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Oil & Gas JOA Defaults: Enforcing Forfeiture Clauses after the Cavendish Square Decision

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The continuing decline in oil & gas prices has led to increasing numbers of defaults under oil & gas joint operating agreements (**"JOAs"**). At the same time, the Supreme Court has handed down its decision in ***Cavendish Square Holding B.V v Talal El Makdessi [2015] UKSC 67*** ("**Makdessi**"), a key case going to the issue of whether contractual remedies are enforceable as a matter of law or whether they fall foul of the rule against penalties (the **"Penalty Rule"**).

While Makdessi itself did not involve oil and gas assets, it is highly relevant in the JOA context and, in particular, to the issue of whether JOA forfeiture clauses can be enforced. It indicates that the courts may be more willing to enforce such provisions than they were in the past.

What do we mean by forfeiture clauses in the JOA context?

Forfeiture clauses are provisions under which a defaulting joint venturer (i.e. who fails to pay cash calls or maintain required security) can be required to transfer its interest in the joint venture to the non-defaulting joint venturers without compensation. See Article 8 (Default) of the Association of International Petroleum Negotiators (**"AIPN"**) 2012 Model JOA. Equivalent provisions also appear in predecessors of the 2012 AIPN JOA and in the Oil & Gas UK JOA (clause 17).

What is the significance of Makdessi?

In short, the case confirms that the Penalty Rule applies to forfeiture clauses and establishes the **"true test"** to be applied. As indicated above, following Makdessi, it appears the courts may be more willing to enforce forfeiture provisions than they were in the past.

More specifically, the following key principles emerge which are highly significant in the context of JOA forfeiture clauses:

1. The Penalty Rule regulates only contractual remedies (secondary obligations) stemming from a breach of primary contractual obligations. For example, it will regulate remedies for failing to comply with payment obligations but would not regulate a primary obligation to pay a fee or take certain action. In Makdessi, the clause in question was deemed a primary obligation (a price adjustment clause), so could not be a penalty.

2. Applying the **true test** in the JOA context, the court will assess, at the <u>time the contract was made</u>:

   (a) the non-defaulting party's **legitimate interest** (financial or otherwise) in contractual performance by the defaulting party; and

(b) whether the remedy for breach is **exorbitant or unconscionable** having regard to that legitimate interest.

3. The court will treat the parties as the "best judge of what is legitimate in a provision dealing with the consequences of breach" where they are properly advised and of comparable bargaining power.

4. What is exorbitant or unconscionable will be dependent on the particular facts and circumstances of each case. The extent to which the parties negotiated at arm's length on the basis of legal advice and had the opportunity to appreciate what they were agreeing will be a relevant factor.

5. The Penalty Rule applies to forced transfer clauses. The court held that a "forced transfer for no consideration or for consideration which does not reflect the value of the asset transferred *may* constitute a penalty" but provided no further specific guidance.

6. A provision can both be a penalty clause <u>and</u> a forfeiture clause, with the result that the defaulting party may seek to avoid the consequences of the clause on either basis: (i) first, by arguing that it constitutes an unenforceable penalty clause; and (ii) second, if the penalty argument fails, by arguing that it is entitled to relief against forfeiture. (However, note that relief against forfeiture would require the defaulting party to cure its breach; something which, where the JOA forfeiture clause applies, it would already have had opportunity to do and would have failed to do. Accordingly, taking account of the likely financial capability of the defaulting party, there may be little scope for relief against forfeiture in the JOA context.)

We now consider questions relating to the impact of Makdessi in the context of JOA forfeiture clauses.

Applying the true test, what are the non-defaulting parties' legitimate interests in enforcement of the forfeiture clause?

In future cases, the non-defaulting parties' legitimate interest in including a forfeiture clause will be closely scrutinised by the court. Oil and gas companies and their lawyers consider forfeiture clauses vital to protect each party's legitimate interest in securing the financial performance of all other parties and hence in maintaining the economic cohesion, and ultimate survival, of the joint venture reflected in the JOA and the licence or concession to which it relates.

Arguments which may be advanced to support the non-defaulting partner's legitimate interest in performance include:

1. needing to replace a defaulting partner with a paying partner so as to progress the project;

2. avoiding delay in effecting a development due to the defaulting partner;

3. avoiding the financial, socio-political and reputational implications of failing to meet work program or development obligations under the licence or concession;

4. avoiding forfeiture of the whole licence or concession due to the defaulting partner's failure to pay; and

5. avoiding prejudice to its other projects or business activities resulting from the need to cover the defaulting partner's share of cash calls (as is required under the AIPN and Oil & Gas UK JOAs).

While there may be relatively little scope for a defaulting party to dispute the legitimate interest of the non-defaulting parties' enforcement, we anticipate detailed arguments may be made as to the application of the second part of the test: whether the application of the clause is exorbitant or unconscionable.

Applying the true test, is the "exorbitant or unconscionable" threshold likely to be met?

