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The Oil And Gas Operator's Texas Advantage

Law360, New York (May 17, 2013, 11:57 AM ET) -- A recent Supreme Court of Texas decision, Reeder v. Wood County Energy LLC, et al., has clarified the extent to which oil and gas operators can be held liable by nonoperators under the 1989 model form operating agreement of the American Association of Petroleum Landmen. Joint operating agreements usually include an exculpatory provision eliminating an operator's liability, absent the operator's gross negligence or willful misconduct. Because an operator takes on the risk of conducting drilling operations on behalf of its other co-tenants and is not doing so to make a profit, the exculpatory provision limits the operator's liability.

Texas and Fifth Circuit case law, however, has varied regarding whether an exculpation clause should apply to the operator's breach of contract in addition to its operations on the drill site. Under Reeder, an operator cannot be held liable, as operator, for either a breach-of-contract claim or its activities in connection with field operations under the 1989 joint operating agreement, except in cases of its gross negligence or willful misconduct. As a consequence, the court's holding in Reeder grants vast protection to operators using the 1989 joint operating agreement that may be unintended.

To understand the implication of Reeder, however, it is useful to review the conflicting interpretations of previous AAPL model form joint operating agreement exculpatory clauses by the Fifth Circuit and Texas Court of Appeals. The 1977 and 1982 AAPL model form joint operating agreements include an identical exculpatory clause, requiring an operator to "conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to the other parties ... except as may result from gross negligence or willful misconduct."

In 1992, the Fifth Circuit interpreted the 1977/1982 exculpatory clause in Stine v. Marathon Oil Company. Under Stine, the court held that protection of the exculpatory clause included not only acts unique to the operator but all acts of the operator under the joint operating agreement. As a result, the court concluded that the 1977/1982 exculpatory clause eliminated an operator's liability for any breach of the joint operating agreement, except in cases of its gross negligence or willful misconduct.

Although the language of the 1977/1982 exculpatory clause differs from the exculpatory clause included in the 1989 joint operating agreement, as discussed below, both Stine and Reeder held that exculpatory clauses covered an operator's breach of the joint operating agreement in addition to tort claims arising from field operations.

Conversely, the Court of Appeals of Texas in 2000 examined the 1977/1982 exculpatory clause in Abraxas Petroleum Corporation v. Hornburg and held that because the clause is located in a provision outlining the operator's responsibility for operations in the contract area, the clause is limited to only an operator's duties with regard to drilling operations. Under the Abraxas approach, an operator can be held liable for any breach of the joint operating agreement but can only be held liable for any actions related to operations upon a finding of gross negligence or willful misconduct.

The exculpation clause from the 1989 model form interpreted in Reeder is slightly different language than the 1977/1982 exculpatory clause. Under the 1989 model form, the operator is required to "conduct its activities under [the] agreement as a reasonably prudent operator," as opposed to "conduct all such operations" as required by the 1977/1982 exculpatory clause.

The court in Reeder found it significant that the 1989 joint operating agreement referred to "its activities under [the] agreement" rather than "all such operations" as used in the 1977/1982 exculpatory clause. Noting that the change broadened the exculpatory protection for an operator, the court interpreted the 1989 language as exculpating an operator for all activities under the 1989 joint operating agreement, including a breach of the joint operating agreement itself rather than only the operator's actions relating to field operations. Under Reeder, an operator is not liable for any action taken under the 1989 joint operating agreement, including a breach of contract, unless its conduct is due to gross negligence or willful misconduct.

The Reeder interpretation of the 1989 joint operating agreement grants vast protection to operators, but by doing so, it is perceived by some as muddling the differences between tort and contract law.

Under Reeder, it does not matter whether an operator acted negligently while conducting drilling operations and caused nonoperators harm or whether it failed to fulfill its contractual obligations under the joint operating agreement. Although the first is a tort claim and the second a breach-of-contract claim, nonoperators cannot hold an operator liable under Reeder for either unless they can show gross negligence or willful misconduct — a difficult standard to prove. Thus, post-Reeder, the broad scope of the exculpatory clause is somewhat problematic for nonoperators.

Traditionally, nonoperators could not hold an operator liable for tort claims, since the operator took on the parties' risk when it agreed to conduct operations. However, nonoperators usually held the expectation that they could sue an operator for a breach-of-contract claim just as they could sue another nonoperator. This understanding aligns with the Abraxas interpretation of the exculpation clause, which limited the clause to operator actions in the contract area. The Reeder decision, although based upon slightly different exculpation language, expands exculpation to all of the operator's actions under the joint operating agreement.

The broader implication of Reeder remains somewhat unclear, as the Supreme Court of Texas decision only impacts parties using the 1989 model forms in Texas. However, other jurisdictions such as Colorado, which does not have settled law on the matter, may find Reeder's analysis useful when interpreting similar exculpatory clause language in joint operating agreements.

The Tenth Circuit, for example, looked to Stine when interpreting the 1977/1982 exculpatory clause, eventually holding that such clause did not universally exculpate an operator and therefore did not bar a claim against the operator for breach of the joint operating agreement.[1]

What is clear from Reeder is that parties entering into a joint operating agreement using any of the AAPL model form joint operating agreements need to carefully consider how broadly exculpation and indemnification clauses should apply to the operator of the contract area. If the parties determine that the exculpation clause should only apply to tort claims, the AAPL joint operating agreement should be amended to specifically clarify exactly what types of claims the exculpation clause covers.

Further, nonoperators should consider revising the AAPL joint operating agreement to include additional covenants that protect them from a contractual default by the operator, even if the language of the exculpation clause has been revised.

Although Reeder, Stine and Abraxas are only a few of several opinions in recent years that interpret operator exculpation under the AAPL model form joint operating agreements,[2] the outcome of the opinions demonstrate that the issue remains divisive, and representatives of both operators and nonoperators should be wary of entering into a joint operating agreement without carefully considering the effect of the exculpation provision among a joint operating agreement's other covenant obligations.

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[1] Shell Rocky Mt. Prod., LLC v. Ultra Res., Inc., 415 F.3d 1158 (10th Cir. 2005).

[2] See, e.g., Shell Rocky Mt. Prod., LLC v. Ultra Res., Inc., 415 F.3d 1158 (10th Cir. 2005); Cone v. Fagadau Energy Corp., 68 S.W.3d 147 (Tex. App. Eastland 2001) (holding that a nonoperator can hold an operator liable for a breach of contract claim without a showing of gross negligence or willful misconduct); PYR Energy Corp. v. Samson Res. Co., 470 F. Supp. 2d 709 (E.D. Tex. 2007) (questioning the holding in Stine based on recent Texas appellate court decisions such as Abraxas, but determining that it is required to follow Stine's precedent).