

## **Joint Operating Agreements:**

Understanding different interests and concerns in the wake of *Reeder v. Wood County Energy*

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### ***I. Introduction***

When the Texas Supreme Court handed down its decision in *Reeder v. Wood County Energy*,<sup>3</sup> a landmark decision narrowing the scope of operator liability under a widely-used model joint operating agreement, the immediate result was consternation and confusion. Indeed, some commentators, noting the expansive protection for operators in the wake of the decision, even questioned whether joint operating agreements still made sense for the other, non-operator parties.<sup>4</sup> This paper discusses the value of joint ventures; the joint operating agreement that serves as the foundational document for such ventures; the allocation of duties and liabilities between the parties to a joint operating agreement; and the underlying facts, procedural history, and outcome of the *Reeder* case and its implications going forward.

### ***II. The value of joint ventures***

Exploration for and development of oil and gas resources typically is a capital intensive enterprise involving complex, specialized, and expensive equipment that must be used by skilled and experienced workers.<sup>5</sup> The work is often conducted in places fraught with danger: in hostile deserts and deep, unforgiving seas, for example, or areas lacking substantial infrastructure or rife

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<sup>3</sup> *Reeder v. Wood County Energy et al.*, 395 S.W.3d 789 (Tex. 2012).

<sup>4</sup> See e.g., MP Averill and CW Sartain, ‘Operators Liable Only for Gross Negligence or Willful Misconduct’ (Energy and the Law, 2012) <<http://www.energyandthelaw.com/files/2012/09/Reeder-v.-Wood-County-Energy-LLC-et-all.pdf>>, accessed 19 April 2016.

<sup>5</sup> Nkaepe Etteh, ‘Joint operating agreements: which issues are likely to be the most sensitive to the parties and how can a good contract design limit the damage from such disputes?’ (Centre for Energy, Petroleum and Mineral Law and Policy, 2010) <<http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=31272>>, accessed 10 April 2016.

with political conflict.<sup>6</sup> The enterprise itself involves extraction of resources usually from miles beneath the earth. In short, it is a challenging business characterized by high upfront costs and substantial risk.

This risk can be managed through the use of joint venture arrangements in which many parties pool their resources to achieve a common benefit – the development of (and profit from) a lucrative resource – while undertaking only what each deem to be a manageable and acceptable level of risk.<sup>7</sup> Because the parties are able to join together to contribute their financial resources, management experience and technical expertise, they each can afford to participate in more projects. This increases the breadth of their exposure to potential loss, but at the same time reduces the depth of their exposure in any one venture. Like an investor purchasing a diversified portfolio of stocks, joint venturers can participate in many projects while limiting their risk of a catastrophic single failure. This lets them increase or decrease their activity as their own situations warrant, and benefits the industry by allowing more projects access to a greater number of participants and the capabilities they each can bring to bear. Perhaps most important, the fact that there are more players in the industry means there are more places for projects to turn for funding and for other resources, in turn increasing the stability and likelihood of success for each project.

### ***III. The joint operating agreement (JOA): foundation of joint ventures***

Joint ventures are typically organized according by a contract called a joint operating agreement (JOA). “Persons wishing or being obliged by regulation to undertake petroleum operations on a joint basis will have to negotiate and enter into an agreement with each other which sets out the rules and procedures governing their co-operation ... referred to as a joint operating agreement.”<sup>8</sup> A JOA “is a contract between two or more parties creating a contractual framework for a [joint venture] between them,” under which they will conduct operations.<sup>9</sup> Sometimes called

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<sup>6</sup> Eduardo G. Pereira, *Encyclopaedia of Oil and Gas Law*, vol. 1 (Globe Law and Business, 2014) 103-104.

<sup>7</sup> Kosia Kasibayo, ‘Fiduciary relationship between an operator and non-operators under a JOA: do the fiduciary duties get extinguished upon control of the operator by the non-operators?’ (Centre for Energy, Petroleum and Mineral Law and Policy, 2013) < <http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=32786>>, accessed 10 April 2016.

<sup>8</sup> Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 133.

<sup>9</sup> Etteh (n. 5).

the joint venture's "constitution,"<sup>10</sup> the JOA defines and divides obligations and rights among the parties to the venture. Because oil and gas ventures are typically complex arrangements involving multiple parties and activities spanning months or often years, JOAs must be broad and flexible enough to cover the potentially-differing views and interests of all the Parties, and also to respond to changes in those interests over time.<sup>11</sup> In terms of importance, an oil and gas JOA is second only to the host government agreement granting access to the resource itself.<sup>12</sup>

Although all ventures are in some senses unique, there are common issues that arise and must be dealt with in each. These include, *inter alia*, who has the right to day-to-day decision-making, who may commit the venture to what sorts of obligations and what authorization (if any) is required to do so, passmarks, procedures for cash calls and other payments, defaults, exclusive operations and dispute resolution.<sup>13</sup> Rather than pay lawyers to draft a new agreement from scratch for each venture – a process which would likely entail increased cost, delay, and possibility of an impasse that might halt the venture in its infancy – joint venturers typically rely on "form" or "model" agreements that cover most common issues. The form agreements can then be used "as-is" or modified as the parties see fit.<sup>14</sup>

The parties to the JOA fall roughly into two categories: the Operator and the non-operator Participants. These are described in more detail below.

