

Construction & Engineering Update

Autumn 2016



Indemnities in Offshore Construction Projects – Do Not Be Shocked by Knock for Knock”

Offshore construction projects, especially those in the oil and gas sector, present a very different risk profile compared to works carried out onshore. As such, the contract provisions which apportion the risks in offshore projects can be unfamiliar territory to those experienced in onshore work.

In this update, we consider the role of “knock for knock” indemnities in offshore projects and how these represent a change in the balancing of risks when compared to onshore construction contracts.

Introduction

For a reminder of the scale of risk involved in offshore engineering and construction projects, one only has to recall the environmental disaster in the Gulf of Mexico in 2010 resulting from a blowout in the Macondo Prospect exploratory oil well that was being drilled by the drilling vessel Deepwater Horizon. The event led to significant damage, including loss of life and environmental damage caused by millions of barrels of oil discharging into the Gulf of Mexico.

Following the Macondo blowout, proceedings were issued by injured parties. These included businesses such as commercial fishermen, property owners and others who brought proceedings against the main parties: BP (who had leased the Deepwater Horizon vessel), Transocean (the vessel owner) and Halliburton (BP’s cement contractor). US regulators also issued environmental and safety violation notices to BP, Transocean and Halliburton. BP commenced legal proceedings against its contractors. The settlements and fines relating to these proceedings ran into tens of billions of dollars (US\$).

In the proceedings that followed the disaster, the issue of contractual “knock for knock” indemnities featured heavily, as parties in the contractual chain relied upon these indemnities to limit their financial exposure to third party claims for negligence and breach of statutory duty, as well as fines and penalties.

In this update, we consider “knock for knock” indemnities: what they are, how they are viewed by the English courts and how they are themselves a demonstrator of the different risk and indemnity position in offshore construction work compared to that in onshore projects.

Indemnities in General

Indemnities are familiar to anyone who has been involved in drafting and negotiating commercial contracts. They are usually some of the more hotly contested elements in a deal. In legal terms, an indemnity is a promise by one party to be responsible for the losses of another party. Indemnities are powerful contractual provisions which are sometimes said to represent a near “pound for pound” compensation for another party’s loss. They are distinct from breaches of contract in respect of which a party will rarely recover all possible losses arising from the breach. For this reason, when agreeing to indemnity clauses, parties must be careful to ensure that the indemnified losses can be met; hence, indemnified losses are usually backed by some form of insurance and usually require sanction by a contracting party’s insurance provider.

“Standard” Indemnities

In onshore engineering and construction contracts, there is commonly a set of indemnities given by one party to the other. These are sometimes (unofficially) referred to as “standard” indemnities. Such indemnities can, for example, be found in the FIDIC Yellow Book (Conditions of Contract for Plant and Design-Build) (first edition, 1999) at Clause 17.1. Under this provision, the Contractor indemnifies and holds harmless the Employer, the Employer’s Personnel and their respective agents, against and from all claims, damages, losses and expenses in respect of:

- Bodily injury, sickness, disease or death of any person arising from the design, execution and completion of the works and the remedying of defects (unless due to the negligence, wilful act or breach of contract by the Employer, the Employer’s Personnel or their respective agents); and

- Damage to or loss of any property, real or personal (other than the works) to the extent that such damage or loss arises as a result of the works and the remedying of defects and which is attributable to any negligence, wilful act or breach of contract by the Contractor, the Contractor's Personnel, their respective agents or anyone directly or indirectly employed by any of them.

The Employer gives indemnities in reciprocal terms to the Contractor taking into account matters which may be excluded from insurance cover.

These general principles that Party A indemnifies Party B for: (i) personal injury or death; and (ii) loss or damage to property (both caused by Party A) are fairly commonly accepted. These indemnities are usually in line with the insurance arrangements, which are held, for example, third party liability insurance.

Oversimplifying somewhat, the standard indemnities could crudely be said to operate on the basis of "if you break it, you pay for it", i.e. the guilty party pays. This is a well-established principle in onshore construction contracts.

