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April 2021

Look Before You Leap: Are Your Oil Patch Liability Clauses Enforceable?

An Analysis Under Civil Law Jurisdictions with Emphasis on Brazil[1]

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Among the many risks of doing business in the oil and gas industry, perhaps the most precarious is wellsite liability, which has the potential to havefor participants to spending more time litigating mishaps than finding and producing oil. This article analyzes common risks the laws of a civil law jurisdiction to a Wellsite Contract.

I. INTRODUCTION

The oil and gas industry requires huge investments involving extraordinary financial, environmental and safety risks. Dramatic images of the Deepwater Horizon (Gulf of Mexico, 2010); Alpha Piper (Scotland, 1988); P-51 (Brazil, 2001); and Campeche (Mexico, 1979) disasters offer chilling reminders of the monumental loss of life, property and environmental integrity that can quickly result from human error. Once the first responders have performed their heroic well control feats, and perhaps even before, armies of lawyers wage war to transfer liability from their clients to others. With this backdrop, industry participants and their insurers learned early on that the normal fault-based approach to wellsite liability did not fit the nature and needs of the petroleum business. Rather, it ran the risk that operators and their various service companies would spend more time and effort suing each other over inevitable mishaps than finding and producing oil.

This article will analyze the risks inherent in applying the laws of a civil law jurisdiction to a Wellsite Contract.[4] We will assume that the reader is contemplating the negotiation of a Wellsite Contract subject to the laws of a civil law jurisdiction, such as Brazil, and needs to understand the relevant implications in order to devise a mitigation strategy.

II. BACKGROUND

Wellsite Contracts need to predict and effectively address the oil patch realities described in Section I. Based on industry experience, a complex system of liability and indemnity clauses ("Standard Approach") has developed, including what are called "knock-for-knock" ("K4K") provisions.[5] The Standard Approach is designed to allocate various types of liabilities between operators and contractors in a way that (i) avoids litigation, (ii) focuses on ability to control, (iii) dovetails with insurance coverage and (iv) balances risk and reward. Indeed, the Standard Approach tends to reflect economic reality and arguably is more concerned with efficient allocation of risk than assignment of fault.

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Wellsite Contract liability provisions are largely based on common law principles and work particularly well in common law jurisdictions. Thus, contracting parties typically prefer, when operating in civil law jurisdictions, to apply the law of England and Wales[6] to Wellsite Contracts. English law is favored because it is (i) generally regarded as user-friendly,[7] (ii) particularly well suited to interpreting the nuances of a contract drafted in English,[8] (iii) flexible, pragmatic and commercially minded, seeking to uphold freedom of contract and (iv) provides a healthy body of oil and gas case law.[9] In addition, English courts are highly respected for their independence, efficiency, predictability and probity.

On the other hand, operators and contractors alike generally avoid applying the laws of civil law jurisdictions to Wellsite Contracts, even when operations take place in such countries. This is due primarily to the differing approach to liability between common law and civil law jurisdictions, given that the civil codes of these jurisdictions often feature rigid fault-based allocation of risk. Nonetheless, the courts of some civil law jurisdictions have favorably viewed K4K provisions and upheld their application to Wellsite Contracts.

Most National Oil Companies ("NOC"s) insist on having their national law govern Wellsite Contracts that they enter. Typically, the matter is not negotiable, and contractors need to reflect that requirement in their Wellsite Contract risk and cost analyses.

III. STANDARD APPROACH

"A person may cause evil to others not only by his actions but by his inaction, and in either case he is justly accountable to them for the injury."

– John Stuart Mill[10]

As indicated above, K4K clauses are designed to streamline the allocation of liability among parties to Wellsite Contracts arising from tortious events and thus minimize related litigation. The Standard Approach works well when the stakes are low and factual clarity is high.