*a. The Operator*

The Operator of a JOA is the person or entity who conducts the day-to-day operations of the entire venture on behalf of the parties who bear the costs and/or share in the benefits of the venture. These parties and their share of the venture's risks and rewards are commonly called "participating interests." The Operator usually holds a participating interest; often, the holder of the largest interest will insist on serving in this role.<sup>15</sup>

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<sup>10</sup> PA Bukari, 'Joint Operating Agreements: how can the most sensitive issues that arise between parties be addressed?' (Centre for Energy, Petroleum and Mineral Law and Policy, 2013) <<http://www.dundee.ac.uk/cepmlp/gateway/index.php?news=32758>>, accessed 10 April 2016.

<sup>11</sup> Etteh (n. 5).

<sup>12</sup> Kasibayo (n. 7).

<sup>13</sup> For a non-exhaustive list of topics typically covered by JOAs, see Pereira (n. 6) 106-120.

<sup>14</sup> *ibid.*

<sup>15</sup> Patrick Murphy, 'Joint Operating Agreements: Should Elements of the AIPN Model Form International Operating Agreement Influence a New AAPL Joint Operating Agreement?' (Association of International Petroleum Negotiators, 2012) <<https://www.aipn.org/StudentComp.aspx>>, accessed 12 April 2016.

Because the Operator carries such a large share of responsibility for success or failure of the joint venture, it is essential that the person or entity selected for the role have sufficient resources and technical expertise to run it. The selection of an Operator may be hotly contested and may be of special interest to related parties, such as the national oil company. Where more than one venturer wants to exercise control or oversight over the joint venture, the participating interests may create a special-purpose entity with multiple owners to serve as the Operator. In the alternative, the participating interests may hire a third party to take this role.<sup>16</sup>

*b. The Participants*

The holders of participating interests who do not act as Operator are the non-operator participants, more commonly referred to simply as Participants. A participating interest generally includes the right to beneficial ownership as a tenant in common of a percentage share of the property, which includes the right to receive and dispose of its percentage share of the petroleum produced under the JOA, as well as the obligation to contribute its percentage share of joint expenses; and a percentage share of all other rights and obligations accruing under the Agreement. Depending on how the JOA is structured, representatives of the non-operator Participants may sit on a Joint Operating Committee (if they have such a mechanism in the JOA) with oversight rights as to certain activities by the Operator.<sup>17</sup>

*c. Third parties*

Although the parties to a JOA are generally only the joint venturers themselves, there are many other parties with direct or indirect relationship with the JOA. These include, *inter alia*, anyone doing business with the venture, or whose interests might otherwise be affected by determining who has the right to enter into contracts for the materials or work needed by the venture, or who might seek to purchase or market the oil or gas produced by it, or a local community. Other third parties such as contractors, unions, and materialmen need to know the scope of authority of the Operator. Insurers need to know the nature and the scope of liability they are underwriting for the venture, its Operator, and the Participants: for example, what claims can

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<sup>16</sup> MK Kanervisto and EG Pereira, 'National Oil Companies Operating in Upstream Petroleum Projects and Participating in Joint Operating Agreements' (OGEL, 2013).

be filed and what defenses asserted, when and by whom. These third parties, however, are outside the scope of this paper.

#### ***IV. The Operator's obligations and liabilities to the Participants***

As previously mentioned, the Operator of a JOA is the person or entity who conducts the day-to-day operations of the entire venture on behalf of the parties who bear the costs and/or share in the benefits of the venture. But what is the liability between the Operator and the non-operator Participants? What kind of losses will be shared by all parties? Should the Operator be exclusively liable under certain types of activities or performance? To answer any question related to the liability of the Operator one must first understand the key points on how the obligations of the JOA parties are commonly established.

First, any JOA should be directly related to the host government instrument which gave rise to the joint venture consortium.<sup>18</sup> This instrument is likely to impose several and joint liabilities for all parties to the JOA.<sup>19</sup> Host governments generally are keen to protect their interests so they can pursue some, any, or all of the JOA parties to enforce the obligations in the host government contract.

Second, the JOA will usually seek to depart from this strict joint and several liability,<sup>20</sup> allocating liability proportionally according to each venturer's participating interest in the JOA.<sup>21</sup>

Third, JOAs generally operate under a philosophy of "no gain, no loss."<sup>22</sup> The Operator ordinarily will not profit from serving in that role, nor bear any incremental risk from doing so.

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<sup>18</sup> Bernard Taverne clearly explains this requirement: "Before being able to undertake any joint petroleum operations the co-operating parties are required to be in possession of a licence or a contract of work. Such licence or contract may be held by the parties jointly in undivided interest, each party possessing a proportional interest in the licence or contract, or by a legal entity which the co-operating parties may have established for this purpose. (...) The parties must make provisions for the joint company to apply for and acquire the required licence or contract." (Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 133.

