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Drilling Contracts

Contested Ground in Day Work Drilling Contracts: Negotiation and Litigation

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TABLE OF CONTENTS

I. Drilling Contract Types. 1
A. Day Work Contract 1
B. Footage Contract 1
C. Turnkey Contract 2
II. Negotiating the Contract. 2
A. International Association of Drilling Contractors – Day Work Contract Form 2
B. References 2
III. Commencement. 3
IV. Parties 3
V. Breach. 4
VI. Term – Length of Contract. 4
VII. Stoppage of Work – Contract Termination 5
A. By Operator 5
B. By Contractor 5
C. Early Termination Compensation 5
VIII. Payment 6
A. Lien Rights 6
IX. Risk Allocation, Release of Liability and Indemnity 7
A. Texas Oilfield Anti-Indemnity Act 7
B. TOAIA and the Drilling Contract 8
C. Specific Risks Addressed 8
D. States having an Oilfield Anti-Indemnity Statute 11
X. Litigation. 11
A. Drilling Contract Litigation – Contract Construction / Indemnification. 11
B. Related Litigation / Master Service Agreements. 14

Drilling rigs are the exclusive means by which oil and gas exploration and production companies physically drill a well into the earth. Drilling rigs are primarily owned by specialized oilfield services companies known as drilling contractors. The equipment, expertise and labor required to drill a modern oil and gas well are capital intensive and require continuous utilization in order to ensure the proper return on the investment for the owners of a rig. Few oil and gas companies today maintain a fleet or even single drilling rig.

For these reasons and the desire of oil and gas companies to focus its expertise on locating reserves rather than drilling techniques, the oil and gas service industry is populated with companies that specialize only in drilling oil and gas wells, and related completion activities. Commonly known as drilling contractors, or simply contractors, they own drilling rigs and ancillary equipment such as drill pipe and are available on a contract basis to drill (and sometimes equip) wells for the production of liquid and gaseous hydrocarbons. The contractor furnishes equipment, labor and performs services for the drilling of a specified well at a certain location approximated in the contract, but to a maximum depth limitation. Contractors often deploy their assets based on the rated capacity of the drilling rig as to depth, creating a limitation as to the types of wells that can be drilled by any given rig. Drilling of a particular well by the contractor for an operator (landowner, mineral owner, lessee or the like, who controls the leasehold and will be the owner and operator of the completed well) comes under three (3) common types of agreements.

I. Drilling Contract Types.

A. Day Work Contract. A day work contract is "a contract for the drilling of an oil and gas well under which 'the drilling contractor furnishes the drilling crew and drilling equipment; he is paid an agreed sum of money for each day spent in drilling regardless of the number of days involved... .'" HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW MANUAL OF OIL AND GAS TERMS, 249, VOL. 8 (LexisNexis 2003) (citing *Haas v. Gulf Coast Natural Gas Co.*, 848 S.W.2d 127, 131 (Tex. Civ. App. – Corpus Christi 1972, no writ)).

The day work contract is highly favored by the drilling industry because the contractor is paid based on the total number of days on station over the well, regardless of the progress as to the depth drilled. The contractor waits for direction by the operator, and most importantly the contractor retains only the specified risks detailed in the contract. All other risks, whether detailed in the contract or unaddressed by the written agreement, are shifted to the operator. This paper focuses on day work drilling contracts, because they are the most commonly used today. Generally, when the economics of the industry are encouraging a high level of exploration and commodity prices are encouraging operators to spud wells at a feverish pace, the leverage to dictate the selection of contracts shifts in favor of contractors.

B. Footage Contract. A footage contract provides that payment is made based on an agreed sum per foot of hole drilled. Much like a day work contract, "the drilling contractor furnishes the drilling crew and the drilling equipment... and is paid an agreed sum of money for each foot actually drilled, irrespective of whether the proposed depth is reached or not... ." WILLIAMS & MEYERS, OIL AND GAS LAW, 408-09, Vol. 8 (LexisNexis 2003) (citing *Haas v. Gulf Coast Natural Gas Co.*, 848 S.W.2d 127, 131 (Tex. Civ. App. – Corpus Christi 1972, no writ)).

For a more complete discussion on whether a day rate or a footage rate is warranted under the circumstances see *Startex Drilling Co. v. Sohio Petroleum Co.*, 680 F.2d 412 (5th Cir. 1982).

C. Turnkey Contract. A turnkey contract is a contract wherein the drilling contractor drills the well, establishes production and turns the completed job over to the operator for the amount specified in the contract. WILLIAMS & MEYERS, OIL AND GAS LAW, 1130, Vol. 8 (LexisNexis 2003). Here all work of drilling and completing a well for production is borne by the contractor. The operator simply waits for the contractor to complete working before becoming the owner of the well.

II. Negotiating the Contract.

A. International Association of Drilling Contractors – Day Work Contract Form. Day work drilling contractors have a trade association, the International Association of Drilling Contractors ("IADC"). Additional information regarding the IADC is available at www.iadc.org. This paper makes reference to the IADC Model Form as a template because the IADC form contains all of the elements commonly found in drilling contracts. *See* International Association of Drilling Contractors, Drilling Bid Proposal and Daywork Drilling Contract – U.S. (2003). This form is the type of contract most commonly in use, especially for small oil and gas companies and independents. Only the major energy companies and very large independents have custom "company" forms by which modifications to the indemnities, risk and release language is changed to a more favorable position for the operator. These "company" forms all focus on risk allocation, and the retention of some limits of liability and risk of loss by the contractor in order to ensure a more consistent and budgetable cost to the operator. In some ways "company" forms tend to modify the day work contract to read more like a turnkey; in that much of the inherent business risk involved in penetrating unknown formations and damage to equipment and routine wear and tear costs are borne by the contractor. *See* American Petroleum Institute, API Drilling Contract, Model Form 4C1, 1st ed. 1983, *available at* http://www.api.org; *see also* Owen L. Anderson, *Anatomy of a Drilling Contract*, 25 TULSA L.J. 359, 480 (1990).

