

An offshore oil and gas rig is silhouetted against a bright, orange sunset sky. The rig's complex structure, including a tall derrick and various platforms, is clearly visible. The sea below is dark with some whitecaps. A semi-transparent yellow horizontal band is overlaid across the middle of the image, containing the title and author information.

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

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Agenda

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1 Knock for knock clauses in action:

(a) *Piper Alpha*

- On 6 July 1988, 167 workers were killed on the Piper Alpha.
- Piper Alpha was Britain's biggest single oil and gas producing platform, producing 10% of the country's total crude oil production. The platform was owned by a consortium including Texaco and was operated by Occidental.
- Occidental settled claims by victims totalling £66m. Subsequently, Occidental instituted proceedings against contractors seeking to enforce indemnities.
- House of Lords upheld knock for knock regime and held that the contractors and their insurers had to bear the ultimate liability for damages paid in respect of their own employees; the loss lay where it fell, irrespective of fault.
- Cost Lloyd's insurance market over £1bn; largest insured man-made catastrophe.
- The Piper Alpha litigation was testimony to the efficacy and operation of knock for knock clauses.

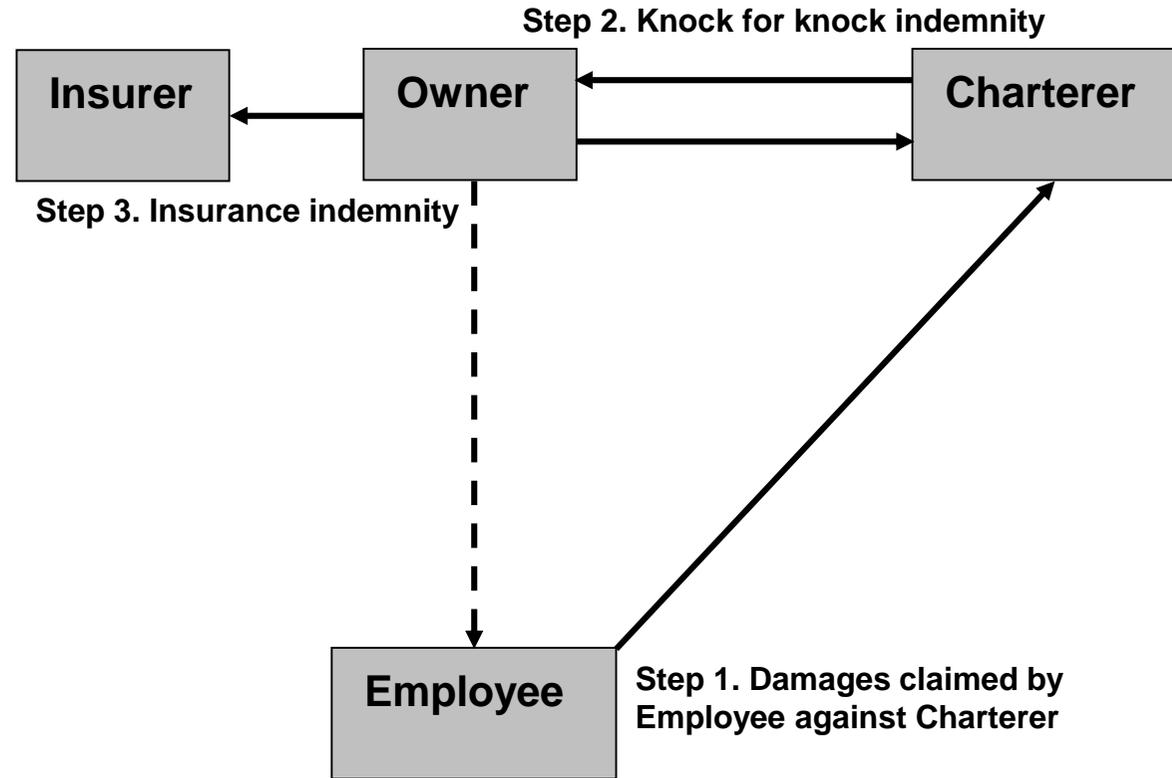
(b) *Deepwater Horizon*

- On 20 April 2010, Deepwater Horizon suffered a blowout, causing 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.
- Deepwater Horizon was owned by Transocean and leased to BP.
- BP settled 100,000 claims for damages by individuals and businesses for US\$7.8bn. BP faces penalties of between US\$5bn and US\$21bn under *Clean Water Act*. In total, BP paid \$43.8bn for clean-up and other costs.
- Transocean relied on knock for knock indemnity to exclude liability for its own employees and for of its own property.

