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CONTRACT RISK MANAGEMENT

SEMINAR ON RISK MANAGEMENT AND INVESTMENTS IN THE CARIBBEAN HOSTED BY THE CARIBBEAN CENTRE FOR MONETARY STUDIES IN COLLABORATION WITH THE CARIBBEAN ASSOCIATION OF INDUSTRY AND COMMERCE

I HAVE BEEN ASKED TO SPEAK ON CONTRACT RISK MANAGEMENT. THIS IS AN EXTREMELY BROAD TOPIC AS THERE ARE MANY DIFFERENT KINDS OF CONTRACT AND RISK MANAGEMENT STRATEGIES AND TECHNIQUES WILL VARY DEPENDING UPON THE NATURE OF THE CONTRACT BEING CONSIDERED. SO THAT IT IS DIFFICULT TO FORMULATE RULES OF GENERAL APPLICATION TO ALL TYPES OF CONTRACT. EFFECTIVE CONTRACT RISK MANAGEMENT STRATEGIES THAT ONE WOULD EMPLOY FOR A PROJECT FINANCING AGREEMENT, FOR EXAMPLE, ARE VERY DIFFERENT FROM THOSE WHICH WOULD BE USEFUL IN AN OILWELL DRILLING CONTRACT.

HAVING SAID THAT, I WILL ATTEMPT TO OUTLINE A FEW GENERAL PRINCIPLES THAT ARE RELEVANT TO MOST CONTRACTUAL SITUATIONS. IN ORDER TO DO THIS, I HAVE BROKEN THE PROCESS INTO FOUR STEPS, WHICH ARE:

1. FIRST, IDENTIFY THE RISK
2. SECOND, ALLOCATE THE RISKS
3. THIRD, MITIGATE THE RISKS
4. FOURTH, MAKE THE ALLOCATION LEGALLY ENFORCEABLE.

WHAT IS THE PURPOSE OF DOING THIS? THE MAIN PURPOSE IS TO PROMOTE CERTAINTY BETWEEN THE PARTIES TO THE CONTRACT. COMPANIES ARE ABLE TO PLAN WHEN THEY ARE AWARE OF THE POTENTIAL AREAS OF EXPOSURE IN ANY TRANSACTION. IN MANY CASES PROPER RISK MANAGEMENT WILL AVOID COSTLY DISPUTES BETWEEN THE PARTIES WHEN SOMETHING HAPPENS TO DETERMINE WHO IS AT FAULT. IT ALSO ALLOWS FOR A UNIFIED RESPONSE TO LITIGATION BY THIRD PARTIES.

1. IDENTIFYING THE RISKS

THERE ARE TWO MAIN TYPES OF CONTRACT. CONTRACTS WHERE RISK IS INCIDENTAL TO THE SUBJECT MATTER OF THE CONTRACT AND CONTRACTS THAT ARE PRIMARILY ABOUT THE ALLOCATION OF RISK. I WILL USE ONE OF EACH TYPE FOR PURPOSES OF THIS PRESENTATION. THE EXAMPLE THAT I HAVE CHOSEN OF A CONTRACT IN WHICH RISK IS INCIDENTAL TO THE CONTRACT ACTIVITY IS A DRILLING CONTRACT FOR AN OILWELL. I WILL USE A PROJECT FINANCING CONTRACT AS AN

EXAMPLE OF THE TYPE OF CONTRACT THAT IS PRIMARILY ABOUT THE REALLOCATION OF RISK.
IN EITHER CASE, THE FIRST STEP IS TO ANALYSE THE TRANSACTION AND IDENTIFY THE RISKS THAT EXIST. IN THE CASE OF THE DRILLING CONTRACT, SOME OF THE MAJOR RISKS WOULD BE:

a. THERE IS AN ACCIDENT IN WHICH PEOPLE ARE KILLED OR INJURED
b. THE WELL TURNS OUT TO BE A DRY HOLE AND DOES NOT PRODUCE ANY OIL OR GAS;
c. THE DRILLING EQUIPMENT IS DAMAGED
d. THERE IS AN OILSPILL CAUSING POLLUTION
e. THERE ARE SIGNIFICANT COST OVERRUNS