B. References. Professor Owen L. Anderson of The University of Oklahoma School of Law has published the two most commonly cited articles on the subject of drilling contracts. Although now over 16 years old, the *Anatomy of an Oil and Gas Drilling Contract*, published in Volume 25, No. 3, Spring 1990 Edition of the University of Tulsa Law Journal, is still considered today the seminal and most comprehensive article discussing onshore drilling contracts. The Tulsa Law Journal article was facilitated by a research grant from the Oil, Gas and Mineral Law Section of the State Bar of Texas; and consequently, the article is available to all section members on the State Bar of Texas Oil, Gas and Energy Resources Law Section website at www.oilgas.org.

One year later, in September 1991, Professor Anderson provided an update on drilling contracts to the Advanced Oil, Gas and Mineral Law Course which focused on Texas law. *See* Owen L. Anderson, *Oil & Gas Drilling Contracts: An Update*, STATE BAR OF TEXAS ADVANCED OIL, GAS AND MINERAL LAW COURSE (Sept. 1991).

III. Commencement.

The contract contemplates that multiple drilling contractors will submit bids to a single operator for drilling of a well at a location, date and depth set forth in the contract and commencing on a date certain. The contract form allows a bid proposal and selection by the operator making the contract appear as an offer to drill a well that may be accepted by the operator. *See Labrador Oil Co. v. Norton Drilling Co.*, 1 S.W.3d 795, 796-97 n.1 (Tex. App. – Amarillo 1999, no pet. h.) (indicating usage of a Drilling Bid Proposal Form in connection with a day work drilling contract).

Since the late 1990s, and continuing through today, contractors have not bid for work, but rather use the day work drilling contract as a written agreement between the two parties requiring mutual assent and execution. Contract terms are negotiated and a written contract is signed. For this reason, the contract may have generalized or no information regarding the location of the well or the commencement date. Commonly, the contractor and operator commit a named rig and crew to an operator for dispatch to the location of the operator's choosing (in the general vicinity of the rig location), for wells to be drilled when the rig is next available or on some future date. The contractor agrees to use commercially reasonable efforts to start on that date. International Association of Drilling Contractors, Drilling Bid Proposal and Daywork Drilling Contract – U.S. § 2 (April 2003). Regardless of the commencement date, the contract requires the operator to pay the contractor for moving the rig to the location (a "mobilization" fee or rate) and also may, as discussed in Section VII below, contain liquidated damages in favor of the contractor if the operator terminates the contract prior to spudding the initial well. Section VI below discusses issues related to contracts for the drilling of more than one well or a fixed period of time.

IV. Parties.

The day work drilling contract is universally prepared as a bilateral contract between one named operator and one named contractor. The contractor, however, is usually conducting work on and improving the leasehold for a number of different working interest owners, usually non-operating working interests under a joint operating agreement. *See* American Association of Professional Landmen Form 610-1989, Model Form Operating Agreement, art. V.A. (setting out the duties of the operator under a joint operating agreement). Nonetheless, the day work contract assumes a single working interest owner of the leasehold upon which the contractor will drill the subject well. Non-operators (whether named or not) are third party beneficiaries under the contract because the operator waives claims on their behalf and then indemnifies and holds the contractor harmless for claims that the non-operators may make for damage to the reservoir or negligent drilling of the well. *See* International Association of Drilling Contractors, Drilling Bid Proposal and Daywork Drilling Contract – U.S. § 14 (2003) (relating to the scope of the operator's indemnity). For all provisions in the drilling contract respecting responsibility for loss of damage, indemnity, release of liability and allocation of risk, the operator agrees that:

> "the indemnities and release and assumptions of liability extended by the parties hereto [written parties to the day work drilling contract] under the provisions of Subparagraph 4.9 [related to reimbursable costs in the hiring of subcontractors

that were to be hired by operator], and 6.3 [economic damages from early termination], and Paragraphs 10, 12 [related to location liability] and 14 [general claims for damages], shall inure to the benefit of such parties, their co-venturers, co-lessees, joint owners, their parent, holding and affiliated companies and the officers, directors, stockholders, partners, managers, representatives, employees, consultants, agents, servants and insurers of each."

Consequently, the liability release given by the operator for damage to the operator's surface equipment, the contractor's in-hole equipment and for reservoir damages, purportedly binds the joint venturers and non-operating working interest owners who are not parties to the contract. To the extent these parties bring a claim directly against contractor for damage to either the hole, the reservoir or surface damage, the contractor has an express indemnity from the operator to protect the contractor from such claims.

V. Breach.

The breach of the drilling contract usually comes in three distinct areas. The first is a breach for nonpayment, which usually amounts to a suit against the operator or a sworn account for payment of past due invoices. TEX. R. CIV. PRO. 185; *see e.g. Siegel v. McGavock Drilling Co.*, 530 S.W.2d 894, 895 (Tex. Civ. App. – Amarillo 1975, writ ref'd. n.r.e); *Hancock v. O.K. Rental Equipment Co.*, 441 S.W.2d 955, 955-56 (Tex. Civ. App. – San Antonio 1969, no writ).

The second area is early termination of the contract prior to the end of the term originally contemplated by the parties. In this case, the contractor will be seeking to be compensated for lost revenues (not profits) that would have been received if the rig had remained in service under the contract of the designated operator. Issues related to mitigation of damages as to the contractor, and cover damages as to the operator (in those cases where the contractor calls for early termination) are explicitly covered by the contracts and are discussed in more detail in Section VII below.

