

# **UNFAIR RISK ALLOCATION IN OIL AND GAS UPSTREAM SERVICE CONTRACTS IN MALAYSIA: THE NECESSITY FOR OILFIELD ANTI-INDEMNITY ACT**

**Wan M. Zulhafiz**

*International Islamic University Malaysia.*

**Nasarudin Bin Abdul Rahman**

*International Islamic University Malaysia.*

## **ABSTRACT**

In Malaysia, the absence of a law to regulate imbalanced risk allocation and unfair indemnity and hold harmless clauses in oil and gas service contracts should be perceived as a serious problem. Such deficiency leads to the problem of inequality of bargaining power resulting from the dominant position of the operators over the contractors. Moreover, to date, there is no statutory restriction on contractual provisions purporting to exclude, limit or indemnify one or both of the parties in relation to liability and indemnity. Some operators opt to take out self-insurance rather than to buy a premium that will extend its coverage to cover the operators and sub-contractors, for example in respect of Construction All Risk. This scenario can cause the contractor to assume uninsured risks, which could lead to detrimental financial exposure on the occasion of a catastrophic incident. The situation might get worse for contractors in the event that contractors have to assume double jeopardy contractual risk, whereby the contractors not only need to assume operators' risk but also sub-contractors' risk. In order to resolve 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 oil and gas service contracts. It is suggested that the Malaysian Parliament should pass a special law, such as, Oilfield Anti-Indemnity Act. It would be ideal and practical solution to have a proper legal framework to control the abuse of imbalanced risk allocation and indemnity and hold harmless clauses in Malaysia. The methodology employed in this paper will be a comparative analysis which will be carried out in a descriptive, analytic and prescriptive manner.

**Keyword:** Malaysian law; Oil and gas industry; Upstream, offshore projects; Oilfield service contracts; Risk allocation, indemnity.

---

*Received: 11 February 2019*

*Accepted: 20 August 2019*

## **1. INTRODUCTION**

In Malaysia, the absence of a law to regulate imbalanced risk allocation and unfair indemnity and hold harmless clauses in oil and gas service contracts should be perceived as a serious issue because it leads to the problem of inequality of bargaining power resulting from the dominant position of the operators over the contractors (Zulhafiz, 2015a). Some operators opt to take out self-insurance rather than to buy a premium that will extend its coverage to cover the operators and sub-

contractors, for example in respect of Construction All Risk (Lima & Bednekoff, 1999). This scenario can cause the contractor to assume uninsured risks, which could lead to detrimental financial exposure on the occasion of a catastrophic incident. The situation might get worse for contractors in the event that contractors have to assume double jeopardy contractual risk, whereby the contractors not only need to assume operators' risk but also sub-contractors' risk. To date, there is no statutory restriction on contractual provisions purporting to exclude, limit or indemnify one or both of the parties in relation to liability and indemnity (Zulhafiz, 2015a; Zulhafiz, 2018). In order to resolve 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 oil and gas service contracts.

Some aspects pertaining to regulation which relate to oilfield service contracts should be referred to and adopted from the UK and the US. Malaysia could be regarded as relatively young in terms of maturity as compared to the United Kingdom Continental Shelf (UKCS) and the US. It has been noted that the legal and regulatory framework's pertaining to the oil and gas industry in the UKCS and the USA 'have changed significantly over time, largely in response to accidents on each country's continental shelf' (Benneer, 2015). Moreover, it has also been observed that these two countries have a very strong position in the offshore business, in which 'they have developed specific solutions concerning enforceability of mutual hold harmless clauses' (Mielcarek, 2012). In addition, the common law in the US and Malaysia originates from one source, i.e. English common law. The laws in Malaysia were derived from the English common law, where the laws were established during the British protectorate in Malaya prior to its independence in 1957.<sup>1</sup> Since the UK is considered as a mature province in the oil and gas industry, and Malaysia has a historical legal connection with English law, it is essential to refer to the UK practice on this particular issue. On the hand, another common law jurisdiction i.e. the US is also used as a benchmark to compare and contrast the legal issues in relation to oil and gas contracts in Malaysia. Both the UKCS and the US were chosen as models for providing the best legal framework pertaining to risk allocation for oilfield service contracts in Malaysia. That said, it should be kept in mind that the unique feature of the US legal system is that it consists of a federal level and a state level. Both the federal and state levels were taken into account while discussing the substantive law. In Malaysia, similar to the US, there are two tiers in the legal system i.e. a dual system with federal and state jurisdiction. That said, all matters pertaining to commerce in Malaysia fall within the ambit of the federal jurisdiction.

This paper provides analyses of risk allocation in the oil and gas service contracts in the UK, US and Malaysia. This paper also analyses the issue of the construction of indemnity and hold harmless clauses in the UK, US and Malaysia, in particular concerning the application of indemnity with regards to indemnification for own negligence, gross negligence, wilful misconduct, and fundamental breach of contract. Finally, this paper also provides proposals and recommendations inspired by the outcomes of the study in relation to imbalanced risk allocation and unfair indemnity and hold harmless clauses in oilfield service contracts in Malaysia. The main proposal is to pass a special piece of legislation, namely the Malaysian Oilfield Anti-Indemnity Act. Furthermore, it

---

<sup>1</sup> The laws would either be applied as case law or adopted into local legislation. Furthermore, by virtue of Sections 3 and 5 under the Civil Law Act 1956, the English common law and the rules of equity can be applied in Malaysia (subject to the cut-off date) if there is any lacuna of law. The cut-off dates for West Malaysia is the 7th of April 1956, Sabah is the 1st of December 1951 and Sarawak is the 12th of December 1949. The effect of English law after the cut-off dates is that it is not binding but it is only persuasive. Therefore, it is relevant to refer to English law. However, it is important to note that after the cut-off date, Malaysia developed into its own local laws in order to suit the needs of local circumstances.

also proposes some innovative ideas on practical measures to implement such regulation.