<sup>19</sup> Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 47.

<sup>20</sup> *ibid.*

<sup>21</sup> See: Chris Wilkinson, *Joint Ventures & Shareholder's Agreements* (3rd ed. Bloomsbury Professional, West Sussex 2009) 3-5 and Gerard M. D. Bean, *Fiduciary relationships, fiduciary duties and joint ventures: the joint operating agreement* (University of Cambridge, Cambridge 1992) 19.

<sup>22</sup> See Sandy Shaw, "Joint Operating Agreements" in Martyn R. David (ed.), *Upstream Oil and Gas Agreements* (Sweet and Maxwell, London 1996) 16, Chris Thorpe, *Fundamentals of Upstream Petroleum Agreements* (CP Thorpe, UK 2008) 126, Hugh Dundas, "Joint Operating Agreements: An Introduction" (1994 Summer Programme: UK Oil and Gas Law, CPMLP 09/09, 1994) 12.

Instead, the Operator bears liability only to the extent of its own participating interest for any action or omission from the conduct of the joint operations. This principle is usually embodied in the JOA in a so-called “exculpatory clause” which provides that simple mistakes and negligence on the part of the Operator impose no special liability; they are instead accepted by the JOA parties as part of the ordinary risks of the venture, with each party bearing their proportional share of any cost stemming from the error.<sup>23</sup>

Fourth, the parties provide reciprocal indemnities to strengthen the effect of the exculpatory clause.<sup>24</sup> In this sense, the principle of no loss is clearly shown. As Peter Roberts notes,

*To reinforce this protection of the operator, the parties (including the party which is appointed as the operator, in its capacity as a party) will also undertake to indemnify the operator (in the proportion of their respective [participating interests]) for any such loss or liability for which the operator might otherwise be responsible. Through this combination of disclaimed responsibility and indemnity coverage, the operator is effectively insulated from liability.*<sup>25</sup>

It is important to note, however, that any indemnity provided in the JOA must be “clear and unequivocal” and/or “conspicuous.” Courts may not enforce indemnity provisions that do not meet these requirements.<sup>26</sup>

Fifth, there are some exceptions to the exculpatory clause as the Operator is not given a “free pass”. The exculpatory clause generally defines the level of the performance required of the Operator, and provides that the Operator must act diligently, prudently and in accordance with

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<sup>23</sup> Peter Roberts describes this issue as follows: “*To this end, the JOA typically provides (in what is sometimes called an ‘exculpatory clause’) that the operator will not be responsible for any loss or liability suffered by a party (or by a third party and claimed against the operator or any of the parties) and which results from the operator having exercised (or having failed to exercise) the obligations which it has under the JOA.*” Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 155.

<sup>24</sup> For further information about indemnities see: Greg Gordon, ‘Risk Allocation’ in Greg Gordon, John Paterson (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 335-382, Ernest E. Smith et al., *International Petroleum Transactions* (3<sup>rd</sup> edn RMMLF, Westminister 2010) 546-579, D. O. Sabey et al., ‘Indemnity and Insurance Clauses in Joint Venture, Farmout and Joint Operating Agreements’ (1970) 8 *Alberta Law Review* 210, J. W. Carter, ‘Contractual Indemnities, Are They Worth Having?’ (2009) 28 *ARELJ* 169, Peter Holden, ‘Commentary on Contractual Indemnities in the Context of Resources Joint Venture Agreements’ (2009) 28 *ARELJ* 176 and Peter Holden, ‘Contractual Indemnities in the Context of Resources Joint Venture Agreements, Some further Thoughts’ (2010) 29 *ARELJ* 171.

<sup>25</sup> Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 156.

<sup>26</sup> Ernest E. Smith et al., *International Petroleum Transactions* (3<sup>rd</sup> ed. RMMLF, Westminister 2010) 546.

applicable laws, regulations and best oil and gas practice.<sup>27</sup> Scott Styles describes this situation as he states that:

*The nature of the duty is usually specified in the JOA as that of “a reasonable and prudent Operator” or as the duty to perform the role of operator in “a proper and workmanlike manner” in accordance with “good and prudent oil and gas field practice”. The exact nature of what counts as good and prudent oil field practice will depend upon the circumstances and will also change as technology changes.*<sup>28</sup>

If the Operator meets this standard of performance in the conduct of the joint operations, it will not be held exclusively liable for any loss or damages; instead, it will only be liable as per the percentage of its participating interest.<sup>29</sup> Even if the Operator fails to maintain this standard, a JOA’s exculpatory clause commonly maintains the previously discussed restriction of liability,<sup>30</sup> except in two situations: gross negligence and reckless misconduct. “A common practice in the industry is to limit the operator’s liability to acts and omissions which are grossly negligent.”<sup>31</sup> In such cases the Operator will not be protected by the exculpatory clause except for unmeasured costs/losses like environmental and indirect losses.