The third area of breach involves the indemnity, release and waiver provisions, inasmuch as when an accident or irregular event occurs at the drillsite, the parties and other third-party contractors, land owners and working interest owners will be making claims and cross-claims. At that time, sifting through the risk allocation provisions and the indemnity obligations will usually bring a breach of contract action for failure to comply with the written obligations.

VI. Term – Length of Contract.

Most form contracts in circulation today contemplate the drilling of between one and three wells. Currently, operators are agreeing to fixed-term drilling contracts ranging from a few months to several years. These long term contracts raise questions of enforcement and payment following breach. In the case of fixed-term contracts, special attention must be applied to Paragraph 6 of the IADC Contract regarding term, and payment rights and obligations for early termination, either called by the operator or the contractor. Because of the actual practicalities of drilling wells, the contract cannot stop on a date certain, but must continue for such additional time after the set date as necessary to complete operations on the well then being drilled across the end of the term of the contract. In this way, the contract is modified to mirror the continuous

drilling clause found in most oil and gas leases. *See* ERNEST SMITH AND JACQUELINE LANG WEAVER, TEXAS OIL AND GAS LAW § 5.2[B][3](a) (discussing how the continuous development clause provides necessary flexibility in oil and gas exploration activities).

VII. Stoppage of Work – Contract Termination.

A. By Operator. The operator has the unrestricted right to direct stoppage of work on a well at any time. International Association of Drilling Contractors, Drilling Bid Proposal and Daywork Drilling Contract – U.S. § 6.3(b) (2003). This is consistent with the concept that the drilling contractor is acting solely as an independent contractor under the direct supervision and at the control of the operator. The ability to stop work is also consistent with the uniqueness of each well, its location, and the superior geologic and reservoir knowledge of the operator.

B. By Contractor. The contractor, likewise, may suspend operations and stop work completely under the bankruptcy of the operator, or the failure to pay past due invoices. If the contractor does suspend or outright terminate operations, the operator provides an express indemnity to cover claims that may arise in favor of operator's co-venturers, co-lessees and joint owners arising out of any drilling commitments or obligations contained in the lease, farmout or the like. International Association of Drilling Contractors, Drilling Bid Proposal and Daywork Drilling Contract – U.S. § 3.6(c) (2003). The contractor is protected in the event he stops work and the stoppage causes direct or consequential damages to the operator or the co-venturers and the lease is lost. In almost all events, the contractor owes no payment or damages to the operator for an early termination.

C. Early Termination Compensation. Drilling contracts always make a distinction between the act of commencing activities that prepare for operations to drill, spudding of a well, and actual drilling with drill pipe and a bit. The American Petroleum Institute Day Work Drilling Order makes the same distinctions among commencement, prior to spudding and subsequent to spudding. The concept embodied in the contract is that costs increase exponentially and opportunities for the contractor to do work for other oil companies with the specified rig are diminished after a rig is mobilized to a location, rigs up and commences drilling operations.

1. Prior to commencement of the *initial well*. In the event the operator terminates prior to commencement of operations (*i.e.* the termination notice comes before the contractor begins movement to the well site or while the rig is being assembled or lifted into a position over the well), then the contract allows the contractor to seek an agreed fixed amount as liquidated damages. *See Id.* at § 6.4(a). This amount is usually predicated on a formula of the specified day rate times a certain fixed number of days or just simply a stipulated lump sum in cash.

2. Prior to and subsequent to spudding of the *initial well*. The early termination compensation provision once the rig is in position contemplates the reimbursement of actual costs incurred by the contractor plus the amount of days actually consumed under the contract (including days to dismantle and lay down the rig, and move to the next location), with some minimum payment predicated on a specified number of days of work. Each of the provisions in the agreement allows for the deduction of labor and fuel costs avoided, *i.e.*

mitigation of damages to the extent the rig is not turning to the right. In the current business environment, however, the early termination provisions are commonly modified to provide that the operator will pay the day work drilling contract drilling rate times the number of days left on the balance of the contract. This is commonly referred to as a "take-or-pay contract." Caution should be exercised in modifying these provisions to address issues related to both cover damages on behalf of the operator and addressing whether or not the contractor must mitigate the accrual of damages by seeking to secure replacement work for the rig. Obviously, the contractor will want the ability to place the rig in service for new business without the revenues from such future activity deducted from the amount of damages he may secure against the operator for early termination of the contract. Here it is solely a matter of contract law between the parties regarding the enforcement of take-or-pay service contracts. *See Aquila Southwest Pipeline, Inc. v. Harmony Exploration, Inc.*, 48 S.W.3d 225, 234-35 (Tex. App. – San Antonio 2001, pet. denied) (discussing the nature of "take-or-pay" contracts).

VIII. Payment.

A. Lien Rights. Because oilfield services do not fall within the scope of the constitutional lien contained in Article XVI § 37 of the Texas Constitution, Chapter 56 of the Texas Property Code provides statutory liens for persons providing materials and/or services provided in connection with the drilling, operations and maintenance of oil and gas well. *See* TEX. PROP. CODE ANN. §§ 56.001 et. seq. (Vernon 1995); *Noble Exploration, Inc. v. Nixon Drilling Co.*, 794 S.W.2d 589, 591 (Tex. App. – Austin 1991, no pet. h.) Specifically, Chapter 56 applies to "digging, *drilling*, torpedoing, operating, completing, maintaining or repairing an oil, gas or water well, an oil and gas pipeline, or a mine or quarry." *Id.* at § 56.001(1) (*emphasis added*). A large volume of the litigation surrounding Chapter 56 liens relates to drilling contracts. *See e.g. Bandera Drilling Co. v. Lavino*, 824 S.W.2d 782 (Tex. App. – Eastland 1992, no pet. h.); *Dunnigan Tool & Supply Co. v. Burris*, 427 S.W.2d 341 (Tex. Civ. App. – Eastland 1968, writ ref'd n.r.e.).

