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An empirical study on the contractual risk allocation provisions and indemnity and hold harmless clauses in the oilfield service contracts in Malaysia

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Oil and gas projects are risky undertakings, which may cause severe damage to property and the environment, not to mention, personal injury and death to personnel. Contractual provision such as an indemnity and mutual hold harmless clause is used as a tool in allocating the risks. Most oil companies, in their task to manage the risks, seek to depart from the traditional form of risk allocation e.g. knock-for-knock indemnity regime. In this respect, there is a tendency that the oil companies will pass a greater share of the risks onto contractors. This problem could lead to financial impairment and unfairness to the contractors. An empirical study was conducted to investigate the issues and problems with regard to risk allocation provisions and indemnity and hold harmless clauses of oilfield service contracts in Malaysia. The data for the empirical study was drawn from the intensive semi-structured interviews of ten respondents from oil companies, contractors and one legal practitioner. The finding of this empirical study indicates that contractors are concerned about the one-way adversarial style of operator-contractor relationship and also that they are being allocated more contractual risks. The methodology employed in this paper will essentially be a combination of literature review and semi-structured interview, which will be carried out in a prescriptive and analytic manner.

Keywords: contract law, oil and gas, Malaysia.

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1.0 Introduction

An empirical study was conducted in Malaysia during the period of February until April 2014 to elicit the opinion of the key players in the oil and gas industry regarding the issue of risk allocation provisions, their attitudes towards the current trends of indemnity clauses under oilfield service contracts in Malaysia as well as their perspective on how to addressing this problem. Korobkin suggests that the study of actual contracting practice is useful ‘to describe in-depth the contracting patterns and norms generally followed by a particular type or group of contracting party.’²⁴⁹ Eigen suggests that empirical study of contracts have a significant tradition in legal scholarship because it helps ‘to understand the diversity of disciplinary approaches and framings of questions about contracts raised in modern empirical explorations’ and it is valuable to articulate concisely the inter-relationship between contract doctrine, theory and empirics.²⁵⁰ The following discussion will be rooted in three major theories, i.e. the concept of contractual risk allocation and indemnity clause, the theory of freedom of contract, the doctrine of inequality of bargaining power and fairness, have become the underlying principles in the whole processes of this study.

2.0 Research Design

The semi-structured interviews were conducted with five companies representing the contractor, as well as, one company and one legal firm representing the operator. The respondents are the legal manager, the contract managers, the procurement managers, the principal technical officer, the project manager of the companies, as well as the legal practitioner who handles litigation for the operator in court. The contractors were selected from three different ranges of size i.e. big, medium and small companies. The respondents were chosen due to their prominence and experience in contractual matters. The big companies were usually equipped with complete legal and contract departments. Whereas, the medium size company might have a legal department, but would not necessarily have a contract department because the contractual matters would be managed by an engineer who would also be the principal technical officer. On the other hand, most of the small companies neither had a legal department nor a contract department. Therefore, the procurement manager who came from a technical background would manage the contractual matters. There were some difficulties in getting appointments with the respondents, especially the operators, who were quite reluctant and not easily accessible. The summary of the respondents is tabled as follows:

²⁴⁹Russell Korobkin. 'Empirical Scholarship in Contract Law: Possibilities and Pitfalls' (2002) U.Ill.L.Rev. 1033

²⁵⁰Zev Eigen. 'Empirical studies of contract' (2012) Annual Review of Law and Social Science, forthcoming 12

Categories of Units of Analysis	Respondents			
	No	Units of Analysis	Designation	No. of Respondents
Contractor	1	Contractor A	1 Legal Manager+ 1 Contract Manager	2
	2	Contractor B	1 Legal Manager+ 1 Contract Manager	2
	3	Contractor C	1 Legal Manager+ 1 Principal Technical	2
	4	Contractor D	1 Procurement Manager	1
	5	Contractor E	1 Procurement Manager	1
Operator	6	Operator A	1 Project Manager	1
	7	Legal Firm Z	1 Legal Practitioner	1
Total Number of Respondents			10	