Sixth, it is reasonable to suggest that large oil and gas companies would argue that the “no gain, no loss” principle should always apply and they would not feel comfortable signing a JOA

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<sup>27</sup> Bernard Taverne states that ‘Inasmuch as the licence or contract will stipulate that the petroleum operations should be carried out according to good oil field practice, it follows that the operator is equally obliged to carry out the operations in this manner. (...) The operator is responsible for maintaining an adequately staffed organisation enabling him to fulfil his duties. If a party acting as operator is an affiliated company such party operator is allowed to receive and pay for technical and other assistance and services from his parent company or other affiliated companies.’ Bernard Taverne, *An introduction to the regulation of the petroleum industry: Law, Contracts and Conventions* (Graham & Trotman, London 1994) 136.

<sup>28</sup> Scott Styles, ‘Joint Operating Agreements’ in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 279.

<sup>29</sup> Scott Styles states that “The corollary of the principle that the operator qua operator is not remunerated for his services is that he will usually only be liable qua operator to the non-operators if he is responsible for ‘wilful misconduct’ or fails to maintain insurance ... However, he will not usually be liable for an ‘honest mistake,’ a misjudgement or negligent act or omission.” Scott Styles, “Joint Operating Agreements” in John Paterson, Greg Gordon (eds), *Oil and Gas Law: Current Practice and Emerging Trends* (DUP, Dundee 2007) 279.

<sup>30</sup> Charez Gonvala states that ‘The joint operating agreement will set the standard to which the operator should reference to what other operators would do in similar circumstances.’ Charez Golvala, ‘Upstream joint ventures – bidding and operating agreements’ in Geoffrey Picton-Tubervill (ed.), *Oil and Gas: A practical handbook* (Globe Law and Business, London 2009) 45.

<sup>31</sup> Claude Duval et al., *International Petroleum and Exploration Agreements: Legal, Economic & Policy Aspects* (2nd ed. Barrows, New York 2009) 293.

that imposed additional liabilities on the Operator. Most international oil companies typically serve as Operators and non-operator Participants, depending on the project. But their main concern is sole liability of the Operator as they often take this role. For this reason some JOAs might provide further protections for the Operator as they require an action or omission conducted by a senior supervisor of the Operator rather than anyone to trigger the sole liability of the Operator.<sup>32</sup> In addition, some JOAs might even determine the type of costs or put a cap on the amount of losses the Operator accept to bear exclusively.<sup>33</sup>

Seventh and finally, the limitations on the Operator's liability apply only to the actions performed by the Operator under the authority expressly provided in the JOA. If the Operator acts outside the authority provided by the JOA, it is not covered by the exculpatory clause.<sup>34</sup>

These above-mentioned principles are commonly established in most JOAs around the globe, and the industry is fairly used to them. But the question remains regarding the interpretation and enforceability of these provisions as some of them might be challenged in courts.

With these understandings in mind, we can examine the *Reeder* decision to see how some courts may interpret a common exculpatory clause. This in turn will shed light on the concerns parties should be aware of before negotiating their JOAs.

## **V. *The Reeder decision: Texas further narrows operator liability***

The proximate cause of the consternation noted above was the decision of the Supreme Court of Texas interpreting the scope of the exculpatory clause in *Form 610-1989 Model Form Operating Agreement* of the American Association of Professional Landmen (hereinafter AAPL Form 610-1989). The provision contained what appeared to be minor changes to the wording of prior form agreements. As we shall see, however, even minor changes can have enormous consequences.

The Texas Supreme Court acted on an appeal from a lower court decision, which had substantially affirmed a trial court judgment against an operator in a northeast Texas oilfield. In *Reeder v. Wood County Energy et al.*, 320 S.W.3d 433 (Tex. App. - Tyler 2010) ("*Reeder I*") the

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<sup>32</sup> See AIPN JOA Clause 4.6 (D).

<sup>33</sup> *ibid.*

<sup>34</sup> Peter Roberts, *Joint Operating Agreements: A Practical Guide* (Globe Law Business, London 2010) 156.

12th District Court of Appeals for the State of Texas held that the AAPL Form 610-1989 exculpatory clause did not apply to breach of contract claims, and so the jury verdict awarding damages against the operator was affirmed. In *Reeder v. Wood County Energy et al.*, 395 S.W.3d 789 (Tex. 2012) (“*Reeder II*”), the Texas Supreme Court reversed the lower courts’ decisions and struck down the award, holding that the “plain and ordinary” meaning of the exculpatory clause was broader than the lower courts believed. A brief discussion of the facts of the case is helpful to an understanding of its significance.