Chapter 56 liens are available to both mineral contractors and mineral subcontractors. A mineral contractor is defined as "any person who performs labor or furnishes or hauls material, machinery, or supplies used in mineral activities under an express or implied contract... ." TEX. PROP. CODE ANN. at § 56.001(2). A mineral subcontractor is defined as any person who "(A) furnishes or hauls material, machinery, or supplies used in mineral activities under a contract with a mineral contractor or with a subcontractor; (B) performs labor used in mineral activities under a contract with a mineral contractor; or (C) performs labor used in mineral activities as an artisan or day laborer employed by a subcontractor." *Id.* at § 56.001(4); *see also Bandera Drilling Co. v. Lavino*, 824 S.W.2d 782, 783-84 (Tex. App. – Eastland 1992, no pet. h.) (discussing the rights of mineral contractors and subcontractors and differentiating between the two).

The distinction between the mineral contractor and mineral subcontractor is important in the context of drilling arrangements because the contractor of an oil and gas well may have the explicit ability to directly "lien up" mineral property, whereas a subcontractor have an opportunity to "lien up" mineral property in an indirect manner. The mineral contractor may directly "lien up" the operator's interest because of their direct contractual relationship.

Conversely, the non-operator, who is not a party to the drilling agreement, may also have its leasehold interest at risk to a mineral contractor's lien on the property and proceeds of production. The non-operator's working interest could possibly be "liened up" because the mineral contractor could be characterized as a subcontractor vis-à-vis the non-operator's interest since the operator is considered to be acting as a contractor for and on behalf of the non-operator under a joint operating agreement. In this way, the drilling contractor might be a subcontractor to the operator and can then place a statutory lien on all of the leasehold. The specific procedures to secure both the mineral contractor's and mineral subcontractor's lien are beyond the scope of this paper. For an complete discussion on mechanics' and materialmen's liens against mineral properties see Debra J. Villareal, *Mechanics' and Materialmen's Liens Against Mineral Property*, 31ST ANNUAL ERNEST E. SMITH OIL, GAS AND MINERAL LAW INSTITUTE (Apr. 1, 2005).

IX. Risk Allocation, Release of Liability and Indemnity.

A. Texas Oilfield Anti-Indemnity Act. In Texas, parties to a contract generally have wide latitude to contract with one another with respect to the parties' own negligence, so long the indemnification is express and is not against public policy. Found in TEX. CIV. PRAC. & REM. CODE §§ 127.001 et. seq. (Vernon 2005), the Texas Oilfield Anti-Indemnity Act ("TOAIA") serves as an exception to this general rule.

The Texas Legislature first passed TOAIA to remedy inequities "fostered on certain contractors by indemnity provisions in certain agreements pertaining to wells for oil, gas, or water or to mines for other minerals." *Id.* at § 127.002(a). TOAIA specifically prohibits any "covenant, promise, agreement or understanding contained in, collateral to, or affecting an agreement pertaining to a well" for the purposes of oil, gas, water or mine which purports to indemnify a person against loss or liability for damage resulting from: (1) the sole or concurrent negligence of the indemnitee or other party responsible to the indemnitee; and (2) arises from the personal injury or death, injury to property or other loss or damage resulting from injury, death or injury to property. *Id.* at § 127.003.

The applicability of TOAIA to oil and gas operations is broad given the vague definitions incorporated in the Act. *See e.g., id.* at § 127.001(a) (defining the word 'agreement' to mean ***any*** "written or oral agreement or understanding concerning the rendering of well or mine services, or an agreement to perform part of those services or act collateral to those services...") (*emphasis added*). Despite the otherwise broad applicability of TOAIA, the Act specifically excludes indemnities contained in joint operating agreements since these agreements are generally understood and are thought to encourage mineral development. *Id.* at § 127.002(c).

The effect of TOAIA is limited, however, by § 127.005 which permits mutual indemnities supported by insurance. For purposes of TOAIA, a "mutual indemnity obligation" is defined as an agreement pertaining to a well or mine in which the parties agree to indemnify each other and each other's contractors (and their respective employees) against liabilities resulting from bodily injury, death or property damage arising from or resulting from the performance of the agreement. *Id.* at § 127.001(3). Mutual indemnity obligations are limited to insurance coverage each party has agreed to provide to the other. *Id.* at § 127.005(b); *see also*

Nabors Corp. Servs. v. Northfield Ins., 132 S.W.3d 90, 96-97 (Tex. App. – Houston [14th Dist.] 2004, no pet. h.)(outlining the scope of § 127.005). While a mutual indemnity is limited by the amount of insurance coverage, the insurance coverage for a unilateral indemnity is limited to $500,000. *Id.* at § 127.005(c).

B. <u>TOAIA and the Drilling Contract</u>. The inherent risks associated with drilling activities receive special attention in the TOAIA. The provisions of TOAIA simply do not apply to losses, liabilities or expenses resulting from: (i) personal injury, death or property injury resulting from radioactivity; (ii) injury to property resulting from pollution, including the cleanup and control of the pollutant; (iii) injuries to the underground reservoir and other underground damage, including the loss of the well bore; (iv) personal injury, death or injury to property while attempting to control a wild well to protect the safety of the general public or preserve natural resources; and (v) costs to control a wild well both above and below the surface. *Id.* at § 127.005. These five unique areas are all viewed as abnormal risks that can be completely shifted to one party – usually the operator – because they involve public safety (*i.e.* radioactivity, pollution, control of a wild well), or are incapable of quantification of the potential damages (*i.e.* reservoir damage).

