Upstream oil and gas series – Part 1

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

Introduction

With oil prices now some 70% off their 2014 highs (Brent trading around US$30 at the time of writing), the last 12-15 months have been incredibly challenging for the oil industry. Producers' revenues have been hit hard while the appetite for investment in exploration and development financing has significantly reduced.

We are beginning to see some distressed M&A and an apparent reduction in the value gap between buyers and sellers. Still, it appears that a resumption of "normal service" remains a way off and financiers are increasingly reluctant to lend. As a result, we are seeing more and more joint venture defaults. In the last six months alone we have advised on a series of default scenarios across the North Sea, West Africa and the MENA region.

In this article, we consider key risks to be managed in default scenarios, looking at the risks from the perspective of the defaulting party, the non-defaulting parties and an incoming farm-in partner. But first, let's start with a brief overview of the key provision of the joint operating agreement (the "JOA").

A Brief Overview of the JOA

At the heart of the upstream oil and gas business is the JOA, with its fundamental principle that each partner pays in and takes out from the joint operations its participating interest share of costs and production.

Simple enough and usually all well and good while each partner has the ability to pay. But, what happens when a partner can't pay?

This is something which has been considered in some detail over the years and is dealt with in the ever more frequently consulted and negotiated Article 8 (Default) of the Association of International Petroleum Negotiators ("AIPN") JOA.

For those doing business in the UK North Sea, the equivalent provision is Clause 17 (Default) of the Oil & Gas UK JOA, and many of the issues raised by the AIPN JOA apply equally.

Article 8 sets out a range of possible remedies for default, including the most common and frequently discussed remedy of forfeiture.

In short, the forfeiture option entitles the non-defaulting parties to require the defaulting party to transfer its participating interest (i.e. its interest in the joint venture) to the non-defaulting parties without compensation if the defaulting party fails to cure its default within a set period (usually between 30 and 60 days).

Other substantive remedies which may be available at the end of the cure period include:

- a buy-out option - the right to buy the defaulting party's participating interest (usually at a discount);
- a withering option - which provides for the non-defaulting parties to take part of the defaulting party's interest in a development in exchange for funding the balance of the development. Put another way, the non-defaulting parties buy-out part of the defaulting party's interest (at a discount), leaving the defaulting party with an interest reflecting the amount paid by it toward the development up to the date of default; and
- a foreclosure option – which enables the non-defaulting parties to enforce a charge over the defaulting party's participating interest such that it can be sold to cure the default.

The buy-out and withering options have been introduced to address concerns about the enforceability of the forfeiture option as a matter of law (see discussion below) and so are perhaps more proportionate in their application given the value paid to or retained by the defaulting party. Understandably, these options are often substantially less popular with non-defaulting parties and so the focus of default related actions is regularly on forfeiture.

A key element of the AIPN default provisions is that, during the cure period, the non-defaulting parties must cover the defaulting party's share of costs pro-rata to their own participating interests i.e. they must effectively carry the defaulting party for the 30-60 day cure period. If the non-defaulting parties fail to do so, then they too will become defaulting parties and will be subject to Article 8 in the same way as the original defaulting party. Providing such a carry may not be manageable for all parties, and can become an unacceptable burden, in particular if more than one party with significant equity defaults.

In addition to the substantive remedies, which lead to the termination of a defaulting party's participation, defaulting parties also lose certain usual rights under the JOA during much of the cure period. These include rights to attend and vote at operating committee meetings and to access data, something which can make farming out difficult. Further, there remains the possibility that the defaulting party can be sued for breach of contract by the non-defaulting parties.

The Defaulting Party's Perspective

Standing in the shoes of the defaulting party, the objective will very often be to conserve cash while delaying forfeiture of the participating interest for enough time to:

- raise finance to cure the default; or
- find a buyer for all or part of the participating interest, salvaging as much value as possible.

This can result in what non-defaulting parties refer to as "carry-abuse", where the defaulting party fails to meet cash calls as they fall due but then (sometimes on a recurring basis) cures these defaults shortly prior to the date on which its participating interest could be forfeited i.e. the defaulting party may require the other partners to carry it for successive 30-60 day periods. Sometimes this can push non-defaulting parties into default if they are not in a position to finance the defaulting party's share.

Interest is charged on this carry and so it is not a free carry. However, often the interest rate payable under the JOA (e.g. LIBOR + 2%, 3% or 4%) will lag behind the cost of capital of the non-defaulting parties and so may make this an attractive source of interim financing for the defaulting party and a loss making exercise for the non-defaulting parties.

A defaulting party may also seek to delay the forfeiture of its interest by taking issue with any deficiencies in the cash calls, default notices or other default related correspondence. In such cases, the defaulting party would be looking to re-set the clock to cure its default (i.e. the 30-60 day period), thereby buying more time to raise finance or effect a transaction. Similarly, defaulting parties may seek to identify practical issues or strategies which would make it difficult for the non-defaulting parties to enforce the forfeiture option, including making use of governmental and other connections.

More to follow next week…

Part 2 will look at the issues and options from the perspectives of non-defaulting parties and potential farm-in partners, focusing on how they can enforce rights and mitigate the significant risks associated with defaulting parties. This includes potential risk mitigation strategies outside of the JOA.

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