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Paul G. Yale

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THE AAPL FORM JOA AND NON-PAYING PARTICIPANTS—“MR. GREEN LEISURE SUIT” REVISITED*

PAUL G. YALE**

I. Introduction

“Mr. Green Leisure Suit,” as I will call him, dropped in on me unexpectedly in my Denver office where I was employed as a near-entry level landman by a major oil company (Exxon) in the early 1980s. Passing

* Special thanks to Nikki Hafizi, an Associate with Gray Reed in Houston for her assistance with this article. I am also grateful to John Melko of Foley Gardere in Houston, and Mitch Ayer, of Thompson Knight in Houston, for their comments and their furnishing to me an advance copy of their joint presentation to be made to the Houston Bar Association Oil, Gas and Mineral Law Section in October 2019, “An Ounce of Prevention: Strategies for Dealing with Potentially Insolvent Counterparties.” Thanks also to Nancy McDonald, Staff Landman, Anadarko Petroleum, Denver, Colorado for once again proving that landmen often know more about the law than most oil and gas lawyers by setting me straight on the proper location for filing UCC financing statements and otherwise providing insightful comments on the subject matter.

** Houston attorney Paul Yale is a Partner in the law firm of Gray Reed & McGraw, LLP. Paul has almost 40 years of legal and land experience working in the domestic U.S. oil and gas industry, including over 25 years with ExxonMobil Corporation and its predecessor companies. His practice focuses on upstream U.S. oil and gas transactional, title, and dispute resolution matters. Licensed as a lawyer in multiple U.S. jurisdictions, including Oklahoma and Texas, Paul has extensive experience in most major U.S. oil and gas basins. He received his B.A. “cum laude” from Vanderbilt University in 1974 and his J.D. from Southern Methodist University in 1977. He is Board Certified in Oil, Gas and Mineral Law by the Texas Board of Legal Specialization. He has certifications in both mediation and arbitration and regularly serves as an arbitrator, mediator and expert witness in oil and gas disputes. He is a past Chair of the Houston Bar Association, Oil, Gas and Mineral Law Section and is active in various other professional and charitable organizations in the Houston area and beyond.

time has obscured details, but I recall most. He entered my office in a pastel green, bell-bottomed leisure suit with a gold pukka shell necklace adorning his well-tanned, very hairy chest. His girlfriend was dressed in a tight-fitting, memorably scant outfit similar to what might be worn today by a “Zumba” dance fitness instructor in a women’s workout studio. Her attire was certainly not business dress, even by business casual dress standards (to the extent such standards existed in the early 1980s). But no matter—she was accompanying him for no apparent business reason.

I had been assigned the task of putting a lease play together in northeastern Colorado, in the same area today seeing large scale horizontal drilling and development in the Niobrara formation. However, this was long before horizontal fracking had come of age, and Exxon wanted to drill vertical test wells, perhaps as many as a dozen, at a drilling and completion cost per well of several million dollars. I had contacted “Mr. Green Leisure Suit” for a farmout of his approximately 10% leasehold position on the prospect. Mr. Green Leisure Suit was the son of a well-known, wealthy, Houston businessman—a fact that I, having recently moved to Colorado from Texas, was unduly impressed by.

Mr. Green Leisure Suit told me he was in town to snow ski but wanted to respond to my farmout request in person while he was here. He then told me he wanted to join in the wells, not farm out. I explained to him that even a 10% interest could cost him millions of dollars, given how expensive the wells were and the number of them that Exxon planned to drill. I also warned him about Exxon’s propensity at the time for significant cost overruns. His response was something like, “Not a problem, I’m ready to run with the big dogs. So, let’s drill these suckers, where do I sign?”

I then had my secretary prepare a stack of authorities for expenditure (“AFEs”) and signature pages to a Model Form American Association of Professional Landmen (“AAPL”) 610 Operating Agreement (probably the 1977 version), all of which Mr. Green Leisure Suit enthusiastically executed. The deal with Mr. Green Leisure Suit closed, Exxon commenced its exploration program. We drilled six or seven dry holes in a row before abandoning the play. There were significant cost overruns. Mr. Green Leisure Suit’s final share of costs was two to three million dollars, which would be a fair amount of money today and was even more so in the early 1980s.

A month or so after we shut the program down, our accounting department contacted me. As it turned out, Exxon had billed Mr. Green Leisure Suit for his share of costs, but he never paid anything. Accounting asked me to contact him about the overdue bills. I tracked him down to a hotel room in

Las Vegas where the phone was answered by a woman, different from the first, made obvious by a thick foreign accent. She explained that Mr. Green Leisure Suit could not come to the phone, but he wanted me to know his “check was in the mail.”

A month later I received a letter in the mail, but no check was enclosed. Instead, I found Mr. Green Leisure Suit’s notice of personal bankruptcy filing in federal bankruptcy court in the U.S. Southern District of Texas (Houston). Exxon, as an unsecured creditor, was to stand in line behind scores of secured banks and lending institutions and ultimately had to write off the two to three million dollars. Somehow my career survived, probably because in the early 1980s Exxon was enjoying record gross annual corporate revenues in the billions upon billions of dollars range and a two to three million dollars write off was insignificant. Additionally, my old boss transferred to a new job and my new boss did not connect the dots. So, it happened that I had my first encounter with a non-paying non-operator. It was not to be my last.

II. Mr. Green Leisure Suit Redux

Some readers may recognize Mr. Green Leisure Suit from a previous article I have written on this same subject published in the Rocky Mountain Mineral Law Foundation Journal in 2014.¹ To those readers, I apologize. To paraphrase the celebrated twentieth century classicist Moses Hadas, perhaps “this [paper] fills a much-needed gap.”²

But given the extraordinary circumstances that have occurred in the U.S. oil patch since early 2014, a revisit of issues raised with non-paying participants under operating agreements seems appropriate. When I wrote the previous article in late 2013, worldwide crude oil prices were in the range of \$100 a barrel.³ Many observers were still bullish on the price of oil, at least in the long term.⁴ To some, however, trouble seemed to lurk on the horizon:

1. This paper is based on another entitled *Mr. Green Leisure Suit Revisited: The AAPL Form JOA and Non-Paying Participants* originally published by the Rocky Mountain Mineral Law Foundation in the manual of the Special Institute on Joint Operations and the New AAPL Form 610-2015 Model Form Operating Agreement (2017).

2. ROBERT BYRNE, *THE 637 BEST THINGS ANYBODY EVER SAID* 108, (Fawcett 1st ed. 1982) (crediting the original quote “*This book fills a much-needed gap*” to a review by Moses Hadas (1900–1966)).

3. See *Average Crude Oil Spot Price*, YCHARTS, https://ycharts.com/indicators/average_crude_oil_spot_price (last visited Jan. 27, 2020).

4. See *Outlook for Energy: A View to 2040* (2013), EXXONMOBIL (Aug. 28, 2019), <https://corporate.exxonmobil.com/Energy-and-environment/Energy-resources/Outlook-for-Energy/Outlook-for-Energy-A-perspective-to-2040>.

“... Justification [for taking steps to address non-paying JOA participants] can be found by reflecting on the experience of the oil and gas industry in the United States in the mid-1980s and comparing it with the eerily similar situation that the industry finds itself in at the time this article is being written in late 2013. Crude oil production in the United States is at the highest level since the 1980s. President Obama and his administration are negotiating a lifting of sanctions with Iran which can potentially unleash millions of barrels of crude oil onto world markets. For the short term, at least, Middle Eastern oil supplies together with new U.S. production coming on-stream appear to be more than adequate in filling international oil demand. Is an oil price crash similar to what was experienced in the mid-1980s out of the question in the mid-2010s? If such a crash were to re-occur how many non-operators (and operators for that matter) might find themselves in serious financial trouble? History, unfortunately, tends to repeat itself.”⁵

Readers of my 2014 article may recognize that paragraph. For once it appears that I wrote something percipient. History did repeat itself—in spades. Oil prices dropped from their 2013 highs of over \$100 a barrel to a low of under \$30 a barrel in January 2016.⁶ Between January, 2015 and November 20, 2019, 208 oil and gas producers filed for bankruptcy in the wake of falling prices and a struggling commodities market.⁷ Moreover, in 2019, the U.S. Energy Information Agency released its Annual Energy Outlook forecast predicting that crude oil prices are not likely to approach \$100 a barrel again for more than a dozen years.⁸ Recent events have not changed the fundamental downward spiral of oil prices that started in 2013. Though oil prices rallied in 2017–2019,⁹ U.S. oil prices dropped to almost

5. Yale, *supra* note 1, at 342–43.

6. *WTI Crude Oil Prices – 10 Year Daily Chart*, MACRO TRENDS, <https://www.macrotrends.net/2516/wti-crude-oil-prices-10-year-daily-chart> (last visited Jan. 27, 2020).

7. *Oil Patch Bankruptcy Monitor*, HAYNESBOONE (Jan. 17, 2020, https://www.haynesboone.com/-/media/files/energy_bankruptcy_reports/oil_patch_bankruptcy_monitor.ashx?la=en&hash=D2114D98614039A2D2D5A43A61146B13387AA3AE..).

8. *Annual Energy Outlook 2019*, U.S. ENERGY INFO. ADMIN., <https://www.eia.gov/forecasts/aeo/data/browser> (last visited Jan. 27, 2020) (referencing Brent crude oil from the North Sea).

9. Michael Lynch, *What Happened to Oil Prices in 2018*, FORBES (Jan. 2, 2019), <https://www.forbes.com/sites/michaelylnch/2019/01/02/what-happened-to-oil-prices-in-2018/#6b71603e6d83>).

\$50 a barrel more recently in the summer of 2019 before recovering back to \$60 a barrel following tensions in the Middle East.¹⁰

To those who read and acted upon some of the recommendations in my 2014 article, congratulations. To those who did not, I am sure you have plenty of company. Perhaps this time around I will have earned your attention.

I have another reason for revisiting the subject. I received a surprisingly large number of comments on my 2014 article. Several people, including some very seasoned industry professionals, expressed surprise that filing a UCC financing statement was necessary to properly perfect the lien provided for in Article VII of the 1989 AAPL Form Operating Agreement. Others said I needed to include more about the proper location for filing UCC financing statements. Several people commented that I should have focused more on unscrupulous, non-paying operators, instead of focusing only on non-operators. I am grateful for these comments and will respond to them in this revised version of my 2014 paper.

