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A Comparison of Non-Operator's Rights Under the Joint Operating Agreement 1982 and 1989 Model Forms

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Companies looking to purchase non-operating working interests will review longstanding operating agreements, or negotiate the terms of new operating agreements, to ensure that appropriate non-operator rights are present and enforceable. Lenders and investors are similarly interested in these rights when utilizing such non-operating interest to secure debt or as the basis for a direct investment in the form of overrides, farmouts, "drillcos", volumetric production payments and a variety of other transactions. This article highlights some rights typically available to non-operators vis-à-vis their operator under the 1982 and 1989 versions of the model American Association of Professional Landmen Form Joint Operating Agreement (Form 610 Model Form).

The 1982 Form and the 1989 Form are commonly the basis for modern joint operating agreements. Important differences between the versions exist, and many operating agreements contain customized provisions added by the parties, which alter or add to the form's printed terms. Therefore, it is important to carefully read every operating agreement to appreciate the rights and obligations of all parties.

Non-Operators May Propose and "Operate" Subsequent Wells and Operations

Any party to the agreement who desires to conduct operations on the Contract Area may propose such operations to the other parties. Under Article VI.B.1 of both the 1982 and 1989 Forms, the party proposing the operation (the "**Proposing Party**") must give written notice of the proposed operation, specifying (1) the work to be performed, including wells to be drilled or reworked, (2) the location, (3) proposed depth, (4) objective formation being targeted for completion and (5) the estimated costs of the operation. The Proposing Party must send an Authority for Expenditure ("**AFE**") to the other parties (the "**Non-Proposing Parties**") to serve as a ballot to indicate whether such Non-Proposing Parties will join in the cost of the proposed operation. Each Non-Proposing Party shall notify the Proposing Party of its election within thirty days, unless there is a drilling rig on location or if the parties have altered the agreement to allow for a longer or shorter period of time. Both forms define "**Consenting Parties**" as the parties who agree to join in and pay their share of the cost of the proposed operation, while "**Non-Consenting Parties**" are the parties who elect, or are deemed to elect, not to participate in the proposed operation.

Article VI.B.2 of both forms states that the operator shall perform the proposed operation on behalf of the Consenting Parties; provided, however, if (1) no drilling rig or other equipment is on location, and (2) the operator is a Non-Consenting Party, then the Consenting Parties can either (i) request that the operator perform the work required by such proposed operation on behalf of the Consenting Parties, or (ii) designate one of the Consenting Parties to perform such work. The 1989 Form specifically states that in the event a Consenting Party is designated, the rights and duties granted to and imposed upon the operator under the agreement are granted to and imposed upon the designated Consenting Party. If any well drilled results in a well capable of producing oil 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 the operator to be operated at the expense and for the account of the Consenting Parties.

Non-Operators May Elect to Forgo Proposed Operations, for a Price

When the Proposing Party circulates an AFE to the Non-Proposing Parties, the Non-Proposing Parties may elect to either (1) participate in such operation (a Consenting Party) or (2) "go non-consent" (a Non-Consenting Party).

Under the 1982 Form, if less than all Non-Proposing Parties approve the proposed operation, the Proposing Party, immediately after the expiration of the applicable notice period, shall advise the Consenting Parties of (i) the total consenting interest and (ii) the Proposing Party's recommendation whether to proceed. Each Consenting Party shall reply to the Proposing Party as to whether: (1) it will hold at its original interest under the agreement for this proposal, or (2) it will increase its interest for this proposal by taking on the Non-Consenting Parties' interest pro rata. The Proposing Party, at its election, may withdraw its proposal if there is insufficient participation.

Under the 1989 Form, if less than all Non-Proposing Parties approve the proposed operation, the Proposing Party, immediately after the expiration of the applicable notice period, shall advise all parties (rather than just the Consenting Parties) of (i) the total consenting interest and (ii) the Proposing Party's recommendation whether to proceed. Each Consenting Party shall reply to the Proposing Party as to whether: (1) it will hold at its original interest under the agreement for this proposal, (2) it will increase its interest for this proposal by taking on the Non-Consenting Parties' interest pro rata, or (3) it will increase its interest for this proposal by taking on the Non-Consenting Parties' interest pro rata, *plus* any whole or portion of the remaining non-consenting interest that the other Consenting Parties elected not to take. Any interest of the Non-Consenting parties that is not carried by a Consenting Party shall be deemed to be carried by the Proposing Party if such party does not withdraw its proposal. The Proposing Party, at its election, may withdraw its proposal if there is less than 100 percent participation. The Proposing Party shall promptly notify the Consenting Parties of their proportional interests in the operation, and the party serving as the operator shall commence such operation.

