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**A Look At The Major Risk Allocation Issues in
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OIL & GAS DRILLING CONTRACTS – A LOOK AT THE MAJOR RISK ALLOCATION ISSUES?*

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I. INTRODUCTION

Risk management for an oil and gas company is a very broad topic, and many different contracts present significant potential risk. Risk of bodily injury, property damage, and pollution is particularly present in “operational” agreements – contracts used by oil and gas companies to get things done – such as drilling contracts, master service agreements, vessel charters, flight service agreements, and construction contracts. For an exploration and development company, one of the most important such contracts is the drilling contract, and drilling contracts have several significant, recurring risk allocation issues. This paper will initially look at risk allocation issues that are common to virtually all operational contracts and then focus on the recurring problem areas in drilling contracts.

II. OVERVIEW OF RISK ALLOCATION IN OPERATIONAL CONTRACTS

Operational contracts typically involve a common workplace and a relatively high risk of bodily injury, loss or damage to property, and pollution damage. Because of the common workplace and the potentially dangerous working environment, these contracts frequently interact, which makes it critical that the contractual risk allocation provisions in the different contracts be consistent. Otherwise, provisions that might work well in isolation may, when acting together, achieve the opposite of the desired result and leave the company facing significant unanticipated risks.

Most of today’s operational contracts allocate much of the risk, if not all, on a “regardless of fault” basis, with indemnity being owed by the party that employs the injured party or owns the damaged property, regardless of negligence or other fault of the indemnified party (the “indemnatee”). This approach has developed for a variety of reasons, including difficulties and

* This paper is partially an update of a paper that has been presented previously to the Rocky Mountain Mineral Law Foundation, William W. Pugh, “A Strategic Look at the Bigger Picture – Risk Allocation in Drilling Contracts and Master Service Agreements,” Paper No. 7 (Rocky Mt. Min. L. Fdn. 2008) (hereinafter “Pugh, Bigger Picture”), which, in turn, contained a number of excerpts from a previous paper, William W. Pugh, “Don’t Lose Sight of the Big Picture — Making Sure the Indemnity and Insurance Provisions in Your Various Contracts Fit Together,” Oil and Gas Agreements: The Exploration Phase, Paper No. 11 (Rocky Mt. Min. L. Fdn. 2004) (hereinafter “Pugh, Big Picture”). The two preceding papers were intended to provide a detailed discussion on developing a consistent contract risk allocation program and a broader look at risk allocation in various operational agreements, including drilling contracts and master service agreements. The purpose of this paper is to focus on issues specific to drilling contracts, recognizing that such a discussion necessarily requires an understanding of risk allocation issues throughout the spectrum of operational agreements.

expense involved in determining proportionate fault in a common workplace and the availability of and reliance upon insurance.

For many years, oil and gas companies have been asked by their contractors to assume certain high dollar risks, such as pollution, loss or damage to the hole and down hole tools, and underground or reservoir damage. While the scope of the assumptions of liability vary from contract to contract, the primary underlying justification is either that a risk is too high for a contractor to assume or too expensive for a contractor to insure. On the other hand, all contractors already carry liability insurance for bodily injury claims, and most either have property insurance covering damage to their property or have made the decision that they prefer not to carry such insurance. As a result, at least historically, a typical operational contract might allocate risk of bodily injury or property damage to the contractor while the company assumed some or all of the potentially more expensive risks.

The intent of the indemnity provisions is generally to achieve certainty by allocating risks in advance without regard to the negligence or other fault of the indemnitee, but, as discussed further below, a series of judicial decisions require that such intent be clearly evidenced in the contract. In addition, the parties often expect insurance to support these indemnity obligations, which has led to a need for much more specific insurance provisions. Also, some states have imposed restrictions on these risk allocation provisions in the form of anti-indemnity statutes. Consequently, enforceability of these risk allocation provisions creates issues that must be understood and addressed.

An important continuing development in the approach to these provisions has been the contractors' efforts to obtain broader and broader protection through broad reciprocal indemnity agreements, whereby each party assumes the risk of any claims of damage to its own property or injury claims by its own employees. This typically began with the drilling contractors, who have historically taken the position that the company should be responsible not only for claims by its own employees (and its own property damage) but claims for injury and property damage by its other contractors as well. This broad "knock for knock" indemnity, or broad reciprocal indemnity, places a significant risk on the company, which would owe indemnity to the drilling contractor for claims by every other contractor at the work site. The scope of risk is even greater if the drilling contractor excludes (or "carves out") those risks that operators have historically been asked to assume, such as damage to the contractor's tools when down hole, and any pollution, loss of hole, or reservoir damage, even if caused by the fault of the contractor. While the merits of the broad reciprocal indemnity can be debated, the justification for such a broad assumption of risk by the company is more persuasive in a drilling contract (where the contractor supplies a large number of personnel and an expensive property item – the drilling rig) than in a master service agreement or other type of operational contract where the risk assumed by the contractor is significantly less than that assumed by the operator. Consequently, one of the threshold issues for developing a contractual risk allocation program is for the company to understand that it will be entering into various different types of contracts and that the risk allocation provisions in each may well need to be different even though the agreements will still need to fit together.

The most common operational contracts entered into by an oil and gas company are drilling contracts and master service agreements, and the operator cannot effectively develop its approach to risk allocation in its master service agreements (or its other operational contracts) without

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