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Updating the Bigger Picture – Risk Allocation in Drilling Contracts and Master Service Agreements

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I. INTRODUCTION

Risk management for an oil and gas company is a very broad topic, and it is difficult to understand the nuances of each area of risk. However, it can be critically important to understand the general risks inherent in different facets of the company's business. The purpose of this paper is to provide an overview and general understanding of some of the most important risk management issues presented by "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. The first parts of this paper will look at the issues from a general standpoint, and the risks related to specific contracts will be discussed thereafter.

Operational contracts typically involve a common workplace and a relatively high risk of bodily injury and loss or damage to property. Because of a 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 are 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.

II. OVERVIEW OF RISK ALLOCATION IN OPERATIONAL CONTRACTS

One of the distinctive features of the oil and gas industry today is that most of the 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 "indemnitee"). This approach has developed for a variety of reasons, including difficulties and 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 breadth of these assumptions 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 these indemnity provisions was to allocate these risks without regard to the negligence or other fault of the indemnitee, but, as discussed further below, a series of judicial decisions mandated that such intent be clearly evidenced in the contract. In addition, the parties often expected 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," or reciprocal, indemnity places a significant risk on the company, which would owe indemnity to each 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 justified 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 types of operational contracts. 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 but 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 understanding the fundamentals of indemnity and insurance and the pivotal role that the drilling contract will likely play.

A. Typical Risk Allocation Scheme in Drilling Contracts

A typical drilling contract[1] will allocate a variety of risks on a broad reciprocal basis, particularly liability for bodily injury/death claims and damage to property. As discussed above, these indemnity obligations will almost always apply regardless of fault.[2] The impact of this

[1] For a detailed discussion of various issues relating to insurance, indemnity, and risk allocation issues in drilling contracts, particularly the International Association of Drilling Contractors (IADC) Offshore Daywork Drilling Contract form, *see* William W. Pugh, "The IADC Offshore Drilling Contract," *Third Special Institute on Oil and Gas Development on the OCS*, 8-1 (hereinafter "Pugh, IADC Drilling Contracts"). For a similar discussion relating to master service agreements, see William W. Pugh, "Master Service Agreements and Risk Allocation – *In Whose Good Hands Are You*?" (Rocky Mt. Min. L. Fdn. 2002) (hereinafter "Pugh, Master Service Agreements").

[2] *See* William W. Pugh, You Can't Always Get What You Want, But You Can Avoid Costly Mistakes: Insurance Issues for Oil & Gas Operators, § 10.05[1] (Rocky Mt. Min. L. Fdn. 1999) (hereinafter "Pugh, Insurance Issues"); *see also* § III *infra*. The operator will probably also assume other risks, such as well control, downhole pollution, downhole tools, loss or damage to the hole, and reservoir damage, subject to some exceptions. The risks allocated to the drilling contractor should be covered by both insurance and indemnity protection from the drilling contractor. For those risks assumed by the

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