

Knock-for-Knock Indemnities: Risk Allocation in Offshore Energy Contracts

Article

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What are knock-for-knock indemnities?

A knock-for-knock clause is a reciprocal agreement to apportion liability for certain losses (usually, death or injury to personnel and damage to property) between contracting parties, supported by mutual indemnities.

A knock-for-knock regime replaces the fault-based liability regime that would otherwise apply at law with the concept that 'loss lies where it falls'.

They are a common risk allocation mechanism in the offshore oil and gas industry utilised to provide certainty and prevent recourse against other parties. They are also increasingly common in other complex offshore projects, such as offshore wind projects.

What are the key features of a knock-for-knock clause?

Knock-for-knock clauses generally maintain the principle that damage and loss to property or personnel suffered by a party's 'group' (as defined in the relevant contract) is borne by that party regardless of fault. The party's group can be extended to include its various subcontractors, affiliates and, in some circumstances, other contractors.

Standard form contracts provided by industry bodies (such as LOGIC) are frequently used by parties for the purposes of complex offshore projects. Even when those standard forms are adopted, bespoke amendments are often made during the negotiation process. This has resulted in a large body of similar, yet

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different, knock-for-knock clauses being used. Each must be interpreted according to its context and the specific language used.

By way of example, in LOGIC's General Conditions of Contract for Marine Construction, Edition 3 (May 2021) the knock-for-knock indemnity is found in section 21.1 and section 21.2.

Nevertheless, most knock-for-knock clauses will have the following features:

- will be mutual. It is fundamental to the knock-for-knock regime that each party accepts liability for losses to its own property or suffered by its own employees and indemnifies its counterparty in respect of liability arising from the same
- their scope will extend beyond the contracting parties to include, for example, losses suffered by a contracting party's subcontractors, affiliates, directors, officers and employees
- they will set out (with more or less particularity):
 - who is covered (eg just the parties or also their subcontractors, affiliates, directors, officers and employees)
 - what is covered (eg what types of losses will be covered by the clause—in offshore oil and gas contracts, for example, it is not uncommon for losses resulting from environmental harm/pollution to also be included); and
 - when claims can be brought
- they will be stated to apply irrespective of the cause of the loss and, frequently, irrespective of a party's negligence or breach of duty

What are the benefits of knock-for-knock indemnities?

A knock-for-knock clause offers certainty and clarity to the parties and their insurers. It is an agreement between the parties to contract out of remedies to which they would otherwise be entitled and it clearly establishes where liability lies. Because there is no requirement to show cause, fault or blame there is less scope for dispute. This reduces the chance of litigation or arbitration and also promotes transparency.

Knock-for-knock clauses may also reduce duplication in the parties' respective insurance policies, by removing the need to consider (or pay for) insurance in respect of other parties' property. This leads to cost savings.

Why are knock-for-knock indemnities used in offshore energy industries?

The advantages of knock-for-knock clauses are of particular benefit in services agreements, and operation and maintenance agreements, as well as in complex projects involving multiple parties where, in each case, significant loss can arise from accidents and other incidents.

The House of Lords noted in *Caledonia North Sea Ltd v British Telecommunications plc* (Lord Bingham at paragraph 2) that the offshore oil and gas environment includes a mixture of manual labour, expensive infrastructure, unpredictable and severe weather conditions, the sea and hydrocarbons. A similar risk profile applies to other complex offshore projects, such as offshore wind projects, with hydrocarbons substituted for complex electrical systems and, often, even more extreme weather conditions (given that strong wind is a fundamental requirement of the location of the infrastructure). To say the offshore environment it is not without its risks is an understatement.

References:

Caledonia North Sea Ltd v British Telecommunications plc [2002] UKHL 4, Lord Bingham at paras [7]–[9] and Lord Hoffman at paras [81] and [82]

In the offshore energy industry, the prospect of a significant and costly accident occurring can never be discounted. Proving blame through litigation or arbitration can be a time consuming and expensive exercise. Pre-agreed knock-for-knock clause can mitigate the complexities of post-event liability allocation between contracting parties.

Their effectiveness in the offshore oil and gas industry was expressly recognised by the House of Lords in the litigation flowing from the Piper Alpha disaster (see Practice Note: Health and safety in the offshore oil and gas sector—safety case regime for more information).

References:

Caledonia North Sea Ltd v British Telecommunications plc [2002] UKHL 4, Lord Bingham at paras [7]–[9] and Lord Hoffman at paras [81] and [82]

Removing the need to prove blame also promotes transparency. This is vitally important in the context of offshore projects, where safety is of fundamental importance. If an accident occurs, rather than defending positions or arguing over fault, the knock for knock regime allows parties to work together to ensure that it does not occur again.

When are knock-for-knock indemnities used in the offshore energy industry?

An operator will typically enter into numerous high value agreements with contractors to carry out standard industry services. These services will often involve various subcontractors. It is common for a knock-for-knock clause to be negotiated in these service agreements including, for example, in drilling

contracts, turbine installation contracts, sales and transportation, processing and operating services agreements, operation and maintenance agreements and EPC contracts.

