Deepwater Horizon Oil Spill: Is Indemnification Clause in Service Contracts Contrary to Public Policy?

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Deepwater Horizon Oil Spill: Is Indemnification Clause in Service Contracts Contrary to Public Policy? By Felix E. Ayanruoh*¹

ABSTRACT:

The recent Deepwater Horizon Oil Spill in the Gulf of Mexico is the most dominant hydrocarbon development disaster in recent history that will be remembered for a long time to come. Events in the past indicated that investigations and legal actions will go on for a long time. This case will be a seminal focus for government, academics, economics, and energy attorneys regarding liabilities and indemnification issues among others, just as some of the most important cases of the past years continue to be analyzed to this day. One of the most interesting and challenging aspects negotiating and drafting international petroleum service contracts revolves around the relationship between Operating Oil Company (OOC) and Service Contractors (SC) and liability/Indemnification issues in legal actions. Whilst these two, often conflicting, principles are generally understood within the international petroleum industry, the question arises as to whether indemnification clause in service contract in favor of OOC for tortious acts committed by SC is against public policy.

The purpose of this paper is to answer the following question: What is the contractual relationship between OOC and SCs and whether OOC can be indemnified by SCs for their tortious acts? In attempting to answer the question, the paper begins with the historic analysis of the deep water horizon spill and the provision of the Oil Pollution Act of 1999 (OPA) and a legal analysis of service contracts and the principle of vicarious liabilities. What follow is a critical analysis of liability issues in service contracts and the implication of indemnity clauses in contractual negotiations.

The paper will find that indemnification provisions in service contracts will contribute more toward achieving a contractual balance and also is in line with public policy.

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AIPN JOA Association of International Petroleum Negotiators Joint Operating Agreement.
BP British Petroleum
CG Coast Guard
Colum. L Rev Columbia Law Review
F.2d Federal Reporter 2nd Series
F.3rd Federal Reporter 3rd Series
Hous. L.Rev Houston Law Review
LA. REV STAT Louisiana Revised Statute
MODU Mobile Offshore Drilling Unit
NMCA New Mexico Court of Appeal
N.Y. 2d New York 2nd Series
OOC Operating Oil Company
OPA Oil Pollution Act
1. **INTRODUCTION**

The Deepwater Horizon oil spill, one of the world’s worst petroleum disasters was caused by explosions at a Mobile Offshore Drilling Unit (MODU) in the Macondo Prospect; a seabed located about forty-one miles off the southeast coast of Louisiana. The rig was owned and operated by Transocean, the world’s largest offshore drilling contractor. Flagged in the Marshall Island, and leased to British Petroleum (BP), one of the world’s largest energy companies, operator and majority interest holder in the Macondo prospect well located on Mississippi Canyon Block 252 in the Gulf of Mexico. BP employed several service contractors to help in the development of block 252.

Transocean, the largest deepwater oil drilling specialist contractor in the world was contracted by BP to drill at the Macondo prospect well at a rate of $500,000 a day.

Halliburton, one of the world’s largest oilfield services suppliers was hired by BP to oversee the cementing of the oil well casing as well as plugging the wellhead with cement for subsequent oil extraction. Schlumberger performed logging, drilling, and measuring services on behalf of BP. Other
service contractors engaged in the Macondo well development included Anadarko, MI-Swaco and Cameron International who provided the blowout preventer that was said to be faulty.

This tragic incident resulted in the death of eleven SC’s employees, massive damages to natural resources, private property, and livelihoods.

The United States Coast Guard, the agency empowered to investigate oil pollution in the Gulf of Mexico designated both BP and Transocean as the Responsible Parties (RP) under the Oil Pollution Act of 1990 (OPA) for claims purposes. OPA is the primary law governing recovery of removal costs and damages resulting from oil spills. It imposes strict, joint and several liabilities on the owner, demise charterer and operator of a vessel/rig from which oil is discharged into the waters of the United States. BP has agreed and has paid claims resulting from the disaster.

In an action filed at the Federal Court in New Orleans, BP alleges that Transocean caused the deadly blowout because every single safety system and device and well control procedure on the Deepwater Horizon rig failed. BP also alleges that Cameron International who provided a blowout preventer with a faulty design caused an unreasonable amount of risk that harm would occur. BP also sued cement contractor Halliburton alleging fraud, negligence and concealing material facts in connection with its work on the rig.

The international petroleum industry heavily relies upon goods and services obtained from third party vendor and contractors. These service contractors provide a variety of specialized services. A major consideration to facilitating these services is the co-ordination of contract documents and actual performance.

