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Operating Alongside Cash Strapped Co-Working Interest Owners

In the midst of the COVID-19 pandemic and plummeting oil prices, oil and gas operators are living through one of the most capital-constrained environments in memory. These developments, on top of what were already short-of-ideal conditions for oil and gas E&P companies, will force operators to confront not only their own capital shortfalls, but also those of their co-working interest owners. Given these conditions, operators and non-operators alike would be well served to review the particular pressure points under the 1989 A.A.P.L. Model Form Operating Agreement ("1989 JOA")[1]1 in light of a cash-strapped environment, in particular: (i) the provisions in relation to liens on the parties' interests in the contract area, (ii) the other remedies provided to address a default by a working interest owner, (iii) other possible commercial resolutions to address a party's desire to delay or minimize capital expenditures, and (iv) the impact of the "Other Operations" clause on an operator's ability to conduct repairs and expend funds not directly related to drilling operations. This paper sets forth key considerations with respect to the above as a primer on such points.

Liens Under the 1989 JOA

Coverage of 1989 JOA Liens

One of the most powerful tools granted to the operator and other working interest owners under the 1989 JOA in the event of a default is the broad lien and security interest granted among parties in Article VII.B to secure the performance of each party's obligations under the agreement.[2] The lien and security interest burden each party's rights in the leasehold and other mineral interests, equipment and other personal property, fixtures, production, and other assets of value in the contract area or used in connection therewith. Therefore, in the event of a default by a working interest owner, each other party holds a lien on the defaulting working interest owner's leases (and

[1] This paper will focus upon the 1989 JOA as perhaps the most commonly used joint operating agreement with respect to onshore United States oil and gas E&P operations (understanding that the 1982 A.A.P.L. Model Form Operating Agreement ("1982 JOA") is also widely used), but will note some key differences between the provisions of the 1989 JOA and the provisions of the 1982 JOA and the 2015 A.A.P.L. Model Form Operating Agreement ("2015 JOA") below.

[2] The 1989 JOA expanded the coverage of liens granted under the JOA, relative to the 1982 JOA. The 1982 JOA limits secured obligations to debts owed for costs and expenses, and such liens do not secure other indebtedness created in the course of operations under the agreement. By contrast, the 1989 and 2015 JOAs expand the scope of obligations secured by the lien and security interest to cover "all obligations under the operating agreement," including obligations to assign and relinquish interests in oil and gas leases and obligations of the operator to properly perform operations. *See* 1982 JOA Article VII.B; 1989 JOA Article VII. B; 2015 JOA Art. VII.B. *See also* Alex Ritchie & Gary B. Conine, *Property Provisions of the Joint Operating Agreement: An Update for the New 2015 Form JOA*, 50 Tex. Tech Law Rev. 489, 506 (2018).

other interests in the contract area), and is a secured creditor with respect to any amounts that are the subject of default.[3]

Perfection and Priority

However, while the non-defaulting parties hold such secured interests to support their claims for amounts in default, they must concern themselves with the priority they have among other potential creditors of the defaulting working interest owner respecting the applicable collateral (given that a working interest owner that has defaulted under a JOA is likely to have other creditors). In order to have priority as a secured creditor, the working interest owners must have perfected their liens on the implicated interests. Perfection of liens is governed by the law of the state where the assets are located. Further, the means of perfecting a lien differ depending on the nature of the collateral.

While the details of the requirements to perfect JOA liens can differ across states, in most instances the process is similar to that required in the state of Texas, to wit: To perfect a lien on oil and gas leases (as real property interests), notice of the lien (in this instance, most commonly a memorandum of JOA and financing statement) must be filed in the county records of the county where the relevant leases are located.[4] The 1989 JOA has attached a form of such memorandum, and provides each party the authority to file such memorandum or other documents necessary to perfect such lien.[5] A security interest in personal property owned under the JOA is perfected by way of the filing of a UCC-1 financing statement with the Secretary of State of the state where the debtor is incorporated.[6] Finally, in Texas (and many other states) a security interest in fixtures and production (as-extracted collateral) is perfected by way of filing a UCC-1 financing statement in the county records where the asset is located (due to the fact that fixtures and as-extracted collateral sit somewhere between real property and personal property).[7]

Among perfected liens, priority is generally afforded to those liens that are first in time.[8] While the 1989 JOA includes a representation by the parties that the liens being granted are liens that would have first priority with respect to the assets, parties should keep in mind that this representation does not guarantee that the liens actuality are first in priority, even if promptly perfected (as often parties will have granted liens to their lenders that predate the JOA, notwithstanding the representation to the contrary).[9] In the event of a default, the operator will have the right to foreclose on its perfected liens and force a sale of the oil and gas leases in question (and other assets covered by the JOA);

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[3] Under the 1982 JOA, each non-operator grants to the operator a lien upon its "Oil and Gas Rights." The term "Oil and Gas Rights" was ambiguous and led to complaints as to the sufficiency of collateral descriptions. By contrast, the 1989 and 2015 JOAs use the terms "Oil and Gas Leases" and "Oil and Gas Interests." Those updated versions of the JOA also include expansive lists of the property rights covered by the lien and security interest. *See* Andrew B. Derman, "*The New and Improved 1989 Joint Operating Agreement: a Working Manual*" VOLUME 19 OF THE MONOGRAPH SERIES PUBLISHED BY THE SECTION OF NATURAL RESOURCES, ENERGY, AND ENVIRONMENTAL LAW OF THE ABA 1, 51.

