RISK MITIGATION: A TRANSACTIONAL PERSPECTIVE

In addition to mitigating risk to the client through the vetting process, there are other risk mitigation steps and due diligence that can be under taken when first considering entering into a transaction with another party. These risk mitigation measures start from the beginning of the proposed transaction and carry through the transaction until the actual execution of the transaction document(s). This summary describes some of the risks and mitigating steps a party may wish to consider as the transaction unfolds and moves toward ultimate conclusion.

I. Counterparty/Country/Compliance Risk

A. It is basic to say that one of the major factors every client considers in entering into any sort of major transaction is the name, reputation and financial wherewithal of the party on the other side of the transaction. From the time we first graduated from law school and learned from practical experience that the best defense against a large judgment is to be judgment proof, we started thinking about certain intangibles which have relatively little to do with the drafting of documents, while at the same time attempting to mitigate some of those very risks through drafting.

Some things that quickly come to mind and that are usually considered in some form or other, sometimes by a client in an organized fashion and sometimes not, include:

Financial ability of the counterparty to both perform the obligations on its side of the contract as well as to respond in damages should the transaction fall apart. This is normally a call of the client's financial group, such as their treasury department; that group can perform an appropriate credit

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check, review of credit rating, review public financials, and the like. However, with internet resources today it is quite possible for anyone, including lawyers, to find a lot of this information with some quick searches. But if the party is one you or your client have concerns about, then there are some alternatives which do get into the drafting. Parent company guarantees; a standby letter of credit to call on; a performance or payment bond--not uncommon in certain industries--all of these can be used to mitigate financial risk. In a joint venture, having each party granting the other partner a security interest in its stock or shares or membership interest in the joint venture company and filing a UCC financing statement or charge on shares, (depending on jurisdiction of formation of the joint venture company and domicile of the parties in question), to record that security interest can also give one joint venture partner some comfort that it will have some recourse to take over the other party's interest and preserve the business of the joint venture if the other party faces financial challenges.

Reputation of the other party in the market place and particularly in they industry in which they work is another one of those intangibles. Are they known for on time performance and cost/budget performance? Are they well known in the particular business you will be working in with them or is this new area for them? There should be no conversations with other companies that might violate any laws, but again, the internet and legal databases provide huge amounts of information which can be readily ascertained. The challenge is trying to sort out the information and determine what information you believe is reliable. Is the other party often in the news but not in a good way? Do the legal search sites show they are especially litigious; if so, what type litigation was involved. Do they have a number of matters pending before Federal agencies such as the Coast Guard or foreign government agencies and what type matters are those? None of this is by any means dispositive of whether a party may or may not enter into a particular transaction. In today's

statutory and regulatory environment, companies frequently face regulatory issues that are constantly and often rapidly evolving due to frequent change both in the regulations themselves and also their interpretation. This type of research does however help assess risk.

Another issue--can the risk profile of the counterparty negatively change over the course of a transaction and what ways are there to mitigate that risk?

Clearly, the most obvious factor is the length of the proposed transaction--the longer the time for the transaction to be performed, presumably the greater the risk of change (though in view of the turmoil that has occurred in recent years in financial markets, it is also clear we can wake up to a new world tomorrow). In drafting to mitigate this risk, the "boilerplate" clause that comes to mind is the prohibition of assignment or delegation clause in the contract. Are there unrestricted rights of assignment or does the contract give limited assignment rights so a party may assign the contract to an affiliate of the without consent of the other party or must any assignment be consented to by the other party? Under U.S. maritime law, assignors can assign both rights and duties, although assignors remain liable for performance of the contract unless the contract either expressly or by implication provides that the assignors are to be released from future liability or unless a true novation of the agreement is used. Under UK law, however, an assignment transfers only the rights of a party, not the obligations or burdens of that party. To transfer the burdens as well, a novation of the agreement must be used.

Joint ventures and partnerships pose special issues in this area. Very often there is a restriction on the transfer of a party's interest in the joint venture. Some joint venture agreements may give rights to transfer the JV interest to a third party only after giving the other partner the right of first refusal to purchase the interest of the transferring party.