*a. Background*

In 1996, several investors formed a joint venture to explore and develop two adjacent and overlapping oil-bearing formations: the Forest Hill Field Harris Sand Unit (“Harris Sand”) and the Forest Hill Field Sub-Clarksville Unit (“Sub-Clarksville”).<sup>35</sup> In 1998, Wendell Reeder (“Reeder”) acquired an interest in Harris Sand and became its Operator. In 2004, Reeder formed a company called Wood County Oil & Gas, Ltd. (“WCOG”) in which he was a 45% owner, to hold his interest in Harris Sand.<sup>36</sup>

Reeder had no prior experience as an oilfield operator, and his relationship with the other venturers deteriorated over time. In 2003, Reeder refused to allow the Sub-Clarksville venturers access to any of the Harris Sand wellbores, despite language in the JOA that gave them the right to use the wellbores to draw from the Sub-Clarksville formation.<sup>37</sup> As Operator of Harris Sand, Reeder sought funds from WCOG for testing or repair of four wells; but the other owners of WCOG (who collectively held a majority interest in the company) denied his request. Eventually, the State of Texas suspended operations at Harris Sand.<sup>38</sup>

In 2004, Reeder sued the Sub-Clarksville venturers, claiming among other things that he had sole right to operate the Harris Sand wellbores and accusing them of pumping oil from Harris Sand in violation of the agreement. WCOG joined in Reeder’s suit as plaintiffs against the Sub-Clarksville venturers. The Sub-Clarksville parties filed claims against Reeder and WCOG relating to the same wells, alleging among other things that Reeder, as successor in interest to the JOA,

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<sup>35</sup> *Reeder I*, 320 S.W.3d at 439.

<sup>36</sup> *ibid.*

<sup>37</sup> *ibid.*, 439-440.

<sup>38</sup> *Reeder II*, 395 S.W. 3d at 791.

breached its terms by pumping oil from the Sub-Clarksville formation and falsely reporting it as coming from Harris Sand.<sup>39</sup>

Prior to trial, the majority owners of WCOG decided to change their litigation strategy. The company dropped its claims for damages against the Sub-Clarksville parties and sued Reeder for damages for his actions as operator, including loss of the Harris Sand unit. They also sought indemnity for any damages that might be awarded against WCOG on the Sub-Clarksville claims.<sup>40</sup>

*b. Trial proceedings*

At trial, Reeder argued that if he was bound by the JOA at all, he was not liable for any breach of contract. He reasoned that the JOA's exculpatory clause protected him from liability except in cases of willful misconduct or gross negligence. The clause was taken from the AAPL Form 610-1989 language and provided in pertinent part

Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.<sup>41</sup>

The trial judge agreed with Reeder's position on the scope of his potential liability and instructed the jurors that to decide against Reeder they had to find he acted willfully or with gross neglect.<sup>42</sup> WCOG objected to the instruction and so preserved the issue for appeal.<sup>43</sup> Despite the instruction favoring Reeder, the jury returned a verdict against him; in so doing, they necessarily concluded that his conduct was the product of willful misconduct or gross negligence. Based on the jury verdict, the trial court entered judgment against Reeder, stripping him of his interest in the Harris Sand unit and ordering him to pay slightly more than \$997,000 USD plus interest.<sup>44</sup>

*c. The intermediate appeal*

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<sup>39</sup> *Reeder I*, 320 S.W. 3d at 440.

<sup>40</sup> *ibid.*

<sup>41</sup> *ibid.*, 444.

<sup>42</sup> *ibid.*, 443.

<sup>43</sup> *ibid.*, 444.

<sup>44</sup> *ibid.*, 440-441.

Reeder timely appealed to the Texas 12th District Court of Appeals.<sup>45</sup> He argued, *inter alia*, that the evidence was insufficient to support a finding of willfulness or gross neglect.<sup>46</sup> The appellate court, however, found it unnecessary to decide that issue. Instead, it concluded that based on earlier case law the exculpatory clause did not protect operators against breach of contract claims. The court relied primarily on its own prior decision in *Castle Tex. Prod. Ltd. P'ship v. Long Trusts*, 134 S.W. 3d 267 (Tex. App. - Tyler 2003) (pet. denied). That case found no protection for the operator of an oilfield against breach of contract claims despite exculpatory language in the JOA taken from the prior (AAPL Form 610-1982) form contract, which provided

[Operator] ... shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of, this agreement. It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.<sup>47</sup>

Because the appellate court had concluded the 1982 version of the exculpatory clause offered no protection from breach of contract claims, and found “no meaningful difference” between that version of the clause and the 1989 version, it concluded that the AAPL Form 610-1989 exculpatory clause offered no protection for Reeder against the breach of contract claims.<sup>48</sup> Because WCOG had timely objected to the jury instruction on the scope of the clause and the appellate court found the instruction was more favorable to Reeder than it should have been, Reeder lost his appeal.

According to the appellate court, it didn't matter whether there was enough evidence to prove Reeder acted willfully or with gross neglect because that was not the proper legal standard to use in evaluating his liability. All that mattered was whether he breached the contract.<sup>49</sup> Assessing the evidence under a conventional breach standard (which generally doesn't require proof of willful misconduct or gross negligence), the court found the evidence was sufficient to

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<sup>45</sup> *ibid*, 441.

<sup>46</sup> *ibid*, 445.

<sup>47</sup> *ibid*, 444, citing *Castle Tex. Prod. Ltd. P'ship v. Long Trusts*, 134 S.W. 3d 267, 283 n. 4 (Tex. App. - Tyler 2003) (pet. denied).

<sup>48</sup> *ibid*.