## 2. RISK ALLOCATION IN OILFIELD SERVICE CONTRACTS AND KNOCK-FOR-KNOCK INDEMNITY

The key players in the oil and gas industries adopt different contractual risk allocation mechanisms in oilfield service contracts to mitigate their risk exposure in every project (Patson Wilbroad, 2014; Zulhafiz, 2017b).

“These mechanisms are different from the usual risk allocation under [English] common law which expects liability to follow the breach of contract or duty. Although the application of contractual risk allocation clauses seem on the face of it relatively straightforward, there are many varying factors that may affect their application and enforceability with a possibility of leaving both contracting parties hugely exposed.” (Patson Wilbroad, 2014, p. 65)

Based on the default allocation of liability under English common law, the party in breach is liable to pay damages, with remoteness imposing the only limitation upon liability (Roberts, 2013). Nevertheless, under a contractual risk allocation, the parties to the contract will agree upon an allocation of liability according to the principle of freedom of contract. In this respect, the risks and liabilities will be distributed to the parties via the risk allocation provisions, such as indemnity and hold harmless clauses.

In the oil and gas industry in the UKCS, they are usually allocated between the operator and the contractor in accordance with a knock-for-knock indemnity regime (Cameron, 2012; Zulhafiz, 2017a, 2017c). A “knock-for-knock” indemnity or “mutual indemnity and hold harmless clause”, otherwise known as a “cross waiver liability clause”, is a unique feature of the oil and gas industry in allocating risk (Aubin & Portwood, n.d.). The clause is designed to avoid the problem of determining the respective liability of parties for a given loss in which the contracting parties will exchange mutual indemnities for any suit or action brought against a counterparty for injuries to or death of both the indemnitor and indemnitee’s employees regardless of fault or negligence.

This practice is accepted under English law and was recognised by the Supreme Court in the case of *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] UKHL 4, [2002] 1 Lloyd’s Rep 553 (“London Bridge”). The practice is incorporated into standard form contracts in the UK. Similarly, a knock-for-knock indemnity is adopted and reflected in many standard forms for oilfield service contracts such as the LOGIC Offshore Service Model Contract and AIPN model contracts. They are well-known associations providing model forms of oilfield services and construction agreements. AIPN stands for the International Association of Petroleum Negotiators while LOGIC means the Leading Oil & Gas Industry Competitiveness.

The knock-for-knock indemnity regime as currently practised in the UK could provide a good mechanism to control the imbalanced risk allocation and unfair indemnity and hold harmless clauses. This is because it provides mutual benefits to both parties, particularly in respect of indemnity and hold harmless clauses. In this regard, the parties could agree to indemnify each other regardless of fault for personal injuries, the death of personnel, loss and damage to their property, pollution, third parties etc. Unfortunately, the concept and application of indemnity and hold harmless clauses in oilfield service contracts have not been widely discussed in Malaysia. The courts in Malaysia, have not made any comments regarding knock-for-knock indemnity in relation to the oil and gas industry. Perhaps, the time has arrived to adopt and recognise this concept in the Malaysian oil and gas industry legal regime.

According to traditional practice in the oil and gas industry, contractual liability is allocated based on knock-for-knock indemnity. However, after the Macondo incident, it has been argued that the operators tend to shift greater risk to the contractors (Zulhafiz, 2017c). The risks are allocated more to the contractors unfairly. Even though model or standard forms of general conditions of contract are available, it is argued that the underlying principle of reciprocal indemnity behind risk allocation in these contracts has not been fully adhered to by the parties. Additionally, ‘the nature and extent of risks tend to be project-specific in today’s high-risk scenarios and multiparty complex projects that adoption of tailor-made contract strategies is more desirable’ (Lam, Wang, Lee, & Tsang, 2007, p. 486; Motiar Rahman & Kumaraswamy, 2002). Moreover, the insurance industry does not want to bear those risks since they are considered to be the operator’s risks. This leaves the contractors without insurance, which means that they might incur massive financial losses if an accident occurs. This scenario is even worse when the operator has inequality bargaining power. It was argued that the operators in Malaysia hold a dominant position when negotiating oilfield service contracts, which enables them to pass greater risk to the contractors (Zulhafiz, 2015a). The oil companies often assume that they can impose whatever conditions they wish since they usually draft the contracts. This scenario influences the parties in negotiating the contract which in turn leads to imbalanced risk allocation and unfair indemnity and hold harmless clauses.

### **3. INEQUALITY BARGAINING POWER**

This paper argues that one of the factors which led to imbalanced risk allocation in oilfield service contracts was the unequal bargaining position between operators and contractors in the Malaysian oil and gas industry (Alramahi, 2013; Cameron, 2012; Thorpe, 2008). The control of ownership and the right to the oil and gas resources could be used to determine whether the operator and contractor have equality of bargaining power. Moreover, the fact that the national oil company, Petronas, forms alliances with the oil companies adds to their bargaining power.