IF WE WERE EXAMINING THE RISKS IN THE CASE OF A PROJECT FINANCING AGREEMENT THEY WOULD BE SOMEWHAT DIFFERENT. IN THAT CASE SOME OF THE MAJOR RISKS WOULD BE:

a. COMPLETION RISK- THE PROJECT NEVER ATTAINS MECHANICAL COMPLETION
b. PRODUCTION RISK- THE PROJECT PRODUCES LESS THAN EXPECTED AND THERE IS INSUFFICIENT CASH FLOW
c. MARKET RISK- THERE IS NO OR NO SUFFICIENT MARKET FOR THE OUTPUT OF THE PLANT OR THE PRICE IS SO LOW THAT THE OUTPUT CAN'T BE SOLD AT A PROFIT
d. FORCE MAJEURE RISK- SUCH AS EARTHQUAKES, FLOODS, STRIKES THAT DISABLE PRODUCTION. (THIS RISK IS ALSO APPLICABLE TO DRILLING CONTRACTS.)

<u>2. ASSIGNING RESPONSIBILITY FOR THE RISK</u>

THE NEXT STEP IS FOR THE PARTIES TO AGREE ON WHO WILL BEAR RESPONSIBILITY FOR EACH CLASS OF RISK IDENTIFIED. RISKS ARE GENERALLY ALLOCATED BY CONTRACT TO THE PARTY BEST ABLE TO CONTROL, MANAGE AND INSURE THE RISK. LET US GO BACK TO THE DRILLING CONTRACT. THE FIRST RISK THAT I IDENTIFIED WAS THE RISK OF DEATH OR INJURY DUE TO ACCIDENT. THE PERSONS KILLED OR INJURED MAY BE THE DRILLING CONTRACTOR'S EMPLOYEES, THE OIL COMPANY'S EMPLOYEES, SUBCONTRACTORS OF EITHER PARTY OR UNRELATED THIRD PARTIES SUCH AS FISHERMEN WHO HAPPEN TO BE IN THE VICINITY OF THE RIG AT THE TIME THAT THE ACCIDENT OCCURS.

IN THE ABSENCE OF A CONTRACTUAL PROVISION, THE COMMON LAW WILL ASSIGN LIABILITY FOR THE ACCIDENT TO THE PARTY WHO WAS AT FAULT. THE PROBLEM WITH THIS APPROACH IS THAT LENGTHY AND EXPENSIVE LITIGATION OR ARBITRATION PROCEEDINGS ARE LIKELY TO BE REQUIRED TO DETERMINE FAULT. IN PRACTICE DRILLING CONTRACTS

ASSIGN TO THE CONTRACTOR RESONSIBILITY FOR INJURIES TO THE CONTRACTOR'S EMPLOYEES AND SUB-CONTRACTORS AND THE OIL COMPANIES ASSUME RESPONSIBILITY FOR DEATH AND INJURIES TO THEIR OWN EMPLOYEES, IRRESPECTIVE OF FAULT. IN MANY CASES, SINCE THIS IS LESS LIKELY TO OCCUR, RESPONSIBILITY FOR DEATH OR INJURY TO THIRD PARTIES IS NOT ALLOCATED AND DEPENDS UPON THE OUTCOME OF LITIGATION TO DETERMINE FAULT.

LET US LOOK AT SOME OF THE OTHER RISKS. THE WELL TURNS OUT TO BE A DRYHOLE. THIS RISK IS BORNE BY THE OIL COMPANY, AS THE PLANNING OF THE WELL IS THE RESPONSIBILITY OF THE OIL COMPANY. THE RISK OF DAMAGE TO THE DRILL BIT OCCURRING BELOW THE ROTARY TABLE IS CUSTOMARILY ALSO BORNE BY THE OIL COMPANY, OTHER DAMAGE TO THE DRILLING CONTRACTOR'S EQUIPMENT IS GENERALLY ALLOCATED TO THE DRILLING CONTRACTOR, IRRESPECTIVE OF FAULT. POLLUTION DAMAGE CAUSED BY THE DRILLING CONTRACTOR'S EQUIPMENT IS ALLOCATED TO THE CONTRACTOR.

