Choice-of-Law Considerations when Drafting Arbitration Provisions for International Oil and Gas Agreements

**I. INTRODUCTION**

In 1987, a Texas court applying New York law awarded Pennzoil Company over $7 billion in actual damages and $1 billion in punitive damages in a lawsuit against Texaco, Inc.2 That case, which sent one of the world’s largest oil companies at the time into bankruptcy, is an example of the importance of choice of law. A key issue in the case was New York’s requirement that binding agreements, even if preliminary, carry a duty of good-faith performance.1 No such duty exists under Texas law. Would the result have been different if Texas law applied? Although the Pennzoil case is often criticized for incorrectly applying New York law, it nevertheless highlights how important choice-of-law issues are in high-stakes disputes.

The majority of international contracts contain alternative-dispute-resolution provisions, such as arbitration clauses, to provide greater certainty when resolving business disputes. Much has been written about the perceived benefits of arbitration and how to draft an effective arbitration clause that, among other things, eliminates the risk of potentially biased local courts and creates a more streamlined process to avoid expensive, prolonged litigation. Accordingly, this article will not retread old ground addressing any of those issues.

Instead, this article examines a contractual provision that receives less attention than the arbitration clause, but that is just as important: the choice-of-law clause. That provision determines what substantive law applies to a contract and any related dispute.

Choosing the right law is important in the oil and gas industry because many aspects or customs are industry-specific or unique. For example, parties often joint venture concerning exploration, forming “areas of mutual interest” or AMIs, and joint, but limited, rights to geological and geophysical data. Companies may also forming “areas of mutual interest” or AMIs, and joint, but limited, rights to geological and geophysical data. Companies may also “farmout” acreage or allow a party to “back-in” after a certain defined (or all too often undefined) “payoff.” An “Operator” may handle marketing arrangements for the oil and gas of other working-interest parties, creating questions of what duties the Operator owes to the “non-operators.” Host-government contracts may create uncertainty in determining, for example, the calculation of royalties or taxes, when certain operations “commence” or “conclude,” when wells are producing in “economic quantities,” what expenses are cost recoverable or deductible, the definition of concepts such as “field,” what is retained at the end of the exploration phase, etc. With increasing frequency, host-government national oil and gas companies are executing operating and other agreements, containing a choice of law other than the host-government law. Some of these agreements are integrated or cross-referenced in the host-government contract and, thus, affect its interpretation.

Choice-of-law selection may also depend on the party’s role in the transaction. When negotiating with a foreign government, the goal may simply be to select a jurisdiction of well-established law to avoid the uncertainty of the host country’s undeveloped law—and to pick a jurisdiction with which the host government will be equally comfortable. When negotiating with partners, parties may wish to consider the differences in the substantive law of each jurisdiction from which they are choosing. An Operator may prefer the law of Texas, for example, whereas a non-operating party may not.4

Given all these issues—and the amount of money at stake—this article briefly surveys the law of New York, Texas, and England to highlight certain issues that typically arise in oil and gas transactions and disputes. All three jurisdictions are commonly named as applicable law in contracts. Each jurisdiction has its advantages and disadvantages that should be weighed before making a choice-of-law selection.

**II. COMPARING THE LAWS OF NEW YORK, TEXAS, AND ENGLAND CONCERNING COMMON ISSUES THAT ARISE IN OIL AND GAS AGREEMENTS**

**A. The scope and extent of an Operator’s fiduciary duties to non-operators**

Owners or participants in oil and gas exploration and producing ventures commonly enter into agreements to govern the performance of activities, including the drilling and operation of...
well.

The typical governing agreement for operations is termed the “Operating Agreement,” and numerous form agreements are available for use by parties. In general, the participants select an Operator to be responsible for the day-to-day operations and monitoring of activities. Even when the participants elect to have an operating committee composed of the participants’ representatives to advise the Operator, the Operator is charged with monitoring activities and either performing the work in the field or making sure the work gets done by contractors. The participants may independently market their own production or rely upon the Operator to make arrangements for the sale of production.

Because an Operator typically collects and handles money from the participants related to operations—and in some instances may distribute proceeds from production—and because the Operator may have varying degrees of involvement in the operations for the non-operators, issues commonly arise concerning the scope of the Operator’s duties to the non-operators. A well-drafted Operating Agreement will attempt to define the scope and limits of the Operator’s duties and liabilities; for example, an Operating Agreement may insulate the Operator from liability except in cases of “gross negligence” or “willful misconduct” and expressly deny any fiduciary duty to the non-operators. Nevertheless, due to the nature of the relationship between the parties, non-operators often claim the Operator is in a position of trust and owes special or additional duties to the non-operators. As substantial sums are typically at stake, it is important for Operators to know the extent of their liability as Operators.

New York. There are no oil and gas cases that definitively rule on whether an Operator owes a fiduciary duty to non-operators under New York law. In general, New York law does not hold that parties to a commercial contract owe fiduciary duties to each other “unless they specifically so agree, or if one party’s superior position or superior access to confidential information is so great as virtually to require the other party to repose trust and confidence in the first party.” Whether one party is a fiduciary of another depends on the relationship between the parties. “[A] simple breach of contract is not to be considered a tort” (such as breach of fiduciary duty) “unless a duty independent of the contract itself has been violated.” New York courts also generally decline to characterize a co-tenant relationship as a partnership or agency.