Another somewhat stinging but true comment I received from an old friend and law school classmate was that the central character in my story, “Mr. Green Leisure Suit,” was a bit dated (and by implication, so was I). Ignoring the personal slight, his point was that, though hucksters are still around, today they are better disguised. Instead of individuals, today’s non-paying participants are more prone to be an entity or group of entities. Instead of being backed by a rich daddy, or the failed Texas and Oklahoma banks of the 1980s, today’s non-paying participants are more likely backed by private equity or other unregulated sources of financing whose credit wherewithal is opaque at best. When banks do get involved in energy lending, the credit provided is often subject to multiple tranches of senior and junior mezzanine debt sandwiched between syndicated secured lenders and other (unsecured) equity holders—which is then made subject to conforming and non-conforming revolving credit facilities with semi-annual borrowing base re-determinations, hedges, and a multitude of other nearly indecipherable modern oil and gas financing arrangements.¹¹ All of which can create traps

10. Myra P. Saefong, *Oil Prices May Drop Back Toward the Year’s Lows Near \$50 a Barrel*, MARKETWATCH (Aug. 24, 2019, 9:15 AM), <https://www.marketwatch.com/story/oil-prices-may-drop-back-toward-the-years-lows-near-50-a-barrel-2019-08-23>; Laura He et al, *US oil prices had their biggest spike in a decade after Saudi attack disrupts global supply*, CNN BUS. (Sept. 16, 2019, 4:52 PM), <https://www.cnn.com/2019/09/15/business/oil-prices-donald-trump-spr/index.html>.

11. This statement is not to imply that there is not a highly specialized group of energy lenders and their lawyers in New York, Houston, Dallas, Oklahoma City and other energy financing centers who fully understand and make their living documenting such transactions.

for unwary operators and opportunities for less-than-scrupulous modern day JOA participants to exploit.

As Houston bankruptcy lawyer John Melko observed in 2008, there are still plenty of oil and gas “outfits that [have] more sizzle than steak.”¹² Though a modern “Mr. Green Leisure Suit” may be more disguised than in the early 1980s, challenges in dealing with non-paying participants under JOAs remain much the same. “Mr. Green Leisure Suit,” therefore, can still be relevant as a lesson and metaphor for all non-paying participants under JOAs past and present. It is in that metaphorical sense that I will be referring to “Mr. Green Leisure Suit” through the rest of this paper.

Some things have not changed since my article was first published in 2014. Article VII of the Model Form JOA is the provision in the 2015 Model Form which is most relevant to the problem of non-paying participants. Generally, the changes being brought forward in the 2015 Model Form Operating Agreement to Article VII are relatively minor.

More broadly, the issue of the non-paying participant under the AAPL Form JOA is not new. Provisions dealing with non-paying parties have been found in all versions of the AAPL Model JOA beginning with the first one in 1956. This updated version of my 2014 article is written to benefit new readers who wish to get their arms around the old problem of non-paying participants under the AAPL Form JOA. It is also written for prior readers who want an update so they can remain vigilant in their efforts to avoid this recurring problem. To those past readers who remain indifferent or who have had their fill of the subject, another quote attributed to Moses Hadas may seem appropriate: “Thank you for sending me a copy of your book, I’ll waste no time reading it.”¹³

For an excellent and highly informative account of the history of oil and gas financing from inception of the American oil and gas industry to the near present, and especially the oil industry financing turmoil of the 1980s, see BERNARD F. CLARK, JR., *OIL CAPITAL: THE HISTORY OF AMERICAN OIL, WILDCATTERS, INDEPENDENTS AND THEIR BANKERS* (2016).

12. John Melko, *An ounce of protection is worth a bbl of cure*, *OIL & GAS J.* (April 1, 2008), <https://www.ogj.com/home/article/17294629/an-ounce-of-protection-is-worth-a-bbl-of-cure> (last visited Jan. 27, 2020).

13. BYRNE, *supra* note 2 (crediting a letter written by Moses Hadas).

*III. A Brief Overview of the History and Use of Operating Agreements
in the Upstream Exploration and Production Sector*

Some have said that “history is ...bunk,”¹⁴ but a bit of history may be helpful for putting in perspective non-paying operators and non-operators and how operating agreements have evolved to address the problem.

Let us start by answering what an operating agreement is and why it is needed. In an oil industry context, a joint operating agreement (often referred to by its abbreviated form, “JOA”) can be defined as an agreement between one or more parties to jointly develop an oil and gas lease.¹⁵

So why is an operating agreement necessary? In a sense it is not, or at least not in writing. The Statute of Frauds requires that agreements providing for the transfer of land be in writing, but it does not apply to oral agreements providing for operating an oil and gas well.¹⁶ In my own practice I regularly observe situations where parties operate oil and gas wells with no written operating agreement, despite the fact that the AAPL operating agreement has been around in one form or another for over 60 years. My perception is that this phenomenon has been increasing, which is a troubling, but perhaps not unexpected, development given the complexity of shale plays and the speed with which companies are developing them.

So, what do parties do if there is no written operating agreement? By and large, they simply act as if one is in place. One party obtains a permit to operate the wells or wells, and then it sends joint interest billings (JIBs) to its partners for payment. Courts have found such arrangements legally enforceable.¹⁷

14. Charles N. Wheeler, CHI. TRIBUNE (May 25, 1916) (citing Henry Ford as saying “History is more or less bunk” during an interview); Roger Butterfield, Henry Ford, the Wayside Inn, and the Problem of “History is Bunk,” 77 MASS. HIST. SOC’Y 53 (1965).

15. “Oil and gas lease” here is used in a generic sense, without worrying about distinctions between true oil and gas leases (contracts with property rights attached) and mineral fee (property rights, only).

16. However, those portions of a standard operating agreement which relate to sales of interests in real estate would come within the Statute of Frauds. See Michael E. Smith, *Joint Operating Agreement Exhibits: An Overview*, in OIL & GAS AGREEMENTS: JOINT OPERATIONS, 2 ROCKY MTN. MIN. L. FOUND. (2008) at 12-3 (suggesting that “[w]hile no case was found holding an operating agreement to be within the Statute [of Frauds], consider the following attributes of an operating agreement,” followed by list of eleven different provisions including those covering lien rights, preferential rights to purchase, maintenance of uniform interest, waiver of right to partition and other provisions which arguably come within the ambit of the Statute of Frauds).

17. See *Exchange Oil & Gas vs. Great American Expl.*, 789 F.2d 1161 (5th Cir. 1986) (applying Louisiana law and finding a non-operator liable to an operator when the operator

Operating a well without a written agreement involves risks as well as missed opportunities. First, the legal status of the parties under such an oral arrangement might be construed as a common law mining partnership. A mining partnership is created where co-owners unite to operate a property and share in profits earned.¹⁸ Courts have found that a mining partnership exists with or without a written agreement where each party to a mining situation has the requisite “mutual control” or “active participation” in operations.¹⁹ The law can therefore impose a mining partnership whether or not the parties have expressly agreed. As Professor Ernest Smith²⁰ has stated:

[T]he mining partnership can be described more accurately as a legal concept, rather than a legal arrangement. Unlike the partnership or the tenancy in common, persons rarely knowingly enter in a mining partnership; rather, one party to litigation seeks to have a relationship characterized as a mining partnership so that certain favorable legal consequences will result.²¹

When the law imposes a mining partnership, a couple events occur. First, a new entity has been created for tax purposes which can potentially lead to double or triple taxation (once at the partnership level, then at a corporate level on partnership distributions, and then again when the corporation

detrimentally relied on representations of the non-operator that it pay its share in the costs of the well despite there being no written operating agreement). *See also* William W. Pugh et al., *Don't Get Stuck with the Dinner Check When It's Not Your Dinner: Indemnity and Insurance Issues Under Joint Operating Agreements*, in OIL & GAS AGREEMENTS: JOINT OPERATIONS, 2 ROCKY MTN. MIN. L. FOUND. (2008), at 6-16; *Hunt Energy Corp. v. Crosby-Mississippi Res., Ltd.*, 732 F. Supp. 1378 (S.D. Miss. 1989) (regarding a situation where there was no signed JOA but the non-operator had signed a written AFE.).

18. The three essential elements of a mining partnership are: (1) joint ownership; (2) joint operation (or right to participate in management) and (3) an express or implied agreement to share in profits or losses. Andrew Derman & Isabel Amadeo, *The 1989 AAPL Model Form Operating Agreement; Why Are You Not Using It?*, in OIL & GAS AGREEMENTS: JOINT OPERATIONS, 2 ROCKY MTN. MIN. L. INST. (2008), at 16-14.

19. Derman & Amadeo, *The 1989 AAPL Model Form Operating Agreement; Why Are You Not Using It?* (citing *Dresser Indus., Inc. v. Crystal Expl. and Prod. Co.*, No. 83-1275 (W.D. Okla. Jan 17, 1984), *aff'd* No. 84-1160 (10th Cir. July 12, 1985)).

20. Rex G. Baker Centennial Chair in Natural Resources Law and former Dean at the University of Texas Law School.

21. Ernest E. Smith, *Duties and Obligations Owed by an Operator to Non-Operator Investors and Other Interest Owners*, 32 ROCKY MTN. MIN. L. INST. (1986), at 12-1, 12-5. *See also* Milam Randolph Pharo and Constance L. Rogers, *Liabilities of the Parties to a Model Form Joint Operating Agreement: Who is responsible for what?*, in OIL & GAS AGREEMENTS: JOINT OPERATIONS, 2 ROCKY MTN. MIN. L. INST. (2008), at 5-1.

declares dividends and its shareholders must report the income on their individual returns).

Second, partnership liability becomes joint, not several. For this reason, practically all form written operating agreements since at least the 1950s include a specific disclaimer that a mining partnership is not being created and that liability is several, not joint and collective.

The BP Deepwater Horizon/Macondo disaster illustrates why this liability classification is important. If BP had been pulled into bankruptcy and joint liability had been found, then BP's partners would still have been liable for BP's share of all damages, consequential or otherwise. The theory behind modern, written operating agreements such as the AAPL Model 610 Form is that liability is several, not joint. Non-operators are liable only for their proportionate shares.

Given this perspective, it is easier to understand the industry adage that operating agreements exist primarily to rein in the operator. They do this by (1) providing that liability is to be several, not joint; (2) ensuring that parties have adequate response time to AFEs; (3) incorporating highly detailed accounting procedures; and (4) otherwise imposing duties and obligations on the operator to benefit the non-operators.

This is why some operators seem indifferent to whether a JOA is entered into. They view a JOA as a relinquishment of an operator's otherwise near total control over the pace and scope of development.

It is difficult to imagine what other industry would allow the investment of millions of dollars in joint ventures with no controlling, written document. In some oil and gas companies, particularly the majors, drilling a well without an operating agreement violates delegation of authority guidelines and leads to career limiting (or ending) audit exceptions.

