Drilling Contract Historical Development and Future Trends Post-Macondo: Reflections on a 35 Year Industry Career

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Summary

The author reflects upon a 35 year drilling industry career to review the evolution of drilling contracts and discuss future contracting trends post-Macondo.

The historical review begins with the advent of the oil and gas industry and considers developments that led to issuance of the first (IADC predecessor) AAODC standard drilling contract in 1952. The article then traces the evolution of drilling contracts as they became more complex and sophisticated while the industry extended into the international and offshore arenas.

Major events that impacted contracting, such as development of various standard contracts, anti-indemnity statutes and other legislation, judicial decisions, the "Drilling in the '90s" and other strategic initiatives are considered. Incentive, variable rate and multi-party drilling contracts are reviewed. The article also discusses contractual provisions that were implemented to address operational and technical innovations such as horizontal drilling, extension into deepwater and dual activity simultaneous operations capability.

The dichotomy between U.S. land operations (which primarily utilize IADC model contract forms) and offshore and international operations (which generally are based on operator standard contracts) is considered along with the impact of market forces upon drilling contract terms. The difficulties encountered when contracting with national oil companies that insist upon adherence to their standard forms are discussed. Controversial issues, such as the enforceability of indemnities in the event of gross negligence, are reviewed.

The article also extensively considers the impact of the Macondo well incident upon contract terms, including a review of recent court decisions involving interpretation and enforcement of the indemnity provisions in the Macondo drilling and cementing contracts.

With this background, anticipated future contracting trends are considered in the context of a post-Macondo world.

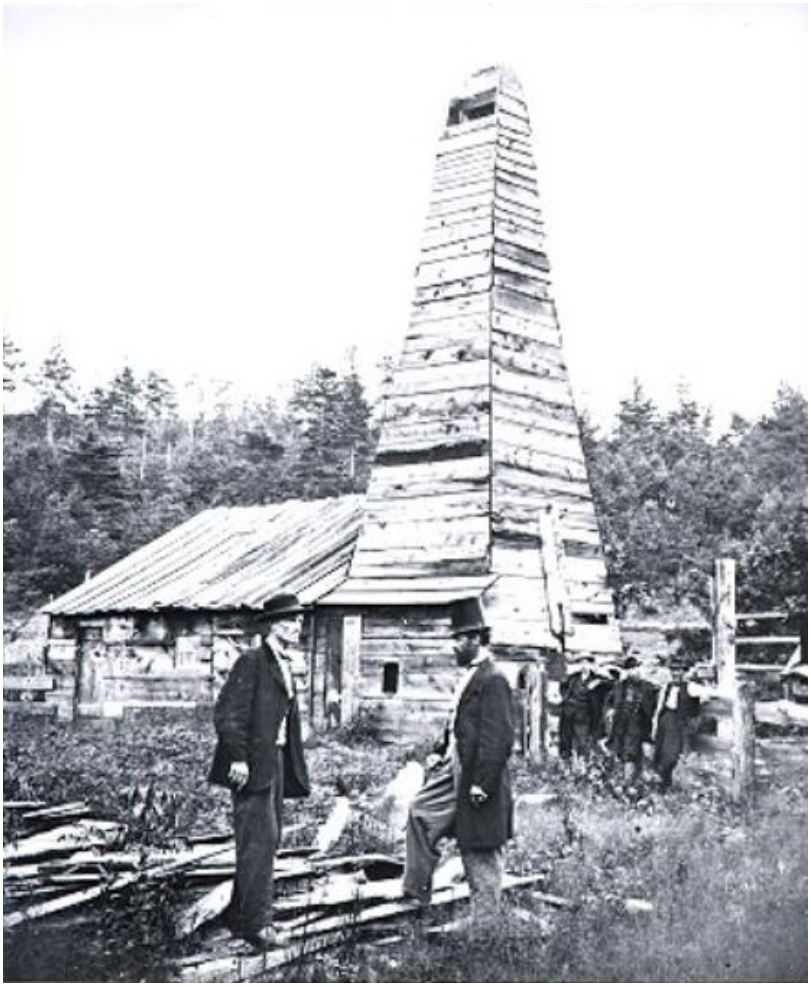
Introduction

This article is largely based on knowledge derived from the author's experience in the drilling industry over the past 35 years, which entailed service as an in-house attorney and executive manager of a contracts/marketing department and included an 18-year stint as General Counsel for two major drilling contractors (Santa Fe and Ensco).

The author chaired the IADC Contracts Committee for a decade is the only practicing attorney to have been named IADC Contractor of the Year.

Having participated in virtually all facets of drilling contracts addressing domestic and international operations involving land and platform rigs, tender rigs, drilling barges, jackups, semi-submersibles and drillships, the author's experience includes traditional daywork, footage, modified footage (a combination of footage and daywork), turnkey and various other forms of incentive contracts as well as strategic alliances and rig sharing agreements.

During the course of his drilling industry career, the author has seen drilling contracts evolve from relatively simple documents to lengthy, complex contractual arrangements. Recent trends in contracting and important new legal precedents resulting from the Macondo well incident are expected to add more complexity to drilling contracts over the next few years.



In the Beginning. In the summer of 1859, Edwin Drake tried to dig a mine shaft to capture oil under some promising seeps in Pennsylvania. When mining techniques were unsuccessful, he improvised and adopted a drilling technique using a steam-powered cable tool rig that enabled him to strike oil at the depth of 69 feet, launching the petroleum industry.

Colonel Drake did not need a drilling contract as he was both the operator and the driller, working with a crew composed of a blacksmith named Billy Smith and Billy's son. When the oil and gas industry emerged, most operators drilled their own wells using in-house equipment and personnel. This trend continued long after the contract drilling industry matured. The last of the large captive drillers, Gulf's Keydril and Murphy's ODECO, were spun-off in 1985 and 1992 respectively.

