

Working Interest Disputes

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WORKING INTEREST DISPUTES

- ▶ Operations Without an Operating Agreement (Don't Do It)
- ▶ AAPL Form Operating Agreements
- ▶ Operator's Liability to Non-Operators
- ▶ Removal and Replacement of the Operator
- ▶ Operator's Remedies for Non-Operator's Default
- ▶ Avoiding Disputes

OPERATIONS WITHOUT AN OPERATING AGREEMENT

Parties become mineral co-tenants when:

- ▶ Multiple parties own undivided interests in leases covering the same land.
- ▶ Multiple parties hold leases from different undivided mineral interest owners.
- ▶ An operator with a lease on a percentage of the mineral rights proceeds with operations when there are unleased interests in the tract.

Without an operating agreement, the law of co-tenancy applies. Producing co-tenant must account to the other co-tenants for their share of the profits:

- ▶ Operator first recovers its reasonable and necessary drilling and completion costs.
- ▶ Severance taxes and reasonable and necessary lease operating expenses are deducted.
- ▶ Co-tenants are entitled to their proportionate share of the profit from the sale of production after the deduction of these costs.

OPERATIONS WITHOUT AN OPERATING AGREEMENT

Non-operators have a “carried” interest in the operations:

- ▶ No cash calls.
- ▶ No liability to suppliers and service providers.
- ▶ No invoices for expenses incurred in unsuccessful operations.
- ▶ Similar to a non-consent operation under an operating agreement, but the operator does not receive a non-consent penalty.

Disputes can arise:

- ▶ What costs are deductible?
- ▶ Are the calculations done on a well-by-well, tract-by-tract, phase-by-phase, or a prospect-by-prospect basis?
- ▶ Are the expenses claimed by the operator reasonable and necessary?

Operating without an operating agreement should usually be a last resort.

AAPL FORM OPERATING AGREEMENTS

Onshore Operations:

- ▶ 1982 Form 610
- ▶ 1989 Form 610
- ▶ 2015 Form 610

Offshore Operations:

- ▶ 2002 Form 710
- ▶ 2007 Form 810
- ▶ 2015 Form 810

OPERATOR'S STANDARD OF CONDUCT

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

1982 Form 610, Section V.A.

OPERATOR'S STANDARD OF CONDUCT

~~It~~ Operator shall conduct ~~all such operations~~ its activities under this 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, but in no event ~~it~~ shall it have ~~no~~ any liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.

1989 Form 610, Section V.A. (compared to 1982 Form 610, Section V.A).

OPERATOR'S STANDARD OF CONDUCT

Leading Cases (before *Reeder v. Wood County Energy, LLC*):

- ▶ Exculpatory clause did not apply to claims for breach of the operating agreement and improper charges to the joint account. *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. App.—El Paso 2000, no pet.), and *Cone v. Fagdau Energy Corp.*, 68 S.W.3d 147 (Tex. App.—Eastland 2001, pet. denied).
- ▶ Exculpatory clause did apply to claim that operator failed to properly deepen a well. *IP Petroleum Co., Inc. v. Wevanco Energy, L.L.C.*, 116 S.W.3d 888 (Tex. App.—Houston [1st Dist.] 2003, pet. denied).

OPERATOR'S STANDARD OF CONDUCT

Reeder v. Wood County Energy, LLC, 395 S.W.3d 789 (Tex. 2013)

- ▶ Conversion, Violations of Theft Liability Act, Breach of Contract
- ▶ Exculpatory Clause Did Apply
- ▶ 1989 Form 610, Not 1982 Form 610

OPERATOR'S STANDARD OF CONDUCT

Operator shall conduct its activities under this 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. **However**, in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred **in connection with authorized or approved operations under this agreement** except such as may result from gross negligence or willful misconduct.

