

A Review on Contractual Risk Allocation in Usance Finance Contracts

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ABSTRACT

Oil and Gas projects as are very complicated. A wide range of risks are included in oil and gas projects and contracts. Different aspects of risks can be addressed in a risk management process which assessment, efficient distribution and allocation of contractual risks are of a high importance. Many researches have studied the Project Risk Management in oil and gas industries with focus on legal and contractual risks aiming to reach to an optimal risk distribution which does not necessarily mean to have a complete contract. In this article with the goal of reviewing contractual risk allocation in Usance finance contracts, a thorough study has been done on related researches and then a complete review has been done on different contracts in Downstream petrochemical projects. Concentration on used risk management mechanisms in both cases and related risks shows severe issues and bugs in both contracts. Some contractual risks are not addressed at all and the case contracts are not balanced in the view of contractual risks distribution.

1. Introduction

Oil and Gas projects are very complicated. More effective elements results in more complexity. More complexity means higher aspects to be covered before achieving contract goals. Uncertainty of elements which is interpreted as perceived risk increases the complexity. According to Concise Oxford English Dictionary risk is the possibility of loss, injury, or other adverse or unwholesome event occurring; especially: a course of action that is subject to such possibility. In the oil and gas industry, risks management plays a vital role. In this industry, variety of risks, huge amounts of investment,

distribution and allocation of contractual risks are of a high importance. Having an effective and efficient contract requires optimal contractual risk management.

very high cost of complete risk identification and analysis including technical, financial, political, environmental, legal, economical, market, contractual and other risks have absorbed the necessity of proper risk policies in this industry.

In project management knowledge, both positive and negative risks are considered; however usually in many disciplines including legal and contractual aspects, only negative effect of risks are accounted.

Different aspects of risks can be addressed in a risk management process which assessment and efficient

Optimal contractual risk management does not necessarily mean to have a complete contract. as having a complete contract and considering all possible risks,

minor or major, will increase the cost of risk Identification, analysis, mitigation or management tremendously which endangers the viability of a project economically, while it means to identify and manage the major effective risks on the project.

Crrrk tt ... (1962) exprsss rrrr ddoxyyyyyconrrccs are both never complete and always complete. Contracts are never fully complete, because some contractual incompleteness is inevitable, given the costs of thinking about, bargaining over, and drafting for future contingencies. In addition, contracting parties may sometimes leave contracts incomplete on purpose, either because one or both of the parties withhold information which necessary to complete the contract, or because the prssshvve drrrr mindd ooagreee ooggreee rrrrr”

In this article, two different cases of Usance Finance Agreements (Procurement services+ Finance) have been considered and compared and studied in respect to contractual risks.

2. Research objectives

To scrutinize two Usance Finance Contracts made by and between Iranian Petrochemical Companies after

effectiveness of JCPOA- Joint Comprehensive Plan of Action- in the view of contractual risk allocation and to check whether both are properly addressed the major contractual risks and properly used risk management mechanisms or not.

3. Literature review

3.1. Risk, project risk management

According to Project Management Institution, PMBOK 6th Edition, (2004) Project Risk Management ss dffnmd ss rrr ottd t ssk Management. Includes the processes of conducting risk management planning, identification,

Analysis, response planning, response implementation, and monitoring risk on a project. The objectives of project risk management are to increase the probability and/or impact of positive risks and to decrease the probability and/or impact of negative risks, nnorder ooopmmuehle hhancoo of protttt tucssss.”