K4K began to emerge in the late 1960s, presumably based on (i) the highly dangerous nature of petroleum operations, (ii) the stark difference in size and profit potential of industry participants and (iii) the desire to reduce litigation. K4K generally assigns liability to the "owner" of property and the "employer" of personnel. Under the Standard Approach, each party, regardless of fault, agrees to protect and indemnify the other against (i) all damage to the indemnifying party´s property and (ii) all injury to or death of its personnel. Many contracts expand K4K through a complex system of cross-indemnities. When fully implemented, all entities involved in an oil and gas operation participate in the cross-indemnity arrangement, indemnifying each other from harm to their own property and personnel.

The Standard Approach is generally considered the best and most efficient model of risk allocation and liability distribution for oilfield services contracts. It has long been incorporated into most model forms developed by independent associations, including the AIPN and major industry players. The Standard Approach arguably (i) simplifies contract negotiation, (ii) reduces litigation, (iii) facilitates contract administration, (iv) allocates liability according to financial ability and reward, and (v) ultimately contributes to cost savings. Typically, the parties to a Standard Approach Wellsite Contract will purchase insurance coverage for some of their assumed risks, typically providing mutual waivers of subrogation and third-party assured status.

IV. TRADITIONAL NOTIONS OF LIABILITY (*RESPONSABILITÉ*) UNDER CIVIL LAW

"Every right implies a responsibility; Every opportunity, an obligation, Every possession, a duty."

– John D. Rockefeller[11]

Under civil law, the general rule for liability is that any person, whether natural or legal, is liable (*obligatio*) for breaching an obligation that causes damages to another party (*debitum*). Thus, any damage should be compensated, provided that the underlying obligation is not unlawful.[12]

In order to establish a duty to remedy damages, the following elements must exist: (i) a duty of care, (ii) a breach of such duty and (iii) the damages claimed were caused by the breach.[13] The conduct that

triggers the responsibility to remedy may be an act or an omission. A fourth element, fault, may be required depending on the particular matter protected at law (e.g., consumer relations and environmental issues).[14]

There are two sources of civil liability: (i) those arising from the breach of an obligation established by an agreement (i.e., contractual liability) and (ii) those derived from the breach of an obligation established by law (i.e., extra-contractual liability).

Regarding the contractual liability, the *pacta sunt servanda* principle holds the parties true to the contracted terms and conditions; thus, any breach of contract is considered fault. In summary, contractual liability arises from noncompliance with the terms and conditions of an enforceable contract. Damages may also lie for breach of ancillary obligations, such as good faith.[15]

Extra-contractual liability derives from the Roman law *lex aquilia*, which established the ability to "assign blame for unjustly caused damage, regardless of a pre-existing contractual relation between the parties."[16] In essence, extra-contractual liability derives solely from operation of law without the need for contractual privity.

However, in certain instances, such liability and the corresponding right to seek damages are limited or even excluded, such as: (i) enforcement of vested rights; (ii) necessity; (iii) exclusive guilt of the victim; (iv) third-party factor; (v) force majeure; (vi) limitation of liability clauses and (vii) liquidated damages.

V. CHOOSING APPLICABLE LAW AND MITIGATING THE EFFECTS

"Risk comes from not knowing what you're doing."

– Warren Buffett[17]

There are three basic scenarios in which the laws of a civil law jurisdiction might be applied to a Wellsite Contract: (i) the operator is an NOC that insists on applying domestic law, (ii) the operator is an International Oil Company ("IOC") headquartered in a non-common law jurisdiction that prefers applying laws of its home nation or those of the country where operations will take place and (iii) the contractor wishes to apply the laws of a non-common law jurisdiction perhaps for "home turf" or enforceability reasons. In scenario (i) and, to a lesser extent, scenario (ii) the operator may also insist on "take it or leave it" acceptance of its standard Wellsite Contract.

Each of the scenarios described in the preceding paragraph requires customized legal and commercial analysis based on the relevant circumstances. Nonetheless, some or all of the following risk mitigating strategies may prove useful in a given situation.