[4] *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982)(holding that recording a document creates constructive notice); TEX. PROP. CODE ANN. 13.001(a).

[5] 1989 JOA Article VII.B.

[6] TEX. BUS. & COM. CODE ANN. § 9.301.

[7] TEX. BUS. & COM. CODE ANN. § 9.301.

[8] TEX. BUS. & COM. CODE ANN. § 9.322.

[9] 1989 JOA Article VII.B.

however, such foreclosure sale will be subject to the fulfillment of any amounts owed pursuant to any more senior liens on the assets.[10]

Practical Consideration

One practical consideration for parties holding liens granted under a 1989 JOA is whether a foreclosure sale outside of bankruptcy will allow for as much recovery to co-working interest owners as the bankruptcy process. If a JOA lien is junior to a defaulting co-working interest owner's liens to its lender for the same collateral (as part of a broader set of liens on the defaulting co-working interest owner's borrowing base), non-defaulting parties may have difficulty recovering amounts due in a foreclosure sale outside of bankruptcy (as in many instances the defaulting party's lenders would be owed in the aggregate far more than the value of the JOA collateral). Consequently, junior JOA liens may have more utility in a bankruptcy process, in which the non-defaulting parties would have roles as secured creditors (in the event that, in the aggregate, the lender is fully secured by way of its liens outside of the contract area).

Other Remedies Against Defaulting Working Interest Owners

The 1989 JOA provides remedies beyond liens in the event of a default by a working interest owner, including suspension of rights and deemed non-consent.

Suspension of Rights

In the event of a default under a 1989 JOA, the non-defaulting parties may suspend the defaulting party's rights under the JOA, including preventing the defaulting party from participating in future operations and receiving proceeds from production in the contract area.[11] This latter right, while specifically set forth in the 1989 JOA, is lacking in detail: In particular, it is unclear what should be done with the production withheld from the defaulting party, as the provision does not specifically grant a right (separate from the liens described above) to sell such production and offset proceeds against amounts owed. However, the language is extremely broad and, as a practical matter, affords operators significant leverage to recover amounts owed from defaulting parties using the explicit authority to withhold production as the contractual hook to justify doing so.

Suit for Damages

The non-defaulting parties, or the operator on their behalf, may also elect to sue the defaulting party for amounts in default, interest accrued thereon, and consequential damages (but if they do so, they cannot utilize the "deemed non-consent" remedy described below).[12]

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[10] TEX. PROP. CODE ANN. § 13.001(a).
[11] 1989 JOA Article VII.D.1.
[12] 1989 JOA Article VII.D.2; 1989 JOA Article VII.D.3. The express right for a non-defaulting party to bring a suit for damages exists in the 1989 JOA and 2015 JOA, but is not present in the 1982 JOA.

Deemed Non-consent

Additionally, non-defaulting parties are permitted to put a defaulting party in a position of "deemed non-consent" with respect to the operation that is the subject of the default, which, when the default is in respect of a development well, may be the most powerful of all rights and remedies under the 1989 JOA.[13]

By permitting the non-defaulting parties to put the defaulting party in a position of non-consent, the 1989 JOA gives such non-defaulting parties the power to absorb the defaulting party's interest in the well or operation in question. While such remedy would require the non-defaulting parties to bear a greater capital expenditure burden with respect to the operation, it would also allow an increased net revenue interest in such well until the non-consent penalty had paid out, allowing recovery through production of both the amount in default and additional compensation for bearing the defaulting party's capital costs. However, because the relevant provision in the 1989 JOA is not written with complete clarity (or at a minimum requires close parsing to divine the relevant details), questions may arise regarding the details of how this remedy would play out—in particular, how the right functions (i) when there are multiple producing wells within a contract area, and the default concerns fewer than all of such wells, and (ii) when the defaulting party has already paid a portion of the costs with respect to the drilling of a well, but has defaulted on further payments.

In the first instance, the question may arise as to whether the provision gives the non-defaulting parties the right to put the defaulting party in a position of non-consent with respect to all of the producing wells, or just the well that is the subject of the default. The 1989 JOA provides that if the right is exercised, "the defaulting party will be conclusively deemed to have elected not to participate *in the operation*... ."[14] (Emphasis added.) By way of the reference to the "operation" instead of the "contract area," the 1989 JOA is clear upon close inspection that the remedy is only with respect to the well that is the subject of the default.