In the UK, the State has absolute control over oil and gas and issues licenses to any oil company with the capability to develop the oilfield (Gordon, Paterson, & Usenmez, 2011). Meanwhile, in the US, the private land owner has ownership of the resources on land but not at sea. Under international law of the sea, offshore natural resources of the Continental Shelf are reserved to the coastal state. Because the USA is a Federation, there is a mixed State-Federal ownership of natural resources in the seabed: in general, the waters surrounding the US soil within a limit of three nautical miles from the shore belong to the coastal states, whereas the waters beyond that point are under the jurisdiction of the US Federal Government (Lowe, 1983).

The situation in Malaysia is quite different, where the national petroleum company, Petronas, solely controls the Malaysian oil and gas resources (Zulhafiz, 2015a). Petronas, together with other Production Sharing Contractors who are either subsidiary of Petronas or multi-national oil companies, would be the operators to develop the oil fields. The operator would then hire service contractors to complete specific tasks.

Under the production sharing contracts, PETRONAS as the NOC exercises ownership and controls and manages exploration, development and production of petroleum in Malaysia. One of the prominent operators in Malaysia is PETRONAS Carigali Sdn. Bhd., which is also the subsidiary of PETRONAS itself. The other operators are multinational oil companies. Usually, one operator is appointed for each operation. The appointment of an operator depends on two things. Firstly, the equity held by the company. Secondly, the operator's appointment has to be agreed upon by both its shareholders and PETRONAS.

Based on the findings of the empirical study which was conducted in 2008, Mohammad argues that there is dissatisfaction among the contractors in respect of the one-way adversarial relation between operators and contractors because the contractors are allocated more risks (Mohammad, 2008). In order to validate Mohammad's findings, an empirical study was conducted by the author from February 2014 till April 2014 in Malaysia (Zulhafiz, 2018). The empirical study investigated the attitude of the key players in the oil and gas industry in Malaysia regarding risk allocation as well as their perceptions on the use of indemnity and hold harmless clauses. In the case studies, ten respondents were interviewed, out of which eight represented the contractors, and two represented the operators (Zulhafiz, 2015). Apart from semi-structured interviews, three samples of an individual contract drafted by three different operators were analysed for the study. The indemnity and hold harmless clauses were compared with the standard form of contracts under LOGIC and FIDIC.

Based on the findings from the semi-structured interviews with the respondents, the contractors alleged that the dominant position of the operators put them in a better position during contractual negotiation (Zulhafiz, 2015). The contractors also claimed that most of the contractual terms and conditions, including the indemnity and hold and harmless clauses in oilfield service contracts, are one-sided because they are more favourable to the operators. Due to the lesser bargaining power, contractors are given less opportunities to modify the terms and conditions in order to make them fairer. Moreover, based on the contract analysis, it appears that the indemnity and hold harmless clauses in the oilfield service contracts drafted by the operators are largely onerous and unfair to the contractors. However, despite the unfair terms and conditions, contractors end up agreeing to them in order to secure existing and future jobs. It could be argued that this is a serious problem. Furthermore, under some oilfield service contracts in Malaysia, the contractors are obliged to indemnify the operators against all claims and demands made or taken against the operators by any third party in relation to any matter arising out of the contract. It is argued that this clause should be drafted reciprocally and the damages should be borne by the guilty party.

#### **4. LAWS PERTAINING TO UNFAIR RISK ALLOCATION IN OILFIELD SERVICE CONTRACTS IN MALAYSIA**

In the context of the Malaysian petroleum industry, it is necessary to strike an appropriate balance between the two competing interests of upholding fair contracts and certainty in the law. This situation had left Malaysian law in a state of ambiguity and uncertainty with regards to its recognition and acceptance of the doctrine of unconscionability and inequality of bargaining power. As a result, any party who finds himself being treated with procedural unfairness has no room to seek justice and to bring any cause of action for unconscionability and inequality of bargaining power to the court. It is argued that a special legal mechanism should be adopted to address this problem.

Generally, contract law in Malaysia is governed by the Contract Act 1950. However, section 77 of the Contract Act 1950 merely discusses the meaning of “contract of indemnity”. Meanwhile, section 78 of the Contract Act 1950 merely talks about “right of indemnity holder when sued”. Based on the case analysis in Malaysia, the courts have not addressed this problem. Furthermore, the judicial position on the doctrine of unconscionability and inequality of bargaining power remains unclear in Malaysia since the Court of Appeal has taken inconsistent views in the cases of *Saad Marwi v Chan Hwan Hua & Anor* [2001] 3 CLJ 98 and *American International Assurance Co Ltd v Koh Yen Bee (f)* [2002] 4 MLJ 301. As a result of this gap in the law, the result is a lack of legal protection for the contractor, and the operator might use his dominant position and continuously shift greater risk over the contractor. This uneven and unfair risk allocation may cause significant financial setbacks to the contractor.

Under Malaysian law, the parties generally have freedom of contract. The 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. Currently, there are no statutory restrictions in Malaysia on contractual provisions purporting to exclude or limit the liability of one or both of the parties in relation to indemnity and liability (Zulhafiz, 2015a).

In Malaysia, contract law is governed by the Malaysian Contracts Act 1950 (Act 136). However, section 77 of the Act merely talks about what is a ‘contract of indemnity’. The section provides that a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person, is called a ‘contract of indemnity’. Meanwhile, section 78 of Malaysian Contracts Act 1950 merely talks about ‘right of indemnity holder when sued’. It is argued that the law of indemnity in Malaysia is open to abuse by the contracting party, especially when that party is in a better position in negotiating a contract. The absence of laws in Malaysia to curb unfair contract practices could be seen as a serious problem.

