Risk allocation in major construction projects

The use of indemnities

How does the standard EPC approach compare to ‘knock for knock’, and what matters should be borne in mind when drawing up indemnities? We consider the position under English law, often used on major international construction projects.

Standard EPC (Engineering, Procurement, Construction) risk allocation

In standard EPC contracts, key risks generally sit with the EPC contractor. Thus the EPC contractor will carry out the detailed engineering design of the project, procure materials and equipment, and carry out construction work, taking responsibility for the delivery of the facility or asset to the owner/employer on time, at the agreed price and to an appropriate design.

Allocating risk in this way has advantages for both sides. Owners/employers have the advantage of dealing with the EPC contractor as a single point of contact for the project who carries most of the risk. EPC contractors can reflect the risks that they are accepting in the price that they offer, and also benefit from having full control over the detailed delivery of the specification.

Nevertheless there are also disadvantages. For owners/employers, the tendered prices may be unacceptably high given the risks that the contractors are being asked to accept. For contractors the EPC route may require them to accept risks whose extent is unknown and over which they have no control.

The parties may therefore seek to manage these risks, either by imposing caps on liability, and/or by adopting different risk allocation models such as the use of ‘knock for knock’ indemnities.

Caps on liability

If contractors have agreed to bear the majority of risks on a project, they will generally insist that their overall liability under the contract is limited. Often an overall cap on liability will be agreed at no more than 100% of the contract price.

The owner/employer will usually require carve-outs from the overall cap on liability, so that liability for matters such as death, personal injury, monies recovered under insurances and fraud will not ‘count’ towards the cap. Gross negligence is sometimes excluded too.

Contractors may also seek to limit their liability for liquidated damages imposed for delay and for failure to meet performance criteria. Each of these will generally be limited to a percentage of the contract price (perhaps 20%), and there will often also be an aggregate cap for both.
Knock for knock indemnities

A different way of allocating risk is to use ‘knock for knock’ or ‘mutual hold harmless’ indemnities. These are common in the oil & gas and offshore sectors. Instead of taking a fault-based approach, each party agrees to take the risk of damage to its own property, people and more. So for example each party will indemnify the other against claims in respect of any:

- death of, or personal injury to, the party’s own employees;
- loss of, or damage to, the party’s own property; and
- pollution emanating from the party’s own property.

Such clauses can apply irrespective of negligence and/or breach of duty, although clear drafting is required to achieve this.

The parties will also assume liability for their own consequential losses regardless of fault, negligence or breach of duty.

In the case of London Bridge it was held that a ‘knock for knock’ indemnity, properly construed, entitled the operator to indemnity from the contractors even where they were not liable at common law, or liable for breach of statutory duty.

Elements of an indemnity clause

A carefully negotiated and drafted indemnity clause is crucial to ensuring that risk is appropriately allocated.

An indemnity is generally made up of a number of key elements:

- A Company/Contractor indemnifies...
- a party/Group...
- against claims, losses, damages...
- in respect of certain subject matter (people, property, consequential loss etc)...
- relating to the performance or non-performance of the Contract/Work...

Where a ‘knock for knock’ approach is taken, the indemnity will apply:

- irrespective of negligence and/or breach of duty (statutory or otherwise)...
- subject to exceptions (eg gross negligence and wilful misconduct).

What is covered by the indemnity?

An indemnity comprises a financial obligation to reimburse the costs, expenses etc which another party has suffered as a result of specified event. The indemnity clause will often contain further obligations, for example:

- ‘hold harmless’ - release the other party from legal liabilities by not suing it or otherwise pursuing it for payment; and stop or prevent others from bringing actions so far as the party is able to do so;
- ‘defend’ – prevent third parties from causing harm to the other party, through litigation or otherwise.

Many standard form contracts try to cover all the bases by using phrases such as: “shall be responsible for and shall save, indemnify, defend and hold harmless...”.

When drafting an indemnity, it is important to ensure that words are used consistently otherwise this is likely to affect the way that a tribunal would construe the indemnity. For example, if several words are used in one clause, and then one is dropped from a later clause, then the tribunal will seek to attribute meaning to the fact that the word was not used in the later clause.

Which parties are covered by the indemnity?

The indemnity may be offered not just to a party but also to a ‘Group’ of others associated with the party. Often this will not just include companies that are part of the same corporate group. Rather, the definition of ‘Group’ is likely to set out all of those parties entitled to receive the benefit of the indemnities. These may include for example co-venturers and directors, other contractors and sub-contractors and even secondees and visitors. It is important that the definition of ‘Group’ is carefully drafted to include only relevant entities.