However, in the offshore sector and particularly in oil and gas projects, the position is quite different. This can come as something of a surprise to parties only familiar with operations onshore.

"Knock for Knock" Indemnities

In offshore construction and in the oil and gas sector in particular, it is common for contracts to contain "knock for knock" indemnities. These are also sometimes referred to as "mutual hold harmless", "cross indemnities" or, more chillingly, "bury your own dead" indemnities. While crass, the last moniker probably best describes the nature of the arrangement.

A "knock for knock" indemnity in the basic sense is that Party A indemnifies Party B against claims in respect of:

- Death or personal injury not to Party B's people but to Party A's own people; and
- Loss or damage not to Party B's property but to Party A's own property (but excluding loss or damage to the works themselves).

This also usually includes pollution claims emanating from Party A. As is the case for standard indemnities, this arrangement is subject to whether Party B was negligent or in breach of contract and the extent to which this caused or contributed to the death or personal injury or property damage.

Like the reciprocity in standard indemnities, Party B gives mutual "knock for knock" indemnities to Party A.

This can be a strange concept for parties used to the "standard" indemnities typically found in onshore engineering and construction contracts. At first sight, it may not seem logical for Party A to give an indemnity which covers only his own people and his own property, as this appears to fly against the usual "you break it, you pay for it" concept.

As an example, in the oil and gas industry, the Logic standard form of contract (Edition 2 – October 2004) "General Conditions of Contract for Marine Construction" contains the following "knock for knock" indemnities in clauses 22.1 and 22.2.

In summary, the Contractor saves, indemnifies, defends and holds harmless the Company Group (i.e. the COMPANY and its co-venturers, its and their respective AFFILIATES and its and their respective directors, officers and employees (including agency personnel) but not any member of the CONTRACTOR GROUP) from and against claims, losses, damages, costs (including legal costs), expenses and liabilities in respect of:

- Loss or damage to property of the Contractor Group arising from, related to or in connection with the performance or non-performance of the contract;
- Personal injury, death or disease to any person employed by the Contractor Group arising from, related to or in connection with the performance or non-performance of the contract; and
- Personal injury, death or disease or loss or damage to property of any third party to the extent caused by the negligence or breach of duty of the Contractor Group.

There is a reciprocal indemnity in similar terms from the COMPANY to the CONTRACTOR GROUP against the same type of claims, etc., which relate to the COMPANY GROUP, people and property.

The "knock for knock" indemnities usually cover a party's "group" in this way.

The Rationale for "Knock for Knock" Indemnities

Going back to the risks involved in offshore works, and as demonstrated by the Macondo blowout example, the reasoning for "knock for knock" indemnities starts to become clear.

Given the complexity of the work involved in this sector, the usual "standard" indemnities might be considered of little use. Imagine in the event of a claim scenario, damage may be caused in the course of the works, investigations might be needed to establish cause, there may be effects of ongoing delay in terms of downtime and lack of production and there may be substantial time involved in resolving a claim on a "fault-based" indemnity. In such a scenario, it quickly becomes obvious that it is probably not worth the time and cost investment required in the context of "standard" indemnities. In addition, if "standard" indemnity type risks were adopted in this sector, then it is unlikely that any contractor would have sufficient balance sheet, appetite or insurance coverage to take on the risk. The risks posed to the supply chain would probably be simply unacceptable and/or uninsurable and so the contractor could not back its risks off. If these risks were accepted, then the supply chain would be looking to pass the inevitable high insurance premiums to the owner, in turn driving up the cost of the works.

In the "knock for knock" arrangement, because a party is only required to indemnify (and hence, insure against) the personal injury/death and damage to property and pollution risk in respect of its own employees and property, this makes the arrangement more practical for the types of risk experienced in oil and gas and offshore projects. This avoids exposure for the main contractor and the supply chain to the potentially enormous costs of claims in the worst-case scenario.

