Limiting Liability in the Oilfield

By Catherine L. Campbell and Thomas G. Wolfe.
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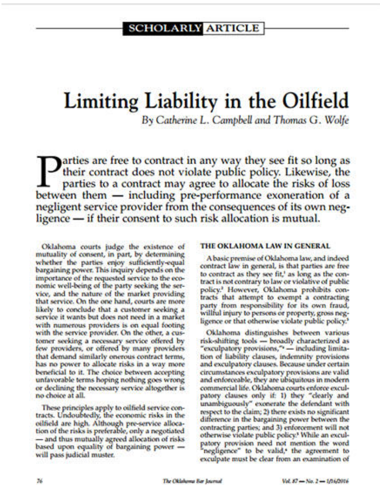
SCHOLARLY ARTICLE

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Oklahoma courts judge the existence of mutuality of consent, in part, by determining whether the parties enjoy sufficiently-equal bargaining power. This inquiry depends on the importance of the requested service to the economic well-being of the party seeking the service, and the nature of the market providing that service. On the one hand, courts are more likely to conclude that a customer seeking a service it wants but does not need in a market with numerous providers is on equal footing with the service provider. On the other, a customer seeking a necessary service offered by few providers, or offered by many providers that demand similarly onerous contract terms, has no power to allocate risks in a way more beneficial to it. The choice between accepting unfavorable terms hoping nothing goes wrong or declining the necessary service altogether is no choice at all.

These principles apply to oilfield service contracts. Undoubtedly, the economic risks in the oilfield are high. Although pre-service allocation of the risks is preferable, only a negotiated — and thus mutually agreed allocation of risks based upon equality of bargaining power — will pass judicial muster.

THE OKLAHOMA LAW IN GENERAL

A basic premise of Oklahoma law, and indeed contract law in general, is that parties are free to contract as they see fit,[1] as long as the contract is not contrary to law or violative of public policy.[2] However, Oklahoma prohibits contracts that attempt to exempt a contracting party from responsibility for its own fraud, willful injury to persons or property, gross negligence or that otherwise violate public policy.[3]

Oklahoma distinguishes between various risk-shifting tools — broadly characterized as "exculpatory provisions,"[4] — including limitation of liability clauses, indemnity provisions and exculpatory clauses. Because under certain circumstances exculpatory provisions are valid and enforceable, they are ubiquitous in modern commercial life. Oklahoma courts enforce exculpatory clauses only if: 1) they "clearly and unambiguously" exonerate the defendant with respect to the claim; 2) there exists no significant difference in the bargaining power between the contracting parties; and 3) enforcement will not otherwise violate public policy.[5] While an exculpatory provision need not mention the word "negligence" to be valid,[6] the agreement to exculpate must be clear from an examination of

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As for equality in bargaining, courts have traditionally concluded that public policy forbids enforcement of exculpatory provisions in 1) bailment contracts, 2) employment contracts, 3) contracts with common carriers, 4) contracts with innkeepers and 5) utilities contracts.9 In these instances, courts perceive that the service provider enjoys vastly superior bargaining power over the consumer. Not incidentally, these service providers often use adhesion contracts – "standardized contract[s] prepared entirely by one party to the transaction for the acceptance of the other."[10] Adhesion contracts are take-it-or-leave-it since "the services that are the subject of the contract cannot be obtained except by acquiescing to the form agreement."[11] By definition, the parties to an adhesion contract do not share equal bargaining positions.[12]

That a contract is one of adhesion (with the consequent presumption of lack of equal bargaining power) is not sufficient, standing alone, to invalidate an exculpatory provision. Instead, Oklahoma courts require evidence of something more than a slight disparity in bargaining power between the parties to nullify an exculpatory provision. When the disparity of bargaining power renders the freedom to contract illusory, an exculpatory clause is unenforceable.