<sup>49</sup> *Reeder I*, 320 S.W. 3d at 444.

support the jury verdict and the judgment of the trial court.<sup>50</sup> It affirmed the award of damages against Reeder with only minor technical modifications.<sup>51</sup>

The appellate court decision was consistent with decisions by other Texas courts. In four previous cases, four different Texas appellate courts interpreted similar exculpatory clauses in the same narrow fashion, holding that evidence of willfulness or gross neglect was not required in a breach of contract claim against the operator.<sup>52</sup> Although there was one federal case that interpreting the clause more broadly,<sup>53</sup> that decision was not binding on Texas state courts.<sup>54</sup> The Texas Supreme Court had never addressed the issue; in fact, it refused to review two of the four prior cases where the question had been raised, letting the rulings in those cases stand.<sup>55</sup>

*d. Appeal to the Texas Supreme Court*

At first glance, it seemed that the judgment against Reeder was on solid legal ground. Nonetheless, he petitioned the Texas Supreme Court for review of his case and the court granted the petition, entertaining argument in February 2012. Six months later, the court rendered a decision in Reeder's favor, reversing the trial court jury verdict and the appellate court decision that affirmed it.<sup>56</sup>

After reciting substantially the same facts as the lower court,<sup>57</sup> the Texas Supreme Court noted that "the primary concern" of courts asked to resolve contract disputes is to "ascertain the true intent of the parties as expressed in the instrument."<sup>58</sup> Addressing this question, the court concluded that in one important respect the trial court was right and the appellate court wrong. The "plain and ordinary meaning" of the exculpatory clause, the Texas Supreme Court held,

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<sup>50</sup> *ibid*, 447-448.

<sup>51</sup> *ibid*, 453.

<sup>52</sup> In addition to the *Castle* case cited above, the Texas courts of appeal issued rulings narrowly interpreting the exculpatory clause in *IP Petroleum Co., Inc. v. Wevanco Energy, LLC*, 116 S.W. 3d 888 (Tex. App. - Houston 2003); *Cone v. Fagadau Energy Corp.*, 68 S.W. 3d 147 (Tex. App. - Eastland 2001) (pet. denied); and *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W. 3d 741 (Tex. App. - El Paso 2000).

<sup>53</sup> *Stine v. Marathon Oil Co.*, 976 F. 2d 254, 261 (5th Cir. 1992).

<sup>54</sup> On questions of state law, U.S. federal courts sitting in diversity generally apply state law; but state courts do not generally apply federal law unless there is a federal question presented by the litigation. *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78, 58 S. Ct. 817 (1938). No such federal question was asserted by Reeder.

<sup>55</sup> The *Castle* case and the *Cone* case, cited above.

<sup>56</sup> *Reeder II*, 395 S.W. 3d at 789. Most U.S. court systems only allow one appeal as of right; any further review is discretionary with the superior appellate court.

<sup>57</sup> *ibid*, 791-792.

<sup>58</sup> *ibid*, 794.

extended to breach of contract claims.<sup>59</sup> The jury instruction given by the trial court was proper, even though the court of appeals thought it was too favorable to Reeder.

In reaching this conclusion, the Texas Supreme Court noted that the AAPL Form 610-1989 exculpatory clause differed from its predecessors: whereas the earlier clauses covered only “operations,” the 1989 language covered “activities.”

Exculpatory clause language from AAPL Form 610-1989:	Exculpatory clause language from AAPL Form 610-1982:
<p><i>Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and in accordance with good oilfield practice, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.</i></p>	<p><i>[Operator] ... shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.</i></p>

According to the court, the change in language made all the difference. Citing law review articles published in 2001 and 2005 suggesting the word “activities” gave the 1989 version broader scope than the previous word “operations,” the court held the change in wording provided a “more expansive exoneration for the Operator” than before. The court reasoned that by using the newer clause, the JOA parties at Harris Sand and Sub-Clarksville must have intended to provide additional protection to the operator, thus shielding Reeder from mere breach of contract claims.<sup>60</sup> In order to prevail against him, the court held, the other parties had to prove Reeder’s willful misconduct or gross negligence.

Of course, under the trial court instruction, the jury necessarily concluded that Reeder *had* acted willfully or with gross neglect. But the Texas Supreme Court was just getting started. Even though the jury was properly instructed, the court concluded that the jurors reached the wrong conclusion. Under prevailing Texas law, a jury’s factual determinations must be upheld unless the evidence is so weak that no reasonable jurors could have reached the same conclusion.<sup>61</sup> Reviewing the trial evidence, the court decided the jury was wrong to find against Reeder because

<sup>59</sup> *ibid*, 795.

<sup>60</sup> *ibid*, 794.

