competitive rates" under Article V.D.1. and "average commercial rates" under Section II.7. of the 2005 COPAS Accounting Procedure, but arguably these are different standards and consistency should be considered. In addition to what appears to be a minor inconsistency in language, Section II.7. of the 2005 COPAS Accounting Procedure is more strict than Article V.D.1., as Section II.7. of the 2005 COPAS Accounting Procedure also applies thresholds as to how much money can be charged by an affiliate (regardless of whether such charges meet the "average commercial rates" standard) and requires the Operator to document and support what constitutes commercial rates in the area.[93] The 1984 COPAS Accounting Procedure does not contain a similar provision or restriction on the use of affiliates, and the parties should be cognizant of what form of accounting procedure is being used.

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92 Art. V.D.1. of the 1989 JOA.

93 Sec. II.7. of the 2005 COPAS Accounting Procedure.

[4] — Article VI. — Drilling and Development.

If Article VI.A. of the 1989 JOA or Horizontal JOA is utilized by the parties, the requirements for the Initial Well described thereunder should be carefully and thoughtfully drafted with specificity, especially when a Lease or another agreement (*e.g.* farmout agreement, participation agreement, development agreement, etc.) has a time sensitive deadline, or requires the well (or Lateral) to meet certain requirements (including Lateral length). First, a joint operating agreement that specifies a date to commence operations is not necessarily "of the essence" unless it is clearly provided to be.[94] Similarly, a party to the joint operating agreement may desire that the well meet certain requirements, such as having a certain Lateral length to meet obligatory requirements agreed to under a farmout, participation or similar development agreement. Also, if using the Horizontal JOA, the parties should consider the potential impact of the additional Operator flexibility granted under Article XVI.B. of the Horizontal JOA (*see* Section 12.04[2] of this chapter).[95]

Article VI.B.8. of the 1989 JOA requires that all parties with an Interest in a well unanimously consent to any Reworking, Deepening, Plugging Back, Completion, Recompletion, or Sidetracking operation regarding a well capable of producing in paying quantities.[96] The parties to the joint operating agreement should consider if such a veto power should be given to each and every party, or if a majority in interest, or a super majority type standard may be more appropriate. The threshold used for such approval will depend upon the ownership of the parties involved and will be a fact specific determination, as each party with an Interest would like to have a substantive consent right, but a party with a small or de minimus interest should not be able to impede further development.

Under Article VI.D. of the 1989 JOA, gathering lines and transportation and marketing facilities are specifically excluded from the joint operating agreement, which often just delays addressing an issue that regularly

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94 Derman, *supra* note 86, at 41 (citing Argos Res., Inc. v. May Petroleum Inc., 693 S.W.2d 663 (Tex. App. 1985). For a general discussion of this concept under Texas law, *see* 14 Tex. Jur. 3d *Contracts* § 303.

95 Art. XVI.B. of the Horizontal JOA.

96 Art. V.I.B.8. of the 1989 JOA.

arises in connection with joint development.[97] The parties to the joint operating agreement should consider striking this exemption from Article VI.D. of the 1989 JOA so that these items can be addressed. If addressed, there are a few simple alternatives available to the parties. First, the joint operating agreement could be drafted to provide that the Consenting Parties can build these facilities, but would charge a reasonable or market rate to the Non-Consenting Parties for use of those facilities.[98] Also, under Article XVI. of the 1989 JOA, the parties can address the use of facilities a party may already own in the area or may later acquire from a third party.

Under Article VI.E. of the 1989 JOA, a party can take over a well (including dry holes and those that have produced) by indemnifying the abandoning parties against any additional liabilities arising from further operations.[99] The requirement of the party taking over the well to give an indemnity is vague, and not all indemnities (or indemnitors) were created equal. More flexibility and protection would be provided by allowing the indemnity to come from a party deemed reasonably satisfactory to the Operator (which could include a parent company or affiliate of the company or companies taking over the well), and by applying this reasonably satisfactory requirement to the indemnity itself.

Article VI.F. of the 1989 JOA provides that the Operator can terminate operations in the event granite or other practically impenetrable substances (or conditions) are encountered which render further operations impracticable.[100] Also, under the Horizontal JOA, Article XVI.B. grants flexibility to the Operator regarding the length of the Lateral to be drilled.[101] The parties to a joint operating agreement, especially those who are also a party to an agreement requiring a well to be drilled to a certain Lateral length, should be cognizant of these provisions and consider if the consent of the

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97 Art. VI.D. of the 1989 JOA.