In *Trumbower v. Sports Car Club of America, Inc.*,[13] the court recognized guidelines for determining whether the contracting parties enjoy relatively equal bargaining positions. First, courts should “generally consider categories of individuals rather than a particular individual.”[14] Second, courts must weigh “the importance which the subject matter of the contract has for the physical or economic well-being of the party agreeing to release the other party.”[15] And, the court must consider “the existence and extent of competition among [service providers] measured by the amount of free choice the [consumer].”[16]

Applying *Trumbower*, Oklahoma courts have enforced exculpatory provisions when the activity at issue is a hobby or sport.[17] Moreover, the releasing party is not forced to use a particular vendor or, ultimately, to engage in the activity.[18] Correspondingly, Oklahoma courts have approved exculpatory provisions where the contracting party presumably had wide choice in service providers.[19]

Some jurisdictions presume that commercial parties generally enjoy equal bargaining power while assuming that ordinary consumers do not.[20] However, Oklahoma law mandates that courts consider the economic realities of the transaction, not the parties’ relative sophistication. Each case stands on its own facts.[21]

OKLAHOMA LAW AS APPLIED TO OILFIELD SERVICE CONTRACTS

All or some variation of the recognized risk-shifting mechanisms – releases, limitation of liability clauses, and indemnity provisions – “are widespread in oilfield contracts” since, like most businesses, providers and consumers of oilfield services benefit from assuring clear allocation of risks at the outset of the contractual relationship.[22] Some oilfield contracts contain indemnity provisions (also known as knock-for-knock provisions) that require each party to assume all risk associated with its equipment and personnel regardless of fault.[23] Often, the parties contemplate that they will insure their respective contractual obligations.[24] Other oilfield contracts treat service providers more favorably.[25] Finally, operators may use master service agreements with contractual terms favorable to them and which allow them to contract with service providers before any work is performed, ideally permitting the parties to negotiate terms in a lower pressure environment.[26]

Oilfield exculpatory clauses are typically clearly delineated and, in any case, are well known in the industry.[27] Therefore, courts may conclude that such agreements "clearly and unambiguously" exonerate the intended party. Nonetheless, as three cases applying Oklahoma law demonstrate, because pre-work risk allocation in the oilfield is legally appropriate only when it results from relative arm's length bargaining, the economic reality of the bargaining positions between the parties is the paramount consideration.

In *Mohawk Drilling Co. v. McCullough Tool Co.*,[28] while performing "specialized" work on Mohawk's well, McCullough lost equipment downhole requiring Mohawk to rework the well. The purchase order stated that McCullough "shall not be held liable or responsible for any loss, damage or injury" to the well resulting from the work it performed.[29] The evidence showed that, because other companies that could have performed the same specialized work used contracts containing similar exculpatory language, the well owner could not obtain the necessary service without exculpating the service provider.[30] Although *Mohawk* predates *Schmidt*,[31] the *Mohawk*court employed the same factors – economic necessity of the requested service and availability of the service in the market free of exculpatory provisions – in determining that McCullough "enjoyed much greater bargaining strength" so that the exculpatory contract was “against [Oklahoma] public policy.”[32]

More than 30 years later, in *Kinkead v. W. Atlas Int’l, Inc.*,[33] Kinkead orally contracted with Western to remove the drill string when it became impacted in the borehole. Before Kinkead executed a written work order, Western lost the drill string in the casing which ultimately resulted in abandonment of the well. First, since the evidence showed that the exculpatory language at issue was common in the industry, the court rejected Kinkead’s argument that the oral agreement with Western did not contain the same exculpatory language as the written agreement.[34] Second, Western offered evidence that Kinkead could have contracted with other companies that either did not require, or would have negotiated to remove or modify, similar exculpatory language. Consequently, impliedly weighing the same factors as the *Mohawk* court, the court concluded that the evidence was sufficient to sustain the jury verdict for Western.[35]