2 Features of knock for knock indemnities

Knock for knock clauses have the following features:

- primary parties, their employees and contractors constitute a “group” for risk allocation purposes;
- damage and loss to a member of primary party’s group is borne by that primary party regardless of fault; loss lies where it falls;
- group members have same protection as primary party by virtue of a Himalaya clause;
- primary party bears liability for damage and loss, indemnifying other primary parties and groups against any liability, irrespective fault;
- primary parties carry insurance cover to protect them and their group against losses and to underwrite their indemnity obligation.



3 Construction of knock for knock clauses

- Knock for knock clauses are construed in accordance with ordinary canons of contractual construction.
- Exclusion clauses are construed in accordance with their “natural and ordinary” meaning, read in light of the contract as a whole, giving due weight to the context of the clause: *Darlington Futures Ltd v Delco Australia Pty Ltd Ltd* (1986) 161 CLR 500.
- Exclusion clauses are construed *contra proferentem*, that is, against the party in whose interest it was included: *Andar Transport Pty Ltd v Brambles Ltd* [2004] HCA 28.
- Australian approach differs from the position adopted in England, where a distinction appears to be drawn in the construction of exclusion clauses on the one hand and limitation clauses on the other:
 - *Ailsa Craig Fishing Co Ltd v Malvern Fishing Co Ltd* [1983] 1 WLR 964 , the House of Lords held that the absence of a reference to negligence in a limitation clause did not prevent it from indemnifying against liability for negligence. The Court held that a limitation clause are not construed in the same manner as exclusion or indemnity clauses.
 - *E. E. Caledonia Ltd v Orbit Valve Co Europe* [1994] 1 W.L.R. 221 (a case arising out of the Piper Alpha disaster), the court held that for negligence to be covered by the knock for knock regime, an indemnity clause should expressly and clearly refer to negligence.

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3 Commercial purposes for knock for knock clauses

Principal commercial objectives of knock for knock clauses include:

- reduce cost of enquiring into, and litigation surrounding, causation and attribution of fault;
- reduce disruptions and delays inherent in establishing causation and attribution of fault;
- reduce insurance costs;
- encourage co-operation in safe operational practices; and
- facilitate expeditious payments of compensation to injured parties, as occurred after the Piper Alpha disaster.

4 Commercial purpose for knock for knock clauses...cont

In *Caledonia North Sea Ltd v British Telecommunications Plc* [2002] 1 Lloyd's Rep 553 (a case concerning the Piper Alpha, the contractual indemnity clause read:

“Contractor shall indemnify, hold harmless and defend the Company... from and against any and all...damages, liabilities...directly or indirectly caused, occasioned or contributed to in whole or in part, by reason of omission or negligence...of contractor...arising...by reason of:...(c) injury to or death of person employed by or damage to or loss or destruction of property of the Contractor...irrespective of any contributory negligence...of the party to be indemnified, unless such injury, death, damage, loss or destruction was caused by the sole negligence or wilful misconduct of the party which would otherwise be indemnified.”
(emphasis added)

Lord Bingham said:

“It is understandable that the right to indemnity should be excluded where the negligence or breach of statutory duty of the party seeking indemnity was the sole cause of the death or injury, but that is the limit of the derogation from the rule that each party, operator or contractor, assumes the ultimate responsibility for compensating its own employees regardless of fault.” (emphasis added)

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4 Commercial purpose for knock for knock clauses...cont

In *Re: Oil Spill by the Oil Rig “Deepwater Horizon” in the Gulf of Mexico* (case 2:10-md-02179-CJB-SS Document 5446), parties agreed the contract should be read as a whole and its words given their plain meaning.