3.0 Result and Analysis

In general, ranges of risk allocation clauses are commonly seen in contracts used in the oil and gas industry including indemnity and hold harmless clauses, clauses excluding liability for ‘consequential loses’ and clauses limiting overall liability.²⁵¹ The actual sharing of risk, indemnities and provisions for supporting insurance is usually determined by the wording of the relevant contract documents.²⁵² Semi-structured interviews were conducted in order to ascertain the industry’s perception of risk allocation of its current practice in Malaysia. Many contractors consider such non-negotiable contracts to be problematic, primarily because they often contain onerous provisions in important areas such as allocation of risk.²⁵³ This can create significant risk exposures.²⁵⁴ In distributing the risk between the operator and contractor, one of the respondents claimed that the contractors usually gained the least benefit and expressed their dissatisfaction at being made to indemnify the operators’ negligence. This can be seen in the following remark made by one of the respondent,

“Supposedly, anything that are risky to us, then we need to take steps to mitigate such risks or deviate from such terms and conditions. However, most of the time, the contractor always be at the losing end, this is because in order to secure a big job, whether the contractors like it or not, the contractors have to meet the operator’s demand and must get ready to take those risks... The problem with the indemnity clause is that, when the operator transfers their liabilities to us by asking us indemnify it and even though it was happened due to their negligence.”²⁵⁵

The respondent also claimed that the indemnity clauses were one-sided. This was because, the bulk of contractual liability, in respect of the indemnity clauses, was placed on the contractors. The general practice is that responsibility for such risk should rest with the party best able to manage it, e.g. the party with the relevant insurance coverage.²⁵⁶ It is suggested that insuring or

²⁵¹ Greg Gordon, 'Risk Allocation in Oil and Gas Contracts' in Greg Gordon, John Paterson and Emre Usenmez (eds), *Oil and Gas Law: Current Practice & Emerging Trends* (2nd edn Dundee University, 2011) p.443

²⁵² Leslie Edwards, *Practical risk management in the construction industry* (Thomas Telford, 1995)

²⁵³ Wan Zulhafiz. 'Unfair Contract Terms Act 1977: does it provide a good model in regulating risk allocation provisions in oilfield contracts in Malaysia?' (2015) 8 Int J Trade and Global Markets 3

²⁵⁴ Cary A. Moomjian. 'Drilling Contract Historical Development and Future Trends Post-Macondo: Reflections on a 35 Year Industry Career' (IADC/SPE Drilling Conference and Exhibition Society of Petroleum Engineers, 2012)

²⁵⁵ Respondent 5 from Contractor C

²⁵⁶ Leslie Edwards, 'Practical risk management in the construction industry' in (Thomas Telford, 1995)

contractually transferring the risk to the insurer and leaving the premium to settle any charges to the other party could mitigate risk exposure; it is in fact the most economically beneficial and practical way for the risk to be dealt with.²⁵⁷ Insurance is used by the indemnitor as a risk cushion in a situation when he is responsible for his own employees and equipment. The insurance in fact is the underlying driver in this case rather than the ancillary tool for risk management.²⁵⁸ This is common for super-majors, who tempt to self-insure and minimize transaction costs.²⁵⁹ But this reason is not applicable to some contractors, as they cannot afford self-insurance. On this point one respondent commented,

“The indemnity clauses mostly are one sided. The contractors would be made to be liable for most of the liabilities, for example the indemnity with regards to property and equipment of the operators, the third party liability, not to mention pollution. Usually we try to keep it and make it consistent with the insurance coverage, for example per occurrence how much we'll be liable. Usually it is always unlimited liability and most of the time the clients refuse to negotiate on that as well.”²⁶⁰