In 1940, the predecessor to the IADC was founded as the American Association of Oilwell Drilling Contractors ("AAODC"), initially with only five paid members. According to a presentation at the 1941 AAODC annual meeting, more than 2,000 drilling contractors were then operating in the U.S. and owned about 75% of the available 4,000 rotary and 2,800 cable rigs. With each contractor having an average of three rigs, this truly was the era of the "mom and pop" drillers. The AAODC also reported that over 10% of the pioneer drillers also were producers.

Early issues of *The Drilling Contractor* magazine shed light on the status of the industry beginning in the 1940s. An article in the May 1945 edition titled "Insurance – A Necessity for Drilling Contractors" illustrates the naiveté that prevailed. Several articles published in the late 1940s and early 1950s addressed the operator/contractor relationship. One such article appearing in the February 1945 issue commented on the fact that lawsuits between producers and contractors were infrequent, noting that "this is doubly significant when considered with the frequency of occasions where the drilling is well underway and sometimes completed before the contract is signed."

Interest in contracts seemingly intensified during the late 1940s. At the 1949 AAODC annual meeting, a paper titled "Contractor's View on Revising Drilling Contract Forms" was presented along with an operator's response. The response agreed with the contractor's comment that "some of the drilling contracts enforced today are on patchwork forms" and also endorsed the observation that "a house-that-Jack-built contract should not be recommended to the industry as a fair expression of the contractual relationship between company and contractor, and certainly should not be used as a yardstick to determine risks and responsibilities in a contractual relationship involving the expenditure of thousands of dollars." This was supplemented by a statement that an agreement to drill a well should "be as complete, plain and unambiguous as we can make it" because "a drilling contract should express the full agreement of the parties."

A Report on Contractual Liability was presented by an AAODC special committee during a Board of Directors meeting held in Chicago in November 1949. The Report articulated seven basic principles to "be adopted in the writing of drilling contracts" by member companies "if found to be fair and equitable."

The interest in contracts continued into the early 1950s. An article in the February 1950 edition of *The Drilling Contractor* magazine titled "Comments on the Drilling Contract" emphasized the "importance of knowing terms of contract in advance" and "checking the terms of the drilling contract."

Twelve years after the AAODC was established, it issued the first standard drilling contract. Heralded "as an important milestone", the April 1952 edition of the *Drilling Contractor* magazine contained the following announcement:

Announcing the A.A.O.D.C.

STANDARD DRILLING CONTRACT

for Contractors and Companies

An Important Milestone . .

APPROVAL of a Standard Drilling Contract by the Board of Directors of American Association of Oilwell Drilling Contractors, in San Antonio April 8, marks an important milestone for the Association and the Drilling Industry. Serious effort toward this goal in recent years has finally reached the point of presenting an actual contract form to be available to the industry generally.

Need of a standard-type contract has been felt for many years. In view of so many considerations connected with the drilling of a well, on the part of both operator and contractor, the progress now attained is indeed a tribute to the numerous companies and individuals within the Petroleum Industry who have cooperated and contributed toward the formation of this standardized contract.

It is recognized that revisions will be in order from time to time, but the Association Directors have agreed the contract, as now presented, comes as nearly as possible to protecting all parties concerned. It is hoped its adoption for use by any one desiring it will be greatly appreciated.

Much credit is due the committees of A.A.O.D.C. concerned with this project. The outstanding work of these committees made possible the culmination of the contract.

On behalf of the American Association of Oilwell Drilling Contractors, it is a real pleasure to present this standard drilling contract to the Drilling Industry.

A. W. Thompson

President, A.A.O.D.C.

The first AAODC standard drilling contract addressed U.S. land drilling operations. From this humble beginning, the IADC has developed a suite of model contracts addressing U.S. and international land and offshore operations on a daywork, footage and turnkey basis. The original AAODC standard contract, which covered both daywork and footage operations, was a whopping eight pages complete with exhibits. The current IADC U.S. land daywork and footage model contracts are fourteen and twelve pages respectively.

Prior to the issuance of the first standard drilling contract in 1952, contracting practices were sporadic. In many cases, according to pioneer driller and originator of the IADC Daily Drilling Report Earle Hellums, an oral contract was often sealed by a handshake. The IADC reported that one contractor in Oklahoma drilled 150 wells for an operator between 1935 and 1940 without any written contracts. Early contracts were described as rudimentary in nature, with a focus on basic commercial terms regarding scope of work, rates and the equipment and personnel to be furnished by the contractor. To quote a column titled “Focus on Contracts” that appeared in *Drilling Contractor* magazine in 1986 “Early drilling contracts were a combination of well specifications and price data, with general terms and conditions spelled out for the particular trade on that well.”

It was not until the late 1940s and early 1950s that *The Drilling Contractor* magazine first discussed the emerging concept of including “hold harmless” provisions in drilling contracts.

Although the original AAODC standard drilling contract bears some resemblance to the current IADC model contract forms, the initial contract was rather rudimentary in nature. By way of example, the first AAODC contract did not include a provision addressing pollution liability.

Apparently, the AAODC contract was not universally embraced by the industry. An article in the April 1955 edition of *The Drilling Contractor* magazine titled “Presenting Some New Concepts in Drilling Contractor – Operator Relationships” contains the following passage:

> The need for a standard form of drilling contract has long been recognized as very desirable. Whether or not it can be achieved is something I am not prepared to say. The American Association of Oilwell Drilling Contractors have offered a form to the industry which was the result of many years of work by an eminently well-qualified committee. It is a good contract and a fair one, but it has not received the recognition or use it deserves.

The weak market for drilling rigs in the early 1960s created an environment in which contractors were compelled to accept unfavorable contracts. In an article published in the October-November 1961 edition of *The Drilling Contractor* magazine titled "Sound Contracting Practices", William Clements, the President of Southeastern Drilling Corporation who later became Governor of Texas, commented:

> To a large degree contractors are responsible for the ills of the oilwell drilling industry. We have created some of our problems by our own actions. We have abetted the establishment of others by bowing down to undesirable contractual clauses and practices.

