CONTRACTUAL RISK TRANSFER IN ENERGY

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Contractual Risk Transfer in Energy
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Introduction

A variety of contract documents describe the agreements between the parties involved in an energy exploration and production project. These written contracts impose many duties, obligations, and liabilities on various parties. Although careful attention may be paid to the operational issues these contracts address, often little or no attention is given to their risk and insurance implications.

From a risk management perspective, contracts can be a valuable tool or a deadly trap. Far too many contracts are drafted or modified by parties who know little about insurance. It is not unusual for contracts to shift to an indemnitor liabilities that are extremely difficult or costly for the indemnitor to insure, or they are even uninsurable. Some contracts actually require the purchase of insurance coverages that do not exist in the current marketplace. However, the fact that a loss is uninsured does not relieve the indemnitor of its contractual liabilities to the indemnitee. When the indemnitor fails to recognize this gap between its contract and its coverage, the indemnitor itself bears the brunt of these liabilities.

Unfortunately, onerous contractual provisions are often accepted without complaint—and often without even being noticed, particularly when the business climate is very competitive. Besides potentially breaching the contract with regard to insurance requirements, blind acceptance of risk-related contractual provisions exposes firms to potentially catastrophic losses. Such unforeseen catastrophes are rare, but they can and do happen. A well-prepared and knowledgeable insurance agent or broker can help clients avoid unfortunate and costly situations of this type.

This course examines the structure of contracting relationships in energy exploration and production and the key provisions in which responsibilities and liabilities are allocated to the contracting parties. It also suggests methods to equitably allocate these liabilities and examines processes for managing the contractual risk transfer process. It also points out problems that may arise if contracts are not properly reviewed and their risks managed.

Chapter 1 of Contractual Risk Transfer in Energy introduces key concepts that provide a foundation for this course—major players, major types of energy contracts, and contractual risk allocation in general. Chapter 2 describes three types of contractual risk transfer provisions—indemnity (hold harmless) provisions, limitation of liability, and waiver of recovery rights. Chapter 3 then deals with the types of insurance requirements found in energy contracts.

Chapters 4, 5, and 6 examine the three most important types of contracts: joint operating agreements (JOAs), drilling contracts, and master service agreements (MSAs), with emphasis on these contracts' risk transfer provisions and ways in which they can be optimized to most effectively meet the contracting parties' goals. A Glossary of terms used in this course follows Chapter 6.

Each chapter concludes with Chapter Review Questions to test comprehension of the material presented in the chapter. A response is given to each answer you select to the questions in the quiz, affirming the correct choice or explaining why the choice you selected was incorrect.

Course Objectives

A student who successfully completes this course will be able to

1. select suitable recommendations and strategies for fairly and legally allocating energy contract risks;
2. identify problematic energy contract provisions, and propose appropriate recommendations in the drafting or negotiation of contract insurance requirements;
3. identify gaps between a contractor's contractually assumed liabilities and its contractual liability

insurance coverage, and assist in obtaining compliance with additional insured coverage requirements; and

4. select appropriate procedures and processes for obtaining and maintaining verification of compliance with contract insurance requirements.

Chapter 1
Contractual Risk Transfer in Energy: An Overview

The oil and gas exploration and production process involves several different parties and several different types of contracts. Like the participants, these contracts are unique to the oil and gas industry, and they differ from construction contracts and general business contracts in some important ways. Standardized language is available for some of these contracts, but even in the standardized contract forms, the indemnity provisions, insurance requirements, and other risk allocation provisions tend to be sketchy. Typically, these provisions have to be expanded, amended, or even added in order to clearly and fairly assign the risks of loss associated with the project.

The first part of this chapter provides a broad overview of the energy exploration and production process and identifies the major parties involved. The chapter then explains the major types of contracts that describe the agreements among these various participants that, among other things, serve to allocate the risks involved in the process. The chapter concludes by discussing risk allocation and contract review and negotiation principles.

Chapter Objectives

On completion of this chapter, you should be able to

1. distinguish between the roles of the major parties involved in energy exploration and production,
2. identify the purpose of each of the major types of contracts used in energy exploration and production,
3. recognize basic risk allocation principles, and
4. recognize the importance of reviewing and negotiating risk and insurance provisions in various contracts.

Energy Exploration and Production Overview

This section of the chapter provides a broad-brush review of the steps involved in exploration and production of oil and gas, from the time the idea to drill for oil or gas is conceived until the product passes into the pipeline. This overview also introduces the major contracts involved in the exploration and production of oil and gas.

The Major Players

Three major groups of parties are involved in energy exploration and production.

- Oil operators
- Drilling contractors
- Well service contractors

The lines of demarcation between these three functions are pretty well defined. The operator will almost never own a drilling rig. A large drilling contractor may operate some wells, but this is usually done through a separate company. Similarly, some drilling contractors have well service operations, but they generally are carried out by separate companies.

The Oil Operator

The oil operator is sometimes referred to as the oil man, the oil company, or the producer. (Although drilling for gas currently represents over 75 percent of the drilling in the United States and Canada, the time-honored phrase "oil operator" lingers on.) The oil operator can be a single individual or a multinational corporation such as Shell or British Petroleum. It is the oil operator that decides where there may be hydrocarbons that will warrant having a well drilled to produce them.

Once someone in the oil operator's organization (perhaps in top management or in the geology division) decides that a certain area has the possibility of producing hydrocarbons, the operator's geologist(s), with the help of seismographic maps, logs, and other data, then put together a subterranean map showing any traps or inclines that can hold hydrocarbons. If a seismographic map is not available, the operator may enlist a seismic firm to "shoot" one. A seismographic map is made by using a series of underground explosions to record the depth and density of the various strata by measuring the echoes from the blasts. By obtaining the time interval between the explosion and the reflected and refracted shock wave, geophysicists can approximate the underground structure, since the deeper the strata the longer the time interval. From these data, geophysicists prepare a contour map indicating the presence of structural traps (if any) in the subsurface. This map helps the geologist determine the presence of hydrocarbons.

The oil operator's "landman" then proceeds to lease the right to produce these minerals from the mineral owner. The mineral owner may or may not be owner of the land that contains the minerals. It is the mineral owner who has the right to drill to recover the minerals.

There are basically two types of mineral interests.

- The party with the *working interest* in the minerals has the responsibility to recover the minerals and bears all costs and liabilities.
- The party with the *royalty interest* (the mineral owner) gets a certain portion of the income off of the top (usually 12.5 percent) without any cost or liabilities.

All other types of mineral interests derive from these two interests.

Once the mineral lease is in hand, the oil operator's exploration department puts together a budget for drilling the well, known as an authority for expenditure (AFE). At this point, the operator may decide not to take 100 percent of the risk but instead to seek investors. These investors are usually, but not always, other operators. The operator sells part of the working interest to the investors, usually keeping the largest interest for itself. These investors become nonoperating working interest owners.

The operator could have from five people to several hundred people on staff. However, the functions of the operator are the same regardless of the organization's size: geology, petroleum engineering, land management, drilling supervision, production supervision, oil and gas sales, financial management, legal matters, and administration. These operations may be carried out by employees or by drilling consultants.

The Drilling Contractor

The next major player in the exploration and production process is the drilling contractor, also known as the driller. The drilling contractor owns the drilling rig and has the employees to run it. Some drilling contractors own only one rig, while others own a number of vessels that are capable of drilling in water as much as a mile deep.

The oil operator contacts the drilling contractor and asks for a bid on drilling the proposed well. Depending on the tightness of the market, a number of drilling contractors may be asked to bid.

Once the price is agreed on, the drilling site is prepared by a specialty contractor. Site preparation takes a few days. Then the drilling rig is brought in and "rigged up." This extremely large piece of equipment (with a derrick that towers over 120 feet tall) and its component parts (engines, hoisting works, pumps, pipe, and pipe racks, etc.) are brought to the drilling site by several trucks and assembled by the rig crew.

The self-contained equipment raises the mast to an upright position and secures it to anchors in the ground with guy wires. The entire process takes only a day or so, depending on the particular terrain.

Finally, drilling begins. The crew of the drilling rig typically consists of the following.

- **Tool pusher—**The foreman who makes certain everything is running correctly and who stays at the rig 24 hours a day, 7 days a week.
- **Driller—**The person who runs the controls of the rig that govern how fast the drill bit turns.
- **Tower man**—The individual who stands on the "monkey board" high in the rig and guides the drill pipe into position for connection.
- **Floor hands or roughnecks—**Three to six individuals who make the connections of the new "stand" of pipe to the string already in the hole and do the general work around the rig.
- **Mud engineer**—The person who makes certain that the drilling fluid (called "mud") has the proper mixture. This position may be filled by one of the other workers. The mud is extremely important in the drilling of a well. It is a combination of dry powder mixed with a water or oil base that circulates through the system to lubricate the drill bit, return the cuttings to the surface, and—of greatest importance—keep subterranean pressure from entering the circulating system and causing a blowout.

While the tool pusher stays at the rig continually, the other members of the drilling crew usually serve 8-hour tours (pronounced "towers"). Drilling continues 24 hours a day until the anticipated depth is reached. At this point, the operator decides to either complete the well (make it ready to produce hydrocarbons) or to plug and abandon it.

Another person who stays at the rig continually is the drilling superintendent (sometimes referred to as the "company man"). The drilling superintendent is an employee of the operator who is there to make decisions that cannot wait long enough to be relayed back to the operator's office for discussion.

Well Service Contractors

If the oil operator decides that the well probably will produce enough hydrocarbons to make it commercially viable, it hires specialty contractors to complete the well. The process of completing the well includes a number of separate processes, such as fracturing the strata, perforating the hole, setting the casing, and cementing the casing. The specialty contractors that perform these tasks are referred to as well service contractors. Some of these contractors will perform a myriad of services, but most specialize in one particular type of well service.

Well service contractors do everything to the well except the initial drilling. They are necessary from completion of the well through its entire producing life. Well service contractors range in size from a one-man welder to extremely large companies (like Schlumberger or Halliburton) that do jobs that may require multimillion-dollar equipment and dozens of workers at the site.

Major Types of Contracts

With all the different types of contractors involved in oil and gas exploration and production, a multitude of contracts are used. The key contracts are the following.

- Mineral lease
- Farmout agreement
- Joint operating agreement
- Drilling contract
- Master service agreement
- Master charter agreement

Mineral Lease

The oil operator generally begins the energy exploration and production process by identifying a promising site and then leasing the right to obtain the minerals from the ground from the owner of the mineral rights. The first contract in the process is the mineral lease that the operator signs with the owner of the mineral rights. Of all the agreements discussed here, the mineral lease generally requires the least amount of attention.

Various mineral lease forms are used, but the general principle is the same. In the lease, the lessee (the oil operator) is granted the right to drill for hydrocarbons and to produce them for a specified number of years. The lessee assumes all of the costs and liabilities and gives the mineral owner a royalty, usually one-eighth (12.5 percent) of the production.

Risk Allocation

The mineral lease puts all liability for loss on the working interest owner. There is no negotiation on that point. Most mineral owners therefore assume that they are "off the hook." However, this can be wishful thinking. If, for instance, there is a blowout or a pollution claim and the operator declares bankruptcy, the mineral owner could be next in line to bear the burden of the resulting expenses. For the mineral owner's protection, therefore, it is prudent to require the lessee to maintain certain types and amounts of insurance and to name the mineral owner as an additional insured on the policies.

Insurance Requirements

The insurance requirements for the mineral lease are usually pretty basic. Generally, the lessor should require the lessee to maintain control of well insurance, plus commercial general liability insurance, business auto liability insurance, workers compensation and employers liability insurance, and (if needed to provide sufficient limits of insurance) umbrella liability insurance.

For the liability coverage, the most common limit arrangement is $1 million per occurrence and $2 million general aggregate for general liability, with $1 million aggregate for underground resources and equipment; a $1 million per-occurrence limit for auto liability; a $1 million per accident limit for employers liability; and an umbrella with a limit of at least $5 million. For control of well coverage, most lessors insist on a limit of at least $3 million per occurrence.

Surface Damage Agreement

The mineral lease allows the lessee to use as much of the surface as necessary to drill the well—no more, no less. In the process of gaining access to the hydrocarbons, the lessee is virtually certain to do at least some damage to the surface of the land. This ordinary and predictable damage to the surface, referred to as "surface damage," is usually dealt with by means of a surface damage or surface use agreement between the surface owner (who may or may not be the mineral owner) and the lessee. Generally, the surface damage agreement is a separate agreement; it is not part of the mineral lease.

In the surface damage agreement, the lessee agrees to pay the surface owner a flat fee in return for the surface owner's agreement to waive any other recovery rights for damage to the surface resulting from normal wear and tear from the lessee's mineral lease activities. (In the event of major damage, exceeding that which results from normal wear and tear, the surface owner may have a claim against the lessee that would be covered by the lessee's insurance program.)

Farmout Agreement

If an oil operator has a mineral lease but does not have any immediate plans to drill on it or cannot afford to drill on it, it may "farm out" the lease to another operator who is interested in drilling a well on the lease, using a farmout agreement. In the farmout agreement, the farmoutee agrees to be responsible for all costs and liabilities with respect to the well that will be drilled and to hold the mineral lease owner (the farmoutor) harmless from such costs and liabilities, regardless of the cause. It is prudent, therefore, to get the farmoutee to back up this indemnification with insurance.

Under the typical farmout agreement, if the new operator (the "farmoutee") makes a good well (a well that will produce an acceptable quantity of oil or gas), it gets to recoup its costs of drilling and completing the well (its "payout") from the initial production of the well. Then the original operator (the "farmoutor") comes back in for a percentage ownership of the well's production (typically, around 50 percent).

While the concept of the farmout agreement is very well accepted in the industry, there is no standard farmout agreement. Therefore, the content and language of the provisions can vary greatly from one farmout agreement to another.

Payout

The definition of the term "payout" in the farmout agreement is very important. Quite often "payout" is simply defined as the cost to drill and complete the well. While this may seem logical, consider a situation where the farmoutee spends $1 million drilling the well and then has a blowout. The control of well insurer pays another $1 million to control the well and redrill it. The cost of drilling and completing the well is now $2 million. If "payout" has been defined as the cost to drill and complete the well, the farmoutor has to wait until all $2 million is recovered by the farmoutee before it can begin to collect its share of the well's production. If the farmoutor's share is 50 percent, this would be a loss of $500,000 (50 percent of the additional $1 million of cost) for the farmoutor. The farmoutee, on the other hand, gets to collect $2 million before starting to pay the farmoutor's share but is out of pocket for only $1 million (less the insurance premium), because the control of well insurer has paid the $1 million additional cost. While this may seem unfair, the courts have upheld this result. The court's rationale: The farmoutee can get the extra amount needed to control the well from any source available. The source of the money is of no concern to the farmoutor unless this is addressed in the farmout agreement.

The answer to this predicament is really quite simple. The definition of "payout" should state that payout means the cost of drilling and completing the well less any insurance proceeds. This keeps the farmoutee from getting the insurance money and still taking production.

Control of Well Insurance

It is important that the farmoutee carry control of well insurance. This coverage pays the expenses of controlling a well that is out of control (a blowout), along with other related costs, such as the cost of redrilling the well. If the farmoutee has a blowout and abandons the project because it does not have the money to pay for the cost of controlling the blowout, the mineral lease owner (the farmoutor) will have to pay the costs. Therefore it is essential that control of well insurance be carried by the farmoutee and that the farmoutor is named as an additional insured.

Other Insurance Requirements

Other insurance requirements for the farmout agreement are usually the same as for the mineral lease: commercial general liability insurance, commercial auto liability insurance, workers compensation and employers liability insurance, and (if needed to provide sufficient limits of insurance) umbrella liability insurance.

Joint Operating Agreement

If the operator gets others to invest in the well by selling them nonoperating working interests, a very powerful instrument called the joint operating agreement (JOA) is used. This instrument provides a basis for sharing rights and liabilities among the parties involved and provides rules for the conduct of operations.

Joint operations enable energy companies to take on larger, more complex, and riskier projects than they would be willing or able to handle on their own. However, the joint venture operations can result in liability exposures that create risk management and insurance challenges. Successfully addressing these challenges begins at the very inception of the joint venture, with the drafting of the JOA.

Joint operating agreements are examined in more detail in Chapter 4.

Drilling Contract

The drilling contract is the most commonly studied document in the exploration and production industry. The most frequently used drilling contract form is promulgated by the International Association of Drilling Contractors (IADC).

There are three IADC forms for land wells:

- the **footage contract**, in which the contractor gets paid per foot drilled;
- the **daywork contract**, in which the contractor gets paid a fixed amount per day regardless of how many feet are drilled; and
- the **turnkey contract**, in which the contractor must drill to a certain depth in order to get paid.

The IADC also promulgates offshore drilling contracts and foreign drilling contracts.

The indemnifications and liabilities vary in each of these drilling contracts. Some very important risk allocation issues must be addressed before the drilling contract is an acceptable instrument. These contracts and issues are examined in Chapter 5.

Master Service Agreement

The contract that establishes liabilities and indemnification between the operator and each well service contractor is called the master service agreement (MSA). While the major and large independent oil operators have used MSAs for many years, the growth in the use of this important document in the last decade has been phenomenal. Ten years ago relatively few operators put much stock in using one. Today, both operators and well service contractors typically insist on having an MSA in place.

Operators, contractors, and especially insurers realize that things can go wrong on a producing well. Using an MSA allows the operator and well service contractors to assign liabilities before anything goes wrong and to use risk management as a tool in deciding how to handle any loss. MSAs are examined in Chapter 6.

Master Charter Agreement

The master charter agreement (MCA) and the charter party agreement are important contracts for operators that have “wet” operations—that is, wells that would involve maritime operations even in the slightest degree.

Consider a well being drilled in West Texas. If the drilling supervisor needs more mud, the dry mud sacks are delivered by truck and left at the well site. If the well is in the Gulf of Mexico, the operator has to charter both a barge to hold the dry mud sacks and a tug to deliver the barge. The tug brings the barge out and leaves it. The charter is in effect the entire time the barge is on the drill site. The charter party agreement determines who is responsible both for the damage done by the barge and for the damage to the barge. It is important that a standardized master charter agreement be used so that both parties know what to expect.

Risk Allocation in Contracts

The following discussion deals with contractual risk allocation in general. Risk allocation in energy contracts is discussed in later chapters.

Some would argue that the goal of contractual risk allocation is to push as much risk onto another party as possible. At each contracting level, various risks tend to get pushed down to the next tier. With construction contracts, for example, the owner shifts certain liabilities to the general contractor, which in turn shifts part of these liabilities to various subcontractors. The subcontractors shift part of their liabilities to their sub-subcontractors, etc. The upstream party typically has the greater bargaining power, and the further downstream a contractor is, the less bargaining power it will have. In most instances, this is because competition at the trade level is very stiff; a contractor that refuses to accept onerous contract provisions is easily replaced by another that will. Further, smaller contractors often lack the expertise to identify problematic provisions and negotiate effectively. That is, most do not have full-time risk managers or in-house legal counsel who can assist in contract review and negotiations.

Some firms take full advantage of their bargaining positions to shift as much risk as possible down the "food chain." Unfortunately, what often happens is that lower-tier subcontractors, which need work to survive, are forced to assume liabilities that are outside their control and that they cannot afford. For example, in some states, a contracting party can shift liability for its sole negligence to the other party. As these liabilities get shifted further down the chain, more and more risk falls on the parties that are typically least able to bear it.

A better approach is to strive for an equitable allocation of risks. A number of factors can influence the appropriate allocation of specific risks, including which party is in the best position to control the risk, which party has the financial wherewithal to bear the risk, and which party will obtain the ultimate benefit of the undertaking that creates the risk. Minimizing time-consuming and costly litigation is another critical factor.

In addition to which party will bear the risk, disagreements also arise over which party will purchase insurance to cover the loss. In most instances, the best way to handle this is to allow the party that bears the risk of loss to purchase insurance to cover its exposure. Unfortunately, that is not the way the contracts are always written.

While parties may disagree on where the lines of fair and acceptable risk allocations fall, they should come to the negotiation table with the intent to treat the other party as they would want to be treated—fairly and professionally. Where risks are transferred, the party accepting the risk should be allowed to factor it into the contract price. While there may be other contractors or subcontractors willing to accept more onerous provisions, contractors are not all created equal. The goal should be to hire the right contractor for the job and to craft an agreement that is fair and beneficial to both parties.

Unfortunately, the ideal is not always the reality, so contractors should go to the table with three sets of parameters. First, they should have their wish list—their preferred positions on various provisions. Second, they should have a fallback position—not ideal, but acceptable. And third, they should have a list of "deal breakers"—contract provisions that expose the firm to an unacceptable degree of risk such that the contractor will walk away from the project. Throughout this course, we will provide some insights into preferred and generally acceptable positions. However, individual contractors must make their own decisions on these issues based on their individual circumstances and tolerance for risk.

Coordination with Insurance

The importance of coordinating contract provisions and insurance policy provisions cannot be overemphasized. All major contracts should be reviewed by legal counsel and the firm's risk management adviser (whether an in-house risk manager, agent, broker, or consultant) before being executed. Contractors' downstream contracts, such as a standard subcontract agreement, should also be reviewed.

An attempt should be made to negotiate more reasonable terms, where warranted. Except on very small projects, contracts are rarely executed without some changes, even when standardized contracts are used. Owners that are truly interested in developing an agreement that is equitable to both parties will generally negotiate with the contractor regarding a number of important provisions. Sometimes all it takes is educating them about the ramifications of certain provisions in order to convince them that changes are necessary. When owners (or other contractors) will not make any concessions, the contractor can either walk away (if the risks outweigh the benefits) or make an informed management decision to accept the risk allocations and plan for them. (When a contract is offered on a "take it or leave it" basis, contractors should carefully consider their involvement in the project. An owner that is this rigid at the beginning of the process is generally equally rigid with respect to other aspects of the project.)

Any section of a contract can have significant risk management implications, but there are three specific areas of particular concern:

- hold harmless/indemnity provisions, which transfer one party's liabilities to another party;
- waivers of subrogation, which prohibit one party's insurer from bringing suit (or subrogating) against another party; and

- insurance requirements, which stipulate the types and amounts of coverage each party agrees to provide.

Some contracts also include limitations of liability, which limit the indemnitee’s recovery against another party to a specified amount, such as the fee paid for the indemnitee’s services.

Later chapters include more detail on these important factors.

Chapter 2
Risk Transfer Provisions

This chapter examines three types of contractual provisions used to effect risk transfers.

- Indemnity provisions, also commonly referred to as hold harmless provisions, require one party to indemnify (compensate) the other party (the indemnitee) for costs incurred by the transferor (the indemnitor).
- A party can contractually limit its liability for certain losses. This effectively shifts the risk of loss in excess of that limit to the other contracting party.
- A contracting party can require the other party to waive its right to pursue recovery against the first party for certain types of losses. When a party waives its own right of recovery, it also effectively waives its insurer's right to pursue recovery against a negligent party for amounts paid under the policy.

To support the risk transfers, most contracts also stipulate the purchase of certain insurance coverages that will respond to these liabilities. The types of insurance that address these requirements are discussed in Chapter 3.

Chapter Objectives

On completion of this chapter, you should be able to

1. recognize the effect of indemnity (hold harmless) provisions in a contract and their relation to insurance coverage;
2. distinguish between broad form, intermediate form, and comparative (limited) form indemnification provisions; and
3. recognize the effect of a contract's limitation of liability clause.

Indemnity (Hold Harmless) Provisions

Under an indemnity, or hold harmless, agreement, one party (the *indemnitor*) agrees to indemnify the other party (the *indemnitee*) for certain liabilities arising out of the performance of the contract. Our discussion begins by examining how construction contracts approach the subject.

In *construction* contracts, the rationale for indemnification provisions is that the risk of loss will be allocated to the party that, at least conceptually, has the most control over the exposure. In *energy* contracts, however, different rationale may apply depending on the nature of the contract. For example, risks may be allocated based on the amount of each party's level of participation in and contribution to a joint operation, or it may be based on the ownership of personnel and property rather than fault. These rationales are examined in later chapters.

Indemnity Provisions in Contracts

In the energy industry, contract relationships are best viewed as a tiered structure. The hiring party is referred to as the "upstream" party, and the party being hired is referred to as the "downstream" party. Typically, the contract with the owner is referred to as the "prime contract," and the various downstream contracts are referred to as "subcontracts." Subcontractors have no direct contractual relationship, and thus no duty, to the owner on the project. The general contractor's obligation to the owner is not altered by its use of subcontractors. In the event of a problem with a subcontractor's work, the owner will make its claim against the general contractor, which will in turn make a claim against the subcontractor. Whether the general contractor can collect anything from the subcontractor is not relevant to its responsibility to the owner.

In most construction contracts, the upstream party is the beneficiary of the indemnity provision (the indemnitee) and the downstream party is the one agreeing to assume certain liabilities associated with the hazards of the construction project (the indemnitor). Therefore, under a prime contract[1] , the owner is usually the indemnitee and the general contractor is the indemnitor. However, in a subcontract, the general contractor is typically the indemnitee, the subcontractor is the indemnitor, and so on down the various tiers of subcontracts.

Two important observations are in order here.

- *The indemnity agreement does not relieve the indemnitee of liability to the injured third party*. The indemnitee is responsible for damages awarded to the injured party whether or not the indemnitor responds to its obligation to indemnify. If, for example, the indemnitor does not have the financial resources to respond to its obligation to indemnify, the indemnitee will still be required to pay damages to the injured party. To ensure that indemnitors have the financial resources to respond, most contracts containing indemnity agreements also require indemnitors to purchase insurance that will respond to these contractually assumed liabilities.
- *The transfer of risk is usually independent of insurance coverage*. That is, the contractual obligation stands on its own and is not governed by the existence or scope of the indemnitor's insurance. Thus, an indemnitor may be required to indemnify a loss that its insurance does not cover.

If the contract complies with any statutory restrictions, the courts will enforce a contract's hold harmless agreement as written. When parties enter into a written risk transfer agreement, they usually forfeit their opportunity to have liabilities governed by general negligence principles. The indemnity provision, as part of a valid contract, effectively replaces common law and becomes the governing law with regard to indemnification issues between the parties. Therefore, contracting parties should be very careful that the language chosen reflects their intended allocation of risk.

Scope of Indemnification Obligation

Indemnification provisions fall into one of three categories.

- Broad form
- Comparative (or limited)
- Intermediate form

In each type, the indemnitor agrees to provide indemnity for costs that result from its own negligence. Where they differ is in regard to the extent to which the indemnitor is required to provide indemnification for losses that are the result of the indemnitee's negligence. The net scope of each form of indemnity is summarized in Exhibit 2.1.

Exhibit 2.1 Indemnity Agreements				
Type	**Liability Assumed by Indemnitor**			**Comments**
	Indemnitor's Negligence	*Indemnitee's Contributory Negligence*	*Indemnitee's Sole Negligence*	
Broad Form	✓	✓	✓	Most states prohibit or severely limit the transfer of liability for one's own negligence, which in turn limits the use of broad form indemnity provisions.
Intermediate Form	✓	✓		The obligation to indemnify is not limited by the degree of the indemnitee's contribution, as long as the indemnitor's negligence was a contributory cause of the loss.
Comparative (Limited) Form	✓			This type of agreement mirrors the obligations imposed by tort law.

A common application of the indemnity agreement in an oil field setting is in regard to a "third-party-over" action brought by an injured worker against other parties on the project. In most states, by virtue of the workers compensation statute, an injured worker's recovery against his or her own employer would be limited to workers compensation benefits (i.e., medical expenses and statutory lost wage benefits). However, a well service contractor's employee can sue a nonemployer, such as the oil operator, for damages over and above those allowed under the workers compensation statute. If a hold harmless agreement is in place between the worker's employer and the party being sued (as there usually is), the indemnitee will seek indemnification for amounts paid to the injured worker. This claim for indemnity for injury to the insured's own employee is known as a third-party-over action or action-over claim. In effect, the employer's exclusive remedy protection is eroded by such actions because the liability is allocated back to the employer through the indemnity clause.