Judge Barbier said:

“A contract of indemnity should be construed to cover all losses, damages, or liabilities which reasonably appear to have been within the contemplation of the parties, but it should not be read to impose liability for those losses or liabilities which are neither expressly within its terms nor of such a character that it can be reasonably inferred that the parties intended to include them within the indemnity coverage. Thus, for example, it is widely held that a contract of indemnity will not afford protection to an indemnitee against the consequences of his own negligent act unless the contract clearly expresses such an obligation in unequivocal terms”.

Judge Barbier upheld the knock for knock clause; intention of the parties to provide mutual indemnities was clearly stated and it was not contrary to any statutory prohibition.

This accords with the principle of contractual construction in the England and Australia: *Darlington Futures Ltd v Delco Australia Pty Ltd Ltd* (1986) 161 CLR 500; *Smith v South Wales Switchgear Ltd* [1978] 1 All ER 18.

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5 Possible restrictions on operation?

(a) Gross negligence

- Offshore marine oil and gas contracts often exclude “gross negligence” from knock for knock provisions.
- Gross negligence is not recognised as a distinct concept in Australia or England.
- Some guidance as to its meaning emerge from the cases:
 - gross negligence = a serious disregard of an obvious breach;
 - conscious wrong doing is not an element of gross negligence;
 - the difference between gross negligence and ordinary negligence is one of degree rather than a difference in kind; and



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5(a) Gross negligence...cont

- Gross negligence is a well established concept under New York law: it is described as conduct that is so careless as to show a complete disregard for the rights and safety of others, or conduct that is “*truly culpable or harmful conduct*”: *Metro Life v Noble Lowndes* 84 N.Y.2d 430 at 439 (1994).
- In *The Hellespont Ardent* [1997] 2 Lloyd Rep 547, the English High Court held that gross negligence under New York law is “...*serious negligence amounting to reckless disregard, without any necessary implication of consciousness of the high degree of risk or the likely consequences of the conduct.*”
- Whether conduct is grossly negligent is a matter of objective determination: *Lester v Atchison, Topeka and Santa Fe Railway Co* 272 F 2 d 42 at 47 (1960).
- Whether a knock for knock clause excludes gross negligence is a matter of construction: *Re: Oil Spill by the Oil Rig “Deepwater Horizon” in the Gulf of Mexico* (case 2:10-md-02179-CJB-SS Document 5446).

5(b) Wilful misconduct

- Wilful misconduct involves an element of wilfulness or intention; a party acts recklessly, not caring whether it is right or wrong, regardless of the consequences of its conduct: *John v Star City Pty Ltd* [2014] FWC 543.
- In *Alpstream AG v PK Airfinance Srl* [2013] EWHC 2370, it was argued that “wilful negligence” equated to gross negligence, removing the element of conscious wrongdoing. The court rejected that argument and held that wilful misconduct equates to, either:
 - an intention to do something which the actor knows to be wrong; or
 - a reckless act, where the actor is aware that loss may result, but does not care whether loss will eventuate.
- The concept of wilful misconduct is clear and capable of significant tailoring to more fully set out what the parties wish to achieve, eg limiting the scope of the knock for knock indemnities in the event of intentional / conscious disregard by senior management of either a contractual provision or of good oil field practice.

5(c) Material breach of contract

- A material breach = a breach that substantially adversely affects interests of the other party: *Elders Ltd v E J Knight & Co Pty Ltd* [2009] NSWSC 1462.
- In *A Turtle Offshore SA v Superior Trading Inc* [2008] EWHC 3034:
 - Tugowner obliged to use “*best endeavours*” to perform their towage and exercise due diligence to “*tender the tug...in a seaworthy condition...*”
 - Knock for knock clause stated that loss or damage “*of whatsoever nature*” would be to the sole account of the hirer.
 - Tug ran out of fuel and deliberately abandoned the rig. After refuelling, tug returned to collect the rig, but the rig had ran aground.
 - Court held that the tugowner’s breach of contract did not preclude reliance on the knock for knock clause, so long as it does not defeat the main purpose of the contract. The clause protected the tugowner provided it was “*actually performing their obligation under the TOWCON, albeit not at the required standard.*”
 - Tugowner was protected by the knock for knock indemnity as it had not abandoned efforts to complete the tow.