The same sentiment was expressed during another industry downturn fifteen years later in an article titled "The Operator's Hey-Day" that appeared in the February 1986 edition of *Drilling Contractor* magazine:

> As previously stated, today the operator can probably dictate the terms of all agreements on the well.

Standard Contracts. From its humble beginning in 1952, the IADC developed a suite of model drilling contracts over the years. The development of additional contract forms included bifurcation of the original AAODC standard contract into separate IADC U.S. land model contracts for daywork and footage operations in February 1986. The first international daywork land model contract was issued by the IADC in July 1983 and was followed by the introduction of a U.S. land turnkey contract in February 1988 and an international daywork offshore contract in February 1989. The IADC U.S. offshore daywork model contract was issued several years prior to the international daywork offshore model contract. A U.S. offshore turnkey model contract was issued in February 1989, revised in October 1995, and withdrawn in August 2005 due to a dearth of sales.

Although widely utilized for U.S. land rig operations, the IADC model contract forms infrequently are used in offshore or international operations. The offshore and international forms are viewed as useful examples of contract language that enables the contracting parties to gauge commercial and legal risk exposures by comparing provisions of a proposed contract to the IADC model forms.

The Canadian Association of Oilwell Drilling Contracts ("CAODC") has issued a Master Daywork Contract and a Standard Meterage Contract tailored for Canadian operations. These contracts, which are similar to the IADC model contract forms, were last updated in 2001 and 1994 respectively. The CAODC form contracts have met considerable acceptance for land drilling in Canada.

The American Petroleum Institute ("API") also entered the foray, perhaps in response to the above-referenced article in which William Clements commented "I believe the API should form a committee to study the possibility of writing a standard drilling contract." In May 1961, the API invited six drilling contractors to join the API Subcommittee on Model Rotary Drilling Contract Class Forms. At that time, the API was preparing model contract forms addressing single or multiple U.S. land wells. This effort continued, albeit sporadically, until the API finally issued model drilling contracts over a decade later. In many respects, the API contracts were similar to the IADC U.S. land model contracts in both form and substance. This may account for the fact that the API contracts met with sparse acceptance and eventually were discontinued in favor of the more popular IADC contract forms. The last API model form drilling contract was issued on February 1, 1983.

In November 1997, a standard drilling contract for the U.K. offshore oil and gas industry was issued by LOGIC (Leading Oil & Gas Industry Competiveness), a non-profit subsidiary of Oil & Gas UK, based upon the former CRINE (Cost Reduction in the New Era) form contract. The LOGIC/CRINE General Conditions of Contract for Mobile Drilling Rigs have been used with some frequency, primarily for operations in the U.K. sector of the North Sea, although the standard verbiage is routinely modified by special provisions.

Most major oil companies, large independents and national oil companies have developed their own cadre of drilling contract forms. The contracts proposed by majors and large independents frequently are subject to qualification by contractors that tender for the work, resulting in negotiated contracts. However, most national oil companies will not deviate from their pro-forma contracts. This creates a "take it or leave it" situation.

Many contractors consider such non-negotiable contracts to be problematic, primarily because they often contain onerous provisions and frequently are ambiguous in important areas such as allocation of risk for pollution liability or reservoir damage. Contracts of this nature can create significant risk exposures. A risk exposure generally can only be mitigated by insuring or contractually transferring the risk. If insurance is not commercially available and the risk cannot be shifted contractually, then management must decide whether the risk can be reduced operationally and determine whether the contract exposure fits within a company's risk tolerance profile.

Drilling contractors often develop their own pro-forma contracts. Such contracts may serve as the starting point for negotiations with an operator that has not prepared a standard contract. Although sparingly used, contractor pro-forma contracts often serve as a comparative guideline utilized by the contractor in evaluating a proposed drilling contract. Many drilling contractors also have developed a contract checklist or contract guidelines to serve this purpose.

Other industries have developed standard contract forms that are widely utilized. As an example, standard contracts for vessel charters and contracts of afreightment are the norm in the shipping industry. With the exception of U.S. and Canadian land operations, such standardization has not been adopted for the drilling industry as the vast majority of contracts for international and offshore drilling operations are based upon negotiated versions of operators' pro-forma contract forms or prescriptive national oil company contracts.

Several of the super major international oil companies have attempted to create a global master contract for drilling operations, often with input from contractors. These efforts never seemed to gain traction, perhaps because of the difficulties associated with creating a "one size fits all" master global contract that, by definition, is unlikely to recognize the nuances of operating different types of rigs in various jurisdictions. Indeed, many oil company standard contracts vary from land to offshore and by jurisdiction.

While there have been various attempts to increase standardization of drilling contracts over the years, the reality is that most international and offshore operators prefer their individual contract forms and are unwilling to utilize standard forms developed by associations such as the IADC or LOGIC. Although countless hours are consumed in the process of preparing, qualifying and negotiating drilling contracts, it is unlikely that standard contract forms will become the norm for offshore or international drilling in the foreseeable future.

To indicate the extent to which various types of standard contracts are utilized, the following table discloses 2010 and 2011 sales of the IADC model contracts:

Model IADC Contract	2010 Forms Sold	2011 Forms Sold
Daywork Drilling Contract – U.S. Land	3600	4208
Footage Drilling Contract – U.S. Land	1450	1370
Model Turnkey Contract	910	680
Offshore Daywork Drilling Contract – U.S.	20	0*
International Daywork Drilling Contract – Land	0	70
International Daywork Drilling Contract – Offshore	170	110

*Sales suspended pending revision

Contract Evolution. Over the years, drilling contracts evolved to address international and offshore operations.