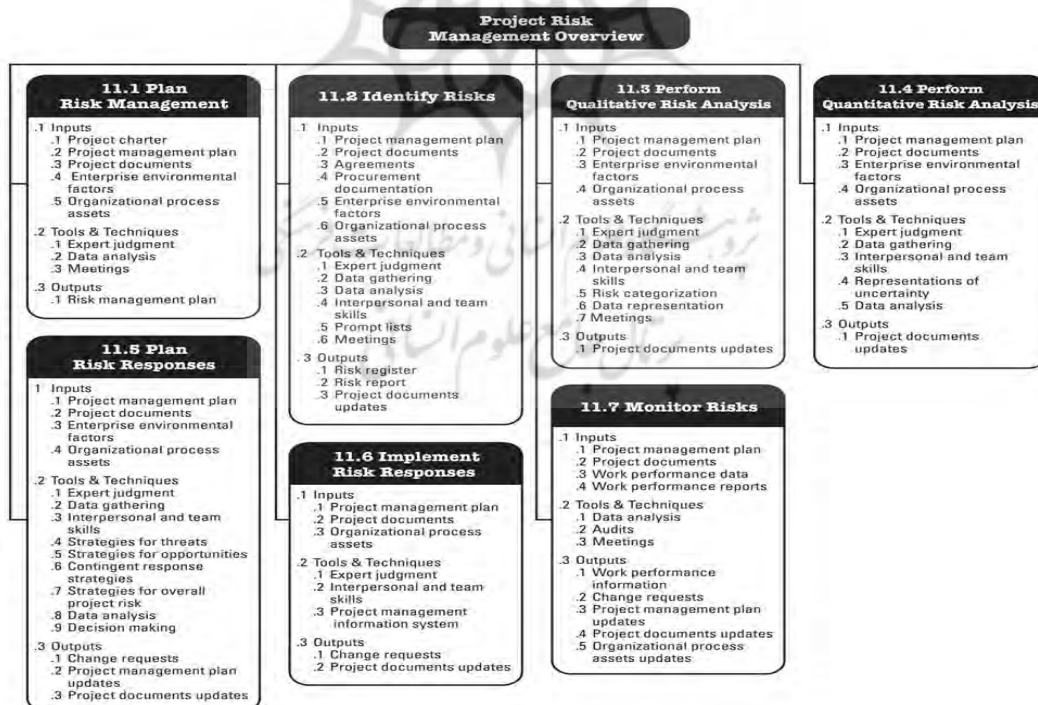


Figure 1: pmbok project risk management overview



Lyons and Skitmore (2003), made a survey on senior management involved in the Queensland engineering construction industry, concerning the usage of risk management techniques.; risk management usage in the execution and planning stages of the project life cycle is higher than in the conceptual or termination phases; risk identification and risk assessment are the most often used risk management elements ahead of risk response and risk documentation; brainstorming is the most common risk identification technique used; qualitative methods of risk assessment are used most frequently; risk reduction is the most frequently used risk response method, with the use of contingencies and contractual transfer preferred over insurance; and project teams are the most frequent group used for risk analysis, ahead of in-house specialists and consultants.

Not all received data and perceived risks also Identified risks can be considered as to be completely studied and reacted risks in risk management process as

it may increase the cost of Project Risk Management dramatically.

Kutscha and MarkHall (2010), first discussed about the which information are utilized and which are deemed to be irrelevant and hence excluded. Little research has been carried out to ascertain the manifestation Of barriers to optimal project risk management such as ‘rrrvvvnnee’; hñe deliberate inattention of risk actors to risk. This paper presents the results of a qualitative study of IT project managers, investigating their reasons for deeming certain known risks to be irrelevant. The results bohhoonfrm and xxpnd on Smhkhon’s [mmithson, M., 1989. Ignorance and Uncertainty. Taxonomy of ignorance and uncertainty and in particular offer further context related insights into the phenomenon of ‘rrrvvvnnee’ nn protttt rsk mnnggmnn. We sugttt hltt oopnrg hhhh ‘rrrvvvnnee’ rqqrrss defense mechanisms, the effective management of relevance as well as the setting of, and sticking to priorities.

