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Reviewing knock for knock indemnities: Risk allocation in maritime and offshore oil and gas contracts

Participants in the maritime and offshore oil and gas sectors operate in a unique environment, characterised by inherently hazardous conditions, high financial stakes and the potential for catastrophic consequences if things go awry. Knock for knock clauses have become industry standard in those sectors and are a fundamental tool in the management of those risks.

The fifth anniversary of the Deepwater Horizon incident is a timely reminder of the benefits of the consensual risk allocation mechanism.

Under a typical knock for knock regime, parties agree that the loss lies where it falls, irrespective of fault and without recourse to other parties.

They are an effective contractual tool that offers contracting parties certainty (by fixing liability at the time of contracting), reducing insurance costs and avoiding the time, expense and difficulties inherent in the task of attributing fault and causation.

This is accompanied by a series of mutual indemnities, all of which leads to circuitry of action among contracting parties. In essence, each party is responsible for and agrees to indemnify the other contracting parties against injury to, or death of, its own personnel, loss or damage to its property and any other specified losses, for example, consequential loss or environmental liability.

Features of knock for knock clauses

Features of knock for knock clauses include:

- primary parties and their employees and sub-contractors constitute a "group" for the purposes of risk allocation. Group members have the same protection as primary parties;
- damage and loss suffered by a member of the primary party's group is borne by that primary party, regardless of fault; the loss lies where it falls in the first instance with no recourse to the other parties;
- the primary party agrees to indemnify other primary parties and their groups against any liability for claims by the indemnifying party's group, irrespective of fault; and
- primary parties have insurance to protect them and their group against losses and to underwrite their obligation to indemnify other primary parties and their groups.

Deepwater Horizon

- On 20 April 2010, *Deepwater Horizon* suffered a blowout, which caused a fire, killing 11 people and injuring 17 others.
- The rig sank in 5,000 feet of water.
- Over the next 87 days, 5 million barrels of oil spilled into the Gulf of Mexico.
- In total, BP as operator has paid $43.8bn for clean-up and other costs and still faces penalties of between US$5bn and US$21bn under the *US Clean Water Act*.
- Knock for knock clauses featured prominently in ligation following the *Deepwater Horizon* incident.

Insurers waive their rights of subrogation against other primary parties and their groups.

Construing knock for knock clauses

Knock for knock clauses are construed in accordance with ordinary canons of contractual construction. In Australia, this includes construing them according to their "natural and ordinary" meaning, read in light of the contract as a whole, thereby giving due weight to the context in which the clause appears.

Where the wording of a knock for knock clause is ambiguous, the clause is construed *contra proferentem,* that is, the preferred meaning should be the one that works against the interests of the party in whose interest the wording was providing.

Clarity of drafting is crucial when defining the scope of the indemnities provided for in knock for knock clauses.

Insurance and knock for knock indemnities

It is important to bear in mind the intersection between insurance and knock for knock indemnities, particularly in the context of Protection & Indemnity Clubs (P&I Clubs).

Parties should not assume liabilities beyond those for which they would otherwise be entitled to limit. Where possible approval should be sought from the insurer or P&I Club before agreeing a knock for knock regime.

Unbalanced knock for knock contracts are not poolable. By way of example, the Standard P&I Club approves knock for knock clauses provided that they are "*balanced and do not expose the member to wider liabilities than those imposed on his contractual partner*" and that the member has not waived his right to limit liability under applicable law.

Excluding liability in knock for knock indemnities

Issues that frequently arise in this area concern the scope of knock for knock clauses and whether they are sufficiently wide to protect the indemnified party from liability arising out of:

- gross negligence;
- material breach of contract;
- consequential loss; and
- strict or statutory liability.

Gross negligence

Increasingly, contracts in the maritime and offshore oil and gas sectors contain clauses excluding liability for losses caused by "gross negligence". Traditionally, gross negligence is not recognised as a distinct concept in either Australia or England. Nonetheless, courts have had to deal with these concepts as a matter of contractual construction. Some guidance that has emerged from the cases include that:

- gross negligence involves a serious disregard of an obvious breach;
- conduct need not be intentional or contumelious to qualify as gross negligence; and
- the difference between "gross negligence" and ordinary negligence is one of degree rather than one of kind.

On the balance of authority, loss and damage caused by negligence in any form or degree will be regulated by the knock for knock regime, subject to the wording of the indemnity extending to cover loss and damage arising out of negligence.

Material breach of contract

Indemnities provided in knock for knock clauses generally only operate in circumstances where the contract is being performed.

In *A Turtle Offshore SA v Superior Trading Inc* [2008] EWHC 3034, the tug was contracted to tow the rig on the standard form TOWCON. The Tugowner was obliged to use "*best endeavours*" to perform the towage and exercise due diligence to "*tender the tug…in a seaworthy condition...*" The knock for knock clause stated that loss or damage "*of whatsoever nature*" would be to the sole account of the hirer.

During the tow, the tug ran out of fuel and it abandoned the rig to refuel. After refuelling, the tug returned to collect the rig, however, the rig had run aground in the interim. The court held that the tugowner's breach of its express duties under the contract did not preclude the tugowner from relying on the protection afforded by the knock for knock indemnity. The clause would protect the tugowner provided it was "*actually performing their obligation under the TOWCON, albeit not at the required standard*."

Consequential loss

When drafting knock for knock clause, parties should expressly address whether or not they wish to exclude liability for consequential loss from the indemnity. An analysis of the relevant case law demonstrates that the specific term "consequential loss" should be avoided wherever possible, to minimise ambiguity.