The early drilling industry was largely U.S.-centric and expansion into international operations created many new issues for contractors and operators to address contractually. Additional terms developed for international contracts include provisions regarding currency of payment, exchange rate fluctuation, taxation, customs duties, compliance with local laws and, more recently, ethics and business conduct (including compliance with the U.S. Foreign Corrupt Practices Act and U.K. Bribery Act). International contracts often include risk allocation provisions addressing expropriation, nationalization, deprivation and confiscation of the contractor's rig and equipment. Dispute resolution provisions are of greater import and complexity in international contracts as the parties focus upon both the designation of the law that governs the contract and the provisions addressing the nature and location of dispute resolution proceedings.

The migration offshore created many issues that impacted contract terms. When Kerr McGee drilled the Ship Shoal No. 32 well off the Louisiana coast using a converted barge in 1947, the era of mobile offshore rigs was launched. As drilling moved to deeper waters during the 1950s, 1960s and 1970s, jackups, semisubmersibles and drillships were introduced.

As the offshore industry developed, drilling contracts were revised and supplemented to address certain unique aspects of the marine environment. The move offshore prompted addition of contract provisions relating to responsibility for transport of personnel and materials between shore and the rig, terms addressing responsibility for providing vessels to mobilize, move and demobilize the rig, as well as revised "sound location" provisions applicable to a marine environment. Risk allocation provisions addressing responsibility for subsea and mooring equipment loss or damage, marine pollution and wreck removal also were developed for offshore drilling contracts.

As drilling contracts evolved to address international and offshore operations, the length and complexity of the associated documentation increased. Today, a long-term contract for a deepwater rig in international operations is likely to be a voluminous and detailed 200-300 page document complete with the customary exhibits addressing personnel, equipment, procedures, HSE and regulatory requirements and sundry matters.

Many Events and Developments Have Impacted Contracting Practices. Drilling contracts have also been impacted by various events and developments involving technological, operational, strategic, legislative, regulatory and judicial activities.

Technical innovations have prompted addition or revision of contract terms. As an example, the advent of the top drive resulted in revised provisions addressing rig time to service the equipment and often sounded the death knell for contractual references to the rotary table. Other examples of contract terms developed in response to technical innovations relate to directional and horizontal drilling, which prompted provisions addressing excessive wear on the contractor's drill string as well as liability provisions allocating risk for sophisticated (and costly) downhole motor and directional tool loss or damage.

The progression of the offshore industry into deepwater prompted contractual provisions addressing rates applicable for rig time consumed while tripping the lower marine package in various circumstances as well as contract terms allocating responsibility for payment during suspension of operations necessitated when encountering loop and eddy currents and while evading tropical storms and hurricanes in the U.S. Gulf. The advent of dual-activity simultaneous operations capability beget special drilling contract terms addressing use (or non-use) of the specialized equipment, partial downtime and patent infringement. The introduction of heavy lift dry haul carriers to facilitate lengthy offshore rig moves also impacted contractual provisions addressing offshore rig mobilization and demobilization.

Operational events have and will influence drilling contract terms. The *Piper Alpha* platform explosion and fire caused 167 fatalities and prompted the Lord Cullen report that resulted in contractual provisions addressing HSE compliance and Safety Case requirements for drilling contracts in the U.K. sector in the North Sea. The catastrophic impact of Hurricanes Ivan, Katrina and Ike on rigs and facilities in the U.S. Gulf of Mexico a few years ago prompted changes in contractual provisions addressing hurricane preparedness/response and removal of rig wreckage and debris. While the loss of life, total rig loss and pollution clean-up costs and liabilities resulting from the Macondo well blowout are unprecedented, prior rig disasters such as those involving the *SEDCO 135, Alexander Kielland, Ocean Ranger* and the *Glomar Java Sea* also caused contractors and operators to refocus on drilling contract terms in general and the risk allocation provisions in particular.

Strategic initiatives have impacted drilling contracts, albeit on a transitory basis. Perhaps the most significant example is Shell's Drilling in the Nineties program. Unveiled during a keynote luncheon speech at the 1990 IADC/SPE Drilling Conference, Shell's initiative was heralded as a means of "revolutionizing" the manner in which operators and drilling contractors would drill wells with a proclamation that "the days of an acrimonious relationship between operators and contractors are over."

In essence, Drilling in the Nineties was an effort to combine two contracting practices, integration and incentives, in a structure whereby the drilling contractor would serve as a general contractor and "bundle" the ancillary well services and materials on a basis that often included a performance-based incentive payment to compensate for the shifting of the administrative burdens and to reward efficiency. The launch of this initiative was followed by a conference hosted by Shell in Holland in which drilling and service contractor representatives addressed certain aspects of the Drilling in the Nineties program. One contractor's presentation, titled "Daywork Works", proved to be most prophetic – the traditional daywork contract has stood the test of time.

Other initiatives, including Shell's WIN 90s program and BP's Strategic Alliances, also impacted contracting practices during the depressed era of the 1990s. Because they placed additional logistic and administrative burdens upon drillers, these programs were not greeted with enthusiasm by drilling contractors. These well-intended initiatives, launched during a difficult period for producers, drillers and service companies, ultimately were abandoned as the industry recovered and

the traditional daywork concept again became the norm for nearly all offshore drilling projects and a majority of onshore work.

Enactment of legislation and regulations has impacted drilling contracts over the years. Contracts frequently were modified to address legislative or regulatory requirements relating to pollution and disposition of waste. In the U.S. Gulf of Mexico, the Oil Pollution Act of 1990 prompted contractual revisions addressing the operator's responsibility for provision of a Certificate of Financial Responsibility while the Clean Water Act, Resource Conservation and Recovery Act, Refuse Act and the Rivers and Harbors Act caused contracting parties to further delineate responsibility for pollution abatement and clean-up, fines, environmental damage and disposition of waste. As discussed below, regulatory enactments and judicial rulings resulting from Macondo have and will impact drilling contract terms.