For example, assume that the subcontract between Mudpie, a mud contractor, and Smooth Operator includes a hold harmless provision whereby Mudpie agrees to hold Smooth Operator harmless from claims arising out of Mudpie's work. A mishap occurs and Walter Wounded, one of Mudpie's employees, falls and is seriously injured. Walter collects workers compensation benefits from Mudpie and files a suit against Smooth Operator for failure to maintain a safe work environment. Under the indemnification agreement, Mudpie may be required to indemnify Smooth Operator for costs it incurs as a result of the suit. The extent of Mudpie's indemnity obligation—100 percent, 0 percent, or something in between—will be determined by the type of indemnity provision the contract contains.

Broad Form Indemnity

Under a broad form indemnification agreement, the indemnitor assumes an unqualified obligation to hold the indemnitee harmless for third-party liabilities arising out of the project, regardless of which party was actually at fault. Even if the damage, injury, or claim is due to the sole negligence of the indemnitee, the indemnitor must respond to the loss.

A broad form provision shifts virtually all liability for third-party injury or damage arising out of the indemnitee's involvement in the project to the indemnitor, including liability arising out of the indemnitee's sole negligence. Clearly, broad form indemnity provides the indemnitee with strong protection against losses arising out of the project.

For the indemnitor, however, broad form indemnity represents a significant assumption of risk, and many parties will resist this degree of risk transfer. For some contractors, this is a deal breaker. Other contractors, despite their objections, will accept these provisions because they fear they will lose the job if they protest too much. And in some cases, they are correct—some operators view contractors as commodities and refuse to negotiate on key contract provisions because they know there is a contractor out there that will accept it. (Whether the contractor has the financial resources to actually fulfill its obligations is often of secondary importance to such an owner.) At a minimum, contractors accepting broad form indemnity obligations should build an extra margin into their bids to compensate for the extra risk.

Before accepting a broad form indemnity agreement, contractors should examine their liability insurance policies to determine whether they have coverage to match their contractual liabilities. In some instances, the contractor's contractual liability insurance coverage may be limited to liabilities for which the insured contractor is at least partially responsible. In that case, a contractor that accepts a broad form indemnity provision is exposing its entire balance sheet to the satisfaction of its contractual liabilities.

Comparative Form Indemnity

At the other end of the spectrum is the comparative fault form of indemnity. As its name implies, this agreement obligates the indemnitor only to the extent of its own fault. For example, if the indemnitor was 20 percent at fault and the indemnitee was 80 percent at fault, the indemnitee would be entitled to indemnification of 20 percent of its loss from the indemnitor.

For the indemnitor, comparative (limited) form indemnity is the most favorable type of indemnity provision. Each party bears the risk of loss arising out of its own negligence, which is the same standard applied under common law. Many risk professionals consider this the most equitable allocation of risks, but many indemnitees view comparative form indemnity as inadequate protection against certain types of claims, such as third-party-over actions. Injured workers routinely seek to recover damages in excess of their statutory workers compensation benefits by making a claim against another party. Even if the claim proves groundless, the cost of defending these claims can be significant.

At first glance, it may appear that the comparative fault form of indemnification does little to increase a contractor's liability beyond the general principles of common law. However, the inclusion of a comparative fault indemnification provision does expand the indemnitor's exposure with regard to employee injuries. In addition to its statutory liability for workers compensation benefits, the indemnitor may be responsible under the indemnification agreement for a portion of damages owed to the employee by another party. (See the earlier discussion of third-party-over actions.) Thus, even comparative fault indemnification represents an increase in the contractor's liability under the contract.

Intermediate Form Indemnity

An intermediate form indemnity agreement represents a middle ground. Under this type of agreement, the indemnitor assumes responsibility for the indemnitee's liabilities except where the injury or damage is the result of the indemnitee's sole negligence. Liability for damages is not apportioned according to the relative fault of each party. Any amount of fault on the part of the indemnitor obligates the indemnitor to indemnify for the total amount of damages. In other words, whether the indemnitor was 10 percent at fault or 90 percent at fault, it nevertheless must provide indemnification for 100 percent of the damages.

Thus, under an intermediate form indemnity agreement, a contractor would be relieved of its contractual obligation to indemnify only when the indemnitee is solely at fault for the loss.

While broad form indemnity is strongly resisted by many contractors, intermediate form is generally acceptable. Further, the standard liability insurance policies will respond to this scope of liability transfer.

Statutory Limitations

Most states have statutes that restrict the contractual transfer of liability for one's own negligence on the grounds that it violates public policy. The theory is that to relieve a party of the financial consequences of negligent or even reckless behavior weakens the incentive to exercise the appropriate degree of care to prevent accidents or injuries. The extent of the indemnification restrictions varies by state and in some cases by the type of contract. Statutes also differ with respect to the type of indemnity that is prohibited, with some states prohibiting any transfer of liability for one's own negligence and others prohibiting only the transfer of liability for one's sole negligence. A few states have no statute at all, making broad form indemnity clauses permissible.

Because state laws vary so widely, energy firms must be aware of the restrictions that apply to every contract they sign, particularly those in which they are the primary beneficiary of the indemnification provisions (i.e., the indemnitee). Courts are not hesitant to void a clause that exceeds the statutory limitations, which means they expected that risk allocations would be unenforceable. Some contracts include language providing that the indemnification agreements apply to the fullest extent provided by state law. This type of qualifier may avoid the nullification of the entire provision and preserve the right to indemnification that does not exceed the statute's allowable indemnification.

Limitation of Liability

A limitation of liability clause does not eliminate liability but merely limits it to a predetermined amount or to a specified type of damages. By limiting the liability of the party in whose favor it operates, the risk of loss above that limitation is transferred to the other contracting party.

The justification for use of a limitation of liability clause is simple. Contractors and design professionals commonly face liability exposures that far exceed the relatively small profit or fee they receive for their performance of a contract. For example, a well service contractor may have liability exposures in the millions of dollars for services for which the contractor receives $100,000. A limitation of liability clause can equalize the imbalance between the potential benefits of undertaking a contract for services and the potential liabilities.

Types of Limitations

Limitation of liability clauses can be categorized based on the method by which they limit liability.

- The most widely used type of limitation puts a cap on the amount of damages for which a party can be held liable to the other contracting party with respect to its performance of the contract. In many instances, the limit is equal to the fee received for services performed or to the amount of insurance available to cover these liabilities.
- In other cases, the limitation may be a stipulated dollar amount.
- Another approach is to limit a party's liability with respect to the type of damages sustained. For example, contracts sometimes contain a limitation of liability for consequential damages, such as lost revenues.

Enforceability

As with any contract risk allocation, in order for the limitation of liability provision to operate as intended, it must be valid and enforceable from a legal standpoint. Because they often favor one party dramatically, limitation of liability clauses are strictly construed, and the burden of clarity always resides with the party that obtains the benefit of the provision. Any ambiguity, therefore, could nullify the limitation and expose its intended beneficiary to unlimited liability. Exhibit 2.2 outlines the elements that are typically required for a limitation of liability clause to be enforced.

Exhibit 2.2 Elements of an Enforceable Limitation of Liability Provision	
Opportunity To Negotiate	Does not require that an actual negotiation took place on this issue but rather that both parties had the opportunity to negotiate.
Limits of the Limitation	The limitation must be clearly defined with respect to the amount or types of damages.
Designation of Persons Covered	The provision must clearly and unambiguously state the parties to which it applies, including employees, agents, or subcontractors, if applicable. Failure to include those acting on the entity's behalf could render the limitation of liability clause useless.
Description of Risks Covered	All types of risks to which the provision is intended to apply must be clearly and unambiguously set forth.

Some firms draft their standard service contracts such that their liability to the other party is limited, but they include an "escape provision" under which the other party can elect to pay an additional fee to avoid the limitation. The extra fee compensates the beneficiary of the provision for forgoing the limitation and can be used to purchase insurance to cover the risk or to finance the retention of the risk. Courts tend to enforce limitation of liability clauses unless they are statutorily prohibited.

Waiver of Recovery Rights/Waiver of Subrogation

Sometimes, in order to ensure a transfer of risk, parties will waive their rights of recovery against one another. That is, they voluntarily give up their right to pursue recovery from the other party for amounts they are legally entitled to collect. In some cases, this waiver is absolute, while in others, it is conditioned on the availability of insurance coverage. In virtually all cases, the waiver is limited to certain types of damages, such as injuries to employees, damage to the project, or consequential damages. To the extent insurance coverage applies, a party that waives its right to recovery effectively waives the insurer's right to recover amounts paid under the policy from the negligent party—that is, the insurer's right of subrogation. For this reason, these types of provisions are sometimes referred to as "waiver of subrogation provisions."

The idea behind many of these waivers is to confine responsibility for the specific types of loss addressed to one insurance policy and thereby minimize the possibility of litigation between the contracting parties. Contractors must be careful in agreeing to give up their rights of recovery against other parties when they are relying on their own insurance to cover the damages. While most insurance policies allow the insured to waive the insurer's subrogation rights prior to the occurrence of a loss, some policies prohibit it. If the contractor violates this provision, it may forfeit its right to collect under the policy.

Chapter 3
Insurance Requirements

Since a promise to be financially responsible for losses is only as good as the promisor's ability to fulfill its obligation, most indemnitees (the parties that receive the benefit of the risk transfer) require indemnitors to purchase appropriate amounts and types of insurance. Requiring certain coverages to be purchased protects both parties against the negative impact of losses on the other party's financial position and thus its ability to complete the contract. That is, the financial protection provided by the insurance makes it less likely that the insured will encounter financial troubles. This protects the indemnitee against the risk of the indemnitor's default, which can increase both the time and cost of completing the project. Likewise, the indemnitor is protected against the risk of nonpayment for its work under the contract as a result of an uninsured loss for the indemnitee.

Most energy contracts therefore include a section on insurance that outlines the coverages each party agrees to provide with respect to the project. These requirements stipulate the types, minimum amounts, and scope of coverage that are to be purchased. Chapter 3 discusses the major types of insurance involved in this process.

Chapter Objectives

On completion of this chapter, you should be able to

1. identify the types of specifications commonly found in a contract's insurance requirements,
2. recognize the effect of insurance requirements found in energy contracts,
3. recognize key factors affecting the ways in which liability and workers compensation insurance policies respond to an insured's assumed contractual liability,
4. identify the purpose and effect of subrogation waivers, and
5. recognize the limitations of insurance certificates.

Contractual Insurance Requirements

Exhibit 3.1 summarizes the types of specifications that are commonly found in a contract's insurance requirements.

Exhibit 3.1 Insurance Requirements Specifications	
• Coverages to be purchased by each party	• Acceptable insurance companies
• Who is covered by the policies	• Order of payment
• Minimum limits of coverage	• Deductibles
• Minimum scope of coverage	• Waiver of subrogation
• Duration of coverage	• Evidence of compliance

Because they are designed to apply to a variety of types of projects, standard contract insurance requirements are not usually overly stringent. As a result, modifications and additions to this section of a contract are commonly included in supplementary documents.

Given the importance of insurance, it is sometimes surprising how little attention the insurance requirements receive during contract negotiations. Many operators and contractors forward this portion of the signed contract to their agent or broker for review, but even that basic step is frequently overlooked.

The types of insurance typically required in energy contracts are commercial general liability (CGL) insurance, workers compensation and employers liability insurance, and auto liability insurance. Many contracts also require control of well insurance, which pays the expenses of controlling a well that is out of control (a blowout), along with other related costs, such as the cost of redrilling the well.

In this section, we examine the application of these specifications with respect to each required coverage line. Certain specifications, including acceptability of insurers, evidence of compliance, and waivers of subrogation, apply similarly across all coverage lines and therefore are addressed separately rather than within each coverage section.

Liability Insurance

Liability insurance serves two main purposes on an exploration and drilling project.

- It provides some protection for damage to the drilling rig or other property. (The drilling contractor's insurance is the primary source of recovery for damage to its rig, but there might be situations where that policy will not respond. In that instance, some coverage may be available under a service contractor's liability insurance policies if the contractor can be held liable for the rig's damage.)
- More importantly, liability insurance provides protection against third-party bodily injury and property damage claims.

Rather than specify specific policies that must be purchased, some energy contracts stipulate the types of claims for which coverage must be provided. For example, each well service contractor is generally required to purchase coverage for claims involving injury to its own employees, third-party injury or damage, claims arising out of the contractor's use of vehicles, etc. Further, contractors are routinely required to ensure coverage that will respond to completed operations claims and to their contractual indemnification obligations. The contractor is responsible for determining what coverages need to be purchased to satisfy these requirements. While umbrella liability insurance is not specifically required, many contractors need this coverage to meet the minimum required limits. (Workers compensation and employers liability insurance cover a separate and distinct exposure and are therefore discussed separately below.)

Who Is Covered

Liability insurance policies cover the named insured (the party purchasing the coverage) as well as certain other categories of insureds, such as employees and stockholders. Liability policies also allow many other parties to be added as “additional insureds.” Indemnitees under energy contracts routinely require additional insured status under indemnitors’ liability policies.

Additional insured status serves as a backup to the indemnity agreement, in which the indemnitor agrees to hold the indemnitee harmless for claims brought against the indemnitee party for damages arising out of the operations involved in the contract. That is, even if a court declares the hold harmless agreement void, the indemnitee, as an insured under the indemnitor’s policy, can submit the claim directly to the indemnitor’s insurer. Additional insured status also guarantees a defense for such claims, the cost of which is outside the policy limits.

For liability coverages, the required limits will vary based on the size of the project, the nature of the project, and the specific trade(s) involved. Because of this variation, liability limits are usually stipulated in supplementary provisions rather than in the basic contract.

Minimum Scope of Coverage

Sometimes a standard policy form will be specified as a minimum acceptable scope of coverage. Because some insurers use adapted versions of standard forms and use an internal numbering system, this type of requirement will usually specify only that the scope of coverage must be “at least as broad as” the standard form and will typically include the applicable Insurance Services Office, Inc. (ISO), form number and edition date to clarify the expected scope of coverage. For example, if the policy specifies that the CGL policy must be a standard CG 00 01 04 13 form or equivalent, the contractor is required to purchase a policy that provides coverage that is at least as broad as the April 2013 edition of the ISO occurrence-based CGL policy. (The edition is specified by 04 13, and the occurrence trigger is specified by form number 00 01.)

As stated above, the liability insurance requirement may not require specific policies but instead stipulate that the policy must provide coverage for certain types of claims, such as completed operations claims and contractual liability claims.

Virtually all unmodified CGL policies automatically include these coverages. However, it is possible to remove completed operations or contractual liability coverages by endorsement. Stipulating that the policy must provide such coverages puts the onus on the contractor to make sure the coverages exist on its policies or else be in breach of the contract.

Contractors are frequently required to make other parties additional insureds under their liability policies. The primary purposes of requiring additional insured status are to provide a backup to the indemnity provision and to obtain a right to an insurer-provided defense against claims. The scope of coverage under standard and nonstandard additional insured endorsements has been significantly reduced over the past 2 decades. In 1993, the additional insured’s coverage for completed operations claims was removed, and in 2004, coverage for injury or damage caused by the additional insured’s sole negligence was removed. Additional insured coverage for completed operations requires a separate endorsement, which is available at the insurer’s option. The 2013 editions of standard additional insured endorsements limit the additional insured’s coverage to the lesser of the policy limit or the amount of coverage required in the contract.

Duration of Coverage

CGL insurance is typically required for the duration of the project and for a period of years after the project has been completed. That is, the contractor is required to continue to carry CGL insurance for a stipulated period of time. This requirement reflects the fact that claims arising out of the work performed on the project may not arise until well after the project is completed. Requiring liability insurance that applies to the completed project improves the odds that there will be insurance to respond to the claim.

In some cases, a contractor may be required to provide completed operations coverage until the applicable statute of repose expires. (A statute of repose stipulates a point in time at which a contractor’s liability ends for some or all claims alleging defective construction. Statutes of repose vary from 4 to 20 years, depending on the jurisdiction.)

Policyholders automatically have coverage for their completed operations liability under their ongoing CGL policy as long as there is no completed operations exclusion on the policy. However, to the extent the completed operations coverage requirement applies to coverage for the additional insured, some contractors may not be able to meet this requirement because their insurer is not willing to extend this coverage to additional insureds.

Auto liability insurance is generally required only until the project is completed. This is consistent with the nature of the exposure. (That is, the exposure is tied to the contractor's presence on the site.)

Order of Payment

While the indemnitee's CGL policy will respond on its behalf to claims arising out of the indemnitor's work on its behalf, the indemnitee's objective is to keep such claims out of its own insurance program to the extent possible. Consequently, the indemnitee will normally take steps to make sure its own liability insurance is "coverage of last resort"—that is, the indemnitee's insurance will be excess and will only be triggered after the indemnitor's policies have paid their full limit of insurance.

Some contracts stipulate that the indemnitor's liability insurance must be "primary and noncontributory" with respect to its work under the contract. ("Primary" indicates it pays before other applicable coverage, and "noncontributory" means the insurer will not seek contribution from other policies that are also triggered by a given loss.) Standard CGL and auto liability policies meet these criteria. However, if both the policy on which the entity is an additional insured and the policy on which it is the named insured (its own policy) provide that they are primary, disputes could arise as to the order of payment.

The standard ISO CGL policy addresses this apparent conflict by stipulating that the policy is excess with respect to other insurance available to the named insured as an additional insured under another policy. This language avoids the instance where both policies claim to be primary and provides a clear order of payment. Some nonstandard policies, or older editions of the standard policies, might not include the clarifying language with respect to additional insureds. In that instance, contractors should request this type of modification from their own insurers. Because it reduces the insurer's exposure, there should be no resistance to the change.

Some insurers resist adding "primary and noncontributory" language to their additional insured endorsements because they want to preserve their right to seek contribution from the policies of third parties under which the additional insured may also have the same status. An operator, for example, may be an additional insured under the CGL policy of every contractor. When multiple contractors share responsibility for injury or damage that imposes liability on the operator, then an insurer that has paid a claim on behalf of its additional insured operator could—and arguably should—be able to recover a portion of the paid damages from other insurers that have also made the operator an additional insured. This process would not force the operator's own CGL policy to contribute to the settlement of the claim, but it would mean that the additional insured coverage in question was not strictly "noncontributory."

ISO's "Primary and Noncontributory Endorsement" (CG 20 01), which was introduced in 2013, enables CGL insureds to evidence compliance with contractual obligations in which they might have to provide another party with additional insured coverage that is "primary and noncontributory." This endorsement states—reiterates, really—that the coverage provided to the additional insured is on a primary basis. However, it further states that the insurer will not seek contribution from any other insurance under which the additional insured is a named insured—in other words, it will not seek to force the additional insured's own CGL insurer to contribute to the settlement or payment of a covered claim. This limitation would not prevent the insurer from seeking contribution from another policy under which its additional insured may also have additional insured status.

Deductibles

Some contracts may stipulate a maximum liability insurance deductible, usually in the supplementary provisions. On the surface, an indemnitee's concern over this point is understandable. A contractor that is retaining more risk than it can afford jeopardizes its ability to fulfill its contractual obligations. Further, as an additional insured under the policy, the indemnitee might want to limit the deductible that may apply with respect to a claim against its company. As outlined below, in most cases, the first concern above can be overcome and the second usually has no legitimate basis. Therefore, contractors that have a large liability deductible in place can often negotiate the deductible limitation out of the contract.

The first of the concerns stated above can be legitimate—that is, contractors that retain more risk may be more susceptible to financial fluctuations. However, that is not a given and is insufficient reason alone to prohibit a deductible. Large, well-capitalized companies may be perfectly able to absorb deductibles of $500,000 or more. Because it relies on the contractor's ability to reimburse it for the deductible, the insurance company typically verifies the contractor's financial condition before agreeing to a large deductible. Indemnitees also benefit from this aspect of the insurer's underwriting process. The deductible also reduces the premiums associated with the contractor's insurance program, which will be reflected in the bid price for the contract. Lastly, contractors' policies are not purchased specifically for each project but rather on an annual basis, and asking a contractor to, in effect, renegotiate its insurance program midterm is simply unreasonable.

The argument that a party is concerned about deductibles applicable to claims against it as an additional insured generally has no valid basis when the standard endorsement is used to impose the deductible. The standard liability deductible endorsement provides that the deductible applies only to damages paid on the named insured's behalf. Coverage for other insureds, including additional insureds, is not subject to the deductible provision. As long as the endorsement follows the standard endorsement language, additional insureds have no legitimate concern over this point. As a practical matter, even if the additional insured's coverage were subject to a deductible, the contractor is usually still responsible for indemnifying that party, so the contractor's CGL insurer would likely end up paying the deductible amount in the form of a contractual liability claim.

Of course, nonstandard endorsements that apply differently can be used, and this may be a concern. However, this must be balanced against the unreasonableness of requiring a contractor to renegotiate its insurance program midstream to protect against a relatively unlikely event. Rather than addressing this issue with a contract provision requiring no deductible exist, it is probably a better approach to discuss the issue with the contractor, determine how its policy is structured, and, if necessary, simply include a contract requirement that the contractor will reimburse any deductibles imposed on the additional insured by the insurer.

Workers Compensation and Employers Liability Insurance

There are several reasons an upstream party would require a downstream contractor to purchase workers compensation insurance.

- If the upstream party is another contractor, most state laws will require its insurer to pay workers compensation benefits to injured employees of its uninsured subcontractor.
- If an injured employee has any concern about being taken care of following his or her injury, as would be the case if a contractor did not have insurance, he or she is much more likely to retain an attorney. This substantially increases the possibility of a suit against the upstream party.
- Uninsured claims against a downstream contractor may impair its financial position, which would increase the risk that it will not be able to meet its project responsibilities.

Therefore, most contracts require contractors to provide coverage for statutory benefits payable to injured employees as well as coverage for those rare circumstances when they (or their families) may bring a tort action against their employer. The standard workers compensation and employers liability insurance covers both of these types of claims. The workers compensation portion of the policy covers benefits payable under covered statutes, and the employers liability section covers other claims arising out of injuries to employees, such as injuries not covered by the statute or claims brought by a relative of the injured employee.

In some instances, the contract insurance requirements will not include a separate section for workers compensation coverage. Rather, the exposures are included in the list of liabilities for which contractors are required to provide coverage. Exhibit 3.2 summarizes typical workers compensation insurance specifications, which are discussed in more detail below.

Exhibit 3.2 Typical Workers Compensation and Employers Liability Insurance Specifications	
Which party will purchase	The employer (i.e., the downstream party contracting to perform work)
Covered parties	The employer
Minimum limits of coverage	Statutory limit for workers compensation coverage. Minimum employers liability limits vary based on project size and type of work to be performed.
Minimum scope of coverage	Claims arising out of bodily injury, sickness, disease, or death of the contractor's employee, including benefits payable under any applicable workers compensation, disability benefit, or other statute that prescribes benefits payable to an injured employee.
Duration of coverage	Until project completion
Acceptable insurance companies	Minimum financial rating, such as A.M. Best's rating of A- or B+
Order of payment	Primary
Deductibles	Maximum allowable deductible may be specified in supplementary conditions. The insured contractor is responsible for any deductible amount.
Waiver of subrogation	Contractor may be required to waive its insurer's subrogation rights against the upstream party.

Who Is Covered

Workers compensation and employers liability insurance covers the named insured employer for liabilities arising out of injuries to its employees. Because coverage is based on statutory obligations, other parties are not normally added to the policy as insureds because they have no statutory obligation for such injuries. Thus, there should be no requirement for additional insured status with respect to workers compensation insurance.

Minimum Limits of Coverage

Workers compensation insurance is generally written on a "statutory" basis. The policy will pay whatever benefits the applicable workers compensation statute prescribes. Therefore, no specific dollar limit of coverage is required in the contract. Rather, the contract will require the contractor to provide coverage equal to its statutory liabilities.

Even though the contract may not specifically reference them, this requirement usually reaches special workers compensation benefits payable under federal statutes, such as maritime. The basic workers compensation policy will not cover benefits payable under federal acts unless endorsed to do so. It is up to the contractor and its insurance professional to determine whether these statutes apply and arrange the appropriate coverages.

A minimum limit of insurance will apply to employers liability coverage, which is written in conjunction with the statutory workers compensation coverage. The standard limits are as follows.

$100,000 Bodily injury by accident—each accident

$100,000 Bodily injury by disease—each employee

$500,000 Bodily injury by disease—policy limit

These limits are frequently increased to $500,000/$500,000/$500,000. In many instances, the contractor will carry an umbrella policy that supplements the employers liability insurance limits. In that case, the umbrella limits should be allowed to satisfy the contractually required limits of insurance.

Minimum Scope of Coverage

As noted earlier, liability insurance requirements often address the types of claims for which coverage is required rather than specific types of insurance policies that must be purchased. For example, the contract might specify that coverage must be provided for damages associated with bodily injury, sickness, disease, or death of the contractor's employee. The standard workers compensation and employers liability insurance policy provides coverage that satisfies this requirement, including coverage for claims brought by a third party, such as the spouse or child of the injured employee.

Note that the employers liability portion of the policy contains an exclusion for liabilities assumed in a contract; therefore, it will not respond to the contractor's obligation to indemnify another party with respect to an injury to the contractor's employee. This avoids an overlap in coverage between the workers compensation and employers liability policy and the CGL policy.

Duration of Coverage

Workers compensation and employers liability insurance is required only through the completion of the project. This is consistent with the contracting party's interest in the contractor's financial stability.

Order of Payment

The contract may stipulate that this coverage is to be primary and noncontributory, but overlapping coverage is of little concern in this line of coverage. The standard policy provisions are adequate for handling this concern.

Deductibles

Some contracts may stipulate a maximum workers compensation deductible, usually in the supplementary provisions. Insurers typically scrutinize the contractor's financial condition before agreeing to a large deductible. Indemnitees also benefit from this aspect of the insurer's underwriting process.

Workers compensation insurance is not purchased specifically for each project but rather on an annual basis. Insurance requirements that force a contractor to change its insurance program midterm, which is difficult, time consuming, and potentially expensive, are simply unreasonable. As a result, deductible limitations should not normally be included in the insurance requirements; contractors can sometimes negotiate changes in these requirements as needed.

Acceptable Insurance Companies

An insurance policy is only as reliable as the insurance company's ability to honor its obligations under the policy. Most contracts, therefore, provide the upstream party with some level of control over the insurer used by the downstream party. In its simplest form, it might merely state that the insurer must be acceptable to the upstream party without defining what "acceptable" is. However, it is probably more common to stipulate that contractually required coverages must be purchased from an insurance company with at least a specified financial rating, such as an A- or better Best's rating. (A.M. Best is a well-known insurance company rating organization.)

Some contractors may have difficulty meeting this requirement due to a lack of available markets. In some instances, availability issues affect individual contractors (e.g., due to poor loss experience), and in others, they affect entire market segments (e.g., due to a broad scale underwriting withdrawal from certain classes of contractors). Thus, upstream parties need to be cognizant of the marketplace and willing to be flexible when necessary.

Certificates of Insurance

The most common method of obtaining evidence of compliance with the contract insurance requirements is to require a certificate of insurance. Standard certificates of insurance allow the contractor's insurance representative (usually the agent or broker) to provide confirmation that property or liability coverages are in effect at the time the certificate is issued, including the coverage period and limits of insurance. When an indemnitee has asked to be added as an insured to the indemnitor's policy, compliance with that request can also be indicated on the certificate.

Beyond these basic data, insurance certificates provide very limited information about the actual scope of coverage available in the policies. For example, while certificates indicate the limits carried, they do not reveal whether prior or pending claims have been made under the policy, which would reduce the amount of remaining coverage available to pay claims arising out of the certificate holder's project; nor do they necessarily indicate exclusions or other limitations in the policy that could restrict the scope of coverage available. Further, in most instances, the certificate is merely a documentation of coverage—it does not actually create coverage or impose duties on the insurer that do not already exist in the policies it represents. An error on the certificate is usually not binding on the insurance company.

