

# REVIEWING KNOCK FOR KNOCK INDEMNITIES: RISK ALLOCATION IN MARITIME AND OFFSHORE OIL AND GAS CONTRACTS

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## 1 Introduction

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 catastrophe around every corner if things go awry. A knock for knock regime is an effective contractual tool that offers parties certainty.

Knock for knock clauses first appeared in the context of motor insurance in the early 20<sup>th</sup> Century.<sup>1</sup> These clauses entered the maritime and energy sectors in the 1960s with the commencement of the North Sea oil and gas exploration. Most maritime and offshore oil and gas contracts now contain a knock for knock regime which either adopts standard industry wording or forms part of a standard form contract.<sup>2</sup> A number of the standard BIMCO forms which contain knock for knock clauses include TOWCON, TOWHIRE, SUPPLYTIME, and HEAVYCON.<sup>3</sup>

The Lord President in *Caledonia North of the Sea Ltd v London Bridge Engineering Ltd*<sup>4</sup> commented that such indemnification is ‘fundamental to the economics of the North Sea operation’.<sup>5</sup> Those remarks are apposite to other operations around the world.

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. This is accompanied by a series of mutual indemnities, all of which leads to circuity 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.

The significant advantages of knock for knock clauses are well documented – from fixing liability at the time of contracting to reducing insurance costs, simplifying (or ideally avoiding) the time, expense and difficulties inherent in attributing fault from both a factual and legal perspective, facilitating expeditious payments of compensation to injured parties where appropriate and encouraging co-operation in establishing and maintaining safe operational practices. The advantages of expediency and co-operation are particularly attractive in light of the complexities inherent in incidents involving multiple parties.

Knock for knock clauses generally have the following features:<sup>6</sup>

- the primary parties and their employees and sub-contractors constitute a ‘group’ for purposes of risk allocation purposes;
- 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;

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<sup>1</sup> *Bell Assurance Association v Licenses & General Insurance Corporation & Guarantee Fund Ltd* (1923) 17 Lloyd’s Rep. 100.

<sup>2</sup> S Rainey, ‘The Construction of Mutual Indemnities and Knock-for-Knock Clauses’ in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 68, 78–9.

<sup>3</sup> See also the industry initiative in the United Kingdom offshore oil and gas sector (LOGIC) which resulted in the development of an industry scheme of a mutual hold harmless deed (IMHH) which aims to fill the contractual lacuna that often exists between contractors working on the UK Continental Shelf concerning risk allocation. Often the contractual relationship between the contractors and the subcontractors is vertical only. IMHH is a background agreement to cater for situations where there is no direct privity of contract between the various contractors. IMHH applies to the UK’s territory of the Irish Sea and the North Sea. The list of signatories to the IMHH is substantial: <http://www.logic-oil.com/imhh/general-guidance>.

<sup>4</sup> [2000] Lloyd’s Rep IR 249; sometimes referred to as the *London Bridge Engineers case*.

<sup>5</sup> Lord Bingham also referred to knock for knock indemnities that cover employees as a ‘market practice [that] has developed to take account of the peculiar features of offshore operations.’

<sup>6</sup> R Williams, ‘Knock for Knock Clauses in Offshore Contracts’ in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 53, 56–7.

- group members (including employees, agents and subcontractors) have the same protection as the primary party by virtue of a Himalaya clause;<sup>7</sup>
- the allocation of risk is accompanied by an indemnity of other primary parties and their groups against any liability for claims, irrespective of fault. Where possible, the indemnity covers liability for employees and property of all parties for whose benefit the work is being undertaken;<sup>8</sup> and
- primary parties have insurance coverage to protect against losses and to underwrite their obligation to indemnify other primary parties and their groups.<sup>9</sup> The insurers are generally required to waive their rights of subrogation against the other primary parties and their groups.<sup>10</sup> The contract may require that each party be named in the other party's insurance contract.

Knock for knock regimes are a simple, consensual scheme of mutual risk allocation. The clauses should be mutual or co-extensive to cover the same liabilities. Notwithstanding this mutuality, knock for knock indemnities can be construed as contractual exclusion clauses, with each party seeking: (a) to exclude its own liability for losses to other parties, even if caused by its own fault; and (b) to obtain an indemnity from other parties for any liability to which it may be exposed, such as to third parties or the other parties' employees, irrespective of fault. The parties contract out of remedies to which they would otherwise be entitled.<sup>11</sup> In some jurisdictions as we will see below, the proper characterisation of knock for knock clauses may potentially impact on their construction.

## 2 Knock for Knock Clauses in Action

Where better to see knock for knock clauses in action than in the litigious aftermath of the Piper Alpha and Deepwater Horizon incidents.

### 2.1 Piper Alpha

On 6 July 1988, off the coast of Aberdeen, two rescuers and 226 workers were killed and or injured in what was the world's deadliest ever oil rig accident. Piper Alpha was once Britain's largest oil and gas producing platform, producing over 300,000 barrels of crude a day (10% of the country's total). The accident cost the Lloyd's insurance market over £1bn, making it the largest insured man-made catastrophe. The platform was owned by a consortium of companies including Texaco and was operated by Occidental.

The initial explosion was caused by an employee of Occidental who started a pump without noticing that a pressure safety valve had been removed for maintenance by a specialist valve contractor engaged by Occidental. Due to the negligence of both the operator and valve contractor, hydrocarbons escaped and ignited when the pump was engaged.

Most of the dead and injured were employed by various contractors hired under a series of contracts to perform specific tasks on the platform. The claimants alleged breach of statutory duty and negligence on the part of the operator. Initially, Occidental settled claims by the victims and their dependants for £66m. Subsequently, Occidental's insurer instituted a series of subrogated proceedings in England and Scotland against twenty-four contractors seeking indemnity under the knock for knock provisions in the respective contracts.

<sup>7</sup> A Himalaya clause extends the benefit of the indemnity of the primary party to other members of the group. The concept of a Himalaya clause arose out of the decision in *Adler v Dickson; The Himalaya* [1955] 1 QB 158; *Port Jackson Stevedoring Pty Ltd v Salmond & Spraggon (Australia) Pty Ltd* (1978) 139 CLR 231; Article IV bis (2) of the *Hague-Visby Rules*; and M White, *Australian Maritime Law* (Federation Press, 3<sup>rd</sup> ed, 2014), 4.5.8.

<sup>8</sup> Standard P&I Club Bulletin, November 2008.

<sup>9</sup> Section 21 of the *Insurance Contracts Act 1984* (Cth) provides that an insured has a duty to disclose to the insurer, before entry into the contract of insurance, every matter that is known to the insured that: (a) the insured knows to be relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or (b) a reasonable person in the circumstances could be expected to know would be relevant. Whether the insured has entered into any cross-indemnities which may expose the insurer to additional risk, is relevant to the insurer's decision.

<sup>10</sup> Parties should ensure that the waiver of subrogation is limited to those claims that fall within the scope of the knock for knock provisions of the contract, and extends to all potential claims.

<sup>11</sup> S Rainey, 'The Construction of Mutual Indemnities and Knock-for-Knock Clauses' in B Soyler and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 68, 71.

One such action was the Scottish case of *Caledonia North Sea Ltd v British Telecommunications plc*,<sup>12</sup> in which the operator sought to enforce mutual indemnities in respect of death of, and injury to, the contractors' own personnel. The indemnity clause read as follows:

Contractor shall indemnify, hold harmless and defend the Company and its parent, subsidiary and affiliate corporations and Participants and their respective officers, employees... from and against any and all suits, actions, legal or administrative proceedings, claims, demands, damages, liabilities, interests, costs... any expenses of whatsoever kind or nature whether arising before or after completion of the Work hereunder and in any manner *directly or indirectly caused, occasioned or contributed to in whole or in part, by reason of omission or negligence...* of contractor, or of anyone acting... on contractor's behalf in connection with or incidental to the work...the Contractor shall indemnify...the Company...from and against any claim, demand, cause of action, loss, expense or liability...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)

Ensuing litigation continued for some 14 years, until the House of Lords pronounced its final judgment in 2002. The court upheld the efficacy of the knock for knock regime agreed by the parties and found that the contractors and their insurers had to bear the ultimate liability for damages paid in respect of the death of, and injury to, the contractors' own employees; that is to say the loss lay where it fell, irrespective of fault.<sup>13</sup>

The contractors had argued that they were not liable to indemnify the operator unless the contractors were negligent or had breached their statutory duty; in other words, they argued that the knock for knock clause did not impose liability where none otherwise existed. The court rejected this argument, holding that on its proper construction, the indemnity clause imposed a general liability to indemnify the operator against any liability in respect of their own employees. The only express exception was if the accident was attributable to the sole negligence or wilful misconduct of the operator. As such, the contractors had to indemnify the operator under the knock for knock clause even though the contractors were not at fault.<sup>14</sup> Lord Bingham said:<sup>15</sup>

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)

Lord Hoffmann found that the cross-indemnity dispelled any concern that it might otherwise be unreasonable to require contractors to indemnify the operator against loss for which the contractors were not responsible. This practice was found to be 'normal' industry practice.