The anti-indemnity acts adopted in Texas, Louisiana and other states caused contractors and operators to re-craft indemnities so as to foster enforceability of indemnification provisions in contracts governed by those state laws. Moreover, state anti-indemnity acts often resulted in selection of another appropriate governing law such as the widespread use of "general maritime law of the United States" in contracts for work in the U.S. Gulf of Mexico.

Court decisions have impacted drilling contracts in several respects, often on a limited basis depending upon the applicable governing law. In many cases, the decisions have impacted wording of contractual indemnity provisions. For example, contracts governed by Texas law were impacted by the decisions in *Atlantic Richfield Co. v. Petroleum Personnel Inc.,* 768 S.W.2d 724, 726 (Tex. 1989), and *Dresser Industries, Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 511 (Tex. 1993), which applied the express negligence doctrine pronounced in a 1987 Texas Supreme Court decision to oilfield indemnities. This doctrine requires the contracting parties to clearly state their intent to provide indemnification to a negligent party, provide fair notice and include conspicuous indemnity provisions in the contract. The underlying concept is that, if a party is to provide indemnification for the consequences of another party's negligent acts, the indemnity provisions should be obvious, be clearly expressed and state the intent to cover various forms of negligence.

In response to the court decisions applying the express negligence doctrine, drilling contracts governed by Texas law generally provide notice of the risk allocation provisions at the beginning of the contract, include liability and indemnity provisions in conspicuous text (often in bold capital letters) and clearly express an intention to provide indemnity notwithstanding various types of negligence or other theories of legal liability. Such contracts often include reciprocal mutual insurance provisions so as to render certain indemnities enforceable under the Texas Oilfield Anti-Indemnity Act. The *Dresser* decision also motivated contracting parties to include provisions addressing releases as well as indemnities in oil service contracts.

Drilling contract terms were also impacted by the Louisiana court decision in *Marcel v. Conoco, Inc.*, 11 F.3d 563, 569 (5th Cir. 1994), which created a judicial exception to the Louisiana Oilfield Anti-Indemnity Act by permitting indemnity when the party being indemnified pays for the indemnitor's insurance coverage. The *Marcel* doctrine is often reflected in drilling contracts governed by Louisiana law so as to render "knock-for-knock" contractual indemnities addressing personal injury and death enforceable.

Rulings in litigation involving U.S. admiralty and maritime law have established that a party may lawfully agree to indemnify another party even in the event of negligence or other culpability by means of traditional "knock-for-knock" oilfield indemnities, where each party generally assumes liability for its own personnel, equipment and property (including the operator's well-related risks) without regard to cause. To quote the U.S. Court of Appeals for the Fifth Circuit decision in *Theroit v. Bay Drilling Corp.*, 783 F.2d 527, 540 (5th Cir. 1986), such provisions generally are enforceable if they are "specific and conspicuous."

Another Fifth Circuit decision, *Corbitt v. Diamond M. Drilling Co.*, 654 F.2d 329, 333 (5th Cir. Unit A Aug. 1981), states that specificity requires maritime contract indemnity provisions to be expressed in clear and unequivocal terms. Court decisions of this nature have impacted contractual wording. As an example, Court decisions prompted inclusion of "talismanic language" or "magic words" in drilling contracts in order to clearly and specifically express the parties' intention to apply the indemnities notwithstanding various forms of negligence, unseaworthiness of vessels, pre-existing conditions or other bases of legal liability. With this in mind, the scope of indemnity provisions in the IADC model contracts were drafted to include a catch-all phrase referencing "any other theory of legal liability" (verbiage that was first included in the IADC contracts many years ago at the suggestion of the author of this article).

Indemnity Provisions. Indemnity provisions are among the most controversial aspects of drilling contracts and have frequently been impacted by legislative enactments (such as the previously discussed Texas and Louisiana Anti-Indemnity Acts) and judicial rulings.

Courts frequently have recognized and supported the fundamental principles underlying indemnity agreements. In an opinion relating to an IADC drilling contract, a Louisiana court identified "the two policy considerations underpinning the use of reciprocal indemnity agreements such as the one at issue in the instant case: (1) The elimination of the expense of redundant insurance coverage and (2) a reduction in unnecessary litigation and its concomitant expense" *Darty v. Transocean Offshore U.S.A., Inc.*, 875 So. 2d 106, 111-12 (La. App. (4th Cir.) 2004). While reviewing an offshore contract in *Rodrigue v. Legros*, 563 So. 2d 248, 255 (La. 1990), the court stated "By allowing indemnity provisions to be fully enforceable, the federal maritime law gives parties the contractual freedom to allocate risks between themselves."

Indemnity provisions, called "hold harmless" provisions in early editions of *The Drilling Contractor* magazine, are intended to allocate risks between the contracting parties for purposes of permitting the parties themselves to decide which of them should bear specified risks and minimizing legal disputes. This avoids unnecessary and costly duplication of insurance coverages and permits each party to assess its risk exposure under the contract. To achieve this objective, liability and indemnity provisions generally should be absolute and unqualified ("without regard to cause").

While such risk allocation provisions eliminate determinations of fault, certain limitations upon reciprocal "knock-for-knock" indemnity provisions are commonplace. Examples of provisions that limit the general protection accorded to contractors include terms commonly included in dayrate contracts that require the contractor to redrill a lost or damaged well at a reduced rate or absorb a stated limited amount of subsurface pollution liability in the event of a specified degree of contractor negligence. Conversely, the general protection accorded to operators for damage or loss of the drilling rig is normally qualified by provisions that place specified liability on the operator for in-hole and subsea equipment loss/damage or rig damage resulting from an unsound location.

Some operator drilling contract forms modify or negate the general risk allocation provisions if a party otherwise entitled to indemnification has committed gross negligence or willful misconduct. When confronted with such provisions, most drilling contractors respond by proposing to delete the "carve out" for gross negligence or willful misconduct. If unsuccessful, contractors often seek to limit or "cap" their liability at a specified dollar amount, propose narrow definitions of gross negligence and willful misconduct, and limit the applicability of the overriding provisions to gross negligence or willful misconduct of personnel at or above a stated level of supervisory authority.