AND SO ON. AND THE PARTIES GO THROUGH AN EXERCISE IN WHICH EACH RISK IS ASSESSED AND A DETERMINATION IS MADE AS TO WHICH PARTY IS BEST ABLE TO MANAGE THE PARTICULAR RISK, AND WHICH IS FAMILIAR WITH THE RISK. THIS IS LIKELY TO BE THE COMPANY IN CONTROL OF THE WORKSITE OR WHO IS THE EMPLOYER OF THE PERSONS PERFORMING THE SERVICE. THIS DETERMINATION WILL ALSO BE AFFECTED BY THE RELATIVE FINANCIAL STRENGTH OF THE PARTES AND WHAT IS CUSTOMARY IN THE PARTICULAR INDUSTRY. IF THE POTENTIAL EXPOSURE IS VERY LARGE, THE PARTY THAT IS STRONGER FINANCIALLY IS IN A BETTER POSITION TO BEAR THAT RISK. IT SHOULD ALWAYS BE BORNE IN MIND THAT IF THE RISK IS LEFT WITH THE WEAKER PARTY, THAT PARTY MAY HAVE TO OBTAIN INSURANCE FOR THE RISK AND INCLUDE THE INSURANCE PREMIUM IN ITS CONTRACT COSTS.

IN THE CASE OF THE PROJECT FINANCING CONTRACT, THE LENDER WILL GENERALLY BE RELUCTANT TO ACCEPT COMPLETION RISK OR MARKET RISK, BUT WILL ACCEPT PRODUCTION RISK AND FORCE MAJEURE RISK.

3. MITIGATING THE RISKS

HAVING IDENTIFIED AND ALLOCATED THE RISKS THE THIRD STEP IS FOR THE PARTIES TO EXAMINE THE RISKS TO SEE WHETHER THEY CAN BE MITIGATED. THE SCOPE OF WORK, THE PROJECT PERFORMANCE SCHEDULE AND THE CONTRACT PRICING CAN BE USED TO MITIGATE SOME RISKS. IN THE CASE OF THE DRILLING CONTRACT, THE CONTRACTOR MAY CHOOSE TO LIMIT THE SCOPE OF THE RESPONSIBILTY ASSUMED BY EXCLUDING CERTAIN CATEGORIES OF FAULT. FOR EXAMPLE, THE CONTRACTOR MAY CHOOSE NOT TO ACCEPT

RESPONSIBILITY FOR INJURIES DUE TO THE GROSS NEGLIGENCE OR WILFUL MISCONDUCT OF THE OIL COMPANY'S EMPLOYERS, OR MAY LIMIT RESPONSIBILITY TO A SPECIFIED MAXIMUM AMOUNT, WHICH CAN THEN BE INSURED.

LET ME SAY A LITTLE MORE ABOUT INSURANCE AS A METHOD OF MITIGATING RISK. FIRST THINK ABOUT YOUR COMPANY'S OVERALL STRATEGY AND WHY YOU WANT INSURANCE BECAUSE IT WILL INCREASE YOUR COSTS, WHILE REDUCING YOUR RISK. REVIEW EACH PARTY'S EXISTING INSURANCE POLICIES TO MAKE SURE THAT THE COVER YOU WANT DOES NOT ALREADY EXIST.