Other joint venture agreements may prohibit any transfers at all without the consent of the other party, even a transfer through judicial action or by operation of law; such a transfer can result in the joint venture being terminated. Other agreements may restrict the transfer to an affiliate of the JV partners only.

There should also be an analysis whether other undertakings should be required of other entities in the corporate structure so that a sale of the stock of the company holding a partner's interest in the joint venture does not result in an indirect transfer of the JV interest through the sale of the stock of that company.

One way to consider addressing certain issues is through "change of control" clauses. These clauses deal with what may occur when mergers or the acquisition of the company holding a JV interest, or its parent, take place. Some of the concerns with a change of control event are as follows:

1) there is basically a new party to the transaction and the original transaction may have been very much, or at least partly, based on a good commercial relationship developed over time--that is not what was originally bargained for and a party should be entitled to look at again at who their partner is going forward;
2) there can be an adverse financial impact on the joint venture due to the creditworthiness of the new entity--debt taken on to make the acquisition can result in cash flow/performance concerns; and
3) there can be adverse tax consequences, issues on what laws may be newly applicable to the transaction, and even the possibility that a competitor is now the new partner.

There are a variety of ways to deal with these issues and mitigate the risk of change of counterparty in the middle of the performance of the transaction. The right to buy out a party in the event of any change of control of that party, tying the change of control to a post-merger credit rating, an option to terminate the business venture or do a forced sale as between the parties-all these can be considered. How a final agreement comes out varies based on the different tensions and constraints each party is bringing to or working under while at the negotiating table. Defining what constitutes a "change of control" and the process to follow when one occurs is the transactional and drafting challenge and in some instances, can be a major challenge.

B. A risk somewhat related to counter-party risk is country risk. This means not only the country where the other party is located, registered, has its principal place or business or where it may conduct operations, but also obviously means the country where the primary operations may take place or where the client may be required to transact operations.

Many agreements will have broad "applicable laws" clauses where each of the parties agree to comply with all laws that may be applicable to the transaction. In entering into a transaction, the client should consider the scope of the laws it may be agreeing to comply with. Those could include the flag state of a vessel, the country of formation of each of the parties, the location of each party's principal place of business, and then the variety of countries that could come into play in order to allow a party to perform the transaction contemplated.

War risks and weather risks are often the subject of commercial terms in the transaction documents. The war risk picture can change quickly. Clauses dealing with war risks and weather risks and how those risks are allocated, who will pay costs of insuring against those type risks, what "line in the sand" a vessel or rig owner may draw in connection with certain of those risks-- all need to be considered and

negotiated. Drafting considerations may include broad or narrow force majeure clauses and the performing party's desire to rid itself of the constraints of *ejusdem generis* when listing the events of force majeure. Operations in countries where there may be concerns over possible foreign government intervention such as requisition of a vessel for title may also be addressed.

Environmental laws are always a source of concern. As states within the US and foreign countries continue to legislate around environmental risks in the wake of the Macondo spill and other major pollution events, attorneys drafting transaction documents need to be aware of the requirements not only of laws now in effect but also consider laws which may be on the horizon, including agency rules and regulations. To mitigate the risk of what may occur, thought should be given as to how to address changes in law. During a long term charter or contract, government regulatory bodies or classification socities may identify new risks and what they believe to be new solutions to reduce certain operational risks. These may be dealt with by clauses that allow a re-opening of terms, a formula for allocating costs of compliance or some form of termination rights by the parties.

Limitation of liability rights for vessel and rig owners is should be considered in drafting the documents. As the charterer of a vessel, what issues are raised if the vessel owner has an ability to limit its liability under a national statute or an international convention? As a vessel owner, one possible form of risk mitigation is the right to limit liability; at the same time, there must be research on what claims an owner may not be entitled to limit against, e.g., see the Oil Pollution Act of 1990.

Many of the issues noted above may well be covered by insurances that a vessel or rig owner would normally have in place through his hull and machinery and P&I cover. For the charterer of the vessel, insurance would not normally cover losses it could sustain through a loss of use of the vessel.

This may be especially true if the vessel is, e.g., an FPSO, a vessel equipped for certain offshore operations and not readily replaceable in the market place as a tanker or bulk carrier may be. Many of these concerns arise in large part from the fact that it is the charterer who desires to conduct operations in countries where risk may be a material concern; this is another aspect of that risk/benefit assessment that is constantly being made and judged.