Although it conceptually may seem unfair to protect a party guilty of gross negligence or willful misconduct, a fundamental purpose of contractual risk allocation is to create a clear line of demarcation so each party will be able to evaluate its risk exposure and obtain appropriate insurance (or elect to bear or self-insure the risk). Absolute, unqualified "hell-or-high water" indemnity provisions eliminate the need for determinations of fault, negligence or the like. Accordingly, the author and many other practitioners believe the preferred means of contracting involves utilization of unqualified indemnity provisions in drilling contracts and often counsel clients to reject risk allocation provisions with carve-outs or overrides that potentially create unlimited "bet the company" exposures. Indemnity provisions are discussed in further detail in the referenced papers "Drilling Contracts: Pursuit of an Equitable and Balanced Relationship between Operators and Contractors" and "Equity in Drilling Contracts: Responding to Operator and Contractor Concerns."

There is an ongoing debate as to whether an absolute, unqualified indemnity will be enforceable in the event the recipient of the indemnity has been grossly negligent (a high standard of culpability that is very difficult to establish). As yet, the issue has not definitively been resolved in many jurisdictions. The determination will be dependent upon facts, circumstances, specific contract verbiage and, perhaps most importantly, the governing law. Since the decision may be based on public policy, the applicable policy under the governing law may be determinative. Public policy, whether based on judicial or legislative pronouncements, can vary considerably between jurisdictions. As an example, the adjacent states of Texas and Louisiana seemingly have opposite views as most practitioners believe that an indemnity can be enforceable in the event of gross negligence under Texas law but would be unenforceable under Louisiana law and statutes.

A decision issued in April 2011 by the U. S. District Court for the Southern District of Texas in *Energy XXI, GOM, LLC v. New Tech Engineering, L.P.*, 2011 U.S. Dist. LEXIS 41223 (U.S. DC Southern District of Texas), addressed the issue of whether an indemnity under a master service agreement governed by U.S. maritime law would be enforceable in the event of gross negligence. In considering the issue, the opinion stated:

> There is more support for the position that, under maritime law, an indemnification clause purporting to exempt a party from liability for its own gross negligence is invalid than for the position that such clauses are an appropriate means of risk shifting.

Somewhat to the chagrin of many in the offshore industry, the decision concluded:

> [T]he court finds that the indemnity provision in this case, to the extent it encompasses claims for gross negligence, is unenforceable.

The *Energy XXI* decision is of questionable precedential value since it was interlocutory in nature and focused upon the wording of a specific indemnity provision. Certification to the Fifth Circuit Court of Appeal has been requested. As discussed below, a recent decision on a summary judgment motion in the Macondo litigation held that the pollution indemnity in the drilling contract, which was governed by U.S. general maritime law, would be applicable even in the event of gross negligence.

Many practitioners question whether a lower court determination that public policy prohibits enforcement of an oilfield indemnity that expressly covers gross negligence and is governed by U.S. general maritime law would stand if appealed to a Circuit Court, especially since there is authority to the contrary. A review of the decisions by the Fifth Circuit discloses that the Court has not enunciated a public policy invalidating the provisions of offshore drilling contracts that contain reciprocal indemnity agreements encompassing gross negligence.

The pending Macondo litigation is likely to create new law in several areas. Recent rulings on summary judgment cross-motions filed by Transocean, Halliburton and BP seeking to determine applicability of certain indemnification provisions contained in the Macondo drilling and cementing contracts are discussed below. Future decisions in the Macondo litigation are expected to clarify several important legal and contractual issues.

Impact of Market Forces. Changes in the rig market often impact contract terms. Provisions addressing the rate structure in general and downtime allowances in particular, as well as term extension options and liability/indemnity provisions, often are influenced by market forces.

The drilling rig market always has been cyclical. The market often tends to be either over-balanced (an abundance of rigs with low utilization and rates) or under-balanced (a shortage of rigs with high utilization and rates). Contractual terms often are impacted by the ebb and flow of the marketplace, albeit in a rather perverse fashion. In soft rig markets, contractors are competing for whatever work is available at low rates and operators dictate contract terms to a significant degree. Conversely, in a tight rig market contractors enjoy high rates and are able to negotiate contract terms that benefit the driller. This creates situations reminiscent of Charles Dickens' introductory words in *A Tale of Two Cities*, "it was the best of times, it was the worst of times." In theory, the converse should apply as contractors should be prepared to accept less favorable terms in robust markets when rig rates are high and operators should relax terms in favor of the contractor in depressed rig markets when rates are low.

During the industry downturns of the 1980s and 1990s, long-term drilling contracts were under pressure as operators were reluctant to pay contract rates that were substantially above the then prevailing (depressed) market rates. To exacerbate the situation, operators often curtailed their drilling programs and released rigs in response to low oil and gas commodity prices. During this period, the author of this article participated in preparing a *Drilling Contractor* magazine editorial that posed the rhetorical question "Is the term 'long-term drilling contract' an oxymoron?"

Since drilling contractors covet customer relationships, they often will renegotiate lower contract rates in order to retain term contracts during a depressed market. Although perhaps counterintuitive, contractors frequently seek additional term in exchange for an agreement to reduce the rates originally specified in a long-term contract.

Conversely, in a robust market when the rates originally specified in a long-term contract are below the prevailing market, contractors do not have an opportunity to renegotiate higher contract rates as operators will insist upon adherence to the contract. To address this unbalanced situation, contractors sometimes enter into variable rate contracts that periodically re-set the dayrates by reference to published rig rates or indices. In rare circumstances, contractors have entered into variable rate contracts that are keyed to oil and gas commodity prices. Variable rate contracts are discussed in detail in the referenced paper "Adjustable Rate Contracts: Go with the Flow?"