When only a partial default has occurred, the parties may question how to apply the non-consent penalties, as Article VII.D.3 states that "the defaulting party will be conclusively deemed to have elected not to participate in the operation and to be a Non-Consenting Party with respect thereto under Article VI.B. or VI.C., as the case may be, *to the extent of the costs unpaid by such party*, notwithstanding any election to participate theretofore made." (Emphasis added.) Does the limiting language referring "to the extent of the costs unpaid" apply to the calculation of the non-consent penalty, or the degree to which the defaulting party's interest is forfeited (or both)? In other words, if a JOA provides for a 200% non-consent penalty, a well costs $2 million to drill, and a party pays $1 million but defaults on the remaining $1 million, is the non-consent penalty $4 million or $2 million? And does the defaulting party forfeit its entire interest in the well, or only 50% of its interest (given that it has paid for 50% of the well)?

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[13] 1989 JOA Article VII.D.3.
[14] 1989 JOA Article VII.D.3.

Texas courts have not directly opined on these issues; however, the language seems clear that at a minimum the non-consent penalty must be calculated only in reference to the amount in default, as it states that the defaulting party is deemed to be a Non-Consenting Party under Article VI.B and VI.C (the articles that set forth the non-consent penalty), to the extent of the costs unpaid by such party.

On the face of the provision, it is less clear whether the phrase "to the extent of the costs unpaid by such party" also modifies the earlier portion of the clause, stating that the defaulting party is deemed to have elected to not participate in the operation. However, the judicial guidance we have and its interplay with other remedies against a defaulting working interest owner support an interpretation that the defaulting party forfeits its entire interest–not a proportionate interest based on the amount that is the subject of default–until the non-consent penalty is paid out. While not key to the court's holding on the issues it faced, the Waco Court of Appeals recognized in dicta that the defendant in *Allen Acquisition Drilling Co*. had forfeited its entire interest in three wells when it had partially defaulted on its obligations with respect thereto.[15] Further, considering the other remedies available to the non-defaulting parties (such as the total suspension of the right to receive production from the contract area), it seems unlikely that the drafters intended for a defaulting party to be deemed to have only partially non-consented (retaining an interest in, and an obligation to pay for, a percentage equal only to amounts previously paid). Therefore, the clearest reading of the clause is that the defaulting party does not retain any interest in the well. However, parties should be aware of the degree of ambiguity on this point in the circumstance of a partial default, which could create conflict between the parties given the lack of clarity.

Commercial Resolutions

To some degree, depending on the situation and the co-working interest owner in question, the remedies laid out above may be imperfect solutions for an operator looking to manage operations when capital is tight. There may be scenarios in which exercising such remedies could be too harsh and damaging to relationships with co-working interest owners to be desirable. As such, operators may look for other creative solutions to allow co-working interest owners to pay less than what they owe (or delay payments owed), but compensate the operator for fronting capital costs, all in the interest of preserving the purpose of the joint operating agreement going forward–the sharing of exploration and development costs, benefits, and liabilities.

Parties could explore agreements pursuant to which the operator permits a co-working interest owner to make a partial or delayed payment of amounts owed in exchange for the conveyance of a non-cost bearing interest carved out of the co-working interest owner's leases in the contract area. This could be accomplished, in the most simple fashion, through the conveyance of an overriding royalty interest. However, parties could also explore more complicated arrangements. A conveyance of a *term* overriding royalty interest would allow the parties to utilize a concept pursuant to which rights to

[15] *Allen Acquisition Drilling Co. vs. Crimson Expl. Inc.,* 558 S.W.3d 761 (Tex. App.— Waco 2018, no pet. h.).

revenues revert to the cash-strapped working interest owner once the operator has received the capital costs it fronted (perhaps plus amounts compensating the operator for such capital outlay). Parties could also explore other reversionary concepts (i.e., assignments of leasehold rights that revert to the assignee if certain conditions are met regarding amounts owed).

Each of these options might provide some room for a cash-strapped party to avoid a capital outlay, but still provide the operator fronting such costs a bankruptcy-proof, real property interest securing the economic arrangement. Note, however, that these options might only be available to cash-strapped parties that are not underwater with their secured lenders, as such lenders might not allow transfers of collateral if amounts owed to such lenders are not fully secured (or such lenders, at a minimum, would closely scrutinize such transactions).