98 Michel E. Curry, "Operations Not Covered or Inadequately Covered by the Joint Operating Agreement and Other Problem Areas," Rocky Mtn. Min. L. Found., *Oil & Gas Agreements: Joint Operations* (Dec. 2007).

99 Art. V.I.E.8. of the 1989 JOA.

100 Art. VI.F. of the 1989 JOA. Please note the 1982 JOA does not address subsequent operations in the "impractical" language which allows the termination of operations.

101 Art. XVI.B. of the 1989 JOA.

Drilling Parties should be required in all instances to terminate or modify operations.

[5] — Article VII. — Expenditures and Liabilities of Parties.

Under Article VII.B. of the 1989 JOA, each party grants to the other a lien and security interest in its property interests in the Contract Area, the Oil and Gas extracted therefrom, as well as the related personal property, fixtures and accounts, among other forms of collateral.[102] The security and lien provisions of the 1989 JOA are much more expansive than the 1982 JOA in terms of the breadth of collateral, as well as remedies, but the 1989 JOA has some deficiencies inherent in any form agreement and is merely a starting point.[103] First, differences in state law must be considered to properly perfect the joint operating agreement's lien and security interest, which is necessary to achieve the priority of the lien and security interest as represented and warranted by the parties under Article VII.B. of the 1989 JOA.[104] Differences in state law will also affect the procedures applicable to foreclose on the collateral.[105] For example, the 1989 JOA provides for a power of sale allowing the non-defaulting party to sell the defaulting party's property without using traditional judicial foreclosure, but each state may have certain requirements that are necessary in order to utilize the non-judicial foreclosure process.[106] If available under state law, the use of non-judicial foreclosure could provide for a significant reduction in costs and burdens to foreclose on the collateral. Similarly, the 1989 JOA provides that each party waives its rights of redemption and any other right available under state law in Article VII.B. of the 1989 JOA, but whether this waiver is effective is a question of state law.[107]

Additionally, if the joint operating agreement is being structured to address the possibility of one or more parties' financial distress (including

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102 Art. VII.B. of the 1989 JOA.

103 Jeffrey S. Munoz and Nikita S. Taldykin, "Best Management Practices — Securing Your Position," Rocky Mtn. Min. L. Found., *Financial Distress in the Oil & Gas Industry*, 3–7 (Feb. 2010).

104 *Id*. at 12–17.

105 *Id*. at 5.

106 *Id*.

107 *Id*.

a bankruptcy filing), remedies such as a right to set off or a right of recoupment may be useful tools to increase the recovery of any outstanding debts.[108]

The parties should also be cognizant that references in Article VII.B. of the 1989 JOA to equipment as collateral may not identity the intended collateral with enough specificity to create a valid lien under the Uniform Commercial Code (UCC).[109] Additionally, the 1989 JOA does not provide a security interest for the Non-Operating Parties to secure an interest in funds held by the Operator, which could be substantial.[110]

Under Article VII.C. of the 1989 JOA, the Operator has the right to require each party to pay its respective portion of costs in advance if the Operator expects to incur those expenses in the succeeding month.[111] The parties to the joint operating agreement should consider if this mechanism, as drafted, is adequate in respect of potential costs such as plugging and abandonment. For example, by the time plugging and abandoning expenses are incurred (or even the twelve months beforehand), the production from the Contract Area may not provide enough collateral to the Operator to pay for such expenses. Various options have been utilized to address this issue, including guaranties, letters of credit, and escrow agreements, among others.[112] Additionally, the parties should confirm that this article of the 1989 JOA (and any revisions thereto) are consistent with the COPAS Accounting Procedure being used (for example, Section I.3.A. of the 2005 COPAS Accounting Procedure also addresses cash advances).[113]

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108 *Id*. at 28–34 (describing these additional remedies and their interaction with the Bankruptcy Code).

109 Gary B. Conine and Bruce M. Kramer, "Property Provisions of the Joint Operating Agreement," Rocky Mtn. Min. L. Found., *Oil & Gas Agreements: Joint Operations*, 6 (Dec. 2007).

110 *Id*. at 6–7.

111 Art. VII.C. of the 1989 JOA.

112 Munoz and Taldykin, *supra* note 104, at 17–26 (examining the advantages and disadvantages of several different methods regarding advance payment).