The litigation following the Piper Alpha disaster is testimony to the efficacy and operation of knock for knock clauses.

## 2.2 Deepwater Horizon

On 20 April 2010, the Macondo exploratory well in the Gulf of Mexico was being drilled by the Deepwater Horizon when it suffered a blowout, causing a fire. The Deepwater Horizon sank 36 hours after the fire began. Over the next 87 days, five million barrels of oil spilled into the Gulf of Mexico. Deepwater Horizon was owned by Transocean and leased to BP, who operated it on behalf of a joint venture. Halliburton was engaged as BP's cement contractor and Cameron had designed the blowout preventer that failed on the rig.

Thousands of law suits were filed against BP, and in August 2010 all of the actions were consolidated into proceedings in the United States District Court for the Eastern District of Louisiana. By agreement with the US Government, BP established a trust fund of US\$20bn to satisfy claims arising from the disaster. Settlement negotiations commenced in 2011, resulting in the Economic Property Damages Settlement and the Medical Benefits Settlement, which received court approval in December 2012. To date, BP has settled approximately 100,000 claims totalling some US\$7.8bn. On 20 May 2015, BP settled the multi-billion dollar lawsuits with

<sup>12</sup> [2002] 1 Lloyd's Rep. 553.

<sup>13</sup> The contractors' obligation under the indemnity clauses were described as a 'primary liability', whereas the operator's insurer's duty to indemnify the contractor was described as a 'secondary liability'.

<sup>14</sup> Lord Bingham summarized the commercial purposes of knock for knock indemnities based on industrial commentaries, such as D Sharpe, *Offshore Oil and Gas Insurance* (Witherby, 1994) and T Daintith and G Willoughby, *Manual of United Kingdom Oil and Gas Law* (Oyez, 1977).

<sup>15</sup> [2002] 1 Lloyd's Rep. 553, [7].

Transocean, Halliburton and Cameron. BP still faces a potential fine of between US\$5bn and US\$21bn under the U.S. *Clean Water Act*. Transocean settled its Clean Water Act liability for \$1bn. BP has paid \$43.8bn in pre-tax charges for clean-up and other costs.

Transocean and its contractors relied on knock for knock clauses in the respective contracts to exclude their liability for loss and damage other than to their own employees and property. Most of the legal issues raised concerning these indemnities were addressed in the decision of Judge Barbier of the United States District Court for the Eastern District of Louisiana.

### 3 Construing Knock for Knock Indemnity Provisions

In the context of commercial contracts, knock for knock clauses are construed in accordance with ordinary canons of contractual construction. In *Darlington Futures Ltd v Delco Australia Pty Ltd Ltd*,<sup>16</sup> the High Court of Australia held that an exclusion clause is to be construed according to its ‘natural and ordinary’ meaning, read in light of the contract as a whole, giving due weight to the context in which the clause appears. Where appropriate, the clause is construed *contra proferentem* in the case of ambiguity.<sup>17</sup> These same principles are of general application to commercial contracts in Australia.

In *Andar Transport Pty Ltd v Brambles Ltd*,<sup>18</sup> Brambles, who provided laundry delivery services, contracted with Andar to outsource that service. Andar employed drivers, including Mr Wail, to collect and unload the linen. Andar contracted to indemnify Brambles for all losses and damages for which Brambles may become liable due to the negligence of Andar. During the course of his employment, Mr Wail was injured and sued Brambles, who in turn joined Andar as a third party seeking indemnity under the contract. The majority of the High Court found ambiguity in the language used in the clause and strictly construed it against Brambles (as the party seeking indemnity) and in favour of Andar (as in effect the surety). In doing so, the High Court applied the traditional rule of construction, that indemnities should be construed strictly against the surety.<sup>19</sup>

The approach in Australia may differ somewhat from that 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. The English position is exemplified by *Ailsa Craig Fishing Co Ltd v Malvern Fishing Co Ltd*,<sup>20</sup> where the House of Lords held that a limitation clause need not be construed in accordance with the same principles that apply to exclusion or indemnity clauses. The absence of a reference to negligence in the generally expressed limitation clause did not prevent it from protecting against the contractor’s liability for negligence.

This should be contrasted with the approach taken by the court in *E. E. Caledonia Ltd v Orbit Valve Co Europe*,<sup>21</sup> which is one of the leading cases arising from the Piper Alpha disaster. The operator sought indemnity from the employer of the service engineer retained to overhaul certain equipment. The indemnity clause was expressed generally and without reference to negligence. The court found that the parties’ right to sue each other for negligence had been preserved, and the plaintiff had exclusively assumed the risk of its own negligence and breach of statutory duties. The court held that for negligence to be covered by a knock for knock regime, an indemnity clause should expressly and clearly refer to negligence.<sup>22</sup> As the indemnity clause in this contract did not do so, it was found that the knock or knock regime did not extend to liability caused by a party’s own negligence.

#### 3.1 Are Knock for Knock Clauses Indemnity or Exclusion Clauses?

The question whether knock for knock clauses are properly construed as indemnity or exclusion clauses was considered in *Farstad Supply A/S v Enviroco Ltd*.<sup>23</sup> The case concerned the outbreak of a fire on an oil rig supply vessel in July 2002. The fire caused causing substantial damage to the vessel and death of an employee of a contractor engaged by the charterer to clean the vessel’s tanks. The owner of the vessel sued the tank cleaning

<sup>16</sup> (1986) 161 CLR 500.

<sup>17</sup> See also *Selected Seeds Pty Ltd v QBEMM Pty Ltd* (2010) 242 CLR 336, [29]–[30]. In *Oz Minerals Holdings Pty Ltd v AIG Australia Ltd* [2015] VSC 185, Hargrave J confirmed that ‘the court does not strain to find ambiguity in exclusion clauses. It is only appropriate to apply the *contra proferentem* principle where ambiguity remains after applying accepted principles of contractual interpretation.’ The issue of the method of construction of exclusion clauses is considered further in the context of exclusion of consequential losses from the operation of knock for knock indemnities.

<sup>18</sup> (2004) 217 CLR 424.

<sup>19</sup> (2004) 217 CLR 424, [17].

<sup>20</sup> [1983] 1 WLR 964.

<sup>21</sup> [1994] 1 WLR 221.

<sup>22</sup> See further *Smith v South Wales Switchgear Ltd* [1978] 1 All ER 18.

<sup>23</sup> [2010] Lloyd’s Rep. 387.

contractor in tort alleging that the fire was caused by the negligence of the contractor's employees. The contractor denied liability and alleged that the rig owner and the charterer had caused or contributed to the accident. It sought a contribution from the charterer pursuant to section 3(2) of the *Law Reform (Miscellaneous Provisions) (Scotland) Act 1940*.<sup>24</sup>

On appeal, Farstad argued that on its proper construction, cl 33.5 was an exclusion clause and the parties had agreed that the charterer was not liable for loss or damage to the vessel, even if caused by its negligence. Lord Clarke (with whom Lords Phillips, Hope, Rodger and Mance agreed) held that the clause was an exclusion clause which operated to exclude the charterer's liability to Farstad for damage to the vessel.<sup>25</sup> The exclusion was held to be operative even where the damage was caused by the charterer's negligence. Lord Clarke said at [24] 'The natural meaning of that expression is that, since [Farstad] must hold [the charterer] harmless from a claim by the owner in respect of damage to the vessel caused by [the charterer's] negligence, [the charterer] cannot be liable to [Farstad] in respect of such damage.'