Moreover, the judicial position to the recognition and acceptance of the doctrine of unconscionability and inequality of bargaining power remains unclear in Malaysia. In *FuiLian Credit & Leasing SdnBhd v Kim Leong Timber Sdn Bhd* [1991] 1 CLJ 522, the doctrine of unconscionability seemed to be recognised by Datuk Cheong Siew Fai J, where the court referred to English cases like *Multiservice Bookbinding Ltd v Marden* [1979] Ch. 84, and *Hart v O’Connor*[1985] AC 1000, and stated that:

“In order that a party may free himself from complying with an agreement he had entered into, he must show that, in the eyes of the court, it was unreasonable. A bargain cannot be unfair and unconscionable unless it is shown that one of the parties to it has imposed an objectionable term in a morally reprehensible manner, that is to say, in a way which affects his conscience or has procured the bargain by some unfair means.” (*Fui Lian Credit & Leasing Sdn. Bhd. v Kim Leong Timber Sdn. Bhd. & Ors* [1991] 1 CLJ 522, 526)

However, the learned judge did not further clarify the status of *Hart v O'Connor* in the Malaysian context. He did not specify whether or not such doctrine could be adopted as an independent ground for relief. Moreover, the principle of inequality of bargaining power formulated by Lord Denning in the case of *Lloyds Bank v Bundy* [1975] QB 326; [1974] 3 All ER 757; [1974] 3 WLR 501 has also not been approved by the courts on the ground of a lack of established precedent. This can be seen in the judgment of Visu Sinnadurai J. in *Polygram Records Sdn Bhd v The Search* [1994] 3 MLJ 127; [1994] 3 CLJ 806; [1994] 3 AMR 2060.

In another case, Gopal Sri Ram JCA, in his judgment at the Court of Appeal in the case of *Saad Marwi v Chan Hwan Hua & Anor* [2001] 3 CLJ 98 recognised the doctrine of unconscionability, which was also referred to as the doctrine of inequality of bargaining power. Unfortunately, the subsequent case at the Court of Appeal did not follow the principles in *Saad Marwi* (Alias & Abdul Ghadas, 2012). In the case of *American International Assurance Co Ltd v Koh Yen Bee (f)*, Abdul Hamid Mohamad JCA chose not to follow Gopal Sri Ram’s CJA’s views on the applicability of the doctrine of unconscionability. He distinguished between the facts of both cases and stated that section 14 of the Contracts Act 1950 only recognises coercion, undue influence, fraud, misrepresentation and mistake as elements that have an effect on free consent.

The issue of unfair trade or contract practices by dominant operators in the oil and gas industry may be addressed through the enforcement of the competition law in Malaysia. Section 10 of the Competition Act 2010 prohibits a dominant enterprise from abusing its dominant position through the imposition of unfair selling and purchasing price and other unfair trading conditions. On the surface, it appears that the contractors may take action under the Competition Act against a large dominant operator who engages in anti-competitive behaviour by imposing unfair trading conditions on the contractor which causes competitive disadvantage to the contractors with weak bargaining power. However, the First Schedule of the Competition Act 2010 was amended in 2013 which excludes all commercial activities regulated by Petroleum Development Act 1974 and Petroleum Regulation 1974 relating to upstream operation from the Competition Act 2010.

## **5. CONSTRUCTION OF INDEMNITY AND HOLD HARMLESS CLAUSE IN OILFIELD SERVICE CONTRACTS IN MALAYSIA, THE UK AND USA**

Indemnity and Hold Harmless Clause is used to allocate risk in the oilfield service contracts. However, the Federal Court in Malaysia has treated indemnity clauses the same way as exemption clauses. In *CIMB Bank Bhd v Maybank Trustees Bhd*, the Federal Court upheld the Court of

Appeal's decision to interpret the indemnity clause in the Trust Deed as an exemption clause. The Federal Court in Malaysia treats indemnity clauses as exemption clauses, which is similar to the position in the UK. However, it is argued that indemnity and hold harmless clauses should be distinguished from exclusion clauses because their application leads to different consequences. This can be seen in the case of *Farstad Supply A/S v Enviroco Limited* [2011] UKSC 16. In this case, the indemnity and hold harmless clause will operate in its original function in respect of any liability arising from the third party (Gordon, 2011a). However, it will operate as an exclusion clause with regard to liability arising from the other contracting parties (Gordon, 2011a). Therefore, extra care must be taken to draw a clear distinction between both clauses. On the other hand, in the US, the courts distinguish between indemnity clauses and release clauses. Indemnity clauses are only applicable to third party liability, whereas release clauses apply between the contracting parties.

With regards to the interpretation of indemnity clauses, all courts in the three jurisdictions apply a similar test albeit under different names i.e. the objective approach in the UK, or the magic language test in the US, or the reasonable man test in Malaysia. The courts in all three jurisdictions will look into the language of the clause and the intention of the parties.

In Malaysia, indemnity clauses will be construed using an objective or reasonable man test. In *Lee KamWah v. Associated Asian Securities (Pte) Ltd* [1991] 3 MLJ 286, the High Court held that,

“[i]t would be wrong to give such clauses such an open-ended construction without trying to ascertain what the parties really intended from the terms of the document in question and the surrounding circumstances at the time the parties entered into the agreement unless the evidence clearly established that the plaintiff was negligent or had been a party to the fraudulent transaction.”