Finally, in *Arnold Oil Props., LLC v. Schlumberger Tech. Corp.*,[36] Arnold contracted with Schlumberger, whose contract contained both a knock-for-knock indemnity provision and a limitation of liability clause. The court concluded that the evidence at trial was sufficient to support the jury’s determination that Arnold and Schlumberger were in unequal bargaining positions because: 1) the service was “critical” to Arnold’s operations; 2) a limited number of providers could perform the services and/or most if not all providers used similar exculpatory language; and 3) the exculpatory terms of three other providers’ contracts were non-negotiable.[37] The court further noted that Schlumberger’s contract did not permit the customer to bargain for a higher limit on liability.[38]

A review of cases applying Oklahoma law reveals that chief among the factors to be resolved in determining whether to enforce an exculpatory provision in an oilfield contract is the number of service providers and whether most, if not all, service providers demand inclusion of similarly burdensome exculpatory provisions. If providers in the market insist on the same contractual provisions, without meaningful negotiation and as a pre-condition to performing economically essential services, the contract clause is unenforceable. The size and sophistication of the provider relative to the customer is not pertinent to the inquiry. Though the customer may eventually opt to accept the offered terms from the provider rather than pay a higher contract price, it must be given a meaningful opportunity to do so. In the absence of the opportunity to negotiate terms, there is no mutual consent.

Oklahoma is not alone in recognizing the fundamental importance of economic reality in oilfield risk allocation. According to *USA Today*, as of Dec. 31, 2011, Texas had the most oil reserves of any state in the country while Louisiana had the 10th highest.[39] To level the playing field between powerful producers and the less powerful contractors who, though forced to indemnify the producers against their own negligence could not procure insurance to adequately cover the risk, both states enacted statutes that generally void oilfield indemnity clauses.[40] Louisiana and Texas made public policy choices based not on the contracting parties' knowledge and sophistication, but on the perceived inequality of bargaining between equally sophisticated commercial entities. Though not codified in statute, Oklahoma law is similar.

CONCLUSION

Undoubtedly, form contracts and industry custom reflect past economic conditions in the oilfield; but, the market for oilfield services is far from static. In recent years, oil and gas production in the United States has markedly increased. During periods of lower production service providers may be more willing to compete for work and more willing to accept greater risk. It is equally true that, during periods of higher production, demand for services outstrips supply, increasing competition for scarce resources. These market factors are magnified when the services provided are highly specialized – which means a decreased number of available service providers.

Oklahoma case law prudently elevates economic realities over industry custom. Where the service purchaser's ability to obtain an essential service is limited either because there are few providers and/or because most providers require acceptance of the same non-negotiable exculpatory language, exculpatory agreements may be unenforceable. Thus, in terms of commercial entities, knowledgeable in the field, the decisive factor is not whether the exculpatory language is unequivocally clear. Instead, at issue is the economic reality underlying the presumed freedom of the parties to strike a deal.

In Oklahoma no party is forced to insure against risks for which it was not afforded a chance to bargain. It is unfair to shift the burden of loss to the operator when it has no power to protect itself. Oklahoma case law is clear: each party to a contract must be allowed to balance the risks against the cost of the service provided. A contract which deprives the party of its freedom to negotiate risk allocation likely violates Oklahoma law.

1. *E. Cent. Elec. Coop. v. Pub. Serv. Co.*, 1970 OK 80, 469 P.2d 662, 664.
2. *Ball v. Wilshire Ins. Co*., 2009 OK 38, 221 P.3d 717, 724, 726.
3. OKLA. STAT. tit. 15, §212.
4. *Schmidt v. United States*, 1996 OK 29, 912 P.2d 871, 874.
5. *Kinkead v. W. Alliance Int'l*, 1993 OK CIV APP 132, 894 P.2d 1123, 1128.
6. *See Estate of King v. Wagoner County Bd. of County Comm'rs*, 2006 OK CIV APP 118, 146 P.3d 833, 844.