Indemnitees sometimes try to improve the quality and enforceability of information they obtain on the certificate by requiring that disclaimer language be stricken, notice of cancellation provisions be altered, and a variety of other modifications to the certificate language be made. Some indemnitees throw out the standard certificates altogether and require contractors to have their insurance representative fill out a certificate created specifically for their own use that strengthens their legal position with regard to the information provided on the certificate. Unfortunately, contractors are not always able to comply with this request because their insurance companies frequently refuse to be a party to them.

General Considerations

In their desire to ensure adequate protection for their risks, indemnitees sometimes attempt to impose overly strict insurance requirements. Unfortunately, all they usually accomplish is to create more difficulty in the contracting process (e.g., obtaining bids that comply with the specifications), to increase the incidence of contractor breach of contract, and to increase legal costs.

Problematic exclusions cannot always be overcome by requiring contractors to delete the exclusions from their policies, because the insurers may not grant these requests. Examples of exclusions insurers will rarely, if ever, modify to broaden the scope of CGL coverage include the faulty workmanship exclusion and the pollution exclusion. To require contractors to modify their CGL insurance to cover these risks is to virtually ensure a breach of contract. Even if the required modifications are technically obtainable, the price may be more than the parties are willing to pay.

Out-of-date terminology in the contract's insurance requirements is a common problem. For example, although the *comprehensive* general liability form was withdrawn in 1986 and replaced with the *commercial* general liability (CGL) form, many contracts still require "comprehensive general liability insurance." (Some may even require older forms of coverage, such as "manufacturers and contractors (M&C)," "owners, landlords, and tenants (OL&T)," or "public liability insurance"; the latter term has not been used since the early 1950s.) Further, a number of coverages that once required endorsements—for example, contractual liability, broad form property damage, and personal and advertising injury liability—are now automatically provided by the standard CGL policy unless they are excluded by endorsement. Nevertheless, some contracts still require that the CGL policy include the old endorsements.

Use of outdated terminology confuses and complicates the contracting process. Someone with knowledge of current insurance markets, such as the agent or broker, should periodically review contracts and update them to reflect current terminology and methods of providing coverage. Exhibit 3.3 lists some out-of-date, yet commonly used, general liability insurance requirements that should be replaced with current terminology or, in some cases, deleted altogether.

Exhibit 3.3 Avoid Outdated and Misleading CGL Insurance Terminology	
When drafting insurance clauses for contracts, avoid using vague, imprecise, or outdated terminology. The following lists some antiquated terms that sometimes appear in contract requirements for general liability coverage, along with suggested alternatives.	
Antiquated Terminology	**Current Terminology**
Comprehensive general liability insurance	Commercial general liability (CGL) insurance
Public liability insurance	CGL and umbrella liability insurance
Manufacturers and contractors liability insurance	CGL insurance
Owners, landlords, and tenants liability insurance	CGL insurance
Contractual liability insurance	CGL insurance
Additional named insured, named insured, coinsured	Additional insured status using ISO endorsement CG 20 10 or equivalent
Cross-liability endorsement	Cross-liability coverage as provided under standard ISO forms' separation of insureds clause
Broad form comprehensive general liability endorsement	CGL insurance
Broad form property damage endorsement	CGL insurance
Combined single limit	Per-occurrence limit, general aggregate limit, and products-completed operations aggregate limit

Waivers of Subrogation

Virtually all property insurance policies and most liability insurance policies contain a subrogation clause. This clause entitles the insurer, once it has paid a claim, to exercise its insured's right of recovery against a third party that caused or contributed to the loss.

In property insurance, it is generally recognized that the insurer has this right even if it is not specifically set out in the policy. The theory behind this is quite logical. Once the insured has been "made whole" for its loss, it no longer has any reason to try to recover the damages from the negligent party that caused the loss. In such a case, the insurer stands in the insured's shoes after paying the claim and assumes the insured's right to recover the amount it paid its insured from the negligent party.

Policy Subrogation Provisions

Technically speaking, a waiver of subrogation is an agreement by the insurer not to pursue recovery from a negligent third party. Practically speaking, a waiver of subrogation is an agreement between two contracting parties to allocate certain losses to the insurer. That is, one party waives its right of recovery against the other contracting party with respect to specified losses. Because the first party's right of recovery has been waived, that party's insurer's right to subrogate, which derives from the insured's right of recovery, has also been effectively waived.

For most coverage lines, insurers are generally willing to waive their subrogation rights, to a certain extent, in recognition of the fact that contracting parties want the ability to allocate risks in this manner. However, requiring a waiver of subrogation in the energy contract may not be sufficient to effect a waiver of subrogation in the insurance policy. As demonstrated in Exhibit 3.4, most insurance policies place limits on the insured's ability to waive subrogation without the insurer's consent. Some policies absolutely prohibit the insured from doing anything that interferes with the insurer's subrogation rights. Policyholders that violate this policy condition may forfeit the coverage they have under the policy with respect to such a claim. On these types of policies, the underwriter's consent should be sought prior to executing the contract. If the underwriter agrees, a waiver of subrogation endorsement would be required to alter the provision and demonstrate the insurer's consent.

Exhibit 3.4
Waiver of Subrogation Provisions

For purposes of this chart, policy subrogation provisions fall into one of the following categories.

Type 1: **Waiver not allowed.** Insured must do nothing to impair the insurer's subrogation rights.

Type 2: **Waiver implicitly allowed.** Insured must do nothing after a loss to impair subrogation rights.

Type 3: **Waiver explicitly allowed.** The insured may waive the insurer's subrogation rights prior to a loss.

Standard Coverage Lines[1]	**Type of Provision**	**Effecting a Waiver of Subrogation**
CGL	Type 2	Insured waives its right of recovery prior to a loss, preferably in writing.
Commercial auto	Type 2	Insured waives its right of recovery prior to a loss, preferably in writing.
Workers compensation and employers liability	Type 1	A waiver of subrogation endorsement is required.
Commercial property	Type 3	Insured waives its right of recovery in writing prior to a loss.
Nonstandard Coverage Lines[2]		
Umbrella	Type 2	Insured waives its right of recovery prior to a loss, preferably in writing.
Contractors equipment	Type 2	Insured waives its right of recovery prior to a loss, preferably in writing, but watch for type 1 clauses from some insurers.

[1] *For standard coverage lines, this chart describes the approach taken in the standard form, which most insurers will follow. However, even in standard lines, insurers sometimes use their own forms, which could include different subrogation language.*

[2] *For nonstandard coverage lines, the approach will vary more significantly. This chart describes the most common approach, but the policy should be checked carefully for the exact language.*

Other policies only prohibit the waiver of subrogation rights after a loss occurs. That is, these policies allow the insured to waive its rights of recovery, and thus the insurer's right to subrogate, as long as the waiver is given before the loss occurs. Some policies explicitly state that pre-loss waivers of subrogation are permitted, while others merely prohibit the insured from doing anything *after* a loss that would impair the insurer's subrogation rights. By long-standing industry consensus, both of these types of subrogation provisions allow the insured to waive recovery rights against others prior to loss. Contractors can therefore agree in a contract to waive their rights of recovery with respect to covered losses without jeopardizing their recovery under that policy—as long as the contract is executed before the loss occurs.

In recent years, some insurers have challenged whether the "shall do nothing after a loss" language does, in fact, grant permission for pre-loss waivers of subrogation by the insured. While the courts have largely held that it does, there is always a risk that specific facts may lead a particular court in another direction. For this reason, it is wise to discuss this issue with underwriters and determine whether or not they wish to be notified of waivers of subrogation. Most underwriters with a large book of energy business understand that this is a typical risk transfer tactic and will allow contractors to waive subrogation without specific underwriter consent or notification. A subrogation provision that affirmatively grants the insured this right will avoid potential coverage disputes on this point.

The bottom line is that each contractor is responsible for knowing whether any additional steps are required to effect a waiver of subrogation as agreed to in a construction contract. Exhibit 3.4 summarizes how various types of policies typically address the waiver of subrogation issue and provides recommendations for securing an effective waiver of subrogation under that type of provision. See the discussion below for more information on specific coverage lines.

General Liability and Auto Policies

Standard CGL policies and business auto policies contain the "must do nothing after loss" language described above. Most nonstandard policies do likewise. Thus, waivers of subrogation with respect to damages payable under these policies do not void the insured's coverage as long as the contract with the waiver was executed before a loss occurred.

Standard liability insurance specifications usually do not require that a waiver of subrogation endorsement be added to the policy. However, there may be provisions elsewhere in the contract in which one party waives its right of recovery against the other party. In that instance, the insurer is prevented from pursuing subrogation to the extent the waiver applies.

Further protection against subrogation actions is provided if the party seeking the waiver is an additional insured under the policy. (Insurers are not permitted to subrogate against their own insureds as that would violate the purpose of insurance.) Despite the automatic protections against subrogation by liability insurers, sometimes a party that receives the benefit of a waiver of recovery rights will insist on evidence that the insurer agrees not to subrogate against that party. A standard endorsement is available for this purpose.

Workers Compensation

While waivers of subrogation are routinely used for many types of claims, workers compensation waivers of subrogation create some unusual and interesting problems.

Workers compensation benefits are statutory and are payable to injured employees for covered injuries without regard to fault. In exchange for these guaranteed benefits, employees give up their right to pursue claims against the employer outside the amounts payable under the workers compensation act. However, there is nothing to prevent a well services contractor's employee from bringing an action against an upstream party, such as the oil operator or the drilling contractor, for damages arising out of the injury, even if the workers compensation benefits covered the employee's damages in full. In some states, amounts paid under the workers compensation act are not even deducted from amounts awarded to the injured employee in an action against a third party.

The standard workers compensation policy published by the National Council on Compensation Insurance (NCCI) contains multiple subrogation provisions—one under each section of the policy and another in the general conditions. Unfortunately, inconsistent wording creates some confusion regarding an insured's ability to waive the insurer's right of subrogation. To be safe, always obtain a waiver of subrogation endorsement from the workers compensation insurer *before* a contractor signs a contract that includes a workers compensation waiver of subrogation provision.

The workers compensation and employers liability policy's general conditions state that the insured must do nothing *after a loss* that would interfere with the insurer's subrogation rights. This would appear to be similar to the provisions in the CGL policy and business auto policies (BAPs). However, within the individual coverage parts (Part One, which provides coverage for statutory workers compensation benefits, and Part Two, which provides coverage for other claims associated with an employee injury) are additional provisions that state the insured must do "*everything necessary*" to protect the insurer's rights of recovery and to help enforce them. There is no wording in this condition to make it applicable only *after* a loss has occurred. To avoid a coverage dispute, the safest strategy for waiving the insurer's subrogation rights is to have a waiver of subrogation endorsement attached to the workers compensation policy.

Waivers of subrogation are much more controversial in workers compensation than in most other lines of coverage because they result in an increased exposure for contractors and present an opportunity for injured workers to recover more than their actual losses. In all states, workers compensation insurers are subrogated to the rights of the injured employee with regard to recovery against a negligent third party. For example, if an injured employee collects workers compensation benefits from the employer's insurer and then files a lawsuit against the oil operator (not his or her employer) for failure to warn of known hazards, the workers compensation insurer is allowed to collect what it already paid for those injuries from any recovery obtained from the negligent project owner. This prevents the injured employee from recovering twice for the same elements of loss, such as medical expenses or lost wages. However, if the workers compensation insurer's right to subrogate has been waived by the insured, it cannot recover such amounts from the third-party suit.

The strongest argument for requiring a workers compensation waiver of subrogation from a downstream party is that it prevents the insurer from initiating a subrogation action on its own—that is, when no action has been filed against the owner by the injured employee. Practically speaking, however, most serious injuries do result in third-party lawsuits; therefore, it is somewhat rare for a workers compensation insurer to pursue subrogation on its own. The primary argument against requiring a waiver is that it can be difficult and costly to obtain, yet when all is said and done, it provides little protection to the owner beyond what is already provided in the contract. That is, the waiver does nothing to prevent the injured employee from filing an action against the owner, and it does not reduce the owner's exposure for this type of injury even if the loss is outside the indemnification agreement. It is merely a question of whether the full amount is paid to the employee or a portion of the award goes to reimburse the workers compensation insurer for benefits already paid. Contractors should attempt to use these arguments to negotiate a workers compensation waiver of subrogation requirement out of the contract.

In recent years, insurers have been much more aggressive in pursuing subrogation. NCCI's standard "Waiver of Our Right To Recover from Others Endorsement" (WC 00 03 13), reproduced in Exhibit 3.5, can be used to waive subrogation with respect to scheduled parties. Unlike the CGL policy, the contractor's waiver must be part of a *written* contract for the waiver of subrogation endorsement to be triggered. A blanket waiver of subrogation provision would remove the need to notify the insurer every time the contractor signs a contract that includes a waiver of subrogation requirement. (There is no standard blanket waiver of subrogation endorsement for workers compensation insurance.) Further demonstrating insurers' position that a waiver of subrogation changes their rights under the policy, most insurers charge a premium for this endorsement, in some cases as high as 2 percent of the policy premium. Several states explicitly disallow workers compensation waivers of subrogation in contracts, even if a waiver of subrogation endorsement is attached to the policy. Companies operating in these states should be careful not to agree to provide a workers compensation waiver of subrogation.

Exhibit 3.5 NCCI Waiver of Subrogation Endorsement
WC 00 03 13 **Effective April 1, 1984** **WAIVER OF OUR RIGHT TO RECOVER FROM OTHERS ENDORSEMENT** We have the right to recover our payments from anyone liable for an injury covered by this policy. We will not enforce our right against the person or organization named in the Schedule. (This agreement applies only to the extent that you perform work under a written contract that requires you to obtain this agreement from us.) This agreement shall not operate directly or indirectly to benefit anyone not named in the Schedule. Schedule
Source: "Waiver of Our Right To Recover from Others Endorsement," (WC 00 03 13), National Council on Compensation Insurance, effective April 1, 1984.

Contractors Equipment

Waivers of subrogation can eliminate the likelihood of needless litigation when contractors lend and borrow equipment to or from other contractors. Each contractor should carry insurance on its own property and not rely on another contractor's coverage for any damage sustained. However, large contractors may self-insure this exposure. Usually, a waiver of subrogation does not prevent self-insured contractors from making a claim against a negligent contractor that damages their equipment.

Contractors equipment forms are not standard, and forms vary with regard to how they address the issue of subrogation. Many equipment forms do allow contractors to waive their rights of recovery prior to a loss, but this should never be assumed to be the case.

Owner's Other Property

Being held liable for potential damage to existing property can be a substantial loss exposure for contractors. For example, consider the property damage liability exposure of a well service contractor doing repair work to an existing drilling rig. While the contractor may have $5 million or more in liability insurance, the liability exposure is much higher. In essence, the contractor is betting its business that no loss will occur, and this huge risk dwarfs the potential profit for the job. Similar imbalances between the risk and potential reward often occur with respect to renovation, repair, and remodeling work.

The most efficient solution to this problem is to use property insurance to cover the direct and indirect (i.e., business interruption) exposure for damage to existing structures. Since property owners already purchase permanent insurance for their property, it would be redundant for a contractor working on the property to also insure it. Instead, any losses can simply be confined to the owner's property insurance through a waiver of subrogation in the property owner's policy. The waiver of rights of recovery generally is structured to apply only to insured losses and may apply outright or above some mutually agreed on threshold. This approach leaves the property owner with the right to seek recovery against the contractor for damage not covered under its property insurance. If the waiver applies above a stipulated dollar threshold, the owner and its insurer would be in a position to recover the applicable deductible and insured amounts up to the agreed threshold.

Policies covering permanent property typically allow insureds to waive the insurer's subrogation rights prior to a loss, using the "shall do nothing after a loss" language found in the CGL policy and business auto policy (BAP). Some policies, including the standard ISO commercial property policy, go a step further by affirmatively stating that, to the extent the insured waives its right of recovery in a written contract prior to a loss, the insurer's subrogation rights are also waived.

Chapter 4
Joint Operating Agreements

Because petroleum exploration and production (E&P) operations involve substantial risk and expense, these operations are rarely conducted by a single party. Rather, companies typically explore and produce hydrocarbons as participants in a joint venture together with other joint interest owners under a contract known as a joint operating agreement (JOA).

Joint operations enable energy companies to take on larger, more complex, and riskier projects than they would be willing or able to handle on their own. However, the associated liability exposures create risk management and insurance challenges. Successfully addressing these challenges begins at the very inception of the joint venture, with the drafting of the JOA.

A JOA creates a framework for a joint venture under which the parties with an interest in the project will conduct petroleum operations. The JOA sets out the structure of the venture, the allocation of risks and costs, and the method for sharing production and profit.

Allocation of liability among co-owners should be clearly laid out in the JOA. Various standard forms provide a foundation on which to build a joint operation's risk and insurance schemes, but they require additional considerations. This chapter provides a general understanding of the risks and liabilities to be recognized and addressed through the JOA.

Chapter Objectives

On completion of this chapter, you should be able to

1. identify the purpose and benefits of a JOA,
2. recognize the rights and duties of the various parties that participate in joint operations under a JOA,
3. recognize the deficiencies of form contracts and identify changes that improve their clarity and avoid disputes,
4. recognize contractual methods of risk allocation that meet the contracting parties' expectations,
5. identify effective claims management strategies under a JOA, and
6. recognize the effect of various insurance requirements under a JOA and identify appropriate methods of addressing them.

Purpose of a JOA

The JOA performs the same role among its parties as another venture's partnership agreement performs between its partners. However, joint interest owners are not partners in the legal sense.

The JOA's two major functions are as follows.

- Providing a basis for the sharing of rights and liabilities. Rights and liabilities are shared in proportion to each party's percentage interest.
- Providing rules for the conduct of operations.

The JOA also clarifies other important matters.

Benefits of a JOA

Entering into a JOA provides numerous benefits, including the following.

- A party that undertakes only a portion of a project can simultaneously invest in several other projects thereby achieving a spread of risks.
- Because a JOA also allows sharing of risk associated with hydrocarbon exploration, no single party bears all the risk of the operation.
- The claims management and risk allocation scheme of JOAs enables participants to team up with one another to share the expenses, minimize the costs, and manage the perils associated with exploration and production work.
- Participation in a joint venture allows the venturers access to each other's skills, which might be in the areas of management, geology, operations, or litigation.

The Players and Their Roles

Various entities play key roles in the exploration and production business, especially with respect to joint operations and the JOA. This section of the chapter discusses the roles of

- professional organizations,
- the operator,
- nonoperators, and
- government agencies.

Professional Organizations

Two professional organizations—the American Association of Professional Landmen (AAPL) and the Council of Petroleum Accountants Societies (COPAS)—play important roles in exploration and production business, particularly in the method of contracting for and administering joint operations.

The American Association of Professional Landmen (AAPL)

The most important player in the onshore E&P business is probably the AAPL. The AAPL counts among its members thousands of oil and gas professionals. One of its significant functions is to draft and publish "model" JOA forms for use by its members. The AAPL was established in 1956, and it released its first form, JOA for onshore operations, that same year. The organization subsequently released revised versions of the form in 1977, 1982, and 1989.

The Council of Petroleum Accountants Societies (COPAS)

COPAS is a professional organization that provides accounting expertise specifically for the oil and gas industry. Just as the AAPL publishes the benchmark form that has become the main JOA document, COPAS publishes a set of accounting procedures that are essentially industry standards and are typically attached to each JOA as an exhibit. The intricacies of those accounting procedures are beyond the scope of this course, but their importance cannot be overstated. They are the basic tools for determining which costs are chargeable to the joint account and the manner in which those costs can be charged in connection with joint operations under the JOA.

The Operator

The JOA designates one of the co-owners in the mineral lease as the "operator." Other parties to the JOA are known as "nonoperators."

Within certain confines, the operator is empowered to run the joint operations on the co-owned property. The designation carries significant power and responsibility. Under the AAPL form, the operator "shall conduct and direct and have full control of all operations on the Contract Area as permitted and required by, and within the limits of this agreement.”

The operator has the roles and responsibilities listed below.

- **Coordinator:** The operator’s most important role is that of facilitator and coordinator, controlling the action of multiple parties and entities—some with the joint venture and some without, such as identifying and contracting with land owners, drillers, service contractors, and regulatory agencies.
- **Banker:** In some ways, the operator acts as a bank, fronting expenses for the nonoperators. However, many oil and gas companies that act as an operator would bristle at the suggestion that it is their role to carry any costs incurred on behalf of a nonoperator beyond the period allowed for in the JOA or in COPAS procedures.
- **Accountant:** An operator also acts as an accountant, tracking expenditures and billing the correct portion of expenditures back to the nonoperators through a joint interest bill (JIB).
- **Contracts manager:** The operator serves an extremely important role as contracts manager, which includes acting as the limited agent of the joint account when hiring and dealing with suppliers, drillers, service contractors, property owners, etc.
- **Reporter/Compliance officer:** The operator spends a great deal of time reporting to regulators, nonoperators, or the operator’s own shareholders or owners and complying with regulations promulgated by those agencies.
- **Claims handler/Litigator:** An operator must be ready to handle claims, including analyzing and paying land owners’ claims, retaining attorneys, monitoring litigation, and keeping the balance of the interest owners informed.

In many ways, the operator’s role resembles that of a general contractor on a construction project. The operator hires the drilling and service contractors, and it sometimes obtains insurance for the entire project. More important, however, the operator is responsible for equipment purchases, hiring of accountants, and filing the appropriate and necessary permits. The operator role also includes administrative tasks such as entering into contracts for joint operations, hiring geologists, obtaining seismic data, procuring licenses, and paying taxes applicable to joint operations, along with all of the operational components. (For example, the operator is responsible for getting wells drilled, sidetracked, producing, worked over, plugged, and abandoned.)

Most operators own a relatively large percentage of the property subject to the JOA. They accept the role of operator for various reasons, including the following.

- **Control:** The interest owner that accepts the role of operator is in charge of the day-to-day operation of the property, decides in the first instance how to confront the daily challenges involved in the operation, usually decides with whom to contract and on what basis (including the specific content of written contracts), and typically has the discretion to retain consultants, including so-called company men, engineers, landmen, and consulting engineers.
- **Expertise/Reputation:** Some operators accept the job because they are good at it; they are skillful managers and money handlers and/or they have particular expertise in the contract area and the type of operations to be performed. Serving as an operator for a successful project also enhances the operator’s reputation as an expert in the field.
- **Economic incentives:** Within COPAS rules, some operators seek to lay off some wider administrative costs among the joint account. Some operators even receive an administrative fee from the balance of interest owners as an incentive to take on a leadership role.

The operator assumes much of the responsibility of the joint operation. However, most JOAs protect the operator from the risks associated with this elevated level of responsibility. Under most JOAs, the operator is exculpated from all liability, except to the extent caused by its own gross negligence or willful misconduct.

Outsider as Operator

Sometimes the co-owners will hire an outsider (i.e., a non-interest owner) to perform the operator role. For practical purposes, the parties can accomplish that arrangement at least three different ways.

Non-Interest-Owning Operator Enters the JOA

One approach is to have the non-interest-owning operator enter into the JOA. The AAPL form generally does not provide for that arrangement. Under the AAPL form, even when the operator resigns or is removed, the form provides that "the successor operator shall be selected from the parties owning an interest in the Contract Area at the time such successor Operator is selected." If the operator subsequently "no longer owns an interest [under the JOA] in the Contract Area ... Operator shall be deemed to have resigned." The primary reason for this peculiarity is to ensure that the party responsible for conducting the joint operations has some skin in the game. Parties rest easier when the operator shares their interest in conducting a safe, efficient, cost-effective operation.

Nevertheless, under certain circumstances, a non-interest owner may be tapped to assume the operator role. Perhaps the original operator resigns or sells its interest and no other interest owner has the capacity or willingness to perform the tasks. Alternatively, the operator may have undergone a shift in corporate structure and one of its affiliates now owns its interest in the contract area. The AAPL form does recognize and allows the latter scenario. Section V(B)(1) provides that "[a] change of a corporate name or structure of Operator or transfer of Operator's interests to any single subsidiary, parent or successor corporation shall not be the basis for removal of Operator." And for some larger E&P companies, this approach—one affiliate owns the interest and another is to perform the operator function—is a standard feature in their custom forms.

Operator Hires a Contract Operator

Another approach is for the operator to hire a "contract operator" pursuant to a separate agreement, under which the operator essentially subcontracts all or a significant portion of its operator duties. Under this approach, however, the operator will remain bound to the nonoperators for performance under the JOA.

Split Responsibilities

In some rare instances, parties to the JOA will split the operator responsibilities, either under the JOA itself or through a side agreement that allocates certain operator responsibilities to be performed by another interest owner. Nontraditional arrangements of this type create risk allocation concerns. No matter who assumes the roles of the operator, the parties must be careful to ensure that the risks of the operations are allocated to the appropriate persons, unique risk allocation concerns are not overlooked, and proper insurance is in place to protect the joint interests.

Nonoperators

Nonoperators are investors whose role is generally passive and limited. If the operations run smoothly, nonoperators pay their participating interest shares of joint operations, vote on some major issues, and (with any luck) collect revenue. Otherwise, the operator runs the show. But if the operations encounter problems, if large casualties occur, or if the operator's management decisions become contentious, nonoperators may need to become more involved. A well-drafted JOA will dictate how the operator and nonoperator relationship works and what role the nonoperator plays if problems arise.

The AAPL form contains several instances that require a vote of a majority of the interest owners. For example, Section V(B)(1) of the AAPL form provides as follows.

> Operator may be removed only for good cause by the affirmative vote of Non-Operators owning a majority interest based on ownership as shown on Exhibit "A" remaining after excluding the voting interest of Operator....

Owners with the largest interests in the project often carry more influence than smaller interest owners do. Of course, the larger interest owners also bear more risk, particularly if large liabilities arise out of the operations. Conversely, unless they are also the operator, parties with small ownership interests in the joint drilling operations typically have relatively little power over the operations themselves.

With regard to certain types of activities, *all* interested parties must agree to participate, so even small interest owners can play an important role in the overall operations. Conversely, some activities may require only an "informational authority for expenditure (AFE)," which merely lets the interest owners know that certain legal or contractually required operations will be conducted and the interest owners have no discretion in paying their proportionate share of the costs from that activity.

Government Agencies

The other major players in the context of joint operations are state agencies, such as the Texas Railroad Commission, the Louisiana Department of Natural Resources, tribal governments, and federal agencies (including the U.S. Environmental Protection Agency and the Occupational Safety and Health Administration) and their state counterparts. These agencies promulgate and enforce rules, conduct inspections, impose reporting requirements, and penalize interest owners for noncompliance.

Modification of Contract Forms

Given the high stakes involved and the sizable risks they face, energy companies usually opt for tried-and-true methods of business. This tradition-bound attitude extends to the contractual relationships that joint interest owners form.

Some operators (particularly large ones) use their own JOA forms. However, the predominant practice throughout the onshore industry is to use either an AAPL form or a slightly modified version of it. Therefore, the provisions set forth in the AAPL form have largely become the benchmark for the entire industry. Unless otherwise indicated, our references in this course to the AAPL form refer specifically to AAPL Form 610–1989: Model Form Operating Agreement.

AAPL forms have a significant impact on the industry as a whole, including those entities that do not use the AAPL forms. But it does not follow that operators should delegate all contract drafting responsibilities to the AAPL. Not all joint operations are the same. Each operation faces its own set of risks and challenges.

- Some operations take place in a permissive regulatory environment; some do not.
- Some drilling or production work is technically difficult; some is easier.
- Some operations are undertaken with cooperative and well-known interest owners; sometimes new or inexperienced interest owners join the group.

Due to tradition, a conservative attitude, or perhaps just inertia—joint interest owners can be reluctant to modify the standard AAPL form. But the form should be modified, both to account for industry changes and to account for the parties' management styles, risk tolerance, and attitudes. And to best modify the form, the parties must first negotiate with one another.

The best approach for a mutually satisfactory contract negotiation is to first understand how the contract is designed to work. Armed with that knowledge, one can understand why certain changes are being requested. For example, AAPL forms must be modified to fit the parties' particular situation and jurisdictional requirements. Accordingly, parties should avoid signing an unmodified AAPL form without considering the particularities of their operations.