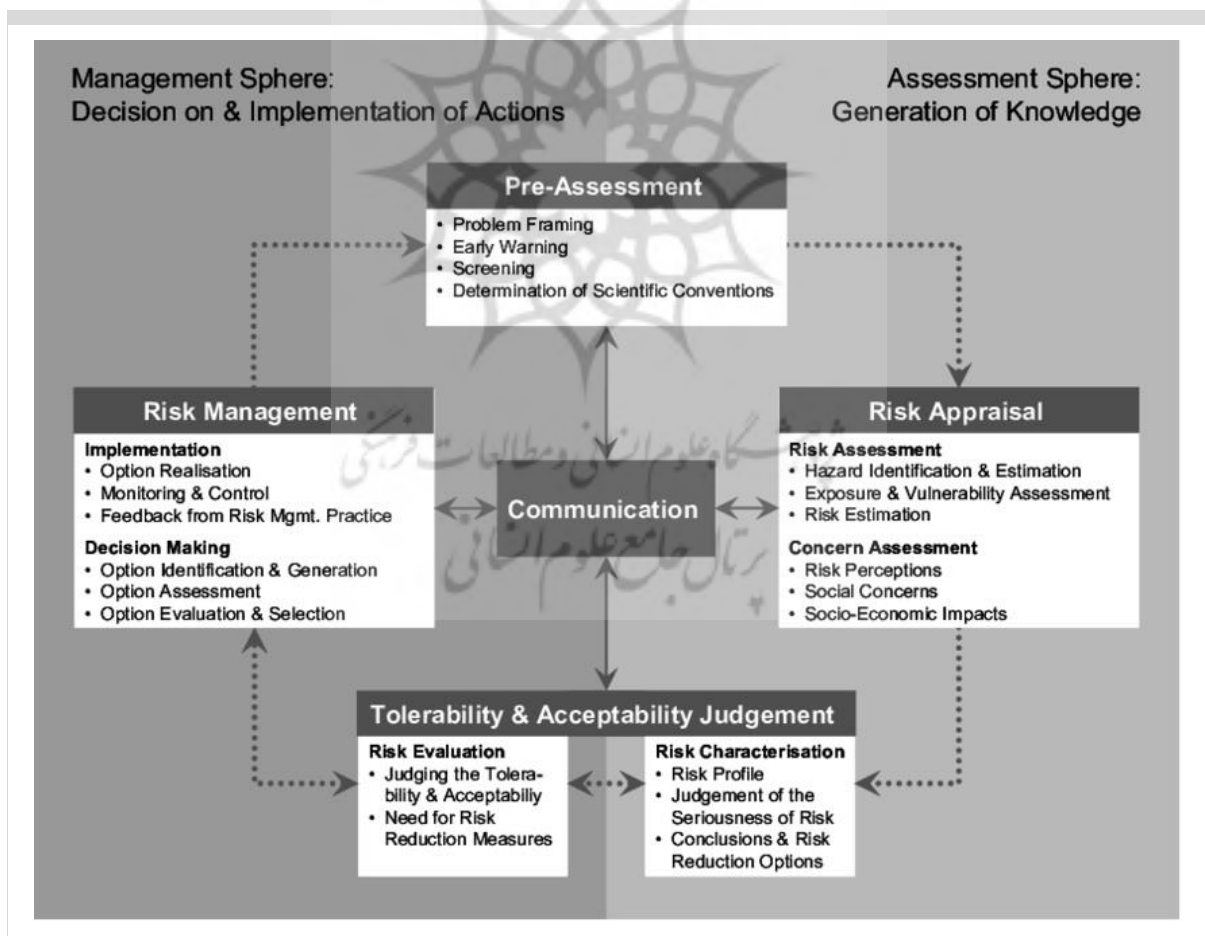


Figure 2: IRGC Risk Governance Process (adopted from IRGC 2005, p. 65)

Van Der Vegt (2018) on his article focuses on the fourth phase of ‘risk management’. This

phase comprises the selection of measures to avoid, minimize, mitigate and offset risk, the implementation of

risk management, the acceptance of responsibility, risk monitoring and control, and stakeholder communication and involvement.

Renn et al (2011) express that neither the characterization (uncertain, complex, and/or ambiguous) of the systemic risk at hand nor the contingent evaluation of the risk (acceptable, tolerable, intolerable, disputed) result in a simple typology for risk management. Nevertheless, the characterizations and evaluations provide some guidance for risk management about how to design a process that holds the promise of being sensible, which risks are to be prioritized and which options seems sensible in which contexts. From the above reflection as well as similar reflections in other contributions to this special issue, it is clear that the traditional risk management style is not just inadequate to deal with systemic risks, but it might even fuel societal controversies around risk.

Schuhmann and Eichhorn (2016) with the aim of Reconsidering contract risk and contractual risk management, followed three objectives: to assess the extent to which theoretical concepts and corporate practice dimensions; to identify ways to make full usage of the contract's risk dimensions for risk management purposes; to overcome the isolation of the contract caused by its perception as a legal instrument by integrating its handling into the overall corporate management processes.

3.2. Incomplete contracts

Baker and Kimberly (2006) worked on Incomplete Contracts in a Complete Contract World. This paper considers the role that contract doctrine should play in facilitating optimal investment in contractual relationships. All contracts are incomplete in the sense that they do not specify the optimal actions for the buyer and seller in every future contingency. This incompleteness can lead to both under and over-investment in resources specifically targeted to the needs of the other contracting party. To solve these investment problems, economists and legal scholars have looked to complicated contractual solutions and the ownership of assets.