7. *Otis Elevator Co. v. Midland Red Oak Realty, Inc*., 483 F.3d 1095, 1105 (10th Cir. 2007).
8. *Mercury Inv. Co. v. F.W. Woolworth Co.*, 1985 OK 38, 706 P.2d 523, 530.
9. Stacy A. Silkworth, *Note: The Pilotage Clause: Albatross of Admiralty Law*, 64 B.U. L. Rev. 823, 848-49 (July 1984); *see, e.g., Sun Oil Co. v. Dalzell Towing Co.*, 287 U.S. 291, 294 (1932); *Bisso v. Island Waterways Corp*., 349 U.S. 85, 90-91 (1955).
10. *Bilbrey v. Cingular Wireless, L.L.C.*, 2007 OK 54, 164 P.3d 131, 135.
11. *Wilson v. Travelers Ins. Co.*, 1980 OK 9, 605 P.2d 1327, 1329.
12. *See, e.g., Max True Plastering Co. v. U.S. Fid. & Guar. Co*., 1996 OK 28, 912 P.2d 861, 864.
13. 428 F. Supp. 1113, 1117 (W.D. Okla. 1976).
14. *Id*. (citation omitted).
15. *Id. See also* 57A Am. Jur. 2d *Negligence* §62 (noting that "a seller must offer a service that is usually deemed essential in nature").
16. *Id. See also Allen v. Michigan Bell Tele. Co.*, 171 S.W.2d 689, 692 (Mich. App. 1969) ("[W]here goods and services can only be obtained from one source, or several sources on non-competitive terms, the choices of one who desires to purchase are limited to acceptance of the terms offered or doing without. Depending on that nature of the goods or services and the purchaser's needs, doing without may or may not be a realistic alternative.").
Additionally, the *Trombower* approach is consistent with the RESTATEMENT (SECOND) OF TORTS §496B. Comment j states that "disparity in bargaining power may arise from the defendant's monopoly of a particular field of service, from the generality of the use of contract clauses insisting upon assumption of the risk by all those engaged in such a field, so that the plaintiff has no alternative possibility of obtaining the service without the clause; or it may arise from the exigencies of the needs of the plaintiff himself,

which leave him no reasonable alternative to the acceptance of the offered term."

17. *See Schmidt, supra* at n. 4, 912 P.2d at 873 n. 7, 874 n. 18 (recreational horseback riding); *Manning v. Brannon*, 1998 OK CIV APP 17, 956 P.2d 156, 159 (parachuting); *Martin v. A.C.G., Inc.*, 1998 OK CIV APP 148, 965 P.2d 995, 997 (health club). These activities are not "necessary or important to [the contracting party's] physical or emotional well-being,"*Manning*, 956 P.2d at 159.

18. *Martin*, 965 P.2d at 997.

19. *Rodgers v. Tecumseh Bank*, 1988 OK 36, 756 P.2d 1223, 1226 (noting that a commercial loan agreement was not an adhesion contract since borrowers have a choice of loan providers, and the evidence showed that the parties actually negotiated the terms of the agreement in an arms-length transaction).

20. *See, e.g., Henry Heide, Inc. v. WRH Prods. Co., Inc*., 766 F.2d 105, 109 (3d Cir. 1985).

21. *Elsken v. Network Multi-Family Security Corp.*, 1992 OK 136, 838 P.2d 1007, 1010; *Thompson v. Peters*, 1994 OK CIV APP 97, 885 P.2d 686, 688; *Trumbower, supra* at n. 13, 428 F. Supp. at 1117; *Kinkead, supra* at n. 5, 894 P.2d at 1128.

22. *Chesapeake Operating, Inc. v. Nabors Indus., USA, Inc*., 94 S.W.3d 163, 167-68, 180 (Tex. App. 2002).

23. *Id*. at 167. The Association of International Petroleum Negotiators (AIPN) 2002 International Model Well Services Contract indemnity provisions state that the indemnities are non-fault. See Chidi Egbochue & Herbert Smith, "Reviewing 'Knock for Knock' Indemnities Following the Macondo Well Blowout," http://goo.gl/yJY9SG.

