Upstream oil and gas series - Part 2

Prices down, defaults up: key risks and practical solutions for dealing with upstream joint venture defaults

The Non-Defaulting Parties' Perspective

Due to the requirement to carry the defaulting party during the cure period, the non-defaulting parties may find themselves in a position where the joint operations and their own finances are at risk. As such, they will often be keen to remove the defaulting party and restore a well-functioning and well-funded joint venture; either taking on the additional participating interest themselves or finding a third party to step into the breach. They may also be motivated by the possibility of picking up a valuable interest without cost.

For the non-defaulting parties, key issues will include:

- ensuring the existing correspondence is in order such that they are entitled to proceed with the forfeiture option;
- understanding the practical steps they need to take to effect the transfer of the defaulting party's participating interest;
- ensuring they have a coordinated approach with other non-defaulting parties to efficiently deal with any resistance by the defaulting party; and
- understanding what scope there may be to negotiate with the defaulting party's lenders or administrators to arrange for the breach to be cured.

The non-defaulting parties will also need to develop their own strategies to ensure they are able to fund the defaulting party's share of cash calls while they remain uncured (or following forfeiture). As indicated above, this is required by the AIPN JOA and is sometimes overlooked with potentially devastating effects, as a non-defaulting party which fails to make such payments will itself become a defaulting party and may itself be subject to the forfeiture remedy.

This is particularly important where there are larger numbers of partners. A partner may consider itself sufficiently funded if it has capital to meet its own share of cash calls and may consider itself well-funded if it has enough to meet its share of a single defaulting partner's cash calls. However, query how it would be placed if it were to find two or more of its partners in default and was required to meet its share of their cash calls as well.

In response to this, we have recently seen more cases of what might be called "tactical" or "strategic" default. This involves a party which has the capacity to pay its share of cash calls choosing to default at times when it anticipates one or more other parties may default. In such cases, the strategically defaulting party may be seeking to avoid some or all of the following potential consequences of remaining a non-defaulting party:

- being obliged to carry its proportion of any defaulting party's share of cash calls. Under the 2012 Model AIPN JOA, it appears such a party would not even be required to provide such a carry following the cure of its own default (although we note that in practice an operator may assert this is required);
- being obliged to accept its proportion of a defaulting party's participating interest (including the associated payment obligations) following the defaulting party being forced to forfeit its participating interest. This is not so much of an issue under the 2012 Model AIPN JOA (which includes a right to opt out of the acquisition of such additional interests), although it is an issue under some older JOAs (that do not have such a provision); and
- being obliged to pay into a joint venture that is not properly functioning and where there may be a heightened risk that the joint operations will stall or fail.

Strategic defaults can be quite powerful in so far as they have the capacity to bring all of the partners to the negotiating table and facilitate a discussion leading to a compromise and the re-financing of the joint venture e.g. through re-distribution of participating interests between the parties or other financing arrangements. However, it also carries a number of risks, including to the level of trust and cooperation in the joint venture, in so far as a deliberate default cuts across the fundamental principle that parties pay in and take out from the joint operations according to their participating interests.

The Farm-In Partner's Perspective

As indicated above, the default provisions in the AIPN JOA have really been put to the test over the last 12-15 months and valuable lessons have been learned. These are lessons which can now be translated into better, negotiated JOAs, both at the time of farming-in to distressed projects and when setting up new joint ventures.

In particular, we would expect well-funded farm-in partners to consider asking for appropriate amendments be made to JOAs prior to farming-in so as to:

- limit "carry-abuse" e.g. by reducing the amount of time the defaulting party has to cure its default, including reduced time periods for repeated defaults;
- ensure the cost of any cure period carry is reflective of the cost of capital of the non-defaulting parties providing it. The current approach in the AIPN JOA of setting a fixed interest rate for all partners seems behind the curve and a movement towards rates reflective of each non-defaulting party's cost of capital seems appropriate;
- ensure the obligation to carry defaulting parties is limited at an appropriate level e.g. a carry might be required where parties holding participating interests up to a certain threshold are in default, but not beyond this. In such cases, the non-defaulting parties might retain the right to force out the defaulting parties but also have the ability to suspend the joint operations until a non-defaulting party agrees to fund the additional shares (and take the forfeited participating interests) or a farm-in partner is found to do this. If such rights are to be provided, careful consideration will need to be given to how any associated costs are born e.g. termination or suspension fees under oil services contracts;
- provide them with flexibility as to whether they wish to accept or decline the participating interest of the non-defaulting party. As indicated above, for some companies, this may be more of a curse than a blessing and accordingly they may want the flexibility to decline the additional interest and the increased financial burden that comes with it; and
- ensure they have appropriate powers in the JOA or in ancillary documentation, which will be effective in the host country, in order to enforce the forfeiture option.

While the existing 2012 Model AIPN JOA contains optional provisions to deal with some of these issues, it does not deal with them all and many JOAs (both pre and post 2012) will also lack the necessary provisions for a range of reasons. Accordingly, it is important that the actual JOA is reviewed, at the time of farming-in to each project, to determine what changes may be required.

In addition to seeking amendments to JOAs, we anticipate farm-in partners may also take a harder line by requiring cash call security to be posted and/or parent company guarantees to be provided as a condition of farming-in. Likewise, we would expect remaining partners to take a hard line on these issues with the farm-in partner, with a view to avoiding the replacement of one non-paying partner with another.

Finally, in undertaking due diligence, farm-in partners will need to:

- ensure they have sight of all documentation relevant to any previous defaults and a full understanding of whether they have been cured and what impact the defaults may have on the transferability of the participating interest. The last thing a farm-in partner wants is to find itself in a position where it has agreed to acquire an interest that has been forfeited or is in dispute; and
- understand the potential financial impact on it should any of the partners default in the future; and
- ensure that the default provisions in the JOA are properly drafted and work coherently with the rest of the JOA (e.g. the withdrawal and transfer provisions). It is not uncommon for JOAs - sometimes put together quickly at the time of initial bidding or early exploration - to contain material errors which should be corrected prior to farming-in.

More to follow next week…

Part 3 will close the series with key conclusions and a brief overview of the recent UK Supreme Court decision in *Cavendish Square Holding v Makdessi*. This is a key case relevant to the enforceability of JOA remedies, including the right to require defaulting parties to forfeit their participating interests under the JOA.

For further information, please contact:

Adam Dann
Partner, Energy
T: +44 (0)20 3400 4033
adam.dann@blplaw.com

Tim Sumner
Senior Associate, Energy
T: +44 (0)20 3400 3697
tim.sumner@blplaw.com

London
Adelaide House, London Bridge,
London EC4R 9HA England

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