Once the JOA is in place, the operator may enter into other contracts to perform the operations, such as drilling contracts and service contracts discussed in Chapters 5 and 6. The various contracts must work together, because the structure of contracts in the E&P business creates a situation in which a promise made in one contract must often be kept through another contract.

Operators should be careful not to make promises in their other contracts that conflict with the JOA. For example, a standard feature of drilling contracts and service contracts is for the operator to indemnify the other party from claims by the operator's broadly defined economic "group." The operator's "group" often includes its nonoperating interest owners. As such, in those service contracts, the operator is being asked to indemnify its contractors from claims by the nonoperators. The operator should obtain specific and sufficient authority within the JOA to bind the nonoperators to traditional provisions in today's drilling and service contracts; these provisions, which are now traditional, include consequential damages waivers, indemnity/hold harmless provisions, confidentiality, etc. The nonoperators should, as discussed later, waive claims against the service contractor to the same extent as the operator.

While language in most JOAs is sufficient to grant the operator authority to bind the nonoperators to such provisions, it is prudent for the operator to specifically confirm and/or verify that it has the nonoperators' permission to make these promises. One way to confirm that the operator has sufficient authority to make these promises on behalf of the joint account is to specifically say so in the JOA as follows.

> The Operator's right and responsibility to conduct operations and activities in the Contract Area includes contracting with service providers and suppliers on reasonable commercial terms. Such terms may include releases and hold harmless obligations, to which the parties hereby consent.

Nonoperators should be more involved than they usually are in modifying the JOA form. Nonoperators that sign the JOA exactly as offered by the operator are often surprised by results or by what is simply not addressed in the form. For example, the JOA might fail to address the following questions.

- On what basis do the parties decide whether to settle litigation affecting the joint account?
- May a nonoperator withhold payment of a joint interest billing (JIB)[2] when it has a dispute with the operator?
- To what extent may the operator bind the nonoperator to contractual limitations with suppliers and contractors?

These questions should (and can) be addressed head-on in an addendum to the JOA form and with the input of nonoperators. Even if the result of these modifications is disadvantageous to one party in relation to the others, the modification creates some certainty that reduces the potential for internal disputes, increased third-party exposure, wasted money, and broken relationships.

Role of Insurance

Insurance plays a key role in connection with joint operations and the JOA.

The Importance of Insurance

Both operators and nonoperators want their liability exposures to be covered by insurance. Many important issues—such as who is responsible for obtaining the insurance, how much insurance to purchase, who is responsible for ensuring that each interest owner has enough insurance, and who is responsible for ensuring that no one is paying for duplicative or illusory coverage—should be allocated in the JOA. It is essential to coordinate insurance programs among interest owners and to record these decisions in the JOA. However, the standard forms do not adequately cover these details.

Operator's Insurance Coverage

Standard JOA forms, for the most part, omit the details concerning insurance the operator must maintain for the benefit of the joint account. They fail to answer the question of whether insurance should be procured jointly by the co-owners or carried severally by each owner to cover its respective participating interest shares.

Sometimes, all parties carry their own insurance. Often, however, nonoperators rely primarily on the operator's insurance program. JOA forms typically require the operator to maintain workers compensation insurance and auto insurance (if necessary), and often general liability coverages, but the other insurance details are left to the parties. In some situations, general liability coverage is not part of the insurance program for the joint account. Rather, each interest owner may be responsible for obtaining liability coverage for itself. Consequently, the parties must carefully and deliberately analyze their insurance needs and determine what coverages the operator is carrying and at what limits.

Unless they also act as operators on other wells, nonoperators rarely carry operators extra expense/control of well (OEE/COW) coverage.[3] Designed to provide coverage for well control, redrill, and restoration expenses incurred in respect of drilling or nondrilling wells (wells that are producing, suspended, or abandoned), OEE/COW coverage is critical to any operation, so it is important to spell out the type and amount of OEE/COW insurance the operator must obtain for the joint account.

The parties might also want the operator to carry a large commercial general liability (CGL) policy, along with umbrella coverage, in order to protect themselves from any potential liability. Additionally, if the operations involve maritime exposures, the JOA may require maritime coverages.

Opt-Ins, Opt-Outs, and Duplicate Coverage

Some JOAs allow nonoperators to opt into or opt out of the suite of coverages that the operator maintains. These arrangements are preferred when some nonoperators maintain their own extensive insurance programs and others do not. However, nonoperators should pay close attention to whether the arrangement is "opt-in" or "opt-out." If it is an "opt-in" arrangement, those parties could have no protection against casualties for which the other interest owners are covered.

Similarly, if a party maintains its own insurance coverages and the JOA contains an "opt-out" mechanism, that party must make sure that it follows the opt-out procedure. Otherwise, it may have duplicate coverage, which not only means the interest owner is paying for double coverage but also creates its own set of problems. An interest owner that maintains its own insurance coverage should be careful to ensure that coverage maintained for the joint account is primary to the interest owner's own coverage to the extent the policies could cover the same risks. Otherwise, two insurance companies and two sets of attorneys may be representing that interest owner in the event of a casualty. This arrangement is inefficient, and it can create conflicts if the two sets of lawyers have different strategies.

General Insurance Concepts in the Context of the JOA

Insurance should be in place to protect all the interest owners from potential casualties that arise during the operations. Most risks will be shared by the interest owners in proportion to their interest in the applicable operation, and the parties should ensure that their insurance protections dovetail with that arrangement.

The "Big Three" Protections for Joint Account Policies

To adequately protect the joint account, all JOAs should include the three critical insurance protections (the "big three") discussed in this section.

- Insured status
- Waiver of subrogation
- Primary and noncontributory coverage

Insured Status

Nonoperating interest owners should either be named insureds on the joint account policies or, at a minimum, be named as additional insureds on the joint account policies.

Each interest owner (if not a named insured) should be named as additional insured on any liability coverages maintained for the joint account (other than workers compensation insurance). In the event of a casualty, and if there were any allegations that the nonoperators were somehow negligent in causing that casualty, additional insured status (or actually having them named as insureds on the policy) will allow for the protection of the nonoperators under the insurance procured for the joint account.

Additional insured protection, however, may not be available for certain insurance coverages, notably workers compensation coverage, operators extra expense/control of well (OEE/COW) coverage, first-party property policies, and professional liability policies. Nevertheless, additional insured status should still be obtained on any insurance coverage related to the work.

Parties should also be careful to ensure that the additional insured protection is not limited inappropriately. For example, some additional insured endorsements are narrow and only apply in certain circumstances.

Waiver of Subrogation

The second "big three" protection is a waiver of subrogation. This protection prevents the insurer of the joint account insurance from asserting claims against the parties' other insurers. Although it can effectively produce some of the same benefits as additional insured status, a waiver of subrogation can apply to policies for which additional insured status is unavailable.

Primary and Noncontributory Coverage

The final "big three" protection is for the joint account coverage to be "primary and noncontributory" to the parties' other insurance policies. Most policies contain "other insurance" clauses that aim to share the risk of exposure with (or shift the entire risk to) other policies of any party that may cover the same loss. Without a statement of primacy, the "other insurance" clause could frustrate the parties' intent to have the joint account coverage respond to the losses arising out of the joint operations.

Insuring Contractual Liability

Nonoperators generally have no duty to third parties and, hence, cannot be sued in tort for bodily injury or property damage that results within a contract area. But sometimes plaintiffs are stubborn or are hoping for an anomaly, and they file suit against the nonoperators anyway.

Under JOAs, the nonoperating interest owners assume indirect responsibility for losses by contractually assuming risk for which they would otherwise not be responsible without the contract. Contractual liability may be (and often is) excluded from a general liability form. When it is covered, contractual liability is often covered only through an exception to the contractual liability exclusion. The parties should seek clarity as to the scope of the contractual liability exclusion for claims, expenses, and defense costs that flow through the JOA. Contractual liability coverage is typically provided through the CGL policy's definition of an "insured contract," which provides coverage for an insured's obligation under a contract or agreement to indemnify another for the assumption of tort liability. There is a potential problem with a nonoperator's insurance when the nonoperator is sued directly, because the insurance may not provide coverage for the contractual indemnity the nonoperator assumed under the JOA.

When only the operator is sued, the source of the nonoperator's exposure is its contractually assumed obligation in the JOA to reimburse the operator for its share of expenses (provided litigation costs are included as "costs" in the JOA). Because the JOA obligates the nonoperator to indemnify the operator for the operator's negligence, this should be a classical example of insured contractual indemnity. This coverage scheme is less than ideal and may create more anxiety rather than comfort. In fact, many policy forms expose the policyholder to potentially catastrophic uninsured losses.

For example, some policy forms provide coverage only if the named policyholder is partially at fault. This proposition can be devastating for a nonoperating interest owner with a large interest in the joint operations, because the nonoperating interest owner will rarely have any fault but could still have significant exposure. Interest owners should therefore be cautious about the narrow policy forms used in the insurance market and take steps to avoid ill effects. One step is to negotiate specially tailored (manuscript) contractual liability coverage to make it clear that the liabilities that flow through the JOA are covered under the nonoperator's CGL policy.

Some insurers have tried to argue that this obligation is simply a partnership arrangement, not an indemnity obligation, and that the losses are business expenses rather than insured casualty losses. At least one federal district court has rejected this position. In Burlington Res., Inc. v. United Nat'l Ins. Co., 481 F. Supp. 2d 567 (E.D. La. 2007), the federal Eastern District Court of Louisiana held that a nonoperator was covered under its liability policy because its exposure for its percentage of a casualty that resulted from a well blowout arose out of its contractually assumed liability for its proportionate interest under the JOA.

The *Burlington* decision represents a significant victory for nonoperators seeking to protect themselves via contractual liability insurance coverage. Nevertheless, nonoperators should still be cautious in their reliance on a decision by a trial court. Nonoperators would be wise to take affirmative steps to avoid the risk that their insurer would take a position similar to that of the insurer in the *Burlington* case by obtaining a broader contractual liability endorsement.

Role of the Insurance Agent or Broker

Operators and nonoperators should involve their insurance agents or brokers to ensure that they have the proper protections in place. Agents and brokers can review JOAs (and other E&P contracts) to evaluate the types of coverage that the participants need. An agent or broker can also guide clients to quality insurers that are less likely to dishonor their coverage obligations or to press strained interpretations of policy limitations. Sophisticated agents or brokers may even be able to obtain manuscript policy endorsements. For larger accounts, an agent or broker may even have the power to negotiate manuscript endorsements that expressly cover some of the risks for which coverage may be questionable under standard insurance language. Taking this step early can prevent or alleviate unexpected exposures from creating problems later.

Analysis of Insurance Limits and Insurance Coverage

The operator, with the input of the nonoperators, should carefully analyze the limits of insurance required. The standard approach to liability insurance (perhaps $1 million of general liability coverage or at most $5 million) might not be appropriate in today's litigious environment. If so, Exhibit D (Insurance and Indemnity) of the 1989 AAPL form, which describes the usual insurance limits, must be modified. Moreover, the parties should ascertain what the general liability policies cover since not all contractually assumed liabilities are covered under standard general liability policies. Furthermore, the parties should clearly state the scope and intent of the insurance obligations in the JOA by addressing the following questions.

- How much insurance is the operator providing?
- What coverages are the nonoperators required to provide?
- What are the applicable insurance policies' limits?
- Should any special exposures be addressed?
- What is the history of well control problems in the area, and are the insurance limits sufficient in light of those problems?

The point here is to not rely on the same old way of doing business. The operator (with the participation of the nonoperators) should consult an experienced insurance agent or broker, dwell for a while on the "parade of horribles" (what bad things can happen, what horror stories have been heard), and think about how to prevent them in the future. In particular, the interest owners should note the policy requirements for the reporting of pollution events and, as discussed in greater detail below, consider addressing the operator's responsibility for reporting these events in the JOA.

Pollution Coverage

A typical pollution buyback provision in a liability insurance policy starts with an absolute pollution exclusion, excluding all liability in any way arising out of a very broadly defined concept of pollution. Then the insurance company allows the policyholder to "buy back" limited pollution coverage that creates an exception to the absolute pollution exclusion, with the exception applying only if strict discovery and reporting deadlines are met. The problem, of course, is that sometimes pollution events take place without the policyholder's knowledge (either because of internal communication challenges or because a contractor or consultant fails to report them).

The parties to a JOA should consider whether to contractually require the operator to be consciously aware of these limitations and to specifically comply with the deadlines imposed within insurance policies, including notice of occurrence, notice of claim, and the reporting of pollution.

Consideration should be given regarding the type of insurance (OEE/COW, property damage, loss of production income/business interruption coverage). Obtaining OEE/COW insurance is usually required and, frankly, a no-brainer. The real issue is from whom to buy the coverage and for what limits. Deciding how much coverage to buy is a function of risk, risk tolerance, and the ability to pay. But attempting to save money by reducing policy limits often turns out to be a bad idea. A well blowout or pollution event can be extraordinarily expensive, easily surpassing the $5 million liability of OEE/COW many operators normally carry.

Risk Allocation

The goal in the exploration and production business is to drill for and produce hydrocarbons in paying quantities. For any number of reasons, this goal is not always accomplished. Beyond the fundamental risk of drilling dry holes, drilling and production operations carry numerous other casualty and business risks. JOAs allocate the costs, liabilities, risks, and rewards of the drilling operations.

An overarching theme of the JOA is to ensure that the amount of risk that each party bears (financially and legally) is commensurate with that party's level of participation in and contribution to the joint operation. The default risk allocation provision of the American Association of Professional Landmen (AAPL) form states:

> Unless changed by other provisions, all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations on the Contract Area shall be owned, by the parties as their interests are set forth in Exhibit "A."[4]

Although the AAPL form sets forth the default rule, most costs and liabilities of the operations are not necessarily borne by all parties but rather only by the parties participating in the particular operation to the extent of their participating interest share of the operation in question.

The parties should carefully consider what constitutes "costs" under this provision. Certainly, the day rate for the driller, the cost of drill pipe and casing, and even attorneys' fees are traditional "costs" and are not subject to challenge if the amounts are reasonable for the work performed. But what about fines, penalties, uninsured pollution cleanup costs, and consequential damages? While the nonoperator's liability of its share of such costs might turn on the effect of the exculpatory clause (discussed later), based on the parties' attitudes and temperament or on trending jurisprudence, the answer might not be clear. The better approach is to specify in the JOA what constitutes "costs."

The operator will usually prefer a broader definition of costs that allows it to more effectively argue that the nonoperators are required to pay their participating interest shares. Nonoperators tend to prefer a more limited definition of costs because it may reduce their exposure to having to pay for things related to a joint operation. Whatever the decision, the JOA form should be modified to reflect the parties' intent.

Basic Commercial Risks of a JOA: Consenting and Nonparticipating Parties

When parties enter into a typical JOA, the only drilling activity to which the parties consent is drilling the initial well (and subsequently plugging and abandoning it). Beyond that, additional activity in the contract area is largely elective. The costs and liabilities of these elective operations are shared by the "consenting parties" (i.e., the parties that agreed to participate in the particular operation).

For operations in which only some of the interest owners elect to participate, "[t]he entire cost and risk of conducting such operations shall be borne by the Consenting Parties in the proportions they have elected to bear" for that operation.[5] This is, in theory, a simple approach. But sometimes, responsibility for costs or liabilities can vary over the course of an operation (e.g., when a consenting party elects to "nonconsent" to a subsequent operation or a supplemental AFE), creating complex liability and accounting issues and certain disharmony among the interest owners.

Although they may avoid the costs and risks of the drilling operations in which they elect not to participate, nonconsenting parties run the risk that the consenting parties hit it big. For example, when coworkers pool their money together and buy lottery tickets for a particularly large jackpot, the prospect that one's colleagues might win, thus leaving out any nonparticipant, could influence one's decision to contribute money to purchase lottery tickets. One might not otherwise be inclined to spend money on the lottery. JOAs have similar pressures built into them. If an operation produces in paying quantities, the consenting parties collect the nonconsenting parties' share of the proceeds up to a substantial amount.

When a party consents to an operation, however, it is typically not just consenting to a specified dollar amount. Rather, it is consenting to the operation itself, regardless of the expense. An authority for expenditure (AFE)[6] is the mechanism used to request authority to undertake operations under the JOA. The AFE is a document, usually prepared by the operator, listing the estimated cost of drilling a well to a specified point and then either completing or abandoning the well. AFEs typically contain estimates rather than firm bids or fully itemized costs. So, in some ways, the consenting parties may be writing what is essentially a blank check. One way to protect against the risks associated with this scheme is for the nonoperating interest owners to insist on a cap of the expenses. The standard form does not provide any type of ceiling, so this is something that the parties will have to negotiate.

Nonjoint Losses, Costs, and Expenses

It is important to consider subsequently created interests and the cost of title examinations, defects, and renewals when parties are negotiating the JOA, including whether the AAPL form's approach to these issues should be modified.

Subsequently Created Interests

When a party contributes a lease or other mineral interest to the joint operations, the assumption is that it will not be later burdened by priority interests. If this occurs, the party that contributed the interest that is later burdened by a subsequently created interest "shall assume and alone bear, pay and discharge the Subsequently Created Interest and shall indemnify, defend and hold harmless the other parties from and against any liability therefor."[7]

Cost of Title Examinations, Defects, and Renewals

Under the standard AAPL form, the consenting parties are responsible for the cost of title examinations performed in connection with each well. But if title to any interest is defective, the party responsible for providing that interest is responsible for all necessary curative work to secure title. Under the AAPL form, the responsible party has 90 days to cure title. If no party is responsible for the loss or failure of title as provided under the JOA, then the loss or failure is borne equally by all parties.

Importance of the Exculpatory Clause

Under most JOAs, the operator is exculpated from all liability, except to the extent caused by its own gross negligence or willful misconduct. In the same way, all consenting parties in a joint operation will be responsible for their participating interest share of the costs and liabilities that flow from that operation, even if the operator was negligent in conducting those operations.

The AAPL form's exculpatory clause states as follows.

> Operator shall conduct its activities under this agreement as a reasonable prudent operator, in a good and workmanlike manner, with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulations, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred except such as may result from gross negligence or willful misconduct.[8]

The exculpatory clause provides enormous protection for the operator because, regardless of the applicable law, gross negligence is difficult to establish. The law throughout most jurisdictions is similar: Mere inadvertence or an honest mistake does not qualify as gross negligence. Rather, gross negligence is willful, wanton, and reckless conduct that falls between intent to do wrong and ordinary negligence.

Both Texas and Louisiana courts have ruled that there is little distinction between willful misconduct and gross negligence.

As a practical matter, proving gross negligence is difficult. Complicating the issue is confusion over whether the exculpatory clause protects the operator from negligence, not only in the operational sense but also in the conduct of so-called administrative matters. For example, an operational mistake may include drilling on the wrong property, allowing accidents to occur during the operation, delays in drilling or producing hydrocarbons, and wasting money. Administrative errors include negotiating disadvantageous service contracts, losing leases due to delays or other errors, and bad accounting practices.

For years, debate raged as to whether the exculpatory clause protected the operator from all errors, meaning both operational and administrative errors or operational negligence only. In 2012, the Texas Supreme Court held in *Reeder v. Wood Cnty. Energy LLC*, 395 S.W.3d 789 (Tex. 2012), opinion supplemented on reh'g (Mar. 29, 2013), that the exculpatory clause applies to both operational and administrative activities undertaken by the operator. Consequently, the rule in Texas is that under the current (and unmodified) AAPL form, the operator is not subject to liability for its operational *and* administrative errors absent gross negligence—a hard standard for a plaintiff to meet.

Whether the *Reeder* court's logic will be followed by other courts remains to be seen, but its holding is at least not illogical. Modifying the contract form would remove any doubt as to the scope of the operator's protection under the exculpatory clause. One possible change is as follows.

> Operator shall conduct its activities under this agreement as a reasonable prudent operator, ~~in a good and workmanlike manner,~~ with due diligence and dispatch, in accordance with good oilfield practice, and in compliance with applicable law and regulations, but in no event shall it have any liability as Operator to the other parties for losses sustained or liabilities incurred <u>in connection with any operational and/or administrative matter pertaining to its activities under this agreement</u> except such as may result from gross negligence or willful misconduct.

This change confirms that all activities undertaken by the operator are subject to the gross negligence standard. It also removes the requirement to perform in a "good and workmanlike manner." Whether any obligation for the operator to perform in a "good and workmanlike" manner is still useful is subject to serious question. If the operator's standard of conduct is to be expressed in negative terms (i.e., unless caused by gross negligence), the affirmative duty to perform in a good and workmanlike manner would seem superfluous.

Removing the Operator

Once the operator has been selected, it typically cannot be removed without "good cause." Specifically, Article V.A., "designation and responsibilities of operator," page 4 of the AAPL Form 610–1989: Model Form Operating Agreement, provides, "Operator may be removed only for good cause by the affirmative vote of Non-Operators owning a majority interest based on ownership ... remaining after excluding the voting interest of Operator."[9] "Good cause" is defined under the form as "not only gross negligence or willful misconduct but also the material breach of or inability to meet the standards of operation contained in Article V.A. or material failure or inability to perform its obligations under this agreement."[10] This standard is a relatively onerous one, as the nonoperators cannot simply remove operators that fall into disfavor, even with a majority vote of the nonoperating interest owners. Accordingly, the clear message to the nonoperators is to be careful when entering into a JOA with a particular operator and, whenever possible, to choose the operator very carefully. As with all contracts, one should only enter into agreements with trustworthy parties.

The Operator as "Independent Contractor"

Under the JOA, the operator functions as an independent contractor. In the context of a JOA, the independent contractor provision provides an important protection to the nonoperating interest owners—it can help to minimize the risk that a court would determine that any nonoperating interest owner acted negligently in causing an injury or other casualty. The independent contractor language in the AAPL form states as follows.

> In its performance of services hereunder for the Non-Operators, Operator shall be an independent contractor not subject to the control or direction of the Non-Operators except as to the type of

> operation to be undertaken in accordance with the election procedures contained in this agreement.

A successful “independent contractor defense” exculpates nonoperators from liability when the operator (their independent contractor) handles the details of operations. Although a nonoperator generally will not have tort liability to a third party, if a nonoperator is brought into a lawsuit along with the operator, the nonoperator can point to the former’s independent contractor status as a defense to liability.

While the independent contractor provision in the AAPL form is probably sufficient, the careful nonoperator interest owner may wish to modify it to a more robust version. The following provides an example of one such modification.

> In its performance of services ~~here~~under <u>this agreement</u> ~~for the Non-Operators~~, Operator shall be an independent contractor not subject to the control or direction of the Non-Operators except as to the type of operation to be undertaken in accordance with the election procedures contained in this agreement; <u>and Operator shall have control and management of all operations, the selection of employees and the fixing of their hours of labor, and no right is reserved to any Non-Operator to direct or control the manner in which the operations are performed, as distinguished from the result to be accomplished</u>.

Although the operator functions as an independent contractor, the parties would be unwise to ignore the talents and opinions of the nonoperators; after all, their collective expertise and experience is one of the reasons the owners banded together in the first place. And while every organization needs a leader, nonoperators should involve themselves in setting certain standards and expectations for the operator. Therefore, the nonoperators should investigate and comment on the qualifications of consultants that are hired, the protections included with service contracts, and the operator’s compliance with regulatory agencies’ directives. The added attention—provided it is not overly aggressive or disruptive—will likely increase protection for the joint account and reduce the chances for unwelcome surprises.

Claims Management

The standard form JOA does not specify how the potentially numerous strategy decisions concerning litigation should be made. This silence can cause the interest owners to become misaligned in third-party litigation. Even the first step in any lawsuit—selecting an attorney—can be difficult when interest owners likely have their own attorney contacts and often have differing opinions as to who should represent their interests.

The parties should acknowledge at least the theoretical potential for litigation, including the possibility of misalignment among the interest owners that can result. The best way to address that concern is to modify the JOA with a claims/litigation annex that addresses numerous issues that arise in the context of third-party claims, including decision making, document production, third-party statements, settlement authority, and internal disputes. The JOA should be adjusted to account for the parties’ risk tolerance and management styles. While there is no right answer, the parties may wish to address issues similar to the following.

- Method of communication with the joint account attorney
- Protocol for dealing with subpoenas and document requests
- Statements made to the media and in court documents
- Postponing the gross negligence determination
- Private arbitration
- Confirming rules on joint interest bill (JIB) payments
- Providing reasonable control and settlement authority up front

Each of these issues is discussed below in greater detail.

Decide the Method of Communication with the Joint Account Attorney

The operator may serve as a single point of contact between the interest owners and the attorney. This approach will often provide the added benefit of a helpful collaboration between the attorney and the entity with the best access to documents and witnesses necessary for most litigation. The operator, however, may have little or no ownership interest, leaving the operator unauthorized to direct the attorney's handling of the case. The lawyer for the joint account may also face a complicated relationship with multiple clients.

Various interest owners can also bring value to litigation with their assorted resources, contacts, and experience. Many interest owners have already experienced litigation and can recommend competent attorneys from prior cases. Additionally, interest owners may have accountants or other experts in-house or as vendors that can provide helpful assistance to a case and perhaps are already familiar with the relevant facts of the litigation.

Create a Protocol for Dealing with Subpoenas and Document Requests

In the context of an underlying third-party lawsuit, nonoperators will likely have to respond to subpoenas. The nonoperators should be required to pass all subpoenas to the operator's legal counsel for response or, alternatively, must agree to allow to have their responses screened for privilege. Moreover, the operator should be free to cooperate with governmental organizations, including producing sensitive documents where required. The JOA can provide that the operator may do so, as long as appropriate confidentiality concerns are addressed.

Be Careful with the Statements Made to Media and in Court Documents

In the context of an underlying third-party claim and a concurrent (or at least possible) nonoperator lawsuit against the operator, nonoperators sometimes indirectly harm their own interests by making statements (either in the media or in pleadings filed by their attorneys in separate litigation) that are critical of the operator. This approach should be avoided. It behooves the joint account to maintain a united front (i.e., not airing dirty laundry in front of underlying plaintiffs, maintaining confidentiality, and not creating "bad" documents).

Certainly, a nonoperator that thinks that the operator breached its duty has a right and perhaps an obligation to bring a lawsuit against an operator. But all of the parties to the JOA can protect themselves by agreeing in advance to a protocol that minimizes damage to the joint account while preserving all of the parties' rights. The ultimate goal here is for the joint account, despite what internal differences it may have, to speak with one voice.

A process should be developed by which any press releases are made only by the operator and always with the express agreement of the nonoperator's representatives.

Postpone the Gross Negligence Determination

Some important questions surrounding gross negligence allegations, especially when brought by an underlying third-party plaintiff, should be addressed proactively in the JOA. For example, the JOA should address where it is to be decided that there has been a breach of the gross negligence standard. Is it the jury or judge in the underlying third-party case? Or should it be the judge or the jury in a concurrent (or later) lawsuit between the operator and nonoperators? Relatedly, it is not entirely clear as to whom the operator's duty is owed. Does the operator owe third parties a specific duty that is judged under the gross negligence standard, or is that standard only applied to nonoperators? While this issue cannot be completely controlled within the JOA, some clarity within the exculpatory clause could be achieved.

Perhaps the most important issue to be addressed in a JOA's dispute resolution provision is whether any gross negligence determination that may be sought by either the operator or the nonoperators is specifically held in abeyance pending the final outcome of any underlying third-party trial. That way, parties to the JOA will not feel compelled to marshal evidence and make assertions regarding the operator's gross negligence; that would only inure to the underlying plaintiffs' benefit and ultimately increase the exposure of all of the parties to the JOA if the operator is not found to be grossly negligent in the third-party proceeding.

Plan for Private Arbitration

The JOA could contain a dispute resolution provision under which the parties contractually reserve the right to bring gross negligence claims against the operator until such a time as the plaintiffs would not benefit from that action. The parties could even agree to file for private arbitrations with a preselected panel or potential panel, with the requirement that the arbitration proceedings are stayed pending a final outcome of the underlying suit. That way, no one has to worry about losing any rights due to a statute of limitations (also known as prescription under Louisiana law).