The clause also operated as an indemnity in respect of claims by third parties. Hence, the contractor was not entitled to a contribution from the charterer under section 3(2) of the *Law Reform (Miscellaneous Provisions) (Scotland) Act 1940*, because it could not establish that 'if sued', the charterer would have been liable to Farstad; the charterer would have a defence to Farstad's claim as any such liability was excluded by cl 33.5 of the charterparty.<sup>26</sup>

The case (despite its somewhat tortuous path) confirmed the efficacy of contractual indemnity clauses, thereby enabling parties to procure insurance for their assumed risks effectively and efficiently. The case exemplifies the protection afforded to parties by knock for knock clauses, even against third parties who are not privy to the knock for knock arrangement.

### 3.2 Knock for Knock Clauses as Part of Standard Form Contracts

In Australia, the principles of contractual construction are well settled:

- commercial contracts are construed objectively – the subjective intention of the contracting parties is irrelevant;
- the court must give effect to the contractual words used, the context, subject matter and purpose of the provisions ascertained by reference to the contractual language used;<sup>27</sup>
- words in commercial contracts are given the meaning that a reasonable business person would have understood those terms to mean;<sup>28</sup>
- commercial contracts are construed so as to avoid commercial nonsense or commercial inconvenience. Courts generally will assume that a commercial result is intended to be achieved;<sup>29</sup>
- contracts are construed as a whole, giving consistent meaning to all of their terms, and avoiding any apparent inconsistency. Preference is to be given to a construction that gives 'a congruent operation to the various components of the whole';<sup>30</sup>

<sup>24</sup> Section 3(2) applies to a claim for contribution by a person who has been held liable 'in any such action as aforesaid'. The reference to 'any such action' is a reference to the action identified in subsection (1) and is thus a reference to an action by a plaintiff against a defendant 'in respect of loss or damage arising from any wrongful acts or negligent acts or omissions' by the defendant. If a defendant, as such a wrongdoer, has been held liable to pay damages or expenses to a plaintiff and if he pays damages, he has a right to recover such contribution, if any, as the court may deem just from 'any other person who, if sued, might also have been held liable in respect of the loss or damage on which the action was founded': *Farstad Supply AS v Enviroco Ltd* [2010] Lloyd's Rep. 387, [11] (Clarke LJ) ('*Farstad Supply*').

<sup>25</sup> [2010] Lloyd's Rep. 387; notably, this case is not at odds with Judge Barbier's decision in *Re: Oil Spill by the Oil Rig "Deepwater Horizon"*. Judge Barbier held that knock for knock clauses merely shift responsibility, and do not exclude it. However, Judge Barbier was interpreting this from the perspective of all parties to the agreement. Properly construed, knock for knock clauses do not create lacunas where no liability exists; one party (or more) will always be liable. Conversely, Lord Clarke in *Farstad Supply* interpreted the knock for knock clause from the perspective of a singular party. In this context, these clauses do exclude liability, but another party will always be liable.

<sup>26</sup> [2010] Lloyd's Rep. 387, [29] (Clarke LJ).

<sup>27</sup> *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451, [22]; *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* (2004) 219 CLR 165, [40].

<sup>28</sup> *Electricity Generation Corporation (t/a Verve Energy) v Woodside Energy Ltd* (2014) 251 CLR 640, [35].

<sup>29</sup> *Ibid.*

<sup>30</sup> *Wilkie v Gordian Runoff Ltd* (2005) 221 CLR 522, [16]; *Australian Broadcasting Commission v Australasian Performing Right Association Ltd* (1973) 129 CLR 99, 109.

- in giving a business like interpretation to contracts, if an exclusion clause is reasonably open to two competing constructions, the construction to be preferred is the one that avoids ‘capricious, unreasonable, inconvenient or unjust consequences’;<sup>31</sup> and
- courts must not re-write the terms of a commercial contract.<sup>32</sup> In *Interpretation of Contracts in Australia*,<sup>33</sup> Lewison and Hughes warned that ‘reliance on background must be tempered by loyalty to the contractual text’. This assumes that there is no basis for the court to rectify the contract on the basis of mistake or otherwise.

In cases where contracts contain a knock for knock regime which either adopts standard industry wording or forms part of a standard form contract, the factual matrix is likely to be irrelevant, as the parties’ particular circumstances and contractual matrix will not inform the drafting of the clauses.<sup>34</sup> That being said, courts have shown a willingness to give effect to the object and purpose of knock for knock clauses, as set out below.<sup>35</sup>

#### 4 Possible Restrictions on the Operation of Knock for Knock Indemnities

It is axiomatic that the scope of knock for knock indemnity clauses is governed by the parties’ contractual language. Some knock for knock clauses expressly exclude certain types of claims. For example, clause 14 of the SUPPLYTIME 2005 charter party excludes from the knock for knock indemnity: (a) undeclared dangerous cargo or hazardous or noxious substances shipped by the charterers on board the vessel, (b) pollution claims and (c) general average. Such claims must be resolved under traditional fault based liability regimes.

As set out above, courts consider that knock for knock indemnities are in effect exclusion clauses and, as such, any attempt to exclude a party’s liability for negligence is only enforceable if its wording is unambiguous. Other issues that frequently arise concern the scope of knock for knock clauses and in particular if they are sufficiently wide to protect the indemnified party include:

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

These areas shall be considered in turn.

<sup>31</sup> *Australian Broadcasting Commission v Australasian Performing Rights Association Ltd* (1973) 129 CLR 99, 109; *Oz Minerals Holdings Pty Ltd v AIG Australia Ltd* [2015] VSC 185, [21].

<sup>32</sup> *Euphoric Pty Ltd v Ryledar Pty Ltd* [2006] NSWSC 2, [31]–[33] (Palmer J).

<sup>33</sup> Sir Kim Lewison and David Hughes, *Interpretation of Contracts in Australia* (Thomson Reuters, 1st Australian ed, 2012), [3.14.5].

<sup>34</sup> S Rainey, ‘The Construction of Mutual Indemnities and Knock-for-Knock Clauses’ in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 68, 78–9; see *Dairy Containers Limited v Tasman Orient CV* [2005] 1 WLR 215, [13]: ‘There may reasonably be attributed to the parties to a contract such as this such general commercial knowledge as a party to such a transaction would ordinarily be expected to have, but with a printed form contract, negotiable by one holder to another, no inference may be drawn as to the knowledge or intention of any particular party. The contract should be given the meaning it would convey to a reasonable person having all the background knowledge which is reasonably available to the person or class of persons to whom the document is addressed.’

<sup>35</sup> *Caledonia North Sea Ltd v British Telecommunications Plc* [2002] 1 Lloyd’s Rep. 553; *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); *E. E. Caledonia Ltd v Orbit Valve Co Europe* [1994] 1 WLR 221.

## 4.1 Gross Negligence

### 4.1.1 Defining ‘Gross Negligence’

‘Gross negligence’ is not traditionally recognised as a distinct concept in either Australia or England.<sup>36</sup> Nonetheless, knock for knock clauses traditionally exclude liability for ‘gross negligence’ or ‘wilful misconduct’. Courts, therefore, have had to deal with these concepts as a matter of contractual construction. Some guidance has emerged from the cases including that:

- gross negligence involves a serious disregard of an obvious breach,<sup>37</sup>
- conscious wrongdoing is not an element of gross negligence – the conduct need not be intentional or contumelious to qualify as gross negligence. As such, it is not contrary to public policy for a party to exclude liability for gross negligence,<sup>38</sup> and
- the difference between ‘gross negligence’ and ordinary negligence appears to be one of degree rather than being a difference in kind.<sup>39</sup>

Under New York law, the principle of ‘gross negligence’ is well established. 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’,<sup>40</sup> ‘egregiously negligent’ or includes a ‘high degree of careless conduct’.<sup>41</sup> Professor Keeton explains that gross negligence is less than reckless disregard or conscious indifference to the consequences but is greater than ordinary inattention or inadvertence.<sup>42</sup> Gross negligence involves a conscious choice of conduct involving an obvious or high degree of risk with serious ramifications. Whether conduct constitutes gross negligence is a matter of objective determination.<sup>43</sup>

### 4.1.2 Excluding Losses Caused by Gross Negligence

In *Re: Oil Spill by the Oil Rig “Deepwater Horizon” in the Gulf of Mexico, on April 2010* (‘*Re: Oil Spill by the Oil Rig “Deepwater Horizon”*’)<sup>44</sup> Transocean claimed that the drilling contract between it and BP required BP to defend and indemnify Transocean from claims and liabilities arising from oil pollution, even if caused by Transocean’s negligence or ‘gross negligence’. BP accepted that it was liable to indemnify Transocean for pollution claims caused by Transocean’s fault or negligence, but it denied liability to indemnify Transocean for claims caused by Transocean’s ‘gross negligence’ or strict liability, such as claims under the *US Clean Water Act*. BP argued that public policy prohibited a contractual indemnity for ‘gross negligence’, punitive damages or statutory penalties. BP further argued that, as a matter of construction, the inclusion of the phrase ‘negligence or fault’ in the knock for knock indemnity clause excluded an indemnity for losses from other causes, such as gross negligence.