3.3. Contractual risk allocation

They do not dispute that not all contracting parties can allocate even unforeseen risks contractually by doing so to a broad variety, (Trmnss1992).

Maniruzzaman (2009) discussed about the Legal/Contractual risk in the Oil and Gas industries focusing on the international oil companies renowned as ICC's and seeeeeempnsss knonn ss hhhhh subject of risk engineering and dispute resolution, the paper discussed the Legal/contractual risk-mitigation engineering over these main titles: Governing Law Clause, Dispute Settlement Clause: Arbitration/Mediation, Stabilization Clause, Progressive Taxation/Profit-Sharing Method, Political Risk Insurance. Then provided some solutions over Risk and Dispute Management.

Shilliday et al. (2007) discusses about Contractual risk-shifting in offshore energy operations. It has focused on the legal issues relating to contractual risk-shifting provisions between the parties engaged in these ventures with the objective of addressing the various risk-shifting and risk-limitation devices commonly used in contracts by offshore oilfields.

Hewitt (2015) looks at some of the liability allocation mechanisms in upstream project contracts, commonly come into play when disaster strikes, where such mechanisms have been considered by the courts.

Zulhafiz (2017) focused on the contractual mechanisms on upstream oil and gas industries that will help to achieve a fair allocation of risk between operators and contractors in the oil and gas projects. Contractual provisions are used in allocating the risks; especially those related to people, property and the environment. Risk allocation provisions deal with hypothetical events. This means that the identity of the person bearing the liability which will accrue if certain events take place is determined in advance.

There is always a concern about unbalanced risk distribution due to the difference in bargaining power of the parties or non-professionally of negotiators.

Zulhafiz and Abdul Rahman (2019) express that in 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

and overall liabilities of a specific risk to the other parties including third parties.

It worth to note that this clause is limited to financial damages according to Iran civil law and some other civil

2.Liability limitation clauses: according to Downie (2012) liabilities and limits or puts cap on them.

3.Indemnification clauses: West and Lewis (2009) explain that first, indemnification provisions generally stipulate the time period after closing during which a buyer may bring a claim based upon a representation and warranty set forth in the transaction agreement. Second, indemnification provisions typically restrict the amount of damages available for any post-closing breach to a specified percentage of the purchase price. Third, most indemnification provisions seek to preclude small claims by establishing which set a minimum dollar threshold below which a buyer's

Zulhafiz (2017) Indemnities can be in different forms of one-party indemnification, mutual indemnification or knock-for-knock indemnity.

4.Liquidated Damages or Penalty Clause: According to Iran civil law, this is a kind of punishment which the national courts cannot sentence the defaulted party to less or more amount agreed and fixed in the contract.

5.Insurance Coverage: Obligation to buy a specified type or a level of insurance coverage or clause. Insurance is one of the most common approaches of contractual risk distribution which one party transfers the specified risk with a specific financial liability to another party against an insurance premium.

Maniruzzaman (2009) discusses about the types of insurance to cover political risks which are also used in ECA finance supported projects. Investment-insurance programs similar to that of the OPIC (related to U.S. Overseas Private Investment Corporation) and MIGA (related to World Bank's Multilateral Investment Guarantee Agency) may be available from export credit agencies ("ECAs") in many countries including some developing countries. However, such programs may be subject to respective national objectives (like minimum national contents), which may impose strict requirements for eligibility. There are also a number of private insurers such as the American International Group, Lloyds of London, Sovereign Risk Insurance

Limited, Chubb, and Zurich Emerging Markets Solutions, which offer comparative alternatives.

There is a close relation between indemnification clause and insurance clause. i.e. the indemnifier party can transfer whole or a part of its liabilities which can be covered by insurance, to the insurance company in the name of liability insurance coverage.

6.Arbitration clause

7.Stability and Frustration clauses regarding interpretation and freezing the governing law

8.Customized drafting of contracts

5. Research findings and discussions

5.1. Results

Two cases of Usance finance contracts in Iran petrochemical industries are considered with the abbreviation of contract I and contract M. after effectiveness of JCPOA (Joint Comprehensive Plan of Actions), as normal arrangements of project finance could not be used due to the uncertainties still existed on political and economic atmosphere, Usance finance were used for financing the greenfield and brownfield projects.

The structure of these finances are Usance which is mostly a short term financing through the ECA (Export Credit Agency). This finance method is not of a high interest among finance absorbers due to very short period of finance however it was used at high uncertainty circumstances after JCPOA.