1. LEGAL OPINION

An obvious first step is to seek legal advice regarding the enforceability of proposed K4K and other provisions in the relevant Wellsite Contract. Ideally, chosen counsel will be both well versed in the theory of *responsabilité* and familiar with Wellsite Contracts. In addition to reviewing any on-point case law and jurisprudence, counsel should also consider analogous legal or administrative rulings upholding other types of clauses familiar to the petroleum industry but alien to the jurisdiction in question.

2. LIABILITY LIMITS

If contractor's counsel opines that K4K clauses would not be enforceable in the relevant jurisdiction, the inclusion of limitations on liability should be considered as an alternative. Rather than requiring one party to indemnify the other party for the latter's own negligence, a limitation on liability simply relieves such party against a certain type of liability or limits its liability at a stipulated monetary amount. Through clever drafting, liability caps may be able to create a bottom-line financial risk profile similar to one achieved through K4K, without offending the fault-based biases of the dispute resolver. Indeed, prior to the recent inclusion of K4K provisions in its standard drilling and charter party agreements, Petrobras included elaborate limits of liability for certain categories of loss as a way of achieving a similar result.

3. ARBITRATION

If parties wish to include K4K provisions in a Wellsite Contract notwithstanding enforceability concerns, they are likely better off choosing arbitration, rather than local courts, for dispute resolution. The reasons include (i) presumed superior knowledge of the petroleum industry (and appreciation of the

compelling logic behind K4K clauses), (ii) independence from political pressure (in the case of state-owned litigants), (iii) the tendency of arbitrators to focus on equity rather than legality, (iv) participation in the arbitrator selection process and (v) an ability to craft instruction language empowering arbitrators to interpret applicable law in the light of international and industry norms and practices.

4. INSURANCE

Some portion of contractor's liability risk may be covered by insurance. Of course, insurance has a cost that must be passed on to the operator or absorbed by the contractor. Unfortunately, certain "catastrophic" risks (loss of production, loss of reservoir, blow-out cratering, etc.) are uninsurable or carry uncommercial price tags. So, while insurance plays an important role in liability risk allocation, it is not a panacea.

5. NEGOTIATIONS

In many instances, Wellsite Contracts are tendered by NOCs on a strictly "take or leave it basis," thus leaving no room for negotiation, even in terms of drafting "improvements" that demonstrably would help both parties by enhancing clarity. Even IOCs at times purport non-negotiability of their standard Wellsite Contracts terms and conditions. In either case, the Portuguese saying, *quem não chora não mama* (a baby that doesn't cry doesn't nurse) holds true. If nothing else, doing so highlights contractor concerns to the NOC (or IOC) operator for future reference. More importantly, it may later support an argument that a disputed "non-negotiable" Wellsite Contract constitutes an adhesion contract, thus bringing into question the fairness or enforceability of its provisions.

6. JUST SAY NO!

In the final analysis, a contractor's assumption of liability risk constitutes one of many costs (along with labor, materials, finance, etc.) that should be considered when pricing rates for Wellsite Contracts. The higher the risk, the higher the rates (at least in theory). When faced with liability clauses so draconian as to render the contract unprofitable or literally expose the contractor to extinction (e.g., assuming liability for certain catastrophic losses), the contractor may well be advised to walk away, if not run. Hopefully, in most cases, logic and reason will prevail, and the contractor can salvage the deal through effective implementation of the mitigation tactics outlined above.

VII. BRAZIL: AS ALWAYS, DANCING TO ITS OWN BEAT

"Brazil is where I belong, the place that feels like home. They love their family, their country and God, and are not afraid to let anybody know it."

– Dionne Warwick[18]

K4K clauses are not common in contracts governed by Brazilian law. As discussed in Section IV, the pervasive standard of civil liability in Brazil is reflected throughout its jurisprudence and legislation, and a party to a contract must compensate its counterparty for any contract-related damages that the former causes the latter through negligence[19] or contract breach. Typically, awardable damages are limited to those that are direct in nature,[20] which may include loss of profits. As so, K4K clauses would be considered a precluded limitation on liability under Brazilian law.