However, under New York law, “every contract contains an implied covenant of good faith and fair dealing in the course of performance of the contract.” “Compassed within the implied obligation of each promisor to exercise good faith are ‘any promises which a reasonable person in the position of the promisee would be justified in understanding were included.’” Such implied covenants also include “a pledge that ‘neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.’”

Texas. A relatively large and well-developed body of Texas case law defines the rights and duties of Operators under Operating Agreements. Although parties can voluntarily assume fiduciary duties to one another by structuring their Operating Agreement relationship as a partnership, most oil and gas companies characterize their relationships as purely contractual. Operating Agreements typically provide expressly that the parties’ liability is several, not joint, and that the parties do not intend to enter a mining partnership or other association that might render the parties liable as partners.

As a result, Texas courts have consistently held that there is no fiduciary relationship between Operators and non-operators under typical Operating Agreements. This is in part because the Operator controls operations and the Operating Agreement states the parties are severally (not jointly) liable. The Texas Supreme Court has held that a contract does not give rise to fiduciary obligations absent a special “confidential relationship” between the parties, and a breach of an ordinary contractual relationship does not form the basis for an action in tort, such as a breach-of-fiduciary-duty claim.

England. English courts rarely have considered contractual disputes involving Operating Agreements. Fiduciary duties may be derived under common law, especially where the Operator is

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Derman, Golding, Katz, and Melsheimer

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*One New York court has cited Oklahoma law for the proposition that lease Operators have an implied covenant to market oil and gas at the highest available price for the benefit of royalty owners. See La Borde v. Seneca Res. Corp., 728 N.Y.S.2d 618, 622 (N.Y. App. Div. 2001). Although the New York court characterized this covenant as a fiduciary duty, it did not expressly adopt it as a rule of law for New York.


*Id. at *6.


*See id. at 6, n. 15.

*See, e.g., Luling Oil & Gas Co. v. Humble Oil & Ref. Co., 191 S.W.2d 716, 722 (Tex. 1945) (courts will not imply special relationship between corporations unless expressly provided in contract); Youngstown Sheet & Tube Co. v. Penn, 355 S.W.2d 239, 245 (Tex. Civ. App.—Austin 1962) (same), modified and aff’d on other grounds, 363 S.W.2d 230 (Tex. 1962); Ayco Dev. Corp. v. G.E.T. Serv. Co., 616 S.W.2d 184, 186–87 (Tex. 1981) (mere contract, without more, does not establish special relationship like partnership or joint venture, unless contract provides required elements); Hamilton v. Tex. Oil & Gas Corp., 628 S.W.2d 316, 320–21 (Tex. App.—El Paso 1982, writ ref’d n.r.e.) (no fiduciary duty because no joint venture; joint owners may contract without creating a partnership or joint venture), disapproved on other grounds by Valence Operating Co. v. Dorsett, 164 S.W.3d 656 (Tex. 2005). But see Atl. Richfield Co. v. Long Trusts, 860 S.W.2d 439, 443, 445 (Tex. App.—Texarkana 1993, writ denied) (Operator viewed as having fiduciary duty as a result of selling non-operator’s production).

*See, e.g., Hamilton, 648 S.W.2d at 321.


*See Inland Revenue Comm’n v. Mobil N. Sea Ltd., [1986] 1 W.L.R. 296 (Ch.) ("By an agreement effective from 5 April 1978 the taxpayer company was appointed ‘operator’ on behalf of the participants in the Beryl Field. This agreement is known as ‘the operating agreement . . . .’"). In determining an insurance-subrogation issue arising under a North Sea Operating Agreement, Lord Bingham of Cornhill observed that the “researches of counsel have not disclosed any Scots or English case in which any contention at all similar to the contractor’s in this case appears to have been advanced,” and then cited several American cases while cautioning that American precedent “must be approached with a measure of reserve.” See Caledonia N. Sea Ltd. v. Norton (No. 2) Ltd., [2002] S.C.L.R. 346, 15 (H.L.) (Lord Bingham).
viewed as the non-operators’ “agent.” But it is unlikely English courts would imply a fiduciary duty if the Operating Agreement expressly states the Operator is not a fiduciary. Instead, the Operator would be held to the standard in the agreement—for example that the Operator conduct joint operations in a proper and workmanlike manner and in accord with the methods and practices customarily used in good and prudent oil and gas practice.

B. The resignation, election, and substitution of Operators

Most Operating Agreements provide for (or should provide for) a mechanism for the resignation or removal of the Operator. Often, removal may turn on whether the Operator is viewed as failing to carry out properly its duties under the agreement for example, in a “good and workmanlike manner.” Additional issues arise concerning whether this determination is made by the non-operators independently or if the parties must first secure a declaration by a court or tribunal that the Operator has failed to perform its duties before the Operator can be involuntarily removed.

New York. There are few New York cases discussing the election and substitution of Operators under Operating Agreements. It is likely New York courts would look to states with more established case law on the subject for guidance.

Texas. Texas courts have rendered several decisions regarding the removal, election, and substitution of Operators under Operating Agreements. In TriStar Petroleum Co. v. Tipperary Corp., for example, the El Paso Court of Appeals addressed the critical question of whether a non-operator must first secure a judicial declaration that the Operator failed in its duties before acting to remove the Operator for cause under an Operating Agreement. The Operating Agreement in that case provided that the Operator could be removed by a vote of two or more of the non-operators if it failed or refused to carry out its duties. After the non-operators voted to remove TriStar as Operator, TriStar refused to turn over operations, arguing that a judicial determination that it breached its duties was a condition precedent to its removal. The non-operators sought and obtained injunctive relief forcing TriStar to turn over operations. The court reasoned that the non-operators had properly followed the procedures for removal under the Operating Agreement and TriStar was no longer the Operator.