113 I.3.A. of the 2005 COPAS Accounting Procedure.

[6] — Article VIII. — Acquisition, Maintenance or Transfer of Interest.

The preferential right to purchase under Article VIII.F. of the 1989 JOA, if utilized by the parties, provides each party to the joint operating agreement the right to buy an Interest in the Contract Area that another party proposes to sell.[114] This right is useful if the parties to the joint operating agreement want (or may want) to increase their Interest in the Contract Area, or want the right to exclude third parties from the Contract Area and the joint operating agreement.[115] For these reasons, a preferential right to purchase may be much more useful and desirable than a simple consent to assign restriction.

In its current form, Article VIII.F. of the 1989 JOA provides for a preferential right to purchase that is applicable when a party desires to *sell* all or part of its Interest in the Contract Area.[116] While the word sell arguably includes other forms of dispositions such as a farmouts and exchanges, the language could be clarified to expressly provide the inclusion of those items.[117] Also, while a sale of "all or substantially all" of a party's Oil and Gas assets is excluded from Article VIII.F. of the 1989 JOA, large package sales are not expressly excluded.[118] Large package sales are common in the Industry, and while such sales may not constitute "all or substantially all" of a party's oil and gas assets, such a sale may represent all or substantially all of its oil and gas assets in the area; the parties to the joint operating agreement may want to exclude such transactions from the preferential right to purchase.

Also, the treatment of transfer restrictions (such as preferential rights to purchase and consent requirements) under state law should be considered in connection with Article VIII.F. of the 1989 JOA. For example, in Texas, a structure referred to as the "Texas Two Step" allows a party to circumvent transfer restrictions in an agreement by transferring its Interest to a subsidiary or affiliate, and then assigning all of the equity interests in the sub-

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114 Art. VIII.F. of the 1989 JOA.
115 Derman, *supra* note 86, at 107.
116 Art. VIII.F. of the 1989 JOA.
117 *Id.*
118 *Id.*

sidiary or affiliate to a third party.[119] To successfully utilize this structure, the applicable transfer restriction would need to permit the assignment of a party's Interest to its affiliate or subsidiary without triggering the transfer restriction. Article VIII.F. of the 1989 JOA, as drafted, permits the assignment of a party's Interest in the Contract Area to a subsidiary or affiliate, and as such, the preferential purchase right in Article VIII.F. of the 1989 JOA can be circumvented in Texas. To prevent the use of the Texas Two Step, a change of control provision could be utilized, whereby the sale of the equity interests in the affiliate or subsidiary would trigger the preferential purchase right. Also, a mechanism that has been used in offshore joint operating agreements is to permit transfers to subsidiaries and affiliates, but require such subsidiary or affiliate to remain a subsidiary or affiliate of the party for some period of time. Currently, few states have examined the use of the "Texas Two Step," but at least one state has declined to allow its use to circumvent applicable transfer restrictions.[120]

An additional modification to the preferential right to purchase that may be desirable to some parties is to exclude transfers of non-cost bearing Interests such as overriding royalties, production payments, etc. Arguably, the JOA is an arrangement between the working interest owners and not the holders of passive interests, and some parties may wish to utilize such passive interests for a variety of reasons, including but not limited to financing transactions in which an overriding royalty interest is granted, or a volumetric production payment is used.

[7] — Article X. — Claims and Lawsuits.

As drafted, the Operator is authorized to settle any single claim under the threshold provided by the parties in Article X.[121] This means that the Operator is authorized to settle several lawsuits under Article X. that are under this threshold, which in the aggregate would be quite substantial. The first sentence of Article X. could be clarified to apply to all claims that

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119 Tenneco Inc. v. Enter. Prods. Co., 925 S.W.2d 640 (Tex. 1996); Bruce E. Cryder and R. Clay Larkin, "Consent Provisions in Natural Resources Agreements," 30 *Energy & Min. L. Inst.* 3, §306[4] (2009).

120 Wamsutter Co. v. Union Pac. Res. Co., 25 P.3d 1064 (Wyo. 2001).

121 Art. X. of the 1989 JOA.

arise out of the same event or occurrence that gave rise to multiple third party claims, and/or an aggregate amount of settlements for a specified time period could be provided to avoid a large aggregate amount of payments without consulting with the Non-Operators.

[8] — Article XIV.B. — Governing Law.