The parameters of the TOAIA inform all of the provisions of the day work drilling contract regarding indemnities given in favor of the contractor and operator. As discussed below, these indemnities are the source of almost all litigation involving day work drilling contracts that survive to the appellate level. The five (5) main areas of disputes usually fall into the following categories:

(i) Blowouts;
(ii) Well control;
(iii) Cost of re-drilling;
(iv) Waiver of subrogation; and
(v) Indemnities.

C. <u>Specific Risks Addressed</u>. The risk allocation provisions of a drilling contract cover both mundane losses (such as fair wear and tear to equipment and tools) and extraordinary events that can occur in the drilling of a well (like blowouts, loss of the hole and catastrophic reservoir damage). Both parties are viewed as understanding the risks inherent with being physically at the wellsite and drilling into pressured formations. For these reasons, the allocation of known events is seen as being a better rationalization of risk than allowing the contractor to set a higher day work price to cover a broad spectrum of potential losses.

1. <u>Surface Equipment</u>. Both the operator and contractor will have equipment and personnel at the drillsite. All drilling contracts provide that the equipment the operator brings will be operator's responsibility and equipment the contractor supplies will be contractor's responsibility in the event of loss or damage caused by any party. Property damage insurance is easily obtained by both parties from their respective insurers, and it is easier to require that both will assume liability for damage to or destruction of their own equipment regardless of ultimate fault.

The only exception to the contractor's retention of responsibility for its own surface equipment is for damage caused by environmental corrosives, hydrogen sulfide, carbon monoxide, or the like. These substances are commonly viewed as pollutants emanating from underground formations. In this case, the operator is invoiced the fair market value or replacement cost of equipment that is ruined by highly corrosive elements or an environmental issue not contemplated by parties. As a practical point, it is recommended that in areas where there is a high level of hydrogen sulfide, the operator may want to modify these provisions.

2. Down-Hole Equipment. In contrast to the rig itself, much of the equipment, including drill pipe and specialized tools that the contractor brings with the rig, will be used down-hole. Common downhole equipment consists of 10,000 feet of drill pipe and a bit. Because the contractor has no control over the location, the formations to be encountered, or a location specific knowledge of the nature of the subsurface environment, the contract requires the operator to reimburse the contractor for any damage or loss to his in-hole equipment. In this way, both ordinary and extraordinary wear and tear on equipment (including total consumption) are viewed as additional financial costs that may be passed to the operator by the contractor. Although the down-hole equipment may be used again, the operator may be invoiced for the diminution in value to the equipment if it is partially or totally consumed in the drilling process. Here, the operator may want to modify the contract to limit payment for damage to in-hole equipment to the actual repair cost or some percentage of new replacement equipment. Otherwise, the contractor will be free to purchase new in-hole equipment and then invoice the operator for same, even if the equipment that was damaged was in barely serviceable shape prior to initiating drilling operations.

3. Damage to the Hole (Wellbore) and the Reservoir (Underground Damage). The two most unique provisions in a drilling contract relate to the hole itself and underground damage, *i.e.* blowouts and well control. The day work drilling contract provides for a specific indemnity from operator in favor of the contractor for any liability or damage to or loss of the hole, regardless of the workmanlike conduct of the contractor. The API form and those favorable to operators commonly modify this provision to provide for the release of responsibility, but with a requisite requirement for the contractor to redrill the hole solely at the driller's cost.

Reservoir damage caused by a "wild well" can involve substantial sums of money that are at great multiples of the contract value. For these reasons and the inability to quantify the risk of reservoir damage in a day work drilling contract, the risk is shifted solely to the operator. Likewise, if the blowout or other down-hole event causes the contractor to undertake extraordinary work in order to regain control of a "wild well," such cost also is borne by the operator. In both cases, the operator gives a one-sided indemnity in favor of contractor to protect against claims brought either by the working interest owners or third-party contractors whose property or equipment may be damaged in connection with either the original blowout, damage to the reservoir, or in the ensuing surface activities.

4. Pollution. It should be noted that drilling contracts always have provisions allocating responsibility of pollution and contamination with the general allocation depending on whether the contamination is caused by surface activities, or down-hole or reservoir activities.

The contractor remains responsible for surface contamination because it generally has the most control over the worksite and bring, use and generate varying amounts and types of drilling mud, lubricants, water, motor oils, pipe dope, paint, solvents, ballast, garbage, refuse and the like. For these reasons, contractor has responsibilities for and indemnifies the operator for surface contamination. By corollary, the operator indemnifies and is responsible for all pollution that emanates from subsurface upward to the surface, including groundwater contamination, the use and disposition of drilling fluids, cuttings and anything that comes out of the hole.

As noted above, the TOAIA provides that the voiding provisions do not affect one-way indemnity obligations in the following circumstances:

a. Property injury that results from pollution, including cleanup and control of the pollution. TEX. PROP. CODE § 127.004(2).

b. Property injury that results from reservoir or underground damage, including loss of oil and gas or the wellbore itself. *Id.* at § 127.004(3).

c. Property injury that results from the performance of services to control a wild well to protect the safety of the general public or prevent the depletion of vital natural resources (wild well). *Id.* at § 127.004(4).

d. Costs of control of a wild well, underground or above the surface. *Id.* at § 127.004(5).

It is important to note that the TOAIA allows one-sided risk shifting provisions found in the sections related to blowouts, loss of wild well, regaining control of wild well, and perhaps even the activities in redrilling if these are ancillary services to control a wild well.