Under both forms, the entire cost and risk of conducting such proposed operations shall be borne by the Consenting Parties in the proportions they have elected to bear. If such operation results in a dry hole, the Consenting Parties are obligated to plug and abandon the well and restore the surface location at their sole cost, risk and expense (the 1989 Form draws a distinction for incremental costs). When the Consenting Parties commence operations of any well, each Non-Consenting Party shall be deemed to have temporarily relinquished to the 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 with respect to the operation in which the Non-Consenting Party did not elect to participate.

Such relinquishment shall be in effect until the proceeds of such share shall equal the total (based on such Non-Consenting Party's share of production) of:

- 100 percent (or a percentage selected by the parties) of the cost of any newly acquired surface equipment beyond the wellhead connections
- 100 percent of the cost of operation
- A percentage selected by the parties of the cost of drilling, reworking, deepening, plugging back, testing and completing the well
- A percentage selected by the parties of all newly acquired equipment in the well

This provision permits the Consenting Parties to recover 100 percent of all costs that are avoidable or without risk, and to encourage risk taking, which gives those that expend risk a return on their investment. There is an additional penalty for any reworking, recompleting or plugging back operation conducted during the recoupment period of a non-consent operation. All figures are determined on a deal-by-deal basis.

It is common for operating agreements to contain special provisions within Article XV of the 1982 Form and Article XVI of the 1989 Form (entitled *Other Provisions*), including those that discuss required wells and operations. For example, an agreement may contain language that states that a Non-Consenting Party who elects to "go non-consent" to an operation that is needed to (1) perpetuate an expiring or terminating lease, leases or interest therein, or (2) earn an additional lease, leases or interest therein pursuant to any farmout or other agreement ("**Required Operation**") shall release and permanently relinquish *all of its interest* in and to the lease, leases, farmout agreements or interest therein that would be perpetuated or earned by such Required Operation. These types of provisions, frequently called "In or Out" clauses, are occasionally seen where parties wish to adopt a forfeiture or obligatory well provision, which provide that if drilling operations are necessary to maintain or acquire a lease, only Consenting Parties shall own or earn an interest in such lease. In such cases, the non-consent provisions regarding penalty or duration of relinquishment would not customarily apply to Required Operations.

Non-Operators are Granted a Lien and a Security Interest to Secure Performance of Obligations

Under Article VII of both the 1982 and 1989 Forms, each party shall be responsible only for its obligations, and shall be liable only for its proportionate share of the costs of developing and operating the Contract Area. Each party grants to the other parties therein a lien and security interest in the real and personal property it owns subject to the operating agreement, to secure (i) the payment of expenses, interest and fees, (ii) the proper disbursements, (iii) the assignment of interests required thereunder, and (iv) the proper performance of operations thereunder. Although the operating agreement grants a lien and security interest encumbering a party to the agreement who has not paid its proportionate share of expenses, necessary security may not be provided unless such interests are perfected under the law of the state governing perfection. Once perfected, such security interests are superior to a subsequent lien creditor and unavoidable as a perfected lien in bankruptcy.

The 1989 Form is broader in its protection by covering both present and thereafter acquired real and personal property, and listing various property rights covered by the lien and security interest. Additionally, non-defaulting parties can, by taking production or proceeds of production, offset any amounts owed by a defaulting party. Furthermore, the 1989 Form states that if any party fails to discharge any financial obligation under the agreement, then, in addition to the remedies available through the foreclosure of a lien or security interest, the non-defaulting parties are entitled to the following remedies: (1) suspension of rights under the agreement, (2) suit for damages, (3) the defaulting party will be deemed to have "gone non-consent", (4) advance payment, and (5) costs and attorneys' fees.

