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Willful Misconduct Defined, How Broad Is That Exception to Your MSA?

Article By:

Timothy R. Cook

In Texas, most Master Service Agreements related to the oil and gas industry provide indemnities based on who or what was injured rather than who caused the injury. For example, the standard knock-for-knock indemnity will provide that an operator will defend and indemnify the contractor for injury to the operator's employees even if the injury to the operator's employees is wholly caused by the fault of the contractor. Similarly, in turn, the contractor will defend and indemnify the operator for injury to the contractor's employees regardless of the operator's fault. The reasoning behind this is that each party is better suited to control and watch over their own employees and purchase insurance for their own employees to mitigate the risk. In a similar fashion, often the most catastrophic risks (pollution, wild well, underground damage) are borne disproportionately by the operator because the operator is in the best position to supervise the site and purchase insurance to cover the risk.

However, almost all MSAs have an exception to their no-fault indemnities for particularly egregious conduct, with most carving out an exception for injuries caused by "willful misconduct" or "gross negligence" of the party seeking indemnification. Gross negligence has long been defined under Texas law, and is even codified by statute, as requiring proof of two elements:

(A) [ ] when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and

(B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others. (Tex. Civ. Prac. & Rem. Code § 41.001(11))

As for "willful misconduct" though, there has been a nearly complete lack of Texas case law defining the term despite its presence in the vast majority of MSAs.

In May, the Houston (14th) Court of Appeals issued its opinion in *Apache Corp. v. Castex Offshore, Inc.*, providing the first concrete, working definition for willful misconduct from a Texas court:

"deliberate mismanagement committed without regard for the consequences." For those who believed that willful misconduct provided a higher standard than gross negligence (more akin to intentional harm) the opinion likely comes as a surprise.

In *Apache*, the operator (Apache) was sued by a non-operating working interest owner (Castex) for the operator's overspending on a project that ballooned from an initial Authorization for Expenditure ("AFE") of $16.9 million to a total cost of $102 million. Castex argued that Apache's knowing and repeated decisions to exceed the budget (without adequate excuse for the same) showed a level of misconduct far beyond mismanagement or negligence. A provision in the parties' joint operating agreement provided that Apache would only be liable for conduct amounting to gross negligence or willful misconduct. A jury found that Apache did not commit gross negligence, but did find that the increased cost was caused by Apache's willful misconduct.

On appeal, Apache argued that willful misconduct required "a subjective, intentional intent to cause harm" and that because Apache clearly did not intend to drive up costs (of which it was 75% responsible) it was not liable for willful misconduct. The court of appeals rejected Apache's suggestion, however, and created a definition based on an intent to do a wrongful act (regardless of the consequences) rather than a specific intent to bring about the consequences. The court held that evidence that showed that Apache deliberately, and repeatedly, disregarded the budget and spent in excess of the AFE (and chose not to submit a supplemental AFE for months) amounted to sufficient evidence of willful misconduct.

So, what does this mean for your MSA? Well, as every lawyer will tell you… it depends. The Houston Court of Appeal's focus on "deliberate mismanagement" will likely make certain scopes of work (such as consultants) more susceptible to the exception than others. Further, the definition of willful misconduct is not going to be uniform across all 50 states and may not even stay the same in Texas if the Texas Supreme Court overrules the Houston Court of Appeals. Given the potential confusion regarding the definition of willful misconduct then, the best route might not be to delete the exception, but to define the term "willful misconduct" in the MSA to what the parties actually intend the term to be.

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