5. Personal Injury and Property Damage Claims Made by Third-Parties – Mutual Indemnity. Finally, the risk allocation and indemnity provisions in the day work drilling contract provide for reciprocal indemnifications of each party against third-party claims that are brought by parties under the control, employment or other relationship with the indemnitor. As discussed above, these indemnities are not voided under TOAIA because they are reciprocal and comply with the provisions respecting insurance coverage as provided under the contracts. These mutual indemnity obligations are defined as written promises found in the oil and gas well drilling contract, whereby the parties agree to indemnify each other and each other's contractors and their employees against loss, liability or damage arising in connection with bodily injury, death or property damage of the respective employees, contractors, and their employees and invitees of each party arising or resulting from performance of the agreement. TEX. PROP. CODE § 127.001(3).

Because both the contractor and operator are in control and select: (i) the subcontractors that each will use; (ii) the employees that each will bring to the wellsite; and (iii) the invitees that each may have on location, they remain responsible in all respects for claims that these third parties bring. If one of the third parties within the "operator group" brings a claim against the contractor, the contractor may seek and is entitled to indemnity from the operator. Likewise, the operator will want protection from claims that the drilling contractor's employees (most likely) will bring against it for injuries they may have. Because the contractor's employees will be limited by the workman's compensation scheme, they will attempt to bring claims against the operator under a premises liability or ability to control the worksite theory. In these cases, the operator will be entitled to an indemnity from the contractor.

While the TOAIA has provided sufficient stability in the oil patch, one recent case focusing on a provision of the Texas Labor Code rather than the TOAIA may have turned the stability of the TOAIA on its head. *See Superior Snubbing Serv. Inc. v. Energy Serv. Co. of Bowie, Inc.*, 158 S.W.3d 112 (Tex. App. – Fort Worth 2003, pet. granted). This case is discussed in greater detail in Section X below.

6. Modification to Form. Often times, parties to the contract want to modify the release, indemnity and risk shifting provisions to provide that the indemnities will not apply in those cases where the indemnitee has been grossly negligent or engaged in willful misconduct. *See Tesoro Petroleum Corp. v. Nabors Drilling USA, Inc.*, 106 S.W.3d 118, 125-26 (Tex. App. – Houston [1st Dist.] 2002, pet. denied). One must note that the modification of the form contract to provide that the indemnity does not apply to gross negligence and willful misconduct allows a broad avenue for the indemnitor to contest coverage based on the theory that the indemnitee was 1% grossly negligent or willful misconduct. In this case, the exception may consume the rule and the indemnity protection may be lost. For these reasons, to the extent a gross negligence or willful misconduct qualifier is added to the provisions, one would suggest that the sole gross negligence or willful misconduct may be the appropriate standard to provide a bright line standard for when the indemnity applies and does not apply. In any case, to the extent gross negligence or willful misconduct qualifiers are added to the indemnity obligation, the drafter must be careful to ensure there is mutuality and that the insurance coverage supports the contractual indemnity to ensure that the indemnity provisions are not voided in whole by the Act.

D. States having an Oilfield Anti-Indemnity Statute. In addition to Texas, at least three other states have specific oilfield anti-indemnity statutes. These states include Louisiana, New Mexico and Wyoming. *See* LA. REV. STAT. ANN. § 9:2780; NM. STAT. ANN. § 56-7-20; WY. STAT. § 30-1-131. The applications and scope of these statutes is beyond the focus of this paper.

X. Litigation.

A. Drilling Contract Litigation – Contract Construction / Indemnification.

Despite the relative amount of extra attention paid to the indemnity provisions of drilling contracts, most reported litigation in the context of drilling contracts concerns disputes over indemnity obligations. The subject matter of these indemnity cases ranges from the relatively simple dispute calling for application of well-established canons of contract construction to

harmonize apparently conflicting provisions to thornier controversies involving the interplay between TOAIA and other state or federal statutes. The following cases are a sampling of recent litigation over aspects of drilling contracts and other contracts with similar indemnity provisions.

Helmerich & Payne Intern. Drilling Co. v. Swift Energy Co., 180 S.W.3d 635 (Tex. App. – Houston [14th Dist.] 2005, no pet. h.) (extension to file petition granted January 19, 2006). Helmerich & Payne sued Swift Energy, the well operator, seeking a declaratory judgment that it was not required under the drilling contract to reimburse Swift for spill clean-up costs. During H&P's operations conducted pursuant to the parties' Daywork Drilling Contract, drilling fluids spilled into the field surrounding the well. Swift spent $155,078.86 cleaning up the fluids and subsequently made demand upon H&P's CGL policy as an additional insured. The insurer acknowledged Swift's additional insured status but denied the claim because it fell within the policy's $750,000 per occurrence deductible. Swift then turned to H&P demanding reimbursement pursuant to Paragraph 13 of the Drilling Contract which provided that H&P procure and maintain insurance for the benefit of H&P and Swift and that H&P bear sole responsibility for all deductibles. H&P refused to reimburse Swift arguing that under Paragraph 14 of the Drilling Contract Swift agreed to indemnify and release H&P from any claim or liability arising from pollution or contamination during operations. Acknowledging the potential tension between an implied obligation to reimburse Swift for cleanup costs and the provision releasing and indemnifying H&P from all such costs, the Court of Appeals held that the latter provision controlled because it was preceded by the phrase "notwithstanding anything to the contrary herein." The Court noted that other paragraphs of the Drilling Contract were specifically excluded from operation of the "notwithstanding anything to the contrary contained herein" language, but Paragraph 13 relating to the insurance and deductible provisions was not.