Non-Operators May Remove the Operator

Under Article V.B. of the 1982 Form, the operator may be removed (1) if it fails or refuses to carry out its duties under the agreement, or becomes insolvent, bankrupt or is placed in receivership, and (2) by the affirmative vote of two or more non-operators owning a majority interest in the Contract Area after excluding the voting interest of the operator. The resignation or removal shall not become effective until 7:00 A.M. on the first day of the

month following a ninety (90) day notice of resignation or removal period, unless a successor operator has assumed the duties of the resigning or removed operator on an earlier date.

The 1989 Form revises the prior form language, stating that the operator may be removed only (1) for good cause, and (2) by the affirmative vote of non-operators owning a majority interest in the Contract Area after excluding the voting interest of the operator. “Good cause” means (i) gross negligence, (ii) willful misconduct, (iii) material failure or inability to perform its obligations under the agreement, or (iv) the material breach of or inability to meet the following standards of operation: the operator shall conduct its activities under the agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation. The vote shall not be deemed effective until written notice has been delivered to the operator detailing the alleged default, and the operator has failed to cure the default within a specified time from its receipt of notice.

Under both forms, upon the removal of the operator, a successor operator shall be selected by the affirmative vote of two or more parties owning a majority interest in the Contract Area at the time such successor operator is selected. Under the 1982 Form, if the removed operator fails to vote or votes only to succeed itself, the successor operator shall be selected by an affirmative vote of two or more parties owning a majority interest after excluding the removed operator’s voting interest.

The 1989 Form revises the prior form language, stating that if the removed operator fails to vote or votes only to succeed itself, the successor operator shall be selected by an affirmative vote of the parties owning a majority interest after excluding the removed operator’s voting interest. The removal of “two or more parties” addresses two problems non-operators face when using the 1982 form: (1) there are only two parties to the agreement or (2) there is insufficient aggregate interest to satisfy the requirement.

The 1989 Form has an additional provision that protects non-operators if its operator becomes insolvent, bankrupt or is placed in receivership. In such instances, the operator is deemed to have resigned. If the removal of an operator is prevented by the federal bankruptcy court, the non-operators and operator shall work together as an operating committee to serve until the agreement has been rejected or assumed pursuant to the Bankruptcy Code. If the operator rejects the agreement, the operator is deemed to have resigned. If the operator assumes and assigns the agreement, the operator is deemed to have resigned and a successor operator would be selected. If the operator goes through restructuring and assumes the contract for itself, the non-operators could remove the operator, but only for good cause and by the affirmative vote of non-operators owning a majority interest in the Contract Area after excluding the voting interest of the operator.

Non-Operators May Limit Operator’s Authority for Expenditures

Proposed operations are preceded by the circulation of an AFE, a budgeting and approval form that is generally considered an estimate of the costs anticipated, and not a firm commitment. The execution of an AFE by the Non-Proposing Parties evidences their written consent to participate in and to pay their share of the costs associated with the proposed operation. Not all operational decisions are preceded by the circulation of an AFE, however, as the authority to make operational decisions is delegated to the operator. Both forms provide that the operator shall conduct, direct and have full control of all operations on the Contract Area.

The operator’s discretionary authority is not totally unlimited. The 1982 Form provides that project expenses that are in excess of the designated amount must be approved by all Consenting Parties. Under the 1989 Form, however, any party that has not relinquished its interest in a well has the right to propose that the operator

perform certain tasks in excess of a designated amount, as long as such tasks are approved by the written consent of the Consenting Parties owning at least a designated percentage of the interests in such operation.

Article V.D.8 of the 1989 Form allows for Consenting Parties to request from the operator estimates, if prepared, of current and cumulative costs incurred for the joint account at reasonable intervals during the conduct of any operation. In addition, under both the 1982 and 1989 Forms, the 2005 COPAS Accounting Procedure, customarily attached to the agreement as an exhibit, establishes an accounting procedure to be used in exploring, developing and operating within the Contract Area, and limits direct charges to those that are "necessary and proper."

Many operating agreements, including the 1982 Form and the 1989 Form, give non-operators various rights, including the right to propose and operate subsequent wells and operations, forgo proposed operations, secure the performance of obligations, remove the operator and limit the operator's project expenses. Both forms, however, may be modified and, therefore, these rights are not absolutely certain. Prior to purchasing non-operating working interests or using such interests to secure debt, companies and lenders or investors should ensure they understand which rights may, or may not, have been granted to such non-operators.