Judge Barbier interpreted the clause as emphasising that BP assumed the risk of subsurface pollution, even if caused by Transocean’s negligent conduct. His Honour found that the clause did not exclude gross negligence, strict liability or other cause of damage. Judge Barbier said that this interpretation was consistent with the

<sup>36</sup> *Tradigrain SA v Intertek Testing Services (ITS) Canada Ltd* [2007] EWCA Civ 154, [23] (Bick LJ); C Sappideen and P Vines, *Fleming’s The Law of Torts* (Lawbook Co., 10<sup>th</sup> ed, 2011), [7.180]; however, contrast *James Thane Pty Ltd v Conrad International Hotels Corp* [1999] QCA 516, [74], (Williams J).

<sup>37</sup> L Brown, ‘Gross Negligence in Exclusion Clauses: Is there an intelligible difference between ordinary negligence and gross negligence’ (2005) 16 *Insurance Law Journal* 1, 9, where the author suggests that risks which are not actually understood or contemplated by the defendant but are due to a ‘serious heedlessness or indifference to the consequence in intended actions or inactions’ are included in the meaning of gross negligence.

<sup>38</sup> *Armitage v Nurse* [1998] 1 WLR 270; *ANZ Banking Group Ltd v Intagro Projects Pty Ltd* [2004] NSWSC 1054, [28]–[29].

<sup>39</sup> *Canerata v Credit Suisse* [2011] EWHC 479 (Comm); *Armitage v Nurse* [1997] 2 All ER 5, 713; contrast *Spread Trustee Co. Ltd v Hutcheson* [2012] 2 AC 194. Lord Clarke expressed support for the notion that a difference lies between negligence and gross negligence. Lord Clarke concluded that English law did recognise gross negligence in some contexts; and that English law recognised the difference in legal principle between negligence and gross negligence and between those types of negligence and fraud: [2012] 2 AC 194, [50]–[51]. Sir Robin Auld stated: ‘On the plain meaning of the words, and as a matter of logic and common sense, the terms ‘negligence’ and ‘gross negligence’ differ only in the degree or seriousness of the want of due care they describe. It is a difference of degree, not of kind’: [2012] 2 AC 194, [117].

<sup>40</sup> *Metro Life v Noble Lowndes* 84 N.Y.2d 430, 439 (1994).

<sup>41</sup> R.A. Percy and C.T. Walton, *Charlesworth & Percy on Negligence* (Sweet & Maxwell, 9<sup>th</sup> ed, 1997) 9.

<sup>42</sup> W P Keeton (ed), *Prosser and Keeton on Torts* (West Publishing Co, 5th Lawyer’s ed, 1984), 215.

<sup>43</sup> *Lester v Atchison, Topeka and Santa Fe Railway Co* 272 F 2 d 42, 47 (1960).

<sup>44</sup> (case 2:10-md-02179-CJB-SS Document 5446).

obligation that BP assume ‘any loss, damage, expense, claim, fine, penalty, demand, or liability for pollution or contamination...not assumed by [Transocean]...’ (emphasis added).

As to whether public policy prohibited a party from being indemnified against its own gross negligence, Judge Barbier noted that he was not able to find a binding case, and was free to decide the question himself. His Honour noted the general rule of freedom of contract, finding that agreements that have been voluntarily and fairly made should be upheld. However, contracts can be invalidated on the grounds that they violate public policy.<sup>45</sup> With reference to the commercial purpose of knock for knock indemnities, on the grounds of public policy, Judge Barbier emphasised that the drilling contract allocated risk to both BP and Transocean, and given this risk allocation, a grossly negligent act by Transocean could have resulted in liability to Transocean as easily as it could have resulted in liability to BP. On that basis, Judge Barbier stated that the reciprocal nature of the indemnity created an incentive for Transocean to avoid grossly negligent conduct, or at the very least, the indemnity could not be said to encourage grossly negligent conduct. As such, the knock for knock clause that included an indemnity for gross negligence was found not to be contrary to public policy.

In *Red Sea Tankers Ltd and Others v Papchirstidis “The Hellespont Ardent”*,<sup>46</sup> the High Court in England construed the phrase ‘gross negligence’ under New York law. Mance J concluded that the concept of gross negligence embraces ‘...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.’<sup>47</sup> Mance J goes on to state that:<sup>48</sup>

If the matter is viewed according to purely English principles of construction, I would reach the same conclusion. Gross negligence is clearly intended to represent something more fundamental than failure to exercise proper skill and/or care constituting negligence. *But as a matter of ordinary language and general impression, the concept of gross negligence is capable of embracing not only conduct undertaken with actual appreciation of the risks involved but also serious disregard of or indifference to an obvious risk.* (emphasis added)

On the balance of authority,<sup>49</sup> it appears likely that in England and Australia, loss and damage caused by negligence in any form or degree will be regulated by the knock for knock regime, subject to the proper construction of the particular clause. If parties do not want to indemnify for certain conduct which may be classified as gross negligence, the exclusion of that conduct should be expressly provided for in the knock for knock clause, rather than relying on the wording of gross negligence as a catch all.

## 4.2 Wilful Misconduct

The main distinction between ‘gross negligence’ and ‘wilful misconduct’ appears to be that wilful misconduct involves an element of wilfulness or intention, where a party acts recklessly, not caring whether it is right or wrong, regardless of the consequences of its conduct.<sup>50</sup> In *Lewis v Great Western Railway Co*,<sup>51</sup> Bramwell LJ held that wilful misconduct includes actual knowledge that harm will result from the conduct, knowing indifference and wilful blindness. Brett LJ stated that:<sup>52</sup>

...if it is brought to [a party’s] notice that what he is doing, or omitting to do, may seriously endanger..., and he wilfully persists in doing that against which he is warned, careless whether he may be doing damage or not, then I think he is doing a wrong thing, and that that is misconduct, and that, as he does it intentionally, he is guilty of wilful misconduct; or if he does, or omits to do something which everybody must know to be a wrong thing to do. I think that those terms together import a knowledge of wrong on the part of the person who is supposed to be guilty of the act or omission.

<sup>45</sup> Citing *Twin City Pipeline Co. v Harding Glass Co.*, 283 U.S. 353, 356 (1931).

<sup>46</sup> [1997] 2 Lloyd Rep 547.

<sup>47</sup> [1997] 2 Lloyd’s Rep. 547, 586.

<sup>48</sup> *Ibid.*

<sup>49</sup> See *Sucden Financial Ltd v Fluxo-Cane Overseas Ltd* [2010] EWHC 2133 (Comm), [54], (Blair J); *Marex Financial Ltd v Fluxo-Cane Overseas Ltd* [2010] EWHC 2690 (Comm), [9] (David Steel J); *Deutsche Bank AG v Sebastian Holdings Inc* [2013] EWHC 3463 (Comm), [1096], (Cooke J): which are recent Commercial Court cases which cast doubt on whether there is any distinction between negligence and gross negligence.

<sup>50</sup> *John v Star City Pty Ltd* [2014] FWC 543. See also E Blackburn and J Lightfoot, ‘Wilful Misconduct and Gross Negligence Exclusions in Knock-for-Knock Provisions in Offshore Contracts’ in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 181, 184.

<sup>51</sup> (1877) 3 QBD 196, 206.

<sup>52</sup> *Ibid.*, 210.