Consideration of “Knock for Knock” Indemnities by the English Courts

There has been relatively little consideration of “knock for knock” indemnities by the English courts.

Recently, however, “knock for knock” indemnities were considered by the Court of Appeal in ***Transocean Drilling UK Ltd v Providence Resources Plc [2016] EWCA Civ 372***. In this case, the court reversed a High Court decision on the interpretation of “knock for knock” indemnities. The court upheld the “knock for knock” indemnities as terms which applied to both parties to a commercial contract. The result was that the contractor succeeded in excluding liability for consequential loss (as that term had been defined in the contract). The court reached its decision based on the plain meaning of the indemnities and did not apply more restrictive methods of interpreting exclusion clauses (as is sometimes the case, for example the *contra proferentem* rule of construction). While a case on the interpretation of contracts, the fact that the court upheld the “knock for knock” clauses suggests a degree of judicial approval of the concept. This decision also reinforces the importance of precise drafting in contracts, particularly where attempts are made to exclude or limit liability.

Earlier, in ***Caledonia North Sea Limited v British Telecommunications Plc (Scotland) and Others [2002] UKHL 4***, the House of Lords held a similar view in that “knock for knock” indemnities were considered standard practice in the arena in which they were used. Lord Bingham described a particular “knock for knock” indemnity in terms of a “market practice” which had “developed to take account of the peculiar features of offshore operations”¹.

In a slightly more disparaging vein, in ***Smit International (Deutschland) GmbH v Josef Mobius, Bau Gesellschaft (GmbH & Co) [2001] CLC 1545***, the court described “knock for knock” indemnities as, perhaps realistically, a “crude but workable allocation of risk and responsibility”².

These cases demonstrate that “knock for knock” indemnities (assuming they are well crafted, precise and clear) are likely to be upheld by the English courts and however crude the arrangement might seem, the courts seem to accept that it does offer some certainty in an extremely risky working environment.

There is some uncertainty, however, on the question of whether a breach of contract can invalidate the indemnity. In ***Smedvig Ltd v Elf Exploration UK Plc (The Super Scorpio II) [1998] 2 Lloyd’s Rep 659***, the parties entered into a contract for the fitting and operation of a vessel intended to drill an offshore oil well in the North Sea. The contract provided a “knock for knock” indemnity from Elf to Smedvig. This covered damage caused by one of Smedvig’s employees to a remote operation vehicle (ROV) hired by Elf. Smedvig was held liable for the damage and sought to recover the loss from Elf under the contract on the basis that the damage was caused by Smedvig failing to take care of Company Items, which was a breach of contract, which invalidated the indemnity. The court held that contractual obligations of safekeeping and taking necessary care were not irreconcilable with those concerning loss and damage and that Smedvig was entitled to be indemnified under the contract. The court, therefore, decided that the obligations were not irreconcilable with the “knock for knock” indemnity, which was upheld.

On a similar point, in a different case (***A Turtle Offshore SA & Anor v Superior Trading Inc [2008] EWHC 3034 (Admlty)***), a party in breach of contractual provisions (in this case, ensuring that a tug carried sufficient fuel and an obligation to use best endeavours to perform towage) also received the benefit of a “knock for knock” indemnity which covered the type of loss that formed the basis of the other party’s claim. The court stated, obiter, that the “knock for knock” indemnity should be construed in the context of the contract as a whole, suggesting that the position might not always be as clear as stated in ***Smedvig***.

Conclusions

Parties becoming involved in offshore construction projects, whose experience lies in onshore construction contracts, should be careful to ensure they understand the differences that are particular to offshore contracts, which result from the offshore environment and the risks involved in the work.

“Knock for knock” indemnities are a feature of this sector and parties must make sure that they are properly understood and that they take advice from an insurance adviser to ensure the appropriate cover is in place.

As with any contractual terms and especially exclusion and limitation clauses, clear and precise drafting is very important to ensure those clauses will be upheld and hence, provide the protection for which they were designed.



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1 At paragraph 7.

2 At paragraph 19.