2015 Form 610, Section V.A. (new language emphasized).

OPERATOR'S STANDARD OF CONDUCT

The Operator shall timely commence and conduct all activities or operations in a good and workmanlike manner, as would a prudent operator under the same or similar circumstances. THE OPERATOR SHALL NOT BE LIABLE TO THE NON-OPERATING PARTIES FOR LOSSES SUSTAINED OR LIABILITIES INCURRED, EXCEPT AS MAY RESULT FROM OPERATOR'S GROSS NEGLIGENCE OR WILLFUL MISCONDUCT

2007 Form 810, Article 5.2

The Operator shall timely commence and conduct all activities or operations in a good and workmanlike manner, as would a prudent operator under the same or similar circumstances. ~~THE OPERATOR SHALL NOT BE LIABLE TO THE NON-OPERATING PARTIES FOR LOSSES SUSTAINED OR LIABILITIES INCURRED, EXCEPT AS MAY RESULT FROM OPERATOR'S GROSS NEGLIGENCE OR WILLFUL MISCONDUCT~~

2015 Form 810, Article 5.2

OPERATOR DOES NOT HAVE A FIDUCIARY DUTY . . .

MDU Barnett Ltd. v. Chesapeake Exploration Ltd., 2014 U.S. Dist. LEXIS 18769 (S. D. Tex. 2014)

- ▶ 1982 Form 610
- ▶ Plaintiff Asserted Tort and Contract Causes of Action Relating to Exploration and Development Agreement and Operating Agreement.
- ▶ Court Granted Motion to Dismiss Fiduciary Duty Claim, Because No Fiduciary Duty Under Operating Agreement.

... UNLESS THE PARTIES FORMED A JOINT VENTURE

Dernick Res. Inc. v. Wilstein, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009, no pet.), and *Dernick Res. Inc. v. Wilstein*, 471 S.W.3d 468 (Tex. App.—Houston [1st Dist.] 2015, pet. denied).

- ▶ Joint Venture Agreement and Operating Agreement.
- ▶ First Opinion: Fiduciary Duty Created by Joint Venture Agreement.
- ▶ Second Opinion: Upheld Forfeiture of Overhead Fees Paid by Non-Operator to Operator as Penalty for Breach of Fiduciary Duty.
- ▶ Petition denied by Texas Supreme Court after briefs on the merits were filed.

CUSTODY OF FUNDS AND PROPERTY

Custody of Funds: Operator shall hold for the account of the Non-Operators any funds of the Non-Operators advanced or paid to the Operator, either for the conduct of operations hereunder or as a result of the sale of production from the Contract Area, and such funds shall remain the funds of the Non-Operators on whose account they are advanced or paid until used for their intended purpose or otherwise delivered to the Non-Operators or applied toward the payment of debts as provided in Article VII.B. **Nothing in this paragraph shall be construed to establish a fiduciary relationship between Operator and Non-Operators for any purpose other than to account for Non-Operator funds as herein specifically provided.** Nothing in this paragraph shall require the maintenance by Operator of separate accounts for the funds of Non-Operators unless the parties otherwise specifically agree.

2015 Form 610, Section V.D.4. (emphasis added).

CUSTODY OF FUNDS AND PROPERTY

Funds received by the Operator under this Agreement may be commingled with the Operator's own funds.

2015 Form 810, Article 6.1.

CUSTODY OF FUNDS AND PROPERTY

Tow v. Exxon Mobil Corp. (In re ATP Oil & Gas Corp.), 553 B.R. 577 (S.D. Tex. Bankr. 2016)

- ▶ Offshore Operating Agreement provided operator could commingle non-operator's funds with operator's own funds.
- ▶ ATP sent Exxon a cash call for decommissioning work, and Exxon paid the cash call.
- ▶ Work came in under AFE, and Exxon demanded repayment.
- ▶ ATP sent Exxon a check less than 90 days before ATP filed for bankruptcy. Trustee filed suit to recover preferential payment.
- ▶ Court rejected claim that ATP held Exxon's funds in a constructive trust.

CUSTODY OF FUNDS AND PROPERTY

Cass v. Stephens, 156 S.W.3d 38 (Tex. App.—El Paso 2004, pet. denied)

- ▶ Operator Billed Joint Account for Services Never Provided and for Equipment Already Owned by Joint Account.
- ▶ Operator Moved Jointly Owned Equipment to Wells Owned Entirely by Operator.
- ▶ Judgment for Fraud and Conversion, Including Exemplary Damages, Upheld on Appeal.
- ▶ Non-Operator Distinguished Contractual Claims, Such as Claims for Incorrect Charges, from Tort Claims, Such as Claims for Stolen Equipment.