CONTRACTS NEED TO SPECIFY THAT THE INSURANCE BE WITH INSURERS THAT ARE ACCEPTABLE TO THE OTHER CONTRACTING PARTY.
IT IS VERY IMPORTANT TO EXAMINE THE POLICY TO VERFY THAT IT INSURANCE POLICY ACTUALLY COVERS THE RISK OR DAMAGE.
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IN THE CASE OF THE PROJECT FINANCING CONTRACT, DIFFERENT MITIGATION STRATEGIES ARE EMPLOYED. COMPLETION RISK IS MITIGATED BY REQUIRING THAT THERE BE A LARGE AND EXPERIENCED CONTRACTOR DOING THE CONSTRUCTION UNDER A FIXED PRICE CONTRACT, BY REQUIRING THE PROJECT OWNERS TO ASSUME THE COST OF CONSTRUCTION COST OVERRUNS OR BY REQUIRING THEM TO ASSUME AS CORPORATE DEBT THEIR SHARE OF THE PROJECT DEBT IF CONSTRUCTION IS NOT COMPLETED BY A SPECIFIED DATE. PRODUCTION RISK CAN BE MITIGATED TO SOME EXTENT BY REQUIRING THAT ONLY PROVEN TECHNOLGY BE USED, AND BY REQUIRING PERFORMACE WARRANTIES ON THE EQUIPMENT. MARKET RISK CAN BE MITIGATED BY REQUIRING THAT THE PROJECT HAVE IN PLACE A LONG TERM TAKE-OR-PAY CONTRACT WITH CREDIT-WORTHY BUYERS FOR THE OFFTAKE OF THE PRODUCT, AND BY THE INCLUSION OF PRICE ESCALATION PROVISIONS. FORCE MAJEURE RISK MAY BE COVERED BY INSURANCE.

4. ENSURING LEGAL ENFORCEABILITY OF THE CHOSEN RISK ALLOCATION

THE BREACH OF A CONTRACT CAN RESULT IN TWO TYPES OF DAMAGE- THE FIRST TYPE IS PROPERTY DAMAGE, OR BODILY INJURY DAMAGE WHICH RESULT FROM PHYSICAL INJURY OR LOSS TO INDIVIDUALS OR TANGIBLE PROPERTY. THE SECOND TYPE IS ECONOMIC DAMAGES, SUCH AS COST OVERRUNS, DELAY DAMAGES AND LOST PROFITS. CONSEQUENTIAL DAMAGES ARE THOSE THAT WOULD NOT BE FORESEEABLE AS A DIRECT AND PROXIMATE RESULT OF THE ACT OR OMISSION CAUSING THE DAMAGE

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NOT ALL CONTRACTS ARE ENFORCEABLE IN LAW AS THEY ARE WRITTEN. NEW CONTRACTS SHOULD BE CAREFULLY EXAMINED BY A LEGAL ADVISER TO ENSURE THAT THE TERMS AGREED BETWEEN THE PARTIES WILL BE ENFOREABLE IN A COURT OF LAW. THE TRINIDAD AND TOBAGO UNFAIR CONTRACT TERMS ACT, 1985 PREVENTS A PARTY TO A CONTRACT FROM EXCLUDING LIABILTY FOR DEATH OR BODILY INJURY RESULTING FROM NEGLIGENCE, EVEN IF THE OTHER CONTRACTING PARTY AGREED. IN THE CASE OF OTHER TYPES OF LOSS OR DAMAGE, LIABILITY FOR NEGLIGENCE MAY ONLY BE RESTRICTED BY CONTRACT IF THE RESTRICTION IS REASONABLE. THERE ARE PROBABLY SIMILAR STATUTES IN MANY CARIBBEAN JURISDICTIONS

SOME OF THE CONTRACTING STRATEGIES THAT MAY BE EMPLOYED TO ENSURE THAT THE CHOSEN ALLOCATION OF RISK IS LEGALLY ENFORCEABLE ARE THE USE OF INDEMNITY CLAUSES, LIQUIDATED DAMAGES, BONDS OR OTHER FORMS OF SECURITY, WARRANTIES AND DISPUTE RESOLUTION CLAUSES.