Ultimately, the court will need to determine whether the "nil" price paid for the interest being transferred is exorbitant or unconscionable having regard to the legitimate interest it is seeking to protect.

At first blush such a transfer may seem exorbitant or unconscionable in that the defaulting party may be transferring a valuable asset in return for no consideration in circumstances where the non-defaulting parties will remain at liberty to sue the defaulting party for the missed cash calls and other damages.

However, when you pause to consider the detail of the decision in Makdessi and explore the issue

further from the non-defaulting parties' perspective arguably the balance moves back towards the non-defaulting parties. Specifically:

1. the test is applied at the time the JOA in entered into, not at the time of forfeiture. Accordingly, the analysis should take account of how the forfeiture clause might have applied for the benefit, and to the prejudice, of each of the parties throughout the life of the JOA. The actual amount in default at the relevant time and the value of the participating interest at that time are irrelevant;

2. the forfeiture clause is reciprocal in its operation. It applies to each of the parties equally, not for the benefit of one party alone. In our view, this is a factor that is likely to be influential for the courts;

3. the forfeiture clause allows a grace period (usually 30-60 days) for the default to be cured;

4. in most cases where defaults occur the petroleum revenues derived from the relevant participating interest are unlikely to cover the costs of cash calls. Accordingly, the non-defaulting parties do not actually pay "nil" for the interest or receive a windfall, instead they end up taking on increased financial obligations together with the associated risks to their own finances. Any rights to sue for the missed cash calls or seek other damages are likely to be illusory in practice;

5. the court will treat the parties as the "best judge of what is legitimate in a provision dealing with the consequences of breach" where they are properly advised and of comparable bargaining power. This seems likely to be the case for most JOAs and moreover the AIPN JOA contains standard wording to the effect that the parties acknowledge that the remedies are appropriate;

6. the extent to which the parties negotiated at arm's length on the basis of legal advice and had the opportunity to appreciate what they were agreeing will be a relevant factor. Again, this seems likely to be the case for most JOAs;

7. the non-defaulting parties may argue that no other remedies are appropriate i.e. they should not be obliged to pay anything to the defaulting party to resolve the issue (e.g. in the case of a buy-out remedy) or to continue to tolerate the defaulting party remaining in the joint venture (e.g. in the case of a withering interest remedy); and

8. finally, as indicated above, the non-defaulting parties have a substantial, legitimate interest in enforcing the forfeiture clause.

How bold do we think the judges will be in the forfeiture context?

Following Makdessi, it is arguable that the balance has been moved back in favour of non-defaulting parties and the enforcement of forfeiture clauses with the outcome that judges and arbitrators may be more bold in giving effect to such provisions.

However, until such time as the courts rule on the enforceability of the forfeiture remedy, we anticipate that arguments as to the enforceability will continue to be made and that this will be a factor encouraging parties to reach agreement as to terms of withdrawal by defaulting parties rather than proceeding with forced forfeitures. Of course, even if there is such a decision, this may not be the end of the matter as each case will remain fact sensitive.

As a related point, however, Makdessi does seem likely to substantially increase the level of confidence non-defaulting parties will have in enforcing other remedies for default, including rights to payments of interest, to buy-out the defaulting party at a discount or to dilute the defaulting party at a discount (i.e. the "withering option"). These remedies were already intended to address the uncertainty of the Penalty Rule and the introduction of the "true test" should make them more certain. This would also be consistent with the current approach of the courts to promote commercial certainty and avoid interference with contractual terms agreed between parties of comparable bargaining power.

How might JOAs be drafted to help avoid the forfeiture clause being struck down as a penalty?

With a view to increasing the likelihood of forfeiture clauses being upheld, companies may now wish to consider:

1. expressly stating in the preamble or appendix to the JOA (or, if preferable, a side letter) the parties' commercial interests in including the forfeiture

clause, and that the parties do not consider the forfeiture clause penal in nature or out of proportion to the legitimate commercial interests which it seeks to protect; and

2. including a written acknowledgement somewhere in the JOA that the parties are of comparable bargaining power and the names of their respective legal advisers.

Further, in our view, there may be scope for restructuring forfeiture clauses with a view to avoiding the Penalty Rule by making these provisions primary (rather than secondary) obligations.

How else might the problem be tackled?

While clearly very important, the forfeiture clause remains but one piece of the default puzzle and other options remain available to both defaulting and non-defaulting parties in seeking to protect their positions.

For defaulting parties, they may seek relief against forfeiture even if their specific clause is not impugned as a penalty. In such a case, the court will examine the position of the parties at and after the breach. However, as indicated above, this may not be a practical remedy in many cases in so far as the defaulting party would need to cure the breach; something its financial position may not permit.

For non-defaulting parties, there are a range of other options:

1. at the time of JOA formation or farm-in - they may seek to require that parent company guarantees or other security arrangements be put in place;

2. at the time of default - they may rely on such parent company guarantee or other security arrangements or, alternatively, explore the other options available under the JOA (e.g. the buy-out, withering and foreclosure options).

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