REMOVAL OF OPERATOR

~~Operator may be removed if it fails or refuses to carry out its duties hereunder, or becomes insolvent, bankrupt or is placed in receivership, only for good cause by the affirmative vote of two (2) or more Non-Operators owning a majority interest based on ownership as shown on Exhibit "A" remaining after excluding the voting interest of Operator; such vote shall not be deemed effective until a written notice has been delivered to the Operator by a Non-Operator detailing the alleged default and Operator has failed to cure the default within thirty (30) days from its receipt of the notice or, if the default concerns an operation then being conducted, within forty-eight (48) hours of its receipt of the notice. For purposes hereof, "good cause" shall mean not only gross negligence or willful misconduct but also the material breach of or inability to meet the standards of operation contained in Article V.A. or material failure or inability to perform its obligations under this agreement.~~

1989 Form 610, Section V.B.1 (compared to 1982 Form 610).

REMOVAL OF OPERATOR

Key differences between the 1982 Form 610 and the 1989 Form 610:

- ▶ Requires written notice of default before the operator can be removed.
- ▶ Provides a clearer definition of when the operator can be removed.
- ▶ Only requires the vote of one non-operator, not two, to remove the operator.

REMOVAL OF OPERATOR

Removal of Operator: Except as provided in Article V.B.5., an Operator that has not voluntarily resigned and is not deemed to have resigned may be removed only for good cause by the affirmative vote of Non-Operators owning a majority interest based on ownership as shown on Exhibit “A” remaining after excluding the voting interest of Operator. Such vote shall not be effective until a written notice has been delivered to Operator by a Non-Operator detailing the alleged default and Operator has failed to cure the default within thirty (30) days from its receipt of the notice or, if the default concerns an operation then being conducted, within forty-eight (48) hours of its receipt of the notice.

2015 Form 610, Section V.B.4.

REMOVAL OF OPERATOR

Non-Owning Operator

- ▶ 2015 Form 610 expressly allows the election of an operator who does not own a working interest in the contract area. Article V.A.
- ▶ If non-owning operator is not an affiliate of a working interest owner, operator can be removed, with or without cause, by a majority vote of the working interest. Article V.B.5.
- ▶ If non-owning operator is affiliated with a working interest owner, removal grounds and procedure is the same as removal of an operator who owns a working interest. Article V.B.5.

REMOVAL OF OPERATOR

Non-Ownning Operator: Unless the parties have otherwise agreed, a non-owning Operator may be removed at any time, with or without cause, by the affirmative vote of parties owning a majority interest based on ownership as shown on Exhibit “A”. Moreover, if good cause for removal of such non-owning Operator, as defined in Article V.B.4., exists, the non-owning Operator may be removed by the affirmative vote of Non-Operators owning a majority interest based on ownership as shown on Exhibit “A” remaining after excluding the voting interest based on ownership as shown on Exhibit “A” remaining after excluding the voting interest of any non-operator who is an Affiliate of non-owning Operator following the procedure set out in Article V.B.4.

2015 Form 610, Section V.B.5.

REMOVAL OF OPERATOR

Selection of Successor Operator: Upon the resignation or removal of Operator under any provision of this agreement, a successor Operator shall be selected by the parties. The successor Operator shall be selected by the affirmative vote of one (1) or more parties owning a majority interest based on ownership as shown on Exhibit “A” including the vote(s) of the former Operator and/or any transferee(s) of the former Operator’s interest, to the extent that they are owners within the contract area; provided, however, if an Operator which has been removed or is deemed to have resigned fails to vote or votes only to succeed itself, the successor Operator shall be selected by the affirmative vote of the party or parties owning a majority interest based on ownership as shown on Exhibit “A” remaining after excluding the voting interest of the Operator that was removed or resigned.

