PAYMENT DEFAULTS AND AVOIDING SPLINTERING OF JOINT VENTURES

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At the heart of any upstream oil and gas joint venture is the parties' agreement to share in the costs of the joint operations to be undertaken. This is enshrined in the "pay now, dispute later" principle which underpins the payment mechanisms and the default procedures set out in joint operating agreements ("**JOA**"). This principle reflects the importance of required funds being made available by parties in a timely manner to ensure the efficient implementation of approved works. However, the combination of a global pandemic, low oil prices, persistent market fluctuations and cash-strapped parties are increasingly set to put this principle to the test in practice. In this article, we consider briefly what happens when joint venture partners fail to make their financial contributions toward the joint venture, the remedies available to the Operator and non-defaulting partners and ways to avoid the splintering of the joint venture in these instances.

There is no question that the contractual consequences for a failure by a party to meet its financial contributions under JOAs are generally severe. The severity reflects the potential harm caused by non-payment by one party to the joint operations. Where one party fails to meet their cash calls or other payment obligations, the other non-defaulting parties will be required under the JOA to bear the defaulting party's share of the costs. The remedies available to non-defaulting parties under JOAs are generally staggered, and will apply where the defaulting party fails to remedy their payment default within the cure period which follows notice of the default being given. Initial sanctions may see the defaulting party deprived of its rights to (i) information and participation, (ii) its share of production, and (iii) divest itself of its interest. Given recent shortages of storage capacity and rising costs of storage, production entitlement has lost some of its appeal as a remedy for default. A persistent and unremedied default can lead to even stricter remedies, including a potential forfeiture (with or without compensation) by the defaulting party of its participating interest to the non-defaulting parties.

Given the ongoing debate, as a matter of English law, on the enforceability of forfeiture clauses (with the recent findings in *Cavendish v Makdessi* [2015] 3 WLR 1373 providing some comfort that these might be upheld), it is also not uncommon to find alternative remedies to forfeiture in JOAs. Examples include buy-out provisions enabling non-defaulting parties to buy out the defaulting party's participating interest at an undervalue, or withering provisions which set out the participating interest the defaulting party is required to forfeit, and which will usually be proportionate to the extent of that party's investment in the joint operations to date.

Should non-defaulting parties opt to exercise some of these harsher remedies, the other typical considerations that will come with any divestment of interests will apply. What consents, including government consents under an underlying licence, are needed? What provisions will apply regarding the transfer of decommissioning obligations? What happens if the Operator is the one divesting its interests? Should the operatorship be transferred? The answer to these questions is typically a matter of contractual interpretation and will depend on the terms of the underlying licence or concession and the JOA. In the event the divestment is triggered by a formal insolvency, non-defaulting parties will also need to be mindful of the statutory insolvency regimes in dealing with or taking possession of the distressed party's assets.

As parties are increasingly cash-strapped, the "pay now, dispute later" principle may yet again come under significant challenge, as we saw after the fall in oil prices in 2014, with parties increasingly disputing the validity of the contributions requested. Common grounds for challenging cash calls include the payments not being a genuine pre-estimate of costs, cash calls not complying with the accounting procedure, or the proper approval processes not having been followed or obtained. To shield themselves from these arguments and minimise the risks of contributions being contested, Operators will need to be particularly weary of complying with the formal Work Program and Budget and Authorisation for Expenditure processes set out in the JOAs.

Indeed, parties disputing certain contribution requests have been successful in recent years in applying for injunctions to restrain Operators from performing certain works or exercising the default provisions in the JOAs where a party has refused to meet a cash call. A good example of this is the recent case of *Pan Petroleum AJE Ltd v Yinka Folawiyo Petroleum Co Ltd & ors* [2017] EWCA Civ 1525 where a non-operator was disputing a cash call issued by the Operator, and refused to pay it. The cash call related to the drilling of new wells which the non-operator argued was a "major modification" that required unanimity under the JOA. The same non-operator successfully applied to the English courts for an injunction restraining the non-defaulting parties from exercising the default remedies under the JOA until the dispute regarding the validity of the cash call had been resolved in arbitration.

The English courts have demonstrated a willingness to provide these types of injunctions, given the draconian nature of the forfeiture remedies. However, parties applying for such injunctions will need to demonstrate, amongst other matters, that the harm caused by the exercise of default provisions cannot be compensated by damages. One argument that has found favour with the courts is the potential operational harm that making the contribution, and the Operator going forward with disputed works, would cause the joint operations in the longer run. Parties intending to apply for these types of injunctions will also then separately need to follow through with proceedings to determine the underlying dispute. This can, and often will, prove costly and time-consuming, with an end result that may not differ to the end result if the "pay now, dispute later" principle had been complied with.

Given the current climate, parties may simply find that the best option for resolving tensions regarding funding constraints remains commercial negotiations, and keeping channels of communications open, with a view to finding alternative solutions which suit all parties.

[Navigating the low price oil environment]

KEY CONTACTS

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