西村あさひ法律事務所
NISHIMURA & ASAHI
Natural Resources and Energy Newsletter

Knock for Knock Liability Provisions

Mark Tudor

'Knock for knock' is an arrangement commonly used in the offshore oil and gas industry. It often gains attention only in the litigation arising after a major disaster when the parties involved are trying to establish whether they (or one of their contracting partners) should be financially liable for the costs of the disaster.

What is knock for knock?

The knock for knock provision in a contract takes the form of mutual indemnities between the parties.

There are variations on the drafting and scope of knock for knock provisions but the basic concept is that Party A bears the risk of (and indemnifies Party B against) any claims made against Party B for:

- the death or personal injury of any of Party A's employees; and
- any loss of, or damage to, Party A's property (which could include Party A's oil rig or FPSO).

Party B provides indemnities to Party A in the same terms.

The indemnities will usually be given by each Party on behalf of all of the employees and property within its "Group". The people and companies that fall within each Party's "Group" will be defined in the agreement and will usually include a Party's subcontractors and affiliates and all of their employees, officers and invitees. As a Party will be responsible for all claims in respect of its Group, it is important that the scope of each Party's "Group" is carefully drafted in the definitions.

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The surprising aspect of the knock for knock provision to those who are not used to it is the fact that, in respect of the Parties and their "groups", there is no concept of "fault" in the allocation of liability – liability is determined purely by relationship of the personnel to a party and ownership of assets (although as noted below some restrictions may be placed on this general principle both contractually and by applicable law).

Common Restrictions

Additional wording is often added to modify the effect of the knock for knock indemnity.

Usually wording is added to provide that the indemnity from Party A will apply regardless of any contributory negligence or breach (either of contract or law) of Party B. Wording may also be included to indemnify against claims arising out of the "gross negligence" and/or "wilful misconduct" of the indemnified party - in such cases it is important to understand the extent to which (if at all) the applicable insurance policies will cover any injury or damage which is a result of gross negligence or wilful misconduct. These provisions should also be reviewed in the context of the applicable law to ensure that the indemnities are enforceable (eg as a matter of public policy some jurisdictions will not permit a party to be indemnified against penalties and fines which are intended to act as a deterrent or punishment).

The litigation arising out of the Macondo disaster is an example of where the courts considered that public policy should take precedence over the express provisions of a contract. BP (the field operator) had given an indemnity in the drilling contract (which was governed by US maritime law) to Transocean (the owner of the Deepwater Horizon drilling rig) in respect of pollution risks below the water's surface. This indemnity was to apply even in the case of Transocean's "gross negligence". Transocean was seeking to be indemnified against amounts of: (i) any damages to third parties which resulted from Transocean's "gross negligence"; (ii) punitive damages awarded to third parties against Transocean; and (iii) civil penalties against Transocean for breach of its obligations the US Clean Water Act. The Louisiana court did not consider the facts of the case and made its ruling on the basis of the law. It determined that, if Transocean had committed gross negligence that caused subsurface pollution, then public policy would not prevent them from recovering from BP any compensatory damages (but not punitive damages) claimed under the indemnities. In respect of issues (ii) and (iii), the court determined that, as the purpose behind punitive damages and these civil penalties was to act as a deterrent and to influence the behaviour of contractors, it would be against public policy to allow Transocean to recover these losses from BP.

It is usual to exclude the knock for knock indemnity provision from the overall aggregate liability cap under the contract and from any exclusion of "consequential losses" (however defined in the agreement).

Why are knock for knock provisions used?

The justification for the use of the knock for knock system is that it would be expensive and practically difficult to adopt a "fault based" approach to liability in offshore energy projects. The Operator will often have numerous interfaces and subcontractors working in parallel and for each to insure itself against: (a) death of any of the employees of the Operator and the Operator's other subcontractors and (b) loss and damage to the property of the Operator and the Operator's other subcontractors, would lead to multiple overlapping insurance policies. This would be economically inefficient and expensive for the project as such costs will ultimately be passed back to the Operator under each subcontract. Additionally, given the significant effect that a delay will have on

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an offshore project it is preferable to know in advance how liability will be apportioned – for example, there could be a significant delay if no insurance payment is made to reinstate the project until after the outcome of a lengthy investigation to establish which party was at fault and any subsequent dispute / litigation between insurers is settled.

Recommendation

During contract negotiations it is very important to get the drafting correct and for the company entering into the contract (and their insurers) to understand the scope and limits of the knock for knock provision in order to avoid any "gaps" which result in uncapped liability for the company – and, where it is not possible to close these gaps through negotiation, to obtain insurance cover to fill these gaps.

Mark Tudor Partner (Foreign Law Partner*)
m_tudor@jurists.co.jp
Mark Tudor joined Nishimura & Asahi in May 2016 and has over 18 years experience advising in the energy and natural resources (with 10 of those years being in Japan with an international law firm). Most recently he worked for an FPSO and engineering contractor and has experience advising on onshore and offshore FEED, EPC and other engineering and construction contracts and on development of oil, gas and LNG projects.

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