2015 Form 610, Section V.B.6. (emphasis added).

REMOVAL OF OPERATOR

Removal for Cause by Vote

Under the following circumstances, the removal of the Operator shall be approved by Vote, excluding the Vote of the Operator:

- (a) the Operator is found liable by a final judicial decision or a final decision under binding arbitration for an act of Gross Negligence or Willful Misconduct regarding the Contract Area;
- (b) the Operator commits a substantial breach of a material provision of this Agreement and fails to cure the breach within thirty (30) days after receipt of written notice of the breach from a Non-Operating Party. If the breach specified in the notice reasonably cannot be corrected within the thirty (30) day period, but the Operator within said period begins action to correct the breach and thereafter diligently carries the corrective action to completion, the Operator shall not be removed. The Operator shall not be removed under this Article 4.4.2 if the Operator is able to prove the non-existence of the alleged breach within thirty (30) days after receipt of written notice of the alleged breach;

GROUNDNS FOR REMOVAL

Tri-Star Petroleum Co. v. Tipperary Corp., 101 S.W.3d 583 (Tex. App.—El Paso 2003, pet. denied)

- ▶ Improper Joint Account Charges
- ▶ Failure to Supply Information to the Working Interest Owners
- ▶ Commingling Legal Fees with Joint Account Funds
- ▶ Double Charges
- ▶ Allowing Acreage to Be Lost
- ▶ Not Meeting Volume Requirements in Gas Purchase Contracts

GROUNDNS FOR REMOVAL

Tri-Star Petroleum Co. v. Tipperary Corp., 101 S.W.3d 583 (Tex. App.—El Paso 2003, pet. denied)

- ▶ Temporary Injunction Affirmed
- ▶ Putting Gas Purchase Contract at Risk
- ▶ Causing Loss of Lease Acreage
- ▶ Threat of Irreparable Injury to Property
- ▶ Prohibitory Not Mandatory Injunction
- ▶ Preserve Status Quo of Non-Operators Having Right to Remove Operator

GROUND FOR REMOVAL

R&R Resources Corp. v. Echelon Oil and Gas, LLC, 2006 Tex. App. LEXIS 326 (Tex. App.—Austin 2006, no pet.)

- ▶ Holding Revenue Checks
- ▶ Not Paying Operating Expenses
- ▶ Not Billing Expenses in a Timely Manner
- ▶ Excess Charges
- ▶ Failure to Maintain and Replace Equipment

GROUNDNS FOR REMOVAL

R&R Resources Corp. v. Echelon Oil and Gas, LLC, 2006 Tex. App. LEXIS 326 (Tex. App.—Austin 2006, no pet.)

- ▶ Temporary Injunction Affirmed
- ▶ Loss or Delay in Revenue Payments
- ▶ Late Payment of Expenses
- ▶ Exposure to Creditors for Non-Payment
- ▶ Delay in Mineral Production
- ▶ Damage to Wellbores and Equipment Located on Leases

GROUND FOR REMOVAL

2015 Form 610 clarifies the grounds for removal.

For purposes hereof, “good cause” shall include, but not be limited to, Operator’s (i) gross negligence or willful misconduct, (ii) the material breach of or material inability to meet the standards of operation contained in Article V.A. or (iii) material failure or inability to perform its obligations or duties under this agreement.

Article V.B.4.

IS POSITION OF OPERATOR ASSIGNABLE?

- ▶ Generally accepted that right to operate is not assignable, but many have argued otherwise.
- ▶ *U.S. Energy Dev. Corp. v. Stephens Energy Grp.*, 662 Fed. Appx. 556 (10th Cir. 2016) held that operator could assign its position. The court rejected the claim of industry custom and usage.
- ▶ 2015 Form 610 expressly provides that operator cannot assign its position. Article V.A.

BREAKING A TIE VOTE FOR ELECTION

- ▶ Forms assume someone will win election for new operator.
- ▶ Generally, no tie-breaker provisions.
- ▶ 2015 Form 610 addresses a tie in the selection of the successor operator. “In the event that such vote results in a tie, the candidate supported by the former Operator or the majority of its transferee(s), shall become the successor Operator.” Article V.B.6.

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

Operator shall promptly pay and discharge expenses incurred in the development and operation of the Contract Area pursuant to this agreement and shall charge each of the parties hereto with their respective proportionate shares upon the expense basis provided in Exhibit "C." Operator shall keep an accurate record of the joint account hereunder, showing expenses incurred and charges and credits made and received.