The contract activities include of P(S) +F services which a foreign manufacturer or exporter supplies the required financial resources for end user through its ownry's ECA rooorees and hte forggg ownry insurance supports it. The procurement service does not include the purchase engineering activities but the participation in commercial negotiations and payment rrrngmnen.. nmmnee srvees ss nn hte form of ECA uupprrrs Crddtt hhhmm for xporrrr forii gn compny. The Supplier Credit criteria are defined and discussed within OECD consensus and Cheney (1985). This type of Contract is also known as Sales Framework Agreement.

5.1.1. Exclusion clause

Contract I do not have an express title of Exclusion clause however some parts related to Termination clause



including Force Majeure have the same exclusion clause application.

The important point is contractor's possible or probable risk of US sanctions or other sanctions. US sanctions are not directly addressed or foreseen in the contract however a number of force majeure shall include war, civil commotion, storm, tidal waves, flood, and any conditions caused by a government's or any other government including US are meant or not.

Contract I also exclude the contractor from transfer of title risk based on Incoterms 2010 delivery. Contractor shall not be responsible for nor bear any risk of loss or damage to the Equipment at all times hereafter.

Contract M also does not have any express title as exclusion clause however, the force majeure is excluding parties from taking some risks. Interesting point is that the contract has accepted "Iranian government's sanctions. Regarding third party sanctions, again it is not explicitly expressing the US sanctions but uses the phrase any obligations under the contract which should expose any party to this Agreement to any measures, of any nature, adopted by foreign authorities including federal or state and/or by international and/or supranational organizations against the Islamic Republic of Iran and its subsidiaries" "any measures or any other" and "direct or indirect" can be interpreted of accepting US sanctions as a force majeure condition.

5.1.2. Liability limitation clause

Contract I have an explicit clause of limitation of Liabilities which limits the contractors for no liability to client over the following risks:

- Retained Obligation- any obligation owed by Contractor under a Sales Contract; except for obligation to pay the purchase price for Equipment sold
- Any right held by contractor in any agreement the solvency of the obligor whether in contract, tort (including negligence), breach of statutory duty or any other legal basis.
- Any loss of profits, loss of operations, loss of data, loss of contracts, loss of market shares, loss of goodwill or any incidental, special, indirect, consequential or other economic loss suffered by any Client Party, any Representative of a Client Party or any

other person under or in connection with any Related Agreement

- Any liability to any party other than Client in connection with a Related Agreement or transaction contemplated in this Agreement

In contrary to Contract I, Contract M does not completely exclude the transfer of title liabilities and just expresses that Supplier shall have no liability for any damages until and unless the Supplier receives it from the Vendor except for the case such delivery failure is caused by the Supplier.

5.1.3. Indemnification clauses

In Contract I, Client will indemnify Contractor in accordance with respect to any breach of a Related Agreement, negligent act or omission or willful misconduct caused by Contractor's negligence

Also, Client shall indemnify Contractor if the commercial negotiations did not go on the pre-agreed advanced payment amount. So, client shall cover all costs and expenses incurred by contractor's cost regarding the purchase orders.

Also, Client shall indemnify contractor in relation to the performance of or failure to perform any obligation owed by contractor to such Vendor under a Vendor Sales Contract with such Vendor (excluding any Retained Obligation); any Equipment sold under such Vendor Sales Contract (including for any defect in Equipment or in connection with export or import of Equipment or any technical or commercial risk associated with equipment) or any failure of Client to compliance with this agreement.

Client also shall indemnify the contractor for any payment by contractor to a Vendor under a Vendor Sales Contract which is restricted or prohibited under any applicable statute, laws, regulation, rule, injunction, judgment, order, decree, ruling, charge, or other restriction of relevant governmental authority or contractor is unable to make such a payment for any other reason.

Client shall indemnify Contractor for the costs and expenses incurred by contractor as a result of delayed Shipment Date later than the date fixed months after the Effective Date as a result of an act or omission of a client Party or a Vendor and not contractor.

However, there is also explicit indemnity clause in the contract I which has two parts of Client and Contractor's responsibilities

Client shall indemnify contractor against any claim, loss, liability and etc. arising from: (i) an event of Default or breach of a contract or a breach by a contractor Party of an obligation it owes under Related Agreement; (ii) a negligent act or omission or willful misconduct of a contractor or a Representative of a contractor in connection with a Related Agreement; or (iii) any other circumstance indemnified under another provision of this Agreement.