The enforceability of limitation of liability clauses in Wellsite Contracts has not been extensively tested by courts, and Brazilian law does not specifically address them. In one case, however, the Superior Court of Justice[21] pronounced that limitation of liability clauses are enforceable if (i) they are reasonable and proportional to the anticipated damage and (ii) their inclusion does not stem from unequal bargaining power. If this were indeed the relevant and unyielding standard or review, then criterion (i) would be problematical: in K4K clauses, limits of liability are often intentionally not proportional to the anticipated damage.[22] Criterion (ii) is less problematical, since oil and gas transactions typically involve players with at least reasonable, if not equal, bargaining power.

In addition, the Civil Code expressly allows liquidated damage clauses (*cláusulas penais*), under which the parties predetermine what damages will be assessed to each, regardless of actual damages suffered. To be enforceable, liquidated damages should (i) not exceed the value of the "main obligation" in the contract and (ii) be the maximum compensation due to the aggrieved party, even if the actual damages incurred were higher.

The willingness of Brazilian courts to wholeheartedly embrace the full range of industry standard limitation of liability clauses in an eventual high-profile case is uncertain, especially where interests of state are involved. Based on analogous oil patch cases, however, the prospects are promising. On balance, based on court and administrative rulings and actions to date, we believe the Brazilian courts, and, even more so, arbitral tribunals, are more likely to uphold limitation of liability clauses (particularly K4K clauses), especially those that reflect the clear commercial will of the parties and were freely negotiated.

VIII. PETROBRAS ADOPTS K4K

"If you can't beat them, join them."

– Ancient proverb

Petrobras, Brazil's semi-public NOC, has traditionally not included K4K clauses in its Wellsite Contracts. Instead, its standard contracts generally used monetary liability limits (i.e., "caps") to allocate liability other than on a strictly fault-based basis. The result was a standard Wellsite Contract that, while far from exemplary, was obviously acceptable to contractors, given their clear willingness to provide services at competitive rates. After all, Brazil is too attractive of a market, and Petrobras too large of a potential client, for contractor to forego based merely on their lawyers' dislike of Petrobras standard form contracts.

Things appear to be changing. Petrobras recently revised its standard drilling services and charter party agreements so as to include a basic K4K provision. Nonetheless, the specific wording in some cases leaves room for improvement, though a detailed review of the clause is beyond the scope of this article. Until some of the kinks are worked out of the K4K clauses and their interaction with other clauses, Contactors might long for the "good old days" when disproportionate allocations of liabilities were achieved with basic, but easily understandable and administered, liability caps.

IX. CONCLUSION

"An ounce of prevention is worth a pound of cure."
– Benjamin Franklin[23]

The international petroleum business involves high risks and high rewards for investors. The true value of the rewards can only be calculated by considering the true cost of those risks. Generally, operators have greater potential rewards than contractors, and thus, over time, special risk allocation methodologies, including K4K clauses and liability limitations (as well as insurance), have developed to reflect that fact. Without them, wellsite contractors, faced with limited rewards and uncapped liabilities, would likely either not execute contracts or be wiped out by one false step. The typical K4K and other liability limiting Wellsite Contract clauses have largely been developed in common law jurisdictions, drafted by common law lawyers and interpreted by common law judges. For a variety of reasons, many Wellsite Contracts are governed by the laws of a civil law jurisdiction. In such cases, the lawyers for each side must engage in a three-prong review process considering (i) the suitability of the wording of the clause, regardless of jurisdictional questions; (ii) enforceability of the clause in the proposed jurisdiction; and (iii) possible strategies to mitigate issues raised by applying common law concepts in a civil law context. When properly conducted, such review should result in either (i) a recommendation against using a particular liability clause in the subject jurisdiction (or in a particular forum); (ii) a suggestion of a viable alternative jurisdiction or forum; or (iii) confirmation of the suitability of the clause for the jurisdiction (and forum) in question, perhaps with modifications. In any case, these issues merit serious consideration (and negotiation), and those who face them are well advised to "look before you leap!"