24. The AIPN 2002 International Model Well Services Contract allows the parties to arrange for self-insurance or insurance.*See* Egbochue & Smith, *supra* n. 23. Similarly, the IADC form drilling contract recognizes that the parties may allocate risk via the purchase of insurance; Andrew R. Thomas, "Service Contracts in the Oil and Gas Industry," Energy Policy Center, Levin College of Urban Affairs

Cleveland State University, December 2013, at 4. http://goo.gl/1be1EN.
As the court, in *Appalachian Ins. Co. v. McDonnell Douglas Corp.*, 262 Cal. Rptr. 716, 731 (Cal. Ct. App. 1989), noted in a complex commercial case:
[I]t was not commercially unreasonable for the parties to agree [Customer] would obtain insurance to protect it against the risk of loss rather than to have [Contractor] warrant performance….As a practical matter, it was a question of whether [Customer] wanted to directly pay for insurance by obtaining insurance itself or indirectly pay for insurance by requiring [Contractor] obtain the insurance and give a warranty.
In *Appalachian Ins. Co.*, Western Union hired McDonnell Douglas, one of two companies providing the service, to launch a communications satellite. Western Union chose McDonnell Douglas as the cheaper and more reliable option though both companies were available to launch on Western Union's schedule. *Id*. at 729. Importantly, despite the limited number of service providers in the highly specialized market, the parties negotiated the terms of their contract including the exculpatory language. *Id*. The evidence showed that the contract resulted from an arms-length transaction between equals. *See also Chi. Steel Rule & Die Fabricators Co. v. ADT Security Sys.*, 763 N.E.2d 839, 845 (Ill. Ct. App. 2002) (observing that there existed no evidence of disparate bargaining power between the commercial entities when 1) the provider was not the only alarm system provider in the market, and 2) the parties' contract allowed the customer to pay more so that the provider would assume more risk indicating that the customer had the opportunity to negotiate to shift the risk).
25. *See* Thomas, *supra* at n. 24, at 4 (noting that the International Association of Drilling Contractors form drilling contract generally favors drillers by placing responsibility for damages to the rig on the operator).
26. *See* William W. Pugh & Harold J. Flanagan, "Master

Service Agreements and Risk Allocation: In Whose Good Hands Are You?” https://goo.gl/2QW901; Thomas, *supra* at n. 24, at 1.

27. *Kinkead, supra* at n. 5, 894 P.2d at 1126.

28. 271 F.2d 627, 632 (10th Cir. 1959).

29. *Id*. at 629.

30. *Id.* at 632.

31. *Schmidt, supra* at n. 4, 912 P.2d at 874.

32. *Id.* (citing an unpublished Oklahoma Supreme Court case in predicting how the Oklahoma courts would rule on the issue).

33. 1993 OK CIV APP 132, 894 P.2d 1123.

34. *Id.* at 1127-28.

35. *Id.* at 1128.

36. 672 F.3d 1202 (10th Cir. 2012).

37. *Id.* at 1208.

38. *Id.* at 1209.

39. Paul Ausick & Michael B. Sauter, “The 10 Most Oil-Rich States,” *USA Today*, Aug. 3, 2013, http://goo.gl/zBHfTW.

40. *See* Louisiana Oilfield Indemnity Act, LA REV. STAT. ANN. §9:2780 and Texas Oilfield Anti-Indemnity Act, TEX CIV. PRAC. & REM. CODE ANN. §127.001. *et seq. See also Fontenot v. Chevron U.S.A.*, 676 So.2d 557, 562 (La. 1996) and*Ken Petroleum Corp. v. Questor Drilling Corp.*, 24 S.W.3d 344, 348 (Tex. 2000). While top-10 producers New Mexico and Wyoming also enacted similar statutes (New Mexico Oilfield Anti-Indemnity Act, N.M. STAT ANN. §56-7-2 and Wyoming Oilfield Anti-Indemnity Act, WYO STAT. §30-1-131 *et seq.*), both did so to promote worker safety. *Pina v. Gruy Petroleum Mgmt. Co.*, 136 P.3d 1029, 1033 (N.M. 2006) *Union Pac. Res. Co. v. Dolenc*, 86 P.3d 1287, 1292 (Wyo. 2004).

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