C. Liability for Costs of Operation

Under the terms of the typical operating agreement, all costs incurred in authorized operations are borne by the parties in accordance with their proportionate interest in the Contract Area.[36] The fractional ownership interests are set out in an exhibit which is attached to the operating agreement.[37] A nonoperator may be held liable for its share of costs even though the billing is delayed for a considerable time after the expense to which it relates has been incurred.[38]

1. Effect of Cost Overruns

As indicated in the preceding section, each party is liable for its share of the expenses even though such costs significantly exceed the original estimate.[39] Indeed, in *Argos Resources, Inc. v. May Petroleum, Inc.*[40] a party was held liable for its share of cost overruns, even though the operator was aware before drilling commenced that its original estimate of costs was too low.

---

[33] *See* Haas v. Gulf Coast Natural Gas Co., 484 S.W.2d 127 (Tex. Civ. App.—Corpus Christi 1972, no writ).

[34] *See* Great Western Oil & Gas Co. v. Mitchell, 326 P.2d 794 (Okla. 1958).

[35] *See, e.g.,* Arkla Exploration Co. v. Shadid, 710 P.2d 126 (Okla. Ct. App. 1985).

[36] 1989 Model Form art. III.B.; M & T, Inc. v. Fuel Resources Dev. Co., 518 F. Supp. 285 (D. Colo. 1981).

[37] *See* Section 17.5(A) of this chapter.

[38] *See* Anchutz Corp. v. Waitz, 582 F. Supp. 1531 (E.D. La. 1984).

[39] M & T, Inc. v. Fuel Resources Dev. Co., 518 F. Supp. 285 (D. Colo. 1981); Cleverock Energy Corp. v. Trepel, 609 F.2d 1358 (10th Cir. 1979).

[40] 693 S.W.2d 663 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).

Nonetheless, there are some instances where a party may successfully resist liability for its proportionate share of costs in excess of those set out in the AFE. The clearest situation is one in which the operator violates the terms of the agreement. For example, in *Haas v. Gulf Coast Natural Gas Co.*[41] an operator who entered into a drilling contract based upon a day-rate basis, rather than a footage basis as specified in the AFE was not permitted to recover the excess drilling costs from the other parties. Even if the operator adheres to all of the terms of the instrument, it may not be able to charge for cost overruns if the operator deliberately understated projected drilling costs in order to induce parties to join in the project.[42] Negligence in estimating costs of the operation may also release the other parties from liability for excess costs, at least if they have relied on the operator's expertise.

The cases holding parties liable for their proportionate share of cost overruns have almost invariably dealt with sophisticated participants who are aware that large cost overruns are common.[43] It is arguable that an unsophisticated investor might limit his or her liability to the estimated costs actually set out in the AFE. This argument may be especially forceful where the prospect has been promoted by the operator who has induced unsophisticated investors to participate.[44]

If a nonoperator is unwilling to take the risk of large cost overruns, a specially drafted clause should be included in the operating agreement or AFE. Such a clause might provide that the specified party has no obligation for costs which exceed a stated percentage of the original estimate. There are, of course, situations where the nonoperator may prefer to impose a limit on expenditures for each stage of the operation, rather than a limit on aggregate expenses. This might be the case if, for example, the operator plans to utilize a process, such as horizontal drilling, with which it has had little or no prior experience; or if past experience suggests that the operator has difficulty controlling costs. If the parties intend to limit a nonoperator's liability for expenses on a stage-by-stage basis rather than an aggregate basis, that intent should be explicitly set out. In *Pegasus Energy Group v.*

---

41 484 S.W.2d 127 (Tex. Civ. App.—Corpus Christi 1972, no writ).

42 *Cf.* Barn v. Maloney, 516 P.2d 1328 (Okla. 1973).

43 *See, e.g.*, M & T, Inc. v. Fuel Resources Dev. Co., 518 F. Supp. 285 (D. Colo. 1981).

44 *See* Robert C. Bledsoe, *Problem Areas in Drafting Operating Agreements—Some Suggested Solutions,* ADV. OIL, GAS & MIN L. COURSE (State Bar of Texas 1981).

Cheyenne Petroleum Co.,[44.1] which involved a JOA clause requiring "written approval . . . for any expenditures which exceeds [sic] the AFEs attached hereto by ten percent (10.00%) or more," the court rejected the nonoperator's argument that the use of the term "AFEs" in the plural and provision for different timing for payment of the nonoperator's share of vertical drilling, horizontal drilling, completion and lifting-equipment costs supported a construction that would have required the operator to get written approval if any of the four listed operations exceeded 110% of its estimated cost.