England. There is little English law regarding the election and substitution of Operators under Operating Agreements. Only two cases describe specific contractual provisions regarding the designation of Operators, but neither discusses the election or substitution of an Operator in significant detail.

C. The enforceability of liens and non-consent penalties

Operating Agreements generally contain provisions addressing the parties’ rights and duties to fund operations by less than all parties, commonly known as non-consent provisions. Most non-consent provisions provide a premium to the participating parties or a penalty to the non-participating party, allowing the participating parties to recover three, five, ten or more times their investment, before the non-participant can rejoin and benefit from the operation. In some cases, the Operating Agreement may even provide for an in-or-out election (a blackout provision), meaning the party choosing not to participate in the operation is deemed to have forfeited its interest in a specified portion of the contract area or the entire contract area.

In addition, most Operating Agreements provide that the parties grant a lien to the other parties on their oil and gas rights (and, perhaps, a security interest in their share of production) to ensure payment of expenses related to operations. Operators (or a non-operator where the Operator is in default) may act to foreclose on the lien and take title to the defaulting party’s interest and/or the proceeds from the sale of oil and gas.

New York. New York law has not specifically addressed forfeiture clauses in oil and gas contracts. New York’s public policy generally opposes the imposition of penalties and forfeitures for which there is no statutory authority. Although a forfeiture clause is not always unenforceable, an arbitrator will enforce it only if the parties have clearly agreed to it and will strictly construe the clause to avoid forfeiture if possible. It is therefore possible that parties to an Operating Agreement governed by New York law may find exclusive-operations provisions (sole-risk and non-consent provisions) and forfeiture provisions strictly construed and limited by a court or even held to be invalid and unenforceable.

Texas. Texas courts recognize non-consent penalties as valid

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20 See, e.g., Tri-Star Petroleum Co. v. Tipperary Corp., 101 S.W.3d 583, 587–94 (Tex. App.—El Paso 2003, pet. denied) (non-operators can act to remove Operator without first securing court finding of breach by Operator); Abra xia s Petroleum Corp. v. Horn burg, 20 S.W.3d 741, 749–52 (Tex. App.—El Paso 2000, no pet.) (holding that parties to an Operating Agreement can waive their right to enforce the provisions for the election of an Operator by permitting another party to act as an Operator and by accepting the benefit of the substitute Operator’s actions); see also generally Hill v. Heritage Res., Inc., 964 S.W.2d 89 (Tex. App.—El Paso 1997, pet. denied); Purvis Oil Corp. v. Hillin, 890 S.W.2d 931 (Tex. App.—El Paso 1994, no writ) (superseded by rule on other grounds as noted in Fort Villas III Condo. A ss’n, Inc. v. Gillenwater, 285 S.W.3d 879, 881 (Tex. 2009)).
21 Id. at S86–87.
22 Id. at S89.
23 Id. at S90.
24 Id. at SBB.
25 Ashbor der B.V. v. Green Gas Power Ltd., [2004] EWHC 1517 (Ch.) (asserting claims for declaration as to ownership of oil and gas licenses, disputed shares, and the person entitled to act as Operator of each license); Rel iance Indus. Ltd. v. Enron Oil & Gas India Ltd., [2002] 1 All E.R. (Comm.) 59 (Q.B.) (presenting issue of whether arbitration under Joint Operating Agreement was to be governed by English or Indian law).
C. The characterization of non-consent

and enforceable.28 Courts have characterized the non-consent penalty as an incentive to a party to take on the risks of exploration and development and a disincentive to a party that avoids them.29 In addition, the Texas Supreme Court recently clarified that non-consent penalties are not viewed as liquidated damages. “Liquidated damages clauses fix in advance the compensation to a party accruing from the failure to perform specified contractual obligations, whereas non-consent penalties reward consenting parties for undertaking a defined risk.”30

Texas courts have also upheld lien provisions in Operating Agreements granting an Operator a preferred lien against the interest of each party to the agreement that failed to pay its share of the lease operating expenses.31

England. There is little case law addressing sole-risk, non-consent, or forfeiture provisions in the oil and gas agreement context. Many common-law cases restate the traditional rule that penalty clauses and liquidated-damages provisions are to be strictly construed.32 English law does, however, distinguish between penalties and forfeitures, and looks more favorably on forfeitures—though in practice telling penalties and forfeitures apart is difficult.33 A damages clause is considered to be a penalty clause, and therefore unenforceable, if its presence is designed to compel the offending party to complete its obligation.34 Further, if the agreed-upon damage amount is extravagant and unconscionable when compared to the actual damage caused by the breach, the damage clause is considered to be penal in nature and unenforceable.35 However, if the damages clause is a genuine estimate of damage, it qualifies as a liquidated-damages clause and is enforceable.36 All of this suggests that a contractually agreed-upon penalty or premium provision may be upheld and enforced if it is: (a) not viewed as a “penalty” for breach; and (b) clearly drafted.