Other oil and gas companies have a more casual attitude, particularly in states, unlike Texas, which have adopted comprehensive and frequently used forced pooling laws.²² If you can force pool another party and enjoy a statutory non-consent penalty (also called a "sole risk" penalty) for doing so, or if you can send JIBs and receive payments anyway, then an operating agreement might seem unnecessary. In shale plays like the Bakken in North Dakota, for example, it is very commonplace for operators to simply ignore the numerous small working interest owners and corral them under a forced

22. The Texas Mineral Interest Pooling Act (MIPA) encourages voluntary pooling rather than a true compulsory pooling act. TEX. NAT. RES. CODE ANN. § 102 (West 2011). *See also*, Ernest Smith, *The Texas Compulsory Pooling Act*, 43 TEX. L. REV. 1003 (1965). In any event the Act is rarely used, at least in comparison with statutes such as those in North Dakota or Oklahoma.

pooling order rather than expend the time and effort required to get all parties to execute an operating agreement. The same is true in Oklahoma, where pre-pooling letter agreements are often substituted for JOAs because they are shorter and quicker to negotiate.²³

Generally, however, not having a written operating agreement is not a best practice. There are at least five significant advantages to having a written JOA. First, in Texas and often in other states, forced pooling can be problematic. Without forced pooling, and absent a written JOA providing for sole risk penalties, you are at risk of having to carry a non-operator with no assurance of recouping any more than the non-operator's share of well costs, i.e., all that you would be entitled to absent forced pooling or a written JOA.

Second, JIBs are easily ignored and often difficult to collect absent written agreements.²⁴ In the absence of a written agreement, attorney's fees are generally not recoverable when suing on a debt.

Third, a written operating agreement can establish a contractual operator's lien on the non-operator's share of production if JIBs are not paid. As noted above, while an operating agreement per se need not be in writing to comply with the Statute of Frauds, the Statute of Frauds requires a written agreement to attach a contractual lien on real property.

An operator's lien is the grant of a security interest by a non-operator which gives the operator the right to foreclose on the non-operator's interest for non-payment of expenses due. Such liens collateralize the assets of the non-operator[s], turning the operator into a secured creditor. Though operator's liens have had deficiencies depending on the form of JOA used,²⁵ they can provide a useful tool in dealing with defaulting non-operators that is not otherwise available under an oral arrangement.²⁶

23. See Jonathan Morris, Address at the Eugene Kuntz Conference on Natural Resources Law and Policy: *Pre-Pooling Letter Agreements: Not a JOA!* (Nov. 17, 2017).

24. Pugh, et al., *supra* note 17, at 16. "Operators have generally been unsuccessful in their attempt to collect "dry hole" drilling costs from a non-operator in the absence of an operating agreement." (citing *Davis Oil Co. v. Steamboat Petroleum Corp.*, 583 So. 2d 1139 (La. 1991); *Zink v. Chevron USA, Inc.*, No. 89-4923, 1992 WL 300816 (E.D. La. Oct. 8, 1992). In the same section of the paper, however, the authors also discuss cases supporting the operator collecting against the non-operator in the absence of a written agreement.

25. See Gary B. Conine & Bruce M. Kramer, *Property Provisions of the Joint Operating Agreement*, OIL & GAS AGREEMENTS: JOINT OPERATIONS, 2 ROCKY MTN. MIN. L. FOUND. 3 (2008) for a discussion of some of the most common deficiencies of JOA operators' liens, which include failure to (1) adequately identify collateral, (2) properly perfect, and (3) attach the lien to after acquired property, among others.

26. There are alternatives to using the consensual lien provided for in the JOA. "For example, in addition to any contractual lien, Oklahoma grants operators of pooled units a

Fourth, a written operating agreement establishes the right of the operator to ask for an advance (also known as “cash call”) on funds needed for next month’s operations. Advances under JOAs are typically due within thirty (30) days.²⁷

The fifth advantage in having a written JOA is that written operating agreements are simply better suited than oral agreements for developing large scale, complicated, capital-intensive oil and gas fields which may be operated over long periods of time. Again, in what other industry would millions of dollars be invested in joint ventures with no controlling, written document?

So, for a myriad of reasons, the oil industry in the United States began using written operating agreements in the early 20th century, and by the 1930s and 40s written operating agreements had become very common. However, each company used its own form as a starting point in negotiations, a cumbersome and inefficient practice. Consequently, in the early 1950s representatives of oil and gas companies, together with independent landmen and oil and gas lawyers, began meeting to discuss the creation of a model form operating agreement. Early efforts centered in the Oklahoma oil and gas community. In 1956, the Ross Martin Company of Tulsa, Oklahoma published the Kraftbilt Form 610 JOA. About ten years later, the American Association of Professional Landmen took the Kraftbilt 610 form under its wing and renamed it the AAPL Model Form 610 JOA. About ten years after that, in 1977, the 1956 610 Form was replaced with the 1977 AAPL 610 Form, and then with the 1982 AAPL Model 610 Form.

statutory lien on participating interests in the unit to secure the costs of operation.” OKLA. STAT. ANN. tit. 52, § 287.8 (2011) (voluntary pooled unit liens); OKLA. STAT. ANN. tit. 52, § 87.1(e) (2011 & Supp. 2015) (forced pooled unit liens).

In addition, and “Unlike Texas, Oklahoma has a trust fund statute that is specific to statutory mineral lien claims and is arguably applicable to joint interest billings.” DEBORAH D. WILLIAMSON & MEGHAN E. BISHOP, *WHEN GUSHERS GO DRY: THE ESSENTIALS OF OIL AND GAS BANKRUPTCY* 134 (2012) (referencing OKLA. STAT. ANN. tit. 42 § 144.2).

Even in states like Texas which lacks comparable statutes to those cited for Oklahoma, there is some authority that a statutory mechanic’s and materialman’s lien could work to the benefit of an operator in a situation where there no written JOA. For example, an argument could be made that the statutory Texas mechanic’s and materialman’s lien (TEX. PROP. CODE ANN. §§ 56.001–56.003 (West 2011)) extends to the operator, because the operator is the person with whom the contract with the mechanic or materialman is made. The statutory lien provisions of Wyoming, Montana, New Mexico and Colorado are similar to what exist in Texas. See Derman & Amadeo, *The 1989 AAPL Model Form Operating Agreement—Why Are You Not Using It?*, *supra* note 18.

27. For more on advance payment requests, see discussion *infra* section A.

It was one of those forms, the 1977 or the 1982 AAPL Form 610 Agreement, that I would have gotten Mr. Green Leisure Suit to sign. My problems with Mr. Green Leisure Suit were not isolated. As oil prices slid in the mid-1980s and U.S. bankruptcy filings for defaulting oil and gas companies occurred on a scale never experienced before, shortcomings in the AAPL Model 610 Form relative to non-paying non-operators and operators became increasingly apparent.²⁸

The problem of dealing with non-paying participants was so severe that the AAPL in the mid-1980s inaugurated still another revision of the AAPL 610 Form then released in 1989. The 1989 AAPL 610 agreement contained numerous new provisions designed to better equip the parties in dealing with defaulting participants. These included expanded advance payment (“cash call”) provisions, provisions allowing the rights of a defaulting party to be suspended, and provisions deeming a party to be non-consenting (and subject to sole risk penalties) if default occurs.

The 1989 AAPL Form JOA has not been without controversy, and some operators either refuse to use it or use it reluctantly because of the perception that the 1989 form made it too easy for the non-operators to remove the operator.²⁹ My advice to clients has been that if this is their only objection, switch out the operator removal provision of the 1989 form with the operator removal provision of the 1982 form. The rest of the 1989 form and particularly those parts dealing with non-paying participants are so superior to the 1982 and earlier forms that there is hardly a contest.

I will no longer need to give this advice because the latest version of the AAPL Form 610 Agreement, the 2015 AAPL Form 610 Operating Agreement, was released in the fall of 2016. This new form was the first major revision of the AAPL 610 Form in more than a quarter of a century.³⁰ This time, one of the principal drivers was to better adapt the form to horizontal drilling operations. In addition, the operator removal provisions of

28. See David E. Pierce, *Transactional Evolution of Operating Agreements in the Oil and Gas Industry*, in *OIL & GAS AGREEMENTS: JOINT OPERATIONS*, 2 ROCKY MTN. MIN. L. FDN. 1 (2008).

29. See *Reeder v. Wood County Energy, LLC*, 395 S.W.3d 789 (Tex. 2012), *opinion supplemented on reh'g* (Mar. 29, 2013) for a discussion of differences in operator removal provisions in the 1989 versus the 1982 versions of the AAPL 610 JOA.

30. The AAPL released a version of the 1989 AAPL 610 JOA with new horizontal modifications in December 2013, but that was an interim revision, not a substantial rewrite like the 1989, 1982, and 1977 revisions. The AAPL officially released the 2015 Form in the Fall of 2016.

the 1989 form were re-written in the 2015 form to put the most common objection to the 1989 form to rest. There are many other upgrades to the form.

To close the history lesson, it is worth noting that the AAPL Model 610 Form has become the most widely used joint operating agreement form in the domestic USA, onshore, oil and gas industry. Through the years competing forms have been introduced,³¹ but the AAPL 610 Form has remained the most accepted model form operating agreement for onshore U.S. oil and gas operations, at least during primary recovery phases and for areas outside the Rockies, and it has had a strong influence on both domestic and international offshore operating agreement forms.

IV. Problems with AAPL Forms Prior to 1989 in Enforcing Operator's Lien

The desire to have a contractual lien in place for enforcement against non-paying non-operators (and operators) was one of the historical drivers for a written operating agreement. The experience of the oil and gas industry in the 1980s, however, revealed that often, the liens provided for in the 1982 and earlier versions of the AAPL 610 Form JOA were not worth the paper they were written on. This was because of the evolution of debtor/creditor laws in the United States, which by the 1980s had rendered unrecorded lien and security interests less valuable and harder to enforce than they had been before.

Specifically, by the 1980s, the U.S. Bankruptcy Code had provisions embedded within it whereby a trustee (or debtor in possession)³² was vested with the rights of a bona fide purchaser of real property (BFP) if when the bankruptcy case was commenced, a hypothetical purchaser could have obtained BFP status. As a hypothetical BFP, the trustee is deemed to have conducted a title search, paid value for the property, and perfected its interest as holder of legal title as of the date the bankruptcy case commenced. The

31. The Rocky Mountain Mineral Law Foundation introduced its own Form 3 in 1959, and the Canadian Association of Professional Landmen has had various forms available since 1969. See Conine & Kramer, *supra* note 25. There are also specialty forms such the Rocky Mountain Mineral Law Foundation Model Form Operating Agreement for Federal Exploratory Units or the American Petroleum Institute Model Form for Fieldwide Units.

