MANAGING THE LIFE CYCLE OF SHALE PROJECTS

Operating Agreement
Models for Unconventional Shale Projects

Re-Evaluating Your Drilling Contracts
Precision Drilling Canada Limited Partnership vs Yangarra Resources Ltd.

Inability to Withhold
Payments under Processing Agreements Where Prior Billings Arguable
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Knock-for-Knock Indemnification Clauses in the Oil and Gas Industry

THE OIL AND GAS INDUSTRY IN ALBERTA AND INTERNATIONALLY IS LARGELY GOVERNED BY STANDARD FORM CONTRACTS. These types of agreements provide certainty and efficiency to contractors and operators alike, on the assumption that the parties have read and fully understand the implications of entering into such a contract. However, a recent decision of the Alberta Court of Queen's Bench illustrates how even sophisticated entities can be caught off guard by the practical results of the provisions in standard form drilling contracts. In Precision Drilling Canada Limited Partnership v Yangarra Resources, 2015 ABQB 433, the court upheld a bilateral no fault contract between a contractor and an operator, resulting in multi-million dollar losses for the operator.

This case illustrates that Alberta courts have been more than willing to hold experienced and sophisticated commercial entities to their agreements, and serves as a cautionary tale for industry to be fully informed about what is contained in its contracts, especially those that purport to allocate liability in a particular manner.

In this case Yangarra Resources Ltd. (“Yangarra”), an oil and gas operator, contracted with Precision Drilling Canada Limited Partnership (“Precision”) to drill two wells. The agreement between the parties was governed by a bilateral no fault contract, or reciprocal indemnity agreement. Agreements such as these are commonly referred to as “knock-for-knock” contracts because, pursuant to the contract, each party agrees to bear the risk of damage to its own assets even if its assets are destroyed or damaged by the fault of the other.

The losses to Yangarra occurred during the drilling of the second well when an employee of Precision improperly mixed the drilling mud. Precision employees then “neglected to test or carelessly tested the drilling mud and wrongly advised Yangarra’s supervisor that the drilling mud was in order.” During drilling, the drill string and bit subsequently became stuck in the hole and could not be extracted, resulting in equipment losses to Yangarra of approximately $300,000.00. It was assumed these losses were due to the use of the improperly mixed drilling mud. Yangarra also incurred additional expenses in the amounts of $720,000.00 in attempts to retrieve the drill string and bit and $2.5 million to drill a replacement well.

This decision may be surprising to some as Precision successfully sued Yangarra for all of its fees, including the extra expenses incurred in fishing operations and to drill the replacement well. Yangarra was required to pay the full amount of Precision’s bill and was not able to set off any of its losses. This scenario was made possible by the wording of the knock-for-knock drilling contract. The contract provided that Yangarra was to assume all of the risk of damage to its equipment or the hole “regardless of the negligence or other fault of Precision or howsoever arising.” The contract further provided that Yangarra was to assume all of the risk of and be solely liable for the cost of repairing and re-drilling a lost or damaged hole, including, without limitation, the cost of fishing operations, regardless of the negligence or other fault of Precision or howsoever arising.

The court relied on a plain language reading of the agreement to find that Yangarra was required to assume all of the losses caused by Precision. Yangarra was also required to pay for Precision’s day work. Yangarra attempted to counterclaim against Precision for the losses it suffered based on arguments of negligence, gross negligence, breach of contract, negligent and fraudulent misrepresentation and unjust enrichment. However, under the contract, Yangarra had released Precision from any and all claims based on negligence or any other theory of legal liability. The court was not willing to overturn the clear intentions of the contract or find a carve-out the parties did not specifically agree to. The ultimate question asked by the court and those who have read this decision is: “why would anyone knowingly make such a contract?”

Oil and gas companies around the world rely on model forms. As commentators have noted, this practice “saves the parties time and transaction costs and gives comfort that they are using documents with which they are already familiar.” One of the most common provisions of a standard form oil and gas service contract is the apportionment of liability or knock-for-knock provision. These types of agreements have become common in the oil and gas industry because they can offer significant benefits to all parties, such as reduced costs with respect to litigation, increased certainty with respect to risk allocation, and decreased friction between multiple parties at a wellsite. However, the Precision case is an example of the most significant drawback of the knock-for-knock regime: the requirement for a contracting party to assume liability for damage for which it is not responsible.

Depending on the jurisdiction, courts have taken different approaches with respect to the enforcement of knock-for-knock indemnification clauses. For example, there is legislation in place in the United States that generally prohibits indemnification for an indemnitee’s own negligence. In addition, some courts have raised the issue of public policy with respect to the enforcement of knock-for-knock provisions. In the Precision case Yangarra attempted to make the public policy argument that the enforcement of the knock-for-knock provisions would encourage negligent and grossly negligent behaviour in the oil and gas industry, therefore placing...
the public at risk. However, the Alberta court made clear that Precision and Yangarra were sophisticated commercial entities with equal bargaining power who had significant motivation to avoid negligent behaviour; the court determined that enforcing the knock-for-knock contract under those circumstances was neither unconscionable nor contrary to public policy.