Article XIV.B. of the 1989 JOA provides for exclusive jurisdiction regarding the agreement to be in the named state in the event the Contract Area is in two or more states.[122] If the Contract Area is in two states, the parties may want to specify that the jurisdiction provided in Article XIV.B. is without regard to any applicable conflict of law or choice of law rules of either state. This is a common provision used to avoid the application of conflict of law or choice of law rules which could result in a different state's law being applied than the one originally selected by the parties.

[9] — Article XVI.

Article XVI. of the 1989 JOA is commonly used to amend and supplement the agreement and to address specific issues that may not otherwise be addressed.[123] The potential modifications that can be made under Article XVI. of the 1989 JOA are almost endless. While some additions under Article XVI. of the 1989 JOA may be applicable and desirable in almost every joint operating agreement, some changes are highly tailored to the specific transaction (such as joint operating agreements used in connection with other development agreements). This section of the chapter focuses on those changes to Article XVI. of the 1989 JOA that would likely be routine and incorporated on a regular basis versus the highly tailored and less common revisions. Since much has been written about Article XVI. of the 1989 JOA and potential additions under this article, rather than reciting those articles,

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122 Article XIV.B. applies to "all matters pertaining hereto, including but not limited to matters of performance, non-performance, breach, remedies, procedures, rights, duties, and interpretation or construction." Each of these items appears to pertain to contractual claims; it may be wise to add matters arising out of tort as well. Another revision to broaden the scope of Article XIV.B. is to replace "pertaining hereto" with "relating to or arising out of this agreement."

123 Or Article XV. if using the 1982 JOA.

this chapter will focus on changes which have been given less attention but nonetheless may be desirable and are commonly used in agreements.[124]

[a] — Disclaimer of Fiduciary Duties.

As discussed in more detail in other articles, some states have imposed a higher standard or even an agency or fiduciary standard on the Operator when holding money or marketing gas for a Non-Operator.[125] This issue is one that arises under state law, but parties to a joint operating agreement (especially an Operator) should be cognizant of these potential issues and should consider including a disclaimer of fiduciary or agency duties in Article XVI. of the 1989 JOA.

[b] — Contractor Release and Indemnity.

Under most joint operating agreements the Operator is authorized to conduct operations under a certain dollar threshold and is further authorized to settle claims under a similar dollar threshold, but the Operator should consider unintended costs arising out of indemnification and release provisions in contracts entered into by the Operator with contractors. Although the Operator is indemnified against liability for its activities under Article V.A. of the 1989 JOA, the Operator's obligation to indemnify or reimburse a third party under a contract could be construed not to be the activities of the Operator under the joint operating agreement (but as contractual commitments or settlement payments for which approval is needed). To acknowledge that the Operator will enter into agreements containing indemnification and release provisions, and to clarify that expenses thereunder will not be borne by the Operator alone, the parties could add a provision to Article XVI. of the 1989 JOA expressly addressing this point.

[c] — Starting Operations Prior to End of AFE Period.

Due to litigation involving AFEs, some modified joint operating agreements include a provision stating that nothing in the agreement shall pro-

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124 Derman, *supra* note 86; Michel E. Curry, "The Perfect Operating Agreement, Considerations in Drafting Changes to the Model Form JOA," 26th *Annual Advanced Oil, Gas and Energy Resources Law Course* (Sept. 2008).

125 *See* Robert C. Bledsoe, "The Operating Agreement: Matters Not Covered or Inadequately Covered," 47 *Rocky Mtn. Min. L. Inst.* 15-1 (2001).

hibit the Operator from commencing operations before the expiration of any applicable notice period, and that such commencement shall not affect the validity of a party's election. This type of provision stems from the *Valence Operating Company v. Dorsett* litigation.[126] In this case, Dorsett sued Valence to dispute the imposition of a non-consent penalty. One of Dorsett's arguments was that Valence, as Operator, improperly commenced working on the proposed operation before the thirty-day election period had expired.[127] Ultimately, the Texas Supreme Court held that the deadline for a Non-Operator to elect to participate under the joint operating agreement does not forbid Valence as Operator from commencing work before the end of the election period, and that commencing operations did not affect the notice period.[128] Although this issue may be settled in Texas, the parties in *Valence* were in court for a number of years to determine that the Operator could commencing operations before the expiration of the notice period. As such, it would be prudent to consider the addition of a similar provision to clarify this point.

[d] — Non-Consenting Party's Access to Well Information.

