

## **SUMMARY OF THESIS**

### **KNOCK-FOR-KNOCK IN ONSHORE CONSTRUCTION CONTRACTS A STUDY OF A DIFFERENT LIABILITY REGIME AND THE IMPLEMENTATION THEREOF**

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*This Paper is a summary of a 1. Prize winning thesis in construction law, which examines the possibilities of applying a knock-for-knock clause in onshore construction contracts. It examines the validity of a knock-for-knock clause implemented in an onshore construction contract under the applicable laws of Denmark, Norway and England. Perspectives are drawn to the new forms of contracts such as Alliance partnerships, IPD and IPI contracts. Publication of the full thesis is pending.*

#### **Introduction**

In the offshore industry the majority of the regulation of risk of damage, loss and injury is based on the knock-for-knock principle.

The main function of the knock-for-knock clause is to reallocate potential liabilities so that the damages stay, where the damages hit, not dependent on what qualified behavior was displayed: negligence or gross negligence. Ultimately the damage is covered by insurance.

The knock-for-knock clause is used in offshore construction contracts and is part of the developed standard contracts for construction offshore. The knock-for-knock clause is applied offshore because the traditional fault-based liability would simply not suffice. The values which needs to be covered by insurance are too high, and so are the risk of damage occurring. The contracting parties therefore uses the knock-for-knock clause which entails cheaper insurance, faster resolution of claims through insurance, and fewer disputes regarding who is to blame for an occurred damage.

All advantages which would also benefit the contracting parties to an onshore construction contract. However only one example of the knock-for-knock clause implemented in an onshore construction contract has been found: the construction project Oslo Airport.

#### **The knock-for-knock clause**

The knock-for-knock clause typically covers three damage categories: (1) damage to the party itself, his employees or his own contracting parties such as a subcontractor, (2) damage to the other party, his employees or his contracting party such as a co-venture, and (3) damage to third parties. The knock-for-knock clause essentially consists of three agreements.

Firstly, a liability exclusion. Each party excludes all liability. As a consequence, each party will be responsible for damage to his own property and employees.

Secondly, an agreement which obligates each party to indemnify the other for claims that the counter-party has had to cover, from both employees and third parties.

Thirdly, an agreement between the parties to ensure, that the insurer waives his subrogation right.

The clause functions as an indemnity, when it is used to determine, who has to bear the cost of third party claims. When the clause is used to regulate claims between the contracting parties, the clause functions as a liability exclusion.

The process of establishing liability under the knock-for-knock clause is simpler and faster than under the fault-based liability. The assessments, which have to be made under a knock-for-knock clause are based on objective criteria: did the damage occur during the performance of the contract and who's employee or

property got damaged. The clause dispenses of many of the uncertainties present under the fault-based liability.

### **Advantages and disadvantages**

A frequently pointed out advantage is that the knock-for-knock scheme enables insurance savings. Firstly, because risk is sought insured under a property insurance instead of a liability insurance, the latter is assumed to be more expensive. Secondly, insurance cost is also assumed to be cheaper, because the risk of damage to an object is only insured once. Normally both contractor A and contractor B, would need a liability insurance because they are both at risk of damaging the same object. Furthermore, the insurances needed under the knock-for-knock clause will often be in place, not depending on the contract opportunity at hand.

Under the knock-for-knock clause disputes are avoided because of the clear and predictable allocation of loss and damage not dependent on fault, and because of the immediate loss compensation through insurance.

One disadvantage, which is often pointed out, is that the knock-for-knock clause removes the incentives for precaution and, therefore, enables more damage, injury and loss, than the fault-based scheme. However, this opinion corresponds very poorly to the general opinion in the offshore industry.

The offshore industry is heavily regulated. Furthermore, contractual measures can be taken, such as screening and monitoring of contractors. These measures are likely to work as a counterweight to the hazardous effect. Further specific measures can be regulated in the contract, for example sanctions and incentives.

### **Validity**

Because the knock-for-knock clause deviates from the onshore construction industry practice, it is relevant to determine, the validity of the clause, when implemented in an onshore construction contract.

#### *English law*

Under English law the contracting parties will, to a great extent, have freedom of contract. They can, with the proper wording, obligate to indemnify, limit or exclude liability for almost any kind of qualified behavior. The validity of the knock-for-knock clause only becomes uncertain, when a liability exclusion effectively relieves a party from his contractual obligations. This is almost impossible due to the traditional construction of the knock-for-knock clause in defined damage categories.

The only defense which can be made under English law is, that the clause is unreasonable pursuant to UCTA section 2, 2. The incentive for a contracting party seeking invalidity of a knock-for-knock clause will most often be, that a loss is left not covered by insurance. Because the assessment of reasonableness pursuant to UCTA section 2, 2 does not include circumstances, which arose after the conclusion of contract, the section will rarely apply to the circumstances, motivating the pursuit of invalidity.