In order for sustainable development to take place in the oil and gas industry, the legal system has to place at the disposal of parties to service contracts the right to contract while regulating the consequences of their actions. The law, however, cannot possibly anticipate the content of an infinite number of atypical transactions into which service contractors may need to enter. Legal framework, therefore, has to give the parties freedom of contract.

The freedom to enter into a contractual relationship in oil and gas development is both moral and profound. It can be effectively argued that the uniformity of terms of contract usually recurring in a service contract is an important factor in calculating risks. Unforeseeable factors causing tortuous acts and liability issues such as the alleged actions of Transocean, Cameron and Halliburton can be effectively taken care of.

Standardized contracts have thus become a necessary tool in eliminating or controlling unanticipated incidents in litigation. It should be noted, however, that they have become a true reflection of the spirit of our time with its hostility to irrational factors in the judicial process, and they belong in the same category as laws.
The first section of this paper will analyze service contracts in the hydrocarbon industry and the principal/agent relationship, this section provides an analysis of the independent contractor relationship with its principal.

The second section will attempt to critically analyze liability issues in service contracts as it relates to the OPA. In addition the paper will look at public policy issues as it relates to damages and the issue of indemnification in service contracts. The effects of anti-indemnity statute in oilfield service contracts will also be examined.

In its conclusion, the paper will find that indemnification provisions in service contract will contribute more toward achieving a contractual balance in the oil and gas industry and also in line with public policy.

2.        CONTRACTUAL RELATIONSHIP

2.1 Service Contracts

Service contractors are the engine that drives petroleum exploration and development around the world and it is also a high risk activity. Major international petroleum companies depend on oilfield service contractors to provide specialized services and technology which supports petroleum production both onshore and offshore, and includes drilling and related services.

In practice, service contractors or individuals work as independent contractors. This means that although they are engaged by the operating companies, they do not work under their control. Within the context of BP’s contractual relationship with its service contractors lies an independent contractor’s relationship.

2.2 Independent Contractor

An independent contractor is distinguished from an agent in that the latter is under the control of the principal, whereas the former is hired merely to perform a specific task or to achieve a certain end result. Consequently, an independent contractor has no power to contractually bind a principal. Additionally, the torts of an independent contractor are not vicariously imputed to the party hiring the independent contractor. It has been argued by some that liability still lies on the principal since he is still the main beneficiary of the enterprise; he selects the contractor and can insist on who is financially responsible and to demand indemnity among others. However, the courts have consistently held that the principals are not vicariously liable for the tortuous acts of the independent contractors unless:

a. The work involved is inherently dangerous in spite of all reasonable care or inherent endangers people passing by on the public way.
b. The person employing the independent contractor interferes with and/or participates in the direction and control of the contractor’s work. Restatement (Second) of Torts §414 imposes employer vicarious liability for an independent contractor’s tort when the employer retains the “right to control the method, manner, and operative detail of the work”, which does not include simply the mere right to inspect or make suggestions.

c. The work delegated was, in fact, a non-delegable duty, e.g. to keep premises, open to the public, reasonably safe. The non-delegable duty exception may be invoked where a particular responsibility is imposed upon a principal by statute or regulation as in the case of OPA in the deepwater horizon spill.

3 OIL POLLUTION ACT

OPA has become the centerpiece of the United States effort to combat oil pollution in the US navigable waters including the exclusive economic zone. The act was enacted as a result of the 1989 Exxon Valdez accident and several other notable oil spills in the US navigable waters. The main objective of this statute is to provide compensation to claimants from oil spill in the United States navigable waters; exclusive economic zone, or shoreline. With the passage of this law congress added to or modified the common law liability system with regards to oil production facilities.

Under this law “each responsible party including owners/operators of vessel or facilities and/or lessee of offshore facilities are liable for (i) oil spill removal costs and (ii) a range of other costs. The damages listed in the statute includes; damages to natural resources, real or personal property, subsistence use of natural resources, lost revenue, lost profits and the increase cost of public services.

The act also provides for an unlimited liability were the spill is determined to have been proximately caused by (i) gross negligence or willful misconduct, or (ii) the violation of an applicable federal safety, construction or operating regulation.

Contractors’ immunity in the OPA is limited. The immunity does not extend to where the incident leading to the spill involved personal injury or wrongful death, or if the contractor is grossly negligent or engages in willful misconduct as indicated in the deepwater horizon spill.

OPA does not prohibit agreements transferring liability as a result of pollution, including oil spills. It should be noted however, that such agreement does not relieve the responsible party of its liability under the act. For example, BP contracting with its service contractors to transfer its responsibility of petroleum production safety will not relieve BP from liability for removal cost and damages under OPA. An agreement may affect indemnity and subrogation rights among others between BP and its service contractors.