This is in line with the Supreme Court case of *Ayer Hitam Tin Dredging Malaysia Bhd v YC Chin Enterprises Sdn Bhd* [1994] 2 MLJ 754, where the Supreme Court held that the existence of an agreement depends upon the intention of the parties, who must be *ad idem*. The parties' intention can be inferred from the language used and the parties' conduct having regard to the surrounding circumstances as well as the object of the contract. In *Hong Realty (Pte) Ltd v Chua Keng Mong* [1994] 3 SLR 819 825, Karthigesu JA explained that, ‘[i]t is trite law that exemption clauses must be construed strictly and this means that their application must be restricted to the particular circumstances the parties had in mind at the time they entered into the contract’.

It is observed that despite whatever terms one used by the courts of any jurisdiction in interpreting the clause, the main objective is to give effect to it according to the intention of the parties. This could either be achieved by using the tests which have been developed by the courts such as the ‘objective approach’ under English law, the ‘talismanic language’ or ‘magic language’ rule under the US law, or even the ‘objective or reasonable man’ test under Malaysian law.

However, English courts have gone beyond the plain and simplistic contextual interpretation. The English courts previously used the old rule of ‘objective bystander’. Later, in the case of *Investors Compensation Scheme Ltd* [1998] 1 WLR 896, Lord Hoffman's restatement added to and refined the old rule to ascertain contractual interpretation and this is known as ‘matrix of facts’. As discussed earlier, this rule has been criticised because it departs from the original meaning of the

contract and also for its potential to cause ‘a degree of uncertainty in the law’ (McKendrick, 2014, p. 381). In this respect, as stated earlier, it is better to disregard Lord Hoffmann’s restatement, but to construe the indemnity and hold harmless clauses with the *contra proferentem* rule.

The courts in Malaysia will apply the *contra proferentem* rule to interpret an indemnity clause and exemption clause, where such clause will be ‘construed against the party putting it forward as the basis for escaping liability which would otherwise be incurred’ (Peel, 2007, pp. 61–75). Thus, if there is any ambiguity and unclear contract wording in the indemnity clause, it will be subject to the *contra proferentem* rule. For example, in the case of *Syarikat Uniweld Trading v The Asia Insurance Co Ltd* [1996] 2 MLJ 160, the High Court applied the *contra proferentem* rule to resolve an ambiguity between the indemnity clause and the exemption clause in the insurance policy. Similarly, in the case of *Sabah Shell Petroleum Co Ltd & Anor v The Owners of and/or any other Persons Interested in The Ship or Vessel The ‘Borcos Takdir’* [2012] MLJU 606, which required the court to interpret an indemnity clause under the oilfield service contract, the High Court used the *contra proferentem* rule in order to give the meaning to Clause 21 (i.e. on ‘Responsibilities and Indemnities’) of the Conditions of Contract.

English law has also traditionally deployed the *contra proferentem* rule to interpret exemption indemnity clauses and it was unexpected that the court would not diverge from that rule. However, ‘the *contra proferentem* rule inclines pejoratively against the party relying on the indemnity clause presupposes a clearly identifiable *proferens*’ (Ugwuanyi, 2012, p. 141). This is because, firstly, it is not relevant if that wording of the contract is sufficiently unambiguous and clear, since *contra proferentem* is a principle of construction, which is to be applied only in the event that a few interpretations of the contract exist. Secondly, it is not relevant if the wording of the contract does not clearly confer a benefit in favour of a single party to the contract or in the event that both parties receive equal benefit from the wording of the contract. In this regard, mutual indemnity and hold harmless clauses will not fit properly with the *contra proferentem* rule. Greg Gordon regards this scenario as being artificial (Gordon, 2011b). In the case of *Gavin Slessor v. VetcoGray UK Ltd* [2006] CSOH 104, Lord Glennie in the Scottish Outer House Court of Session, has argued that ‘the *contra proferentem* which apply in instances of ambiguity, has much less impact where the exemptions and indemnities are mutual or reciprocal’. In such situations, both parties could be the *proferens*. Lord Glennie further stated that, ‘it makes little sense to construe the clause against each one of them leaving the possibility of a hole in the middle’. Therefore, it could be said that the application of the *contra proferentem* rule to interpret mutual indemnity and hold harmless clauses is defective because it is not an established proposition.

The rules of interpretation have changed as a consequence of the recent decision of the Supreme Court in *Arnold v Britton and others* [2016] 1 All ER 1; also see [2015] UKSC 36. The court set out seven factors as guidelines to construe contractual clauses. Even though the rule of interpretation in *Arnold* was claimed to be comprehensive, the problem of unbalanced indemnity and unfair risk allocation in oilfield service contracts cannot be solved by the rule. The reason for that is because, indemnity clauses which are drafted by the operator might be clear and unambiguous. However, the indemnity clauses consist of unfair terms. In that respect, the contractor enters into the contract not because he cannot understand the contractual terms; however, he has no option but to agree to the contract in order to secure a job despite the unfair

terms. When Lord Hodge delivered judgment in *Arnold*, he also highlighted this problem. He said, at paragraph 79, page 21 of the said judgment, that the court did not have the power to remedy unfair terms in the tenancy agreement. He went on to suggest that a special law should be passed by the UK Parliament to protect tenants against unreasonable service charges. Applying this scenario to the issue of unbalanced indemnities in oilfield service contracts in Malaysia, it could be argued that there is a need for particular legislation to be passed by the Malaysian Parliament, which specifically addresses the issue of risk allocation between operators and contractors in oilfield service contracts.