Article V.D.5. of the 1989 JOA states that the Operator will provide information to the Consenting Parties and Non-Consenting Parties including technical information regarding the drilling and testing of the well.[129] Although the Non-Consenting Parties will need access to information regarding revenues and expenses for purposes of determining the status of recoupment and applicable non-consent penalties, the parties should consider if the technical information should be shared with Non-Consenting Parties who did not bear the risk of obtaining that information. Arguably the non-consent penalty is enough in some circumstances, but in some environments (such as operations in areas that have not been de-risked through development) the information gained may be extremely valuable and may

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126 Valence Operating Co. v. Dorsett, 164 S.W.3d 656 (Tex. 2005).
127 *Id*. at 659.
128 *Id*. at 662–63.
129 Art. V.D.5. of the 1989 JOA.

have been obtained at a greater risk.[130] Additionally, a confidentiality provision may be considered to protect such information or to protect unique and proprietary information regarding the operations being conducted.

[e] — Common Miscellaneous Provisions; No Third Party Beneficiaries.

Similar to Section 12.5[1][a] of this chapter and the disclaimer of fiduciary duties, it may also be wise to include a no third party beneficiaries provision. In *Tawes v. Barnes*, a lessor of lands sued the Consenting Parties under a joint operating agreement by claiming to have standing under the joint operating agreement as a third party beneficiary.[131] Ultimately, the Texas Supreme Court found that the plaintiff was not a third party beneficiary, but the test applied was whether there was a "clear and unequivocal expression of the contracting parties' intent to directly benefit a third party."[132] Although there is not much concern that a third party could prevail and find such an expression under the terms of a joint operating agreement, it would be beneficial to clearly express the intention not to create any such benefit in favor of a third party. This is a fairly typical contract provision benefiting all parties to the agreement, and given the number of potential third parties to a joint operating agreement, such an addition should not be a controversial supplement to Article XVI. of the 1989 JOA.

[f] — Common Miscellaneous Provisions; Amendment.

Agreements lasting for long periods of time with multiple parties often need the ability to be amended or supplemented, and the joint operating agreement is no different. Although the 1989 JOA does not restrict amendments to the agreement, the parties could require in the joint operating agreement that all amendments or supplements thereto be made in writing and signed by each party. This addition, if made to Article XVI. of the 1989 JOA, should benefit and protect all parties to the agreement and should be an acceptable change.

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130 Derman, *supra* note 86, at 39; for alternatives to non-consent penalties (such as farmout or relinquishment of interest provisions), Derman, *supra* note 86, at 53.

131 Tawes v. Barnes, 340 S.W.3d 419 (Tex. 2011).

132 *Id*. at 428.

[g] — Common Miscellaneous Provisions; Forum/ Jurisdiction Selection.

Forum/jurisdiction selection clauses allow the parties to agree to an exclusive forum for causes of action arising out of or in connection with the underlying agreement. Generally courts have upheld forum selection clause if they have been freely bargained for and are not contrary to public policy.[133] Without specifying an exclusive forum, the parties run the risk of being stuck in an unfavorable jurisdiction. The sophistication of the forum can also be relevant to effectively and quickly adjudicating any causes of action. Depending upon the location of the Contract Area and the parties to the joint operating agreement, providing for an exclusive forum may not be a contentious exercise. If the joint operating agreement is entered into in connection with a farmout, participation or joint development agreement, the relevant provisions (if applicable) from the underlying agreement should be incorporated into the joint operating agreement to prevent disputes over forum and to preclude a party from forum shopping.

[h] — Common Miscellaneous Provisions; Waiver of Jury Trial.

Contractual arrangements often provide for a waiver by the parties of their right to a jury trial in connection with causes of action arising out of the contract. This approach is often preferred due to the uncertainty associated with using a jury as the trier of fact, especially for contracts pertaining to a sophisticated subject matter. If a waiver of jury trial is included, it should be noted that state law will determine whether a waiver is effective. For example, under Texas law a jury waiver has to be entered into knowingly and voluntarily, which is why these provisions are often written in bold, all caps letters to make the waiver language more conspicuous.[134]

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133 Robert Casad, *Jurisdiction and Forum Selection* § 4.17 (2d ed. 1999).

134 *In re* Prudential Ins. Co. of. Am., 148 S.W.3d 124, 132 (Tex. 2004); *see also* Mikey's Houses LLC v. Bank of Am., 232 S.W.3d 145, 149 (citing *In re Prudential* and providing that jury waivers are only enforceable if made "knowingly, voluntarily, and intelligently with sufficient awareness of the relevant circumstances and likely consequences").