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Alberta Decision on Knock-for-Knock Allocation of Liability in a Standard Form Drilling Contract

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Case Commented On: *Precision Drilling Canada Limited Partnership v Yangarra Resources Ltd*, 2015 ABQB 433

This case involves the interpretation of a standard form drilling contract. Under that contract, said (at para 5) to be negotiated between the Canadian Association of Oilwell Drilling Contractors and the Canadian Association of Petroleum Producers, the drilling contractor (here Precision) and the oil and gas operator (here Yangarra) agreed to accept an allocation of risks and liabilities based essentially on ownership interests rather than fault. Thus, Article 10.1 of the contract, subject to some listed exceptions, provided that:

> Precision shall at all times assume all of the risk of and be solely liable for any damage to, loss of, or destruction of Precision's Surface Equipment, regardless of the negligence or other fault of Yangarra or howsoever arising and Precision specifically releases Yangarra in regard to any claims that Precision may otherwise have in regard thereto.

By the same token, Yangarra (Article 10.3 and 10.4) agreed to accept risks and provide an indemnity in relation to any downhole issues:

> Yangarra shall at all times assume all of the risk of and be solely liable for ...any loss, damage to or destruction of:
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> (ii) Yangarra's equipment ...
>
> (iii) the hole, reservoir or any underground formation ...
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> regardless of the negligence or other fault of Precision or howsoever arising, and Yangarra shall defend and indemnify Precision from and against any and all actions, claims, losses, costs, damages and expenses resulting therefrom and specifically releases Precision from any claims Yangarra may otherwise make in regard thereto.
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> Yangarra shall at all times during a drilling program 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, and Yangarra specifically releases Precision from any claims Yangarra may otherwise have in regard thereto;

(emphasis added by the Court)

Master Prowse refers to this (at para 15) as a "negotiated form of bilateral no fault arrangement" but it is more commonly referred to a "knock-for-knock" contract. While unlawful or contrary to public policy in some jurisdictions (because the provisions potentially diminish the incentive to take care) they are common in some sectors (e.g. the offshore oil and gas industry) as an efficient way of resolving disputes especially where multiple parties (and especially sub-contractors) might be involved.

In this particular case Yangarra hired Precision to drill a number of wells. The first well was drilled successfully. During the drilling of the second well the facts (or the facts as claimed by Yangarra, since the case came before Master Prowse on a motion by Precision for summary judgment and thus Master Prowse accepted Yangarra's version of the facts in the event of any conflict) suggested that an employee of Precision wrongly added sulfamic acid to the drilling mud rather than caustic potash and that as a result the drill string and bit became stuck. The well was subsequently abandoned and some of Yangarra's equipment was lost downhole. As a result a substitute well was required. Precision commenced that operation but was ultimately replaced by another contractor. Precision sued for monies owing for its work on the drilling of these three wells. It appears (at paras 16, 28 & 29) that Yangarra in turn sought to set-off by way of counter claim any amount owed by Yangarra by its own damages including not only the value of the lost equipment but also the cost of the replacement well ($2.5 million) and the cost incurred by fishing operations on the second well in an attempt to recover equipment ($720,000). Precision sought summary judgment on these assumed facts on the basis that under the contract Yangarra had assumed liability for all of these costs and was therefore not entitled to any set-off.

Master Prowse concluded that this was an appropriate case for summary judgment and made the order sought by Precision. In so ordering Master Prowse rejected a number of arguments brought to bear by Yangarra.

The first such argument appears to have been that Yangarra might be able to recover on the basis of some legal theory (at para 34) (e.g. unjust enrichment) that was not covered by the allocation of risk in the contract. Not so, said Master Prowse quoting Article 10.13 of the contract:

> For greater clarity, Precision and Yangarra acknowledge and agree that:
>
> (a) the purpose of this Article X [ten] is to allocate contractually between Precision and Yangarra certain of the risks, responsibilities and potential losses or liabilities associated with the operations and activities involved in drilling a well under a drilling program; and,
>
> (b) such allocation shall prevail in the place and stead of any other allocation of risks, responsibilities, or potential losses or liabilities that might be made on the basis of the negligence or other fault of either party or howsoever arising or any other theory of legal liability and notwithstanding the breach or alleged breach by either party of any provision of the drilling program not included in this Article X [ten]
>
> (emphasis added by the Court)

While the contract might not cover the intentional infliction of harm there was no evidence that that was the cause of the harm.