Confirm the Rules on JIB Payments

One very practical matter that should be determined contractually is to decide whether the payment of joint interest bills (JIBs) continues when an underlying third-party claim is ongoing. Some nonoperators believe that it is practical and just to withhold payment of JIBs where they believe the operator's grossly negligent conduct caused damages to the nonoperators. Operators, on the other hand, contend that they should not have to front money and carry nonoperators based only on the mere allegation of grossly negligent conduct.

An operator-centric addition to a JOA would require the payment of JIBs pursuant to the JOA and/or Council of Petroleum Accountants Societies (COPAS) without any attempted "setoff" ("compensation" under Louisiana law) and with all of the parties' rights to reimbursement preserved until disposition of the underlying third-party claim. Many nonoperators, especially those with significant litigious experience, might initially reject this approach. But from a utilitarian standpoint, it makes sense for all of the parties to continue to contribute their proportionate shares of expenses, which ensures that the joint account remains solvent and that the operator does not either run out of money itself or decline to pay any further bills; either approach would cause damage to the joint account.

Provide Reasonable Control and Settlement Authority Up Front

The parties to a JOA should decide—well before litigation or other disputes occur—how decisions regarding the litigation or disputes will be made and how much authority will be provided to the operator. When handling the logistics of third-party claims, most JOAs specify that the nonoperator may not "unreasonably" withhold consent to settlement. Even when not specified in the JOA, some courts have implied this duty. The practical key here is to give the operator reasonable settlement authority; $5,000 or even $25,000 in authority simply does not make sense when settlement of most third-party claims will exceed such amounts. If the operator is to be firmly in control of the day-to-day operations, including handling the logistics of third-party claims, it should be given the realistic authority to do that job. Experience teaches that an operator that becomes subject to micromanagement in the handling of claims is less efficient and sometimes less effective (due to the effect of decision making by committee). Consequently, a claims management plan should answer the following questions.

- Can the operator make the initial settlement decision, subject only to veto of a supermajority of nonoperators?
- Or, should every decision be the subject of a vote?
- And, if a vote is to be made, do the parties merely calculate voting power based on percentage of ownership?

The latter approach might favor the biggest block of like-minded interest owners; but it often leads to myopic decision making and does not take account of the broad experience of other nonoperators. When decisions are made by a majority vote according to ownership interest, this often means the one or two interest owners with the largest percentage of ownership will end up driving all litigation decisions. If 10 owners each own a 10 percent interest, however, the litigation can become difficult to manage absent a consensus about how to defend or prosecute a case. Setting some ground rules in the JOA regarding control of third-party claims and settlement authority for such claims is a practical way to ensure claims are handled effectively and efficiently.

Chapter 5
Drilling Contracts

Oil and gas drilling operations present the potential for significant bodily injury, property damage, and lost revenue. In the absence of a contract controlling the parties' rights and responsibilities, a judge or a jury will allocate any damages that result from those operations based on applicable law. Many companies involved in drilling operations, however, are uncomfortable with the uncertainty of such an "at law" risk allocation model for several reasons.

- Exactly what is the applicable law is not always clear. States apply various formulations for determining which law should apply to a controversy, and the law that ultimately applies to a controversy can significantly impact the outcome.
- Determinations by juries and judges can be unpredictable, creating additional uncertainty as to both the amount of the loss and its allocation.
- Allocating risk of loss through a contract reduces uncertainty and—when the contract works as designed—keeps legal costs low.

Consequently, many opt to allocate the risk of the operations by means of a written contract. No contract or insurance program can eliminate risk, but understanding the risks can allow for proper planning and mitigation through insurance and contractual risk transfer.

Drilling contracts do not stand alone, however, and other supporting contracts must be consistent in terms of risk allocation mechanisms and approach to avoid potentially dangerous gaps in protection. Standard contract forms should be modified to account for the parties' expectations. And indemnity obligations must be backed up with the correct insurance, including the basic insurance protections required for all oil and gas industry service contracts, as well as the insurance for the particular risks presented by drilling operations.

This chapter explains customary risk allocation arrangements in contracts between operators and drilling contractors, pitfalls in drafting those arrangements, and the insurance protections that dovetail with those arrangements.

Chapter Objectives

On completion of this chapter, you should be able to

1. recognize the importance of tradition and the role of the International Association of Drilling Contractors (IADC) in the wording of drilling contracts;
2. recognize the factors that influence the oil and gas exploration and production industry's decision to allocate risk based on ownership of people and property;
3. distinguish between narrow, broad, and modified reciprocal indemnity;
4. recognize that legal responsibility for third-party claims remains "at law";
5. recognize the role of indemnification provisions in allocating responsibility for losses;
6. identify the characteristics of "magic language" in indemnity provisions;
7. recognize the effect of anti-indemnity acts and their potential for nullifying contractual indemnity agreements;

8. recognize modifications that may appropriately be used to modify the risk allocation provisions in a drilling contract;
9. recognize the important role of insurance in risk allocation;
10. identify the “big three” insurance protections and recognize the importance of each;
11. identify appropriate ways of dealing with certain insurance issues specific to drilling operations; and
12. recognize the role of insurance certificates and identify their major deficiencies.

The Role of Custom in Drilling Contracts

Throughout the years, operators and drilling contractors have developed a general understanding regarding which party will assume responsibility for certain risks. These customary approaches to risk allocation have both positive and negative implications. On the one hand, when the operator and drilling contractor enter into negotiations, each party understands the broad categories of risk that the other will likely seek to allocate. Industry tradition has thus created a largely well-defined starting point that shapes the parties’ expectations from the beginning of the negotiation. On the other hand, some parties remain unyielding, even formulaic, in their approach to negotiating risk allocation provisions. Some parties automatically resist any modification whatsoever to their desired risk structure. This mind-set could stymie negotiations.

It would be unfair and overly simplistic to categorize the tendency to resist modifications in risk structure as mere obstinacy. There are at least two very good reasons to refuse even slight modifications in risk allocation.

- Risk allocation in one contract impacts a party’s exposure in others (and vice versa).
- Courts and legislatures have created rules regarding risk allocation that require strict adherence to formulaic approaches or specific language.

These issues are discussed in more detail later in the chapter.

Despite their power, custom and tradition have left significant risk allocation issues unsettled. Parties to a drilling contract must be prepared to approach risk allocation issues with attention to detail and a deep understanding of both the oil and gas industry and the law surrounding it.

The Significant Impact of the IADC

The International Association of Drilling Contractors (IADC), briefly mentioned in Chapter 1, is a worldwide trade organization for drilling contractors. One of its many functions is to provide contract forms for daywork, turnkey, and footage drilling contracts.

- **Daywork contract:** The contractor gets paid a fixed amount per day regardless of how many feet are drilled.
- **Turnkey contract:** The contractor must drill to a certain depth in order to get paid.
- **Footage contract:** The contractor gets paid per foot drilled.

The latest versions of these contract forms were published in 2013, but the 2003 form discussed in this chapter is still the form most commonly used. These forms are available for purchase to members and nonmembers of the IADC. They establish an overarching framework and starting point that allow the parties to insert their own commercial terms and other modifications that meet the parties’ particular needs.

It would be naïve and impractical to ignore the significant presence of IADC forms in the drilling contract market. IADC contract forms—particularly the 2003 IADC Daywork Contract —serve as the basis of the vast majority of negotiated drilling contracts, along with other contract documents that are similar to the IADC form. Larger exploration and production companies have their own forms, but even these forms implicitly acknowledge the IADC forms with parallel provisions. Consequently, this section addresses issues common to the IADC forms and uses them as a frame of reference.

The IADC contract forms provide an excellent framework for risk allocation. However, these contract forms must be modified to fit the parties' particular situation and jurisdictional requirements. Moreover, the IADC forms are fraught with potential ambiguities regarding liability to third parties, damage to the drilling rig due to a faulty drilling site, pollution, and other issues. The insurance requirements listed in Exhibit A of the forms provide only a starting point. Consequently, parties should avoid signing an unmodified IADC contract.

Satisfactory contract negotiation begins with understanding how the contract is designed to work. Only then can one explain why certain changes are being requested.

Basic Principles of Risk Allocation

In a drilling operation, the drilling contractor's employees and costly equipment—including the drilling rig—are all at risk. The operator generally has fewer direct employees and less equipment at the drilling site, but its investment in the entire project (including initial research and well planning) is at stake. The operator's rights in the lease (including the reservoir of hydrocarbons and the legal right to explore for and extract those hydrocarbons from the ground) are also at stake. Moreover, once the operation has begun, the operator's cumulative payments toward the entire operation—payments to the drilling contractor and other service contractors—are all at risk. Considering the stakes for all the players and the inherent danger in the operations, the significant attention that risk allocation provisions receive—or, at least, should receive—is well founded.

Uncertainty of the "At Law" Framework

Casualties often occur in the oil and gas exploration and production industry. Consequently, litigation is also common. The legal landscape in most jurisdictions requires that, in the absence of a contract, each party is liable for the damages that result from its fault. This arrangement is commonly referred to as "at law" risk allocation.

It is often difficult and very expensive to determine the extent of each party's fault in causing a particular casualty. Even when fault has been determined, the amount of damages ultimately payable may depend on an unpredictable jury's perception of an individual's loss or which party's expert is more persuasive to the judge. As a result, oil and gas casualty litigation is usually very expensive, time consuming, and uncertain.

The Industry's Desire for Certainty

Major participants in the oil and gas exploration and production industry found that allocating risk on the basis of ownership of the people and property involved in the casualty, rather than on the basis of fault, could introduce a moderate level of certainty, time savings, and cost reduction in the handling of litigation.

The method chosen to implement this plan was to allocate risks without regard to fault and assign risks of casualty to the employer of the injured personnel or the owner of the damaged property. As with other no-fault schemes, the expectation was that, if each participant in the operation accepted responsibility for any loss to its equipment or personnel without regard to fault, then in the event of an accident, there would be no squabbling over fault, litigation could be avoided, executives' and senior officers' time would not be wasted in depositions, legal costs would be reduced, and business relationships would be preserved. Moreover, each party would have a better idea of the type and limits of insurance coverage that it needs.

"Knock-for-Knock" Indemnity

With guidance from the courts, the oil and gas industry arrived at various contractual formulations to implement the intent that each party would ultimately bear the cost of any loss to its own personnel or property. Over time, this arrangement began to be known loosely as a "knock-for-knock" indemnity.

Knock-for-knock, however, means different things to different people, and there are various forms of so-called knock-for-knock indemnities.

The industry shorthand for a knock-for-knock indemnity is, "You take your people and property, and I take mine." That description begs two critical questions about the scope and breadth of the indemnity obligation.

- First, who are "your people" and who are "mine"? In other words, is each party's obligation limited to indemnifying the other party for injury to the former's own payroll employees and damage only to property actually in the party's name? Or does the obligation extend to indemnifying for injury or damage to the contractors and subcontractors of the indemnitor and their employees as well?
- Second, the shorthand description also fails to answer the question, "Whom does each party have to indemnify?" Only the other party itself? Or the other party and its contractors, subcontractors, and joint venturers?

The breadth of the indemnity obligations and the impact on each party's overall risk allocation program (the interplay between and among all of the parties' contracts) depend on the answers to those two questions. Which of three knock-for-knock indemnity models the parties will choose depends on factors such as each company's contracting philosophy, its market leverage, its other contracts, the availability of insurance coverage, and the law likely to be applied to a casualty.

Models of Knock-for-Knock Indemnity

There are essentially three models: a narrow reciprocal indemnity, a broad reciprocal indemnity, and a modified reciprocal indemnity.[11] In sum, these models work as follows.

- **Narrow reciprocal indemnity**: Each party accepts responsibility for loss to its own people and property. The protection only covers claims for injury or property damage to the parties and their direct employees. Protection is extended to the indemnitee only; the indemnitee's contractors and subcontractors do not receive the benefit of the indemnity. Under this approach, the parties elect to answer both of the above questions narrowly.
- **Broad reciprocal indemnity**: Each party accepts responsibility for loss to its own people and property and for the people and property of its contractors and subcontractors. Additionally, the protection is extended to the other party (as indemnitee) as well as its contractors and subcontractors. Pursuant to this arrangement, the parties answer both of the above questions by providing broad protections. Even within the framework of a broad reciprocal indemnity, the parties may make the protections more or less broad. For example, some broad reciprocals include customers, clients, invitees, or others within the scope of one or both sides of the equation. Therefore, parties must not only determine whether the indemnity is a broad reciprocal but also answer the question, "How broad is it?"
- **Modified reciprocal indemnity**: This is a catchall term for a hybrid of the two models discussed above. It has some elements of a broad reciprocal and some elements of a narrow reciprocal. In one version, one party accepts responsibility only for loss to its own people and property and extends that protection to the indemnitee as well as its contractors and subcontractors. The other party, however, indemnifies a broad group of indemnitees for loss to the indemnitor's own people and property, as well as the people and property of its contractors/subcontractors.

Sometimes contracts include subtle modifications to the overarching model. At first glance, an indemnity provision may appear to provide a straightforward approach (either narrow or broad), but hidden in the details is a modification that drastically changes the scope of one party's protection and/or the other's obligation. Some of these exceptions, or carve-outs, are discussed later in the chapter.

Third-Party Claims: People and Property That Are Neither Yours Nor Mine

The knock-for-knock approach does not address claims for injury or damage to true third parties, i.e., nonparties to the contract and other entities that are not included within the breadth of the indemnity. This may include governmental agents, neighboring land owners, passersby, and even trespassers. For the most part, both drilling contractors and operators expect that responsibility for claims by true third parties will remain "at law." Some drilling contractors, however, seek to shift responsibility for all third-party claims to the operator regardless of fault, arguing that the operator's return on the drilling operation justifies this shift of responsibility. Operators, on the other hand, typically oppose that type of broad shift because, as relates to claims by third parties due to the drilling contractor's fault, the operator has no control over either the drilling contractor's methods or the tort victim and thus may not be able to insure the risk.

One typical approach is to have reciprocal provisions in which each party simply agrees to indemnify the other for such third-party damage, essentially leaving allocation of third-party damage to the statutory or jurisprudential law selected by the parties. Depending on the jurisdiction, that approach may be acceptable. However, it is probably a better idea to specifically say that each party shall be responsible for third-party damage but only to the extent it is caused by that party.

Depending on the companies' philosophies, this dispute can destroy the negotiations. In most situations, however, the parties agree to allocate responsibility only for certain categories of third-party claims, such as pollution.

"Magic Language": Drafting Indemnification Provisions That Apply Regardless of Fault

Once the parties have agreed on the risk allocation, they need to ensure that (to the extent possible under applicable law) the language effectively applies to all claims regardless of fault, even the fault of the indemnitee. Originally, the contractual formulation for expressing that intent was simple and rather straightforward, as follows.

> Each party to this Contract shall be responsible for and indemnify the other for all claims of bodily injury or property damage arising out of the contract, howsoever caused.

The parties expected that this language effectively expressed their intent that responsibility for any casualty belongs to the owner of the damaged property or to the employer of the injured personnel.

Courts, however, demonstrated a general hostility toward any provision in which any party was to be indemnified for the consequences of its own fault. Construing indemnity obligations strictly against the indemnitee, courts began to promulgate strict drafting standards (which vary by jurisdiction) to create an enforceable indemnity arrangement. The language that satisfies that standard is often called "magic language." The standards promulgated by the courts, particularly Louisiana, Texas, and the U.S. Fifth Circuit, do not require the use of specific words or phrases. The intent for one party to indemnify the other for its own negligence, however, must be expressed in clear and unequivocal language. The 2003 IADC Daywork Contract provides language in paragraph 14:13 that would satisfy all jurisdictions. It is shown in Exhibit 5.1.

Exhibit 5.1 IADC "Floating Magic Language" Provision
Except as otherwise expressly limited in this Contract, it is the intent of parties hereto that all releases, indemnity obligations and/or liabilities assumed by such parties under terms of this Contract, including, without limitation, Subparagraphs 4.9 and 6.3(c), Paragraphs 10 and 12, and Subparagraphs 14.1 through 14.12 hereof, be without limit and without regard to the cause or causes thereof, including, but not limited to, pre-existing conditions, defect or ruin of premises or equipment, strict liability, regulatory or statutory liability, products liability, breach of representation or warranty (express or implied), breach of duty (whether statutory, contractual or otherwise) any theory of tort, breach of contract, fault, the negligence of any degree or character (regardless of whether such negligence is sole, joint or concurrent, active, passive or gross) of any party or parties, including the party seeking the benefit of the release, indemnity or assumption of liability, or any other theory of legal liability. *Source: International Association of Drilling Contractors Drilling Bid Proposal and Daywork Drilling Contract, U.S. April 2003, Paragraph 14.13.*

Texas courts maintain the most stringent standards. Under the Texas Fair Notice Doctrine, the intent to indemnify another party for its own negligence must be stated in clear and unequivocal terms, with the particular provision meeting the Uniform Commercial Code definition of "conspicuous," typically requiring bold fonts, separate headings, and other visual devices designed to draw the reader's attention to the provision.

Anti-Indemnity Acts

Contract language expressing the intent to indemnify without regard to fault can be quite clear and unequivocal. Yet, some state legislatures have decreed that, for public policy reasons, indemnification for claims based on a party's own fault is *contra bonos mores* (against good morals). Four states have such oil and gas anti-indemnity acts: Louisiana, Texas, New Mexico, and Wyoming. To a certain extent, the underpinnings of all of these acts are (1) a belief that operators have an unfair commercial advantage over contractors in the context of oil and gas contracts and (2) the notion that a party that is responsible for the results of its own actions is more likely to be careful and, thus, the anti-indemnity act promotes safety. Each state's act is unique.

Additionally, approximately 40 states have construction anti-indemnity acts. As of this writing, Louisiana is the latest state to add a construction anti-indemnity act, which became enforceable on January 1, 2011. In the Louisiana act, as in many other states' acts, the definition of "construction contract" is very broad. The Louisiana definition includes "any agreement for the design, construction, alteration, renovation, repair, or maintenance of a building, structure, highway, road, bridge, water line, sewer line, oil line, gas line, appurtenance, or other improvement to real property, including any moving, demolition, or excavation." Although drilling contracts probably do not fall within this definition, other service contracts that share a common workplace with the drilling operations may be affected by a construction anti-indemnity act.

Parties must carefully harmonize the risk allocation arrangements in all contracts related to the drilling operation to ensure that they work together and do not result in exposure to unanticipated risk.

Applicable Law

The law applicable to the drilling operation will—absent a contravening agreement by the parties and subject to the extent of freedom of contract applied by applicable law—allocate fault in the event of a casualty and determine the enforceability of the contractual risk allocation. Most jurisdictions provide for a comparative fault system; that is, each party bears liability in accordance with its percentage of fault in causing the casualty.

Applicable law becomes most important in those states that have anti-indemnity acts. The parties can agree to the risk allocation scheme, only to see it struck down as being a violation of applicable law. Moreover, as discussed earlier, each jurisdiction has its own particular rules, aside from public policy concerns like anti-indemnity acts—rules for enforcement of indemnity without fault.

Exceptions, Carve-Outs, and Other Modifying Provisions

The basic risk allocation bargain between the operator and the contractor is usually some sort of reciprocal knock-for-knock arrangement—narrow, broad, or modified. But the general framework tells only half of the risk allocation story. The other half of the story is made up of the many exceptions, carve-outs, and other provisions that are common to drilling contracts. These have a significant impact on risk allocation and deserve special attention.

Daywork Drilling Contract Preamble

Many daywork drilling contract forms contain language in the preamble that can have a significant impact on risk allocation. For example, the IADC 2003 Daywork Contract defines “daywork basis” as the drilling contractor’s being under the “direct supervision and control of the operator.” This definition implies a relationship that arguably does not (or should not) exist. It is true that the drilling contractor follows a drilling program that the operator’s engineer designed. However, the specific methods of drilling the hole (which member of a drilling crew does what, how fast to make the hole, when to trip out of the hole, etc.) are often, as a practical matter, left to the contractor. Some operators view their drilling contractor as the expert in drilling operations. Consequently, the contract should not reflect the operator’s direction, supervision, and control of the contractor but rather that the contractor performs as requested by the operator. In other words, the contractor decides the details of the drilling operation, consistent with the contractor’s role as an independent contractor. The parties should consider revising any preamble that overstates the operator’s control of the drilling operations.

The IADC preamble also limits the contractor’s obligations to those that the contractor has “specifically assumed.” This means that the balance of potential liabilities is necessarily assigned to the operator. Thus, any risks that are left unallocated in the indemnity section of the contract, such as claims by true third parties, are automatically allocated to the operator. Some parties prefer to allow the indemnity section of the contract (paragraph 14 in the 2003 IADC Daywork Contract) to exclusively control the parties’ indemnity obligations.

Thus, the parties can be presented with several options relative to the scope of risk allocation.

- Specifically allocate in the contract’s indemnity section all risks of the operation.
- Allocate only those risks that involve the parties and their contractors/subcontractors (leaving the issue of liability to third parties to be decided by applicable law, e.g., based on relative fault).
- Allocate, generally on a reciprocal basis, risks that involve the parties and their contractors and subcontractors, but allocate by default third-party liability to the operator.

“Floating Magic Language”

The 2003 IADC Daywork Contract also contains “floating magic language,” a provision (section 14.13) that establishes that all obligations assumed in the contract are regardless of fault. The language of this provision is shown in Exhibit 5.1.

That means that liabilities impliedly left to the operator (in the preamble and other parts of the IADC form, such as Article 10, Sound Location, discussed later under the “Sound Location Provisions“ heading) would apply regardless of the negligence of either party. If this is not what the parties intended, they should modify the indemnity section to limit “magic language” to apply as intended.

Carve-Outs: Exceptions to the “Knock-for-Knock” Arrangement

The general knock-for-knock arrangement that the parties choose is often subject to exceptions or “carve-outs.” These carve-outs are almost exclusively in the contractor’s favor, requiring the operator to be responsible for certain losses (or for portions of those losses) that would ordinarily be for the contractor’s account. Typical carve-outs include well control costs and damage to the contractor’s down-hole tools, the hole itself, and the reservoir.

Operators generally accept these exceptions as standard in the oil and gas business. But the scope of the carve-outs is not standard and often causes disputes during negotiation. The parties should carefully examine the language of the carve-outs to ensure that the scope, as expressed, meets the parties' expectations. The exceptions should not swallow the rule, and they should allow both parties to mitigate exposure through available insurance.

Carve-outs often state that the exception applies to "all claims arising out of" a particular event or circumstance rather than "all claims for" a particular type or category of damage. For example, operators typically accept that if there is a blowout, the operators extra expense/control of well (OEE/COW) insurance will respond to pay the cost to bring the well in control, put out fires, and redrill if necessary. However, operators do not expect that, if personnel are injured in connection with a blowout, the operator will be responsible for bodily injury claims by the contractor's employees. That broader "arising out of" language arguably expands the operator's liability in the event of a blowout to bodily injury claims by the contractor's employees and loss of the contractor's equipment. This would be contrary to the intent of both parties, who would typically anticipate that those types of claims will fall within the general risk allocation arrangement. The language of the carve-outs should not create unintended ambiguity.

Another ambiguity can arise regarding carve-outs for "down-hole tools." It is important to specify whether the carve-out applies to all down-hole tools regardless of where they are when damaged or (as operators typically expect) only to those tools that are damaged while actually in the hole, below the rotary table.

In addition to ensuring that any carve-out provision is narrowly tailored to a particular category and situation, an additional provision at the end of the carve-out, shown in Exhibit 5.2, is recommended.

Exhibit 5.2 Clarification of Carve-Out Language
This indemnity [specify the subsection] shall in no way limit or modify the general indemnities contained within this Agreement, except as to responsibility for that particular category of property damage identified in this subsection, such that any exceptions for particular/discrete items of property damage in no way affect any protection, release, or indemnification for bodily injury, illness, death or damage to other property.

In sum, carve-outs should specifically state that they apply only for the subject matter they address and that they do not override the balance of the indemnity obligations.

Sound Location Provisions

The so-called sound location provision, which is a typical feature of most drilling contracts, is a source of significant uninsured liability for an operator. The sound location provision of the 2003 IADC Daywork Contract (paragraph 10) is shown in Exhibit 5.3.

Exhibit 5.3 2003 IADC Daywork Contract Sound Location Provision
Operator shall prepare a sound location, adequate in size, and capable of properly supporting the drilling rig, and shall be responsible for a casing and cementing program adequate to prevent soil and subsoil wash out. It is recognized that Operator has superior knowledge of the location and access routes to the location, and must advise Contractor of any subsurface conditions, or obstructions (including, but not limited to, mines, caverns, sink holes, streams, pipelines, power lines, and communication lines) which Contractor might encounter while en route to the location or during operations hereunder. In the event subsurface conditions cause a cratering or shifting of the location surface, or if seabed conditions prove unsatisfactory to properly support the rig during marine operations hereunder, and loss or damage to the rig or its associated equipment results therefrom, Operator shall, without regard to other provisions of this Contract, including Subparagraph 14.1 hereof, reimburse Contractor for all such loss or damage, including removal of debris and payment of force majeure rates during repair and/or demobilization, if applicable. *Source: International Association of Drilling Contractors Drilling Bid Proposal and Daywork Drilling Contract, U.S. April 2003, Paragraph 10.*

Paragraph 10 of the 2003 IADC Daywork Contract, and similar sound location provisions, create the potential of significant misunderstandings. For the operator, they also create the potential of uninsured liability.

Sound location provisions often assume the operator's superior knowledge of the drill site. That assumption might or might not be valid. If the sound location provision contains an affirmative statement as to the operator's superior knowledge, the parties should consider modifying it to reflect that the operator "might have" superior knowledge of the drill site and has the duty to advise the contractor of "known" subsurface conditions that may damage the rig.

Sound location provisions also place liability for damage to the drilling rig on the operator. The operator, however, might not have insurance in the sufficient types and amounts necessary to avoid uninsured exposure for a catastrophic incident. As discussed later, under the "Loss of the Drilling Unit" heading, some limited coverage under the OEE/COW policy, particularly in the care, custody, and control provision, might apply while the rig is moving onto location. However, OEE/COW forms are not consistent in this regard. Since the drilling contractor will have first-party property insurance on its rig, the best approach may be to allocate to the operator only liability for the amount of the contractor's drilling rig insurance deductible.

Relatedly, a typical sound location provision establishes that a special rate, called the "force majeure rate," applies during the time the rig is damaged and being repaired. However, there is no limit as to how long that force majeure rate can run. Consequently, the parties should consider placing a cap on the operator's exposure for payment of the force majeure rate. For example, the contract could specify that the force majeure rate is payable for a maximum of 15 days.

Termination of Location Liability Provisions

Many drilling contract forms, including the 2003 IADC Daywork Contract, include a provision regarding "termination of location liability." Paragraph 12 in the 2003 IADC Daywork Contract recites that, once the drilling contractor "has concluded operations at the well location," it can have no liability for any occurrence. There are several problems with this provision.

First, what does it mean to "conclude operations"? Does it mean that the contractor has ceased drilling? Does it mean that the equipment is packed up? Or does it mean that the contractor has actually taken all of its personnel and equipment from the well site and departed the area?

Second, some variations of the termination of location liability provision require the operator to restore the location to its previous condition, i.e., fill in holes and mud pits, level the ground, pick up trash, etc. If that is the intention, it should be clearly stated in the contract.

Third, many such provisions are, with an unmodified contract form, subject to the "floating magic language" of section 14.13, so that they apply regardless of fault. The result is that the operator can have liability for certain losses, even if they result 100 percent from the contractor's fault. If this is not what the parties intend, then the contract should be modified to more closely reflect their mutual intent.

One option to make the parties' rights and obligations clearer is to specify that the contractor's protection from all liability "is subject to Contractor's compliance with reasonable requests of Operator to clean up and restore the site" and applies "only after all Contractor Personnel and Equipment have been removed from the drilling site and are on public roads." Furthermore, if the parties do not intend that the contractor be granted a free pass for any liability arising from the location (regardless of its fault), any contractual mechanism that ties the termination of location liability provision to magic language (often contained within paragraph 14.13) should be stricken.