2015 Form 610, Section V.D.2.

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

OPERATOR'S (AND NON-OPERATOR'S) LIEN

Each party grants to the other parties hereto a lien upon any interest it now owns or hereafter acquires in Oil and Gas Leases and Oil and Gas Interests in the Contract Area, and a security interest and/or purchase money security interest in any interest it now owns or hereafter acquires in the personal property and fixtures on or used or obtained for use in connection therewith, to secure performance of all of its obligations under this agreement including but not limited to payment of expense, interest, and fees, the proper disbursement of all monies paid hereunder, the assignment or relinquishment of interest in Oil and Gas Leases as required hereunder, and the proper performance of operations hereunder.

2015 Form 610, Section V.D.2.

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

OPERATOR'S (AND NON-OPERATOR'S) LIEN

- ▶ The lien provides a security interest in both real and personal property.
- ▶ The lien on real property (leasehold interests, mineral fee interests, and hydrocarbons in the ground) must be perfected by filing in the county or parish real property records.
- ▶ The lien on personal property (equipment not considered to be fixtures, severed hydrocarbons, and proceeds from the sale of production) must be perfected by filing with the Secretary of State.
- ▶ File the Recording Supplement (usually Exhibit H to Form 610, Exhibit G to Form 710, and Exhibits M and N to Form 810) in:
 - County or parish real property records;
 - As a UCC-1 with the Secretary of State;
 - With BOEM if the property is offshore.

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

- ▶ Collect Defaulting Party's Share of Revenue (Netting Out). Form 610, Article VII.B.; Form 710, Ex. I, Article 8.6.1; Form 810, Ex. F, Article 6.3.a.
- ▶ Advanced Billing of Next Month's Estimated Operating Expenses. Form 610, Article VII.C.
- ▶ Add provision in Article XVI of Form 610 to allow Operator to issue cash calls for subsequent operations.
- ▶ Collect Defaulting Party's Share from Other Working Interest Owners. Form 610, Article VII.B.; Form 710, Ex. I, Article 8.6.3; Form 810, Ex. F, Article 6.3.d.

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

- ▶ Notice of Default and Suspension of Rights. 2015 Form 610, Article VII.D.1; Form 710, Ex. I, Article 8.6.2; Form 810, Ex. F, Article 6.3.b.
- ▶ Suit for Damages. 2015 Form 610, Article VII.D.2.
- ▶ Deemed Non-Consent. 2015 Form 610, Article VII.D.3.
- ▶ Cannot deem a party non-consent and then sue them for damages. 2015 Form 610, Article VII.D.3. But see *Allen Drilling Acquisition Company v. Crimson Exploration Inc.*, Case No. 10-15-00277-CV, pending in the Waco Court of Appeals.

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

- ▶ Sue Defaulting Party's Predecessor in Interest on the Theory that Assignment of Interest Does Not Constitute a Release of Obligations under the Operating Agreement.
- ▶ Offshore Operations. *Seagull Energy E&P, Inc. v. Eland Energy, Inc.* 207 S.W.3d 342 (Tex. 2006); *Chieftain International (U.S.), Inc. v. Southeast Offshore, Inc.*, 553 F.3d 817 (5th Cir. 2008).
- ▶ Onshore Operations. *Indian Oil Co. v. Bishop Petroleum Inc.*, 406 S.W.3d 644 (Tex. App.—Houston [14th Dist.] 2013, pet. denied).

OPERATOR'S REMEDIES FOR NON-OPERATOR'S DEFAULT

- ▶ 2015 Form 610 expressly prohibits suing predecessor in interest. Article VIII.D. Assigning party gives operator the assignment. Assignment becomes effective 30 days later, and the assignor has no further liability.
- ▶ 2015 Form 810 limits circumstances where predecessor can be sued. Article 24.1.

HOW TO AVOID DISPUTES

- ▶ Conduct Due Diligence on the Other Party Before Signing the Contract.
- ▶ Properly Prepare and Complete Closing Documents.
- ▶ Make Sure All Agreed Upon Changes Have Been Made.
- ▶ Fill in Blanks and Make Elections. *Anderson Energy Corp. v. Dominion Okla. Tex. Exploration & Prod.* 469 S.W.3d 280 (Tex. App.—San Antonio 2015, no pet.).
- ▶ Beware of Non-standard or Contradictory Forms or Agreements.
- ▶ Both Sides Should be Represented by Experienced Oil and Gas Counsel.

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