The second argument was that the contract should be interpreted in light of a presumption that neither party would release the other from liability for gross negligence. Master Prowse's response to this was that while such a presumption might be appropriate (at para 40) in situations involving "inequality of sophistication or bargaining power" that was not this case:

> [43] In my view, it is entirely sensible to contemplate Precision and Yangarra releasing each other from claims based on gross negligence.
>
> [45] Perhaps it is because, over time, drilling companies and petroleum companies have found it cheaper in time and money to insure their property and waive subrogated claims against the other, rather than retaining the right to sue the other?

A third argument was that an interpretation of the contract which relieved Precision from liability would lead to an absurdity or an inconsistency in the overall construction of the contract insofar as Precision had also contracted to drill the well in a good and workmanlike manner. Master Prowse found no such absurdity:

> [57] In my view, in the context of a bilateral no fault contract, the court should not presume that Yangarra's releasing of Precision from some of the consequences of not drilling in a good and workmanlike manner is commercially absurd.
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> [58] It is important to note in this context that Precision's breach of its promise to drill in a good and workmanlike manner does have meaningful legal consequences under the contract.
>
> [59] Significantly, the contract expressly allows Yangarra to remove Precision from the site, and take over the operation of Precision's drilling rig "in the event of a default by Precision in performing its obligations under a drilling program" (see article 8.1)
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> [60] As well, these parties have an ongoing commercial relationship pursuant to a Master Contract under which specific jobs are added from time to time. In addition to removing Precision from this specific job under article 8.1, presumably Yangarra could also cease adding new jobs for Precision under the Master Contract.
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> [61] In other words, the interpretation I have given to this contract does not render Precision's promise to drill in a good and workmanlike manner meaningless. There are negative legal and commercial consequences to Precision for breaching its covenant.

Nor was Precision's approach inconsistent with the overall structure of the contract (at paras 62 – 65).

Master Prowse also rejected Yangarra's argument to the effect that the exemption from liability should only apply to third party claims – an argument founded on Justice Hunt's judgment in *Erehwon Explortion Limited v. Northstar Energy Corp.*, 1993 CanLII 7238 (AB QB), in relation to the CAPL operating procedure. Master Prowse rejected the analogy principally on the grounds that this contract dealt clearly and separately with both inter-party and third party claims.

Finally, Master Prose considered the decision in *Tercon Contractors Ltd. v. British Columbia (Minister of Transportation and Highways)*, 2010 SCC 4 (CanLII) with respect to exculpatory clauses, and in particular whether the clause in this case could be said to be unconscionable at the time the contract was made, and whether there might be public policy reasons for declining to enforce it. As for unconscionability, and given the usual informing considerations (grossly unfair, absence of legal advice, overwhelming imbalance in bargaining power, and vulnerability), Master Prowse wasted little time before ruling that the clause was not unconscionable. In particular stating (at para 88) "Since the no-fault provisions are bilateral, I do not believe them to be grossly unfair or improvident."

It is evident from Master Prowse's judgment that Yangarra mounted a very broad public policy attack on knock for knock provisions alleging that such clauses should not be permitted in the context of high risk activities since, absent liability for fault, those engaged in those activities would have no incentive to take care and, in this case (quoting from Yangarra's brief at para 101) "safe drilling practices would be undermined." Master Prowse gave four reasons for thinking that this overstated the case. First, and as already noted, there were (at para 104 & paras 58 – 61 quoted above) adverse contractual consequences for Precision. Second, there were reputational consequences for Precision (at para 105). And third, there was in any event a complex regulatory framework in place which offered further assurance that Precision would follow safe drilling practices (at paras 106 – 110). And finally

> [112] We are not dealing with an inequality of bargaining positions here, where a commercially sophisticated entity is seeking to take advantage of a less sophisticated customer. We are dealing with an industry wide bilateral no fault contract, adopted by two very sophisticated parties.

This was an appropriate case for summary judgment. The principal issue was one of contractual interpretation and the contract was clear.