D. The contractual disclaimer of agency relationships

New York. New York courts and federal courts applying New York law acknowledge the validity of contractual disclaimers of an agency relationship and refuse to create such a relationship when the parties expressly disclaim it.37 Still, some courts look beyond a contract’s terms and consider all relevant facts to determine whether an agency relationship truly exists between parties.38 This scenario typically arises when a third party tries to overcome the contracting parties’ characterization of their relationship, as opposed to the contracting parties trying to overcome their own characterization.39

Texas. Texas courts often look to agency disclaimers to determine that no agency relationship exists between contracting parties.40 However, a party can still provide sufficient evidence to establish an agency relationship exists, despite a contractual disclaimer.41 Furthermore, courts will not give conclusive effect to an agency disclaimer if the contract’s terms are unconscionable.42

England. English courts likewise recognize that parties may contractually disclaim the existence of an agency relationship.43 However, one English court has referred to an agency disclaimer as “nugatory,” or useless.44 Although parties may expressly disclaim the existence of an agency relationship in writing, English courts still consider whether the parties otherwise consented to an agency relationship through their actions.45

E. The creation of AMIs

An AMI provision is a common contractual provision in Operating Agreements and other oil and gas contracts. An AMI provision ensures that every party to an Operating Agreement receives an opportunity to acquire a proportionate interest in any acquisitions within a specified area encompassing the contract area.

New York. New York courts generally have not interpreted AMI provisions in the context of oil and gas.

Texas. Texas courts, including the Texas Supreme Court, have
analyzed AMI provisions. A contract provision “requires that any party acquiring any oil and gas interest within the contract area... give notice of the acquisition and its terms to all other parties to the operating agreement, who then have an option for a specified period to elect to participate in the acquisition.”7 Texas courts routinely enforce AMI and preferential-purchase provisions.8

England. Few English courts have interpreted AMI clauses in Operating Agreements.9 Cases are few and do not involve an in-depth analysis of AMI issues.10 While case law does not reject the concept of an AMI, the lack of precedents in this area injects uncertainty as to how an AMI provision would be construed. While English courts would likely give effect to the clearly expressed intentions of the parties, there would be little precedent to apply to language that unintentionally turns out ambiguous or that fails to address a specific circumstance.

F. The interpretation of “best endeavors” and “best efforts” clauses

New York. As one court recently noted, “New York law interpreting best efforts clauses is ‘far from clear.’”5 New York courts generally require that the contracting parties provide objective criteria of what constitutes “best efforts” to make a “best efforts” clause enforceable.5 A contract does not have to specifically define what is meant by “best efforts” but should give a court some guidelines, whether explicit or implicit, by which the court can judge whether a party acted reasonably, or made its “best effort,” in performing under the contract.5 At the very least, a “best efforts” obligation requires more than a “good faith” effort and imposes on a party a duty to pursue all reasonable methods to fulfill its voluntarily assumed contractual obligations.54 A party’s “best efforts” are evaluated by that party’s circumstances, and a party’s financial condition is one factor a court considers in determining whether that party has fulfilled a “best efforts” undertaking; courts also consider “marketing expertise and experience attributable to the ‘average, prudent, and comparable[y]’ placed party.”55 A “best efforts” provision does not require a particular course of action; a party may rely on its own business judgment to determine how best to achieve its goal.56

Texas. Texas courts and the U.S. Court of Appeals for the Fifth Circuit have given Texas arbitrators a clear set of rules to use in enforcing “best efforts” provisions in oil and gas contracts.57 To be enforceable, a “best efforts” contractual provision “must set some kind of goal or guideline against which best efforts may be measured.”58 If such guidelines exist, the contracting party that meets that goal or guideline, or performs within its scope, fulfills the contract without regard to the quality of its efforts.59 England. English parties occasionally use “best efforts” provisions to measure their contractual performance, but most prefer to use the term “best endeavors” or “all reasonable endeavors.”60 The first case to construe this type of provision held that, “[b]est endeavors means what it says—it does not mean second-best endeavors.”61 However, courts have effectively implied a reasonableness standard so that the terms “best endeavors” and “reasonable endeavors” are not very distinct. For example, in Terrell v. Mabie Todd & Co., a case concerning a contractual obligation to promote the use of certain fountain pens, it was held that a “best endeavors” clause imposed an obligation to do what can reasonably be done under the circumstances, under a standard equal to that of a reasonable and prudent board of directors acting properly in the company’s interests.62 English law also requires that there be some definiteness in what a “best efforts” or “best endeavors” clause requires, or else the provision may be unenforceable.63 Recent decisions distinguish between “best endeavors” and