32. As a technical matter, the concept of a "trustee" in a federal bankruptcy context exists, for the most part, only in a Chapter 7 liquidation. Most of the time, in Chapter 11, the debtor remains "in possession" and in control of the case and its business and its property, hence the term of art, "debtor in possession" or "DIP." The DIP is vested with, among other things, the powers of a trustee to assume or reject contracts, avoid liens, etc. On occasion a Chapter 11 trustee is appointed to take over operating the business where there has been fraud, incompetence, etc.

trustee was therefore able to avoid any liens or conveyances that a BFP could avoid,³³ including the operator's lien in an unrecorded AAPL 610 Form Operating Agreement.

Now, this problem did not arise overnight, and for many years before a small minority of operators routinely recorded joint operating agreements in county and parish courthouses to perfect their operator's liens. But this procedure was much more the exception than the rule for many reasons, including the per-page cost of recording lengthy documents such as a JOA with all its exhibits in multiple counties or even states if the Contract Area was very large. The number of non-operators going into bankruptcy was perceived to be relatively small whereas the number of operating agreements that would need to be recorded was large. In addition, often operating agreements are not acknowledged and therefore would not qualify for recordation. Rather than undertake the hassle, most operators just threw the dice and took their chances.

Then, in 1987, the Oklahoma Supreme Court ruled in *Amarex, Inc. v. El Paso Natural Gas. Co.* that the filing of a Memorandum of a Joint Operating Agreement would suffice to perfect an operator's lien.³⁴ The industry reacted immediately, and many companies began recording memoranda of JOA.³⁵ The *Amarex* case was highly influential on the AAPL Committee tasked with revising the 1982 Model Form JOA, and the subsequent 1989 version of the AAPL JOA incorporated for the first time a recording supplement. The recording supplement was designed to comply not only with the real property laws of the states insofar as establishing lien priorities but also with security interest provisions of the Uniform Commercial Code (UCC) which had been first introduced in the United States in the early 1950s and was eventually adopted in one form or the other in all fifty states. The UCC greatly expanded upon the breadth and scope of state lien law and provided for the creation and perfection of security interests through financing statements normally filed in the local secretary of state office or equivalent office.

33. The trustee (or DIP) can exercise the rights of a bona fide purchaser ("BFP") regardless of actual knowledge, but the trustee's rights as a BFP do not override state recording statutes and allow avoidance of an interest of which a trustee would have had constructive notice under state law.

34. 772 P.2d. 905, 909 (Okla. 1987).

35. For an example of a recording memorandum in the wake of the *Amarex* case, see ANDREW B. DERMAN, PROTECTING OIL AND GAS LIENS AND SECURITY INTERESTS: USE OF MEMORANDUM OF OPERATING AGREEMENTS AND FINANCING STATEMENTS (1987) (published as part of ABA Natural Resources Law Monograph Series).

This raises an issue sometimes overlooked by landmen and other industry professionals who work with JOAs. Most landmen recognize that to perfect the mineral lien provided for in a JOA, something must be filed in the real property records of the county in which operations occur. This is because before extraction, oil, gas and other minerals are real property.

After extraction, however, oil and gas become goods and are no longer real property. Therefore, the mineral lien would no longer apply. This is why Article VII.B. of the AAPL 610 Operating Agreement establishes both a mineral lien and a security interest in extracted oil and gas. For those unfamiliar with the concept, a “security interest” is a property interest created by agreement or by operation of law over assets to secure the performance of an obligation, usually the payment of a debt. In this sense it is similar to a mineral lien; it gives the beneficiary of the security interest certain preferential rights in the disposition of secured assets. Such rights vary according to the type of security interest, but usually a holder of the security interest may seize, and sell, the property to discharge the debt that the security interest secures.

A type of security interest commonly seen in oil and gas operations is the one provided for by Article 9 of the UCC. A UCC Article 9 security interest differs from a mineral lien because it is an interest in personal property and fixtures, only (i.e. the proceeds of sales of extracted oil and gas and the facilities needed to produce oil and gas such as well-heads, storage tanks, processing facilities and so forth).

Contractual security interests such as the one provided for in UCC Article 9 are therefore entirely different creatures than mineral liens. Mineral liens are real property interests. A mineral lien can be contractual (for example, the contractual mineral lien provided for in the AAPL 610 Form JOA), or it can be statutory. An example of a statutory mineral lien would be a mechanic and materialman’s lien recorded on the county records by an oil field services provider against an oil and gas well operator delinquent on his or her bills.³⁶

A statutory mineral lien might create a foreclosable interest in minerals in place but in Texas, at least, arguably does not attach to the proceeds of production.³⁷ The contractual lien and security interest provided for in the

36. *See e.g.*, TEX. PROP. CODE ANN. § 56.001 (West 2011).

37. *See* David Lauritzen, Speech at the 29th Annual Energy Law Institute of Attorney’s and Landmen: Mechanic’s and Materialman’s Liens in the Third Great Oil Bust (Aug. 31-Sept. 1, 2016) for a detailed discussion of what the author calls the “traditional view” in Texas that mechanic’s & materialman’s liens do not attach to proceeds of production. However, Lauritzen also discusses *Abella v. Knight Oil Tools*, 945 S.W. 2d 847 (Tex. App.–Houston [1st Dist.] 1997) and points out that *Abella* is often cited for the opposite view. *See*

AAPL 610 Operating Agreement in Article VII.B (1977, 1982 and 1989 versions) creates both a mineral lien and a security interest against the non-operator's share of production which explicitly applies not only to oil and gas rights in the ground but to the proceeds from extracted oil and gas.

Recording the JOA memo in the county may suffice to perfect a mineral lien in oil and gas when it is still in the ground. But to perfect a JOA security interest in extracted oil and gas, special steps must be taken under Article 9 of the UCC which go beyond recording the memorandum in the county.

"Perfection" of a security interest is UCC terminology for the process of providing notice to all creditors of security interests in property.³⁸ Essentially, this involves filing a "financing statement" with the secretary of state.³⁹ The authors of the 1989 AAPL 610 JOA recognized the issue and incorporated the most common UCC financing statement requirements into

WILLIAMSON & BISHOP, *supra* note 26, at 17 n.337. *But see also* WILLIAMSON & BISHOP, *supra* note 26, at 116–23. The authors discuss the *Abella* case and highlight that even in Texas, mineral lien claimants might have the right under state law to commence a lien foreclosure action and request the appointment of a receiver who could seize and preserve the proceeds of production. Additionally, the authors express that Oklahoma is a state where mechanic's and materialmen's liens by statute explicitly attach to the proceeds from the sale of produced oil and gas. *See also* OKLA. STAT. ANN. tit. 42, § 144 (2013).

38. *See* Derman & Amadeo, *supra* note 18, at 10.

39. An operator's security interest in proceeds otherwise owed non-paying participants is unperfected under the AAPL 610 JOA unless it is recorded at the secretary of state's (or equivalent) office. To further emphasize consider that in 1983 the Texas legislature enacted a non-uniform, Texas-specific UCC article which gave producers and royalty owners an automatically perfected security interest on severed oil and gas sales proceeds held by a first purchaser *without* the necessity of filing a financing statement. TEX. BUS. & COM. CODE ANN. § 9.343 (West 2011). The thought was that royalty owners, in particular, are apt to be unsophisticated when it comes to compliance with UCC Article 9 financing statement provisions, so an exemption seemed appropriate. The drafters expanded the coverage in 1987 when they amended the definition of "first purchaser" to expressly include the operator who disburses proceeds of production. H.B. 2591, 70th Reg. Sess. (Tex. 1987). Note, however, that § 9.343 (sometimes referred to as the "producer's lien," *See* CLARK, *supra* note 11, at 209) only applies to funds in the hands of a *first purchaser* (or an operator acting in that capacity). It does not relieve the requirement of filing a JOA memorandum as a financing statement at the secretary of state's office in order to attach a lien on proceeds which may be due for unpaid JIBs or other sums due from a participant under the JOA. Other states, likewise, have similar "producer's liens" including Kansas, New Mexico, North Dakota, and Oklahoma. Oklahoma's statute was originally part of its version of the Uniform Commercial Code but was later replaced with a statutory lien by OKLA. STAT. ANN. tit. 52, §§ 548-549.12 (West 1988). *See* CLARK, *supra* note 11, at 208.

a “Memorandum of Operating Agreement and Financing Statement normally attached to the operating agreement as Exhibit H.”⁴⁰

The technical requirements of UCC financing statements can vary from state to state and a detailed discussion of what is required to perfect a security interest under UCC Article 9 is beyond the scope of this article. However, a topic that has come to my attention since I wrote the earlier version of this paper relates to which secretary of state’s office the “financing statement” must be filed in, namely whether the proper office is the one in the state where the Contract Area is located or where the JOA participant is organized

Article VII B of the 1989 Form and the new 2015 AAPL Form JOA both state that:

“to perfect the lien and security agreement provided herein, each party hereto shall execute and acknowledge the recording supplement and/or any financing statement prepared and submitted by any party hereto in conjunction herewith or at any time following execution hereof, and Operator is authorized to file this agreement or the recording supplement executed herewith as a lien or mortgage in the applicable real estate records and as a financing statement in the applicable real estate records and as a financing statement with the proper officer under the [UCC] *in the state in which the Contract Area is situated* and such other states as Operator shall deem appropriate to perfect the security interest granted hereunder.”⁴¹

This language followed Article 9 of the Uniform Commercial Code as it was in place when the 1989 AAPL Model Form Agreement was developed in the late 1980s in that the financing statements were to be filed with the secretary of state in the state in which the collateral was located.

However, in the late 1990s Article 9 of the UCC was amended to address situations where collateral is moved to another state. For example, a hardware store in New Jersey but incorporated in Delaware might take out a loan from a local bank and offer its inventory as collateral. Before the late 1990s changes to the Uniform Commercial Code, the bank would file its financing statement with the New Jersey Secretary of State. But then, unbeknownst to the bank, the hardware store owner moves his store to New York, taking his

40. See e.g., ANDREW B. DERMAN, THE NEW AND IMPROVED 1989 OPERATING AGREEMENT: A WORKING MANUAL (1991) (published as number fifteen in the ABA Natural Resources Law Monograph Series).