<sup>61</sup> *ibid*, 795, citing *City of Keller v. Wilson*, 168 S.W.3d 802, 807 (Tex. 2005).

the evidence was insufficient to find either willfulness or gross neglect.<sup>62</sup> Accordingly, the court reversed the judgment as to the breach of contract damages against Reeder. In the end, he still lost his rights in Harris Sand, but the million-dollar judgment (inclusive of interest) against him for breach of his obligation as its Operator was entirely wiped out.<sup>63</sup>

*e. Analysis*

The Texas Supreme Court concluded that when the parties to the JOA agreed to the 1989 model contract, they intended its exculpatory clause would extend to breach of contract claims against the Operator. The court cited no any evidence supporting its conclusions: there was no testimony by the parties or their representatives concerning negotiation of the JOA, no correspondence or other contemporaneous documentary evidence discussing the scope of the clause, and nothing about Reeder's understanding of the clause when he took on his duties as Operator of Harris Sand. The court could have remanded the case with instructions to take evidence on the parties' intent, but such extrinsic evidence is generally not required (and generally not admissible) when the terms of the agreement are clear and unambiguous.<sup>64</sup> By reversing the judgment of the trial court rather than remanding, the Texas Supreme Court necessarily found that the exculpatory clause of AAPL Form 610-1989 so clearly covered breach of contract claims that there could be no other reasonable interpretation of its scope.

The obvious rejoinder – that the parties had no reason to believe that exculpatory clause reached such claims because no Texas court had ever said so – was not addressed in the *Reeder* decision. In fact, the earliest authority relied on by the court was a law review article written in 2001, five years *after* the original parties signed the JOA and three years after Reeder became Operator of Harris Sand. To the extent the parties to the JOA had taken time to research the scope of the exculpatory clause or consult legal counsel regarding it, they would have found no authority warning them that the broad interpretation was correct.

As a practical matter, it is unlikely that the original JOA parties or Reeder gave the scope of the clause even the slightest thought. Certainly there is no evidence in the record that they did. Moreover, the language of the clause itself speaks to standards of care that could be interpreted to

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<sup>62</sup> *ibid*, 796.

<sup>63</sup> *ibid*, 797-798.

<sup>64</sup> *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W. 2d 517, 521 (Tex. 1995).

cover tort claims rather than contract claims, suggesting that the issue is not so clear-cut as the Texas Supreme Court suggests. Nonetheless, based on the substitution of the new language word “activities” for the prior word “operations,” the court held that all the parties *must have known* contract claims were covered, even though no court in Texas had ever said so. That ruling is now binding law in all courts in Texas.

## **VI. Action post-Reeder**

The *Reeder* decision controls not only cases brought in Texas state courts; it also must be applied by all federal courts sitting in diversity in that state and any other tribunal required to apply Texas law.<sup>65</sup> In 2014, the U.S. federal district court for the Southern District of Texas applied *Reeder* to dismiss claims against Chesapeake Exploration LP, the Operator in a joint venture based in the Barnett Shale.<sup>66</sup> To the extent that other breach of contract claims against operators in Texas are pending or may arise, potential plaintiffs will need to evaluate their position in light of *Reeder*. Although prior language exonerating operators from all but willful misconduct or gross negligence in “operations” is not a defense to breach of contract and a case alleging breach under a JOA using that language need not prove willfulness or gross neglect, a breach of contract claim under a JOA with the new “activities” language will have to do so. The case may be able to proceed even under the higher standard if the evidence of willfulness or gross neglect is sufficiently strong; but as *Reeder* and his business associates learned, the plaintiffs’ odds of prevailing are markedly lower.

This takes us back to a relevant question raised in the wake of the *Reeder* case: why should would-be participants even bother with a JOA that may include onerous provisions that such as “non-consent penalties of 300% or more rather than the common law rule of straight cost recoupment, restrictions on assignment rather than free alienability of property rights, and the granting of liens for failure to pay costs” if operators are expansively insulated against liability?<sup>67</sup> This is not an entirely unreasonable query. The “golden age” of oil and gas development, in which “there was an assumption of mutual good faith among the members of a joint venture,” is over.<sup>68</sup> Complex and detailed JOAs protect venturers against predation and, in some instances, may be the

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<sup>65</sup> *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78, 58 S. Ct. 817 (1938).

<sup>66</sup> *MDU Barnett L.P v. Chesapeake Exploration L.P.*, No. H-12-2528 (S.D. Tex., Feb. 14, 2014) (mem. op.).

<sup>67</sup> Averill & Sartain (n. 4).

<sup>68</sup> Eduardo G. Pereira, ‘Protection against Default in Long Term Petroleum Joint Ventures’ (Oxford Institute for Energy Studies, 2012), 2.

only plausible vehicle for vindication of their rights. But willfulness and gross neglect are very high standards: if an operator can now be absolved of responsibility for all of his contractual obligations (or at least shielded from any possible lawsuit) absent such egregious behavior, participants may be on very shaky ground. Some commentators suggest that former JOA parties may now prefer common-law co-tenancy in mineral rights.<sup>69</sup> Such co-tenancies provide for accountings, rights to the proceeds of the mineral estate, and duties of good faith that must be exercised by superior interest holders, including a good-faith duty to develop the resource.<sup>70</sup> In the post-*Reeder* world, one might ask whether the parties would get substantially the same rights without an agreement.