In return, contractor shall indemnify client against any claim, loss, liability and etc. arising directly or indirectly from: (i) a breach by contractor of an obligation it owes under this Agreement; or (ii) a negligent act or omission or willful misconduct of contractor or a Representative of contractor in connection with this Agreement.

Contrary to the contract I, the contract M does not include any indemnification clause explicitly or implicitly.

5.1.4. Liquidated Damages clause

Contract I do not include any liquidated damages clause but the contract M has several liquidated damages terms.

- If the Supplier fails to deliver any of the Products in accordance with relevant Individual Contract, the Supplier shall pay to the Purchaser liquidated damages in the amount which the Supplier actually receives from vendor in accordance with relevant Vendor Contract. Such payment of liquidated damages shall be in complete satisfaction of the Supplier's liability for loss and/or damages caused by delays in delivery of the Products, and the Supplier shall

have no further liability whatsoever to the Purchaser in respect thereof.

5.1.5. Insurance clause

Due to nature financial resources of both contracts, those are covered with ECA mandatory insurance-Export and Investment Insurance-. The insurance policy covers all transaction contemplated in the agreements, pre-shipment and post-shipment stages.

5.1.6. Arbitration clause

Contracts I and M both use the arbitration clause for dispute resolution. Both contracts use ICC rules of arbitration with the arbitration seat of Zurich, Switzerland.

5.1.7. Governing Law/ Stabilization/ Frustration/ Compliance clause

Both contracts use the laws of Switzerland as governing law of the contract and express that The United Nations Convention on Contracts for the International Sale of Goods shall not apply to this Agreement.

An article of Compliance has been set in both contracts which obligates the Client to guarantee the contract full compliance with all applicable anti-bribery and corruption laws (UK Bribery Act) and sanctions laws and regulations.

5.1.8. Customized drafting of the contracts

Both contracts are customized through several round of negotiations in different aspect which reduces the risk of Standard Forms contracts. The results of studying and comparison of both case contracts are summarized in below table.

Table 1: Risk Management Mechanisms Used in Contracts I and M.

Contractual Risk Management Mechanism	Type of Covered Risk	Contract I	Contract M
Exclusion clauses	Force Majeure Risks	Yes	Yes
	US Sanctions Risk	No	No
	Transfer Of Title Risk	Yes	-
Liability limitation clauses	Liability Risks	Yes	Yes
	Transfer Of Title Risk	-	Yes



Indemnification clauses	Commercial Negotiations Risk	Yes	No
	Defect in Equipment, export or import of Equipment or any technical Risk	Yes	No
	Restricted or Prohibited Payment Risk	Yes	No
	Foreign Exchange Risks		
Liquidated Damages	Liquidated Damages	No	Yes
Insurance Coverage	Different Risks	Yes	Yes
Arbitration clause	Dispute Risk	Yes	Yes
Governing Law/ Stability and Frustration clauses	Legal and Change of Law Risk	Yes	Yes
Customized drafting of the contracts	Drafting and Standard Form Risk	Yes	Yes

6. Conclusion

Legal and contractual risks management is an important part of total project risk management process. The first step in risk management is to study and identify the risks may occur in a project. The main question over here is to what extent and which depth those risks shall be identified and taken into account which affects the expense, time schedule and implementation procedures of risk management process.

As discussed above, two case Usance finance contracts in the form of sales framework agreement were chosen to be analyzed. The reason for choosing these contracts was very high customization level – none standard form- of those due to high uncertainty degree governing them.

Analyzing the results by concentrating on used risk management mechanisms in both cases and related risks shows severe issues and bugs in both contracts.

Some risks are not addressed at all –for example US Sanctions risk- and some contractual terms are suffering from lack of clarity which itself will result in further disputes.

The total risk distribution in case contracts is not in a balanced manner. Contract I apparently looks to be a more complete contract in respect of covered risks in comparison with contract M; however in contrast with the contracts between state owned companies or semi-state owned companies- like petrochemical companies of Iran- and private companies which the risk distribution is unbalanced toward contractor- private company-, due to special conditions of Iran, the financiers have much higher bargaining power in negotiations which the results can be seen in Liability limitation Clause.

Considering the current political status of Iran which still limits the normal finance and project finance arrangements, it is recommended for further studies to have a more detailed contractual risk list and to provide solutions for balanced risk distribution among parties in an optimal way which is better for both client and contractor.

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