41. Emphasis added.

collateralized inventory with him. The collateral in New York is then pledged for another loan and the New York bank then perfects its lien by filing a UCC Financing Statement with the New York Secretary of State. By the time the bank in New Jersey discovered it and refiled the financing statement in New York, the hardware store was bankrupt. The New Jersey bank then discovered it was junior to the New York lienholder.

To address this problem, a revised version of Article 9 of the Uniform Commercial Code came out in the late 1990s. The rules for determining the proper location for filing financing statements are complex. For example, the appropriate place to file a financing statement when the debtor is a registered organization (such as corporations, LLCs, and so forth, a category including the majority of signatories to the AAPL Model Form Operating Agreement) would be the state where the debtor is registered, not the state where the collateral is located, under UCC Section 9.307 (e). The theory was that lenders should not have to continually monitor collateral moving from state to state.⁴²

The problem is, the 1989 AAPL Model Form and now the 2015 Form refer to the Operator's filing the financing statement with the proper officer under the [UCC] "*in the state in which the Contract Area is situated and* [italics and underlining added] such other states as Operator shall deem appropriate...." With a registered entity this would *arguably* mean that the financing statement should be recorded in two places: the state where the Contract Area is located and the state where the JOA participant's entity was registered.

It makes little sense that the person seeking to perfect a lien under the AAPL Model 610 Form JOA would have to go beyond the UCC when it comes to filing UCC financing statements. Surely the drafters of the Model Form did not intend this result. This issue may be for a court to decide, but in the interim, it is important to note that the lien created by the AAPL Model Form JOA is a *contractual* lien, not a statutory lien. All elements of the contract must be met or arguably a statutory lien is void.

Regardless, filing the financing statement in the state where the Contract Area is located is advisable because oil and gas transform from real property to proceeds only after point of sale. Another issue that arises is whether the financing statement must be centrally filed where the secretary of state's office is (usually in the state capital), or whether filing the financing statement in the real property records at a county clerk's office will suffice.

42. See U.C.C. §§ 9-301, 9-307, 9-501 (Am. Law Inst. & Unif. Law Comm'n amended 2003).

There is at least one operator who takes the position that to perfect a lien under the 1989 AAPL Model Form JOA, filing a UCC financing statement in the county records suffices. This is because the 1989 Model Form JOA (and now the 2015 JOA) states only that that financing statement is to be filed “in the *state in which the Contract Area is situated.*” In other words, it is *arguably* unnecessary to file a financing statement at the centralized secretary of state’s office insofar as the contractual requirements of the AAPL Model Form JOA are concerned. Filing the financing statement in the real property records at the county clerk’s office would *arguably* suffice provided that the UCC financing statement is also filed with the secretary of state’s office in the state where the JOA participant’s entity was registered.

But here is a fuller version of the sentence as it appears in Article VII.B of both the 1989 and now the 2015 version of the AAPL 610 JOA:

“To perfect the lien and security agreement provided for herein...Operator is authorized to file this agreement or the recording supplement...*with the proper officer under the Uniform Commercial Code in the state where the Contract Area is situated* [italics added] and such other states as Operator shall deem appropriate...”

The question is, for purposes of interpretation of Article VII.B of both the 1989 and now the 2015 version of the AAPL 610 JOA, is the “*proper officer under the Uniform Commercial Code in the state where the Contract Area is situated*” exclusively the centralized office of the secretary of state (which is typically in the state capital)? Or could the county clerk in whatever county the Contract Area is located be in effect the representative of the secretary of state so the requirements of Article VII.B are met if: 1) the financing statement is filed in the state where the JOA participant’s entity is registered, and 2) filed in the county records? Or would it also be required for purposes of Article VII.B that the financing statement be filed at a third location —the centralized records of the secretary state in the state capital of the state where the Contract Area is located?

There is no case authority that addresses this question. Common sense would suggest that the authors of Article VII.B would have intended that whatever course of action that imposes the least burden on the JOA participant filing the financing statement consistent with the law should win the day. Having to file a UCC financing statement in three locations is not only beyond the UCC as it has been in effect since the late 1990s, but would seem unduly burdensome and beyond the reasonable scope of what the

authors of Article VII.B in both the 1989 and the 2015 AAPL Form JOA forms would have intended.

Another issue raised following the earlier version of this article is “what about as-extracted collateral?” The Uniform Commercial Code at Article 9-301(4) states that liens on as-extracted collateral are to be filed under the local law of the jurisdiction where the collateral is located, which normally means the real property records in the county. There is no requirement that a lien on as-extracted collateral be likewise filed at the secretary of state’s office. As-extracted collateral can include harvested timber, or oil in the tanks or gas in the pipeline. What distinguishes as-extracted collateral from proceeds is point of sale. Before the point of sale, as-extracted collateral such as oil in the tanks retains its real property character insofar as the UCC is concerned; after point of sale it becomes proceeds and UCC financing statement requirements become applicable.

Suffice to say that the rules determining when and where a UCC financing statement is to be filed are complex and can vary depending on the version of the UCC or other laws of the state in place where the Contract Area is located.⁴³ This, of course, sounds very complicated and time consuming for hard-pressed landmen and their attorneys to deal with. So what happens if you are the operator under an AAPL Model Form 610 JOA and you record the JOA in the county (or parish) records, but neglect to file a financing statement with the secretary of state (or file the financing statement in the

43. Though not a JOA case, the seminal 2009 SemGroup bankruptcy case (*Samson Res. Co. v. SemCrude, L.P. (In re Semcrude, L.P.)*, 399 B.R. 388 (Bankr. D. Del., 2009), *add’d* 428 B.R. 590 (D.Del. 2010)) illustrates how important it is to perfect liens in the right place. In July 2008 SemGroup L.P. filed for bankruptcy in U.S. Bankruptcy Court in Delaware after suffering a \$2.4 billion loss incurred when short positions went awry. Despite the fact that the “producer’s liens” had been automatically perfected in Texas pursuant to the Texas version of the Uniform Commercial Code, discussed *supra* in notes 36 & 38 (TEX. BUS. & COM. CODE ANN. §9.343 (West 2011)), the Delaware bankruptcy court held that the automatically perfected lien in Texas would be junior to purchase-money security interests in accounts receivable held by SemCrude because SemCrude, as a Delaware entity, was subject to Delaware law which controlled over the local laws of the states where the producers delivered and sold their oil. Delaware law did not recognize automatic perfection and required financing statements to be filed locally in Delaware. *See CLARK, supra* note 11, at 208–09, and 334–35. The lower priority in the SemCrude case resulted in a loss to the Texas owner’s interest in oil and gas proceeds of approximately \$57 million. *See Ayer, supra* note 26, at 7. *See* further discussion in Ayer, *supra* note 26, at 8. For a more recent, related SemCrude proceeding, see *Arrow Oil & Gas, Inc. v. J. Aron & Co. (In re SemCrude L.P.)*, 864 F.3d 280, 301 (3rd Cir. 2017) where the 3rd Circuit discussed how important it is in order to get the best priority for a Texas producer’s lien to file the financing statement in the state of incorporation of the first purchaser and not rely on automatic perfection.

wrong secretary of state's office⁴⁴), and the operator fails to pay and/or goes bankrupt?

Lenders financing oil and gas operations usually take both a mortgage (or in Texas, a deed of trust) on the real property and a security interest that attaches to the extracted oil and gas as they become goods. First purchasers such as gatherers, processors, pipeline companies, or marketers likewise might give their lenders a lien and financing statement on extracted oil and gas. So the operator under an AAPL Model Form JOA must be prepared to assert its mineral lien and security interest against a variety of lenders and other lien holders who will invariably have filed both mineral liens and financing statements.

Battles between secured lenders and mineral lien claimants over who is first-in-right to oil and gas leasehold collateral and who has the best claim to proceeds of production can be among the most divisive issues in foreclosure, bankruptcy and other creditor's rights proceedings.⁴⁵ Having properly perfected a security interest by filing a financing statement with the proper secretary of state's office may or may not lead an operator to prevail over another secured creditor; but not having properly perfected a security interest by both recording a JOA in the county records and filing a financing

44. For another example of how filing a financing statement in the State where the collateral was located but not in the state where the debtor was registered resulted in a creditor's claim being denied priority, see *Diabetes America, Inc. v. Frank Basile*, 2012 WL 6694074, United States Bankruptcy Court (S.D. Texas, Houston Division 2012).

45. WILLIAMSON & BISHOP, *supra* note 26, at 71. See also Brookner, et al., *Farmout Agreements in Bankruptcy: Lessons Learned from the VNR Bankruptcy*, GRAY REED & MCGRAW LLP, <https://www.grayreed.com/portalresource/lookup/wosid/cp-base-4-100604/media.name=/This%20Land%20Is%20Your%20Land%20This%20Land%20Is%20My%20Land%20-%20Farmout%20Agreements%20in%20Bankruptcy.pdf> (last visited Jan. 28, 2020), at 11. An operating agreement is generally thought of as an executory contract which may be either assumed or rejected within the time frames specified by § 365 of the Bankruptcy Act. However, there are arguments that can be made against rejecting operating agreements as executory contracts, or at least certain parts of them, such as the lien provisions. This gets into the "safe harbor" provisions of the Bankruptcy Code found at 11 U.S.C. § 541(b)(4) and other highly complex provisions and nuances of bankruptcy law which are beyond the scope of this paper. For an excellent discussion of these "safe harbor rules" and many other topics related to oil and gas bankruptcy, see generally Ayer, *supra* note 26. For a particularized discussion of "safe harbor rules relative to farmouts, which can include JOA non-consent interests, and production payments, see Ayer, *supra* note 26 at 20–22. Essentially the "safe harbor" rules exclude certain properties of the debtor and related creditors from the jurisdiction of the bankruptcy court.

statement at the appropriate secretary of state's office seems a near certain path to defeat.⁴⁶

So what happens if an operator files a UCC financing statement in the wrong secretary of state's office, a non-operator goes bankrupt, and the operator's claim filed on behalf of the joint account in the bankruptcy proceeding loses priority due to the improper filing? Can the non-operators sue the operator for negligence in filing the UCC financing statement in the wrong place? First, Article VII.B of the Model Form JOA says that the operator may file UCC financing statements but does *not require* that the operator file a UCC financing statement, so arguably no affirmative duty to file a UCC financing statements exists. Second, Article VII.B of the Model Form JOA authorizes any party to file financing statements so the question might arise if a non-operator sued the operator for breach of duty—why did not the non-operator engage in self- help by filing the UCC financing statement itself?