The short answer is “no.” First: The world is not limited to Texas, and *Reeder* decision only binds courts obligated to follow Texas law. Even where the 1989 language absolving operators of liability for “actions” is part of the JOA, other courts may not choose to read the language as broadly as did the Texas Supreme Court. A participant in another jurisdiction is free to argue the Texans just got it wrong; and an operator who assumes he now has *carte blanche* to engage in cavalier treatment of the participants may be in for an unpleasant (and costly) verdict to the contrary.

Nonetheless, the *Reeder* case will provide ammunition for operators in future cases to argue that even where there is no binding precedent *requiring* a broad reading, there is now persuasive authority to do so. The *Reeder* decision may not mandate an operator-friendly result outside Texas, but as a decision from a jurisdiction with significant impact on the oil and gas industry, it may persuade tribunals that such a result should be rendered. It would therefore behoove participants who have not already reviewed their JOA’s exculpatory clause to do so as soon as possible, to ascertain what rights they may have – or not have any longer – in the event of an operator breach.

Second: Relying on mineral co-tenancy rights rather than a JOA is an inherently risky proposition. Those rights, to the extent they exist at all, can vary substantially from one place to the next. Each party would have to conduct extensive (and possibly very expensive) research into the applicable law to know how the mineral estate value would be calculated, adding a layer of

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<sup>69</sup> Averill & Sartain (n. 4).

<sup>70</sup> David E. Pierce, ‘Transactional Evolution of Operating Agreements in the Oil and Gas Industry’ (Rocky Mountain Mineral Law Foundation, 2007).

complexity and risk onto an already-uncertain business assessment. With added risk comes added cost for insurance, reserves, and other forms of contingency planning and mitigation, and fewer opportunities in which the would-be venturer might afford to participate. The *Reeder* decision doubtless came as an unpleasant surprise to many; but it is difficult to see how a state court unconstrained by contract language and given unfettered discretion to realign the parties' rights according to its own notions of common-law tenancies would be better.

In fact, the industry has already spoken decisively on this point. Even before the advent of the modern form JOA, oil and gas professionals recognized that co-tenancy rights were not enough to order the affairs and structure of an enterprise as inherently complex, expensive, and risky as oil and gas field development. The earliest form contracts, starting with the 1956 AAPL Ross-Martin form, drew on more than a dozen existing JOA contracts.<sup>71</sup> The cost and complexity of hydrocarbon development today – where the fiscal, legal, and technical regimes are far more intricate and demanding than 60 years ago – may provoke a certain nostalgia for the past, but there is no plausible way to turn back the clock.

Third: It may be difficult to find anyone qualified and willing to be an operator in the absence of clearly-defined obligations and authority. Qualified parties may not choose to accept uncertain and potentially broad liability in an environment where there is no JOA to protect them – and this risk would likely be compounded in the absence of any tools (such as default provisions) to enforce compliance and cooperation of the parties who would have been non-operator participants in a JOA. Given that operators will likely always insist on some level of exculpation, the key for would-be participants is to negotiate better exculpatory clause language, or conduct better due diligence regarding the proposed operator – or both.

Moreover, the risk to participants from their peers' malfeasance may be at least as great in the absence of a contract as the risk from the operator. A “defaulting party may be happy to be losing its participating interest if the liabilities are greater than the value of the assets,” as typically happens during the decommissioning process or when the resource is underperforming.<sup>72</sup> Even where the JOA does not provide the expected protection against one party, it can still reduce risk as to the others.

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<sup>71</sup> *ibid*, 14.

<sup>72</sup> Pereira (n. 68), 14.

Finally: without the structure and clear lines of authority created by a JOA, third parties may be reluctant to do business with the venture. Without a single entity speaking on behalf of the venture, their risks would multiply without any corresponding upside. Though there would still be businesses willing to provide goods and services for development of the resource, the price would have to be scaled up to reflect this increased risk. Insurance for all parties would likely become vastly more expensive, if it could be obtained at all. A JOA may not cure all the ills that can beset a joint venture but still be worth having.

## **VII. Conclusion**

In private business, what matters is profit,<sup>73</sup> and accurately estimating the likelihood of profit from a given enterprise can make the difference between successful businesses and those that fail. The *predictability* of rights and obligations can be more important than their *substance*, because companies will review the available opportunities, price their participation, and choose their ventures accordingly. If a proposed JOA contains language like AAPL Form 610-1989 the would-be participant deems too onerous, they can either insist on amending the language or refuse to be part of the venture. From this perspective, the final decision in *Reeder* was problematic not because it allowed the Operator of Harris Sand a far-reaching defense against liability, but because it gave him a defense that was broader than the courts were previously willing to give. The other parties could with some justification say they were not able to price their risk properly because the authorities relied on by the Texas Supreme Court in 2012 did not exist when they entered into the JOA in 1996, or when Reeder became Operator two years later.

There may today be other parties in similar positions: with contracts whose exonerations for the operator are now different from what they expected. In the wake of the *Reeder* decision, they must reassess their liability and reprice their rights and obligations accordingly. If the risk is too great, they need to reinsure or sell their interest. The JOA remains a valuable tool for spreading risk and reward, even if the balance has shifted for some in a post-*Reeder* world.

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<sup>73</sup> *ibid*, 1.