'Other Operations' in a Cash-Strapped Environment

In addition to navigating possible delays and deficiencies with respect to amounts owed, operators must contend with their responsibility to conduct necessary operations in the contract area at a time in which there may be little appetite to incur such costs. Under the 1989 JOA, the general mechanics for proposing and approving operations only apply to the "drilling, Sidetracking, Reworking, Deepening, Completing, Recompleting or Plugging Back of a well."[16] Any other operations (except to address an explosion, fire, flood or other sudden emergency) are treated by the "Other Operations" provision in Article VI.D of the 1989 JOA, which only allows the operator to undertake such operations of its own accord up to a cost threshold designated by the parties. Any operations costing more than that amount must be approved by a percentage of the working interests designated by the parties.[17]

In a cash-strapped environment, the "Other Operations" mechanics can put an operator in a tough position. Over time, operators must undertake numerous operations at the field level that are not directly related to "drilling, Sidetracking, Reworking, Deepening, Completing, Recompleting or Plugging Back" a well, such as repairing well casings, maintaining compressors and generally keeping wells and equipment in an adequate state of repair to comply with laws relating to health, safety and the environment. Many of these operations, however, may technically fall within the scope of the 1989 JOA's "Other Operations" clause if not to address a "sudden emergency," meaning that if the cost of the operation is above a certain threshold, the designated percentage of the working interests in the operation must approve the operation.[18]

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[16] 1989 JOA Article VI.D.

[17] Under the 1982 JOA, costs for "Other Operations" above a designated threshold had to be unanimously approved. Operators and commentators found this provision burdensome, resulting in revisions when the 1989 JOA was promulgated to instead require the approval of a threshold percentage of the working interests under the JOA. *See* 1982 JOA Article VI.D; 1989 JOA Article VI.D; 2015 JOA Article VI.D.

[18] *See* Christopher S. Kulander, *Old Faves and New Raves: How Case Law Has Affected Form Joint Operating Agreements—Problems and Solutions (Part One)* 1 OIL & GAS, NAT. RES. & ENERGY J. 1, 40 (2015) ("Some cases have defined

Therefore, an operator may find itself in a position in which it feels it must make a repair in order to fulfill its duties as operator vis-à-vis regulatory authorities, but nevertheless may not be able to conduct such operation as an "Other Operation" if other working interest owners are tight on cash, want to defer repairs to maintain capital, and own a large enough working interest to block an operation costing more than the designated threshold. Further complicating matters, it is not clear whether operators may conduct such an operation and pay for it themselves, as Texas courts have split as to whether operators are flatly prohibited from conducting the operation in question, or just from recovering proportionate amounts from co-working interest owners.[19]

Notwithstanding the generally strict interpretation of the Other Operations clause by the Texas courts, it is possible that in certain circumstances where the need to conduct the operation to comply with environmental law, for example, is clear, but there is a question as to the "suddenness" of the emergency, a court might interpret the "sudden emergency" exception broadly enough to encompass environmental issues that eventually will cause an emergency if not addressed. However, Texas courts have not yet addressed such a question. Further, though perhaps cold comfort, the primary case standing for the proposition that the "Other Operations" clause prohibits any unapproved action dealt with an operation to facilitate production (rather than a repair or measure to ensure environmental, health or safety compliance). It seems at least possible that a court would view such a mutually beneficial operation differently and allow the operator to conduct the operation at its own cost. Though not a help with respect to existing joint operating agreements, operators should also consider incorporating into new joint operating agreements revisions to the "Other Operations" clause granting the operator broader authority to undertake necessary repairs and charge related costs to the joint account.

Conclusion

In a challenging environment such as this, E&P companies are facing tough decisions daily. Given the nature of joint operations, those decisions will extend beyond managing one's own financial situation to also grappling with difficulties stemming from the financial position of co-working interest owners. The 1989 JOA provides frameworks and tools for navigating these complicated situations, which will apply to many working interest owners, making familiarity with respect thereto key for E&P players in the coming days and months.

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the 'other operations' clause quite broadly to include any operations that cost more than the dollar limit provided for in the JOA and that have either not been specifically authorized by the parties or that are necessary to correct a 'sudden emergency.'").

[19] *See Cone v. Fagadau Energy Corp.*, 68 S.W.3d 147 (Tex. App.—Eastland 2001) (holding that the "Other Operations" clause under a JOA based on the 1982 JOA does not prohibit parties from conducting other operations, just from recovering proportionate amounts from co-working interest owners); but see *Texstar N. Am., Inc. v. Ladd Petroleum* 809 S.W.2d 672 (Tex. App.—Corpus Christi 1991, writ denied) (holding that under a JOA based on the 1982 JOA the "Other Operations" provision blocked the contemplated operation (a fracture to stimulate a well) unless the stipulated approval was obtained). While both of the above cases dealt with versions of the 1982 JOA, there is no obvious reason why the updates to the "Other Operations" clause in the 1989 JOA and 2015 JOA would lead to different interpretations, as those revisions primarily replaced the unanimity requirement with a requirement that a threshold percentage of interests approve the operation.

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