Zurich American Ins. Co. v. Hunt Petroleum (AEC), Inc., 157 S.W.3d 462, (Tex. App. – Houston [14th Dist.] 2004, no pet.). This case involves a dispute over responsibility for damage to an oil rig that was submerged in saltwater during a tropical storm. Zurich brought a subrogation claim against Hunt for damage to its insured's drilling rig. Floodwaters from a tropical storm caused the rig to be submerged in four feet of saltwater, which caused serious corrosive damaged to the rig. Nabors Drilling, the rig owner, made a claim under its Commercial General Liability policy. Zurich paid the claim and sought payment from Hunt under the "Contractor's Equipment—Environmental Loss or Damage" provision of their IADC contract. The environmental loss paragraph provided that Hunt "shall assume liability at all times for damage to or destruction of [Nabors'] equipment caused by exposure to highly corrosive or otherwise destructive elements... ." Hunt moved for summary judgment based on the force majeure provision of the Drilling Contract which provided that neither party would be liable to the other for loss occasioned by an "action of the elements." Zurich filed a cross motion for summary judgment on the theory that Hunt was liable at all times, even in a force majeure situation, for damage caused by "exposure to highly corrosive or otherwise destructive elements," such as salty floodwater. The trial court found the force majeure clause controlling and it therefore granted Hunt's motion and denied Zurich's. Faced with conflicting expert testimony about the common industry understanding of "highly corrosive or otherwise destructive elements," the Court of Appeals found a fact issue on that point and also concluded that the contract was susceptible to more than one reasonable interpretation. Consequently, the Drilling Contract was found to be ambiguous and the case remanded to the trial court.

Cleere Drilling Co. v. Dominion Exploration & Production, Inc., 351 F.3d 642 (5th Cir. 2003). *Cleere* concerns the allocation of liability and risk of loss under a Footage Drilling Contract following a blowout and complete loss of the well prior to reaching contract footage depth. After Cleere lost control of the well, Dominion hired other contractors to control the well and then to drill a replacement well. Cleere sued Dominion for the contract value of the footage drilled and for damages on a day work basis after the blowout. Dominion counterclaimed against Cleere for the costs or controlling the well, restoring the surface and for the difference between the cost of the replacement well and the contract well cost. After a bench trial, the trial court awarded Dominion its damages and denied Cleere compensation for work performed prior to or after the blowout. The district court held that Cleere was liable for its own negligence and that the indemnity provisions of the IADC Footage Drilling Contract were void because they did not meet the Texas Supreme Court's "conspicuousness" prong of the "fair notice" test. *See Ethyl Corporation v. Daniel Construction Co.*, 725 S.W.2d 705 (Tex. 1987) ("fair notice" test requires that a party seeking indemnity from its own negligence must "clearly express" that intent and the release and indemnity provisions must be "conspicuous"). The Fifth Circuit reversed this ground and avoided the fair notice test by finding that Dominion had actual knowledge of the indemnity and release provisions of the contract. The Fifth Circuit affirmed the district court's judgment to the extent it denied compensation to Cleere for the work performed before or after the blowout. The Court noted that Cleere was not entitled to be paid on a footage basis for the portion of the well that was drilled before the blowout because the well never reached "contract footage depth," a condition precedent to payment under the IADC Footage Contract. The Court also rejected Cleere's arguments that the contract subsequently converted to a day work basis.

Primrose Operating Co. v. Jones, 102 S.W.3d 188 (Tex. App. – Amarillo 2003, pet. denied). Primrose was the operator of an oil and gas well in King County. It contracted with Palmer to drill a well to 3,600 feet on a per-foot basis. Pursuant to the parties' contract, additional work to a maximum of 3,650 feet, would be paid on a day work basis. In July 1997, the crew encountered difficulty with the well that ultimately resulted in an injury to one of the drilling company's employees. The injured employee sued Primrose and Primrose sought indemnification from Palmer under the drilling contract. The King County jury found both Primrose and Byrd negligent and attributed 90 percent of the responsibility to Primrose and 10 percent to Byrd. The trial court found that Primrose was entitled to indemnification from Palmer in the amount of $1,000,000. On appeal, a central issue was whether plaintiffs had established at trial who was in control of the drilling operations at the time of the injury. Because the contract contemplated control over the drilling operations switching from the drilling company to the operator under different circumstances, plaintiff was required to establish which party was in control and responsible during the injury. The contract was a standard "footage drilling contract" and provided that Primrose was to pay Palmer $10 per foot to drill and install casing in the well to a depth of 3,600 feet. It also provided "all drilling below the... specified contract depth shall be on a day work basis as defined herein." The contract went on to specify a maximum depth of 3,650 feet.

> "The Term 'footage basis' means contractor [Palmer] shall furnish the equipment, labor, and perform services... to drill a well as specified by [Primrose] to the contract footage depth.... While drilling on a footage basis [Palmer] shall direct, supervise, and control drilling operations and assumes certain liabilities to the

> extent specifically provided for herein.... The term 'day work basis' means [Palmer] shall furnish equipment, labor, and perform services as herein provided, for a specified sum per day under the direction, supervision and control of [Primrose]. Except for such obligations and liabilities specifically assumed by [Palmer, Primrose] shall be solely responsible and assumes liability for all consequences of operations by both parties while on a day work basis, including results and all other risks or liabilities incurred in or incident to such operations."

It was undisputed that the well exceeded 3,600 feet in depth. The injured employee argued that the contract became a day work contract, giving control to Primrose the moment the drill bit exceeded 3,600 feet. After analyzing various provisions of the footage contract which appear to shift control back and forth between the operator and the drilling contractor depending upon the depth of the operations being conducted the court held that the contract does not reveal an intent that all operations conducted after the well exceeded the footage contract were to be conducted on a day work basis. Accordingly, liability for the injury would fall upon the party in control of the well at the moment of the injury and there was no evidence of the depth of the operations at the moment of injury.