4 LIABILITY AND TRANSFER OF RISK

The allocating of risk and liability is generally addressed in the liability and indemnity clause of service contracts. A balanced risk, liability and management clause should not be one sided. Also known as the indemnity clause, this provision shifts responsibility for any liability arising out of the performance of the (service) contract. The RP undertakes to assume any liability that may accrue to the other party through
the performance of the contract. The liability and indemnity clause includes a list of those liabilities which will be assumed, an undertaking of liability by one party to the contract, and the limits on any liability assumed. As a general rule, an operator is not liable for injury to the employees of an independent contractor.

4.1 Indemnification

The principle of Indemnity under common law doctrine allows liabilities to be transferred from one party to another. Black’s law dictionary defines indemnity as (i) a duty to make good any loss, damage or liability another has incurred (ii) The right of an injured party to claim reimbursement for its loss, damage, or liability from a person who has such a duty and (iii) reimbursement or compensation for loss, damage, or liability.

In the context of petroleum development, Dennis C. Stickley in his book, Framework for Negotiating & Managing Petroleum Industry Service Contracts summed it up best where he stated thus, “This clause makes the party giving the indemnity liable to pay compensation for loss or damage that arises from a specific event. It is a means of shifting the financial consequences of an event to another party. The parties may give “cross-indemnities” for loss or damage to their own personnel and equipment under a so-call “knock-for-knock” provision which means that each will be responsible for injury, loss or damage for their own personnel and equipment.”

Aside from the knock-for-knock provision there is also the fault based provision. This is where the assuming party is indemnified for loss caused by his own negligence, strict liability, or other fault. Knock-for-knock indemnities or control based indemnities; unlike the fault based indemnity reduces and sometimes eliminates high cost of litigation between parties to the contract. Responsibility is resolved by looking into the express term in the contract and identifying the assuming party under the circumstance. Suffice it to state; however, that fault based indemnity cannot be completely avoided. Furthermore, it can be negotiated with other terms in the contract.

Indemnity provision in service agreement may also take the form of either held harmless and defend or exculpatory or release from liability clause which limits or exclude a party from liability of its own tortuous act. However, where a party tends to overreach another, the courts have held the contracts as void and contrary to public policy. The US Supreme Court in the Bisso case mentioned above stated that the rationale behind its decision is (a) to discourage negligence by making wrongdoers pay damages and (b) the desire to protect those in need of goods and services from being overreached by others who have the power to drive hard bargains. Exculpatory clause in contracts cannot and should not shield a party contractually from liability for gross negligence.

Usually gross negligence is left to fault, along with intentional or willful misconduct. However, recent service contracts have included gross negligence as negligence in indemnity provisions.

The courts have consistently held that indemnity provisions that are contrary to public policy are unenforceable. Consequently, parties relying on indemnification clauses have the burden of proving that they are not at fault. That is, the contracts are enforceable before the court of law. While a party may
not be primarily liable in a culpable sense, he is liable by contract if the parties have bargained for the terms of indemnity and there is no disparity in bargain power or undue influence.

A body of jurisprudence relating to liability/indemnity clauses is of the view that agreements that impose liability different from that provided by the law should be strictly construed against the drafting party.

4.2 Anti–Indemnity Statutes

Several states place restriction on oilfield service contracts with indemnity clauses, specifically indemnity from one's own negligent acts. Four states, Louisiana, Texas, New Mexico and Wyoming have statutes prohibiting certain indemnity provisions in oilfield service contracts otherwise known as anti-indemnity Acts. The provisions of the four acts are similar in restricting indemnity provision in oilfield agreements.

4.3 Louisiana Statute

Prior to the enactment of the Louisiana anti-indemnity Act, it was generally accepted law to indemnify a party from all acts. However, the courts have consistently held that they will not enforce contracts that are contrary to public policy. This is pursuant to the principle that they injure the public welfare or interest, or are contrary to public decency, sound policy, and good morals. Also the Louisiana anti-indemnity Act sought to remedy the perceived inequity placed upon certain contractors by agreement which purported to indemnify the indemnitee, its agent, employee or independent contractor directly responsible to indemnitee from negligent acts or strict liability.

The Louisiana courts have stated that contracts providing indemnity from indemnitees own negligence is null and void and also contrary to public policy, unless the terms of the agreement clearly express so in unequivocal terms “To determine the scope of the indemnity, courts focus on words such as 'losses resulting out of' or 'losses sustained in connection with' a certain event or condition.”

It has been argued that the real inequity in indemnity contracts is the superior bargaining position held by oil companies over service contractors. However, the courts have held that the promotion of safety is an underlying policy of the act, if a party is liable for its own negligence.

