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To Forfeit or not to Forfeit? – Enforceability of Forfeiture Clauses in Oil and Gas Joint Operating Agreements (JOA)

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A recent arbitration award has highlighted the question of the enforceability of forfeiture provisions in oil and gas JOAs. The effect of such provisions is that a defaulting party forfeits its participating interest ("**PI**") in a project on account of a default, such as a failure to pay a cash call. We look at some of the practical considerations for parties to existing JOAs and those entering into new JOAs, as well as their advisers.

Background

In December 2013, an ICC tribunal handed down an award in an arbitration between RSM Production Corporation ("**RSM"**) as the claimants and Victoria Oil and Gas ("**VOG"**) and Rodeo Development Limited ("**RDL**") as the respondents in relation to a JOA between the parties on a gas exploration field in Cameroon. The tribunal decided that RSM had not forfeited its 40% PI in the project as a result of a default for its failure to pay a cash call.

There was an earlier arbitration between the parties in 2011 when RSM had failed to pay a prior cash call. The tribunal in that arbitration determined against RSM and the question in the 2013 arbitration turned on whether RSM was in prior default as a result of the 2011 arbitration award. If RSM was deemed to be in prior default as contended by the respondents, the contractual cure period of 15 days would apply before automatic forfeiture. If there was no prior default, the period was 30 days.

The forfeiture provision was subject to Texas law. The tribunal decided that RSM's earlier default was not established to the degree of certainty required by Texas Law and therefore, RSM had not forfeited its 40% PI after a 15-day contractual cure period, as argued by the respondents.

Legal principles

The summary of the tribunal's award has been published by the respondents. As is usual in commercial arbitration, the tribunal has not published its award. The tribunal relieved RSM from forfeiture on a technical point and it would have been interesting

to see whether the tribunal had any comments about the enforceability of forfeiture clauses generally. For example, there is uncertainty whether English courts would enforce forfeiture provisions, because they may be deemed to be penalty clauses. This is best illustrated with an example.

Suppose a defaulting party's PI worth US$100m (and possibly more) is forfeited because of its short term failure to pay a cash call for US$5m – this could be deemed to be penal and an English court may refuse to enforce it. The non defaulting parties ("**NDPs**") have acquired an interest worth US$100m because of the defaulting party's default for US$5m. English law would view the defaulting party's loss of US$100m as "extravagant and unconscionable" compared to the loss suffered by the NDPs. Historically, a clause had to contain "a genuine pre-estimate of loss" suffered by NDPs for it to be enforceable.

However, the modern approach of the English courts recognises that a clause may be commercially justified even if it does not represent a genuine pre-estimate of loss provided that its predominant purpose is not to deter breach of contract. In other words, it is compensatory in nature. Courts have particularly been ready to uphold a clause which has been agreed between parties of comparable bargaining power.

Even if a forfeiture clause is deemed not to be penal, a defaulting party may claim equitable relief against forfeiture. Texas law, which was applied in the RSM v VOG and RDL arbitration, recognises that equity abhors a forfeiture. In English law, relief from forfeiture has been granted in cases involving forfeiture of tenants' leasehold interests by landlords. However, English courts have been less willing to grant relief from forfeiture where a provision has been freely agreed by commercial entities. This is consistent with the approach taken in relation to determining whether a damages clause is penal in commercial agreements. It can also be argued that a defaulting party typically has a period of 30 to 60 days to cure its default before forfeiting its PI, which means that the intervention of equity should not be necessary.

Reasons for default

Although default is very rare in the oil and gas industry – there is reputational risk for a party seen to be in default – the RSM v VOG and RDL arbitration is an example that default can occur. There may be a variety of reasons for a default. A co-venturer may dispute the way operating expenses were calculated as the basis for a cash call. A party might deliberately default to exit from a joint venture where the prospects of oil or gas discovery are low or the operations are nearing the end of their productive stage. Also, a party may simply not be able to obtain enough credit to meet its cash call obligations in what is a very capital intensive sector. Alternatively, a party may persistently default yet avoid forfeiture by curing each default within the contractual cure period, or have a 'cavalier' disregard for its cash call obligations.

It is worth bearing in mind that forfeiture is not always to the benefit of NDPs. For example, NDPs may not have the resources to continue with a project without the contribution of a JOA partner. In such cases, it pays for NDPs to be better protected in the event of a default or the threat of default by one of its co-venturers.

In summary, both NDPs and potential defaulting parties may be well advised to consider alternative clauses to forfeiture in their JOA.

Alternatives to forfeiture clauses

The Association of International Petroleum Negotiators' 2012 Model International Joint Operating Agreement (the "**2012 JOA**") contains the provisions outlined below as alternatives to forfeiture clauses.

(i) Withering option: a defaulting party assigns part of its PI to NDPs where a default occurs under an approved development plan. However, the formulas used to apply the withering option in the 2012 JOA are incredibly complex and the clause has not proved to be very popular to date (not least because parties in the first flush of a deal may not see the need to spend time negotiating it when things are going well).

(ii) Buy-out: a defaulting party sells its PI to other JV partners or a third party at a price which is discounted by an agreed percentage. The discount minimises the risk that a party may force other JV partners to buy-out at a fair market value. This is arguably the most reasonable of the alternative default clauses to an outright forfeiture provision.

(iii) Enforcement: the NDPs elect to enforce a mortgage and security interest on the defaulting party's PI.

The parties may consider forfeiture as the ultimate sanction in a JOA – the 2012 JOA includes this as an optional default provision.

Tribunal's likely approach

The question of forfeiture in an oil and gas JOA has not come up before an English court. It often comes up before an arbitral tribunal given that arbitration remains the choice of dispute resolution mechanism between multi-jurisdictional co-venturers in oil and gas concessions. A tribunal would consider the facts of each case very carefully. Its approach to a defaulting party that has invested considerable sums of money in a project which has now commenced petroleum production is likely to be more sympathetic than a party which has defaulted towards the beginning of a concession.

The risk of a tribunal striking down a forfeiture clause may be very small, because parties to a JOA tend to be of equal bargaining strength and the JOA is negotiated and entered into at arm's length. It could be argued that a tribunal ought to give effect to the commercial bargain that co-venturers have made including the enforcement of any forfeiture provision. However, it is likely that a tribunal will consider a range of options such as fixing a period of time for the defaulting party to pay a cash call. This seems to have been the tribunal's approach in the first RSM v VOG and RDL arbitration. It will turn on the particular facts of each case and no doubt a tribunal would also be swayed by principles concerning penalty clauses and the equitable doctrine of relief against forfeiture.

Practical considerations

Below are some practical issues that co-venturers should consider when including a forfeiture clause in their JOA:

1. In the event of insolvency, forfeiture of a defaulting party's PI would give unfair preference to NDPs over unsecured creditors. This would contravene the longstanding English law principle that a private contract cannot be used to avoid the application of the law of insolvency. An Australian court has decided that the law of insolvency would take precedence over forfeiture to NDPs.

2. In jurisdictions where local content is required by law, it may not be possible to remove a defaulting national oil company from the joint venture because of local law requirements.

3. Where a licence for exploration and production is granted, it is usually in the name of the parties involved in the project rather than in the name of the JV. The JV is usually an unincorporated association without a separate legal personality.

4. If the JV enters into third party contracts with subcontractors and/or suppliers, there may be change of control clauses which require the contracts to be entered into again when there has been a change of counterparties.

5. A defaulting party must remain liable for past costs, confidentiality and non-compete obligations.

This entry was posted on Tuesday, March 4th, 2014 at 9:17 am and is filed under Arbitration, Forfeiture Provisions, Joint Operating Agreements
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