This paper suggests that an indemnification for the indemnitee's own negligence should be allowed, provided that the indemnity and hold harmless clauses operate reciprocally for both parties. In respect of third party liability, the consequences of damages should be borne by the guilty party who causes the negligence. With regards to gross negligence, wilful misconduct, and fundamental breach of contract, even if the parties have contractual freedom, it is argued that they should not be allowed to indemnify each other in respect of these causes because it could be regarded as contrary to public policy.

Even though it was argued that mutual indemnity and hold harmless clauses could provide for a solution with regards to imbalanced risk allocation in oilfield service contracts, it is also important to note that the clauses will be subject to the interpretation requirements because they are generally troublesome to draft and difficult to understand (Peng, 1993, p. 156). On this point, Greg Gordon notes that:

“Even experienced lawyers or contract analysts entering the oil and gas industry for the first time may find it is not easy to draft a wholly satisfactory set of indemnity provisions, as the failed attempts and “borderline successes” which litter the case reports readily attest. All that said, many of the problems that arise with indemnification are essentially points of more detail, most of which arise because of the complexity and hazardous nature of the operations and risks that the contract seeks to govern, but some of which as a result of the unnatural interpretation the courts have traditionally given to indemnity clauses. These difficulties are generally susceptible to being resolved by careful thought and skilful drafting, although this can lead to lengthy and complex clauses.” (Gordon, 2011b)

Moreover, by virtue of freedom of contract, contracting parties are free to negotiate and agree upon any terms of their choice. The parties might opt not to subscribe to the idea of knock-for-knock indemnity and draft a one-sided or an unfair clause instead since no regulation is in place to prevent them from doing so. As discussed earlier, the UKCS does not have any regulations comparable to the oilfield anti-indemnity statutes in the US (which will be discussed later) to control the use of risk allocation and indemnity hold harmless clauses. This position opens to criticisms.

## **6. CRITICISMS ON KNOCK-FOR-KNOCK INDEMNITY**

It is quite interesting to note that the UK does not have any special legislation to regulate this matter. The UKCS relies on knock-for-knock indemnities to distribute the risk reciprocally between the parties. With the support of the IMHH and the guidelines issued by the DECC, the

knock-for-knock indemnity regime has been maintained and preserved in the oil and gas industry in the UK.

The knock-for-knock indemnity regime could be considered as a good mechanism to control the imbalanced risk allocation and unfair indemnity and hold harmless clauses because it provides mutual benefits to both parties (Zulhafiz, 2017b). The validity of the offshore industry practice of “knock-for-knock” indemnity has even been recognised under English law as shown by the House of Lords in the case of *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] UKHL 4, [2002] 1 Lloyd’s Rep 553 (the “London Bridge”). Therefore, it could be perceived as the ideal solution to resolve the issue of imbalanced risk allocation and unfair indemnity and hold harmless clauses in Malaysia. That said, several problems have been identified which can be seen as follows:

Firstly, due to the doctrine of privity of contract, contractors who were not in a contractual relationship with contractors in other groups would not be beneficiaries of the existing indemnity agreement. Therefore, in general, third parties who are not beneficiaries of an indemnity cannot enforce such a right, unless the parties have been covered by indemnity and insurance clauses in favour of the company group and the contractor group (Gordon, 2010). However, under the Contracts (Right of Third Parties) Act 1999, third parties can make a claim for indemnity under a contract. This is not the case in Malaysia, where there is no comparable law to address this issue. Thus, it seems necessary for the Malaysian Parliament to pass a law which would fill in this lacuna in the law. That said, even though third party contractors or sub-contractors are now entitled to claim as beneficiaries by virtue of the Contracts (Right of Third Parties) Act 1999, they still cannot enforce the indemnity clauses if they are not parties to the contract. In other words, despite the existence of the 1999 Act, a gap does remain regarding how to deal with the different contractors and sub-contractor groups; it appears that the only method to deal with this problem is by either incorporating back-to-back the clauses in each contract or by requiring that the parties are signatory to the Industry Mutual Hold Harmless Deed (IMHH).

Regarding back-to-back clauses, it is vital that all parties at each level i.e. operators, contractors, subcontractors and sub-subcontractors incorporate a knock-for-knock indemnity in their contracts (Gordon, 2011b, p. 455). Otherwise, the contractual chain will be broken, which would defeat the purpose of having a knock-for-knock regime. Regarding the IMHH Deed, it is important to make sure that all parties are signatory to the IMHH Deed. That said, the problem with the IMHH Deed is that it operates voluntarily. There is also no enforcement mechanism for the IMHH Deed, neither are there any sanctions for not signing up to the Deed.

Secondly, based on the analysis of the judicial control of knock-for-knock indemnity under English law, it could be argued that this is a complex issue, where the construction of mutual indemnity and hold harmless clauses depends on the courts’ interpretation (W. M. Zulhafiz, 2017a). The courts take different approaches to interpreting the clauses (Gordon, 2011b). For example, some courts have given weight to the intention of the parties, taking into consideration the context and matrix of fact. However, it appears that this approach has not solved the issue of construction. Therefore, some courts apply the *contra proferentem* rule in order to overcome the issue of

construction. However, this approach cannot be regarded as established, as stated in *Gavin Slessor v. VetcoGray UK Ltd* [2006] CSOH. This is because, the contra proferentem rule would not be applicable where both parties are the proferens. Another problem with the construction of mutual indemnity hold harmless clauses is the uncertainty with regard to the meaning of gross negligence and wilful misconduct. The reason is that neither have an exact definition. Moreover, there is also a grey area in relation to the judicial interpretation of deliberate repudiatory breach and fundamental breach of contract.