It is argued that the practicalities of risk allocation should be limited by certain basic requirements for those to whom risk is being transferred. These requirements would be, for example, the ability to undertake a hazardous task, willingness to take the risk, financial capability of the company to deal with the risk in the event that a disaster occurs, continued existence and adequate finance during the period of liability.²⁶¹ It is also argued that the responsibility for indemnifying the consequences of a risk event resulting from the activities of one of the contracting parties should ideally rest with the party who has control over that risk.²⁶² The Operator is always in the best position to control the risk. Operators have confirmed that both quantified risk and unquantified risk including indemnity would be transferred to contractors. They maintained that it is the responsibility of the contractor to understand and convert the risk into monitories. On this point, one of the respondents said,

“As operator, all the quantified risk will be transferred to contractor and stated in contract. The contractors are to put the price of each risk identified in contract. It is responsibility of contractor to understand and convert the risk into monitories... The risks are made clear to contractor. Contractor will put the prices for those scope specified in the contract. Any risk is to be priced by contractor... Uncounted quantity will use reimbursable cost plus... Indemnity scope is to be taken by contractor; cost of premium for indemnity will be claim to operator.”

However, the contractor would end up having to take up the risk and cost the risk into the price. On this matter, one of the respondents commented

“Let say, there are some conditions that we could not afford to accept them in the event the operators attempt to shift greater risks to the us – now the operators go for competitive bids so our chances to be awarded is lesser if we stick to our qualification.”²⁶³

²⁵⁷Max Abrahamson. 'Risk Management' (1984) 2 ICLR 241

²⁵⁸ Caledonia North Sea Ltd. v British Telecommunications Plc same v Kelvin International Services Ltd. same v London Bridge Engineering Ltd. same v Norton (No. 2) Ltd. (In Liquidation) same v Pickup No. 7 Ltd. same v Stena Offshore Ltd. same v Wood Group Engineering Contractors Ltd. - [2002] 1 Lloyd's Rep 553

²⁵⁹ BP Annual Report and Accounts 2007, p.39

²⁶⁰ Respondent 3 from Contractor B

²⁶¹Leslie Edwards, 'Practical risk management in the construction industry' in (Thomas Telford, 1995)

²⁶²ibid

²⁶³ Respondent 3 from Contractor B

Another commented that,

“However, we are not in the position to change the conditions, so what we normally do is, we will take note on that and accordingly advise to our technical people, “*please calculate this risk into your cost*”. Well, the thing is that, the operators would not entertain if we put so much qualification in the contracts. Sometimes, the operator is just going say, “*if you can't comply and you have a lot of exceptions to the clauses, then you will be disqualified*”. As a result, we are not going to get the job.”²⁶⁴

The contractor would be facing a problem to set an ideal price after absorbing the risk,

“...We need to set the price. The price should be an ideal one. Not too high as there is possibility our submission would be rejected, but not too low to the extent that it might jeopardies our profit.”²⁶⁵

Nevertheless, due to the high competitive bid, the contractor faces a dilemma in relation to setting the price. On one hand the contractor is afraid of not getting the job if the price is too high after converting the risk into monitories. On the other handhe fears financial difficulty if the price he sets is too low. On this point, one of the respondents observed,

“Usually, in order to mitigate the risks, we have to cost in the impact into pricing. Whatever the risks involved, the cost has to be reflected in the pricing. Sometimes, this would be a problem, when we were trying to cost in everything, the cost will be too high and we afraid that we are not going to get the job. But, if we neglect the risks now, then if anything happen in future, the risks would be at our own cost. So, it is real challenge for us to draw a middle line between these two.”²⁶⁶

A contract could be regarded‘ as a trade-off between the contractor’s price for undertaking the work and his willingness to accept both the controllable and uncontrollable risks.’²⁶⁷ However, contractual agreements should be concluded taking into account who should bear the burden of risk and also how much risk each party would take.²⁶⁸ It is imperative to note that an improper tender style and unreasonable risk burden could be the primary reasonof contractual disputes between the parties. It is claimed that the main factor for increase of overall cost is due to the usage of disclaimer clauses such as indemnity clauses, in allocating risk.²⁶⁹ This is because, once the risk is transferred to the contractor and ‘the contractor has no means by which to control the occurrence or outcome of the risk, the contractor must either insure against it or add a contingency to the bid price.’²⁷⁰ The cost of transferring risk to the contractor through such clauses carries hidden costs such as ‘restricted bid competition, increased potential for claims and disputes and above all, more adversarial owner–contractor relationships.’²⁷¹ One of the respondents who is a practicing lawyer