Pollution

Typically, the drilling contractor proposes that (1) it will accept responsibility—without regard to fault—"for all claims, demands and causes of action of every kind and character arising from pollution that originates from above the surface of the land, and which is wholly in Contractor's possession and control and directly associated with Contractor's equipment and facilities," and (2) the operator shall be responsible for all other claims "arising out of or related to" pollution or contamination.

This approach has two problems. First, the parties' pollution indemnity should be narrowed to address only "cleanup and remediation" of pollution events and not responsibility for all types of damage (property damage, injury, illness, or death), for example, to land owners, the government, and other third parties. Second, under this scheme, the contractor is only responsible for pollution liability if three requirements are met: (1) the pollution originates from above the land surface; (2) it is wholly in the contractor's possession and control; and (3) it is directly associated with the contractor's equipment. That approach creates a very narrow window for the contractor ever to have responsibility for a pollution event. Therefore, operators' typical approach is to remove the words "wholly" and "directly" and to replace the word "and" with "or." These two subtle changes, shown in Exhibit 5.4, often provide an acceptable middle ground for both parties.

Exhibit 5.4 Pollution Indemnity Provisions with Revisions
Contractor shall assume all responsibility for, including control and removal of, and shall protect, defend and indemnify Operator from and against all claims, demands and causes of action of every kind and character arising from pollution or contamination, which originates above the surface of the land or water from spills of fuels, lubricants, motor oils, pipe dope, paints, solvents, ballast, bilge and garbage, except unavoidable pollution from reserve pits, **~~wholly~~** in Contractor's possession **~~and~~ or** control **~~and~~ or ~~directly~~** associated with Contractor's equipment and facilities.

For some contractors, however, deletion of the "arising from" language causes problems. Operators typically do not expect to take responsibility for third-party illness, death, or property damage that "arises from" pollution caused by the contractor. Rather, they expect that those risks will be unallocated and remain "at law." This issue is causing increasing dispute when parties negotiate these provisions.

Warranty Disclaimers

Many contractors insist on robust warranty disclaimers, specifically disclaiming any warranty of fitness for use for a particular application and providing that a breach of the warranty subjects the contractor to a maximum penalty of having to re-perform the work or having to pay the costs of the work. Exhibit 5.5 provides an example.

Exhibit 5.5 Sample Warranty Disclaimer
Contractor warrants that all work provided under this agreement shall be performed in a good and workmanlike manner in accordance with good oilfield practices and in accordance with the specifications contained in the service order or purchase order. Contractor warrants that materials furnished under this agreement shall conform to the quality and specifications represented. Contractor warrants all its products to be free of defects in material and workmanship for a period of six (6) months from the date of installation or twelve (12) months from the date of delivery, whichever occurs first. The above warranty does not apply to products that have been modified by anyone at Operator's request, supplied by Operator or purchased by Contractor at Operator's request, and/or that have been subjected to improper handling, storage, application, installation, operation or maintenance by anyone other than Contractor. Operator's sole remedy for breach of this warranty provision is re-performance of defective work or re-supply of defective material. The foregoing warranties for services and products are in lieu of all other warranties, whether oral, written, express, implied or statutory. Implied warranties of fitness for a particular purpose and merchantability shall not apply.

Operators generally accept these limited warranties and disclaimers, but they need to ensure that the disclaimers do not override the contractor's indemnity and insurance obligations. To make sure that the scope of warranty disclaimers does not impact the indemnity obligations or the insurance obligations that dovetail with the indemnity provisions, operators should clarify by adding the following italicized language: "*Subject to Contractor's indemnity and insurance obligations contained in this agreement,* Operator's sole remedy for breach of this warranty provision is re-performance of defective work or re-supply of defective material." This protects against arguments by aggressive litigators that losses caused by a breach of warranty are outside of the scope of the indemnity and insurance obligations.

Independent Contractor Provision

An independent contractor provision stating that the contractor is hired as an independent contractor and that the operator is interested only in the results obtained can help minimize risks for both parties by emphasizing that the contractor is in charge of the specific details of the work. A sample provision is provided in Exhibit 5.6.

Exhibit 5.6 Sample Independent Contractor Provision
Contractor shall at all times be an independent contractor, and nothing in this Contract shall be construed as creating the relationship of principal and agent, or employer or employee, between Operator and Contractor or between Operator and Contractor's agents or employees. Contractor shall have no authority to hire any persons on behalf of Operator, and any and all persons whom Contractor may employ shall be deemed to be solely the employees of Contractor. Contractor shall have control and management of the Work, the selection of employees and the fixing of their hours of labor, and no right is reserved to Operator to direct or control the manner in which the Work is performed, as distinguished from the result to be accomplished. Nothing herein contained shall be construed to authorize Contractor to incur any debt, liability, or obligation of any nature for or on behalf of Operator.

A successful independent contractor defense relieves the operator from liability for claims caused by the contractor. It means that damages to third parties that result from the operation may not be assessed against the operator, provided that the operator did not oversee the step-by-step details of the work. In the context of risk allocation arrangements in most drilling contracts, this is good for the contractor as well, because it may limit the exposure for which the contractor must indemnify the operator (i.e., claims by the contractor's employees). Additionally, this protection can be particularly important for the operator if the indemnity or insurance protection owed to the operator is unenforceable.

Consequential Damages Waiver

Most drilling contracts contain mutual consequential damages waivers. Regarding these waivers, the contractor's main concern is the operator's potential lost production claims. The waiver benefits the operator as well, inasmuch as a lost hire claim (i.e., a claim for the time in which revenue is lost due to damage to equipment) from a rig or other large piece of equipment or tool could be significant.

There are two potential pitfalls to consider when drafting or negotiating these waivers. First, the parties should ensure that the definition of consequential damages is broad. The terms "consequential" and "indirect" damages are arguably not specific enough to guard against the creative formulations of damages that a lawyer can find after an accident. And jurisprudence addressing the meaning of the term "consequential damages" leaves significant gray areas. Therefore, the parties should provide a definition in the contract. They should draft a broad, general definition that expressly includes the type of damage that is most important to each party ("lost production" for the contractor and "lost rent or hire" for the operator). The definition should also include lost business opportunity, spread costs, and unabsorbed overhead.

Second, the parties should be careful about an "indemnity" within the waiver that requires the parties to indemnify for the consequential damages claims of others. A consequential damages waiver should be just that—a waiver. It generally should not also be an indemnification requirement. The problem is that the parties may be agreeing to an obligation that they cannot pass along to another party—for example, another interest owner. A waiver is different from an indemnity provision and may not include a defense obligation. Thus, a party may be taking on significant unprotected risk if it gives indemnification protection to the other party that it cannot pass through to the damaged party.

Similarly, some contract forms require the operator to indemnify the contractor for consequential damages suffered by all the operator's co-owners, co-venturers, co-lessees, farmors, farmees, partners, and joint owners. This is a potentially dangerous formulation. To give this broad protection to the contractor, the operator must first have the right to release the contractor for the claims brought by its co-owners or co-lessees. Otherwise, the operator may find itself in a dispute with its co-owners and having to indemnify the contractor for a claim against the operator's own co-owner. An operator should either exclude from the consequential damages waiver and indemnity provision those over whom it does not have direct control, or alternatively, ensure that it has the right to make promises on behalf of its co-owners.

Insurance

Insurance is an important component of a drilling contract risk allocation program. Obtaining the proper insurance helps both parties in their status as either indemnitor or indemnitee. Insurance serves several purposes in the drilling contract, including the following.

- Insurance is a support or backstop to indemnity. The best practice is to ensure that insurance obligations dovetail with the indemnity provisions. Indeed, because of the potential for indemnity provisions to fail (whether due to improper draftsmanship or anti-indemnity statutes), an insurance provision may provide more protection than indemnity. Nevertheless, whenever any party agrees to provide insurance protection, it should limit that protection "to the extent of the risks and liabilities undertaken" by the indemnifying party. This precaution prevents an argument that the indemnified party has provided a "free" insurance policy, free of any restrictions, to the indemnitee. Moreover, the qualification "to the extent of risks and liabilities assumed" helps to avoid an argument that the indemnitee obligation itself must be enforceable in order to trigger insurance. A further step in this regard is to state that the insurance obligations are severable and not dependent on the enforceability of the indemnity provisions. This precaution minimizes the opportunity for an unintended consequence in the event of an invalid or unenforceable indemnity obligation. Because an insurance company will eventually be the entity funding an indemnity obligation, the parties' mutual intent is thereby achieved.
- Insurance protects against the insolvency of the indemnitor, enhancing the probability that the indemnitor will be able to meet its defense and indemnity obligations when triggered under the contract. Indeed, most defense and indemnity obligations are not satisfied by the payments out of the indemnitor's operating account but are provided through insurance.
- Insurance is particularly important in the context of drilling operations because drilling operations present unique risks. For example, the drilling rig is an extraordinarily expensive piece of equipment. Drilling operations also involve a relatively high risk of pollution loss, and some risks are distinctive to drilling operations, such as a loss of control (blowout) and resultant damage. Moreover, because drilling operations often involve complicated geological and petroleum engineering functions, there is the added possibility of a so-called professional services loss (e.g., from a flawed well plan or ill-advised casing program). These special risks cannot be insured with the insurance products typically available in the general oil and gas service industry market. They require specialized policy forms tailored to the drilling industry.

The "Big Three" Insurance Protections

In the drilling contract, as with any contract, both parties should demand the "big three" insurance protections: additional insured status, waiver of subrogation, and primary status. In keeping with the practice of matching insurance protection to indemnity, all three protections (additional insured, waiver of subrogation, and statement of primary and noncontributory coverage) should be extended to all indemnified parties—for example, "company group" or "contractor-indemnified parties."

Additional Insured Status

Additional insured status is now commonly requested in most oil field service contracts, including drilling contracts. Additional insured status provides several benefits.

- When properly used, it allows the indemnitee/additional insured to place the other party's insurance in front of the indemnitee's own policy, thereby protecting the policy limits of the indemnitee's insurance program.
- Additional insured status gives the party additional moral authority in the context of a coverage dispute; additional insureds generally have the same rights to defense and indemnity as the named insured. Consequently, when the additional insured demands coverage and, if necessary, sues the insurer for coverage, it does so with the status of policyholder, not as a stranger to the insurance contract.
- Additional insured status also significantly augments the total amount of coverage available for a

particular loss or series of losses.

Waiver of Subrogation

A waiver of subrogation provision is also an important component of risk allocation in drilling contracts. The drilling contract should contain a provision specifying that both the operator and the drilling contractor waive their rights of recovery of damages against each other (and their agents, officers, directors, and employees) to the extent that the damages are covered by the insurance policies required under the contract. The waiver prevents the unintended result of an indemnitor's insurer claiming against the indemnified party for its share of a loss. Absent a waiver of subrogation (and excluding for the moment the indemnitee's additional insured status), an insurance company that pays a loss is ordinarily entitled to subrogate (claim over) against the party at fault to the extent of its negligence or responsibility. An insurance company generally cannot subrogate against its own insured, even an additional insured, and thus some regard the waiver of subrogation as unnecessary. This position might, under nearly all circumstances, be correct.

Not having a waiver of subrogation provision in the contract and in the policy is taking an unnecessary risk. The subrogation provision in a standard commercial general liability (CGL) policy allows the insured to waive rights of recovery prior to loss, so that a waiver of subrogation endorsement would not be necessary to waive the insurer's right of subrogation once the insured has waived its own recovery rights in the contract. However, if either of the parties to the drilling contract has or might have a nonstandard CGL policy, the policy's subrogation provision might not allow pre-loss waivers of recovery rights by the insured. Any uncertainty on this important point can be avoided with a waiver of subrogation endorsement in which the insurer expressly waives any rights of subrogation against the other party to the drilling contract. One contracting party routinely gives such protection to the other (at least as respects risks and liabilities assumed). Furthermore, a waiver of subrogation provides the suspenders to the belt of additional insured protection. It is not unheard of for an administrative error or misunderstanding to result in a lack of additional insured protection, even when required by contract. The waiver serves, to a certain extent, as a backup to additional insured status in case it is ineffective.

Particularly in the context of a drilling contract, a waiver of subrogation is prudent because the magnitude of the property risk is high. Furthermore, operators in particular should be careful to seek a waiver of subrogation, especially as respects the contractor's equipment, because the operator might not have coverage for such equipment. Finally, it should be noted that sometimes a waiver of subrogation provides more protection even than being named as an additional insured.

Primary and Noncontributory Coverage

Each party's insurance should be designated as primary and noncontributory to any insurance available to the indemnified parties. This type of provision prevents another unintended consequence: the indemnitor's insurer attempting to invoke its policy's "other insurance clause" to reduce or to avoid coverage. Thus, a statement that the indemnitor's insurance coverage is primary for the risks it assumes merely reinforces the parties' intent that the insurance protection will match the indemnity and blunt any argument that the indemnitors' insurance was intended to act as coinsurance, such that the indemnitor's policy requires contribution from the indemnitee's policy.

Contractual Liability Coverage

Parties to a drilling contract often take on indirect responsibility for casualties; that is, they contractually assume risks they would not without a contract. So-called contractual liability is often excluded in a general liability policy form. In fact, most general liability coverage forms, including those drafted by the Insurance Services Office, Inc. (ISO), initially exclude coverage for contractual liability and then provide some limited coverage through an exception to the exclusion through the definition of an "insured contract." The provisions work together to limit the named insured's contractual liability coverage to those instances in which it assumed the tort liability of the other party.

The ISO CGL "Amendment of Insured Contract Definition Endorsement" (CG 24 26), promulgated in 2003, further limits the contractual liability coverage of the policy it is attached to to instances in which the named insured is at least partially at fault. This endorsement exposes the policyholder to potentially catastrophic uninsured losses if the indemnitee is proven to be solely at fault. The indemnitee under this scenario would likewise be concerned, because insurance is the most common form of ensuring an indemnitor's ability to meet its indemnity obligations. As a result, although a party has agreed to undertake an indemnity for "all claims arising under certain circumstances," its contractual liability coverage is not so broad. In that case, the indemnifying party still owes the obligation, but it does not have the insurance to fund that obligation. That sets up a situation where the party is now relying on the indemnitor's solvency to honor its indemnity obligations. Operators and contractors should be aware of the use of narrow CGL coverage forms and endorsements in the market and take steps to avoid their effects.

Each party should ensure that its own obligations are correctly insured. As an initial matter, the mere fact that the coverage is found within an exception to an exclusion could make some oil and gas operators/contractors somewhat uneasy. Indeed, the definition of "insured contract" arguably does not capture all of the potential contractually assumed liabilities a party may have in a typical drilling or service contract. For example, under "sound location" provisions in drilling contracts, the operator is asked to assume liability for the rig even in the absence of the operator's fault or tort liability. Therefore, under sound location provisions, when the operator agrees to accept liability for the driller's own equipment, even if it is damaged by the sole fault of the driller, it could be argued that the operator is not thereby taking on the "tort liability of another"—the driller cannot have tort liability for damaging its own equipment. An insurer, however, may argue that there is no coverage for any contractual liability for damage to the other party's property where that liability is assumed without regard to fault. The insurer argues that, because the other party/indemnitee has no tort liability for damage to its own property and because there is coverage only for the named insured's assumption of tort liability, there is no contractual liability coverage for the promise to indemnify another party for loss to its own equipment due to its own fault. And, as discussed above, indemnity without regard to fault is typical in drilling contracts.

Relatedly, the contract should specify that each party is to obtain contractual liability coverage that is broad enough to fund all of the liabilities undertaken within the indemnity provisions of the contract. This provision helps awaken the conscience of both parties and causes them to verify that they have contractual liability coverage that is broad enough to actually fund their obligations. Here is an example provision:

> The indemnifying party's contractual liability coverage must provide coverage for all of the release, defense, indemnity, and hold harmless obligations undertaken by that party in Section [_] of this Contract.

Such a provision will alert the indemnifying party that it might not have contractual liability coverage in its own liability policy. Furthermore, it can blunt an argument by that indemnifying party that it technically complied with contractual liability requirements, even though the coverage that it actually obtained was so narrow as to be illusory. The existence of general liability coverage forms that provide restricted contractual liability coverage serves to emphasize the importance of the so-called Dickerson provision, which confirms that a party's indemnity obligations are not limited by insurance: "Contractor's indemnity obligations shall be supported, but not limited by, liability insurance with minimum limits as indicated in Exhibit 'A.'" As with the base of the contract itself, the insurance requirements should specify that minimum limits are not a limitation or restriction on indemnity.

The best practice is to obtain a specific contractual liability endorsement (or at least a specialized oil and gas insurance form) that is crystal clear that whatever liability that it traditionally undertakes in a drilling contract is covered under the contractual liability provision. The contractual liability endorsement should provide broad and unambiguous coverage for the contractual obligations that the party typically assumes in a drilling contract, such as the operator's potential liability for damage to the rig, certain pollution liabilities, down-hole tools, etc. Thus, instead of relying on the basic language provided in an ISO form, with its potential pitfalls, the most prudent step to take is to seek a manuscript endorsement that squarely covers such typical liabilities. One possible sample manuscript contractual liability endorsement is shown in Exhibit 5.7. Whether an insurer will provide such a manuscript contractual liability endorsement will vary, depending on such things as account size and insurance market conditions.

Exhibit 5.7 Sample Manuscript Contractual Liability Endorsement
Without limiting the contractual liability coverage provided within the Policy, including but not limited to that which is provided through the definition of "insured contract," this Policy is specifically endorsed to cover the indemnity and hold harmless obligations undertaken by the Named Insured in a drilling contract, master service agreement, and/or similar agreement.

Insurance Issues Specific to Drilling Operations

Inconsistencies between indemnity obligations and insurance coverage and the need for comprehensive insurance protection create huge problems in the context of a drilling contract. These operations present enormous risks of loss from third-party liability, first-party property losses, and loss of income. Operating without the proper insurance can place an enterprise's very existence at risk.

Some of the major risks involve loss of the drilling unit, debris and wreck removal, and loss of the hole.

Loss of the Drilling Unit

The drilling rig and its appurtenances are very expensive pieces of equipment. Some drilling contract forms, like the IADC, attempt to shift risk of loss to the drilling rig and/or other parts of the drilling unit (i.e., drill string and other in-hole equipment) to the operator in certain circumstances. In most cases, such liability would be excluded in the operator's general liability policy; so the operator's only insurance coverage, if any, may be found in its OEE/COW policy. If present, that coverage is found in the "care, custody, and control" endorsement to the OEE/COW policy. And the coverage often comes with unsatisfactory limitations: coverage is often limited to $250,000 or $500,000, and some forms only cover the drilling unit while it is on location or if the loss is due to cratering or blowout. Of course, those limitations leave the operator with significant uninsured exposure.

Unmodified, paragraph 10 ("Sound Location") in the 2003 IADC Daywork Contract presents a potential gap between indemnity obligations and the OEE/COW insurance coverage that most operators carry. The standard sound location provision shifts liability for damage to the drilling rig while moving onto the location or at the drill site to the operator without regard to fault (in contravention of the standard knock-for-knock arrangement). Thus, if the rig is damaged by an unsound location due to the drilling contractor's sole fault, the operator will be responsible for the damage. The operator, however, might have no insurance coverage for this contractually assumed liability. Most operators are unwilling (perhaps unable) to assume that risk. Therefore, operators should obtain additional insurance coverage or modify the drilling contract to manage their exposure. One way to accomplish this is to negotiate, in the drilling contract, a monetary limit on the operator's exposure that equates to the operator's OEE/COW insurance coverage.

Debris and Wreck Removal

The IADC form shifts liability for debris and wreck removal to the operator in the event of an unsound location (paragraph 10) or well control event (section 14.10). Some OEE/COW insurance policies, however, do not provide broad coverage for third-party wreck removal.

For example, some OEE forms limit wreck removal coverage to first-party property. This is problematic because coverage for removal of third-party property is essential for risks allocated pursuant to the drilling contracts. Also, removal of first-party property may be covered by the operator's property policy anyway. Fortunately, even if the wreck removal endorsement to the operator's OEE/COW policy only covers first-party property, the operator will likely have some coverage for third-party wreck removal under COW coverage. Unfortunately, wreck removal under COW coverage will only pay to move the wreckage away from the wellhead in order to control the well; it might not pay to take the wreckage off-site. Therefore, this protection is not as beneficial as a broad wreck removal endorsement with ample limits, but it is useful when the wreck removal endorsement is narrow or contains a low sublimit.

Therefore, in the drilling contracts, operators should try to limit their obligations to pay for third-party wreck removal to the extent necessary to bring the well under control. That way, the operator helps ensure that (regardless of its policy form) it will likely have at least some degree of insurance protection for its wreck removal obligations.

Another way to ensure broader coverage for wreck removal is to negotiate with the insurer for wreck removal protection under the “care, custody, or control” endorsement of the OEE/COW form, which could potentially have higher limits than the wreck removal endorsement. Of course, insurance coverage often varies depending on the specific policy, and this is particularly true of wreck removal coverage. Coverage limits for wreck removal in an OEE/COW policy may be subject to the policy’s combined single limit, a sublimit under the combined single limit, or an additional limit separate from the combined single limit. In any case, coverage under the care, custody, or control endorsement could provide additional or possibly greater protection.

Although the unmodified IADC form again presents significant uninsured exposure to the operator, the operator can mitigate this risk by obtaining more insurance or by negotiating in the drilling contract limits on its liability that align with its insurance coverage.

Loss of the Hole

Under section 14.5 of the 2003 IADC Daywork Contract, the operator assumes responsibility for loss of the hole under all circumstances. Most OEE policies, however, only cover the cost of redrill if caused by a wild well incident or by fire. Operators may obtain “extended redrill” coverage to cover other perils, but, in any event, none of the standard forms on the market (even for extended redrill coverage) are “all risk” coverages. In other words, only loss from specified perils will be covered. Therefore, absent a manuscript redrill endorsement, the operator may not be able to insure loss of the hole under all of the circumstances for which it assumes responsibility under the drilling contract.

Moreover, negotiating carve-outs or limits to the operator’s responsibility for loss of the hole is difficult and unlikely. Some contractors, however, are willing to perform redrill operations at a discounted rate (e.g., 65 percent of their standard cost) if the loss of the hole is caused by their sole or gross fault. This compromise does help to mitigate the operators’ uninsurable exposure for loss of the hole.

Lost Business Income

Under a typical waiver of consequential damages, each party will likely bear its own risk of lost income: for the contractor, its lost day rate for a damaged or destroyed rig; and, for the operator, its lost or deferred production income. These waivers typically apply regardless of fault. These types of losses can be crippling. Management may find it hard to swallow that, when another party destroys a huge revenue stream due to its own negligence (either the operator that destroys the contractor’s rig or the contractor that destroys the operator’s reservoir), the negligent party is not responsible for the innocent parties’ lost revenue. That, however, is the reality in the industry. Insurance is a useful tool to fill in some of that gap.

For drilling contractors, this protection would generally come in the form of traditional business income coverages, summarized as follows.

- Business income coverage: coverage applies to loss of income resulting from suspension of operations due to physical damage by a covered cause of loss to covered property.
- Contingent/Dependent property business income coverage: coverage applies to loss of income suffered as a result of damage from a covered cause of loss to property of others on which the insured’s operations rely.
- Ingress/Egress coverage: coverage applies to income loss when the insured’s operations are suspended because of inability to access covered property as a result of a covered cause of loss.
- Civil authority coverage: coverage applies to income loss suffered when government action suspends the insured’s operations or prevents access to its facilities as a result of a covered cause of loss.

For operators’ lost or deferred production income, however, the insurance protection is more specialized to the oil and gas industry. The insurance industry offers “loss of production income” coverage to oil and gas exploration companies. This is a specialized product that often provides coverage on a "valued basis." This means that value of the lost or deferred production is determined by a formula at the time the coverage is purchased. Once the coverage is triggered and the time frame of the loss or deferral is established, valuation of damages is calculated based on the value established on the front end.

Insurance Certificates

A final insurance protection is obtaining insurance certificates from the other party to verify that its coverage is appropriate and complies with the requirements under the contract. At a minimum, the certificate should reflect that the basic insurance protections (additional insured, waiver of subrogation, statement of primary coverage) are in place. This information can be provided in the certificate's "notes" section.

However, it is not appropriate to rely on certificates of insurance to ensure the other party's compliance. Most insurance certificates provide very limited information: the type of coverage (general liability, commercial property, etc.), policy limits, dates, the name of the insurers, and the identity of the named additional insured. Clerical personnel often produce the certificates without much oversight by the agent or broker. Depending on the insurance agent's practices, the certificate may also include some limited information as to additional insured status and waivers of subrogation, but certificates rarely provide important information regarding exclusions, endorsements, or the scope of additional insured protection. Moreover, the disclaimer language found on most insurance certificates is problematic, inasmuch as the courts have held that the certificate holder has no right to rely on the representations made in the certificate.

Asking for a custom-made certificate is possible but not always practical. Consequently, parties to a drilling contract should take the initiative and ask for specifics or significant modifications to the insurance certificate. If the agent or broker is unwilling to cooperate, then a prudent party to a drilling contract should ask to see the other party's policy or a synopsis of it or ask specific questions regarding exclusions and endorsements. One good practice is to contractually reserve the right to require adjustments to the certificate from the other party if a review shows potential problems or omissions. This is particularly important in the context of a drilling contract, where there are special risks not encountered in the run-of-the-mill surface contract. A sample provision could look like this:

> Operator shall provide an insurance certificate on a form satisfactory to Contractor, evidencing the above coverages are in place.

An insurance certificate generally does not bind the insurer. But where there is a close question on a coverage issue, a court may consider extrinsic evidence to determine the insurance policy's intent. Moreover, a complete insurance certificate may provide some leverage needed to win a coverage dispute or at least to provide a basis of a detrimental reliance/estoppel argument.

Chapter 6
Master Service Agreements

The master service agreement (MSA) is a contract that establishes liabilities and indemnification between the operator and each well service contractor. Oil field operations involve multiple employers, many workers, and expensive property, often at a common work site. Oil and gas operations can be dangerous, and the risks to property and personnel are sizable. Accordingly, a comprehensive system of risk allocation—one that works cohesively on an enterprise-wide basis—is essential to mitigate the effects of casualties, to foster certainty in the case of an accident, and to reduce litigation costs. But creating and maintaining a unified risk allocation program is difficult. An MSA is a useful tool to help that system work properly.

MSAs often use the term "Operator Group" to refer to the operator and its affiliates, partners, owners, agents, contractors, and subcontractors; likewise, they use the term "Contractor Group" to refer to the contractor with whom the operator is contracting, plus its affiliates, partners, owners, agents, contractors, and subcontractors. MSAs enable operators and contractors to meet the fast-paced operational demands and complex risk allocation demands of the oil field confidently and efficiently. Used properly, they create cohesive risk allocation programs that bring a certain degree of certainty to often dangerous endeavors. However, MSAs are not suited to every situation. They are best suited for recurring or ongoing work that involves a common workplace. And when they are used, they must be part of a consistent program that takes into account other MSAs, drilling contracts, fracking contracts, other specialty contracts, the parties' insurance programs, and applicable law. Without an organized approach that integrates risk allocation concepts into an enterprise-wide program, even a brilliantly drafted MSA can create unacceptable and unintended risk.

This chapter explores risk allocation matters within MSAs and how MSAs interplay with one another, other types of contracts, and insurance coverage. Some of the issues discussed here have previously been discussed in the context of other contracts. This chapter's discussion focuses on their application to MSAs.

Chapter Objectives

On completion of this chapter, you should be able to

1. identify an MSA's basic functions,
2. recognize the fundamental risk allocation principles generally used in the oil field,
3. recognize the implications of an MSA's risk allocation provisions,
4. recognize potential clashes between risk allocation provisions in an MSA and risk allocation or indemnity provisions in other contracts,
5. recognize the importance of "magic language" in drafting indemnity provisions,
6. distinguish between "indemnify" and "release," and
7. identify the "big three" types of insurance protections and recognize the importance of each.