As might be expected, negotiating knock-for-knock indemnification provisions can be a time consuming and heated endeavour. Part of this negotiation process often involves the carve-out of specific circumstances in which liability will be apportioned to each party. For example, a knock-for-knock contract may have a carve-out for negligence or gross negligence. One of the key factors in this decision was that the contract provided indemnification for damage based on any theory of legal liability. In Canada, there is no legislation in place which prohibits this type of broad indemnification clause. In the Precision case the court found that the indemnity clause covered all heads of damage advanced by Yangarra and concluded that the indemnity clause would only be unenforceable in circumstances in which intentional harm was inflicted.

As discussed, standard form contracts (some complete with knock-for-knock provisions) are common in the oil and gas industry worldwide. These types of agreements are often drafted by experts over many years and negotiated with certain purposes in mind. For example, if we look slightly closer to home, the CAPL 2007 Operating Procedure is a widely used and accepted standard form document. The Operating Procedure is by all accounts a “norm based” standard form document and was designed by its drafters to serve “typical” situations and transactions (remember $90.00/bbl oil?), all in an acknowledged environment of ever-increasing non-typical situations and transactions. Modifications to the norm were expected to address special circumstances and efforts were made (see the inclusion of special related annotations to assist users in recognizing areas for which modifications might be appropriate) to highlight this potential need and to facilitate special circumstance customization. However, to understand when modifications to a standard form document are necessary, one first has to completely understand what the norm is and what the standard form document purports to do. I have it on good authority that it was never the drafters intention to create a document that could be mindlessly stapled onto a generic and one-size-fits-all head agreement. Quite the contrary in fact. The situation faced by Yangarra with respect to the use of a standard form drilling contract should cause every reader to reach to their shelf to review the liability provisions of the Operating Procedure.

In the Precision case, the contract used by the parties was not a CAPL standard form document, but instead was negotiated between the Canadian Association of Oilwell Drilling Contractors and the Canadian Association of Petroleum Producers. As cautioned, contractors and operators alike must still carefully consider and fully understand the provisions of such contracts, including the liability and release provisions they are committing to. For example, parties might turn their minds to allocating certain risks between them instead of
releasing each party completely. One way parties can accomplish this is to identify in advance certain circumstances in which one party has complete control of a particular aspect of the job and carve out an exception to the knock-for-knock contract that allocates responsibility to such a party. In this instance the parties had the opportunity to allocate some risk to Precision, which might have covered the preparation of the drilling mud. However, the contract used by Precision and Yangarra noted that the risk allocated to Precision would be “nil.” If parties do proceed with the broad form of indemnification they need to consider whether there are gaps in their insurance coverage which a knock-for-knock contract might expose. Additionally, parties should be aware of how the indemnification clauses in their agreements interact with the contract’s payment terms. Here the parties agreed that Precision would be paid day rates, which resulted in additional losses for Yangarra due to Precision’s continued work at the wellsite. A requirement for Precision to drill a complete well may have resulted in reduced losses to Yangarra. Finally, operators headquartered in jurisdictions outside of Alberta with a different approach to the interpretation of indemnification clauses should carefully consider choice of law clauses in their standard from agreements. The results of this case indicate that Alberta courts may hold sophisticated commercial entities to their agreements and will not hesitate in enforcing them, whatever the result may be.

Kourtney Rylands

Notes
1. Trent Mercier, Josh Kane, and Sharbil Nammour, “Drafting Oilfield Master Service Agreements”, 52 Alta L Rev 245 (2014) at p 247 [Drafting Oilfield Master Service Agreements].
2. Precision Drilling Canada Limited Partnership v Yangarra Resources, 2015 ABQB 433 at para 5 [Precision v Yangarra].
3. Ibid at para 17.
4. Ibid at para 11.
5. Ibid at para 29.
6. Ibid at para 36.
7. Ibid at para 44.
9. Model Oil and Gas Services Contracts, supra note 10 at p 333; Drafting Oilfield Master Service Agreements, supra note 1 at p 255.
12. Ibid at p 247.
13. Precision v Yangarra, supra note 2 at paras 101-112.
15. Precision v Yangarra, supra note 2 at para 37.
16. Precision v Yangarra, supra note 2 at para 5.
17. Reciprocal Indemnification Agreements, supra note 12 at p 231.
18. Precision v Yangarra, supra note 2 at para 30.