However, it will be difficult to compel parties in the Malaysian oil and gas industry to incorporate knock-for-knock indemnities in their contracts. The parties which hold greater bargaining power might not be willing to include such a clause in the contract (W. M. Zulhafiz, 2018). Some states in the US, such as Texas and Louisiana, have passed legislation to regulate the allocation of liability, namely the oilfield anti-indemnity act.

## **7. OILFIELD ANTI INDEMNITY ACT**

In the US, knock-for-knock indemnities are subject to the requirements of oilfield anti-indemnity statutes in some states, such as Louisiana, Texas, Wyoming and New Mexico. Oilfield indemnity statutes nullify an indemnity clause that provides for indemnification for the indemnitee's own negligence. Even though the oilfield anti-indemnity statutes have not been implemented in all US states, the statutes are widely implemented by many states adjacent to the Outer Continental Shelf (OCS), including Texas and Louisiana.

These statutes were passed in response to petitions made by the contractors. The contractors claimed that as a result of unequal bargaining power between the operators and contractors, operators have promulgated contractual inequity and unfairness and have required contractors to indemnify the operators' negligence. After the anti-indemnity statutes were instated, the Guidance Notes for AIPN Model Service Contract for Well Services and Seismic Acquisition for example, stated that the current form of indemnity clauses in the model contract are not applicable to Texas and Louisiana.<sup>2</sup>

However, it is important to emphasise that these statutes did not have an impact in the Macondo case since the parties had agreed that Maritime Law should have governed the Drilling Contract instead. Even though some argued that this legislation somehow interfered with freedom of contract, the legislation is important for public policy reasons. Therefore, on grounds of public policy, special legislation comparable to the legislation in the US should be adopted in Malaysia. This will help to protect the contractor from unfair distribution of risk between the parties. Moreover, with the existence of the NOC and its PSC contractor, less protection is available to the contractor. Thus, it is especially appropriate to enact an oilfield anti-indemnity law in Malaysia on the grounds of public policy.

## **8. DISCUSSION AND CONCLUSION**

---

<sup>2</sup> AIPN (2002) Guidance Notes on International Model Contracts, Well Services and Seismic Acquisition, p. 23.

Based on the above discussion, it is argued that statutory intervention is needed to regulate unfair risk allocation and imbalanced indemnity and hold harmless clauses in oilfield service contracts in Malaysia. A statutory law is important because it will provide legal protection to contractors from unfair risk allocation and unbalanced indemnity and hold harmless clauses. The statutory law would take into consideration all of the fundamental issues as discussed above and would reflect the key findings of this paper. However, until the proposed statutory law is passed by the Malaysian Parliament, it is suggested that the contracting parties, especially on the contractor side, should take steps to ensure that the indemnity and hold harmless clauses are drafted properly to prevent unfair risk allocation.

It is suggested that the Malaysian Parliament should pass a special law, namely the Malaysian Oilfield Anti-Indemnity Act (MOAIA). It is an ideal and practical solution to have a proper legal framework to control the abuse of imbalanced risk allocation and indemnity and hold harmless clauses in Malaysia. As discussed previously, both TOAIA and LOAIA were enacted in Texas and Louisiana as a measure to correct the perceived unequal bargaining power between oil contractors and oil companies in oilfield service contracts. These statutes could be used as an example as well as a working model in drafting the potential MOAIA. That said, it is important to note the ‘differences in basic principles and in terminology between Louisiana and Texas in oil and gas law’ (Martin & Lanier Yeates, 1991, p. 860).

In relation to implementation, it seems that MOAIA would be less complex and easier to implement in Malaysia as compared to TOAIA in Texas and LOAIA in Louisiana. The reason for the complexity in the US is because of the jurisdictional division at the federal level and state level. For example, under the US legal system, risk allocation in oilfield service contracts at the federal level will either be governed by Outer Continental Shelf Lands Act (OSCLA) or Maritime law. Which law is applicable to each contract depends on the nature of the contract itself, i.e. whether it is ‘maritime’ or ‘non-maritime’. Where the contract is maritime, then Maritime law will be applied. Meanwhile, OSCLA will be applied if the contract is non-maritime. Under OSCLA, the law of the adjacent state is applicable as the surrogate law. Both TOAIA and LOAIA are state law. Such complexity causes difficulty for their implementation. In contrast, even though Malaysian law can be divided into federal level and state level as well, according to the Malaysian Federal Constitution, under the Ninth Schedule (List I—Federal List), contracts and commercial matters fall under federal jurisdiction. Therefore, MOAIA would be treated as federal law and its enforcement is equal to all states. This should be taken as a strong point in terms of the practicality of its implementation.

In addition, the IMHH as practised in the UK should also be introduced in Malaysia to encourage the use of knock-for-knock indemnities. Moreover, the implementation of IMHH would help to resolve the issue of multiple parties under separate agreements. In every project there will be several chains of contractual relationships. However, there is no contractual relationship among contractors at a horizontal level (Gordon, 2011b). Thus, subcontractors and sub-subcontractors will be regarded as third parties. Under the doctrine of privity of contract, subcontractors and sub-subcontractors are not parties to the contract and therefore have no rights under the contracts. The IMHH scheme fills in the contractual gap by creating a mutual hold harmless arrangement between

contractors, in which the arrangement is made under the IMHH Deed (“Supply Chain Code of Practice,” 2012).

