YOUR FAULT, MY FAULT, THEIR FAULT … DOES IT EVEN MATTER? INDEMNIFICATION AND EXCULPATORY AGREEMENTS IN THE OIL PATCH

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"Every time a lawyer writes something, he is not writing for posterity. He is writing so endless others of his craft can make a living out of trying to figure out what he said. Course perhaps he hadn't really said anything, that's what makes it hard to explain." Will Rogers.

This presentation aims to prove Mr. Rogers wrong. Lawyers can write agreements that say something. In the case of indemnity and exculpatory provisions, that "something" can be quite helpful in protecting their clients from the hazards of litigation associated with oil and gas operations.

THE INDEMNITY PROVISION

Indemnity?

Many, even some of those in our chosen profession, see the term "indemnity" and cringe (think "IRS"). If the document containing the indemnity provision (if viewing in Word) does not reflect a red "underline" denoting a misspelling, the viewer usually moves on to the next provision. This practice is fraught with peril. So, what exactly is an indemnity?

1. *Black's Law Definition*: (1) A duty to make good any loss, damage or liability another has incurred. (2) The right of an injured party to claim reimbursement for its loss, damage or liability from a person who has such a duty. (3) Reimbursement or compensation for loss, damage or liability.

2. *"Plain English" Definition*: An undertaking by which the indemnifying party ("indemnitor") agrees to make good any loss or damage that the indemnified party ("indemnitee") has incurred, or to safeguard the indemnitee against liability.

Why do we have indemnities? To allocate risk. 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.

However, creating and maintaining a unified risk-allocation program is difficult. A discussion of all factors affecting a company's program is outside the

scope of this paper. However, certain considerations are necessary to proper analysis of any risk allocation scheme.

Oilfield operations involve multiple companies, personnel, and expensive property, often at a common worksite or location. Going a step further, each party and person present has a unique risk profile and capacity for assumption of risk. Each party has different bargaining and market power. The scope of a party's role at the worksite is a significant factor in the type and breadth of risk it will assume (or, in some instances, whether the party will even agree to indemnify). Finally, the ability of a party to fulfill its indemnity obligations (whether through insurance or financial wherewithal) is an ongoing concern.

As an aside, many states have enacted "anti-indemnity" statutes. These statutes are public policy-based, and mandate certain requirements for the validity of an indemnity in favor a party for its own negligence. Each such statute is unique in its requirements and application. The effect of these statutes is beyond the scope of this presentation.

Scope of Indemnity:

How does indemnity coverage differ? Indemnity clauses come in many forms and the precise language of each clause should be carefully reviewed. For example, one important issue to consider is the scope of the indemnity clause.

Liability vs. Loss: What is covered by the indemnity? Is an indemnitor's obligation triggered by a "claim" of damage or when the "actual" damage determined?

Liability: An indemnity against liability obligates the indemnitor to protect the indemnitee from a loss or the ***cause*** of a loss. The right to recover on an indemnity against liability ***accrues*** when the liability becomes fixed and certain, regardless of whether the indemnitee has suffered an actual loss.

Example: A indemnifies B from claims arising from the acts or omissions of A.

Loss: A contract against loss or damage obligates the indemnitor to reimburse the indemnitee for amounts ***actually*** paid. The right to recover on an indemnity against loss ***accrues*** only upon the indemnitee's actual payment of damages. In other words, the indemnity is a reimbursement.

Example: A indemnifies B from loss or damage suffered by B as the result of the acts or omissions of A.

Indemnitees prefer "liability" clauses because they provide more expansive protection. Indemnitors prefer "loss" clauses because they provide for a more narrow indemnity obligation.

Entity vs. Group: Who is covered by the indemnity? Who have the parties contractually agreed to extend the indemnity protection?

Individual: A contract of indemnity in favor of an individual entity obligates the indemnitor to protect only that entity from liability or loss.

> Example: A indemnifies B from claims arising from the acts or omissions of A.

Group: A contract of indemnity in favor of a defined group obligates the indemnitor to protect all members of that group from liability or loss.

