INDEMNITIES FOR OFTO ASSETS

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In a cautionary decision for parties involved in OFTO transactions, the English High Court recently held that an indemnity in a sale and purchase agreement limiting liability for damage to assets "prior to Completion" was limited to damage occurring in the period between signing the SPA and completion. The judgment confirms the importance of precise drafting within SPAs and other OFTO transaction documents to ensure that the parties' intentions regarding risk allocation are reflected accurately.

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BACKGROUND

The Gwynt y Môr wind farm, situated off the north Wales coast, was owned and operated as at the time of the claim by the defendants/vendor, a joint venture led by Innogy, Stadtwerke München, Siemens and the UK Green Investment Bank. The claimant/purchaser, a consortium comprising Balfour Beatty Investments and Equitix, was awarded a license to become the offshore transmission owner ("OFTO"). The parties entered into a sale and purchase agreement on 11 February 2015 (the "SPA") pursuant to which the defendants agreed to sell to the claimant the wind farm transmission assets (the "Assets"). The transaction completed on 17 February 2015, at which point the Assets transferred to the claimant.

The Assets included four subsea export cables, two of which failed in March and September 2015 respectively. On examination, which was only possible after repairs were complete, it was found that the excised section of each cable had suffered from severe corrosion, dating back months or years and likely caused by a manufacturing defect. The claimant therefore sought the reinstatement costs from the defendants pursuant to an indemnity clause in the SPA.

THE INDEMNITY

Clause 8.2 of the SPA (the "Indemnity") provided that:

"*If any of the Assets are destroyed or damaged prior to Completion (Pre-Completion Damage), then, following Completion, the Defendants shall indemnify the Claimant against the full cost of reinstatement of any Assets affected by Pre-Completion Damage*."

The claimant contended that the natural and ordinary meaning of the Indemnity meant that it applied if the Assets were damaged at any time before completion, including before the execution of the SPA. However, the defendants claimed that, properly construed, the Indemnity only covered the costs of reinstating the Assets if they were damaged in the period between the signing of the SPA and completion.

THE RELEVANT LEGAL PRINCIPLES

Before considering the parties' submissions, Phillips LJ referred to the relevant legal principles on contractual interpretation as set out in Wood v Capita Insurance Services Limited. In summary, the court's task is to ascertain the objective meaning of the agreement in accordance with the whole contract. In Wood, Lord Hodge noted that some agreements (e.g. those prepared by professionals) may be principally interpreted by textual analysis whereas other, less formal agreements, may require a greater contextual analysis. However, it was acknowledged that these are flexible rules and that even formal agreements may require a consideration of the factual background.

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THE PERIOD OF TIME COVERED BY THE INDEMNITY

Philips LJ noted that in determining the temporal scope of the Indemnity it was necessary to consider the tense used and the natural and ordinary meaning of the words as at the date the SPA came into force. It followed that the phrase "*if any of the Assets <u>are</u> destroyed or damaged prior to completion*" (emphasis added) applied to damage which occurred after the execution of the SPA. If the wording was to include damage occurring before execution, the phrase would have said "*if any of the Assets <u>have been</u> destroyed or damaged…*" and might even have included the words "*including before this Agreement*".

The judge also had regard to the context of the Indemnity, and in particular its location in the agreement between clauses covering execution and completion, which indicated that it was intended to cover damage occurring between the signing of the SPA and completion so as to ensure that the claimant was covered against any risk it might be exposed to within that time frame. This might include the risk resulting from the fact that after execution of the SPA the claimant was obliged to purchase the Assets, but it would not have title to them and so would not have an insurable risk.

The judge also considered a warranty given by the defendants that as at the date of the SPA there was no damage to the Assets other than of a *de minimis* value and which was discoverable and reasonably likely to cause disruption to the OFTO. The judge concluded that if the Indemnity was to be interpreted as per the claimant's argument, then this warranty would be rendered pointless because the defendants would have been liable for any damage suffered prior to the execution of SPA in any event. Furthermore, if the claimant's interpretation was correct, then the Indemnity would remove the incentive of disclosing against the warranty since the defendants would remain liable.