Those questions aside, the new 2015 Model Form JOA provides relief for an operator who might find itself in a situation where a UCC financing statement was improperly filed or was not filed. Here is the second paragraph of Article XIV.C (“Compliance with Laws and Regulations/Regulatory Agencies”) of the 2015 Model Form with new language underlined and old language from the 1989 form version stricken through:

“With respect to the operations hereunder, Non-Operators agree to release Operator from liability above and beyond its proportionate share of any and all losses, damages, injuries, claims, and causes of action arising out of, incident to, or resulting directly or indirectly from Operator’s interpretation or application of rules, regulations or orders of the Department of Energy or Federal Energy Regulatory Commission or

46. Filing a UCC financing statement should not be looked upon as a one-time occurrence. A UCC financing statement is normally effective for a period of five years after the date of filing and automatically lapses if a continuation statement is not filed/recorded within six months prior to the end of this five-year term. A financing statement's lapse does not terminate the lien. Rather, upon lapse, any security interest that was perfected by the financing statement becomes unperfected. Such loss of perfection renders the collateral clear of the financing lien as against a purchaser of the collateral for value. Therefore, in the event a decision is made to perfect a security interest under an AAPL 610 JOA, a “tickler” file should be set up to remind the operator to file a continuation statement after a period of five years. This decision, of course, requires discipline in today's world where constant churning of personnel and/or overworked staffs tends towards either ineffective follow up and/or a lack of accountability for failures.

~~predecessor or successor agencies~~ any government agency having jurisdiction to the extent such interpretation or application was made in good faith and does not constitute gross negligence or willful misconduct.“

This new language in the 2015 form appears to exculpate the operator from liability for filing a UCC financing statement in the wrong secretary of state's office.⁴⁷

Besides providing for a better method of perfecting an operator's lien, the 1989 AAPL Form JOA and now the 2015 AAPL Form JOA also required the inclusion of future acquired personal property and required the parties to make representations about lien priorities. There were other improvements, in addition. Overall, the lien provisions in the 1989 form and now the 2015 form are a significant improvement over prior versions.⁴⁸

As complex as it may seem, not having a recording supplement executed and properly perfected by recording in county records and with the appropriate secretary of state's office at least in connection with new operating agreements would appear to be a missed opportunity to reduce risk. What bank or other financial institution would not bother to record a mortgage or deed of trust and financing statement to secure an apartment complex or an office building when rents are due and used to secure the loan? Yet, I constantly see situations where sophisticated oil and gas companies simply do not take advantage of the opportunity to record JOA supplements in the county records and/or file financing statements with the secretary of state and thereby make their lien and security interests in minerals and extracted oil and gas junior to other secured creditors. I would surmise this is primarily for reasons of overworked and undermanned legal, land and accounting staff. This may be an area where either reprioritization or an increase in staff may yield dividends. Outsourcing the task is another option.

V. Unique Features of the 1989 AAPL Model Form JOA and Now the 2015 JOA Form in Dealing with Non-Paying Participants

One of the primary drivers behind the revisions to the 1989 Model Form JOA was to better deal with the problem of the non-paying non-operator in the fallout of the oil price crash of the mid-1980s. The recording supplement

47. Thanks to Houston attorney Jeff Weems of the law firm of Staff Weems LLP and member of the 2015 AAPL Model Form Task Force for pointing out to me that this change to Article XIV.C could release an operator from liability for misfiling a UCC financing statement.

48. See generally DERMAN, *supra* note 40.

was only one of the new features. Article VII of the 1989 JOA, Expenditures and Liability of Parties, was the most comprehensive re-write of the section of the AAPL Model Form 610 Agreement dealing with defaults in payment since the form first appeared in the mid-1950s.

The drafters of the AAPL 2015 Model Form JOA have essentially kept Article VII in the 1989 form intact, with a few minor changes. Three provisions of both the 1989 Form and now the 2015 Form can eliminate or at least greatly/considerably mitigate the gaming of the process that Mr. Green Leisure Suit was so successful with at Exxon's expense. These three provisions, all found in Article VII.D, "Defaults and Remedies," are "Advance Payment," "Suspension of Rights," and "Deemed Non-Consent." As usual, there is strength in numbers and it is the interplay among these three, complimentary, sections of the AAPL form that can provide such a powerful deterrent to non-paying behavior.

Some might say, why not perform a credit check on the proposed non-operator at the outset and use that data as the basis for a "go" or "no-go" decision before getting in further with a potential non-paying non-operator? A credit report may be interesting, but as a practical matter, what happens if the report comes back bad? With Mr. Green Leisure Suit, for example, you would still be stuck with a leaseholder who owns a significant portion of your prospect and who refuses to dilute his interest by farming out. Your remaining alternatives absent proceeding with an agreement with Mr. Green Leisure Suit are: 1) to abandon your prospect; 2) to drill the well and carry him under common law co-tenancy principles; or 3) if you are in a state with a strong forced/compulsory pooling regime, to attempt to have a forced pooling penalty imposed.

Common law co-tenancy principles do not provide for sole risk penalties, so carrying a party under common law co-tenancy rules is not always a viable economic option. As for forced pooling, under practically all forced pooling regimes the party being forced pooled must be given an opportunity to join the well. Having to allow a party to join the well as a precondition to forced pooling puts you back at square one. What if he or she says "yes"?

So, consider the other option—holding your nose despite the credit report (or not even bothering with a credit report), and proceeding to have the non-operator execute a 2015 Model Form JOA. Then what happens if the non-operator proves to be non-paying?

A. Advance Payments

The key to avoiding being taken advantage of by non-paying non-operators is relatively simple: get your money up front. If the non-operator

does not have sufficient funds to pay for operations, find out early. The vehicle for doing this is a JOA's "Advance Payment" (cash call) provision. This provision allows the operator to demand advance payment for the next succeeding month's estimated expenditures. Such provisions have been incorporated in all versions of the AAPL Model Form beginning with the 1956 Form. They are also incorporated in the model form accounting procedure published by the Council of Petroleum Accountants Society (COPAS), though COPAS provisions and procedures generally reflect and complement advance payment provisions in the AAPL 610 Form.⁴⁹

Recall earlier that in the instance of Mr. Green Leisure Suit, advance payment was sought. The problem in that situation, and under the earlier AAPL 610 forms before the 1989 form, was what happens if the party ignores advance payment requests and the operator drills a dry hole? An operator's lien in that instance is not worth anything. The operator can sue the defaulting non-operator and attempt to collect the debt, but that can take years and, as in the case of Mr. Green Leisure Suit, can be thwarted by a bankruptcy filing. Even if the well is completed as a producer, nothing would have prevented Mr. Green Leisure Suit from taking the well logs to a bank (or his daddy) and borrowing his share of the drilling costs. He could then pay off any arrearages or operator's liens and come back into the well as if he had been participating from day one with no penalty.

The earlier versions of the AAPL 610 Agreement provided unscrupulous non-operators such "free rides" with no penalty and/or suspension of rights. Perhaps even more galling is that the earlier form AAPL agreements still entitled the defaulting party to receive full well information.

The "Advance Payment" provision now found at Article VII.D.4 of the 1989 and 2015 forms was not conceptually new. What was new about it was that it was tied to a new provision within the same Article VII.D.1, "Suspension of Rights." Under the 1989 and 2015 forms, the initial advance payment may be requested as early as the first day of the month preceding the operation. Once the request for an advance is received, the advance is due within fifteen days under the 1989 form, and within thirty days under the

49. The most recently published COPAS accounting procedure for onshore operations is the 2005 version, which was a revision of a prior version, released in 1984. There was substantially no difference between the 1984 and 2005 COPAS procedures with regard to Advance Payments. See Jonathan D. Baughman and J. Derrick Price, *COPA and the 2005 COPAS Accounting Procedure—Significant Changes for Changing Times*, State Bar of Texas Oil, Gas and Energy Resources Bulletin, Section Report, Vol. 29, No. 3, p. 28 (March 2005) (Appendix—Comparison of Major Provisions in 2005 COPAS Accounting Procedure with 1984 Onshore Accounting Procedure).

2015 form (Article VII.C). The drafters of the 2015 form decided that lengthening the period to thirty days was appropriate given the substantial sums involved in horizontal operations and the difficulties some parties may have in raising such large sums on such short notice.⁵⁰

If payment is not received, the operator may then send a thirty-day Notice of Default. If the Notice of Default period runs with no response, then under Article VII.D.4 of both the 1989 and the 2015 forms the operator may send further notice providing for an immediate cash call of any expenses due from the non-operator anywhere in the Contract Area, irrespective of whether they are or are not related to the new operation. In other words, the operator in this situation is not limited to demanding only the next succeeding month's estimated expenses; instead, the operator can cash call for all remaining estimated expenses in the proposed operation or any other operation in the Contract Area. The expanded cash call is in addition to any other remedies provided for in Article VII, including Suspension of Rights and Deemed Non-Consent.

In addition, though not in either the 1989 or the 2015 forms, I recommend that operators attempt to negotiate a special provision under Article XVI, "Other Provisions," that expands on the "Advance Payment" provision in Article VII of the form to give the operator the right to demand all estimated well expenses for a proposed well (not just the next succeeding month's estimated expenses). This not only reduces the operator's risk of being taken advantage of by a defaulting non-operator, but can reduce the administrative burden on all parties to the operation by eliminating multiple billing of 30-day increments within the same operation.⁵¹ If a non-operator objected to having to prefund such an operation on a time value of money basis, a discount could be factored in. An operator would normally be better off giving a discount to get non-operators to pay all estimated costs up front rather than risk non-payment for succeeding months after the operation is underway and the operator has committed to its completion.

Still another special provision not found in either the 1989 or the 2015 model JOA is a provision providing for an escrow of plugging and

50. Jeff Weems, *Changes Incorporated into the AAPL 2015 610 Model Form Joint Operating Agreement*, Institute for Energy Law 68th Annual Oil & Gas Law Conference (2017), <http://www.cailaw.org/media/files/IEL/ConferenceMaterial/2017/oilgas/weems-paper.pdf>, at 22.

51. See OIL AND GAS LAND: A REFERENCE VOLUME CPL AND RPL EXAM STUDY GUIDE, AMERICAN ASSOCIATION OF PROFESSIONAL LANDMEN 171 (11th ed. 2012).

abandonment costs. This is another form of advance.⁵² Essentially the operator asks the non-operators to contribute a monthly payment to an escrow account to be used when the oil and gas field is abandoned. Otherwise, by the time the need arises production may have depleted, and the operator has nothing to set off against should the non-operator refuse to pay.