#### *Danish law*

The knock-for-knock clause purports to exclude liability for gross negligence. When no basis for invalidity is claimed, the determination of validity is uncertain. Two judgements with very different results exist; in the case UfR 1993.851 H, the liability limitation clause was held invalid because it excluded gross negligence. In the case UfR 2005.2438 H, the liability limitation clause was held valid without further reasoning. The most recent judgement is the UfR 2005.2438 H, which would indicate that the result in this judgement is the one to be followed. Unless it is found that special circumstances contributed to the damage, as such the result in the case UfR 1993.851 H would apply. This renders the determination dependent on special circumstances, for instance the degree of the grossly negligent behavior, which inevitably causes uncertainty as to what result the contracting parties can expect.

The Contract Act § 36, was sought relied on in the case UfR 2006.632 H, but the court found that the liability limitation clause was reasonable, due to the facts that it was balanced, based on a calculated risk and that insurance was available.

Each of these factors would also be present under the knock-for-knock clause. However, the question as to whether other factors would outweigh the ones just described remains. The fact that the implementation would be highly unusual in an onshore setting, compared to the established industry practice, and the fact that the allocation is not a necessity onshore, because other adequate regulation exist, might essentially outweigh the reasoning applied in UfR 2006.632 H and, therefore, cause another result.

Furthermore, The Danish Building and Construction Arbitration Board has been criticized for their conservatism in handling terms which deviates from the industry recognized standard contracts. This practice could pose a threat to the knock-for-knock clause, when implemented in an onshore construction contract.

#### *Norwegian law*

Under Norwegian law, the discussed caselaw regarding liability exclusion and limitation clauses indicate, that such a clause would be held valid. One notable judgement, LG-2012-77280, makes the exception, and establishes uncertainty, as to the scope of the exception. Following this judgement, it is unclear whether the knock-for-knock clause would be held valid, when multiple violations of safety norms have been committed, and when this results in an actual safety hazard. Furthermore, it is not clear whether the exception is dependent on both an actual risk of safety hazard and multiple violations of safety norms, or whether one of the factors would be enough to hold the clause invalid.

Even though the applicable law was that of Norway, it is not unlikely that a Danish court would reach the same conclusion, under similar circumstances. The most extensive threat to a knock-for-knock clause, implemented in an onshore construction contract, is the Contract Act § 36 and the test of reasonableness, which it entails.

#### **Perspectives**

Some of the advantages that the knock-for-knock clause entails are already sought obtained through new forms of contract and collaborations, specifically for the onshore construction industry. One of these is the Integrated Project Insurance model (hereafter "IPI model").

The IPI model has been developed by Integrated Project Initiatives Ltd and insurance brokers Griffiths & Armour.

IPI is in itself an insurance product, from which the IPI model got its name. The IPI model is meant to work with an Alliance model of contract, which is essentially a multi-party framework contract, which establishes a contractual relationship between all the involved parties. The effect is not unlike the approach under the knock-for-knock clause. The Alliance model of contract has features, which establish the basis for the insurance coverage of the Integrated Project Insurance (hereafter "IPI"). This distinguishes this model from other collaboration contracts such as the IPD contracts.

Under the Alliance model of contract, a virtual company is created. Each firm will have a member on the Board of the Alliance. The regulation in the Alliance contract seeks to "[...] [align] the interests of all the participants [...]". This is achieved by a mechanism that regulates shared "pain" and "gain". In the Alliance model the overall cost of the project is estimated, and a target cost is set. In the target cost several posts are included such as: the teams profit, the cost of doing the work and an amount for unforeseen risk.

The possible reward lies below the target cost and is meant to provide an incentive for the Alliance members to achieve savings. The Alliance members will share the possible savings in proportions previously agreed by them. The possible risk lies above the target cost, and the same mechanism applies – the Alliance will share an overspending. The parties risk of covering overspending is capped at an agreed amount. The IPI will provide cover for the cost overrun which lies above the parties agreed cap.

The provided IPI will also be capped and overspending that exceeds the insurance cover will ultimately be borne by the client. The insurer's interest in the project is supported by assessments of risk as the project progresses, provided by a technical independent risk assessor and a financial independent risk assessor. The IPI policy covers the client and the Alliance partners: the consultants, specialists, manufacturers, construction

managers and their supply chains. In effect the IPI comprises the construction all risks insurance, the third-party liability including non-negligent liability and delay in completion.

In parallel with the knock-for-knock clause, the Alliance members and their supply chains, waives their rights to direct claim against each other, the insurer waives the right of subrogation against all the assured at every tier. In effect the parties exclude all liability and are obligated to not direct claims toward each other, almost identical to the knock-for-knock clause.

The IPI model is distinctively different from the traditional standard construction contracts. It comprises the advantages of the knock-for-knock scheme and more, but also entails a completely different way of conducting the build process including a process prior to the execution of works. The model includes several obligations not warranted under a knock-for-knock scheme.

Collaborative contracting has gained popularity, but it might not be financially sustainable on all construction projects.

The knock-for-knock clause could essentially be part of an alternative.