In *Alpstream AG v PK Airfinance SárI*<sup>53</sup> the court considered the meaning of ‘wilful negligence’ in the context of an attempt to equate it to gross negligence and to thus remove the element of conscious wrongdoing. Burton J rejected this construction and adopted the test set out by Longmore J in *National Semiconductors (UK) Ltd v UPS Ltd*,<sup>54</sup> that wilful misconduct equates to: ‘...either (1) an intention to do something which the actor knows to be wrong or (2) a reckless act in the sense that the actor is aware that loss may result from his act and yet does not care whether loss will result or not or... ‘he took a risk which he knew he ought not to take’.<sup>55</sup>

While the basic concept of wilful misconduct is relatively clear, the concept is capable of significant tailoring to more fully set out what the parties wish to achieve, should they seek to exclude liability arising from wilful misconduct. By way of example, it is possible to limit the scope of the knock for knock indemnities in the face of intentional or conscious disregard at the senior management level of either a contractual provision or of good oil field practices.<sup>56</sup>

### 4.3 Material Breach of Contract

Courts have refused to limit the operation of mutual indemnity regimes by predicating their operation on compliance by the party seeking indemnity with its contractual obligations, provided that the indemnity does not undermine the purpose of the contract.

A ‘material breach’ of contract is one which substantially adversely affects the interests of the other party: *Elders Ltd v E J Knight & Co Pty Ltd*.<sup>57</sup> A similar approach was taken in *Androvitsaneas v Members First Broker Network Pty Ltd*,<sup>58</sup> where the Victorian Court of Appeal accepted that the word ‘material’ means ‘important’ and connotes ‘significance’.<sup>59</sup>

In *Smit International (Deutschland) GmbH v Josef Mobius Bau-gesellschaft GmbH*,<sup>60</sup> it was argued that clause 18 of the TOWCON contract (concerning damage to a third party’s property) had to be read restrictively, so as not to apply where the tugowner fails to provide a seaworthy tug. Morison J rejected that argument on the basis that it conflicted with the purpose of knock for knock indemnities. His Honour said:<sup>61</sup>

The knock for knock agreement is a crude but workable allocation of risk and responsibility: even where the tug or tow is wholly responsible for the accident liability depends entirely upon the happenstance of which of the two collided with the third party. Where damage is caused to an innocent third party during a tow it may often be difficult to ascertain whether the tug or tow or both were at fault. So far as the innocent third party is concerned, provided he receives full satisfaction, the identity of the tortfeasor is unimportant. But if there were disputes between tug and tow, with each blaming the other, absent the agreement there would be a risk that the third party would have to institute proceedings and await judgment before receiving compensation...

Introducing arguments about seaworthiness into this blunt and crude regime would lessen the effectiveness of the knock for knock agreement. (emphasis added)

The operation of a knock for knock clause in the face of a material breach of contract also arose in *A Turtle Offshore SA v Superior Trading Inc*.<sup>62</sup> The tug *Mighty Deliverer* was contracted to tow the *A Turtle* semi-submersible drilling rig from Brazil to Singapore on the terms of TOWCON. The tugowner was obliged to use its ‘best endeavours’ to perform the towage and to exercise due diligence to ‘tender the tug at the place of the departure in a seaworthy condition and in all respects ready to perform the towage.’ The knock for knock clause provided that loss or damage ‘of whatsoever nature, howsoever caused or sustained by the Tow’ would be to the sole account of the hirer, without recourse to the tugowner.

During the tow, the tug ran out of fuel and deliberately abandoned the rig in the South Atlantic. After refuelling, the tug returned to collect the rig, however, the rig ran aground. The owners of the rig sued the tugowners for loss

<sup>53</sup> [2013] EWHC 2370; an appeal is pending on this case.

<sup>54</sup> [1996] 2 Lloyd’s Rep. 212, 214.

<sup>55</sup> [2013] EWHC 2370, [94].

<sup>56</sup> E Blackburn and J Lightfoot, ‘Wilful Misconduct and Gross Negligence Exclusions in Knock-for-Knock Provisions in Offshore Contracts’ in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 181, 186–7.

<sup>57</sup> [2009] NSWSC 1462, [48].

<sup>58</sup> [2013] VSCA 212, [89].

<sup>59</sup> This approach was adopted in *Apache Oil Offshore Pty Ltd v Santos Offshore Pty Ltd* [2015] WASC 318, [199] (Chaney J).

<sup>60</sup> [2001] CLC 1545.

<sup>61</sup> *Smit International (Deutschland) GmbH v Josef Mobius Bau-gesellschaft GmbH* at [19]–[20].

<sup>62</sup> [2008] EWHC 3034.

of the rig and removal costs. The tugowners counterclaimed against the rig owners for freight that was due on arrival of the tug and tow at the destination.

While TOWCON obliges the tugowner to exercise due diligence in tendering a seaworthy tug ready for towage, 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. Teare J said that the wording of the clause was sufficiently wide that, construed literally, the tow must take for his sole account any damage whatsoever suffered by the tow, so long as it does not defeat that main purpose of the contract or which reflects the contractual context. Thus, the clause would protect the tugowner provided it was 'actually performing their obligation under the TOWCON, albeit not at the required standard.' As the tugowners had not abandoned their efforts to complete the tow, notwithstanding that those efforts fell short of the required standard of care; the court held the tugowner was protected by the knock for knock indemnity.<sup>63</sup> This may be problematic as it may be difficult in any given situation to discern when contractual obligations are no longer being performed, such as would exclude the operation of a knock for knock clause.

In *Smedvig Ltd v Elf Exploration UK plc; "The Super Scorpio II"*,<sup>64</sup> Smedvig and Elf Exploration entered into an agreement containing mutual indemnities. Elf Exploration agreed to indemnify Smedvig against all claims in respect of damage to Company Items. Under the contract, Smedvig undertook to 'take all necessary care of Company Items as required by good oil and gas industry practices and to return them to [Elf Exploration] in their original condition'. During operations, a Company Item, a ROV called the *Super Scorpio II* was damaged by one of Smedvig's employees. The owners of the ROV obtained damages from Smedvig for the cost of repairs to the ROV, and Smedvig sought an indemnity from Elf Exploration. Elf Exploration contended that it was not obliged to indemnify Smedvig where Smedvig breached its contractual obligation to take all necessary care of the Company Items.

The court held that the allocation of risk in the knock for knock clause was clear; Smedvig was obliged to take care of any Company Item entrusted to it, but any liability for any damage caused by lack of care was nonetheless allocated to Elf Exploration under the knock for knock clause.

This issue was addressed by Judge Barbier in *Re: Oil Spill by the Oil Rig "Deepwater Horizon"*. BP claimed that Transocean breached the contract and, or alternatively, acted in a way that materially increased BP's risk, which voided BP's obligation to indemnify Transocean. Judge Barbier accepted that breach of a fundamental, core obligation of the contract could invalidate the indemnity clause. His Honour cited *Mobil Chem Co v Blount Bros Corp*,<sup>65</sup> where the court explained that where there is a serious breach of contract, the entire contract becomes void for mutuality: '[the indemnitee] would have no obligations under the contract; it could breach the contract in any way and to any extent and [the indemnitor] would be liable to itself! This interpretation would be ridiculous.'

While accepting the possibility that a material breach of the contract could invalidate an indemnity clause, by reference to article 25.1, which required BP to indemnify Transocean 'without regard to the cause or causes thereof, including...breach of representation or warranty [or]... breach of contract...', Judge Barbier said that BP's arguments appeared doubtful. However, he was not prepared to resolve these issues in a summary judgment application.

#### 4.4 Statutory or Strict 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"*, Transocean argued that the statutory penalties were in the nature of civil penalties under the *US Clean Water Act* in respect of which it sought an indemnity were primarily remedial, such that an indemnity in respect of the statutory liability did not offend public policy. Judge Barbier rejected Transocean's argument. He found that the primary goal of the civil penalty provisions was to punish and deter future pollution, and as such it 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

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<sup>63</sup> To a similar effect, albeit in a non-maritime context, see *Kudos Catering (UK) v Manchester Central Convention Complex* [2013] EWCA Civ 38, where the Court of Appeal considered a knock for knock clause in a catering and hospitality services contract.