INDEMNITY CLAUSES

IT IS POSSIBLE TO ARRIVE AT A CONTRACTUAL ALLOCATION OF RISK ON A BASIS OTHER THAN THE NEGLIGENCE CRITERIA CONTAINED IN THE LEGISLATION IN ORDER TO ACHIEVE CERTAINTY AND TO ASSOCIATE THE RISK WITH THE PARTY BEST PLACED TO BEAR THE RISK. THIS CAN BE ACHIEVED BY THE USE OF INDEMNITIES THAT REIMBURSE THE PARTY TO BE INDEMNIFIED FOR ANY LEGAL LIABILTY WHICH THAT PARTY IS HELD TO BE UNDER.

IF WE GO BACK TO THE DRILLING CONTRACT IN WHICH THE OIL COMPANY AND THE DRILLING CONTRACTOR AGREED THAT EACH WOULD BEAR THE RISK OF DEATH OR BODILY INJURY TO ITS OWN EMPLOYEES IRRESPECTIVE OF FAULT, THE UNFAIR CONTRACT TERMS ACT DOES NOT ALLOW EACH PARTY TO EXCLUDE LIABILTY FOR ITS OWN NEGLIGENCE. HOWEVER, THE ACT DOES NOT PREVENT THE DRILLING CONTRACTOR FROM AGREEING TO DEFEND AND INDEMNIFY THE OIL COMPANY FROM ALL LIABILITY FOR DEATH OR BODILY INJURY OF THE EMPLOYEES OF THE OIL COMPANY, IRRESPECTIVE OF NEGLIGENCE, THEREBY ACHIEVING THE SAME RESULT. THESE INDEMNIFICATION OBLIGATIONS MUST THEN BE CAREFULLY MATCHED WITH INSURANCE PROVISIONS. CARE SHOULD BE TAKEN TO AVOID DUPLICATION OF INSURANCE COVER WHERE BOTH PARTIES ARE CARRYING INSURANCE COVER FOR A RISK THAT HAS BEEN ALLOCATED TO ONE PARTY.

A WARNING: BE SURE TO OBTAIN PROPER LEGAL ADVICE IN DRAFTING THESE INDEMNITY CLAUSES BECAUSE THE COURTS CONSTRUE THEM VERY STRICTLY AND AGAINST THE PARTY SEEKING TO RELY ON THEM.

LIQUIDATED DAMAGES

THE PARTIES TO A CONTRACT MAY AGREE BEFOREHAND WHAT SUM WILL BE PAYABLE BY WAY OF DAMAGES IN THE EVENT OF BREACH. FOR EXAMPLE, A BUILDER MAY AGREE THAT HE WILL PAY $1000 FOR EVERY DAY THAT THE BUILDING REMAINS UNFINISHED AFTER THE CONTRACTUAL DATE FOR COMPLETION. THIS IS CALLED LIQUIDATED DAMAGES AND IT CONSTITUTES THE AMOUNT THAT THE PLAINTIFF WILL BE ENTITLED TO RECOVER IN THE EVENT OF BREACH WITHOUT BEING REQUIRED TO PROVE ACTUAL DAMAGE.

HOWEVER IF IT IS IN THE NATURE OF A THREAT HELD OVER THE OTHER PARTY TO SECURE PERFORMANCE OF THE CONTRACT, IT IS CALLED A PENALTY AND WILL NOT BE ENFORCED BY A COURT.

LIQUIDATED DAMAGES CAN BE A VERY USEFUL TOOL FOR ESTABLISING CERTAINTY IN A CONTRACT. HOWEVER, IT IS IMPORTANT TO ENSURE THAT THE AMOUNT IS NOT DISPROPORTIONATELY LARGE SO THAT IT WILL BE STRUCK DOWN AS A PENALTY.

LIMITATION ON DAMAGES

ANOTHER MECHANISM THAT IS USED TO LIMIT EXPOSURE IS FOR THE PARTIES TO AGREE TO A CAP ON THE DAMAGES THAT WILL BE PAYABLE. IN THIS CASE, THE PARTY CLAIMING DAMAGES WILL RECOVER THE AMOUNT THAT HE HAS LOST, SUBJECT TO A PRE-AGREED MAXIMUM AMOUNT. THIS AMOUNT CAN THEN GUIDE THE AMOUNT OF INSURANCE THAT IS OBTAINED.