> Example: A indemnifies B and B's parent, subsidiaries, affiliates, partners, co-owners, joint interest owners, contractors, subcontractors and all of their respective agents, officers, directors, employees, and representatives from claims arising from the acts or omissions of A.

Indemnitees prefer "Group" clauses because they provide more expansive protection. Indemnitors prefer "Individual" clauses because they provide for a more narrow indemnity obligation.

Contract Management:

Where are the Indemnities? Generally, the Operator (also the "Lessee", for purposes of this discussion) is the "common denominator" within the risk management scheme at a given worksite. In this role, the Operator's task is to implement and manage an effective contract management scheme that fairly allocates risk and liability between the affected parties. This includes negotiation of indemnity provisions in numerous agreements including, generally:

1. Oil, Gas and Mineral Leases;
2. Surface Use Agreements;
3. Joint Operating Agreements;

4. Drilling Contracts; and
5. Master Service Agreements.

Indemnity Provisions:

How does the indemnity scheme work? Each of the aforementioned contractual agreements (involving one or more parties at the worksite) often contains risk allocation provisions with varying rights, duties, obligations and, ultimately, purposes. However, in the event of an incident, the different contractual indemnity provisions will often need analysis and reconciliation in concert.

Oil, Gas and Mineral Lease: As Lessors become more sophisticated (and represented by counsel), so do the oil and gas leases (generally, a "Lease"). With this comes the inclusion of broad indemnity provisions. For example:

> "Lessee agrees to indemnify, protect and hold Lessor harmless of and from any and all claims, demands, costs (including but not limited to attorney and expert fees), expenses, damages, losses, causes of action or suits for ***damages for injury to persons (including death)*** and ***injury or damage to or loss of any property or improvements*** **caused by the operations** upon the Leases Premises or Land pooled therewith. This obligation of Lessee shall apply **regardless of cause or fault**, including, without limitation, any negligent act or omission of Lessor, Lessor's representatives, agents or employees."

This is an extremely broad indemnity by Lessee in favor of Lessor. Before determining how this indemnity obligation interacts with other indemnity obligations of Lessee with respect to services provided by third-party contractors on the Leased Premises, let's review a few "stand-alone" scenarios.

Scenario 1:

Deer Hunter decides to use Lessee's oil tank as his hunting "blind." Overcome with "buck fever," Deer Hunter takes aim, fires…and Lessee's oil tank explodes. Deer Hunter is killed; all of Lessee's surface facilities are destroyed; Lessee's well is shut-in; and Lessor's Hereford bull (on loan from Neighbor) is killed.

- Deer Hunter's family sues Lessor, seeking damages from Lessor arising out of Deer Hunter's death.

- Neighbor sues Lessor, and recovers damages from Lessor arising out of Hereford bull's death.

Lessor tenders an indemnity claim under the Lease indemnity provision, requesting Lessee's indemnify, protect and hold Lessor harmless from claims of damages suffered by Lessor/Deer Hunter's family/Neighbor caused by Lessee's operations.

What is the result?

- As between Lessor and Lessee, Lessee owes indemnity to Lessor for both the injury to Deer Hunter and the damage to Neighbor assuming that the losses are "caused by the operations."

[Note that Deer Hunter's actions are not "operations," but the explosions are the result of Lessee's operations.]

Master Service Agreement:

An Operator will, at various times, have multiple service contractors on location, performing different services with varying risk profiles. Managing the risk and liability associated with each is a daunting task. Generally, the industry has moved toward a simplified risk management scheme – with contractual allocation of risk on a "regardless of fault" basis, with indemnity being owed by the party that employs the injured party or owns the damaged property. A discussion of the various exclusions to broad "knock-for-knock" indemnity provisions, insurance coverage and requirements and forms for "pass-through" protection is beyond the scope of this paper. Therefore, our examples and scenarios will rely on a simple, broad "knock-for-knock" indemnity scheme in their analysis and resolution. For example:

> **"6.1 Liability of Contractor.** Contractor shall Indemnify Company Group against all Claims arising out of or related to: (i) illness, bodily injury or death suffered by any member of Contractor Group; or (ii) property loss or damage suffered by any member of Contractor Group (including property owned, leased, hired or chartered) EVEN IF CAUSED BY THE FAULT OF COMPANY GROUP.