Chesapeake Operating, Inc. v. Nabors Drilling USA, Inc., 94 S.W.3d 163, (Tex. App. – Houston [14th Dist.] 2002, no pet.). Employees of subcontractor Nabors brought personal injury actions against Chesapeake, Nabors, and others, seeking to recover for injuries sustained while working at the oil well being drilled in Louisiana. Nabors filed cross-actions against Chesapeake for indemnification. Under IADC Daywork Drilling Contract, the court follows *Maxus Exploration* in applying the "fair notice" requirements to test enforceability of the indemnity provisions. Because the day work contract at issue contained the same "without limit and without regard to the cause or causes...or the negligence of any party" language, the Court of Appeals found that the contract meets the "express" prong of the fair notice test. Again, actual notice of the indemnity provision was held to obviate the conspicuousness requirement. Although the well was drilled in Louisiana, the court found that Texas law applied to the question of whether the indemnity obligations were enforceable. The Court noted that Nabors' claims were for liability and legal services were incurred in Texas, not for drilling services performed in Louisiana. Considering only the particular issue in dispute, the place of performance of that obligation was in Texas. Consequently, under the "most significant relationship" test, the analysis turned on which state had the most significant relationship to the particular substantive issue to be resolved, the enforceability of the indemnities.

B. Related Litigation / Master Service Agreements.

Superior Snubbing Serv. Inc. v. Energy Serv. Co. of Bowie, Inc., 158 S.W.3d 112 (Tex. App. – Fort Worth 2003, pet. granted). Mitchell Energy entered into a Master Service Agreement with Superior Snubbing. The MSA provided in part that the Superior would indemnify Mitchell and its contractors, which included Energy Services Company of Bowie, Inc. ("ESC"), for claims of injury to Superior's employees in connection with work to be performed under the MSA. One of Superior's employees subsequently became injured while performing services under the contract. Superior was a subscriber under the Workers' Compensation Act at the time of the injury. Subsequently, the employee sued ESC and others for his injuries,

resulting in a settlement between the injured employee, ESC, and Mitchell. ESC and Mitchell then filed suit against Superior seeking indemnity under the contract for the cost of defense and the settlement paid. Superior asserted that ESC's claims were barred by the exclusive remedy provisions of the Texas Labor Code and that the contract was unenforceable under TOAIA. The trial court granted summary judgment for ESC on the contractual indemnity issue. On appeal, the Fort Worth Court of Appeals considered claims by Superior that (1) ESC's indemnity claims were barred by the exclusive remedy provisions of the Texas Labor Code and (2) that the MSA was unenforceable under TOAIA. The Court of Appeals reviewed the history of the Labor Code provision, particularly a 1989 amendment adding third party language to the indemnity section, and concluded that the legislature intended that non-signatory third-party beneficiaries (such as the "contractors" of each signatory party) were not permissible indemnitees under Section 417.004 of the Labor Code. Section 417.004 provides that "[i]n an action for damages brought by an injured employee…against a third party liable to pay damages for the injury...that results in a…settlement by the third party, the employer is not liable to the third party for reimbursement or damages...unless the employer executed, before the injury or death occurred, a written agreement with the third party to assume liability." Because the third party in this case (ESC) was not a signatory to the MSA and its indemnity provisions, Superior was not liable to ESC for reimbursement of the settlement amount and costs.

The Texas Supreme Court granted petition for review on October 14, 2005. The resolution of this case has potentially profound consequences for signatories to MSAs, drilling contracts and other oilfield service agreements with cross indemnity provisions. Relying on TOAIA and the decades of decisions interpreting the Act, operators, service companies, drilling contractors and others have established conventions for the industry regarding the allocation of risk during operations involving multiple parties and services. If the Fort Worth Court of Appeals decision is affirmed, this risk-allocation framework will be largely deconstructed until the various parties involved in well operations and drilling are able to contract back to the state of risk allocation that they intended by the common form drilling contracts and MSAs.

Nabors Corporate Services, Inc. v. Northfield Ins. Co., 132 S.W.3d 90 (Tex. App. – Houston [14th Dist.] 2004, no pet.). In this case, Abraxas operated a well on which it engaged Pool to perform work pursuant to a Master Service Agreement with mutual indemnity provisions. An employee of Pool was fatally injured while working on Abraxas' well. The employee's heirs sued Abraxas and others. Abraxas' insurer demanded Pool defend and indemnify Abraxas in accordance with the parties' Master Service Agreement. Pool hired counsel to defend Abraxas. In September 2001, the litigation was settled on behalf of Abraxas and its insurer for $1,545,000, but Pool's insurer, Reliance, became insolvent prior to funding the settlement. The original wrongful death plaintiffs filed suit against Abraxas to enforce the settlement agreement, and Abraxas looked to Pool for indemnity. Pool contributed $1,000,000 to the subsequent settlement and then demanded reimbursement from Abraxas' insurer, Northfield. Northfield subsequently filed a declaratory judgment action, claiming that it did not owe reimbursement to Pool. Pool counterclaimed against Northfield and Abraxas for, among other things, indemnification and unjust enrichment. The trial court subsequently granted Northfield's motion to dismiss Pool's claims against Abraxas and Northfield. On appeal, Pool argued that the insolvency of Abraxas' insurer voided Pool's indemnity obligation under TOAIA. The Court reasoned that once Abraxas and Pool agreed in writing that the indemnities in the

Master Service Agreement would be supported by insurance, they complied with the safe harbor provision of TOAIA. The subsequent insolvency of one of the parties' insurers did not retroactively void the indemnity obligations.