For English law contracts, it is also worth considering the Contracts (Rights of Third Parties) Act 1999. Is it intended to confer benefits on non-signatories to the contract that they may enforce directly against a contracting party? If not, then the Act should be excluded in clear words.

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1 Caledonia North Sea Ltd v London Bridge Engineering Ltd [2002] UKHL 4 – a House of Lords’ Scottish case relating to the Piper Alpha disaster.
2 Being the party holding the licence or lease, and responsible for petroleum operations.
3 Farstad Supply AS v Enviroco Ltd and another (The MV Far Service) [2010] UKSC 18
What claims are covered by the indemnity?

Indemnity clauses will often include a definition of the “Claims” that are covered; these may include claims, judgments, awards, losses, damages, costs, expenses etc.

It is often worth including a reference to legal costs/expenses to ensure that no argument can be brought that such costs are not costs arising out of the triggering event for the indemnity, but are costs arising out of the indemnity itself and as such are not included.

Subject matter of indemnities

Indemnities can cover a range of subject matters. The main ones are people (death, injury or illness), property damage and consequential loss.

In relation to property damage, it is helpful to specify whether an indemnity is to cover only property that is owned by the party or also property that is leased, hired or otherwise provided.

In relation to consequential loss, it is very important that the losses intended to be covered by or excluded from the indemnity are carefully defined. Under English law lost profits (which many people might consider to be an indirect or consequential loss) have been held to be recoverable as direct losses unless expressly excluded.

Many contracts now exclude all liability for certain categories of loss, such as all loss of profit and all loss of production, even where these losses flow naturally from the breach i.e. they are direct losses not consequential losses. See for example the LOGIC approach: “Consequential Loss shall mean: (i) consequential or indirect loss under English law; and (ii) loss and/or deferral of production, loss of product, loss of use, loss of revenue, profit or anticipated profit (if any), in each case whether direct or indirect to the extent that these are not included in (i), and whether or not foreseeable at the EFFECTIVE DATE OF COMMENCEMENT OF THE CONTRACT.”

What aspects of performance are covered?

The parties must decide whether the indemnity covers any incident arising out of the contract or only incidents arising from a specified range of services. It is important that the contract wording is clear on this.

A key point of contention in offshore contracts is often: who will take pollution risk? Often a contractor will only accept responsibility for pollution coming directly from its own property or equipment (for which it can insure). If any pollution liability is not covered by the contract, then the general law will apply. Often therefore the contractor will expect the owner/employer to take liability for all other pollution arising out of the contract regardless of fault.

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5 See Campbell v Conoco (UK) Ltd [2003] All ER (Comm)35(CA) on the meaning of “resulting from, arising out of or in connection with the performance or non-performance of the Contract”.
Exclusion of liability for negligence

Generally, where a party obtains an indemnity against the consequences of certain acts, that indemnity will not cover the consequences of the party’s own negligence unless there are express words to that effect, or by necessary implication. However, there may be exceptions.

For example, in the recent case of Greenwich Millennium Village Ltd v Essex Services Group plc and others [2014] EWCA Civ 960, previous case law was distinguished on the facts and the Court of Appeal held that a party’s negligence does not necessarily prevent it from recovering under an indemnity clause. In the Greenwich case the beneficiary’s failure to notice its subcontractor’s defects was a passive failure rather than an active act of negligence and it did not defeat the operation of the indemnity clause.

Further, ‘knock for knock’ indemnities operate on the basis that they apply regardless of which party is at fault, and so will include express words to the effect that they apply: “irrespective of cause and notwithstanding the negligence or breach of duty (whether statutory or otherwise)” of the indemnified party.

If the indemnity is intended to be complete, there is no need to mention gross negligence or wilful misconduct.

But if you wish to ensure that the indemnity will not apply in the event of gross negligence/wilful misconduct, then you need to define those terms carefully – they are not terms of art under English law (Moore-Bick LJ in Tradigrain SA v Intertek Testing Systems (ITS) Canada Limited [2007] EWCA Civ 154).

A later article in this series will deal with the topic of gross negligence.

Conclusion

An advantage of ‘knock for knock’ indemnities is that risk is allocated to the party best able to bear it and/or to insure against it. However, in the post-Macondo world, the concept of the knock for knock indemnity is under greater challenge. Owners/employers may question a situation where contractors arguably have ‘less at stake’ than the employer and do not take the full consequences of any negligent actions or omissions. Against that background, standard EPC risk allocation is likely to remain a popular approach in many sectors.

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Please note that this article deals with the position under English law.

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