If limitations on liability for cost overruns are included in the JOA, a provision must also be included specifying which parties are liable for the excess costs and whether their payment of such costs entitles them to an additional share of production. In most instances, a party to an operating agreement who is given special relief when costs exceed the original estimate must also relinquish rights to production until the other parties who have borne its share of the excess costs have recouped all of their costs plus an additional charge.

If none of the nonoperators are willing to pay costs in excess of those set out in the AFE, a clause putting the entire risk of cost overruns on the operator could be included in the agreement.[45] Alternatively, the parties could be given partial protection by a clause requiring the operator to distribute a new AFE if costs exceed the original estimate by a stated percentage.[45.1] Under this type of clause each party could decide whether to consent to continued operations, and those who agreed could continue bearing a share of the expenses originally attributable to the nonconsenting parties. The parties who agreed to continue bearing costs of the operation would then be entitled to the well's production until they had recovered all of their costs plus some additional charge.[46]

2. Remedies for Default in Payment

The operating agreement contains relatively extensive provisions gov-

---

[44.1] 3 S.W.3d 112 (Tex. App.—Corpus Christi 1999).

[45] See the operating agreement described in Smith v. L.D. Burns Drilling Co., 852 S.W.2d 40 (Tex. App.—Waco 1993, writ denied).

[45.1] See the operating agreement at issue in Pegasus Energy Group v. Cheyenne Petroleum Co., 3 S.W.3d 112 (Tex. App.—Corpus Christi 1999).

[46] See Bledsoe, *supra* note 44, for drafting suggestions for these and similar provisions.

erning the rights of the participants when one of the parties to the JOA refuses or is unable to pay its share of costs. Articles VII.B. and C. of the 1982 Model Form and articles VII.B., C., and D. of the 1989 Model Form are the principal provisions setting out the parties' contractual remedies. These include a lien on the defaulting party's oil and gas interests within the Contract Area, suspension of the defaulting party's rights under the operating agreement, a security interest in the defaulting party's share of production, and the right to collect proceeds from the sale of the defaulting party's oil and gas and apply them to the debt owed by that party. These contractual remedies are usually, although not invariably, asserted against a defaulting nonoperator by the operator, whose interests are further protected by the right to demand payment of estimated costs one month in advance.

Priority of the operator's liens and right to proceeds has consistently been upheld. A bank that took a deed of trust against a nonoperator's working interest as security for a loan was deemed to have taken subject to the operator's lien, even though the operating agreement was unrecorded.[47] The court reasoned that the bank was on notice of the preexisting lien because recorded assignments of the nonoperator's working interest contained references to the operating agreement. Similarly, where a nonoperator had failed to pay its share of drilling and well completion expenses, the operator, rather than creditors who had received an assignment of the nonoperator's share of production, was entitled to proceeds from the nonoperator's share of production being held in suspense by the purchaser of production.[48]

A party's failure to make timely payment may have an adverse impact upon the other nonoperators. Article VII.B. provides that if a party fails to pay its share of costs within sixty days, the operator can impose proportionate liability for the unpaid costs upon all of the other parties to the agreement. If the operator exercises its rights under this provision, it is required to bear its proportionate share of such costs also. This is one of the contexts in which a nonoperator rather than the operator may invoke the remedies provided for in the operating agreement.

The remedies set out in the operating agreement are not necessarily

---

[47] MBank Abilene, N.A. v. Westwood Energy, Inc., 723 S.W.2d 246 (Tex. App.—Eastland 1986, no writ).

[48] Enduro Oil Co. v. Parish & Ellison, 834 S.W.2d 547 (Tex. App.—Houston [14th Dist.] 1992, writ denied).

exclusive. An operator may seek a personal judgment against a defaulting nonoperator if the remedies provided under the operating agreement are inadequate to satisfy the debt owed.[49] Moreover, the operator is not required to choose the contractual remedy which is least onerous to the defaulting nonoperator. An operator can foreclose its lien on the defaulting nonoperators' working interests, rather than sell the nonoperators' share of natural gas under the operator's natural gas sales contract.[50]

---

[49] *See* Tiger Flats Prod. Co. v. Oklahoma Petroleum Extracting Co., 711 P.2d 106 (Okla. 1985).

[50] *See* Andrau v. Michigan Wis. Pipe Line Co., 712 P.2d 372 (Wyo. 1986).

[50.1] 1989 Model Form art. VIII.

[50.2] 207 S.W.3d 342 (Tex. 2006) (citing this treatise for the definition and function of an operating agreement).

[50.3] Cauble v. Hanson, 249 S.W. 175, 177 (Tex. Comm'n App. 1927, judgm't adopted), involving the continuing liability of a lessee who reassigned a grazing lease and cited by the court in *Seagull Energy* in support of the proposition that a party remains liable on its contractual obligations after making an assignment of them.

[50.4] The defendant in *Seagull Energy* obtained its working interests at some point after the agreement had been entered into.