6.2 Liability of Company. Company shall Indemnify Contractor Group against all Claims arising out of or related to: (i) illness, bodily injury or death suffered by any member of Company Group; or (ii) property loss or damage suffered by any member of Company Group (including property owned, leased, hired or chartered) EVEN IF CAUSED BY THE FAULT OF CONTRACTOR GROUP.

6.3 Third Party Liability. Contractor shall Indemnify Company Group against all Claims arising out of illness, bodily injury, death, property loss or damage suffered by Third Parties, to the extent attributable to the Fault of Contractor. Likewise, Company shall Indemnify Contractor Group against all Claims arising out of illness, bodily injury, death, property loss or damage suffered by Third Parties, to the extent attributable to the Fault of Company.

6.4 *Pollution*. Subject to Section 6.1 and 6.2, Company shall Indemnify Contractor Group against all Claims for loss of or damage to property on account of an unauthorized release or discharge (including, but not limited to, any spilling, leaking, pumping, pouring, mining, emptying, injecting, escaping, leaching, dumping, or disposing into the environment) of any substance, material, compound, mixture, pollutant, or contaminant, which arises out of or is connected to Company Group's activities connected to this Agreement. Likewise, subject to Section 6.1 and 6.2, Contractor shall Indemnify Company Group against all Claims for loss of or damage to property on account of an unauthorized release or discharge (including, but not limited to, any spilling, leaking, pumping, pouring, mining, emptying, injecting, escaping, leaching, dumping, or disposing into the environment) of any substance, material, compound, mixture, pollutant, or contaminant, which arises out of or is connected to Contractor Group's activities connected to this Agreement."

Scenario 2:

Operator retains Contractor to conduct a fracture stimulation treatment on a well located on the Lease. The frac does not go as planned. The wellbore is lost. The casing fails, and the frac enters fresh water-bearing strata. Use of Lessor's water well is lost.

- Lessor sues Lessee/Operator, seeking damages for loss of use, and contamination, of Lessor's water well.

- TCEQ assess fines against Lessee/Operator as a result of the failed casing and fresh-water bearing contamination.

Lessee tenders an indemnity claim under the MSA, requesting Contractor's indemnity (reimbursement/payment) of the damages suffered by Lessee/Operator and Lessor.

What is the result?

- As between Operator and Contractor, damage to the wellbore and casing is Operator's property, and therefore Operator is liable and cannot tender indemnity to Contractor.

- As between Operator and Lessor, damage to the water well is damage to Lessor's "property and improvements" under the Lease, and therefore Operator is liable.

- As between Operator and Contractor, damage to the water well is damage to "property of Company Group" and therefore Operator is liable and cannot tender indemnity to Contractor.

[Note: As alluded to earlier, the "Group" may be defined to include any number of parties. In this example, if "Company Group" in the MSA between Operator and Contractor includes lessor, then Operator is liable. Conversely, if "Company Group" does not include lessor, then lessor is a "Third Party" and liability will apportioned on a fault basis.]

- As between Operator and Contractor, Operator will argue that TCEQ fines resulted from Contractor's negligence, and Operator will try to recover these costs from Contractor.

Scenario 3:

In addition to the facts set forth in Scenario 1, Neighbor drinks contaminated water from Lessor's water well and contracts an incurable illness.

- Neighbor sues Lessor, Lessee/Operator and Contractor, seeking damages.

Lessor tenders an indemnity claim to Lessee under the Lease. Lessee/Operator tenders an indemnity claim to Contractor under the MSA. Contractor tenders an indemnity claim to Lessee/Operator under the MSA.

What is the result?

- As between Operator and Lessor, Operator is liable for Neighbor's personal injury under the Lease. [Note: there may be an issue whether the injury was *caused by* the operations].

