Operators Liable Only for Gross Negligence or Willful Misconduct

By: Martin P. Averill[1] and Charles W. Sartain[2]

On August 31, 2012, the Texas Supreme Court issued its long-awaited decision in *Reeder v. Wood County Energy, LLC et al*. The decision addresses the scope of the exculpatory clause in the 1989 AAPL Form 610 Joint Operating Agreement. *Reeder* has important ramifications for both Operators and Non-Operators, and could materially alter the manner in which those parties negotiate their respective contractual rights with respect to jointly owned prospects in the future. It will also impact existing litigation and the parties' rights under existing Joint Operating Agreements.

The 1989 Form JOA

Various provisions of the 1989 Form, in particular Article V.D "Rights and Duties of Operator," appear to impose mandatory duties on the Operator—the phrase "Operator shall" is used liberally throughout. Moreover, Article VII.A imposes upon all parties an "obligation . . . to act in good faith in their dealings with each other with respect to activities hereunder." The COPAS Accounting Procedures, Exhibit C to the JOA, also contain various ostensibly mandatory duties and impose a dispute resolution process in Paragraph 5 regarding audits by non-Operators. Texas courts have for many decades addressed non-operator's claims that operators allegedly breached of these duties, as well as more creative tort-type claims such as negligence, fraud, unjust enrichment, constructive trust and breach of fiduciary duty.

Despite all of these seemingly mandatory obligations for the Operator, one clause in the Agreement could trump them all. Article V.A.1 of the 1989 JOA provides: "Operator shall conduct ***its activities under this agreement*** as a reasonable prudent operator, in good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulation, but in no event 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." (Emphasis supplied). The difference between this language and the language in Article V.A.1 of the 1977 and 1982 Forms is that the earlier forms required the Operator to "conduct ***all such operations*** in a good and workmanlike manner . . . ." (Emphasis supplied).

What Did The Court Decide?

The question before the Court was whether breach of contract claims are viable against operators under a standard 1989 Form JOA. The Court held that breach of contract is not a viable cause of action for non-operators, reasoning that Article V.A.1's "exculpatory clause" shields operators in Texas from liability for all but gross negligence or willful misconduct. This decision departs from prior Texas appellate decisions interpreting the differently worded exculpatory clauses in the 1977 and 1982 Form 610 JOA. In those cases, the courts held that the exculpatory clause was limited to operational activities rather than all activities under the JOA.

According to the Court, relying on "legal commentators" in the industry, this change in verbiage was a "meaningful difference" that broadened the clause's protection of operators: The phrase "such operations" in the earlier forms limited the clause's scope to operational activities on the Contract Area or at the wellsite rather than to all actions under the JOA, while the new language of "its activities under this agreement" applies to everything the Operator does in its role as the designated Operator under the JOA.

With this decision, the Court essentially adopted the reasoning of the United States Court of Appeals for the Fifth Circuit in the 1992 decision *Stine v. Marathon Oil Co.*—where the Fifth Circuit exempted operators from liability (under the 1977 Form) for "any acts done under the authority of the JOA 'as Operator' "—and left little wiggle room for a contrary view: "Because the parties modeled their joint operating agreement after the revised

[1] Martin P. Averill is a Member of Looper Reed & McGraw P.C. in Dallas, Texas, specializing in oil and gas transactions and litigation.
[2] Charles W. Sartain is a Shareholder in Looper Reed & McGraw P.C. in Dallas, Texas. His practice focuses on litigation and oil and gas matters.

exculpatory clause in the 1989 Form, the operator is exempted from liability for activities under the agreement unless the liability arises from gross negligence or willful misconduct."

The Litigation

The parties were not getting along on major operations decisions. Reeder, the operator, sued Wood County Energy (in which he was a 45% partner) and the other non-operators alleging that as operator he had the exclusive right of possession of certain well bores and for other claims. The defendants counterclaimed that he illegally produced oil, fraudulently reported oil from one formation as being produced from another, and failed to sustain production in the quantities required by the JOA. All parties alleged conversion, violations of the Texas Theft Liability Act, and other misdeeds.

The jury found that Reeder breached his duties as operator. The non-operators were awarded damages and a declaration that Reeder owned no interest in the two formations at issue. The Court of Appeals agreed but the Supreme Court reversed. After holding that only gross negligence or willful misconduct were actionable under the 1989 Form, the Court then examined Reeder's conduct in light of the evidence and found "no evidence that Reeder knew about the peril but did not care about the consequences."

The Takeaway

What impact will *Reeder* have on future joint operations in Texas and litigation about joint operations?

A. Litigation and disputes under existing 1989 Form JOAs

After *Reeder*, and under the express terms of the exculpatory clause, Non-Operators may still sue Operators for gross negligence or willful misconduct, but proving these claims is very difficult under existing Texas law. As explained in *Reeder*, gross negligence has both an objective and a subjective component. *Transp. Ins. Co. v. Moriel*, 879 S.W.2d 10, 21–22 (Tex.1994). In examining proof of the subjective component, courts focus on the defendant's state of mind, examining whether the defendant knew about the peril caused by his conduct but acted in a way that demonstrates he did not care about the consequences to others. Determining whether an act or omission involves peril requires "an examination of the events and circumstances from the viewpoint of the defendant at the time the events occurred, without viewing the matter in hindsight."