There is risk that is now getting a great deal of attention that is not an insured risk- compliance with various anti-corruption, anti-bribery, money laundering and similar laws now in effect in various countries. Part of the attention stem from some high profile prosecutions brought by the United States Department of Justice under the U.S. Foreign Corrupt Practices Act (the "FCPA") while at the same time the UK Bribery Act (UK- BA) has recently gone into effect and in several ways upped the ante in this area.

It is far beyond the scope of this discussion to get into the details of either of those Acts. There are a large number of resources available which can explain the perceived scope of such legislation and what it is meant to cover, though since the UK BA just recently went into effect, how that law will be interpreted in practice remains very much open. However in advising the clients in this area a couple of points are worthwhile to consider when deciding whether expert advice may be appropriate:

> The jurisdiction of each of those laws sweeps broadly by their words. In reviewing a transaction, it is important to think through all the parties to the transactions, the primary location of the work and the various geographic locations that the parties may need to engage (contractors and subcontractors that could be used in various countries worldwide). Just because no part of the performance of the work may be done in either the US or the UK that in no way means that those laws may

not be applicable. Do not forget either the laws of the country where the primary operations will occur; many countries are now legislating in this area and while the focus has been on the US and UK, other laws in this area could be applicable to the transaction.

The UK BA has drawn much attention because it covers two things differently than the FCPA. Under the FCPA, "facilitation payments" are allowed under certain conditions and subject to certain reporting requirements Unlike the FCPA, The UK BA makes it unlawful to make facilitation payments.

In addition, the FCPA addresses payments made to foreign governments, foreign officials and the like. The UK BA prohibits "commercial bribery", i.e., a bribe between two non-governmental parties can constitute a violation of the UK Act.

To mitigate risks, there is a due diligence process a company should consider and there are firms, resources and companies that specialize in helping mitigate this risk. The Transparency International Corruption Perception Index can be found at their website-home page, www.transparency.org. Their website states:

> *The 2010 Corruptions Perception Index measures the perceived levels of public sector corruption in 178 countries around the world.*

Therefore the attorney looking to get an initial assessment of this risk can quickly check to see how the countries it may be concerned about are thought of.

A vetting or audit program of some type should be considered. Whether the counterparty will be dealing with government officials is a consideration. The type service or industry in which the work is being performed,

whether the counterparty makes large use of local agents, whether previous government proceedings have been instituted as a result of activities in that country and whether a counterparty has a program in place to address these concerns and issues with his employees, agents and contractors?

The FCPA and similar laws are not the only laws that can cause compliance concerns. Some countries are now enacting confidentiality legislation to protect employees' personal information. The United States has anti-boycott legislation which also has a broad reach. Emission standards, emission reporting and possible taxes on emissions are being considered by some countries. All these statutes are items that must be dealt with, at the negotiation stage, a party needs to consider them each, allocate the risk and costs of compliance and draft the agreement accordingly.

II. Indemnities and allocation of risk

This portion of the discussion might be better called "risk allocation" rather than "risk mitigation" but it hopefully fits with the overall subject matter in describing some recent cases that help outline what risks may be mitigated but which ones cannot because of the findings of the Courts under particular fact situations. The two cases described below are from the United States Court of Appeals for the 5th Circuit and basically involve offshore oil and gas activities. Living and working in Texas which is a part of the 5th Circuit, and living in a city that has the energy business as its major industry, those are the ones most important to what I do. However, there does also seem to be national recognition by many that the 5th Circuit is a Court that regularly sees these issues and writes on them often so hopefully the discussion has some broader applications.

Unlike traditional blue-water shipping which uses standard form charter parties and sets out the risk allocation between

cargo and vessel on the basis of COGSA and other similar regimes, the offshore oil and gas industry uses manuscript contracts and traditionally allocates risk on a knock for knock basis with exceptions to that for certain type risks. Each party agrees to take the risk of personal injury or death for their own employees even if caused by the negligence of the other party. Similarly, each party takes the risk of loss or damage to its own property, again, even if caused by the negligence of the other party. Risk of loss or damage to 3rd parties can be dealt with on a comparative law basis or in the case of pollution for example, allocated principally to one of the parties.