THE MEANING OF DAMAGE

The judge then went on to explore the meaning of the phrase "*are destroyed or damaged*" so as to determine what kind of damage was covered by the Indemnity. The claimant argued that the Indemnity did not qualify the word "*damage*" and that the corrosion constituted a continuing adverse change to the physical condition of the cables and therefore fell within the Indemnity. The defendants claimed that the Indemnity only applied to "*new and patent physical harm*".

On this point the judge disagreed with the defendants, stating that the Indemnity should not be confined to *entirely* new damage or to damage caused by an external event. For example, had a cable failed during the Indemnity period, the relevant section would have been described as destroyed or damaged, albeit by the culmination of corrosion resulting from a latent defect. However, the Indemnity did require the damage to be patent, meaning readily observable or discoverable, noting that the fact that the word "damaged" was coupled with "destroyed" indicated that either destruction or damage short of destruction was contemplated, and this was inapposite to encompass the slow process of continuing corrosion. Further, if unobservable corrosion was included it could result in the defendants being liable for failures occurring many years in the future, which would be commercially unsound, particularly given the finding that the Indemnity was limited to the short period between execution and completion of the SPA.

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The judge continued by noting that, even if unobservable corrosion could constitute damage under the Indemnity, it would only do so if it impaired the value of or usefulness of the cables, and in the present case, there was nothing to suggest that the corrosion during the days between the signing of the SPA and completion was sufficient to impair the value or usefulness of the Assets.

THE CONTEXTUAL ANALYSIS

Since Philips LJ rejected the claimant's textual interpretation, it was not necessary to conduct a contextual analysis. However, the judge did comment that the defendants fell a long way short of establishing the existence of an industry standard risk allocation which could affect the interpretation of the Indemnity, namely that from completion the OFTO takes the risk of failure of the Assets due to latent defects or damage acquisition. He also confirmed that the parties' pre-contractual negotiations were inadmissible as an aid to the interpretation of the SPA

CONDITION PRECEDENT REQUIREMENT

The judge also rejected an argument by the defendants that the requirement to give notice of pre-completion damage and to allow the defendants the opportunity to repair the Assets was a condition precedent to the claimant's right under the Indemnity.

CONCLUSIONS & COMMENTS

Based on the above, and holding that even if he was wrong on the interpretation of the SPA, he would have rectified it in such terms anyway, the judge concluded that the claimant was not entitled to an Indemnity under the SPA for the cable failure and the claim was dismissed.

Agreements between offshore wind farm developers/owners and OFTOs relate to high value infrastructure projects. The costs of, and liabilities arising from, fixing and/or repairing the transmission assets can be significant, as demonstrated by this case where the reinstatement cost was £15m. It is therefore crucial that parties allocate risks inherent within the projects and are aware of their possible liabilities to remedy such risks. Failure to accurately record such risk allocation within the documentation can lead to disputes, and the inevitable costs and time that follow.

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OFTOs take the transmission assets on the understanding that there is inherent risk with subsea assets, but on the assumption that they have been manufactured and installed properly. The risk allocation in OFTO SPAs is designed with that in mind and to reflect that the OFTO's fixed income stream is not usually suited to large remedial costs (especially where Ofgem will likely categorise those costs as foreseeable and therefore not an Income Adjusting Event). As such, OFTOs can ill afford liability for unforeseen reinstatement costs. Conversely, vendor/developers give the pre-completion warranties, undertakings and indemnities required by the OFTO on the understanding that, following transfer of the Assets, all risk passes to the OFTO. As such, a change to the contractual risk allocation from that which was agreed in negotiations because of an unexpected interpretation of the transaction documents, could be considerably costly and detrimental to either party.

The outcome of this case turned on the specific wording of the Indemnity and construction of the SPA. Based on these factors, the judge arguably reached the correct decision. However, his construction does not sit well with the intention behind the OFTO regime, which is designed to protect purchasers from risks/liabilities accrued prior to transfer. The specific split of risk between the vendor/developer and OFTO is usually a fiercely negotiated element of any OFTO transaction, taking months to agree.

In such circumstances, where liabilities will usually be split in time between the vendor and OFTO, this decision makes it fundamentally important to properly and accurately define the temporal scope of risk allocation provisions. Parties should therefore take care to ensure that their contracts properly reflect the agreed allocation of risk, and should seek specific legal advice in this respect prior to entering into any agreement.

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