Basic Functions of an MSA

MSAs establish a contractual relationship that can govern ongoing or reoccurring work during exploration, drilling, and production without renegotiating general terms and conditions over and over again. This is important in the oil field, where operations can move fast—much faster than lawyers can negotiate contracts. The MSA establishes the governing framework under which the parties will operate if they enter into an agreement for particular work in the future.

Once an MSA is in place with a service contractor, the operator can "call out" (assign a certain work project to) that contractor for specific work under a purchase or work order. The work order will usually contain specifics about the nature of the work—specifications, time frame, equipment, workforce, and cost—whereas the general terms and conditions (e.g., risk allocation, standard of performance, termination, etc.) have already been negotiated in the MSA.

Parties benefit from having risk allocation provisions established in advance of an actual work order. The need to have a predetermined risk allocation structure is magnified when the operations involve multiple employers at a common work site.

Risk Allocation in the Oil Field

Risk Allocation Based on Fault

Allocating fault for accidents at multiemployer work sites can be complex and costly. It is rare that an oil field accident can fairly be attributed solely to the failure of a single individual or company to follow good practices, to be attentive, or to comply with regulations.

When a casualty results from an unfortunate confluence of errors committed by multiple people and/or multiple companies, it is often difficult to figure out each party's percentage of the blame. That difficulty can give rise to lengthy and expensive litigation, which ties up personnel and resources, fosters uncertainty in budgeting and risk management, and sours business relationships. In bodily injury litigation, sometimes the plaintiffs' lawyers gleefully allow two oil field companies to marshal negative evidence about each other, raising the value of the injured person's lawsuit to the detriment of both defendant companies.

Risk Allocation Based on Ownership

To avoid the problems associated with fault-based risk allocation, the parties often agree to allocate risk based on ownership of personnel and property—not on fault. Allocating risk based on ownership rather than fault makes post-casualty finger-pointing unnecessary. The parties can reduce litigation expenses and introduce at least a moderate level of certainty about the possible risks of their operations. Moreover, if a party knows that it will be responsible for its own personnel and property (e.g., three workers and $4 million worth of equipment) regardless of fault, it can better assess the extent of its exposure.

An MSA with the ownership-based risk allocation structure discussed here is not always appropriate for work that does not involve multiple employers at a common work site. When one employer controls the entire work site and workforce, allocating fault is less difficult, and the benefits of allocating risk without regard to fault are reduced. In fact, without a common workplace, the underlying assumptions that dictate the use of ownership-based risk allocation generally do not exist.

Setting the Basic Indemnity Framework

The decision to allocate risk on an ownership basis should be an all-or-nothing proposition, with as few exceptions as possible. This applies not only to the general decision to allocate risk based on ownership rather than fault but also to the scope of that indemnification arrangement. Therefore, the fundamental question for contracting parties is to determine the nature and scope of the risk allocation program that will apply at common work sites. Exhibit 6.1 lists and describes the three types of ownership-based indemnity arrangements commonly used in energy contracts.

Exhibit 6.1
Examples of Ownership-Based Oil Field Indemnity Arrangements

- **Broad reciprocal indemnity:** Each indemnifies the other party—and the other party's contractors and subcontractors—from claims arising out of injury, illness, death, and loss/damage to property of its own employees and property of its own contractors' and subcontractors' employees and property.
- **Narrow reciprocal indemnity:** Each party indemnifies the other party—but not the other party's contractors and subcontractors—from claims arising out of injury, illness, death, and loss/damage to property of its own employees and property but not of its contractors' and subcontractors' employees and property. The protection extends only to the indemnitee and not to its contractors and subcontractors.
- **Modified reciprocal indemnity:** This hybrid approach could include a number of varieties. In one variety, the indemnitor indemnifies only for loss to its own people and property—but extends that protection to the other parties' contractors and subcontractors as well. There are numerous varieties of this approach.

A party should not employ a broad reciprocal indemnity in some of its MSAs and a narrow reciprocal indemnity in others. Here's why. Imagine an operator that has two MSAs. One is with a crane provider and contains a broad reciprocal indemnity provision. The other is with a tool supplier and contains a narrow reciprocal indemnity provision. If the crane provider negligently destroys the tool supplier's equipment, the operator would ultimately be responsible for that loss—even though it neither caused the loss nor owned the property—because of the broad reciprocal indemnity provision in the MSA with the crane provider. If the tool supplier were to sue the crane provider, the crane provider could properly tender the suit to the operator. The operator would have no recourse against the tool supplier because its MSA with the tool supplier contains a narrow reciprocal indemnity. That is the worst of both worlds for the operator.

Foreman v. Exxon: A Case Study on the Need for a Unified Risk Allocation Structure

The U.S. Fifth Circuit Court of Appeals decision in *Foreman v. Exxon Corp*., *770 F.2d 490 (5th Cir. 1985),* provides a good case study on the fundamental importance of maintaining a cohesive risk allocation program throughout the entire enterprise. *Foreman* was a bodily injury case. The jury apportioned fault among Exxon, its drilling company, and a casing company (the injured party's employer) as follows.

- Fifty-five percent to the drilling company
- Ten percent to Exxon
- Thirty-five percent to the casing company

Exxon sought indemnity from the casing company for its 10 percent of the fault pursuant to its contract with the casing company. Exxon also had an indemnity agreement with the drilling company—which required Exxon to pay the drilling company's apportioned fault of 55 percent. Exxon also sought indemnity from the casing company for this 55 percent contractual liability.

But the court found that the language of the contract between Exxon and the casing company did not permit recovery of Exxon's contractual indemnity because the indemnity provision was limited to claims arising on account of bodily injury. For the contract with the casing company to include indemnification for third-party liabilities Exxon incurred through separate contracts, Exxon would have to have expressed this more clearly: "We conclude that [the casing company's] obligation to indemnify Exxon for Exxon's contractual liability to [the drilling company] may arise only from the plainly expressed intention of the parties, spelled out in unambiguous terms." Accordingly, Exxon (although only 10 percent at fault itself) was responsible for 55 percent of the claim.

The lesson here is that a party's obligation to indemnify the other does not include the indemnitee's contractually assumed liability. The unexpected liability that results from forgetting that lesson can be called "the *Foreman* problem."

Pass-Through Indemnification: The Solution to the Foreman Problem

The solution to the *Foreman* problem is to make sure any MSA program that includes broad reciprocal indemnity provisions also contains pass-through indemnity provisions in all MSAs (and other types of contracts). For an indemnity provision to cover the indemnitee's contractual liability to third parties, the parties must clearly express that in the agreement. Failing to include a pass-through in even one contract could create a significant unanticipated exposure.

There are several ways to create a pass-through. A common and effective approach is to create defined categories of entities and individuals to whom indemnity protections flow under the MSA. By broadening the universe of indemnitees to include the contracting parties' affiliates, partners, owners, agents, contractors, and subcontractors—often defined as the "Operator Group" and the "Contractor Group"—the parties simply and effectively create pass-through protection for those indemnitees. This approach also reduces the risk of inconsistency within the MSA, particularly regarding coordination of the indemnity arrangement with the insurance plan (discussed in more detail later).

Trendsetters: Drillers, Fracking Companies, and Large Service Contractors

For a drilling operation, the driller often employs the most laborers and brings the most expensive piece of equipment onto the work site. The primary piece of equipment is the drilling unit itself. Similarly, for fracking operations, the fracking company usually brings the most expensive equipment and largest number of employees to the work site. Therefore, although drilling and fracking contracts are not typically governed by master agreements, the MSA program must contemplate and fit together with the risk allocation provisions in those contracts.

A disconnect between the drilling or fracking contract and an MSA potentially creates a large gap in protection for the operator. For example, if an MSA requires the operator to indemnify the fracking contractor for claims by a broad Operator Group, but the fracking contract does not release a broad Operator Group from damage to the frack fleet, the operator may be responsible for a lost frack fleet. In other words, the operator would have a *Foreman* problem—not having a proper "pass-through"—and the exposure would be the entire frack fleet.

Several large service providers offer numerous services through the oil and gas industry and throughout the country. If an operator depends on getting certain services from a particular service provider, the risk allocation arrangement in the MSA with that service provider can shape the risk structure in the operator's entire MSA program.

Carve-Outs: Exceptions to the Overarching Indemnity Framework

Although the general plan is to allocate risk based on ownership, parties increasingly seek and agree to carve-outs from that general framework. These exceptions can be significant. Like all risk allocation features, they must be analyzed, not in isolation but in the context of the entire risk program for the common work site.

Carve-Outs for Contractors' Down-Hole Equipment

One common carve-out is the contractor's down-hole equipment. The contractor's justification for carving out down-hole tools from the ownership model is generally that well conditions are unknown and beyond the contractor's control.

Operators typically accept the carve-out for down-hole tools as standard in the industry. Other proposed carve-outs, however, often meet greater resistance (e.g., equipment in transit by operator-provided transportation, any equipment not in the contractor's control, or materials that the contractor provides at the operator's request beyond the scope of work).

Even for carve-outs that are generally accepted as industry standards (like the down-hole tool carve-out), one should pay close attention to the *basis* of the carve-out. For example, consider the difference between the two down-hole tool indemnity provisions shown in Exhibit 6.2.

Exhibit 6.2 **Sample Down-Hole Tool Indemnity Provisions**
Sample 1 (assigns operator the responsibility for loss to Contractor Group's down-hole tools): Operator shall be responsible for and shall release, protect, defend, indemnify, and hold harmless Contractor Group from and against any and all loss of or damage to Contractor Group's *down-hole tools* REGARDLESS OF FAULT. **Sample 2 (assigns operator the responsibility for Contractor Group's tools lost or damaged in the hole):** Operator shall be responsible for and shall release, protect, defend, indemnify, and hold harmless Contractor Group from and against any and all loss of or damage to Contractor Group's *tools that are lost or damaged in the hole* REGARDLESS OF FAULT.

Do the parties intend for down-hole tools to be the operator's responsibility even if they are destroyed on the deck of the drilling rig? Probably not. The language shown in Sample 2 likely accomplishes the parties' intent more accurately than the language shown in Sample 1.

Special Events Clauses: The Ultimate Carve-Out

The so-called special events clause (sometimes called a "catastrophic loss" clause) is particularly controversial. The friction between contractors and operators appears to center around the nature of the clause: whether it is a complete overhaul of the general indemnity arrangement under certain circumstances, strictly an allocation of extra expenses from particular types of events, or some amalgam of those two.

Exhibit 6.3 shows two examples of a special events indemnity provision. The language shown in Sample 1 is an example of a particularly aggressive "special events" indemnity clause, which could be read to be a complete overhaul of the general indemnity arrangement. Under this language, contractors could argue that the entire general indemnity arrangement is inapplicable in the event of a fire or blowout and that the operator is responsible for everyone's losses (bodily injuries, deaths, and property damages). An aggressive interpretation or application of the "arising out of or in connection with" language could result in what is perhaps an unintended result.

Exhibit 6.3 Sample Special Events Indemnity Clauses
Sample 1: Notwithstanding any other provision of this MSA, Operator shall release, protect, defend, indemnify and hold harmless Contractor Group from and against any and all Claims [defined broadly] *incurred by any member of Company Group, Contractor Group, or any other person or entity arising out of or in connection with* uncontrolled well conditions, fire, cratering, explosion, wild well or blowout, pollution and/or radiation contamination. [Emphasis added] **Sample 2 (modification of Sample 1):** Notwithstanding any other provision of this MSA, Operator shall release, protect, defend, indemnify and hold harmless Contractor Group from and against any and all ~~Claims~~ <u>costs or expenses</u> incurred by any member of Company Group, Contractor Group, or any other person or entity ~~arising out of or in connection with~~ <u>for controlling and/or cleaning up any</u> uncontrolled well conditions, fire, cratering, explosion, wild well or blowout, pollution and/or radiation contamination.

Operators typically accept that, in the event of a blowout, their operators extra expense/control of well (OEE/COW) insurance will respond to bring the well under control, put out fires, and redrill the well if necessary. But operators do not expect to be responsible for all bodily injury and property damage claims that "arise out of or in connection with" that blowout and fire. In fact, the operator might not be able to obtain insurance for that broad swath of responsibility. Therefore, an operator might want to seek to modify the above language as shown in Sample 2.

The language in Sample 2 places the extra expenses and costs incurred as a result of the specified "special events" on the operator. But it does not override the general indemnity arrangement for bodily injury, death, and property damage claims. This arrangement takes into consideration the parties' respective insurance programs. The contractor, which likely cannot practically obtain insurance protection for well control costs, has no responsibility for those types of expenses. And the operator, which typically does not have insurance for contractors' property that is not within its control, similarly is not responsible for those damages.

An additional protection for ensuring that the carve-outs are narrowly tailored to a particular category and situation is adding a provision at the end of the carve-out to make this clear. Sample language for this clarification of the carve-out language is shown in Exhibit 6.4. This ensures that the carve-outs accomplish their intended objective without being overly broad and completely overriding the underlying indemnity arrangement.

Exhibit 6.4 Sample Clarification of Carve-Out Language
This section shall in no way limit or modify the general indemnities contained within this MSA, except as to responsibility for that particular category of property damage identified in this section, such that any exceptions for particular/discrete items of property damage in no way affect any protection, release, or indemnification for bodily injury, illness, death or damage to non-specified property.

Allocating True Third-Party Losses

As mentioned earlier, MSAs often use the term “Operator Group” to refer to the operator and its affiliates, partners, owners, agents, contractors, and subcontractors. Likewise, they use the term “Contractor Group” to refer to the contractor with whom the operator is contracting, plus its affiliates, partners, owners, agents, contractors, and subcontractors. MSAs sometimes do not specifically address allocation of losses or damages incurred by true third parties—individuals or entities that are not included in the definition of either “Operator Group” or “Contractor Group.”

Land owners, passersby, and motorists on nearby highways are the typical third parties. When the MSA is silent as to those types of damages, the general assumption is that true third-party losses will be allocated “at law”—meaning that the general tort law of the governing jurisdiction will determine the allocation of losses. In most jurisdictions, that would mean that each party would be responsible for losses or damages to the extent of its own negligence or other fault.

Some contractors, however, include general statements in their MSA form that any risk that is not specifically allocated to the contractor is the operator’s responsibility. This arguably includes true third-party losses.

Rather than remaining silent on the issue, the MSA should state affirmatively that each party is responsible for third-party damage “to the extent, but only to the extent” caused by that party. This should remove any ambiguity about the general allocation of third-party losses. Exhibit 6.5 provides a simple example of that language.

Exhibit 6.5 Sample MSA Third-Party Liability Provision
Each Party shall protect, defend, indemnify, and hold harmless the other Party Group from and against any and all Claims on account of bodily injury, illness, death, or damage to property of any Third Party to the extent that those Claims are caused by (or are attributable to) its own negligence or other fault. “Third Party” means any person or entity that is not a member of “Operator Group” or “Contractor Group.”

Even when third-party losses remain generally “at law,” there are typically exceptions to that framework. Some standard exceptions are pollution claims, claims for reservoir damage, and claims for loss of hydrocarbons. In particular, allocation related to third-party pollution claims varies and can be a contentious negotiating point.

Allocating Pollution Risks

Although many third-party liabilities remain unallocated, pollution risks (at least some of them) are typically addressed explicitly. One common approach is to allocate liability for pollution claims to the parties that owned the source of the pollutant. Under a variation of that general approach, the contractor is responsible for pollution that originates from its equipment *and* occurs above the surface of the land or water. Under another variation, the contractor accepts liability only for pollution (1) originating from above the land surface, (2) *wholly* in the contractor’s possession and control, *and* (3) *directly* associated with the contractor’s equipment. That narrow approach places very little responsibility on the contractor.

The scope of the pollution indemnification is also important. Does the indemnification apply to “all claims arising out of or related to” the specified type of pollution? Or does it apply only to “all costs of cleanup and remediation of” the specified type of pollution? These are important questions, because insurance for pollution is often very limited. Parties should consult their insurance brokers to ensure that their insurance programs cover the scope of their pollution responsibilities. This is particularly important with respect to pollution risks because most insurance programs contain pollution limitations.

With these comments in mind, Exhibit 6.6 shows a possible revision of a pollution indemnity provision.

Exhibit 6.6 Sample Revised Pollution Indemnity Provision
Contractor shall assume all responsibility for claims ~~arising out of or in any way related to~~ <u>for control and removal of</u> pollution or contamination, which originates above the surface of the land or water from spills of fuels, lubricants, motor oils, pipe dope, paints, solvents, ballast, bilge and garbage, <u>or</u> that is in Contractor's possession ~~and~~ <u>or</u> control ~~and~~ <u>or</u> ~~directly~~ associated with Contractor's equipment and facilities.

These types of changes to the language of a typical pollution indemnity provision in an MSA are particularly important if the MSA shifts all unallocated pollution risks to the operator.

Drafting Indemnity Provisions

Courts have held that the intent for one party (as indemnitee) to be exculpated or protected by another party (as indemnitor) from liability caused by the indemnitee's own negligence must be "clear and unequivocal." In many cases, the jurisprudence has determined that terms once considered sufficiently clear are not. For example, it has been held that the words "howsoever arising in any way directly or indirectly" in a hold harmless clause do not adequately show an intention to indemnify another party for its own negligence.

Include "Magic Language" in the Indemnity Provision

The key to an effective indemnity provision is to include "magic language" that meets the strict drafting standards imposed by courts in many jurisdictions to create an enforceable indemnity provision.

Because MSAs often contemplate work in multiple states, it is a good practice to draft MSAs to the highest drafting standard of the possible governing jurisdictions. Texas courts maintain the most stringent standard. Under the Texas Fair Notice Doctrine, the intent to indemnify another party for its own negligence must not only be stated in "clear and unequivocal terms," but the provision must also meet the Uniform Commercial Code definition of "conspicuous," typically including bold fonts, separate headings, and other visual devices designed to draw the reader's attention to the provision. The 2003 International Association of Drilling Contractors (IADC) Daywork Contract contains a good example of "magic language" that should be enforceable under the standards of any jurisdiction, including Texas. It is shown in Exhibit 6.7.

Exhibit 6.7
IADC-Style “Magic Language” Provision

[I]t is the intent of parties hereto that all releases, indemnity obligations and/or liabilities assumed by such parties ... be **WITHOUT LIMIT AND WITHOUT REGARD TO THE CAUSE OR CAUSES THEREOF INCLUDING, BUT NOT LIMITED TO, PRE-EXISTING CONDITIONS, DEFECT OR RUIN OF PREMISES OR EQUIPMENT, STRICT LIABILITY, REGULATORY OR STATUTORY LIABILITY, PRODUCTS LIABILITY, BREACH OF REPRESENTATION OR WARRANTY (EXPRESS OR IMPLIED), BREACH OF DUTY (WHETHER STATUTORY, CONTRACTUAL OR OTHERWISE), ANY THEORY OF TORT, BREACH OF CONTRACT, FAULT, THE NEGLIGENCE OF ANY DEGREE OR CHARACTER (REGARDLESS OF WHETHER SUCH NEGLIGENCE IS SOLE, JOINT OR CONCURRENT, ACTIVE, PASSIVE OR GROSS) OF ANY PARTY OR PARTIES, INCLUDING THE PARTY SEEKING THE BENEFIT OF THE RELEASE, INDEMNITY OR ASSUMPTION OF LIABILITY, OR ANY OTHER THEORY OF LEGAL LIABILITY.**

Source: International Association of Drilling Contractors Drilling Bid Proposal and Daywork Drilling Contract, U.S. April 2003, Paragraph 14.13.

Beware of “Floating” Magic Language

The IADC language shown in Exhibit 6.7 states that “all releases, indemnity obligations and/or liabilities” are subject to the so-called magic language. This is a good, efficient approach: rather than repeating the magic language in each indemnity provision, the IADC approach states the standard once and it applies throughout the contract. But the parties must be careful that this “floating” magic language does not broaden the intended framework by (1) undoing any intentional limitations on the indemnities or (2) inadvertently importing magic language to provisions that the parties did not intend to be subject to magic language.

The Difference between “Indemnify” and “Release”

An agreement to “indemnify” is different from an agreement to “release.” Courts and contracts often loosely use the term “indemnify” to mean “release and indemnify,” but the differences can be significant.

- A true indemnity agreement determines which party to a contract will ultimately bear the risk of injury to a third party.
- A release pertains to claims by the parties themselves; it surrenders legal rights or obligations between the parties to an agreement.

In the *Sundance* case,[12] the pertinent contract required that one party “*indemnify and hold harmless* [the other party] from and against any and all claims ... which may be brought against [that other party] incidental to, arising out of or in connection with the work to be done.” But the court refused to read that provision to create a release, noting that the “clause now before us is devoid of language in any way signaling plaintiff’s intention to release defendant as well as holding it harmless from actions by third parties.” The court noted that agreements to indemnify a party against actions by third parties and to release the other party from any claims a party itself might bring are “two different animals.” Because courts strictly construe exculpatory provisions, the best practice is to be very specific and to state that each party “shall release, protect, defend, indemnify, and hold harmless” the other party.

To avoid any reason for doubt, the indemnity provision should specify that the hold harmless/indemnity obligations apply even to losses arising out of strict liability, preexisting conditions, and breach of contract or warranty. Furthermore, if the parties intend that attorneys’ fees will be awarded for an indemnitee’s pursuit of hold harmless/indemnity protection, that must be specified, too.

Indemnity for Gross Negligence and Punitive Damages

Whatever decision parties make regarding allocation of gross negligence/punitive damages, they must be careful to maintain harmony with their other contracts and MSAs. In other words, this is another area in which parties can get themselves into “pass-through” problems.

In the multidistrict litigation surrounding the April 2010 Deepwater Horizon incident, a court order focused on the difference between a release and an indemnity for purposes of determining whether parties can agree to shift liability for gross negligence and punitive damages.

By way of background, "gross negligence" has been defined in various cases as "want of even slight care and diligence," "want of that diligence which even careless men are accustomed to exercise," and conduct that indicates that a party "had actual subjective knowledge of an extreme risk of serious harm." The concept is relatively similar throughout U.S. jurisdictions. Proving gross negligence is difficult because the term refers to particularly bad behavior—behavior that goes beyond ordinary negligence.

On principle, some parties think that would-be indemnitees should not be exculpated from the consequences of their own gross negligence (or, similarly, "willful misconduct" or punitive damages). Therefore, they prefer to exclude gross negligence, willful misconduct, and punitive damages from the scope of the indemnity obligations. By contrast, other parties reason that carving those concepts out of the indemnity obligations invites costly litigation. These competing viewpoints can cause problems during negotiations.

Whether parties actually can exculpate one another from gross negligence and punitive damages is an open question. It might be against public policy to do so. In the *Deepwater Horizon* litigation, the district court held that the public policy question hinges on whether the exculpation is a release or an indemnity. Significant jurisprudence holds that parties may not release one another from the consequences of the released party's own negligence. But the district court decision in the *Deepwater Horizon* case distinguishes those cases from an "indemnity" situation and holds that public policy does not bar parties from agreeing to indemnify one another from the consequences of the indemnitee's gross negligence.

Punitive damages are yet another story. The court in the *Deepwater Horizon* case noted that the purpose of punitive damages would be defeated if the burden of such damages were shifted by contractual indemnity. Therefore, the court held that agreements to indemnify another party for punitive damages violate public policy. Even if the parties are inclined to provide exculpation for gross negligence or punitive damages, and even if public policy does not forbid that, insurability is an additional consideration. The parties may not have insurance for punitive damages. In fact, whether insurance for punitive damages violates public policy is also uncertain in many jurisdictions.

Assuming that exculpation for punitive damages and/or gross negligence can survive public policy scrutiny, parties must be careful not to indemnify for gross negligence in Contract A and carve gross negligence out of the indemnity obligation in Contract B. That could create another problem like the "*Foreman* problem" mentioned earlier.

Battle of the "Notwithstandings"

Contractual provisions, such as standard warranty waivers, often include statements that "notwithstanding anything in this agreement to the contrary, Contractor shall have no responsibility for...." These provisions may conflict with similar "notwithstanding" notions in the general indemnity sections. The typical assumption the parties make is that the risk allocation provisions will "trump" any other provision in the contract. Therefore, any provisions that relate to risk allocation or tend to create contractual responsibility should be expressly "subject to" the parties' general indemnity obligations. Otherwise, there may be an irreconcilable conflict (an ambiguity) within the MSA.

Anti-Indemnity Acts

It might not matter that the parties draft impeccable indemnity arrangements that thoroughly and accurately reflect their intentions. Several states—Louisiana, Texas, New Mexico, and Wyoming—have oil field anti-indemnity acts that, based on public policy, invalidate contractual provisions that exculpate parties from loss and damage caused by their own fault.

Additionally, about 40 states have construction anti-indemnity statutes that do the same thing. These construction anti-indemnity statutes generally contain far-reaching prohibitions. For example, the Louisiana construction anti-indemnity act applies to "any agreement for the design, construction, alteration, renovation, repair, or maintenance of a building, structure, highway, road, bridge, water line, sewer line, oil line, gas line, appurtenance, or other improvement to real property, including any moving, demolition, or excavation." While these construction acts are apparently not intended to apply to true oil and gas operations, an aggressive and disappointed contracting party might be tempted to seek refuge from an indemnity obligation based on these acts' broad language.

Anti-indemnity statutes are based on a perception that operators and contractors have inequitable negotiating positions, a presumption that forcing each party to bear losses according to its own degree of fault will promote safety, and the notion that non-fault-based risk allocation is fundamentally unfair. Each oil field anti-indemnity act is unique, with state-specific applications, exceptions, carve-outs, and possible work-arounds. Parties must understand these statutes, know which ones may apply to their work, and plan for their potential applicability when crafting their indemnity arrangements—because if any one of these statutes applies to a particular claim, the parties' risk allocation arrangement can be unenforceable, and the responsibility would be allocated "at law."

Insurance

The party responsible for a particular exposure for indemnity purposes should also be the party responsible for insuring that exposure. Coordinating insurance coverage with indemnity obligations is therefore essential. MSAs should not only require certain insurance protections but also ensure that the insurance provisions dovetail with the indemnity and other risk allocation provisions in the MSA.

With regard to risk allocation in MSAs, insurance serves several important purposes.

- Insurance guards against the insolvency of the indemnitor.
- Under some circumstances, the insurance coverage is valid whereas the indemnity obligations are not (e.g., certain situations involving the Texas and Louisiana oil field anti-indemnity acts).
- The availability of adequate insurance can ease tension between companies (which are often still working together) in the event of a loss.

The MSA's indemnity obligations must dovetail with the insurance requirements. Here are a few tips for accomplishing that goal.

- Be careful not to make the insurance requirements in the MSA overly broad. They should all be limited "to the extent of the risks and liabilities assumed" by the party procuring the particular insurance coverage. This is important to prevent one party's insurance program from extending to losses that are not the named insured's responsibility under the terms of the MSA.
- Use the "Group" concept. If the MSA provides for a broad reciprocal indemnity, make sure that all of the insurance requirements extend to the indemnitee's entire "Group."
- Employ the "big three" insurance protections described below.

The "Big Three" Insurance Protections

All MSAs should include provisions requiring "the big three" critical insurance protections:

- additional insured status,
- waiver of subrogation protection, and
- primary and noncontributory coverage.

Additional Insured Status

Each party (and its indemnified "Group," if the MSA includes a broad reciprocal indemnity) should be named as an additional insured on the other parties' insurance "to the extent of the risks and liabilities assumed" by that other party. Additional insured status provides important benefits. It increases the available amount of insurance protection for a particular casualty; it insulates against negative loss history; and it gives direct rights against the other party's insurer. Also, it might increase the chance of recovery for “bad faith” damages in the event of a coverage battle.

Additional insured status may not be available in certain insurance coverages (e.g., workers compensation coverage, OEE/COW, first-party property policies, and professional liability coverage). But it should be obtained on any coverage related to the work for which it is available.

Parties should be careful to ensure that the additional insured protection is not limited inappropriately. Some additional insured endorsements are narrow, in that they only apply in certain circumstances. This could be bad for both parties. For the party added as additional insured on a narrow form, its own insurance program could unnecessarily be called on to respond to a claim, with negative effects on that party’s loss history. And the other party (the indemnitor) could be exposed to potential uninsured liability, because it agreed to provide indemnity protection for a particular claim, but the indemnitee is not eligible for corresponding insurance protection.