In addition to maritime law considerations in drafting indemnities in offshore oil and gas related contracts, practitioners in the 5th Circuit must also be mindful of state prohibition of indemnity statutes which may be applicable to such contracts by virtue of the U.S. Outer Continental Shelf Lands Act. Both Texas and Louisiana have such statutes. Last, but by no means least, is the prohibition of indemnity agreements by L & H employers in favor of vessel interests contained in Section 905(b) of the U.S. Longshoremen and Harbor Workers' Compensation Act and the exception thereto under Section 905(c) for reciprocal indemnity agreements when the L & H Act applies by virtue of the Outer Continental Shelf Lands Act.

Grand Isle Shipyard v. Seacor, 589 F.3d 778 (5th Cir. 2009), cert den., 2010 U.S. Lexis 4646 (U.S., June 7, 2010) is a 5th Circuit case that has drawn a lot of attention and several talks given on it given and articles written. [1]

In Grand Isle, BP was the oil company with work to be done in the Gulf of Mexico. In its contract Grand Isle BP had a clause that said if other contractors of BP had agreed in their contracts with BP to indemnify BP's other contractors such as

[1] See for example, Professor David Robertson, *OCS Indemnity Contracts: State Law or Maritime Law? (Grand Isle Shipyard v. Seacor Marine)*, Admiralty and Maritime Law Conference presented by University of Texas School of Law, November 10, 2010.

Grand Isle, Grand Isle would in turn indemnify those other contractors on the same basis. A Grand Isle employee was injured while on board a Seacor vessel. Seacor had the same clause in its contract with BP so it called on Grand Isle to indemnify it since each had agreed with BP to indemnify the other contractors of BP on a reciprocal basis.

Grand Isle refused to indemnify Seacor arguing that the indemnity clause violated the Louisiana Oilfield Indemnity Act and Louisiana law was the applicable law in connection with the injury to the plaintiff.

BP's purpose in putting this clause in each contract seems clear. With the number of contractors and subcontractors involved in the operations of drilling a well or producing oil from that well, it makes sense that if each party agrees to take the risk of their own people and property, irrespective of the negligence of any other entity and whether those parties were in direct contract with each other, there should be a fairly seamless risk liability scheme that allows each party to insure accordingly and reduce litigation.

The 5th Circuit in an *en banc* decision held that Grand Isle did not owe Seacor any indemnity obligation as Louisiana law was applicable to the injury and the indemnity clause was invalid in the context of the personal injury claim. The 5th Circuit found that the "focus of the contract" test is to be used determine the applicable law with respect to the contract in question (in this case the contract between BP and Grand Isle); under that test, the Court looked to where the majority of the contemplated was to be performed. Since the BP/Grand Isle contract called for the majority of the performance of the work to be on a stationary platform on the Outer Continental Shelf, Louisiana law applied under the provisions of the Outer Continental Shelf Lands Act. The majority of 5th Circuit rejected the test of "where the injury occurred" as being the basis to determine whether maritime law was applicable. Even though the plaintiff was injured on a vessel, the

contractual indemnity Grand Isle agreed to was for primarily platform based work and therefore the injury did not fall under maritime law.

The case raises several interesting points, among them, can the risk allocation BP was trying to further be really successful? In the *Grand Isle* case it seems clear-had a Seacor employee been hurt through the negligence of a Grand Isle employee, the mutual indemnity scheme would have worked as planned. The BP/Seacor contract was for the use of a vessel; the majority of the performance of the work was clearly to be done on a vessel. General maritime law imposes no limitations on the indemnities in these contracts so Seacor should be held to indemnify Grand Isle.

Therefore, if faced with a similar request by a party to enter into a regime where indemnities given to one party can end up being for the benefit of another, as yet unknown party, a party whose contract will be primarily of a maritime nature may have no incentive to enter into such an arrangement. Only if all the parties are engaged in primarily maritime matters might that make sense; otherwise the street potentially may only go one way to the detriment of the maritime service provider.

