MANAGING CONTRACTUAL EXPOSURES

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The club is always available to help members in assessing whether their contract terms are drafted to properly protect the member's position.

The Standard Club offers a contract review service which aims to proactively advise members involved in the offshore oil and gas industry of the effect of the contractual arrangements they have concluded in terms of their P&I cover, including any extra extensions to cover that the contract liabilities may require. The club's intention is to provide a level of comfort in terms of the member's cover before any potential liabilities arise. During the 2009 policy year, we reviewed nearly 400 contracts covering all types of offshore operations, from EPIC (engineer, procure, install and commission) and operating contracts for FPSOs (floating production storage and offloading vessels), through drilling and construction contracts, to numerous supplyboat charterparties. Most of these contracts are relatively straightforward, but we do see a number of common issues that arise again and again, and that can lead to members finding themselves in a position where their insurance cover and their contractual liabilities may not match up. The intention of this article is to draw some of these issues to readers' attention in the hope of making them more easily avoided in the future.

CAR/EED INSURANCE

One area that often causes confusion is a lack of understanding as to the interaction between the various insurances that respond to the liabilities incurred in offshore operations. Most offshore operations involve an oil company or companies, either as the direct or the ultimate client of the shipowner, and many of the liabilities that the shipowner can potentially incur during these operations should most appropriately fall on the oil company's insurance programme. For instance, offshore construction projects are normally covered under a Construction All Risks (CAR) insurance, which is purchased by the oil company client to respond to physical loss or damage to the permanent property being installed. Energy Exploration and Development (EED) insurance responds to exposures incurred in respect of pollution and control of well during drilling or workover operations or the operating phase of an FPSO contract, and again, is normally purchased by the oil company operator.

Offshore P&I cover is not designed to respond to these risks, since they are insured under very different terms and rating arrangements, and indeed, the exclusions in the Standard Club's rules in respect of offshore risks are intended to dovetail with the cover offered under CAR and EED insurances. The 'contract works' exclusion to P&I cover refers to the project property insured under a CAR policy, whilst the Standard Offshore rules contain exclusions in respect of control of well costs and seepage and pollution from the well, wellheads and subsea equipment, which are exposures insured under an EED policy.

EXCLUDED RISKS

Problems arise when a shipowner involved in offshore operations takes on liability under a contract or fails to obtain a sufficiently watertight indemnity (which often amounts to the same thing) for risks that are most appropriately covered under CAR or EED insurances. For instance, during a floatover operation, a topsides module will be installed on a jacket, both of which are excluded from club cover under the Standard Club's definition of contract works. In order to protect himself from liability, the shipowner will need to make sure that he obtains an indemnity from his contracting partner for damage to the topsides and the jacket, both of which should be covered under the CAR policy. Any liability that the owner has for such damage is excluded from club cover as a contract works exposure, whether incurred under contract or otherwise. It is practically speaking impossible to purchase an extension to P&I cover for damage to contract works, so an owner should ensure that he contracts on terms that sufficiently protect him, or he may find himself in a position where he is without insurance cover for a very significant level of risk. Owners of drilling units and FPSOs who are insured under the Standard Offshore rules should similarly check that they are indemnified by their contracting partners for risks that fall within the Offshore rules' exclusions, such as control of well expenses and liability in respect of pollution from the reservoir and subsea systems.

EXCEPTIONS TO THE INDEMNITY REGIME

When entering into offshore contracts, members should ensure that liability and indemnity provisions are drafted so as to prevail over other contract terms, and that they will apply in all circumstances regardless of the cause of a loss. It is not uncommon for contractual indemnities to apply regardless of the negligence of the party to be indemnified, save where the loss in question is caused by that party's own gross negligence or wilful misconduct. This may seem like a benign amendment since most owners do not believe that they or their employees would be guilty of either gross negligence or wilful misconduct, but it nevertheless creates a hostage to fortune in that it introduces an element of subjectivity into what should be a completely objective knock-for-knock liability matrix. In the aftermath of a large incident, it is more than likely that the parties will resort to litigation to try to avoid liability and any possible contractual loophole will be exploited. The decision as to whether particular behaviour falls to be considered as either grossly negligent or as wilful misconduct will be made by a court, which may well be in the jurisdiction where the incident took place, and, particularly where an incident involves loss of life or substantial pollution, there may be a perceived desire to see the 'guilty party' held liable. In such circumstances, gross negligence or wilful misconduct exceptions to indemnity clauses may well be used so as to deny an owner the benefit of an indemnity upon which he might otherwise have expected to rely. This is a risk that is all the more serious since many of the losses for which owners are indemnified under offshore contracts are not covered by P&I insurance, as mentioned above.

We have recently seen some contracts dealing with offshore construction projects that refer to the requirements of the Warranty Surveyor and to the QA/QC (Quality Assurance/Quality Control) provisions of the CAR insurance and state that the contractual indemnities will not apply in situations where a breach by the shipowner of the Warranty Surveyor requirements or of the QA/QC provisions loses the oil company client the right to rely on the cover provided by the CAR policy. In such cases, the knock-for-knock indemnities are more or less useless, since the owner cannot know in advance of an accident, and analysis of the cause, whether or not he can rely on his contractual indemnities to protect him against exposures that are generally excluded from P&I cover as liabilities in respect of contract works. Whilst, of course, owners should always strive to operate their ships properly and in accordance with the requirements of the particular project, it is not realistic to expect shipowners to bear what can be excessively high exposures, especially since the owner's overall benefit from the project is way below that which can be expected by the oil company field operator.

Overall, in any offshore project, it makes sense when considering the level of risk that the parties can reasonably expect to bear to look at the entire operation and to consider where the major exposures, whether insured or not, can fall most appropriately and cost-effectively, and then to draft the contract to reflect this. Unfortunately, this is a counsel of perfection, and there are several factors that militate against it, among them the desire of some clients for their marine subcontractors to "have some skin in the game", a feeling that parties should not expect to be indemnified if they are guilty of really heinous conduct, a lack of clarity on the part of one or both parties about where their bottom line actually lies, and sometimes, a failure to obtain or review the full contract terms in sufficient time to allow for amendment. In one recent case, a member was providing a tug and barge for shipment of a module to a big construction project off West Africa. The day before the charterparty was to be signed, and two days before the shipment was due to take place, the member was sent over 200 pages of additional contractual terms to be incorporated in the charterparty, as the charterer was obliged under the terms of his head contract with the oil company client to ensure that certain terms from the head contract were included in all subcontracts. The 'new' terms included the full liability and indemnity provisions from the head contract, a contract covering a multi-million dollar EPIC project, which had doubtless been negotiated over many months and pored over by numerous corporate lawyers, but which the hapless tugowner was given less than 24 hours to agree, despite the fact that the head contract terms were to take precedence over the terms of the charterparty.

In my opinion, such situations are not helpful for the owner who is at the end of the charterparty chain, nor for the charterer or the ultimate oil company client. It is practically impossible for any owner to accurately assess his exposure in these circumstances or to purchase insurance for the liabilities which he takes on. The charterer may have complied with the terms of the head contract, but the outcome is a liability and indemnity matrix that is highly unclear, that will certainly be subject to expensive and protracted litigation in the aftermath of an accident and that may leave the party ultimately "holding the baby" without insurance. It is far preferable for the parties to negotiate clear and unambiguous contracts under which the risks that they take on are well defined, appropriate and insurable. The club is always available to help members in assessing whether their contract terms are drafted to properly protect the member's position and to advise whether the risks assumed by the member under contract are appropriate for the level and type of insurance that the club can provide.