B. Suspension of Rights

If the non-operator does not respond within the 30-day Notice of Default Period, then under Article VII.D.1 of both the 1989 and the 2015 forms, “all of the rights of the defaulting party granted by this agreement may upon notice be suspended until the default is cured.” The rights of the defaulting party that may be suspended include (paraphrased):

1. The right to receive information as to any operation (well logs, production tests, etc.)
2. The right to elect to participate in any operation under the agreement
3. The right to receive production proceeds from any producing well (or conversely, the right of the operator to set off liabilities of the non-operator against production).

Mr. Green Leisure Suit, therefore, would no longer be getting the well logs to use for loan purposes. Likewise, he forfeits his rights to participate in any existing production and any future operations. The import of his not being able to participate in future operations becomes apparent when Article VII.D.3 of both the 1989 and the 2015 forms, “Deemed Non-Consent,” is examined.

C. Deemed Non-Consent

The last of the three new features of Article VII.D of the 1989 AAPL form, now carried over to the 2015 form, is perhaps the most erosive one of all when it comes to the rights of a non-paying non-operator. This is the “Deemed Non-Consent” provision found in Article VII.D.3.

52. Though such provisions are often found in offshore and international operating agreements, they are rarer in US onshore JOAs. I credit an article written by Michael C. Sanders and presented at the Rocky Mountain Mineral Law Foundation 62nd Annual Institute for reminding me to mention. See Michael C. Sanders, *Operator Remedies against Defaulting Non-Operators*, 62 ROCKY MTN. MIN. L. INST. § 13.02(1)(e) (2016). Non-operators, of course, are not enthusiastic about advancing such costs as the operator usually gets the use of such funds for long periods of time and could go bankrupt or otherwise mishandle the escrow.

Had either a 1989 Form AAPL Agreement or a 2015 JOA form been in place for use with Mr. Green Leisure Suit, immediately following the expiration of the 30-day cure period after a Notice of Default, Mr. Green Leisure Suit could have been sent a Notice of Non-Consent Election. Mr. Green Leisure Suit would have been non-consent subject to sole risk penalties despite his earlier election to participate. Significantly, his non-consent status would be irreversible. No more waiting the well down and then taking the well logs to a friendly banker to borrow money to get back into the well.

At this point Mr. Green Leisure Suit would have been much worse off than had he farmed out, despite dilution; he would get no overriding royalty during payout as is typical under a farmout and, unless the well was extremely good, would be unlikely to see any income for years (if ever), waiting on multiple sole risk payouts to occur prior to his interest reverting. The operator has the last laugh.

All three of these provisions taken together—“Advance Payments,” “Suspension of Rights,” and “Deemed Non-Consent”—permit an operator to in effect “Blitzkrieg” a non-operator with fast moving notices of default, follow up notices of suspension of rights, and deemed non-consent which cumulatively strip the non-operator of practically all right, title and interest in the Contract Area, at least until the sole risk penalties pay out. As the *coup de grâce*, I recommend one more special provision which can be added under Article XVI, “Other Provisions.” That would be to say that if “deemed non-consent” provisions are invoked due to a non-operator not paying its bills, then the normal sole risk penalties in the JOA are doubled (or even tripled).⁵³

Now, what about the common law rule that liquidated damages must constitute a permissible forecast of damages rather than an impermissible penalty? Would doubling the sole risk penalty in a deemed non-consent situation pass muster with a court?

There is no Texas case directly on point. However, there is authority in Texas for upholding non-consent penalties in a JOA as permissible forecasts of damages.⁵⁴

53. In practice this would mean doubling, for example, the 300% drilling non-consent penalty (or whatever the number may be) due by a non-consenting party to 600% if the party originally claimed to be a fully participating operator.

54. At least one court has viewed non-consent penalties as permissible and held it to be a “...mechanism utilized to allow the consenting parties the opportunity to recover their investments and receive defined returns from future operations.” *Valence Operating Co. v. Dorsett*, 164 S.W.3d 656, 664 (Tex. 2005). Thus, the court removed them from the context of an analysis as a liquidated damages provision

But a provision in a JOA doubling the normal non-consent penalty in a deemed non-consent situation might be pressing the envelope. It is conceivable that a court could find as a matter of law that such a penalty bears no reasonable relation to actual damages. But one could make the argument that such doubling of the penalty is appropriate to compensate not only for actual damages, but for consequential damages as contemplated by the agreement (see discussion which follows). Until an appellate court examines the issue, having additional sole risk penalties in such situations might at least cause a potential non-paying non-operator to think twice.⁵⁵

While on the subject of penalties, the drafters of the 2015 AAPL Form at the end of Article VII. D.3 have included a usury savings clause intended to preclude any non-consent penalty being usurious interest. The provision states as follows:

“to the extent that all or any part of the risk penalty to be recovered pursuant to Article VI.B or Article VI.C, as the case may be, in connection with the provisions of this Article VII.D. 3, is determined to constitute interest on debt, such interest shall not exceed the maximum amount of non-usurious interest that may be contracted for, taken, reserved, charged or received under law.”⁵⁶

This provision was added apparently upon the recommendation of attorneys concerned that clients may be sued for usury due to the imposition of sole risk penalties under the Model Form AAPL Agreement. I am unaware of any case law holdings to this effect but including the provision should put the issue to rest and is another reason to use the 2015 Form.

Something else that many operators forget or at least fail to take action upon when non-operators default is that if a party defaults on its payments to the operator, the remaining, non-defaulting parties may be required by the operator to pay their proportionate shares of the default amounts due to the operator. (Article VII.B, 1989 and 2015 forms.). In other words, the operator need not be the only “banker” for a defaulting non-operator—the other parties to the JOA can be required to bear the burden as well. This is an exception to the normal rule under the JOA that liabilities are several, not joint and collective. If a party refuses to pay their share of the defaulting

55. There has been a move to allow liquidated damages to be judged reasonable or not at time of breach, instead of just at the time of contracting. CALAMARI AND PERILLO, *The Law of Contracts* § 14.31 (5th ed. 2003). See also RESTATEMENT (SECOND) OF CONTRACTS § 356.1 (1981). This trend might bode well for upping liquidated damages when a party breaches a JOA by non-payment.

56. Weems, *supra* note 50, at 22–23 (internal quotations omitted).

party's costs, that party can likewise be put on notice of default, suspended, deemed non-consent and so forth.

D. Attorneys' Fees, Late Payment Interest, Court Costs, Consequential Damages

Last, Article VII of both the 1989 and 2015 AAPL Operating Agreement Forms expand upon prior versions of the 610 Agreement with regard to suits for damages, attorneys' fees, late payment interest, court costs and consequential damages. These are now all available for recovery against a defaulting non-operator despite whether such damages may already be provided for under state law.

There appears to be no case law dealing with what types of consequential damages might be available for recovery against a non-operator in these situations. Given the exhaustive suspension of rights and deemed non-consent provisions that may be used against a defaulting non-operator, fact situations calling for consequential damages may not be common. Lost opportunities in losing a lease by not drilling a well might be such a fact situation if the operator could prove that its line of credit was impaired, for example, by having to cover for a non-paying non-operator and being left short of funds to either purchase a lease or perpetuate it through drilling. This could theoretically make a defaulting non-operator liable for the reserve value of the lost lease, which could conceivably be tens or hundreds of millions of dollars or more in consequential damages. Again, the real power in the consequential damages provision is that it puts another element of risk on the non-operator which in turn might cause it to pause and reflect more before defaulting.

E. Other Changes to Article VII in the 2015 AAPL JOA Form

One other change to Article VII of the new 2015 Form is worth mentioning. Under the 1989 form and prior AAPL forms, if a party was in default for its share of expense, interest, or fees, including improper use of funds by the Operator, the other parties had the right to collect from the first purchaser oil and gas sales proceeds otherwise due the defaulting party until the delinquent amounts are made up. The 2015 form changes this provision (new language in bold and old stricken through as indicated):

*In addition, upon default by any party in the payment of its share of expenses, interests ~~or~~ fees **or other financial obligations under this agreement**, or upon the improper use of funds by ~~the Operator~~ **a party**, the other parties shall have the right, without prejudice to other rights or remedies, to collect from the*

purchaser the proceeds from the sale of such defaulting party's share of the Oil and Gas until the amount owned by such party, plus interest as provided for in Exhibit "C," has been received, and shall have the right to offset the amount owed against the proceeds from the sale of such defaulting party's share of Oil and Gas.

This provision in effect provides for a set-off of indebtedness due from defaulting parties against their share of oil and gas sales proceeds otherwise due from a first purchaser.⁵⁷

So what issues were the drafters of the 2015 form attempting to address by these changes? The first change, the addition of "or other financial obligations under this agreement" (in addition to expenses, fees or interest) appears to address obligations such as a non-defaulting party's share of expenses attributable to a defaulting party as discussed in the preceding section. Attorney's fees, consequential damages, court costs, or capital costs would now also be unquestionably covered if they were not before.

The second change was striking the words "the Operator" and substituting "a party" in connection with improper use of funds. This change was perhaps in recognition that the Operator is not the only party to the JOA who might be entrusted with (or accidentally be paid) common account funds. For example, what if a first purchaser accidentally remitted a larger percentage share of oil and gas proceeds to a party than it was entitled to? Under the 2015 form the other parties would have the right to offset those improperly paid funds against any party to the JOA, not just the Operator.

There were other less noteworthy, grammatical and relatively minor changes made to Article VII of the 2015 form. I applaud the drafters of the 2015 form both for keeping the wholesale revisions of Article VII of the 1989 form in place and for improving upon them.

VI. Issues with Non-Paying Operators

A discussion of non-paying operators under the AAPL 610 JOA can be made relatively short because almost everything brought up so far relative to non-paying non-operators under Article VII of the 1989 and the 2015 form

57. A common question is whether or not funds can be set off against indebtedness arising in other JOA Contract areas or whether funds from other JOA Contract Areas can be used to set off default amounts due from another Contract Area. Sometimes case law in a local jurisdiction provides for set off of obligations under separate contracts while sometimes it does not. Including a broadly worded set-off provision in the JOA might avoid the issue. See Sanders, *supra* note 52, § 13.08 (1).

JOAs likewise applies to operators.⁵⁸ For example, the lien provisions in Article VII.B are reciprocal between the non-operators and the operator. Any party may record the liens and financing statements and the non-operators can demand that the operator, likewise, pay its share of unpaid amounts within 120 days of rendition of a statement. The Suspension of Rights, Deemed Non-Consent, and Advance Payment upon default provisions discussed earlier apply as equally to the operator as to the non-operators.