Waiver of Subrogation

The second of the “big three” protections is a waiver of subrogation provision. Each party’s insurance policy should contain this protection to prevent the other party’s insurer from asserting a claim against the indemnified party for its share of fault for a casualty. A waiver of subrogation provision can effectively produce some of the same benefits as additional insured status can (e.g., an insurer cannot subrogate against its own policyholder). It also can apply to policies for which additional insured status is unavailable (property policies, workers compensation policies, and OEE/COW policies).

Primary and Noncontributory Coverage

The final “big three” protection is for the indemnitor’s coverage to be “primary and noncontributory” to the indemnitee’s insurance policies. Most policies contain “other insurance” clauses that aim to share the risk of exposure with (or shift the entire risk to) other policies—of any party—that may cover the same loss. Without a statement of primacy, the “other insurance” clause could frustrate the parties’ intent that the indemnitor’s coverage respond to the losses that have been allocated to it under the MSA.

Other Important Insurance Protections

It is important that the insurance protections do not limit the indemnity obligations. In other words, the indemnity obligations should not be limited by the dollar amount of required insurance. The *Dickerson* case[13] held that, based on the language of the contract applicable in that case, the indemnitor’s indemnity obligation was limited to the amount of insurance required under the contract.

Parties should expressly negate any implication that insurance coverage limits the indemnity obligations. The insurance provisions should also take into consideration any potentially applicable anti-indemnity statute; this might necessitate the use of state-specific insurance protections or endorsements.

Insuring Contractual Liability

In the oil field, parties often assume indirect responsibility for losses by contractually assuming risk for which they would not be responsible without that contract. Contractual liability may be—and often is—excluded from a general liability form. And when it is covered, it is often covered only through an exception to the general exclusion. That is not comforting. Many policy forms expose the policyholder to potentially catastrophic uninsured losses. For example, some forms provide coverage only if the named policyholder is partially at fault. That can be devastating if the indemnitee is solely at fault. Operators and contractors should be cautious about the narrow forms used in the insurance market and take steps to avoid its effects.

Each party should first make sure that its own obligations are fully insured. The MSA should also specify that each party must obtain contractual liability coverage that is broad enough to fund all of the liabilities undertaken within the indemnity provisions of the contract. Exhibit 6.8 provides sample language.

Exhibit 6.8 Sample MSA Contractual Liability Coverage Requirement
The indemnifying party's contractual liability coverage must provide coverage for all of the release, defense, indemnity, and hold harmless obligations undertaken by that party in Section [_] of this MSA.

At the very least, this type of provision in the MSA should alert the parties (and their insurance brokers, who should be reviewing the insurance and indemnity obligations) to the need for broad form contractual liability coverage. Moreover, it can rebut an argument that the indemnitor complied with the technical contractual liability requirements by providing anemic coverage.

Larger companies (like big oil field operators and service contractors) might have the leverage to obtain manuscript policy endorsements. (A manuscript endorsement is a nonstandard endorsement that is drafted to meet the needs of a particular insured.) Considering the expansive use of contractual risk allocation in the oil field, pursuing a manuscript contractual liability endorsement may be worthwhile. Exhibit 6.9 provides an example of a manuscript endorsement that at least one insurer in the oil patch has agreed to for a moderately sized onshore operator.

Exhibit 6.9 Sample Manuscript Contractual Liability Endorsement
Without limiting the contractual liability coverage provided within the Policy, including but not limited to that which is provided through the definition of "insured contract," this Policy is specifically endorsed to cover the indemnity and hold harmless obligations undertaken by the Named Insured in a drilling contract, master service agreement, and/or similar agreement.

The Proper Use of Insurance Certificates

As with other contracts, insurance certificates should provide assurance that the parties named in the certificates are carrying the proper insurance coverage. But many certificates—including the standard Association for Cooperative Operations Research and Development (ACORD) forms—contain worrisome limitations regarding reliance on the certificate and notice of cancellation. Most certificate of insurance forms include only very basic information and fail to alert the additional insured to significant endorsements, exclusions, and other conditions that might significantly limit the value of the coverage. One court even held that those who take such certificates at face value do so at their own risk.

Considering these limitations, parties might want to use customized insurance certificates that are drafted to ensure compliance with the MSA's insurance requirements. These custom certificates can expressly certify, without disclaimer or limitation, that the proper insurance is in place and describe key policy endorsements and exclusions. This approach often meets resistance from agents and brokers, but it can give both parties comfort that they are getting what they bargained for.

Even without a customized certificate of insurance, parties should reserve the right to require proper adjustments to the certificate or to the insurance program if significant information is wrong or missing. For example, the MSA might state: "Each party shall provide an insurance *certificate on a form satisfactory to the other party,* evidencing that the above coverages are in place." This helps to alert the parties to potential deficiencies in their insurance programs. Although the certificate typically cannot alter the policy, it might provide appropriate extrinsic evidence to determine the policy's intent if there is an ambiguity in the policy.

Role of the Insurance Agent or Broker

The insurance agent or broker should be involved in reviewing MSAs. An insured should provide the agent or broker with copies of the company's contracts for review. The agent or broker should be able to spot issues and confirm that the company has the right coverages, including those required by the MSA. This is important because a party's failure to obtain insurance as required by a contract makes that party the "insurer" of its obligations.

Particular Provisions Bearing on Risk Allocation

This section of the chapter discusses the following provisions in MSAs that warrant special comment because they have a bearing on risk allocation.

- Warranty and indemnity provisions
- Independent contractor provisions
- Statutory employer provisions (for Louisiana)
- Choice of law provisions
- Savings clauses
- Primacy clauses
- Consequential damages waivers

Warranty and Indemnity Provisions

Many contractors insist on warranty limitations and warranty disclaimers that state that

> Notwithstanding anything in this agreement to the contrary, Contractor shall have no obligation—and Operator shall have no remedy—for Contractor's breach of any warranty (express or implied) other than those remedies expressly provided in this warranty section [typically re-performance or replacement of the defective work].

Similarly, the MSA's basic indemnity provisions often include statements like the following.

> Notwithstanding anything in this agreement to the contrary, Contractor shall release, protect, defend, indemnify, and hold harmless Company Group from and against any and all Claims [broadly defined] on account of bodily injury, illness, death, or damage to property of Contractor Group ... REGARDLESS OF CAUSE.

This is an example of the battle of the notwithstandings.

What if a contractor's employee is injured as a result of the contractor's breach of warranty? Which provision controls? The parties almost certainly intend for the indemnity provision to apply to that loss—for the contractor to be responsible for claims by its injured employee. However, an overly aggressive party might argue that the warranty limitation applies to the loss. Therefore, the warranty limitation should include an express statement that it does not limit the contractor's general indemnity and insurance obligations.

Warranty provisions also cause negotiating disputes because many contractors resist the word "warranty" (which means "guaranty") and creates a type of strict liability with regard to that obligation. Contractors are understandably reluctant to expose themselves to that high standard. Moreover, contractors rightly question whether the "warranty" could be used by the operator to circumvent the general risk allocation framework. So in certain circumstances, it is appropriate to replace the word "warrant" with "shall." Then the contractor has not guaranteed a result, but it is still obligated to perform properly.

Independent Contractor Provisions

Independent contractor provisions can help to minimize the risk that a court would determine that the operator acted negligently in causing an injury. Considering the typical oil field risk allocation arrangement ("you take your people and property and I take mine"), this helps contractors as well as operators because it decreases the possible tort exposure for which contractors may have to indemnify if their employees get injured on the job. A sample independent contractor provision, with the key language shown in italics, appears in Exhibit 6.10.

Exhibit 6.10 Sample Independent Contractor Provision
Contractor *shall at all times be an independent contractor*, and nothing in this Contract shall be construed as creating the relationship of principal and agent, or employer or employee, between Operator and Contractor or between Operator and Contractor's agents or employees. Contractor shall have no authority to hire any persons on behalf of Operator, and any and all persons whom Contractor may employ shall be deemed to be solely the employees of Contractor. Contractor *shall have control and management of the Work, the selection of employees and the fixing of their hours of labor, and no right is reserved to Operator to direct or control the manner in which the Work is performed, as distinguished from the result to be accomplished.* Nothing herein contained shall be construed to authorize Contractor to incur any debt, liability, or obligation of any nature for or on behalf of Operator.

A successful "independent contractor defense" exculpates the operator from liability where an independent contractor handles the details of operations. This protection is particularly important for the operator if the contractor's indemnity or insurance protections are unenforceable, perhaps because of an anti-indemnity act.

Louisiana Statutory Employer Provisions

Louisiana law has an interesting and unusual feature: the "statutory employer" concept. A statutory employer is immune from tort claims asserted by its "statutory employees." "A statutory employer relationship shall exist whenever the services or work provided by the immediate employer is contemplated by or included in a contract between the principal and any person or entity other than the employee's immediate employer."[14]

Louisiana law also provides that, except in those instances covered by the two-contract theory, a statutory employer relationship "shall not exist ... unless there is a written contract between the principal and a contractor which is the employee's immediate employer or his statutory employer, which recognizes the principal as a statutory employer."[15]

Therefore, statutory employer provisions are essential in any MSA when there may be work performed in or offshore of Louisiana. If there is a statutory employer provision in the contract, a rebuttable presumption of statutory employer status exists, triggering the immunity for the statutory employer. Demonstrating that the work was not integrally related or essential to the ability of the principal to generate its goods, products, or services is the only way to overcome the presumption.

This mechanism also helps contractors. To the extent the operator is protected by the statutory employer provision, the contractor decreases its liability under its indemnity obligation. Therefore, contractors should not resist these clauses.

Choice of Law Provision

Many companies prefer to apply the law of their home state to their MSAs. Parties are comfortable with their home state's law and likely have relationships with local lawyers. They may like particular features of the law of their home state. However, the law of one party's home state may not be favorable in all circumstances. Courts generally uphold choice of law provisions if one of the parties or the work to be performed has a sufficient relationship to that state, but either party may argue that application of that state's law would be improper on public policy grounds.

Selecting applicable law deserves serious consideration, taking into account anti-indemnity acts, implied warranty acts, location of the work, and enforceability. To make sure that the chosen state's conflicts rules will not apply, the parties should state that the selection is "*exclusive* of conflicts of law principles."

Savings Clauses

Savings clauses are important, particularly when an anti-indemnity statute or other act might arise that could invalidate any of the provisions. Parties should not rely on courts to excise improper concepts from the MSA. Courts may instead strike the entire provision—not just the specific offending portion. The best way to retain the parties' intent is to formulate the provision to amend offending provisions "to the extent—*but only to the extent*—necessary to comply with applicable law."

Primacy Clauses

When parties use work orders, delivery tickets, and invoices in connection with an MSA, the provisions of those documents may be inconsistent with one another. Work orders are necessary to memorialize the scope of work, specifications, prices, and discrete tasks, but many work orders include interest provisions, releases, and even insurance and indemnity requirements. The parties probably do not intend for the work order to trump the MSA, so primacy clauses are important to negate provisions contrary to the risk allocation framework of the MSA.

Parties should ensure (contractually, in the MSA) that field personnel are not authorized to amend the provisions of the MSA, but parties should also educate field personnel that they have no authority to sign documents or execute agreements that purport to impact risk allocation—particularly because many of these provisions are hidden on the back of field tickets or even invoices.

An example of a primacy clause that also contains a statement prohibiting field personnel from modifying risk allocation concepts is shown in Exhibit 6.11.

Exhibit 6.11 Sample Primacy Clause
The parties specifically object to and reject any terms contained within any purchase orders, work orders, invoices, or delivery tickets that (i) conflict with the terms of this MSA or (ii) purport to impact the allocation of risk between the parties. The parties' field personnel have no authority to modify or amend the terms of this MSA.

Consequential Damages Waiver

Waivers of consequential damages are common, and both parties typically want them. But if these provisions are not carefully drafted and scrutinized—because both parties just adopt some boilerplate language that someone lifted from another contract—they can be potential land mines.

Waivers of consequential damages may not cover everything that the parties expect them to cover. Operators typically want to avoid loss of income claims by contractors that are unable to work (or rent out their expensive tools) due to the operator's fault. Similarly, contractors want to avoid lost revenue and deferred production claims by operators whose wells are adversely impacted by contractors' negligence. Depending on the circumstances, however, these types of losses might not be "consequential damages" unless the parties expressly define them to be.

In some jurisdictions, "consequential damage" is a flexible notion. Under maritime law, for example, consequential damages have been defined as "those unusual or indirect costs that, although caused by the defendant's conduct in a literal sense, are beyond what one would reasonably expect to be the ordinary consequences of a breach." Does that include lost profits? Deferred production? Maybe or maybe not. To avoid taking chances with the risk allocation program, the MSA should define the term "consequential damage." The definition should specifically include lost hire, lost rental, loss of business opportunity, and unabsorbed overhead. That way, the exclusion is categorical instead of situational. The parties know that certain types of damages are always excluded and that the exclusion does not depend on the circumstances of the loss.

The consequential damages waiver must fit within the parties' overarching indemnity programs. One common problem is for MSAs to state: "Notwithstanding anything contained in this MSA to the contrary, neither party shall be responsible to the other for consequential, special, or indirect damages." But what about consequential damages that are part of a claim for which one party must indemnify the other party? Typically, the parties really mean the following: "Notwithstanding anything contained in this MSA to the contrary, neither party shall be responsible to the other for consequential, special, or indirect damages *suffered by the releasing party*." Thus, the parties may be assuming unprotected risk if they offer protection that they cannot "pass through" in other contracts and MSAs.

Glossary

AAPL—See American Association of Professional Landmen.

additional insured—A person or organization not automatically included as an insured under an insurance policy who is included or added as an insured under the policy at the request of the named insured. A named insured's impetus for providing additional insured status to others may be a desire to protect the other party because of a close relationship with that party (e.g., wanting to protect church members performing services for the insured church) or to comply with a contractual agreement requiring the named insured to do so (e.g., project owners, customers, or owners of property leased by the named insured). In liability insurance, additional insured status is commonly used in conjunction with an indemnity agreement between the named insured (the indemnitor) and the party requesting additional insured status (the indemnitee). Having the rights of an insured under its indemnitor's commercial general liability (CGL) policy is viewed by most indemnitees as a way of backing up the promise of indemnification. If the indemnity agreement proves unenforceable for some reason, the indemnitee may still be able to obtain coverage for its liability by making a claim directly as an additional insured under the indemnitor's CGL policy.

American Association of Professional Landmen (AAPL)—The American Association of Professional Landmen unites more than 21,000 landmen and land-related persons throughout 44 affiliated local associations in the United States and in Canada. AAPL serves as the voice of the landman profession to encourage fair trading terms that work in the best interest of all parties, wise utilization of natural resources, and responsible employment of the land's surface. One of its significant functions is to draft and publish "model" joint operating agreement (JOA) forms for use by its members.

anti-indemnity statute—A law that defines the scope of legal liability that one party may transfer to another in a contract. Anti-indemnity statutes may prohibit the transfer of any liability attributable to the transferor's negligence; or, alternatively, they may prohibit only the transfer of liability arising from the transferor's sole negligence. In some states, anti-indemnity statutes also limit the ability of one contracting party to require additional insured status under the other party's insurance policies. Anti-indemnity statutes are most commonly used to regulate the risk transfer provisions of construction contracts.

at law risk allocation—Risk allocation based on the law that applies in the absence of a contract.

big three protections—(1) Additional insured status, (2) waiver of subrogation, and (3) primary and contributory coverage.

broad form indemnity agreement—Contract provision by which the indemnitor assumes an unqualified obligation to hold the indemnitee harmless for third-party liabilities arising out of the project, regardless of which party was actually at fault.

broad reciprocal indemnity—Each party indemnifies the other party—and the other party's contractors and subcontractors—from claims arising out of injury, illness, death, and loss/damage to property of its own employees and property of its own contractors' and subcontractors' employees and property.

carve-outs—Contractual exceptions.

certificate of insurance—A document providing evidence that certain general types of insurance coverages and limits have been purchased by the party required to furnish the certificate.

CGL—See commercial general liability policy.

commercial general liability (CGL) policy—A standard insurance policy issued to business organizations to protect them against liability claims for bodily injury (BI) and property damage (PD) arising out of premises, operations, products, and completed operations, and advertising and personal injury (PI) liability. The CGL policy was introduced in 1986 and replaced the "comprehensive" general liability policy, which was also referred to as a CGL.

comparative form indemnity—Contractual agreement that obligates the indemnitor only to the extent of its own fault. Also known as limited form indemnity.

consequential damages—Consequential damages are an indirect result of a direct loss. Lost profit, lost rents, and lost business opportunities are examples of consequential damages that could be incurred as a result of a direct physical loss to property.

***contra bonos mores*—**Against good morals.

Contractor Group—As used in master service agreements (MSAs), the contractor with whom the operator is contracting, plus its affiliates, partners, owners, agents, contractors, and subcontractors.

control of well insurance—Insurance coverage that pays the expenses of controlling a well that is out of control (a blowout), along with other related costs, such as the cost of redrilling the well.

COPAS—See Council of Petroleum Accountants Societies.

Council of Petroleum Accountants Societies (COPAS)—Organization that provides expertise for the oil and gas industry through the development of Model Form Accounting Procedures, publications, and education.

daywork contract—Drilling contract in which the contractor gets paid a fixed amount per day regardless of how many feet are drilled.

driller—The person who runs the controls of the rig that govern how fast the drill bit turns.

drilling contract—Contract between the operator and the drilling contractor.

drilling contractor—The party that owns and operates the drilling rig.

drilling superintendent—An employee of the operator who is at the rig continually to make decisions that cannot wait long enough to be relayed back to the operator's office for discussion.

exculpatory clause—A provision in a contract that relieves one party of all liability to the other in connection with the performance of the contract. The enforceability of an exculpatory clause may be restricted by common or statutory law or by legal precedent in a given jurisdiction.

farmout agreement—Contract used when an oil operator has a mineral lease but does not have any immediate plans to drill on it or cannot afford to drill on it and will "farm out" the lease to another operator who is interested in drilling a well on the lease.

farmoutee—The party to a farmout agreement who actually drills the well.

farmoutor—The party to a farmout agreement who was the original operator and comes back in for a percentage of the completed well's production.

floor hands—Individuals who make the connections of the new "stand" of pipe to the string already in the hole and do the general work around the rig.

footage contract—Drilling contract in which the contractor gets paid per foot drilled.

gross negligence—Willful and wanton misconduct.

hold harmless agreement—A provision in a contract that requires one contracting party to respond to certain legal liabilities of the other party. For example, construction contracts typically require the contractor to indemnify the owner with respect to the owner's liability to members of the public who are injured or whose property is damaged during the course of the contractor's operations. There are a number of types of hold harmless clauses, differentiated by the extent of the liabilities they transfer. The most commonly used types of clauses are the "broad," "intermediate," and "limited" form hold harmless clauses.

- **Limited form**—Where Party A holds Party B harmless for suits arising out of Party A's sole negligence. Party B is thus protected when it is held vicariously responsible for the actions of Party A.
- **Intermediate form**—Where Party A holds Party B harmless for suits alleging sole negligence of Party A or negligence of both parties.
- **Broad form**—Where Party A holds Party B harmless for suits against Party B based on the sole negligence of A, joint negligence of A and B, or the sole negligence of B. Broad form hold harmless agreements are unenforceable in a number of states.

indemnitee—The person or organization that is held harmless in a contract (by the indemnitor).

indemnitor—The person or organization that holds another (the indemnitee) harmless in a contract.

indemnity—Restoration to the victim of a loss up to the amount of the loss.

indemnity provision—See hold harmless agreement.

independent contractor—An individual or company that has signed an agreement with another party to perform some job or function on behalf of that party without the direction or oversight of the party. As respects workers compensation, many states have established criteria that determine whether an individual is functioning as an independent contractor or employee. A worker classified as an independent contractor and not an employee is ineligible to receive benefits under the workers compensation policy of the other party. In spite of the rules established, the delineation of an independent contractor remains in many jurisdictions a legal ambiguity.

insurance certificate—See certificate of insurance.

intermediate form indemnity—The indemnitor assumes responsibility for the indemnitee's liabilities except where the injury or damage is the result of the indemnitee's sole negligence.

JIB—See joint interest billing.

JOA—See joint operating agreement.

joint interest billing (JIB)—A specialized form of accounting used in the oil and gas industries.

joint operating agreement (JOA)—A contract that sets forth the duties and obligations of both the operator and nonoperating working interest owners of a mineral lease. The JOA serves several purposes, including identifying the property interests of the parties in the mineral lease, designating the party that is to act as operator, and setting forth the method for sharing expenses and for the allocation of liability for the oil and gas exploration and production operations.

knock-for-knock indemnity—A form of indemnity that is used in energy industry contracts. Knock-for-knock indemnity is reciprocal in nature and is based on ownership of property and personnel as opposed to allocating risk based on fault. Each party to an oil and gas contract agrees to take responsibility for and to indemnify the other party against injury and loss to its own property and personnel.

landman—Person who interacts and negotiates with land owners to acquire oil and gas drilling leases on the behalf of oil and gas companies.

limited form indemnity—See comparative form indemnity.

magic language—Contract wording that meets a legal standard.

master charter agreement—Contract for operators that have maritime operations.

master service agreement (MSA)—A contract used by oil and gas companies to enter into an agreement in advance with their contractors that specifies the terms and conditions that will govern the contractors' work. The agreement is typically used for on-site services performed by oil field service contractors on a repetitive basis, such as equipment maintenance, well services, and cementing services. Its goal is to speed up and simplify future contracts for long-term client/vendor relationships.

mineral lease—A contract between a mineral owner (the lessor) and a company or working interest owner (the lessee) in which the lessor grants the lessee the right to explore, drill, and produce oil, gas, and other minerals for a specified period of time. The oil and gas lease is granted in exchange for royalty payments to the lessor.

modified reciprocal indemnity—Hybrid approach that could include a number of variations. In one variety, the indemnitor indemnifies only for loss to its own people and property—but extends that protection to the other parties' contractors and subcontractors as well.

mud engineer—The person who makes certain that the drilling fluid (called "mud") has the proper mixture.

MSA—See master service agreement.

narrow reciprocal indemnity—Each party indemnifies the other party—but not the other party's contractors and subcontractors—from claims arising out of injury, illness, death, and loss/damage to property of its own employees and property but not of its contractors' and subcontractors' employees and property. The protection extends only to the indemnitee and not to its contractors and subcontractors.

noncontributory insurance—Insurance issued on the basis that it will not seek contribution from other insurance policies that apply to a covered loss on the same basis (e.g., primary). Requests for additional insured status sometimes specify that it be provided on a noncontributing or noncontributory basis. The additional insured in such cases is seeking assurance that its own policy will not be asked to contribute to a covered loss.

nonoperators—Well investors with a nonoperating working interest.

oil operator—The person or organization responsible for the exploration, development, and production of an oil or gas well or lease.

Operator Group—As used in master service agreements (MSAs), the operator and its affiliates, partners, owners, agents, contractors, and subcontractors.

opt-in arrangement—The parties that do not carry their own suite of protections must be careful to elect the coverages that they specifically need.

opt-out arrangement—Parties are covered by the JOA's suite of coverages unless they follow the designated opt-out procedure.

primary coverage—The policy that responds first to an insured loss, either on a first dollar basis or after allowing for a deductible. When the primary coverage limits are paid, any remaining loss is covered by whatever excess layer of insurance may be in place.

release—The document relinquishing a claim. A plaintiff or claimant signs a release in exchange for monetary payment, thereby giving up the right to pursue further indemnity in connection with the claim.

roughnecks—Individuals who make the connections of the new "stand" of pipe to the string already in the hole and do the general work around the rig.

royalty interest—Ownership of a portion of the resource or revenue produced from the leased property. Typically, the owner of the leased property retains a royalty interest. The party with the royalty interest is not responsible for the costs and liabilities associated with the exploration, development, and operation of a well.

savings clause—A clause in a contract providing that the rest of it will stand if part is held invalid.

sound location provision—Provision in a drilling contract that requires the operator to provide a sound location for the drilling rig.

subrogation provision—A provision in an insurance policy addressing whether the insured has the right to waive its recovery rights against another party that may have been responsible for loss covered under the policy. In standard commercial policies, the subrogation provision is called "Transfer of Rights of Recovery Against Others to Us."

subrogation waiver—An agreement between two parties in which one party agrees to waive subrogation rights against another in the event of a loss. The intent of the waiver is to prevent one party's insurer from pursuing subrogation against the other party. Generally, insurance policies do not bar coverage if an insured waives subrogation against a third party before a loss. However, coverage is excluded from many policies if subrogation is waived after a loss because to do so would violate the principle of indemnity.

surface damage agreement—Agreement in which the lessee agrees to pay the surface owner a flat fee in return for the surface owner's agreement to waive any other recovery rights for damage to the surface resulting from normal wear and tear from the lessee's mineral lease activities.

termination of location liability—Provision to the effect that the drilling contractor can have no liability for any occurrence after it has concluded operations at the site.

tool pusher—The foreman who makes certain everything is running correctly and who stays at the rig 24 hours a day, 7 days a week.

tower man—The individual who stands on the "monkey board" high in the rig and guides the drill pipe into position for connection.

turnkey contract—Drilling contract in which the contractor must drill to a certain depth in order to get paid.

waiver of recovery rights—An agreement to voluntarily give up a party's right to pursue recovery from the other party for amounts it is legally entitled to collect.

waiver of subrogation—See subrogation waiver.

well service contractors—Specialty contractors that perform various tasks at a drilling site.

workers compensation and employers liability policy—An insurance policy that provides coverage for an employer's two key exposures arising out of injuries sustained by employees. Part One of the policy covers the employer's statutory liabilities under workers compensation laws, and Part Two of the policy covers liability arising out of employees' work-related injuries that do not fall under the workers compensation statute. In most states, the standard workers compensation and employers liability policy published by the National Council on Compensation Insurance (NCCI) is the required policy form.

working interest—A percentage of ownership in a mineral lease granting its owner the right to explore, drill, and produce oil and gas from the leased property. Working interest owners bear all of the costs and liabilities associated with leasing, drilling, producing, and operating a well but share in only part of the production revenue from a successful well. The share of production revenue to which a working interest owner is entitled will always be smaller than the share of costs that the working interest owner is required to bear, with the balance of the production revenue accruing to the royalty owners. For example, the owner of a 100 percent working interest in a lease burdened by a land owner's royalty of 20 percent would be required to pay 100 percent of the exploration, development, and operating costs but would be entitled to only 80 percent of the production revenue. The royalty owner would be entitled to the remaining 20 percent of production revenue.

End Notes

[1] The prime contract is held either by the project owner or by a main or primary contractor having full responsibility for the job.

[2] "Joint interest billing," or JIB, is a form of accounting unique to the oil and gas industry.

[3] An operators extra expense (OEE) policy, also known as a control of well policy, is a specialized policy available to oil or gas well operators that covers the cost of regaining control of a wild well. Coverage for pollution, stuck drill stem, evacuation expense, and care, custody, or control (CCC) exposures can be added by endorsement.

[4] Section III(B) of the AAPL form.

[5] AAPL form at Section IV(B)(2(b).

[6] Authority for expenditure, a budgetary document.

[7] AAPL form at Section III(C).

[8] AAPL form at Section V(A).

[9] Section V(B) of the AAPL form.

[10] Ibid.

[11] These three types of reciprocal indemnity—narrow, broad, and modified reciprocal—should not be confused with the three types of indemnification agreements—broad, intermediate, and limited form—that were discussed in Chapter 2.

[12] *Sundance Cruises Corp. v. American Bureau of Shipping*, 799 F. Supp. 363 (S.D.N.Y. 1992).

[13] *Dickerson v. Continental Oil Co.*, 449 F.2d 1209 (5th Cir. 1971).

[14] La. Rev. Stat. Ann. § 23:1061.

[15] Ibid.