The oil and gas industry has also seen an expansion of knock-for-knock clauses in agreements with contractors in the midstream market. Traditionally, knock-for-knock clauses were more common in contracts relevant to the upstream market that related to onsite activities at the well or field. Before accepting such terms, along with the standard commercial practicalities of entering into risk sharing transaction agreements, such midstream contractors would need to consider if their insurance adequately covers their liability under a knock-for-knock regime.

On more complex multi-party projects a 'mutual hold harmless agreement' may be agreed between all the relevant project parties. This arrangement is similar to that described above in respect of bilateral services agreements, except that each of these project parties (individually rather than as two distinct groups under the services agreements) indemnifies all the other project parties on a knock-for-knock-basis. This is often a suitable arrangement where there are more than two parties with regular cross-over and interaction over the life of the project. Adopting this horizontal approach, rather than a more traditional vertical approach, with each party paying out under one contract and then seeking reimbursement under another, negates the risk of a party in the chain becoming insolvent, which may prevent recovery.

How are knock-for-knock clauses construed under English law?

The starting point under English law is that knock-for-knock clauses are contractual clauses which must be interpreted in the same way as any other contractual clause.

References:

Transocean Drilling UK Ltd v Providence Resources plc [2016] EWCA Civ 372

The modern approach to contractual construction was explained in *Arnold v Britton*, emphasising that particular importance must be given to the express wording of the contract in question.

References:

Arnold v Britton [2015] UKSC 36, at paras [15]–[23]

It is a 'unitary exercise [which] involves an iterative process by which each suggested interpretation is checked against the provisions of the contract and its commercial consequences are investigated'.

References:

Wood v Capita Insurance Services Limited [2017] UKSC 24 at para [12]

A knock-for-knock clause will therefore be construed by identifying its natural and ordinary meaning by considering the express wording of the provision, the wider contractual context and the factual matrix.

Where the parties are sophisticated and of equal bargaining power and the contract has been 'negotiated and prepared with the assistance of skilled professionals', which will usually be the case with contracts in the offshore energy industry that include knock-for-knock provisions, the express wording of the clause may (but will not always) take on more importance than the context.

References:

Wood v Capita Insurance Services Limited [2017] UKSC 24 at para [13]

In addition, the following principles may apply to the interpretation of knock-for-knock clauses:

- a knock-for-knock clause will invariably result in a party contracting out of a liability it would otherwise have under the common law (for example, a liability to pay damages in respect of loss resulting from its breach of contract).

As a matter of English law, a party will be presumed not to have intended to abandon those common law rights and clear and express wording is required to rebut this presumption.

References:

Gilbert-Ash (Northern) Ltd v Modern Engineering [1974] AC 689 at para [717]

This means that, as with all exemption or exclusion clauses, clarity in the drafting is key. 'The more valuable the right, the clearer the language will need to be'

References:

Stocznia Gdynia SA v Gearbulk Holdings Ltd [2009] EWCA Civ 75

- one of the key features of knock-for-knock clauses is that they will apply irrespective of fault or blame. The parties should consider at the drafting stage whether the effects of the clause should also apply in circumstances where one party has been negligent. Again, clear wording is required if the intention is to exclude liability for negligence. Where that is the intention of the parties 'negligence' should expressly be mentioned in each aspect of the knock-for-knock clause to which it applies.

References:

Canada Steamship Lines v The King [1952] AC 192

Where it is expressly referred to in one part of the clause but is not referred to in another 'the disparity must be taken as intentional'

References:

Colour Quest Ltd v Total Downstream UK plc [2009] All ER (D) 152 (Apr)

- an exclusion clause that deprives the contract of any meaningful obligations will be unenforceable. If the knock-for-knock clause reduces the contract to no more than a declaration of intent, this principle will be applied and the scope of the clause reduced accordingly.

References:

Suisse Atlantique Société d'Armement Maritime SA v NV Rotterdamsche Kolen Centrale [1967] 1 AC 361

However, the principle should 'be seen as a last resort' and the courts have suggested that it may only apply 'in cases where the effect of the clause is to relieve one party from all liability for breach of any of the obligations which he has purported to undertake'. Whether a knock-for-knock clause will have that effect will depend on the words used

References:

Transocean Drilling UK Ltd v Providence Resources plc [2016] EWCA Civ 372 at para [27]

- the *ejusdem generis* rule operates to limit the scope of general words which follow a list. Where, for example, a knock-for-knock clause lists a number of specific categories of loss in respect of which it applies and then states 'and any other loss', the scope of the catch-all language at the end may be limited by the listed categories of loss. Whether this argument is successful will depend on the facts

Whether the *contra preferentem* rule (a rule providing that in cases of true ambiguity as to the effect of a contractual provision the term will be construed against the party that put them forward) will apply to knock-for-knock clauses in offshore oil and gas contracts was considered by the Court of Appeal decision *Transocean Drilling UK Ltd v Providence Resources Plc*.