<sup>64</sup> [1998] 2 Lloyd's Rep. 659.

<sup>65</sup> 809 F.2d 1175, 1182 (5th Cir. 1987).

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.<sup>66</sup>

Similarly, in England, courts will not generally allow indemnities to extend to criminal penalties, subject to important caveats.<sup>67</sup> In *Askey v Golden Wine Co Ltd*,<sup>68</sup> the plaintiff sought an indemnity in respect of repatriation expenses and fines imposed on him under the *Food and Drugs Act* for his crime of selling ‘contaminated cocktails unfit for human consumption.’<sup>69</sup> The claim for indemnity failed on public policy grounds. Denning J upheld the principle of English law that 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. Furthermore, Denning J noted that public policy prohibits an indemnity in respect of expenses that an offender has incurred by reason of being compelled to make reparation for their crime.

In *Osman v J Ralph Moss Ltd*,<sup>70</sup> 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*.<sup>71</sup>

Thus, it can be said that whether knock for knock indemnities are unenforceable in respect of claims for statutory liability is determined on a case by case basis, having regard to the nature of the offence, the legislative intention 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 operate, so as to understand what risks/potential liabilities can be contractually allocated.

## 4.5 Consequential Loss

Some contracts seek to exclude consequential loss from the operation of knock for knock indemnities. An analysis of the relevant case law highlights that when drafting knock for knock clauses the specific term ‘consequential loss’ should be avoided to minimise ambiguity.

### 4.5.1 The Meaning of ‘Consequential Loss’

A party claiming damages for breach of contract is to be placed in the same position as if the contract had been performed, as far as monetary compensation can do so. This rule is subject to the limitations of mitigation and remoteness. The limitation of remoteness was established in *Hadley v Baxendale*,<sup>72</sup> where Baron Alderson identified the two types of losses:

- those that arise naturally or directly (the first rule); and
- those that may reasonably be supposed to have been in the contemplation of both parties at the time of contracting as the probable result of a breach because of special knowledge at the date of the contract (the second rule).

In *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd*,<sup>73</sup> Nettle JA (as his Honour then was) stated that the true distinction between the two rules in *Hadley v Baxendale* is that ‘normal loss’ is loss that every plaintiff in a like situation will suffer, and ‘consequential loss’, is anything beyond the ‘normal measure of damages’, such as profits lost or expenses incurred through breach.<sup>74</sup> It is not correct to construe ‘consequential loss’ as limited to the second rule in *Hadley v Baxendale*. His Honour held it would be unrealistic to suppose that the parties used the term ‘consequential loss’ in any other sense other than in its natural and ordinary meaning, when read in light

<sup>66</sup> *Ibid*, 23.

<sup>67</sup> C Egbochue, Reviewing ‘Knock for Knock’ Indemnities Following the Macondo Well Blowout (2013) 7 *Construction Law International* 7, 13.

<sup>68</sup> [1948] 2 All ER 35.

<sup>69</sup> The contaminant was methylated spirits.

<sup>70</sup> [1970] 1 Lloyd’s Rep. 313.

<sup>71</sup> (1996) Aust Torts Reports 81-401, 39–43.

<sup>72</sup> (1854) 9 Exch 341.

<sup>73</sup> [2008] VSCA 26.

<sup>74</sup> *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26, [87]; H McGregor, *McGregor on Damages* (Sweet & Maxwell, 18<sup>th</sup> ed, 2009), [1-039].

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.<sup>75</sup>

A similar approach was adopted in *Ferryways NV v Associated British Ports; "The Humber Way"*,<sup>76</sup> where Teare J considered whether the words 'including without the limitation the following' indicated that the parties were giving their own definition of indirect or consequential losses so as to include the specified losses even if they are the direct and natural result of the breach in question. Teare J found that:<sup>77</sup>

...those words do not provide the sort of clear indication which is necessary for the defendant's argument. The parties are merely identifying the type of losses (without limitation) which can fall within the exemption clause so long as the losses meet the prior requirement that they "of an indirect or consequential nature". Had the parties intended that liability for losses which were the direct and natural result of the breach could be excluded they would have hardly have described such losses as "indirect or consequential".

Based on the above case examples, the question whether a knock for knock clause excludes consequential loss will depend upon the construction of the particular clause in question. Against this background, we shall now consider of some of the standard form clauses used in the maritime and offshore oil and gas sectors dealing with consequential loss.

#### 4.5.2 Example Clauses Excluding Consequential Loss

##### **SUPPLYTIME 89**

Clause 12 (c) of the SUPPLYTIME 89 form reads:

Neither Party shall be liable to the other for, and, each party hereby agrees to protect, defend and indemnify the other against, *any consequential damages* whatsoever arising out of or in connection with the performance or non-performance of this Charter Party, including, but not limited to, loss of use, loss of profits, shut-in or loss of production and cost of insurance. (emphasis added)

The intention behind this clause has been considered in 2002 by a London arbitral tribunal in a confidential arbitration,<sup>78</sup> in which the charterers claimed damages for breach of contract. The owners argued that the losses claimed were 'consequential' losses, which were expressly excluded by the contract.

The arbitral tribunal held that most of the damages claimed by the charterers related to the loss of use of equipment rented by the charterers and that, even if those losses were considered to be direct (and fell within the first rule in *Hadley v Baxendale*) they would be excluded by the words 'loss of use' in clause 12(c). The tribunal also held that the cost of hiring and purchasing substitute equipment was recoverable as direct losses, which were not excluded under the clause. This decision appears to be inconsistent with *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* and *Ferryways NV v Associated British Ports*. Following the construction adopted in those cases, 'loss of use' would only have been an excluded loss if it was indirect or consequential. This case highlights the importance of clarity in drafting, so as to avoid uncertain outcomes.

##### **TOWCON/TOWHIRE**

The TOWCON and TOWHIRE standard form contracts contain a similar exemption in cl 18(3): '...neither the Tug owner nor the Hirer shall be liable to the other party for loss of profit, loss of use, loss of production or any other indirect or consequential damage for any reason whatsoever'.

This clause was considered in *Tsavliris v OSA Marine Ltd (trading as OIL Marine Ltd); The Herdentor*.<sup>79</sup> The *Herdentor* was chartered by Tsavliris, a salvor, from the tugowners, OSA Marine, to assist in a salvage operation. A disagreement arose as to the duration of services provided by the *Herdentor*. OSA Marine argued that the tug would only be provided for a limited period, as the tug was already engaged for another tow, and on this basis OSA Marine withdrew the tug. Tsavliris sued OSA for wrongful termination and claimed damages, arguing that the base award given to it as a contractor in a separate arbitral dispute was less than it would have received had

<sup>75</sup> *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26, [93].

<sup>76</sup> [2008] EWHC 225 (Comm).

<sup>77</sup> *Ferryways NV v Associated British Ports; The Humber Way* [2008] EWHC 225 (Comm), [84].

<sup>78</sup> 2002 LMLN 585, 18 April 2002.

<sup>79</sup> Unreported 19 January 1996.

the tug remained in service until the salvage was complete. 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 profits, use and production were excluded under clause 18(3).

In *Ease Faith Ltd v Leonis Marine Management Ltd*,<sup>80</sup> a towage agreement provided that the tug operator would use its best endeavours to tow the *Kent Reliant* to China, where it was to be sold for scrap. The tug was delayed and by the time the *Kent Reliant* arrived, the market price for scrap had fallen, and Ease Faith was only able to sell the vessel at a reduced rate. Ease Faith sued Leonis alleging the tug’s failure to proceed with the voyage with proper dispatch had caused damages in the amount of the reduction in purchase price. Leonis argued that the claim was one for loss of profits, which was excluded under cl 18(3). Ease Faith argued that its claim was not for loss of profits and, in any event, the exclusion in cl 18(3) only applied to loss of profit where they are indirect; and in this case, the claim was for direct losses.

In characterising Ease Faith’s claim as one for a diminution of price rather than loss of profits, the court held the claim fell outside the meaning of cl 18(3). Andrew Smith J held that:

It is true 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.

Unlike the arbitral tribunal’s construction of the indemnity clause in the SUPPLYTIME 89 form, this decision is consistent with *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* and *Ferryways NV v Associated British Ports*, focusing the inquiry on the characterisation of the loss claimed and the nature and object of the clause in issue.