Aside from gross negligence (total lack of care) or willful misconduct (the Operator did it on purpose), non-operators will have an uphill climb attempting any other type of claim. Non-Operators likely cannot sue for standard negligence because the JOA exists. Under longstanding Texas precedent, where a contract exists to govern the parties' relationship, tort claims (a "tort" is a legal wrong in violation of a duty) are unlikely to succeed.

Non-Operators cannot sue for breach of contract, which is directly foreclosed by *Reeder*. Claiming a breach of fiduciary duty will likely fail, as fiduciary duties are expressly disclaimed in Article VII.A of the 1989 Form. Even without this express limitation, past precedent from Texas courts indicated a general reluctance to impose fiduciary duties on Operators except, rarely, in extreme cases of self-dealing in the handling of joint monies (i.e., a species of "willful misconduct").

But there could be many ways that a Non-Operator could be severely damaged by an Operator's actions that might fall short of gross negligence or willful misconduct. For instance, if a COPAS dispute arises and the non-operator is correct that incorrect charges were made to the joint account, what cause of action would the non-operator assert against the Operator to remedy the improper charges? This example is even more interesting in light of the COPAS Exhibit's inclusion of a dispute resolution mechanism which expressly contemplates the possibility of a lawsuit after mediation. Another example: If the Operator negligently fails to obtain the required insurance and an incident happens which results in a release event, a blowout, or harm/death, or property damage for third parties, and the Non-Operators are sued, will the Non-Operators be able to assert indemnity claims against the Operator? Or if the Operator fails to secure the necessary equipment and labor to drill a well and leases are subsequently lost, what claims remain for the Non-Operators to remedy the damage caused? In all of these examples, if the Operator's

conduct was not intentionally wrong or grossly negligent, but merely just a mistake, it is reasonable to question whether under *Reeder* the aggrieved non-Operator, despite being right, will have any ability to remedy the mistake.

If an Operator's breach relates to a financial obligation, Article VII.D of the JOA might present an interesting dilemma after *Reeder*. Article VII is titled "Expenditures and Liability of Parties." Article VII.D.1 addresses "Defaults and Remedies," and allows non-Operators to appoint a replacement Operator effective immediately if the Operator fails to cure its default within thirty days of notice thereof. Article VII.D.2 allows "Non-defaulting parties" to sue to collect the amounts in default for the benefit of the joint account and at joint account expense and further provides: "Nothing herein shall prevent any party from suing any defaulting party to collect consequential damages accruing to such party as a result of the default." The viability of this provision after *Reeder* may hinge on the difference between the Operator <u>as Operator</u> and the Operator as just another working interest owner. As operator, the Operator has very little actual financial responsibility (vis-à-vis the Non-Operators) for the costs of joint operations—the working interest owners pay those costs as a general matter. Thus, this provision may be relevant only in cases where the Operator who owns an interest in the Contract Area does not pay its proportionate share of costs for its <u>working interest</u> in the Contract Area.

Finally, removal of the operator remains viable, but would do nothing to remedy past harms. The Operator may be removed only for "good cause" by a majority vote of Non-Operators. "Good cause" is defined in Article V.B.1. to include gross negligence and willful misconduct, but also "the material breach of or inability to meet the standards of operation contained in Article V.A. or material failure or inability to perform its obligations under this agreement." A material breach, generally, is one that is significant enough to destroy the value of the contract, rather than a minor failure to comply with the contract's terms. Regarding removal, injunctive relief may be available to Non-Operators, and in fact may be easier to obtain in light of *Reeder*. Since Non-Operators arguably have no ability to obtain a damages award for negligence or standard breaches of contract, they may have no "adequate remedy at law," one of the elements necessary to obtain an injunction.

Given their limited ability to fix operational miscues after the fact, Non-Operators in Texas would be well advised to heighten their monitoring of operations, notices, lease issues and financial issues. Simply relying on the Operator to get things done is no longer a reasonable manner of conducting business.

<u>**B.**</u> <u>**Future joint operations**</u>

At the end of the day, the parties to any contract have the ability to define their relationship and expectations in that contract. Naturally, knowing and trusting your Operator is an obvious good business practice for any working interest owner in any state. Parties with longstanding relationships and plans for future operations will want to maintain those relationships and resolve disputes amicably. But due diligence and past practice go only so far.

If total operational exemption from liability is not intended by the parties to a JOA, the exculpatory clause should be modified to specifically reflect the intended limits of the Operator's exemption. In addition, even though it would not fix the harm already done, non-Operators may wish to make removal of an Operator easier by shortening the removal timeframe, broadening the definition of "good cause" for removal, or deleting good cause altogether and allowing removal at will. *Reeder* also presents potential new disclosure and risk warning dilemmas for those in our industry raising capital from third parties through private placements—if something goes wrong, investors will want recourse that may no longer be available after this decision.

If an Operator will not modify the JOA's form language as requested by a Non-Operator, the Non-Operator could refuse to sign the JOA and rely instead on its common law rights and remedies with regard to the development and operation of jointly owned minerals. It is fair to question, after *Reeder*, just what benefit Non-Operators receive from being a party to the JOA. If the Operator is insulated from any liability for its actions under the JOA except for, essentially, purposeful malfeasance or complete lack of care, and other provisions therein actually constrain Non-Operators and penalize them in certain circumstances—including among others 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—Non-Operators may simply decide to forego the decades-old practice of entering into a JOA and fall back on their common law rights as co-tenants.