- As between Operator and Contractor, Neighbor's injury is an injury to a "Third Party," and therefore liability is allocated based on the proportionate fault of each party.

Scenario 4:

Instead of the facts set forth in Scenario 2, one of Contractor's frac crew employees drinks contaminated water from Lessor's water well and contracts an incurable illness.

- Employee sues Lessor, Lessee/Operator and Contractor, seeking damages.

Lessor tenders an indemnity claim to Lessee under the Lease. Lessee/Operator tenders an indemnity claim to Contractor under the MSA. Contractor tenders an indemnity claim to Lessee/Operator under the MSA.

What is the result?

- As between Operator and Lessor, Operator is liable for Employee's personal injury under the Lease.

[Note: there may be an issue whether the injury was *caused by* the operations].

- As between Operator and Contractor, Employee's injury is an injury to a member of "Contractor Group" and therefore Contractor is liable and Company may tender indemnity to Contractor.

What does this all mean?

- Under a traditional lease with an indemnity, the lessee / operator assumes broad liability for all damages regardless of fault.

- Under a traditional MSA, the operator and the contractor each assume broad liability for their respective people and property, regardless of fault, under a knock for knock indemnity.

- The operator, as the common dominator contracting party, must be conscious of how its indemnity obligations fit together and how much liability it is assuming.

- Although the industry has worked hard to inject some certainty in its contracts by allocating risk on the basis of ownership of the people and property involved, as opposed to legal fault, certainty has not yet been achieved.

The Exculpatory Clause

What is an Exculpatory Clause?

Texas Supreme Court: A "clause in a contract designed to relieve one party of liability to the other for specified injury or loss incurred in the performance of the contract."

This discussion will focus on the clause in the Model Form Joint Operating Agreement, but the concepts apply to other oil patch agreements.

The 1956 AAPL Model Form 610 Onshore Operating Agreement:

> 5. Operator shall conduct all such operations in a good and workmanlike manner, but is shall have no liability as Operator to the other parties for losses sustained, or liabilities incurred, except such as may result from gross negligence or from breach of the provisions of this agreement.

The 1977 Model Form reads as follows:

> V.A. Operator . . . shall conduct and direct and have full control of all operations on the Contract Area . . . . It shall conduct all such operations in a good and workmanlike manner, but it shall have no liability as Operator to

> the other parties for losses sustained or liabilities incurred, except such as may result from gross negligence or willful misconduct.

The 1982 Model Form reads as follows:

> Operator … shall conduct all such operations in a good and workmanlike manner, 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.

The 1989 Model Form reads as follows:

> Operator shall conduct its activities under this agreement as a reasonably 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 regulation, 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.

Scenario 5 (1989 Form):

The Operator and Non-Operators were not getting along on major operations decisions. Two oil bearing formations were in the Contract Area, the Upper formation and the Lower formation. Production from the unitized Upper formation held the leases as to all depths. At this same time, the parties attempted to recomplete wells in the Lower formation. Because the Upper tracts were unitized, production anywhere on the unit would be treated as production from all unit tracts. The Lower formation was not unitized. The Operator failed to conduct RRC-required fluid level tests on several wells. Two of the wells that were tested showed excessive fluid levels, but the Operator did not retest, repair, or attempt to plug those wells. The RRC severed the Upper Unit and suspended production. This resulted in loss of leases.

Operator alleged that as Operator he had the exclusive right of possession of certain well bores. Non-operators counterclaimed that he illegally produced oil, fraudulently reported oil from one formation as being produced from another, and failed to sustain production in the quantities required by the JOA.

Because of the language of the 1989 Form, only gross negligence or willful misconduct were actionable for both operational and administrative claims against

the Operator. The court examined Operator's conduct in light of the evidence and found "no evidence that Operator knew about the peril but did not care about the consequences." *Reeder v. Wood County Energy, LLC,* Texas Supreme Court.[1]

Scenario 6 (1977 Form):

The Operator drilled three wells. The Non-Operator assumed operations and drilled additional wells. Disputes arose about the operation. In some cases the new Operator plugged wells despite the Non-Operator's desire to take them over pursuant to the JOA. With other wells, the Non-Operator claimed the Operator withheld information regarding productivity of certain wells that prevented the Non-Operator from making informed decisions about whether or not to abandon or complete. The non-operator also claimed that the operator tortuously interfered with sales contracts.