69 See DAINITTM & WILLOUGHBY at 1096 (describing UK practice involving AMIs but citing no cases).
70 Moffet Eilion Ltd. v. Gen. Dynamics Land Sys., No. 07 Civ. 4566(LAP), 2008 WL 344725, at *2 (S.D.N.Y. Feb. 4, 2008) (quoting Bloor v. Falstaff Brewing Corp., 603 F.2d 609, 613 n.7 (2d Cir. 1979)).
72 See id.; see also Scott-Macon Sec., Inc. v. Zeltok Corp., No. 04-CIV-2124-MBM, 2005 WL 1183476, at *14 (S.D.N.Y. May 27, 2005) (stating that “New York courts use the term ‘reasonable interests’ interchangeably with ‘best efforts’ but also citing New York cases that reference a need for some kind of objective criteria, aff’d, No. 06-2711-CIV, 2007 WL 2914873 (2d Cir. Oct. 4, 2007).
74 Bloor v. Falstaff Brewing Corp., 454 F. Supp. 258, 269 (S.D.N.Y. 1978), aff’d, 601 F.2d 609 (2d Cir. 1979); accord In re Gulf Oil/Cities Serv. Tender Offer Litig., 725 F. Supp. 712, 730 (S.D.N.Y. 1989) (“A ‘best efforts’ clause requires that one work toward the object of the contract ‘to the extent of [one’s] total capabilities.’” (quoting Bloor, 454 F. Supp. at 267); see also in re Chateaugay Corp., 186 B.R. 561, 594–95 (S.D.N.Y. 1995), aff’d, 198 B.R. 848, aff’d, 108 F.3d 1369 (2d Cir. 1997) (“While a best efforts clause requires good faith activity in light of the party’s own capabilities and expertise, once such activity is demonstrated, it is clearly erroneous for a court to speculate as to what other steps the party should have taken.”) (citations omitted).
77 CKB & Assocs., 809 S.W.2d at 581; accord Maranantha Temple, Inc. v. Enter. Prods. Co., 893 S.W.2d 92, 103–04 (Tex. App.—Houston [1st Dist.] 1994, writ denied) (“[T]he ‘words of good faith effort’ or ‘best effort’ are not tautological; their presence in an agreement does not automatically mean that the provision which contains them is enforceable.”).
78 See CKB & Assocs., 809 S.W.2d at 582.
79 Robertson v. Armageddon Records Ltd., (Ch. Div., April 1, 1984) (“I think ‘best efforts’ must mean something more than in the end waiting to cash in on someone else’s efforts.”).
“reasonable endeavors.” In *Rhodia International Holdings Ltd. v. Huntsman International LLC,* 64 the court found that a “reasonable endeavors” clause imposes “less stringent” requirements than a “best endeavors” clause65 and likely requires a party to pursue one reasonable course of action.66 In contrast, “best endeavors” clauses require a party to pursue all reasonable courses of action.67 A course of action is reasonable when a reasonable individual, acting in that party’s interests, would take that action; unless the contract provides otherwise, a party is not “required to sacrifice its own commercial interests” when undertaking reasonable endeavors.68

The requirements of an “all reasonable endeavors” clause are unclear. The Rhodia court equated “all reasonable endeavors” with “best endeavors.”69 But an earlier case, *Jolley v. Carmel Ltd.,* 70 placed “best endeavors” and “reasonable endeavors” at two ends of a spectrum, with “all reasonable endeavors” somewhere in between.71 A later case suggests that “all reasonable endeavors” is not the same as “best endeavors” and that “all reasonable endeavors” clauses do not always require a party to forgo its own commercial interests.72 In light of these decisions, it is not entirely clear how English courts interpret an “all reasonable endeavors” clause.

G. The award of exemplary damages

**New York.** For tort claims, New York law permits punitive-damage awards in order to punish and deter wrongful acts.73 The first requirement for a punitive-damage award is proof of tortious conduct that is morally culpable or actuated by “evil and reprehensible motives.”74 An alternative description is wrongful conduct done willfully, wantonly, or maliciously.75 The moral culpability required to support punitive damages under New York law was described by the Second Circuit as close to criminal recklessness.76 Punitive damages are generally recoverable only where the alleged wrong is “aimed at the public generally.”77

Punitive damages are recoverable in breach-of-contract cases only when the defendant’s conduct is also actionable as an independent tort.78 Furthermore, the wrongful conduct must be egregious or part of a pattern of conduct aimed at the general public.79 An isolated instance in an otherwise legitimate business does not warrant punitive damages.80 For example, a pipeline owner who failed to fulfill his contractual obligations to install crossings and restore an access road was not liable to the landowner for punitive damages because there was no showing of egregious tortious conduct that was part of a pattern directed at the general public.81

While New York substantive law permits punitive-damage awards, the issue is slightly more complicated in the arbitration context. In *Garrity v. Lyle Stuart, Inc.,* New York’s highest court held that an arbitrator had no power to award punitive damages, even if agreed on by the parties.82 However, in *Mastrobuono v. Shearson Lehman Hutton, Inc.,* the United States Supreme Court interpreted a New York choice-of-law clause narrowly to include New York’s substantive law on punitive damages, but not New York’s arbitration policy.83 Some New York courts apply the *Mastrobuono* rule only in securities arbitration, while others interpret *Mastrobuono* as abolishing state limits on arbitration.84 An express agreement providing that an arbitrator has the authority to award punitive damages is generally enforceable.85 Note, however, that most current Operating Agreements generally expressly negate the awarding of punitive damages.