4.4 Texas Statute

Before the enactment of the Texas anti-indemnity act, operating oil companies frequently entered into service contracts with service contractors that require the contractors to indemnify them from both the contractor's negligence as well as that of the operating companies. In a bid to correct this unfair practice the Texas legislature passed its anti-indemnity statute. Like the Louisiana Act, the Texas law also provides that agreements relating to wells for oil, gas, or water, or to mine for a mineral that
attempts to indemnify a party from its own negligence and also resulting from personal injury or death or property damages among others is void and unenforceable.

However, like the Louisiana act the Texas Act provides for similar principle regarding freedom of parties to enter into contract with respect to indemnity. The law provides that indemnification against one’s negligence is not contrary to public policy, provided such intent is expressed in specific terms (otherwise known as the express negligence doctrine). The Texas court rejected the Louisiana statute of clear and unequivocal terms as well as its exceptions.

Article 4.6 (Operator liability) of the Association of International Petroleum

Negotiators Model Form International Joint Operating Agreement (AIPN JOA) is a standard for the drafting of a valid and enforceable indemnity clause that complies with the requirements of the Texas Express Negligence Doctrine.

Also, the Texas statute allows the insurance against own negligence by mandating the Operator to be named as an additional insured. An indemnity agreement is permissible if the parties agree in writing that the indemnity obligation will be supported by liability insurance coverage to be furnished by the party giving the indemnity.

4.5. New Mexico Statute

The New Mexico anti-indemnity law provides that the indemnity clauses in service contracts can be enforced to the extent that those clauses require the contractors to indemnify for liability arising out of the contractors’ negligence. The New Mexico Act does not prohibit indemnity for the partial fault of the indemnitee even if the indemnitee is also partially at fault.

4.6. Wyoming Statute

Like the other anti-indemnity laws, the Wyoming statute prohibits any agreement pertaining to oilfield services that indemnifies a party against its own negligence. The act also allows for partial indemnity to the extent that the indemnitee is not negligent.

5. NEGOTIATING/DRAFTING INDEMNITY PROVISION

Frequently, the object of an indemnity provision is a complete transfer or total shift of all risk connected with the bargained for performance. A conventional indemnity then can be said to be a contract which provides for shifting of responsibility from one person to another. Notwithstanding the application of anti-indemnity laws, in form and substance, a contract of indemnity must clearly set forth its scope and
its legal reach. The area to which the indemnity is to apply, i.e. its scope may include losses resulting out of, or arising from—-or sustained in connection with a specified event or condition.

Negotiation of enforceable contractual indemnities is a significant part of risk management in petroleum development and also a difficult task. Understanding the contractual relationship between an operating oil company and a service contractor is seminal in negotiating and drafting service contracts with enforceable indemnity provisions. One has to look whether or not if the service contractor is an independent contractor or agent to the operating oil company. Once it is determine that the relationship is one of independent contractor with no imputed responsibility, the next issue will be transfer of liability from one party to the other.

The next issue is the determination of the validity and enforceability of the indemnity provision in the agreement before applying the anti-indemnity statutes. If the indemnity provision is enforceable, then there is no recourse to the anti-indemnity statute.

Furthermore, it is also valid to determine the relevant public interest, the conflict between the interest and the contract in question. In deciding public interest, the courts have consistently looked to anti-indemnity provisions as well as acts that injure the public welfare or interest, or are contrary to public decency, sound policy, and good morals.

6. CONCLUSION

The purpose of this research paper was to examine and explain if indemnity clauses in service contracts are contrary to public policy. After an examination of the deepwater horizon disaster in the Gulf of Mexico and the body of jurisprudence regarding indemnity provisions in service contracts, it is evident from the above analysis that proper negotiation and drafting of indemnity clause can be beneficial to both operating companies and service contractors. Operating companies like BP should be vigilant of model contracts that hold operators solely responsible and assume liability for all consequences relating to oil development and exploitation. Also, service contractors should beware of model contracts that hold service contractors liable for liabilities caused by operator’s negligence or fault.

The present liability/indemnification issues dogging BP and its service contractors as a result of the Deepwater horizon disaster would have been less profound if an enforceable and valid indemnity provision is included in the service contract.

Also, as a matter of fact, the choice of forum clause or applicable law is paramount in negotiating and drafting service contract. The forum clause provides for a particular jurisdiction where parties agree in advance that a dispute concerning the contract can be resolved. Close attention should be paid to the applicable or governing law that is agreed by the parties. The applicable or governing law will impact the drafting and enforceability of the provisions of the contract. It should be noted, however, that choosing the Texas, Louisiana as well as New Mexico and Wyoming as the governing law may not be enforceable. These states have anti-indemnity Acts that inhibits freedom of contract regarding indemnities. However,
the State of Oklahoma, the United Kingdom and Province of Alberta have better choices as they have a more extensive jurisprudence on oil and gas law.

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