## REFERENCES

- Alias, S. A., & Abdul Ghadas, Z. A. (2012). Inequality of bargaining power and the doctrine of unconscionability: Towards substantive fairness in commercial contracts. *Austl.J.Basic&App.Sci.*, 11(6), 331.
- Alramahi, M. (2013). *Oil and Gas Law in the UK*. Bloomsbury Professional.
- Aubin, Y., & Portwood, T. (n.d.). International Business Law Journal Mutual indemnity and hold harmless agreements.
- Benbear, L. S. (2015). Offshore oil and gas drilling: A review of regulatory regimes in the United States, United Kingdom, and Norway. *Rev. Env. Econs. Pol’y.*, 9(1), 2–22.
- Cameron, P. (2012). Liability for catastrophic risk in the oil and gas industry. *International Energy Law Review*, 207.
- Gordon, G. (2010). Contribution and indemnification: Farstad Supply AS v Enviroco Ltd. *Edinburgh Law Review*, 14, 102.
- Gordon, G. (2011a). Contribution, indemnification and exclusion: Farstad in the supreme court. *Edinburgh Law Review*, 15, 259.
- Gordon, G. (2011b). Risk Allocation in Oil and Gas Contracts. In G. Gordon, J. Paterson, & E. Usenmez (Eds.), *Oil and Gas Law: Current Practice & Emerging Trends* (Vol. 2nd). Dundee University Press.
- Gordon, G., Paterson, J., & Usenmez, E. (2011). Oil and Gas Law on the United Kingdom Continental Shelf: Current Practice and Emerging Trends. In G. Gordon, J. Paterson, & E. Usenmez (Eds.), *Oil and Gas Law: Current Practice & Emerging Trends* (2nd ed.). Dundee University Press.
- Lam, K. C., Wang, D., Lee, P. T. K., & Tsang, Y. T. (2007). Modelling risk allocation decision in construction contracts. *Int. J. Project. Mgmt.*, 25(5), 485–493.
- Lima, S. L., & Bednekoff, P. A. (1999). Temporal variation in danger drives antipredator behavior: the predation risk allocation hypothesis. *Am.Naturalist*, 153(6), 649–659.
- Lowe, J. S. (1983). *Oil and gas law in a nutshell*. West Publishing Company.
- Martin, P. H., & Lanier Yeates, J. (1991). Louisiana and Texas oil & gas law: An overview of the differences. *La.L.Rev.*, (52), 769.
- McKendrick, E. (2014). *Contract law: text, cases, and materials*. OUP.
- Mielcarek, P. (2012). *The knock-for-knock agreements in the offshore sector under the United States and Norwegian law.: The problem of gross negligence and wilful misconduct*. University of Oslo.
- Mohammad, M. F. (2008). Procurement strategies for the oil and gas industry: To Capture changing values and dealing with multi cultural complexity. *ICCBT*, (3), 29–38.
- Motiar Rahman, M., & Kumaraswamy, M. M. (2002). Risk management trends in the construction industry: moving towards joint risk management. *Engin. Const. & Architec. Mgmt.*, 9(2), 131–151.
- Patson Wilbroad, A. (2014). *Risk Allocation in Oil and Gas Service Contracts*. LAP Lambert Academic Publishing.
- Peel, E. (2007). Whither Contra Proferentem? In A. Burrows & E. Peel (Eds.), *Contract Terms* (pp. 61–75).
- Peng, D. (1993). Mutual Indemnities in North Sea Contracts - Liability and Insurance Clauses. In

- D. Peng (Ed.), *Insurance and Legal Issues in the Oil Industry* (p. 156). Kluwer Law International.
- Roberts, P. (2013). *Petroleum Contracts: English Law and Practice*. OUP Oxford.
- Supply Chain Code of Practice. (2012). *Streamlining processes and increasing value for the oil and gas industry*. Retrieved October 20, 2015, from <http://oilandgasuk.co.uk/wp-content/uploads/2015/05/SC021.pdf>
- Thorpe, C. (2008). *Fundamentals of Upstream Petroleum Agreements*. C P Thorpe Ltd.
- Ugwuanyi, C. S. (2012). Examining the exclusionary nature of oil and gas contract mutual indemnity hold harmless clauses. *Int. Energy L. Rev.*, 36.
- Zulhafiz, W. (2015a). Unfair Contract Terms Act 1977: Does it provide a good model in regulating risk allocation provisions in oilfield contracts in Malaysia? *International Journal of Trade & Global Market*, 8, 3.
- Zulhafiz, W. M. (2015). An empirical study on the contractual risk allocation provisions and indemnity and hold harmless clauses in the oilfield service contracts in Malaysia. In *Paper Proceedings on "Second International Conference on Interdisciplinary Legal Studies (ICILS) 2015" on 9th-10th June 2015 in Toronto, Canada* (p. 103). Toronto, Canada: Unique Conference Canada, June.
- Zulhafiz, W. M. (2017a). A comparative analysis on the enforceability of knock-for-knock indemnities in Thailand and the United Kingdom. *Journal of Malaysian and Comparative Law*, 44(1).
- Zulhafiz, W. M. (2017b). On the contractual risk allocation in oil and gas projects. *The Law Review*, (2), 168.
- Zulhafiz, W. M. (2017c). Recent trends in allocation of risk post-macondo: The growing tension between oil and gas standard forms of contract, and contractual practice. *International Energy Law Review*, (5), 170.
- Zulhafiz, W. M. (2018). Perception of contractual risk allocation in the oil and gas contracts in Malaysia. *International Journal of Trade and Global Markets*, 11(1–2), 127–137.