**Texas.** “A breach of contract alone will not support punitive damages in Texas; the existence of an independent tort must be established.”86 Texas statutes specifically govern exemplary damages.87 The law governing exemplary-damages awards for torts in Texas depends on when the case was filed because the

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64 [2007] EWHC 292 (Comm.).
65 Id. para. 35.
66 See id. para. 33.
67 See id.
68 See id.
69 Id. para. 35.
70 See id. para. 33.
71 [2000] 2 EGLR 1534.
76 See Roginsky v. Richardson-Merrill, Inc., 378 F.2d 832, 843 (2d Cir. 1967); In re Methyl Tertiary Butyl Ether (“MTBE”) Prods. Liab. Litig., 725 F.3d 65, 127 (2d Cir. 2013), cert. denied, 134 S. Ct. 1877 (2014).
78 See Rocalova, 634 N.E.2d at 943–44.
81 Murray-Gardner, 646 N.Y.S.2d at 420.
83 514 U.S. at 64.
85 Mastrobuono, 514 U.S. at 58.
87 See TEX. CIV. PRAC. & REM. CODE §§ 41.001–41.013.
relevant statute was altered significantly in 2003.88

For cases filed after September 1, 2003, there are two basic requirements for exemplary damages to be available. First, a party must be awarded actual “damages other than nominal damages.”89 “The mere availability of a tort-based theory of recovery is not sufficient; actual damages sustained from a tort must be proven before punitive damages are available.”90 Second, once actual damages have been established, a party also must prove, by clear and convincing evidence, the existence of fraud, malice, or gross negligence to recover exemplary damages.91 Further, exemplary damages are capped because a party is entitled to recover only the greater of: (a) two times the amount of its economic damages, plus up to $750,000 of any non-economic damages found by the jury; or (b) a maximum of $200,000 if the total of the calculation under (a) above is below $200,000.92

At least one Texas court has specifically declined “to adopt a public policy prohibiting punitive damages awards in arbitration,” stating that no Texas court had ever done so.93 Federal law also supports the position that arbitrators, absent contractual language to the contrary, may award punitive damages.94

**England.** Under English law, exemplary damages are available in only three situations: (1) where there are arbitrary, unconstitutional, or oppressive acts by governmental agents or servants; (2) where exemplary damages are expressly authorized by statute; and (3) where a defendant has violated the rights of a plaintiff with a premeditated calculation to make a profit thereby.95 The second category is not relevant (an empty set) as no statute relevant to the oil and gas industry appears to expressly authorize exemplary damages. Given that one category is an empty set and another applies only to governmental entities, the scenarios possibly imposing exemplary damages upon a non-governmental entity are narrow. English courts will award exemplary damages for breach of contract only in exceptional circumstances.96

**New York.** To recover lost profits under New York law, a party must show that lost profits were fairly within the contemplation of the parties to the contract at the time the contract was made.97 Accordingly, the parties to a contract may expressly exclude lost profits in an exculpatory provision in the contract.98 And unlike English courts, one New York court has held that provisions barring recovery of “any lost profits, lost savings, or other consequential damages” and “loss of profit, loss of business, or other financial loss” will successfully defeat an argument that the limitation on recovery of consequential damages does not prevent recovery of direct lost profits.99

While contractual provisions barring lost profits are generally enforceable, they are not enforceable to the extent they grant exemption for liability for willful or grossly negligent acts.100 Thus, in the breach-of-contract context, to overcome a provision excluding recovery of lost profits, a party would be required to show a “willful act” beyond the breach, such as a broader scheme to defraud or the breach of a special duty.101

Even where a contract is silent on lost profits, a party seeking lost profits still has the burden to establish that: (1) such damages were actually caused by the breach; (2) the particular damages were fairly within the contemplation of the parties to the contract at the time it was made; and (3) the alleged loss is capable of proof with reasonable certainty.102

**Texas.** Under Texas law, lost profits may be deemed direct damages or consequential damages, depending on the nature of the loss.103 In a contract claim, profits lost on the contract itself are recoverable direct damages, while profits lost on other contracts or relationships are consequential damages.104 To recover consequential damages like lost profits, a party must demonstrate that the damages were foreseeable and directly traceable to the wrongful act.105

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88 For cases filed before September 1, 2003, see former Texas Civil Practice and Remedies Code sections 41.001 to 41.013.
89 TEX. CIV. PRAC. & REM. CODE § 41.004(a).
90 Davis, 904 S.W.2d at 665.
91 See TEX. CIV. PRAC. & REM. CODE § 41.003(a).
92 See TEX. CIV. PRAC. & REM. CODE § 41.008.
93 See Kline v. O’Quinn, 874 S.W.2d 776, 784 (Tex. App.—Houston [14th Dist.] 1994, writ denied) (citing USX Corp. v. West, 781 S.W.2d 453, 455–56 (Tex. App.—Houston [1st Dist.] 1989, no writ); Grissom v. Greener & Sumner Constr., Inc., 676 S.W.2d 709, 711 (Tex. App.—El Paso 1984, writ ref’d n.r.e.)).
94 See Gateway Techs., Inc. v. MCI Telecomms. Corp., 64 F.3d 993, 998–99 (5th Cir. 1995) (citing the U.S. Supreme Court and the First, Seventh, Eighth, Ninth, and Eleventh Circuits, abrogated in part on other grounds by Hall St. Assocs., L.L.C. v. Mattel, Inc., 552 U.S. 576, 589–90 (U.S. 2008)).
98 Metro. Life Ins. Co., 192 A.D.2d at 92 (rejecting plaintiff’s contention that, regardless of the limitation on recovery of consequential damages, it could recover lost profits, which plaintiff termed “cover damages,” because they were direct and not consequential); see also Empire One, 888 N.Y.S.2d 722–24 (granting lost profits despite contractual disclaimer of “indirect, incidental, consequential, reliance, punitive, or like damages, including without limitation, damages for lost profits,” because plaintiff pleaded gross negligence and willful misconduct).
100 Id. at 89–90.
101 Davis, 904 S.W.2d at 665.
102 See Davis, 904 S.W.2d at 673.
104 Cherokee Cnty., 305 S.W.3d at 314.
Parties to a contract may exclude lost profits by expressly limiting the universe of recoverable damages. Yet, to achieve the desired preclusion, the language of these exculpatory clauses—or “limitation-of-liability provisions”—must address the dual nature of lost profits; this is important because Texas courts have held that exculpatory clauses preventing recovery of consequential damages generally, or consequential damages “including lost profits,” do not operate to preclude lost profits that are direct in nature. Thus, to ensure that all lost profits—whether direct or consequential—are excluded, an exculpatory clause must be explicit.