5(d) Consequential loss: A matter of contractual construction

- In *Hadley v Baxendale* (1854) 9 Exch 341, the court identified the 2 types of losses:
 - 1 losses that arise naturally or directly (*first rule*); and
 - 2 losses that may reasonably be supposed to have been in contemplation of both parties when contracting as the probable result of a breach because of special knowledge at the date of the contract (*second rule*).
- Consequential loss does not necessarily fall within the second rule; it is a matter of construction of the particular clause: *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26.

5(d) Consequential loss...cont

- In *Ferryways NV v Associated British Ports* [2008] EWHC 225 (Comm), the claimant sought to recover from the defendant the sums paid in respect of the death of an employee. Teare J:
 - held that a party must use clear and unambiguous language if it seeks protection from liability for losses otherwise recoverable for breach of contract. The parties used wording - ‘consequential’ and ‘indirect’.
 - said use of ‘indirect’ juxtaposes it with ‘direct losses’ ie “*losses which flow naturally from the breach without other intervening cause and independently of special circumstance*”. Indirect and consequential losses = losses which are not the direct and natural result of the breach.
 - held that liability for death and repatriation expenses = losses which were the direct and natural result of defendant’s breach of contract causing death of the claimant’s employee and, as such, were not excluded under the contract.

5(e) Statutory or strict liability

- Whether knock for knock indemnities are enforceable in respect of claims for statutory liability is determined on a case by case basis, dependent on nature of offence and of conduct; the criminal nature of the offence is not by itself dispositive.
- In *Osman v J Ralph Moss Ltd* [1970] 1 Lloyd's Rep 313, the Court of Appeal held that the plaintiff could recover damages, including the sums related to the criminal proceedings, because the plaintiff had no degree of *mens rea* nor culpable negligence in committing the offence.
- In *Krakowski v Trenorth Ltd* (1996) Aust Torts Reports 81-401, Eames J stated that the general rule is that where a party is liable for civil wrong, there is no policy barrier to an indemnity from a third party; subject the exception, being where the party committed what amounted to a criminal offence (even if not prosecuted for that offence).

6 Limitation of liability

- Most knock for knock clauses expressly preserve any right to limit liability that may be available under the relevant law – In Australia, 1976 Limitation Convention and *Limitation of Liability for Maritime Claims Act 1989* (Cth).
- Generally must invoke any available right to limit liability before invoking the indemnity under the knock for knock provisions. The knock for knock regime does not give rise to any right to limit, but it enables any existing right to survive.
- By way of example, cl14(d) of SUPPLYTIME 2005, provides:
“Nothing contained in this Charter Party shall be construed...to deprive the Owners or the Charterers, as against any person or party, including as against each other, of any right to claim limitation of liability provided by any applicable law, statute or convention, save that nothing in this Charter Party shall create any right to limit liability. Where the Owners or the Charterers may seek an indemnity under the provisions of this Charter Party or against each other in respect of a claim brought by a third party, the Owners or the Charterers shall seek to limit their liability against such third party.”

6 Limitation of liability cont...

- In Australian oil and gas sector, limitation provisions most likely to be invoked by support vessels (given the definition of “ships”).
- Limitation of liability in the context of mutual indemnities may cause an “imbalance” of compensation payable; e.g. if one contracting party is able to limit and the other is not or if the limitation fund constituted is not be sufficient to indemnify a party for the full amount of damages it paid to the injured party.

7 Final thoughts

- Courts recognise important role knock for knock clauses play in commercial structure of operations within those sectors and will be enforced in Australia and England, but may not be in some other jurisdictions – check governing law clause.
- Clarity in drafting is crucial – not boiler plate clause: 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?
 - 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 offshore marine oil and gas sectors – they are here to stay.



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