Performance-Based and Multi-Party Contracts. Performance-based and multi-party contracts respectively contain special provisions to address incentive compensation and rig sharing arrangements.

As previously noted, performance-based incentive contracts, primarily based upon turnkey or footage drilling, have been utilized since the inception of the drilling industry. Incentive contracts generally have been more prevalent in U.S. land rig operations.

Other forms of incentive or bonus contracts – which are often based upon achieving or exceeding pre-determined goals relating to completion of certain drilling operations on the well ("beat the curve") or safety performance – have been

utilized with varying frequency over the past several decades. Such contracts have been applicable in all facets of the industry, domestic and international, onshore and offshore. In some cases, contracts provide that a bonus for good safety performance will be awarded directly to the rig crews. Performance-based contracts are discussed in detail in the referenced paper "Incentive Drilling Contracts: A Logical Approach for Enhancement of Drilling Efficiency."

Another innovative form of contracting relates to a multi-operator drilling contract in which two or more operators agree to utilize a rig for a specific term, often pursuant to a separate related rig sharing agreement. Such arrangements often occur when the costs to mobilize a rig to the general operating area would be prohibitive for a single operator with limited work, where there is a shortage of a specific type of rig or when two or more operators each have multi-well programs that they do not want to drill on a continuous basis. While multi-operator contracts require special provisions and add a considerable degree of complexity to the contract and related negotiations, rig sharing arrangements can be beneficial to all concerned parties and have been utilized with increased frequency over the past several years.

Impact of Macondo. The April 20, 2010, Macondo well blowout caused substantial human, economic and environmental losses. Eleven of the 126 workers on the Deepwater Horizon semisubmersible perished as fire engulfed the rig, which became a total loss. An estimated 4.9 million barrels of oil were discharged from the well. Although the costs relating to Macondo are ongoing, it is clear that the resulting expenses, losses, liabilities and damages will amount to tens of billions of dollars. Macondo has already impacted drilling contract terms and surely will serve to add complexity to drilling contracts over the next few years.

In general, the post-Macondo industry still maintains the traditional "knock-for-knock" risk allocation principle and the operator assumes the well-related risks, including costs and expenses in relation to pollution abatement, clean-up and liability, perhaps with a limited carve-out under circumstances involving a specified degree of contractor negligence.

In the aftermath of Macondo, with the renewed focus upon contractual provisions addressing liability for pollution emanating from the well, operators are attempting to whittle away at the traditional risk allocation by proposing to qualify the general indemnity relating to subsea pollution so as to exclude coverage for punitive damages, fines or penalties attributed to the contractor. Post-Macondo contracting also has witnessed an increase in proposals by operators to negate indemnity coverage in the event of the indemnitee's gross negligence or willful misconduct. Contractors obviously are resisting such fundamental changes to customary risk allocation.

Macondo has and will also impact other aspects of contractual risk allocation. In many cases, contractors are proposing to change terms to address post-Macondo concerns. Such changes include expansion of the indemnified parties to include service companies, equipment manufacturers and other parties that have received an indemnity from the contractor, provisions stating that a material breach of contract shall not impact the contractual risk allocations as well as proposed terms addressing an obligation to fund defense of claims subject to indemnity and recovery of costs incurred to enforce the contractual indemnities.

Recent drilling contracts for work in the U.S. Gulf of Mexico often address new post-Macondo regulatory requirements relating to BOP certification and testing. Provisions obligating the contractor to act in accordance with the operator's Safety and Environmental Management System ("SEMS") requirements are also frequently proposed by operators along with more stringent terms addressing maintenance, testing and certification of BOPE, rig crew training, etc.

Another impact of Macondo relates to the offshore drilling moratoria that were imposed by the U.S. Government following the oil spill. Post-Macondo, operators frequently propose to modify contractual force majeure clauses so as to include moratoria, stop orders, refusal to issue drilling permits and similar government actions in the definition of force majeure events. Conversely, contractors frequently propose to include delays and suspensions of operations caused by such activities in the list of events that are subject to the standby rate.

Insurance provisions have been impacted by Macondo, especially since BP claimed entitlement to coverage as an additional insured under the drilling contractor's liability policies. Post-Macondo, the parties have focused upon drilling contract provisions relating to additional assured endorsements and waivers of subrogation. Macondo has impacted the wording of insurance policies and certificates of insurance in several respects.

Macondo may also signal the demise of the traditional takeover clause in drilling contracts. A typical takeover clause provides that the operator is entitled to takeover and operate the contractor's rig in specified circumstances, which often include unsatisfactory or unsafe performance. Such provisions have been included in the vast majority of drilling contracts, although they are virtually never invoked. Post-Macondo, operators and their legal advisors have viewed such provisions as problematic since they may impact risk allocation before and after a takeover and could raise questions as to why an operator did not exercise the right to takeover operations when it knew or should have known that the drilling contractor was acting in a negligent manner or operating unsafely. Elimination of the takeover clause may be the only contractual impact of Macondo that likely would be embraced by both contractors and operators.

Future Trends Post-Macondo. Undoubtedly, drilling contract terms will continue to be impacted by operational, strategic, judicial, legislative and regulatory events, the most significant of which will likely be driven by implications of Macondo. Although the initial impact of Macondo primarily has been in relation to contracts for deepwater drilling in the U.S. Gulf of Mexico, it is anticipated that Macondo will ultimately impact contracts for shallow water and onshore drilling as respects both U.S. and international operations.