References:

Transocean Drilling UK Ltd v Providence Resources Plc [2016] EWCA Civ 372

The Court of Appeal emphasised that the *contra preferentem* rule will not apply where there is no ambiguity (because the words of the contract are clear) and where the clause in question 'favours both parties equally, especially where they are of equal bargaining power'. For more information on contract interpretation generally, see Practice Note: Contract interpretation—rules of contract interpretation.

References:

Transocean Drilling UK Ltd v Providence Resources Plc [2016] EWCA Civ 372 at para [20]

Gross negligence and wilful misconduct in the context of knock-for-knock clauses

Knock-for-knock clauses often make reference to 'gross negligence' and 'wilful misconduct'. They are used as exceptions to the clause and result in certain behaviour being carved out from the mutual risk allocation regime. Care must be taken when using these terms.

English tort law does not recognise 'gross negligence' as distinct from simple negligence.

However, where the parties to a contract include 'gross negligence' as a term the courts will construe that term as they would any other contractual provision. Defining 'gross negligence' will provide clarity and will reduce the scope for dispute, which is the very purpose of the knock-for-knock clause. It is therefore common practice for such a definition to be negotiated.

References:

Camerata Property v Credit Suisse Securities (Europe) Ltd [2011] EWHC 479 (Comm) at paras [161]–[162]

Conversely, 'wilful misconduct' has been given effect by the English courts. In summary, it arises where a person deliberately or recklessly carries out a wrongful act, or wrongfully omits to do something, either knowing that it will cause harm or where they are reckless as to whether harm will occur. Whether an act has been deliberate or reckless and the standard to which the parties are to be held is unclear and will depend on the context. Is the relevant threshold any wilful misconduct? Or just certain types of misconduct? Therefore, as with 'gross negligence', defining 'wilful misconduct' in the contract provides certainty by enabling the parties to specify the threshold at which the knock-for-knock clause will no longer apply.

References:

Lewis v Great Western Railway Co (1877) 3 QBD 195

Consequential loss in the context of knock-for-knock clauses

It is common in the offshore energy industry for the knock-for-knock regime to cover 'consequential loss', where each party indemnifies and holds harmless the other party from its own consequential losses. Sometimes, the term 'consequential loss' is left undefined. On other occasions, the types of loss that fall within 'consequential loss' are extensively listed. Both approaches leave scope for dispute and, therefore, uncertainty. Which approach is preferable will depend on the circumstances.

The term 'consequential loss' will not be interpreted in isolation but will be construed in the context of the entire contractual liability regime. Traditionally, the interpretation of 'consequential loss' was limited to excluding indirect loss. However, recent cases have placed emphasis on the proper construction of the

provision in question, meaning that 'consequential loss' may include both types of loss referred to in *Hadley v Baxendale*.

References:

Star Polaris LLC v HHIC-PHIL INC [2016] EWHC 2941 (Comm)

Hadley v Baxendale [1843-60] All ER Rep 461

2 Entertain Video Ltd & Ors v Sony DADC Europe Ltd [2020] EWHC 972 (TCC), [2021] 1 All ER 527

Drafting considerations

When drafting knock-for-knock clauses the following points should be considered:

- how far do the indemnities in the knock-for-knock clause extend? Should they be limited to the contracting parties themselves or should their subcontractors, affiliates, directors and employees also have the benefit of them?
- should the indemnities cover claims for loss suffered by third parties?
- what types of loss are covered by the knock-for-knock regime? Should it be limited to death/personal injury and damage to property? Should it also include losses resulting from environmental harm? What about loss of profit, loss of use or 'spread costs' (the latter was the focus of the *Transocean* case)? If the types of loss covered by the clause are listed, consider how the *ejusdem generis* rule will operate

References:

Transocean Drilling UK Ltd v Providence Resources plc [2016] EWCA Civ 372

- do the parties intend to limit the application of the knock-for-knock regime in circumstances where the loss results from one party's negligence? If so, this must be expressly stated. Where this is the intention, do the parties wish the threshold to be common law simple negligence? Or do they wish to impose a higher contractual threshold such as 'gross negligence'? If so, how should that term be defined?
- should an additional limitation to the application of the knock-for-knock regime be imposed in circumstances where the loss results from one party's wilful misconduct? If so, should 'wilful misconduct' be defined to tailor it to the parties' specific requirements?
- will the clause be acceptable to the parties' insurers?
- how should claims be regulated? Do the indemnifying parties have any rights to assume the conduct of any claims? If so, on what terms?
- as with all indemnities the parties should also consider the following questions: Should the indemnified party achieve 100% recovery? Is the

indemnified party under an obligation to mitigate its losses? Should the rules on remoteness of damage apply or should the indemnified party be able to recover 'unforeseeable' losses? Express drafting should be included to cater for these situations in a way that reflects the parties' intentions

The purpose of the knock-for-knock regime must always be remembered: To provide certainty by minimising the scope for dispute and lengthy adversarial proceedings concerning fault and liability.

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