Under Texas law, lost profits are generally calculated by deducting the cost of a plaintiff’s expenses from the lost business activity. A plaintiff is not required to prove lost profits by an exact calculation; but the amount of the loss must be shown by competent evidence with reasonable certainty. The reasonability-certainty requirement is intended to be flexible enough to accommodate the myriad circumstances in which claims for lost profits arise.

English courts permit the recovery of lost profits where they are a direct and foreseeable consequence of a breach of contract, as long as they are not specifically, clearly, and unambiguously excluded by the terms of the contract. English courts do not permit recovery of lost profits where they are indirect, unforeseeable, or consequential. Whether lost profits are direct and foreseeable, as opposed to indirect, unforeseeable, or consequential, has been framed as an issue of "remoteness," and English courts do not permit the recovery of lost profits where they are too remote from the breach. Direct loss is “loss which flows naturally from the breach without other intervening cause and independently of special circumstances.” “By contrast, indirect or consequential losses are losses which are not the direct and natural result of the breach.”

English courts may apply the remoteness test even if the terms of a contract explicitly seek to prohibit the recovery of lost profits by categorizing all lost profits as indirect or consequential. But even if the limitations clause explicitly excludes recovery of lost profits by listing them as a category of consequential damages, an English court will not consider that a bar to recovering lost profits if they stem directly from the breach.

Whether the common-law rule or the terms control depends on whether the parties clearly and unambiguously exclude recovery of lost profits as direct damages. If they do, then the exclusion is valid and enforceable. On the other hand, an exclusion that bars damages of an “indirect or consequential nature” will not preclude a claim for lost profits that are direct and foreseeable. Parties intending to exclude lost profits under English law must do so for both direct and indirect forms of lost profits.

I. Indemnification

New York. While there are no oil and gas cases directly on point, New York courts disfavor contracts where a party attempts to exculpate itself from the consequences of its own negligence. For example, New York courts favor the “express words” litmus test, which requires the contract to specifically state in clear, unequivocal, and unmistakable language that one party is absolving another from future liability for negligence.

Different standards govern indemnity agreements. Because the issue in indemnity agreements is not whether the injured party has forfeited a right to recover damages, but who must pay the damages, New York courts do not follow the express-words test in such instances. When sophisticated business entities negotiate an indemnification agreement at arm’s length with the intent to allocate between themselves the risk of liability to third parties, the rule has been somewhat liberalized.

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necessary that the exculpatory language refer expressly to the indemnitee’s negligence, so long as the intention to indemnify can be clearly implied from the agreement’s language and purpose, and the surrounding facts and circumstances.126

Texas. The Texas Supreme Court has repeatedly recognized the need for oil and gas businesses to determine and contractually modify the scope of their rights and duties by adopting the express-negligence and fair-notice tests.127 The “express-negligence rule” holds that whenever a party seeks to compel a second party to indemnify the first party from the consequences of its own negligence, the resulting agreement must express that intent clearly within the four corners of that contract (i.e., provide fair notice).128 Texas courts have held that even a completely blameless indemnitee sued for its own negligence cannot recover for its settlement costs, losses, or attorneys’ fees under a contract that fails to fully and boldly disclose the existence or contents of an indemnification provision.129

England. Under the Unfair Contract Terms Act 1977, a party may not contract out of liability for death or personal injury arising from its own negligence,130 or possibly even for other damages, if the contract is between parties of unequal bargaining power.131 A party may, however, be indemnified against other losses arising from its own negligence, provided the indemnification is expressly so provided. In a significant case arising out of an Operating Agreement and the July 6, 1988, Piper Alpha platform disaster in the North Sea, a British Court of Session, Outer House, addressed a series of issues regarding indemnification.132 Lord Caplan noted that “an indemnity that protects a party against what may prove to be serious claims arising out of his own negligence must be expressed in very clear words if it is to be given effect to.”133 “[I]n case of doubt, wording in a contract is to be construed against a party who seeks to rely on it in order to diminish or exclude his basic obligation, or any common law duty which arises apart from contract.”134

Although English courts prefer that parties use express language when they include in an indemnity clause, courts are willing to interpret a clause written in “wide” language as including negligence if that is the only cause of damage that the parties intended to indemnify.135 This said, some English courts rely on more general and discretionary rules of contract construction,136 which can make it difficult to predict how an English court or arbitrator might rule in a particular case.