Macondo already has prompted new regulatory requirements and will surely result in additional legislative/regulatory pronouncements. The Report to the President by the National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling that was released on September 14, 2011, includes many pages of recommendations for proposed new administrative actions and regulatory enactments. The proposals address operational requirements involving pressure testing, kick detection and response procedures, shear ram design, acoustically controlled subsea BOP systems, redundant BOPs, rig audits and minimum standards for well control training. Upon release of the Report, the Bureau of Ocean Energy Management, Regulation and Enforcement ("BOEMRE") proposed additional SEMS regulations that authorize unannounced rig inspections and third party audits of SEMS programs. The proposals would also require lessees to systematically identify risks, establish procedures to address those risks, authorize any employee on an offshore facility to stop work, delineate authority for operational safety and establish guidelines for reporting unsafe conditions. On October 1, 2011, BOEMRE morphed into two separate agencies, the Bureau of Ocean Energy Management and the Bureau of Safety and Environmental Enforcement.

Although the extent to which the recommended new administrative actions and regulations will be implemented or enacted remains to be determined, it is clear that future U.S. Gulf of Mexico drilling contracts have and will be impacted by changes in the regulatory regime. Among the provisions that have and will be impacted by recently imposed and anticipated new administrative actions and regulations are terms addressing change in laws and regulations, payment for rig time consumed for new BOP testing and certification requirements (including time required to pull and run the BOPE and perform remedial work) and payment for rig time consumed during rig inspections. While the current focus is largely U.S.-centric, it is anticipated that other countries also will enact new regulatory requirements that will impact contract terms.

Drilling contracts also will be impacted by the results of the litigation relating to Macondo. The plethora of pending litigation involves liability claims filed against the principal parties (the operator, driller and cementing contractor) by a myriad of parties including individuals, corporations and governmental entities, various claims and counterclaims between the principal parties and a maritime limitation of liability proceeding brought by the rig owner. The results of this pending litigation, especially as respects the interpretation and application of the provisions of the drilling and other associated contracts in general and the enforceability of indemnities in contracts governed by U.S. maritime law in particular, are likely to influence contract terms in several respects and could even cause contractors to relocate their rigs to other jurisdictions. Resolution of the litigation will be a protracted process that will likely span many years.

A January 26, 2012 order ruling on partial summary judgment cross-motions in the BP/Transocean Macondo litigation involving interpretation and enforceability of the drilling contract indemnity provisions determined that:

- BP generally is required to indemnify Transocean for third-party claims resulting from subsea pollution, even if resulting from gross negligence or strict liability;
- The indemnity does not apply to punitive damages assessed against Transocean;
- The indemnity does not apply to penalties assessed against Transocean under the Clean Water Act, but does apply to penalties assessed under the Oil Pollution Act of 1990 (which expressly permits contractual indemnification);

- The court deferred ruling on whether Transocean's alleged material breach of contract would invalidate the indemnities that benefit Transocean; and
- BP was not obligated to fund Transocean's expenses to defend third-party claims at that time.

On January 31, 2012 an order was issued in relation to partial summary judgment cross-motions in the BP/Halliburton Macondo litigation involving the interpretation and enforceability of the cementing contract indemnity provisions. That order generally followed the above determinations in the BP/Transocean litigation and also held that fraud could void an indemnity clause on public policy grounds given that it necessarily includes intentional wrongdoing.

It should be noted that the foregoing rulings were issued by the U.S. District Court for the Eastern District of Louisiana in the context of partial summary judgment cross-motions and relate to contracts governed by U.S. general maritime law. The most significant aspect of the rulings -- that oilfield indemnities are enforceable even in the event of gross negligence (when so expressed) -- is contrary to the April 2001 decision by the U.S. District Court for the Southern District of Texas in the *Energy XXI* litigation discussed above. We thus have two District Courts within the Fifth Circuit that are dynamically opposed in respect of their determinations as to whether an oilfield indemnity that expresses an intent to be applicable in the event of gross negligence will be enforceable as a matter of public policy under U.S. general maritime law. Moreover, the ruling in the BP/Halliburton litigation seemingly indicates that the Court would not enforce an oilfield indemnity governed by U.S. general maritime law in the event of willful misconduct or other intentional wrongdoing.

These are interesting and important rulings that are likely to be subject to further clarification at trial, on appeal or in other pending or future litigation. Although the interlocutory summary judgment rulings in respect of the drilling contract indemnity provisions are of particular import, the author of this article is of the opinion that there are certain significant aspects of the governing contractual verbiage which may prove to be outcome determinative that were not addressed in the motions, the associated briefs or the Court's order.

The results of the ongoing litigation relating to Macondo undoubtedly will impact the indemnity provisions of future drilling and oil service contracts, especially as respects operations in the U.S. Gulf of Mexico. While the litigation is expected to provide clarity regarding the extent to which the parties may or may not be able to lawfully allocate various liabilities, risks and exposures, the rulings also are expected to raise many questions for practitioners, producers, contractors, insurance underwriters and the courts to address over the ensuing years.

Future drilling contracts also are expected to be impacted by various operational, strategic, legislative, regulatory and judicial developments. As an example, the latest evolution in rig design technology that entails provision of dual BOP stacks on deepwater rigs is likely to engender changes in contractual terms. Moreover, new U.S. and foreign regulations are likely to increase liability and fines for oil pollution, clean-up and abatement. Such new regulations may impact future drilling contract terms addressing the respective parties' obligations and the allocations of risk.

It should be noted that the impact of Macondo is likely to extend beyond drilling contracts. As an example, the terms of post-Macondo joint operating agreements between E&P companies will probably shift additional liability to the designated operator. Operators that have been compelled to bear more risk than non-operating participants may attempt to modify future drilling and service contracts in order to transfer some or all of that risk. Indeed, Macondo is expected to impact all manner of contracts associated with drilling operations, including contracts with oilfield equipment manufacturers as well as service companies.

Conclusions

Since the advent of the drilling industry over a century ago, drilling contracts have evolved to become increasingly more complex. This largely reflects the growth and development of the industry, expansion internationally and offshore, technical innovations, as well as operational, strategic, legislative and judicial developments. Moreover, Macondo has and will impact drilling operations and related contracts.

The future is uncertain and the only certainty is that drilling industry practices, technology, equipment, regulatory requirements and contracts will continue to evolve and change.

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