It is evident from these cases that the term ‘consequential loss’ is prone to conflicting interpretations. If parties wish to make reference to *Hadley v Baxendale*’s second rule, they should use alternative express and clear language.

#### 4.6 Proportionate and Concurrent Liability

Proportionate and concurrent liability has the potential to impact on the commercial allocation of risk.

Each Australian State and Territory has adopted a statutory scheme of risk allocation, which applies to ‘apportionable claims’ where there are two or more concurrent defendants.<sup>81</sup> If a claim falls within the proportionate liability provisions, the legislation provides that the liability of each concurrent wrongdoer is limited to an amount which the court considers justly reflects that proportion of the loss and damage for which each tortfeasor is responsible.<sup>82</sup>

Apart from circumstances where liability is proportionate, each Australian State and Territory has legislation which allows tortfeasors to recover from the other concurrent tortfeasors a contribution towards the amount paid to claimants.<sup>83</sup> The amount of contribution which may be recovered is ‘such as may be found by the court to be just and equitable having regard to the [other party’s] responsibility for the damage’.<sup>84</sup>

If either proportionate or concurrent liability were to apply, can a contractual right of indemnity be enforced? The answer to this question depends on the operation of the specific legislation. There are variances in the

<sup>80</sup> [2006] EWHC 232.

<sup>81</sup> *Civil Law (Wrongs) Act 2002* (ACT), ch 7A; *Civil Liability Act 2002* (NSW), pt 4; *Proportionate Liability Act 2005* (NT), ch 2; *Civil Liability Act 2003* (Qld), pt 2; *Law Reform (Contributory Negligence and Apportionment of Liability) Act 2001* (SA), pt 3; *Civil Liability Act 2002* (Tas), pt 9A; *Wrongs Act 1958* (Vic), pt IVAA; *Civil Liability Act 2002* (WA), pt 1F.

<sup>82</sup> *Civil Law (Wrongs) Act 2002* (ACT), s 107F(1); *Civil Liability Act 2002* (NSW), s 35(1); *Proportionate Liability Act 2005* (NT), s 13(1); *Civil Liability Act 2003* (Qld), s 31(1); *Law Reform (Contributory Negligence and Apportionment of Liability) Act 2001* (SA), s 8(2); *Civil Liability Act 2002* (Tas), s 43B(1); *Wrongs Act 1958* (Vic), s 24A1(1); *Civil Liability Act 2002* (WA), s 5AK(1); see also R Balkin and J Davis, *Law of Torts* (LexisNexis Butterworths, 4<sup>th</sup> ed, 2009), [29.41].

<sup>83</sup> *Civil Law (Wrongs) Act 2002* (ACT), pt 2.5; *Law Reform (Miscellaneous Provisions) Act 1946* (NSW), pt 3; *Law Reform (Contributory Negligence and Apportionment of Liability) Act 2001* (SA); *Wrongs Act 1954* (Tas), s 3; *Wrongs Act 1958* (Vic), pt IV; *Law Reform (Contributory Negligence and Tortfeasor’s Contribution) Act 1947* (WA); *Law Reform Act 1995* (Qld), pt 3.

<sup>84</sup> *Civil Law (Wrongs) Act 2002* (ACT), s 21(2); *Law Reform (Miscellaneous Provisions) Act 1946* (NSW), s 5(2); *Law Reform (Contributory Negligence and Apportionment of Liability) Act 2001* (SA), s 6(5), (7); *Wrongs Act 1954* (Tas), s 3(2); *Wrongs Act 1958* (Vic), s 24(2); *Law Reform (Contributory Negligence and Tortfeasor’s Contribution) Act 1947* (WA), s 7(2); *Law Reform Act 1995* (Qld), s 7.

proportionate liability legislation of each jurisdiction. In Queensland, parties cannot contract out of the proportionate liability scheme.<sup>85</sup> In Western Australia, New South Wales and Tasmania, parties are expressly permitted to opt out of the legislation<sup>86</sup> and the legislation expressly provides that contractual indemnities are effective as between concurrent tortfeasors<sup>87</sup>. The legislation of the other States and Territories is silent on the parties' ability to opt out of the legislation. In each Australian State and Territory, tortfeasors under the concurrent liability regime are not entitled to claim a contribution in circumstances where there is a contractual indemnity in respect of the damages for which the contribution is sought.<sup>88</sup>

Further, there is some doubt as to whether proportionate liability can apply to a claim made between a primary party and a subcontractor of another primary party. According to Professor Davis:

There is...a series of decisions at first instance in Australia in which a building owner has been denied the right to sue a sub-contractor of the prime contractor in negligence for pure economic loss resulting to the owner from the carelessness of the sub-contractor, on the basis that the sub-contractor does not owe a duty of care to the owner. The reason for the denial of a duty of care is that, the parties having structured their relationship in such a way as to preclude any contractual liability between owner and sub-contractor, because of the operation of the doctrine of privity of contract, it would be inconsistent with their presumed intentions to impose a duty of care in negligence on the subcontractor.<sup>89</sup>

## 5 Limitation of Liability

Most knock for knock clauses expressly provide that nothing in the contract is to deprive either party from relying on any right to limit liability that may be available to them under any relevant law, statute or convention, and that, before invoking the indemnity each party must, utilise any rights it has to limit its liability to third party claimants.<sup>90</sup> Relevantly, the knock for knock regime does not give rise to a right of limitation, it merely allows parties who have that right to access it. If no right to limit exists under the relevant law, an indemnifying party under a knock for knock regime will not be able to limit the quantum of that indemnity.<sup>91</sup>

The Convention on Limitation of Liability for Maritime Claims 1976 and the *Limitation of Liability for Maritime Claims Act 1989* (Cth), which gives it the force of law in Australia, allows shipowners to limit their liability to pay compensation for general ship-sourced damage. The 1976 Limitation Convention applies to claims for loss of life and personal injury, as well as loss of or damage to property and to pollution damage where no other convention applies. The 1976 Limitation Convention does not impose strict liability to pay compensation for damage on the shipowner, rather the amount of compensation that a court is able to award is limited and calculated based on the size of the ship. There are three categories of ships, offshore structures, platforms or rigs that do not come under the 1976 Limitation Convention:<sup>92</sup> (a) ships constructed for, or adapted to, and engaged in drilling,<sup>93</sup> (b) air-cushion vehicles<sup>94</sup> and (c) floating platforms constructed for the purpose of exploring or exploiting the natural resources of the seabed or the subsoil thereof.<sup>95</sup>

In Australia, there are no limitation provisions that are applicable to offshore drilling ships while they are engaged in drilling. The 1976 Limitation Convention only applies to 'ships', and drilling rigs are not ships. Similarly, the

<sup>85</sup> *Civil Liability Act 2003* (Qld), s 7(3).

<sup>86</sup> *Civil Liability Act 2002* (NSW), s 3A(2); *Civil Liability Act 2002* (Tas), s 3A(3); *Civil Liability Act 2002* (WA), s 4A.

<sup>87</sup> *Civil Liability Act 2002* (WA), s 5AL(2); *Proportionate Liability Act 2005* (NT), s 15(2); *Civil Liability Act 2002* (Tas), s 43C(2).

<sup>88</sup> *Civil Law (Wrongs) Act 2002* (ACT), s 21(3); *Law Reform (Miscellaneous Provisions) Act 1946* (NSW), s 5(1)(c); *Law Reform (Contributory Negligence and Apportionment of Liability) Act 2001* (SA), s 6(9)(a); *Wrongs Act 1954* (Tas), s 3(1)(c); *Wrongs Act 1958* (Vic), s 24AD(4); *Law Reform (Contributory Negligence and Tortfeasor's Contribution) Act 1947* (WA), s 4(1A), (1B); *Law Reform Act 1995* (Qld), s 6(c).

<sup>89</sup> R Balkin and J Davis, *Law of Torts* (LexisNexis Butterworths, 3<sup>rd</sup> ed, 2004), 13.70; J Thomson, L Warnick and K Martin, *Commercial Contract Clauses: Principles and Interpretation* (Thomson Reuters, 2012), [26530]; *Shrimp v Landmark Operations Ltd* (2007) 163 FCR 510; *Macquarie Bank Ltd v Meinhardt* [2010] NSWSC 1320.