²⁶⁴ Respondent 1 from Contractor A

²⁶⁵ Respondent 4 from Contractor B

²⁶⁶ Respondent 3 from Contractor B

²⁶⁷ Ka Chi Lam and others. 'Modelling risk allocation decision in construction contracts' (2007) 25(5) Int J Project Manage 485

²⁶⁸Latif Onur Uğur. 'İnşaat Sektöründe Riskler ve Risk Yönetimi' (2006) Türkiye Müteahhitler Birliği Yayını, Ankara p.120

²⁶⁹F. Hartman. 'Construction dispute resolution through an improved contracting process in the Canadian context.' (PhD thesis Loughborough University of Technology, UK 1993) ;G. Jergeas and F. Hartman. 'A contract clause for allocating risk' (1996) Transaction of the American Association of Cost Engineers ;J. G. Zack Jr. "'Risk-Sharing" - Good concept, bad name' (1996) 38(7) Cost Engineering (Morgantown, West Virginia) 26

²⁷⁰GF Jergeas and FT Hartman. 'Contractors' Protection Against Construction Claims' (Annual Meeting-American Association of Cost Engineers American Association of Cost Engineers (ACE), 1994) 8

²⁷¹ D. Becker. 'The cost of general conditions' (1993) (September) Am Assoc Cost Eng Trans 7

and used to litigate on behalf of the operator shared her perspective on this issue. She commented that,

“I assume when the contractors signed the contract, the contractors were fully aware of those liabilities that they will be carrying on. So, if anything happen in future, I think it is their obligation to get protection for those liabilities by way of insurance. Plus, the parties are able to practice contractual freedom. I don’t see any problem with regard to this matter, unless, there is issue with regard to fairness, but such allegation should be proven by separate cause of action and proper hearing in court.”

It is true that as a matter of contractual freedom, the parties may freely decide the terms of the contract including the risk allocation provisions.²⁷² However, the lawyer might not be aware that, in the industry, during the contract formation process, there exists inequality of bargaining power between the parties, which means that contractual freedom has not been exercised properly. As a result, the contract is one-sided and the risk is not shared fairly between the parties. The contractors are actually aware of the situation, but they are neither in the position to change or qualify any of the terms nor given opportunity to discuss or negotiate on the allocation of the risk. One of the respondents gave the following remark, to describe the situation,

“The most we can do is to voice our dissatisfaction to the clients. Sometimes they may listen to us, unfortunately most of the time they are not. How would we mitigate? Basically it is good to have both parties to sit down and explain and discuss about the risks involved in each project. But I suppose they are going to say that, it is them who invest money, thus they will not accept any of our qualification with regard to the risks.”

In some occasion, the contractor may have to indemnify the operator for the operator’s negligence in respect of operator’s personnel and property, or vice versa.²⁷³ The adjustment of the indemnity clause would undermine the traditional risk allocation of a “knock-for-knock” indemnity regime.²⁷⁴ As a result, ‘it is likely that the existence of negligence may first have to be proved in the courts for an indemnity to operate, which defeats one of the primary objectives of the knock-for-knock regime.’²⁷⁵ Moreover, such adjustment may also represent uninsurable risk to the contractor.²⁷⁶ Furthermore, this would give rise to the possibility of increased costs since the contractor attempts to insure a risk where he does not have a real insurable interest.²⁷⁷ One of the respondents discussed on this scenario,

“We always have problem when it comes to indemnity clause. We are expected to bear most of the liabilities. The worst part is that, sometimes they (operators) expect us to be liable for something which is due to their faults. Could you imagine that? But, what can we say; we have no choice but to agree with such clause. It is always be the case, either that we take or leave it... The risks have to be covered by insurance. We do not afford to take the risks without any financial back up from the insurance company... This is the problem.