Endnotes

[1] This is a condensed version of the article of the same name originally published in *The Journal of World Energy Law & Business* ("*JWELB*"), Volume 14, Issue 1, March 2021, Pages 49–66, https://doi.org/10.1093/jwelb/jwab004, and published here with the permission of the *JWELB* editor

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[4] A Wellsite Contract is an agreement covering support services for petroleum operations, such as drilling, cementing, mud, wireline, workboats, seismic and aviation.

[5] See description at *infra* Robert Mead and Nicholas Neuberger, "Knock-for-knock indemnities: risk allocation in offshore oil and gas contract" (2019) *LexisNexis*. https://bracewell.com/sites/default/files/news-files/Knock-for-Knock%20Indemnities%20–%20Risk%20Allocation%20in%20Offshore%20Oil%20and%20Gas%20Contracts.pdf , accessed June 10, 2020.

[6] United Kingdom of Great Britain and Northern Ireland has three separate and distinct legal systems: (i) Scotland; (ii) England and Wales; and (iii) Northern Ireland. Indeed, the Scottish courts and the Scottish legal profession operate separately from the courts of England. Thus, it is prudent to refer to the Laws of England and Wales.

[7] Peter Roberts, *Petroleum Contracts, English Law and Contracts, Second Edition, 2016. Paragraph 1.06 (p. 3).*

[8] Ibid, Paragraph 1.08.

[9] Ibid, Paragraph 1.09.

[10] From ON LIBERTY, retrieved January 7, 2021, from https://www.brainyquote.com/quotes/john_stuart_mill_109325 , accessed January 8, 2021.

[11] Quoted at https://www.academicintegrity.org/responsibility/quotes-blog-5-responsibility/ , accessed January 8, 2021.

[12] *See* Christophe Quezel-Ambrunaz, "Fault, Damage and the Equivalence Principle in French Law" (2012) 3:1 J of European Tort Law 21.

[13] *See* Caio Mario da Silva Pereira, "Instituições de Direito Civil – Introdução ao Direito Civil: Teoria Geral do Direito Civil", (2011) 24 ed., Vol. 1, Rio de Janeiro: Editora Forense, p. 553.

[14] In Brazil, the consumer and environmental law regimes generally apply strict liability, thus obviating the presence of fault.

[15] Brazilian civil law establishes the principle that trust is an ancillary obligation of contracting parties. This principle derives from the requirement of *good faith dealing* imposed on contracting parties by Article 422 of the Civil Code. Typically, contracts do not specifically require parties to act in good faith. But the failure by a party to do so may, by operation of Article 422 and general civil law principles, entitle the aggrieved party to damages or even contract termination.

[16] *See* Sílvio de Salvo Venosa "Direito Civil: responsabilidade civil" (2015), Vol. 4. 15th edition, São Paulo: Atlas. p. 21.

[17] "The Three Essential Warren Buffett Quotes to Live By" by James Berman, www.forbes.com., April 20, 2014.

[18] Dionne Warwick Quotes. (n.d.). Retrieved January 7, 2021, from: https://www.brainyquote.com/quotes/dionne_warwick_480628

[19] Technically, *culpa* or *dolo*.

[20] That is, damages that directly stem from the event (e.g., physical damage) rather than indirectly (e.g., loss of reputation).

[21] See Special Appeal nº 1.076.465 – SP (2008/0160567-4), published on November 21, 2018.

[22] Indeed, in K4K clauses, liabilities are allocated for convenience, avoidance of litigation, and ability to pay, but not on the basis of proportionality to the anticipated damages

[23] From, "On Protection of Towns from Fire, 4 February 1735," printed in *The Pennsylvania Gazette, February 4, 1734/5, accessed at* https://founders.archives.gov/documents/Franklin/01-02-02-0002 , January 8, 2021.