The exculpatory clause was clear and unambiguous; the Non-Operator could not recover from the Operator for acts taken as Operator, such as "the completion, testing or turnover" of the well absent proving gross negligence or intentional misconduct. The court rejected the Non-Operator's theory that the exculpatory clause should not excuse an Operator's liability for non-physical acts such as administrative and accounting duties and recovery of costs. *Stine v. Marathon Oil Company*.[2]

Scenario 7 (1977 Form):

The Operator sent an AFE for "reworking operations" and asked the Non-Operators to elect whether or not to participate. The Non-Operators claimed the operations were routine operations that do not require an AFE or an election. If an AFE was unjustified under the circumstances it may constitute a breach of the JOA. The Operator relied on the exculpatory clause of the JOA and argued that there would be no liability except for acts of gross negligence or intentional misconduct.

The court found the exculpatory clause to be unambiguous. The scope of protection under the exculpatory clause extended only to claims that Operator failed to act as a reasonable and prudent operator, and not claims that he breached the JOA. The court then concluded that the AFE was not justified because the operations were not "reworking". *Abraxas Petroleum Corp. v. Hornburg.*[3]

What does this all mean?

- You never know what to expect at the courthouse.
- What court you are in matters.
- The precise language of the contract makes a difference.
- "Boilerplate" has meaning.
- *Abraxas* is still good law if the 1977 form is used AND you are in state court.

Indemnified and Exculpated

As previously noted, the scope of parties to which the indemnity will apply is varied. Often times, Lessee/Operator includes its "joint interest owners, co-working interest owners…etc." in a defined "Company Group." By doing so, Operator creates two practical results when applying an indemnity provision utilizing "group" concepts: (1) Non-Operator's "people and property" become that of the Operator for indemnity purposes; and (2) Non-Operator is entitled to the same indemnification from Contractor as Operator.

Scenario 8:

Operator and Non-Operator each own a 50% working interests in the Lease and are parties to a JOA with exculpatory language. They conduct a workover on an existing well. The Operator hires Contractor to perform the frac. The workover operation fails and ruins the well. The well must be plugged and abandoned. An employee of the Contractor is injured and claims his injuries resulted from the Operator's negligent supervision.

- Lessor sues Operator and Non-Operator, and recovers damages.
- Contractor employee sues Contractor, Operator and Non-Operator, and recovers damages.

Operator tenders indemnity to Contractor for damages paid to Lessor, alleging Contractor gross negligence.

Operator invoices Non-Operator for its share of damages paid.

Operator tenders indemnity to Contractor for damages paid to Contractor Employee.

- Non-Operator sues Operator to avoid payment of its proportionate share of the damages. Operator asserts the exculpatory clause as a defense.

What is the result?

- As between Operator, Non-Operator and Lessor, Operator and Non-Operator are liable for damage to Lessor's "property and improvements" under the Lease, and therefore Operator is liable.

- As between Operator, Non-Operator and Contractor, Employee's injury is an injury to a member of "Contractor Group" and therefore Contractor is liable and Company may tender indemnity to Contractor on its behalf and that Non-Operator.

- Is the Operator protected from liability? Inasmuch as the loss arises from operations, regardless of its liability to Contractor or Lessors, Operator will not be liable to Non-Operator for ordinary negligence. The Non-Operator would have to prove gross negligence or willful misconduct – a difficult task.

Conclusion

Don't believe Will Rogers. Lawyers and their clients write indemnity and exculpatory provisions for good reasons. Make sure you are aware.

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[1] _____ S.W.3d _____ 2012 WL 3800231 (Texas 2012).

[2] 976 F.2d 254 (5th Cir. 1992).

[3] 20 SW3d 741 (Tex. App.—El Paso 2000, no pet.)