²⁷² Privy Council in *Ooi Boon Leong v. Citibank N.A.* [1984] 1 MLJ 222, confirmed that “parties to an agreement have much scope to negotiate and incorporate terms acceptable to them”

²⁷³ Helen Franklin. 'Irretrievable Breakdown? A Review of Operator/Contractor Relationships in the Offshore Oil and Gas Industry' (2005) 23(1) *Journal of Energy & Natural Resources Law*

²⁷⁴ *ibid*

²⁷⁵ *ibid*

²⁷⁶ *ibid*

²⁷⁷ *ibid*

Sometimes, we have to absorb all risk regardless whether such risk is being covered by the insurance company.”²⁷⁸

From the contractors’ point of view, more often than not, the risk is not one that can be passed on to the subcontractors.²⁷⁹ Where offshore exploitation is concerned, the contractor would usually cap his liability by stating that he has little to no control of the catastrophic risks, such as blowout, explosion and pollution emanating from the reservoir.²⁸⁰ This is because, without the liability cap the contractor may be made responsible to bear most of the uninsured risk. In that event, such risk may be disproportionate to the scope, size and profit margin on the contract.²⁸¹ Nevertheless, the quid pro quo for insurance coverage by the operator is that, the contractor should be willing to expose his insurance to the benefit of the operator. It was argued that, ‘it is not reasonable to expect limitation of, and/or indemnity from, catastrophic and third party risks to the extent that the contractor’s own insurance would in fact respond.’²⁸² On this issue, one of the respondents commented,

“Again, the indemnity clauses mostly are one sided. The contractors would be made to be liable for most of the liabilities, for example the indemnity with regards to property and equipment of the operators, the third party liability, not to mention pollution. Usually we try to keep it and make it consistent with the insurance coverage, for example per occurrence how much we’ll be liable. Usually it is always unlimited liability and most of the time the clients refuse to negotiate on that as well.”²⁸³

In order to combat this problem, some of the respondents suggested that fairness could be achieved if the legislator passes a law to protect the contractors’ affairs²⁸⁴ while another respondent suggested that legal protection should come from an anti-indemnity law. Building on this suggestion, one responded commented,

“I know that in US, they have oilfield anti-indemnity law, but I am not quite sure how far does the law really efficient to address this issue. What I can confirm, we have nothing yet in Malaysia to that effect. To certain extent, I think yes, we need rules by the government to solve the problem with regards to indemnity clauses.”²⁸⁵

While, another commented that the legislator in Malaysia should issue guidelines in order to monitor this problem which would work back-to-back with the Petroleum Act.²⁸⁶

4.0 Conclusion

In conclusion, the fact that there is no law to regulate the current imbalance of risk allocation and unfair indemnity clauses in oilfield service contracts should be perceived as a serious problem. This problem is caused by inequality of bargaining power between operators and contractors, which itself arises from the dominant position held by the operators over the contractors. It is observed that these alarming problems deserve attention from the authorities. It is crucial that the

²⁷⁸ Respondent 1 from Contractor A

²⁷⁹ Franklin (n26)

²⁸⁰ *ibid*

²⁸¹ *ibid*

²⁸² *ibid*

²⁸³ Respondent 3 from Contractor B

²⁸⁴ Respondent 5 from Contractor C

²⁸⁵ Respondent 3 from Contractor B

²⁸⁶ Respondent 7 from Contractor E

authorities act because this problem could potentially threaten the commercial development of the oil and gas industry in Malaysia. Even though insurance provisions are sometimes provided in the contract, there are no guidelines available for the parties. Moreover, the insurance requirements have not been made mandatory to the parties. This could cause the contractor to assume uninsured risks, which could lead to detrimental financial exposure in the event of a catastrophic incident. This problem could be made worse if the contractors have to assume double jeopardy contractual risk, whereby the contractors not only need to assume the risk from the operators but also from the sub-contractors. In order to solve this problem, it is argued that a specific legal mechanism should be adopted in Malaysia to protect and limit the liability of the contractors under the oilfield service contracts.

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