But who takes the lead among the non-operators in pursuing an operator who is not paying its own bills? This brings up what I believe is an often-overlooked provision imbedded in the 1989 and now the 2015 Model Form JOA. This provision is found in Article VII.D.1, “Suspension of Rights”:

If Operator is the party in default, the Non-Operators shall have in addition the right, by vote of Non-Operators owning a majority interest in the Contract Area after excluding the voting interest of Operator, to appoint a new Operator effective immediately.

What is the trigger for this operator removal provision under Article VII? Unlike the more detailed operator removal provisions found in Article V.B.1 (“Resignation or Removal of Operator and Selection of a Successor”) in both the 1989 and 2015 forms, factual questions such as “good cause” or the operator being “no longer being capable” do not factor in. Nor does the operator have to file bankruptcy or found to be insolvent. All that is required for operator removal under Article VII of both the 1989 and the 2015 forms is that any party, including the operator, “fail to discharge any financial obligation under this agreement...” (Article VII.D).⁵⁹

So, if an operator, for example, were to fail to pay service companies and allow liens to attach to the Contract Area, a majority vote of non-operators could remove the operator. To put this process in play the non-operators would need to send the operator a “Notice of Default” as described above in the discussion of the “Suspension of Rights” provision found at Article VII.B.1. Similarly, the non-operators can send the operator a Notice of

58. This recognition does not minimize issues that can arise between operators and non-operators. For an excellent and much more comprehensive discussion see Michael C. Sanders, Address at the 34th Annual Advanced Oil, Gas & Energy Resources Law Course for the Oil, Gas & Energy Resources Law Section of the State Bar of Texas: Disputes between Working Interest Owners and Operators (September 29-30, 2016).

59. For more detailed discussion of this provision and associated case law, see Christopher S. Kulander, *Old Faves and New Raves: How Case Law Has Affected Form Joint Operating Agreements—Problems and Solutions (Part Two)*, 1 OIL & GAS, NAT. RESOURCES & ENERGY J. 165 (2015).

Deemed Non-Consent, can demand advances from the operator if default amounts are due, can sue the operator for damages including attorney's fees and consequential damages, and can generally avail themselves of all the rights and remedies under Article VII that the operator can pursue against non-paying non-operators.

Is Article VII D.1 a reason for a prospective operator to avoid using either the 1989 or the 2015 AAPL Form JOAs? If it is, the non-operators should be very leery of the prospective operator. Removing an operator for "good cause" as defined in Article V.B. 4 of both the 1989 and now the 2015 JOA forms arguably submits the operator to a relatively subjective standard as the definition of good cause uses words like "gross negligence," "willful misconduct," "material breach," and "material inability or failure to perform."⁶⁰ On the other hand, removing an operator for failing to discharge financial obligations after being given notice and an opportunity to cure under Article VII.D.1 imposes a relatively objective standard. If an operator refuses to pay its share of bills, it should be removed sooner rather than later. Article VII.D.1 of both the 1989 and now the 2015 forms provides a mechanism for accomplishing this.

VII. Conclusion: Best Practices in Avoiding Issues with Non-Paying Participants

The drafters of the 1989 and 2015 AAPL Model Form 610 JOAs have done such a good job in addressing situations similar to the one I encountered with Mr. Green Leisure Suit, that I wonder if a more modern day Mr. Green Leisure Suit (the older one having obviously been much slyer than I had given him credit for) would ever agree to sign a 1989 or a 2015 AAPL Form 610 JOA. His or her attorney should advise of the potentially draconian consequences of default under the 1989 and 2015 forms with their Suspension of Rights and Deemed Non-Consent provisions. That might make the non-operator more seriously consider a farm out, which is probably what any rational individual or small non-operator should consider doing

60. The definitions of "good cause" in both the 1989 and now the 2015 form JOA are nearly identical (new language is underlined and deleted language is stricken through): "*For purposes hereof, "good cause" shall include but not be limited to, mean not only Operators' (i) gross negligence or willful misconduct; (ii) but also the material breach of or 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.*"

before joining a company the size of ExxonMobil in a well and attempting to “run with the big dogs.”⁶¹

The 1989 and the 2015 AAPL JOA forms therefore have the potential of scaring away certain non-operators. This may be an unintended consequence of introducing the 1989 AAPL 610 Form JOA and its changes to Article VII (all being carried over into the 2015 AAPL 610 Form)—some non-operators may prefer not to agree to it at all rather than risk being made subject to the new “Suspension of Rights” and “Deemed Non-Consent” provisions. But does an operator want to do business with a non-operator possessing such an attitude?

Regardless, the following are what the author would consider seven best practices in avoiding issues with non-paying participants under the AAPL Model Form JOA:

1. **Credit Checks.** As mentioned earlier, there are practical problems with running credit checks on non-operators. If the credit report comes back bad, you are still stuck with the non-operator as a co-tenant and must deal with them whether they sign a JOA or not. However, credit checks can be useful. As powerful a tool as Article VII of the 1989 and 2015 JOAs is, it may not make much difference if the well is a dry hole and there is no production to set off against. Having a better idea of the creditworthiness of a proposed JOA participant on the front end can assist in risk mitigation. If the credit report comes back bad perhaps a letter of credit, a bond, a personal guaranty, an upfront advance of *all* well costs, or a combination of the above should be considered.

Credit checks might also be arguably less important in the age of horizontal drilling and fracking because the statistical odds of drilling dry holes have been dramatically reduced. Chances are there will be production in amounts sufficient to recover drilling and completion costs from non-paying operators in horizontally drilled and fracked wells, or at least those wells completed in proven areas. But not all exploratory wells are drilled in shale formations and not all shale wells are sure bets. Attention should always be focused on the creditworthiness of all the participants in a proposed JOA, the operator included.

61. If you do join ExxonMobil or any other large oil company in a well, at least propose a cost overrun provision.

2. **Written JOA.** Always have a written Joint Operating Agreement. Any loss of control by the operator is offset by the advantages of avoiding mining partnership status and rights in dealing with defaulting non-operators.
3. **Make Finalization of the JOA a Priority.** Do not delay getting the operating agreement finalized. If you get nothing else out of this paper, come away with an appreciation of the importance of getting your money up front by invoking the cash call provisions under the JOA. To cash call under a JOA, however, so that suspension of rights and so forth can be a remedy, the signed JOA must be in place. Too often parties postpone the JOA negotiation to a point so late in the process that the well is spudded before cash calls are made. At that point the non-paying non-operator can wait out the notice of default periods before deciding to pay or not and avoid taking the risk of a dry hole if the well reaches target depth soon enough.
4. **Cash Call as Early as Possible.** Exercise your rights to “cash call” (call for advances) early in the drilling cycle. Stay in communication with your company’s (or your client’s) accounting staff and monitor the response of the non-operators. Even if you are operating under an earlier form JOA, a demand letter can be sent (as a prelude to a suit for damages) and an operator’s lien invoked against production should the non-operator ignore the cash call. Also, do not forget that the remaining, non-defaulting parties can have to cover their share of the amounts defaulting parties owe the operator. This is an area where engagement and fast action by the operator in taking administrative advantage of all the provisions of the JOA can yield large dividends.
5. **Record the JOA Memo and Perfect the Financing Statement.** Timely execute and record a JOA Recording Supplement at least in the county, and preferably with both the county and the Secretary of State (for UCC Article 9 purposes). This is a relatively easy process that can reap dividends if a non-operator becomes insolvent. An “ounce of protection...” as a prominent Texas bankruptcy lawyer once wrote, “...is worth [an oil] bbl of cure.”⁶² In addition, create

62. Melko, *supra* note 12, at 2–3. “Get a recordable interest—and record it....Recent bankruptcy cases repeatedly demonstrate that investors have plunked down cash expecting to acquire certain assets, only to find that what was delivered was not everything investors thought they were getting.”

processes that ensure continuation statements are filed after the requisite statutory period (usually 5 years) for the previous financing statement lapses.

6. **Use the Most Recent JOA Form (2015).** Next, switch to the 2015 AAPL Form as soon as possible. The controversial operator removal provisions of the 1989 form have been revised essentially back to the 1982 version. If a non-operator pushed back on the 2015 JOA form because of the “Suspension of Rights” and “Deemed Non-Consent” provisions, it raises the questions, why the protest and do you really want to do business with them?

I have “heard” there are still operators in some parts of the United States (the Appalachian basin was recently cited to me as one area) who are still refusing to consider not only the 2015 and the 1989 versions of the AAPL Form 610 JOA but also the 1982 AAPL Form JOA. In other words, they are still using the 1977 version of the AAPL Form 610 Agreement over 40 years after it was issued and now with the third superseding version released. If this is true— well, let us just say those operators are running against the tide of history. So if you have not done so already, get familiar with the new 2015 AAPL Form JOA and incorporate it wholeheartedly into future negotiations.

7. **Special Provisions.** Last, consider adding special provisions to Article XVI, “Other Provisions,” so 1) an operator can cash call all well costs, not just the succeeding month’s estimated expenditures; 2) to provide that the sole risk penalties in “deemed non-consent” situations are doubled (or tripled); 3) escrow accounts for plugging and abandonment costs; and 4) broadly worded set off provisions allowing revenues from another JOA Contract Areas to be applied against indebtedness (assuming the law of the local jurisdiction allows).⁶³

All of the above of course requires time and effort and today’s overworked landmen, company attorneys and affiliated private counsel or other personnel may question whether the potential benefit outweighs the risk.

63. There are numerous other special provisions that are beyond the scope of this article, but which should be considered when negotiating JOAs. *See, e.g.,* DERMAN, *supra*, note 40, at 127–85. *See also* Mark A. Mathers & Christopher S. Kulander, *Additional Provisions to Form Joint Operating Agreements*, 33 OIL, GAS AND ENERGY SECTION REPORT, STATE BAR OF TEXAS (Dec. 2008).

For justification, I will refer to the paragraph from my earlier article on this subject which I quoted earlier in this paper. The best practices referenced above seem consistent with prudent planning for both worst- and best-case oil price scenarios. Insurance always seems expensive until one has a claim. Providing more insurance for clients and oil companies against insolvent participants by taking some of the simple steps outlined above may be worthwhile in dealing with the uncertainties of the future. As Shakespeare wrote: “[t]o fear the worst often cures the worse.”⁶⁴ In more modern English, planning for a worst-case outcome can sometimes prevent the worst from happening.

As I mentioned in closing the original version of this paper, there is yet one more “best” practice not listed above but still worth considering. If an individual ever comes in your office wearing a very dated green leisure suit with a gold pukka shell necklace and proposes that he partner with your company or your client in an oil and gas well, first—be wary.

Second—ask him to give the author a phone call, there is old business to discuss.

64. WILLIAM SHAKESPEARE, *TROILUS AND CRESSIDA*, act 3, sc. 2.