Whether some contract drafting solutions could work is a possibility. If a company trying to impose the "knock for knock" regime over all the work is willing to indemnify the maritime company if the land based contract company fails to meet its obligations because the indemnity is only one-way is one possibility. Limiting the scope of the mutual clause BP was trying to get in its entire set of contract to only other contractors whose contracts in turn are governed by maritime law is another possibility. Qualifying the obligation of the maritime service provider to indemnify another contractor only if that other company would have had an enforceable obligation to reciprocate is a variation of that same type solution.

The 5th Circuit indicated that the "focus of the contract" test helps the parties assess risk-by knowing whether their contract is a maritime law contract or may be based on the adjoining state law, they can predict and insure against liabilities. However for a company engaged in contracts clearly maritime in nature, *Grand Isle* does not appear to encourage those companies into entering into contracts with the global, mutually based liability type knock for knock clause at issue in the *Grand Isle* case.

Becker v. Tidewater Inc, 586 F.3d 358 (5th Cir. 2009) is another recent case of interest.

A summer intern for Baker Hughes suffered serious injuries while working as part of the crew on a Tidewater vessel which was outfitted for well stimulation services, Baker had the vessel on time charter from Tidewater.

The contract between Tidewater and Baker Hughes provided for reciprocal indemnities, each party to indemnify the other for personal injury or death of their own employees. At trial, the Court assessed fault for the incident as follows: 55% against Baker; 45% against Tidewater. Based on the indemnity clause of the contract between Baker and Tidewater, Tidewater sought full indemnity for its portion of the fault.

Baker appealed to the 5th Circuit claiming that it did not owe indemnity to Tidewater. Some of the holdings of interest by the Court of Appeals:

- Baker argued that the reciprocal indemnity agreement between Baker and Tidewater was invalid under Section 905 of the Longshore and Harbors Worker Compensation Act (LHWCA). Certain agreements for an employer to indemnify a vessel for injuries to a longshoreman, in this case the plaintiff, are invalid. However such an agreement is

not invalid when there is a reciprocal-agreement between the employer and the vessel and the longshoreman is entitled to LHWCA relief under the Outer Continental Shelf Lands Act. The Court found that the case here.

- Baker claimed the indemnity clause did not apply since Tidewater was guilty of gross negligence. The 5th Circuit stated:

  > It is undisputed that Baker escapes indemnity if Tidewater's actions leading to Seth's injuries were grossly negligent. *(citing a case)*

  The Court found there was no clear error in the District Court finding that Tidewater was not grossly negligent.

- Baker claimed that Tidewater had breached the time charter with Baker by delivering the vessel in an unseaworthy condition; Baker then argued that since the time charter had been breached the indemnity clause of the contract was invalidated. The Court held there was no clear error on the part of the District Court in finding Tidewater had not breached the contract and stated that even if a breach could invalidate the indemnity agreement, there was not present in this case.

- Baker contended that Tidewater was required to exhaust its liability insurance policies before turning to Baker for indemnity. The Court held that even though Tidewater was to name Baker as an additional insured under its policies, Tidewater was only contractually required to do so to the extent of the risks assumed by Tidewater under the time

> charter between the parties and such agreement did not relieve Baker of its indemnity obligation.

The *Becker* case included several other holdings but the ones described above do show some of the pitfalls and risks that can be inherent in any transaction where indemnity and insurance clauses are structured to try and allocate risks in what the parties presume to be a way that that allow the parties to understand the risks they are taking on. *Grand Isle* tells us that anti-indemnity statutes may trump what is believed to be an agreed upon allocation of risk and liability. In presumably stating what public policy is, *Becker* says, with no real discussion, that gross negligence can negate an indemnity obligation. [2] All to say, in assessing risk, many business clients would like a clear summary of what risks they face and how they will mitigate and insure against those risks. For better or worse, that is often simply not possible in a world today where operations get increasingly complex, legislation is passed to perceive what Congress or a state legislature considers an imbalance in the marketplace and new fact situations arise every day. There is a constant challenge in drafting contracts to assess and determine what risks are important to the client, which ones they are prepared to take on and mitigate risk and liability in a variety of ways.

[2] For much fuller discussion by 3 Federal Judges on several OCSLA issues including the gross negligence issue, see *Judges Panel, OCSLA Issues: Jurisdiction, Choice of Law, Indemnity, and Remedies,* Admiralty and Maritime Law Conference presented by University of Texas School of Law, October 14, 2011.