J. The award of attorneys’ fees

New York. Attorneys’ fees are generally not recoverable in contract disputes unless authorized by agreement between the parties, by statute, or by court rule.137 Attorneys’ fees are generally viewed as a “contract right,” not an award of damages.138 Where parties agree to attorneys’ fees in the underlying contract, a party may recover attorneys’ fees.139 Attorneys’ fees also may be awarded in tort actions where malice is shown or where the plaintiff incurs attorneys’ fees in litigation with a third party as a result of the tortious acts of the defendant.140

Section 7513 of the New York Civil Practice and Law Rules states that “[u]nless otherwise provided in the agreement to arbitrate, the arbitrators’ expenses and fees, together with other expenses, not including attorneys’ fees, incurred in the conduct of the arbitration, shall be paid as provided in the award.”141 Despite this language, however, New York law allows the award of attorneys’ fees in arbitration in certain circumstances. For instance, the Southern District of New York explained in McDaniel v. Bear Stearns & Co. that “[c]ourts have held that, consistent with section 7513, arbitrators may award attorneys’ fees if either (1) the parties’ agreement to arbitrate so provides . . . or (2) the parties acquiesce to the payment of attorneys’ fees.”142 A party can acquiesce by its conduct in arbitration, by “making its own demand for attorneys’ fees or by failing to object to the other party’s demand for such fees.”143

Texas. Similar to New York, attorneys’ fees are generally awarded only when provided for by statute or by contract.144 Numerous Texas statutes provide for either mandatory or discretionary attorneys’ fees awards in connection with causes of action ranging from contract145 to fraud146 to injury to aquatic
wildlife.147 The most commonly pleaded statutory provisions for fees include the award of attorneys’ fees in contract disputes (regardless of whether the contract so provides),148 declaratory judgment actions,149 and Texas Deceptive Trade Practices Act (“DTPA”) claims.150

Chapter 38 of the Texas Civil Practice and Remedies Code, which governs breach-of-contract claims, requires courts to award attorneys’ fees to a successful party who asserts a claim for breach, with the only discretion being the amount.151 Similarly, attorneys’ fees are generally a mandatory award for successful DTPA claims.152 But successful defendants under DTPA claims also may recover their fees if the suit was groundless, brought in bad faith, or for the purpose of harassment.153

In tort cases, attorneys’ fees generally are not recoverable as a specific element of damages; however, they may be awarded as punitive damages.154

Arbitrators have essentially the same authority to award attorneys’ fees as the courts.155 Thus, although the general rule in Texas is that each party pays its own attorney, there are a wide variety of exceptions to this general rule.

England. Attorneys’ fees are considered “costs” in England and are regulated by the Civil Procedure Rules.156 These rules apply to costs incurred before arbitrators, umpires, tribunals, and other statutory bodies as well as to costs payable to a solicitor and those costs that are payable by one party to another under a contract.157 The Civil Procedure Rules do not differentiate between contract and tort cases.

Under the Civil Procedure Rules, a court has discretion to, and generally does, order the unsuccessful party to pay the costs of the successful party in a lawsuit.158 In making such determinations, a court is statutorily mandated to consider the conduct of the parties, the parties’ success in part of a case (even if not successful on the case in whole), and admissible offers to settle.159

III. CONCLUSION

A comparison of New York, Texas, and English law reveals that, while the law of all three jurisdictions is generally similar, Texas has the most developed and comprehensive body of law addressing the more common operational disputes that arise in oil and gas transactions. This is not surprising as the number of oil and gas operations in Texas far exceeds the activity in New York or the United Kingdom.

A tribunal applying Texas law may, at the very least, be able to review and rely upon cases where similar technical issues and facts related to Operating Agreements or operations have been analyzed and decided. However, that does not mean Texas law is necessarily the most favorable. It may be more favorable (and predictable) for the parties to be under the law of England, for example, as it relates to the general unavailability of punitive damages; further, the rule on costs may serve to deter speculative attempts to assert an unintended construction of the contract. In addition, New York is generally viewed as having a more fully developed body of law addressing corporate securities and financial disputes.

Choice of law may depend on the nature of the agreement—for example, whether it is relatively narrow and addresses specific technical operations or whether it is more expansive and governs in a more general fashion the parties’ relationship. Parties should not choose a substantive body of law automatically. Rather, they should evaluate and select a choice of law based on the context of the agreement and their specific needs and objectives. In selecting a choice of law, drafters need to consider what law, when viewed in conjunction with the terms of the underlying agreement and the original intentions of the parties, offers the most clarity and certainty to facilitate efficient and expeditious dispute resolution.

147 TEX. WATER CODE ANN. § 7.109(c).
148 TEX. CIV. PRAC. & REM. CODE ANN. § 38.001(8).
149 TEX. CIV. PRAC. & REM. CODE ANN. § 37.009.
150 TEX. BUS. & COM. CODE ANN. § 17.50(c)–(e).
152 TEX. BUS. & COM. CODE ANN. § 17.50(d).
153 TEX. BUS. & COM. CODE ANN. § 17.50(c).
154 Artco-Bell Corp. v. Texstar Corp., 591 S.W.2d 945, 950 (Tex. Civ. App.—Fort Worth 1979, writ ref’d n.r.e.).
155 See, e.g., TEX. CIV. PRAC. & REM. CODE ANN. § 171.048(c)(1)–(2).
156 See CPR Part 43.2(1)(a) (including fees in definition of costs); see also CPR Part 44 (General Rules About Costs).
157 CPR Part 43.2(2).
158 CPR Part 44.2(6).
159 CPR Part 44.2(4).

Authors may be contacted at the following:

Andrew Derman: Andrew.Derman@tklaw.com; Anthony Golding: Anthony.Golding@tklaw.com
William M. Katz, Jr.: william.katz@tklaw.com; Andrew Melsheimer: andrew.melsheimer@tklaw.com