EXCLUSION OF CONSEQUENTIAL DAMAGES

CONTRACTS OFTEN PROVIDE THAT NEITHER PARTY SHALL BE LIABLE TO THE OTHER FOR INDIRECT OR CONSEQUENTIAL LOSS, DEFINED AS INCLUDING BUSINESS INTERRUPTION, LOSS OF PROFITS. THIS IS USEFUL IN RESTRICTING POSSIBLE EXPOSURE. HOWEVER, SUCH CLAUSES NEED TO BE CAREFULLY DRAFTED AS THE COURTS CONSTRUE THESE CLAUSE VERY STRICTLY.

BONDS, GUARANTEES AND OTHER FORMS OF SECURITY

BONDS OR PARENT COMPANY GUARANTEES CAN ALSO BE USED TO ENSURE THAT CONTRACTUAL COMMITMENTS ARE PERFORMED. OTHER TYPES OF SECURITY SUCH AS LETTERS OF CREDIT, MORTGAGES OR DEBENTURES ARE USEFUL FOR ENSURING THAT THERE IS AN ALTERNATIVE METHOD OF COLLECTING UNDER A CONTRACT WHEN

THERE IS A RISK OF DEFAULT, AND OF AVOIDING UNCERTAIN AND EXPENSIVE LITIGATION, THEREBY REDUCING RISK.

WARRANTIES

WARRANTIES ARE OFTEN USED TO LIMIT THE EXPOSURE OF ONE PARTY WHO WARRANTS THE SERVICE PERFORMED OR GOODS SUPPLIED FOR A SPECIFIED PERIOD ONLY AND WHO MAY LIMIT THE RECOURSE OF THE OTHER PARTY TO HAVING THE DEFECTIVE WORKMANSHIP CORRECTED.

DISPUTE RESOLUTION

FINALLY A WORD ON DISPUTE RESOLUTION. THE INCLUSION IN THE CONTRACT OF A RIGHT TO ARBITRATION BEFORE AN ARBITRATOR WITH EXPERTISE IN THE FIELD WHICH IS THE SUBJECT OF THE CONTRACT MAY SERVE TO CREATE GREATER CERTAINTY AS TO THE OUTCOME OF THE DISPUTE. IN SOME CASES WHERE THE CONTRACT PROVIDES FOR ARBITRATION BEFORE A BODY OF ARBITRATORS IN A FOREIGN JURISDICTION, THIS HAS THE EFFECT OF ENCOURAGING DISPUTE RESOLUTION BETWEEN THE PARTIES, IN AN EFFORT TO AVOID THE EXPENSE OF ARBITRATION.

SUMMARY

TO SUMMARIZE, IN SEEKING TO MANAGE CONTRACT RISK, PARTIES NEED FIRST TO IDENTIFY THE POTENTIAL RISKS, THEN DECIDE BETWEEN THEMSELVES WHICH PARTY IS BEST PLACED TO BEAR EACH RISK IDENTIFIED, BEARING IN MIND THAT THE PARTY WHO IS MOST ABLE TO CONTROL THE RISK SHOULD PROBABLY THE PARTY TO WHOM THAT RISK SHOULD BE ALLOCATED. THE NEXT STEP IS TO SEEK TO MITIGATE OR TRANSFER THE RISK, USING SOME OF THE TECHNIQUES THAT I OUTLINED. IN PARTICULAR, INSURANCE OF RISK IS AN EFFECTIVE WAY OF CONTROLLING THE EXPOSURE, BUT IT IS IMPORTANT TO VERIFY THAT THE APPROPRIATE INSURANCE HAS BEEN OBTAINED. FINALLY, LEGAL METHODS SUCH AS INDEMNIFICATION CLAUSES, LIQUIDATED DAMAGES, LIMITATION ON DAMAGES, BONDS AND OTHER FORMS OF SECURITY MAY BE USED TO ENSURE THE LEGAL ENFORCEABILITY OF THE RISK ALLOCATION DECIDED UPON BETWEEN THE PARTIES.

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