In *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008]

VSCA 26, Nettle JA (as his Honour then was) stated that the true distinction is between the two limbs of *Hadley v Baxendale* (1854) 9 Exch 341 is that "normal loss" is loss that every plaintiff in a like situation will suffer, and "consequential loss" is anything beyond the normal measure, such as profits lost or expenses incurred through breach. His Honour held that "consequential loss" is not limited to the second rule in *Hadley v Baxendale*.

Nettle JA held it would be unrealistic to suppose that the parties used the term "consequential loss" in any other way other than its natural and ordinary meaning, when read in light of the contract as a whole, giving due weight to the context in which the clause appears, including the nature and object of the contract. A similar approach was adopted in *Ferryways NV v Associated British Ports (The Humber Way)* [2008] EWHC 225 (Comm) at [84].

Clause 18(3) of the TOWCON/ TOWHIRE standard form was considered in *Tsavliris v OSA Marine Ltd*, unreported 19 January 1996 (*The Herdentor*). Clarke J held that the phrase "*any other indirect or consequential damage*" gives meaning to "*loss of profit, loss of use, loss of production*", such that only indirect loss of profit, use and production were excluded under clause 18(3).

Clause 18(3) of the TOWCON/ TOWHIRE standard form was also considered in *Ease Faith Ltd v Leonis Marine Management Ltd* [2006] EWHC 232. The tug was to tow the *Kent Reliant* to a location where she was to be broken up and sold for scrap. The tug was delayed and by the time the *Kent Reliant* arrived, the market price for scrap had fallen. Andrew Smith J acknowledge that: "*...loss of profits is capable of being a direct loss, but it need not be. For my part I do not find it remarkable that parties seeking to exclude all indirect loss but being particularly concerned about indirect loss of profit should agree upon provision that makes specific reference to loss of profits*."

These decisions are consistent with that in *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd,* focusing the inquiry on the characterisation of the claimed loss and the nature and object of the clause. Clauses purporting to exclude consequential loss do not necessarily exclude loss of profits.

As with other issues arising in the context of knock for knock clauses, clarity of drafting is crucial. Parties should specify exactly what losses they intend to exclude when carving out consequential loss.

Strict or statutory liability

Courts will not generally allow indemnities to extend to criminal penalties if they offend public policy.

In *Re: Oil Spill by the Oil Rig "Deepwater Horizon" in the Gulf of Mexico, on April 20, 2010* (case 2:10-md-02179-CJB-SS Document 5446), Transocean sought an indemnity from BP in respect of penalties it had to pay under the strict liability provisions of *US Clean Water Act*. Transocean argued that the statutory penalties were in the nature of civil penalties and were primarily remedial, such that an indemnity did not offend public policy. Judge Barbier rejected Transocean's argument. He found that the primary statutory goal of the civil penalty provisions was to punish and deter future pollution, and as such, it was was analogous to punitive damages. The indemnity clause therefore was not valid in respect of civil penalties imposed under the *US Clean Water Act*. On the other hand, the court noted that unlike a penalty, removal costs are aimed at restoring the status quo and are remedial in nature. As such, public policy did not invalidate the indemnity in so far as it covered removal costs.

In *Askey v Golden Wine Co Ltd* [1948] 2 All E.R. 35, the plaintiff sought an indemnity in respect of repartition expenses and fines imposed under the *Food and Drugs Act* for his crime of selling "*contaminated cocktails unfit for human consumption*." The claim for indemnity failed on public policy grounds. Denning J recognised the principle that the punishment inflicted by a criminal court is personal to the offender, and that civil courts will not allow an indemnity for the consequences of that punishment. Public policy requires that no indemnity should be enforced for expenses that an offender has incurred by reason of being compelled to make reparation for their crime.

In *Osman v J Ralph Moss Ltd* [1970] 1 Lloyd's Rep 313, the plaintiff sought to recover a fine imposed in criminal proceedings against him and an indemnity for damages which the plaintiff paid in a civil action arising out of the same conduct. The Court of Appeal held that the plaintiff could recover those sums, because the plaintiff had no mens rea (it was a strict liability offence and the plaintiff did not himself know the conduct was unlawful), nor was he culpably negligent.

The latter two cases were cited with approval in the Australian case of *Krakowski v Trenorth Ltd* (1996) Aust Torts Reports 81-401.

Whether knock for knock indemnities are enforceable in respect of claims for statutory liability is determined on a case by case basis, depending on the nature of the offence and the nature of the conduct. The criminal nature of the offence is not by itself determinative of the position.

It is advisable for market participants to have an understanding of the laws of the jurisdiction in which they are operating, to obtain an understanding of what risks/potential liabilities can be contractually allocated.

Final thoughts

- Australian and English courts recognise the important role that knock for knock clauses play in the commercial structure of operations within maritime and offshore oil and gas sectors and will be enforced in Australia and England, other jurisdictions may adopt a different approach, therefore, it is important to clarify the position.
- Clarity in drafting is crucial. These are not boiler plate clauses and need to be specifically considered, and where necessary, adapted. Issues for specific attention include:
  - what liabilities are to be covered by the indemnities; are the indemnities intended to cover loss arising out of negligence, gross negligence, or breach of contract?
  - which parties are covered by the indemnities? Who fails within the indemnified group?
  - what losses are covered by the indemnity; is the indemnity intended to cover consequential loss or statutory liabilities?
- Knock for knock clauses are a fundamental part of the maritime and offshore oil and gas sectors and are here to stay.

Contacts

Dr Pat Saraceni
Director, Litigation and Dispute Resolution
T: +61 8 9262 5524
E: pat.saraceni@cliffordchance.com

Nick Summers
Associate, Litigation and Dispute Resolution
T: +61 8 9262 5538
E: nicholas.summers@cliffordchance.com