<sup>90</sup> R Williams, 'Knock-for-Knock Clauses in Offshore Contracts' in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 53, 65: see for example, clause 14(d) of SUPPLYTIME 2005, as set out in that chapter, which states: 'Nothing contained in this Charter Party shall be construed or held 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.'

<sup>91</sup> R Williams, 'Knock-for-Knock Clauses in Offshore Contracts' in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 53, 65.

<sup>92</sup> M White, *Australian Maritime Law* (Federation Press, 3<sup>rd</sup> ed, 2014), 14.3.1.

<sup>93</sup> Article 15(4) of the 1976 Limitation Convention.

<sup>94</sup> Article 15(5)(a) of the 1976 Limitation Convention.

<sup>95</sup> Article 15(5)(b) of the 1976 Limitation Convention.

limitation provisions do not apply to floating platforms constructed for the purpose of exploring or exploiting the natural resources of the seabed or the subsoil.<sup>96</sup> Thus, any claim that is likely to be the subject of a limitation of liability will involve support vessels operating in the offshore oil and gas industry. By their nature, these claims will be of the type that would normally be the subject of limitation rights under various international liability conventions that are in force in the relevant jurisdiction, including Australia.<sup>97</sup>

The operation of limitation of liability within the context of a knock for knock regime may result in an imbalance of compensation payable. By way of example, property owned by a company within the owner's primary group is damaged by a company within the charterer's group. The former company pursues a claim and recovers its full loss against the latter company. The charterer will have to indemnify the latter for its full loss paid and then claim an indemnity from the owner under the knock for knock indemnity in the charter party. If the owner is able to limit its liability in accordance with the size of the vessel, the limitation fund which is available to the charterer from the owner may not be sufficient to indemnify it for the full amount of the damages it paid to the compensatee for the amount it paid to the injured company in the owner's primary group.<sup>98</sup>

## 6 The Intersection between Insurance and Indemnity

It is important to note the intersection between insurance (particularly protection and indemnity liability) and knock for knock contracts.

P&I Clubs are mutual insurance associations, owned by shipowner members and controlled by a board of directors. The shipowner members effectively act as the insurer and the insured. On a regular basis, shipowners contribute to a pool of funds which exists to pay out legitimate claims of the Club's members. The international 'top-tier' P&I Clubs have rigorous standards that must be met for shipowners to become members, and, similar to standard insurers, will pay out claims if Club rules are met.

Poolable cover generally does not respond to liabilities that members incur voluntarily. Members should not therefore assume responsibility for any loss for which they would not otherwise be liable. However, P&I Clubs will often review and, if appropriate, approve knock for knock clauses provided they are balanced and mutual and provided the member has not waived any right to limit liability under any applicable law. Unbalanced knock for knock contracts are not poolable in respect of any liabilities to which the member would not have been exposed in the absence of the contract.

In addition, for knock for knock liabilities to be poolable, they must incorporate indemnities, protecting members if they are sued by a third party who is not bound by the contract.

Knock for knock clauses must apply regardless of fault or negligence. Some P&I Clubs recommend that contracts should *not* carve out an exception gross negligence or wilful misconduct. If a party does not indemnify the other party for claims arising out of the indemnified party's gross negligence or wilful misconduct, the main advantages of knock for knock regimes may be undermined. The ambiguity and subjectivity of what amounts to 'gross negligence' or 'wilful misconduct' obviates the certainty and clarity in the consensual allocation of liabilities. Further, the application of the exception is likely to lead to litigation, which again undermines the advantage of avoiding time-consuming and expensive disputes as to causation or fault.

The P&I Clubs' general approach to knock for knock clauses has been influenced by the recognition that knock for knock contracts have become industry standards in offshore business. They have devised a standard knock for knock provision for members' convenience. Ultimately, it is most important that members contract on terms that do not expose them to disproportionate liabilities.

## 7 Governing Law Clauses

The choice of a governing law clause is a very material consideration when allocating risk under a knock for knock regime. This paper has addressed the enforceability of knock for knock clauses under Australian, English and US law. However, such clauses may not be embraced in some other jurisdictions. It is therefore advisable to

<sup>96</sup> M White, *Australian Maritime Law*, (Federation Press, 3<sup>rd</sup> ed, 2014), 14.3.1.

<sup>97</sup> The 1924, 1957 and 1976 Limitation Conventions (and the 1996 Protocol to the 1976 Convention) are currently in force in a number of jurisdictions; for a summary of which jurisdiction the above conventions apply see the help guide prepared by Hill Dickinson: *Shipping 'At a Glance' Guide 2*.

<sup>98</sup> R Williams, 'Knock-for-Knock Clauses in Offshore Contracts' in B Soyer and A Tettenborn (eds), *Offshore Contracts and Liabilities* (Routledge, 2015) 53, 65-6.

consider whether the jurisdiction selected to govern the contract will uphold knock for knock clauses, or any exclusions that have been carved out of the operation of the clause, such as gross negligence. As we have seen, an exclusion of gross negligence that will operate under New York law, may have no effect under Australia or English law.

## 8 Conclusion

Knock for knock clauses are a fundamental part of the maritime and offshore oil and gas sectors. English and Australian courts recognise the role that these hold harmless and indemnity clauses play in commercial operations within those sectors and give effect to knock for knock clauses<sup>99</sup>, although, there is the potential to limit their scope.<sup>100</sup>

Courts will carefully examine the wording of knock for knock clauses in determining their meaning, scope, operation and efficiency. Clarity in drafting such clauses is therefore paramount to ensure that they achieve their intended purpose. Some issues that require specific attention include:

- what liabilities are to be covered by the indemnities? Do the knock for knock clauses expressly provide indemnity in the event of negligence? Do the indemnities cover loss arising out of gross negligence, wilful misconduct or breach of contract? These matters should, where possible, be expressly dealt with in the clauses.
- which parties are to be covered by the indemnities as part of the primary parties' respective groups?
- do the clauses extend to cover third party liabilities and if so are they subject to that party's negligence?
- what losses are to be covered by the indemnity; is the indemnity intended to cover consequential loss or statutory liabilities?
- do the parties intend to exclude any proportionate or joint tortfeasor legislation where possible?
- do the knock for knock clauses express preserve the parties' right to limit liability?
- are the knock for knock provisions reciprocal or back to back?
- do the insurance provisions cover the hold harmless and indemnity provisions?

It is important to ensure that the specific terms of the knock for knock clause are acceptable to, and have been approved by, the P&I Club (or other insurer) before the terms are agreed, particularly given the potential for massive environmental liabilities, such as were incurred in the Deepwater Horizon and Piper Alpha disasters.

One issue that warrants further consideration is the apportionment of liabilities to other parties within the operational supply chains. As set out above, there is capacity, at least under Australian law to apportion liability or to claim contribution from other parties. Traditionally, international oil companies have been considered to be better placed to manage the risk of loss and damage than the contractors they engage. The converse argument, which was touched on by Judge Barbier in *Re: Oil Spill by the Oil Rig "Deepwater Horizon"*, is that exposing contractors to risk may incentivise 'best' behaviour in identifying and managing risk. Undoubtedly, in light of the massive operational risks faced by operators, the apportionment of risk and carve outs for negligence and material breach of contract is a discussion worth having. A detailed discussion of this question is beyond the scope of this paper.

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<sup>99</sup> Whether such clauses are enforceable in other jurisdictions is beyond the scope of this paper. Before agreeing the governing law of the contract, it is prudent to check that the law of the chosen jurisdiction recognises and gives effect to knock for knock clauses. For a summary of the position in Canada see Kangles, R Rogers, Z Allidina, C Harris B, 'Risk allocation provisions in energy industry agreement: Are we getting it right?' (2011) 49(2) *Alberta Law Review* 339.

<sup>100</sup> See for example the *Texas Oilfield Anti-Indemnity Act, Civ. Prac. & Rem Code 127.001-127.007*, which provides that agreement[s] pertaining to wells for oil, gas or water or to a mine for a mineral which provides indemnity to a person against liability for death, personal injury, property loss or damage, is unenforceable. Allowance is made for indemnity agreements if they are backed up by liability insurance cover which accords with specified requirements; T Makarov, 'Indemnity in the international oil and gas contracts: key features, drafting and interpretation' University of Dundee.