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Arbitration & Energy: Three Recent JOA Developments

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Three Recent Developments

- Two arise out of recent judgments of the English courts:
  - ***Spirit Energy Resources Limited and others v. Marathon Oil UK LLC*** [2019] EWCA Civ 11 – Court of Appeal,
  - ***TAQA Bratani Limited and others v. Rockrose UKCS8 LLC*** [2020] EWHC 58 (Comm)
- Why are they important? There are not many reported judgments in this area – most disputes are arbitrated, so court guidance is always welcome.
- The third arises from an LCIA arbitration under Brazilian law.
- Why is it important? Oil and gas lawyers have long feared that the default and forfeiture of interest clauses in JOAs might be unenforceable in civil law systems. This tribunal upheld the validity AIPN model clause.

First Development: Spirit Energy Resources Limited and others v. Marathon Oil UK LLC [2019] EWCA Civ 11

> *"There is no identifiable logic whereby the Participants can take the benefits but avoid the risks."*

- A case about the "no profit / no loss" principle, an important protection for the Operator.
- This case is a resounding judicial statement of support for the principle that an Operator should not be exposed to losses arising out of joint operations.
- The Court of Appeal's judgment contains a stinging dismissal of the other participants' attempt to burden the Operator with unforeseen liabilities.

Spirit Energy – The Factual Background

- The claimant was the Operator under a North Sea joint venture. The defendants were the other participants.
- With the approval of the Operating Committee, the Operator had engaged employees in connection with joint operations, and provided them with a defined benefit pension.
- As with many occupational DB schemes, the pension scheme suffered from a funding deficit – valued in excess of £68m.
- The Operator sought to recover the cost of repairing the deficit from the other participants, in proportion to their participating interests.
- The other participants refused to pay, arguing that in the absence of a further decision of the Operating Committee, the whole amount should be borne by the Operator.
- The participants lost at first instance, and appealed to the Court of Appeal.

Spirit Energy – The Contractual Framework

- Operating programmes and budgets to "*include as a minimum the work required to be performed during the budget period and the requirements of the Operator, having regard to previously approved programmes and budgets and its operations*".
- The Operator is authorised to make expenditure and incur obligations in accordance with the approved programme and budget, including hiring employees and determining remuneration, including pensions.
- All expenses to be borne by the participants, in proportion to their participating interests, and in accordance with the Accounting Procedure.

Spirit Energy – The Arguments

- The non-operators argued that they were not obliged to pay for the funding deficit even though they acknowledged that the deficit had arisen out of approved operations because:
  - Operator only recovers costs "specifically authorised" by the Operating Committee.
  - The authorisation of the annual budget was only directed at approval of costs incurred during the 12-month period of that budget. Costs arising out of previous budgets to be incurred in the following 12-month period must be added to the next budget are re-approved by the Operating Committee.
  - In order to be recoverable, the Operator must obtain approval of the funding deficit costs via a new budget and the non-operators were under no obligation to approve it under the JOA.
  - Any other construction would provide a "blank cheque" to the Operator

Spirit Energy – The Court Of Appeal's Judgment

- The Court of Appeal held that the effect of the JOA was clear:
  - The pension deficit was a cost that arose out of operations approved by the Operating Committee.
  - Under article 7.2, when approving programmes and budgets proposed by the Operator, the Operating Committee was **obliged** to take into account the requirements of the Operator, that is the liabilities which arose out of the earlier approved programme and budget needed to be taken into account when approving subsequent budgets.
  - Under article 10.1, all expenses of all operations shall be borne by the participants.
  - Under article 10.2, "***all costs and expenses of whatsoever kind*** *that are incurred in the conduct of operations*" are to be dealt with under the Accounting Procedure.
  - The Accounting Procedure specifically made clear that its purposes included "*to provide that Operator neither gains nor loses by reason of the fact it acts as Operator*".
- As such, **all** costs arising out of approved operations – including unknown and unforeseeable costs – are to be shared amongst the participants.

Spirit Energy – The Court of Appeal's Judgment

- The Court of Appeal clearly was not impressed with the attempts to shift responsibility for the pension contributions to the Operator.:
  - The non-operators arguments were said to be "*counterintuitive and lacking in commercial logic*".
  - "*With respect, I was unpersuaded that this could ever be considered commercially rational in the context of an agreement of this sort*".
  - "*A combination of the Participant's right and ability to exercise prior approval coupled to the accepted duty of the Operator to act genuinely, honestly and in good faith undermine any argument that ex post facto approval was necessary or made business sense*".
- The main takeaway is that the parties are in it together – joint operations are conducted for the benefit of all participants, so all participants must share the associated costs.

Spirit Energy – The Cost Overrun Provision In The JOA

- The JOA in *Spirit Energy* had a narrow cost overrun provision dealing with decommissioning.
- Many model forms deal with cost overruns in a broader range of circumstances.
  - Clause 6.9 of the AIPN Model International Operating Agreement (2012)
  - Clauses 10.5, 11.4, 12.4 and 13.4 of the OGUK Model JOA (2009)
- Would these clauses have made a difference in *Spirit Energy*?
  - If applicable, the Operator must obtain the consent of the Operating Committee before agreeing a recovery plan with the pension scheme trustees…
  - …however, if the Operating Committee withheld consent, the Pensions Regulator could simply impose payment obligations on the Operator anyway.
  - In those circumstances, it is difficult to see what the Operator could do differently – and why the "no loss" principle should not continue to apply.
- These clauses are designed to limit Operator choosing to incur further expenditure, rather than shifting responsibility for unforeseen liabilities which the Operator has no ability to avoid.

Spirit Energy - Considerations For Operators And Participants

- First and foremost – check your JOA terms – how do the provisions dealing with overruns operate?
- Any ongoing / future costs should be assessed on an annual basis when considering the next programme and budget proposal. Participants should take advantage of their broad information rights.
- Participants should consider whether anticipated costs can be mitigated: e.g. can steps be taken to minimise future pension costs, by making accrual less generous, closing to new members, moving to defined contribution arrangements etc.
- Particular care needs to be taken when considering potentially open-ended or unquantifiable commitments – examples might include decommissioning costs. These should be considered at a very early stage – i.e. before the FID.
- Are there other potentially unplanned costs coming down the road? Environmental costs / carbon taxes??

Second Development: TAQA Bratani Limited and Others v. Rockrose UKCS8 LLC [2020] EWHC 58 (Comm)

> *"Contracts such as the JOAs are to be interpreted principally by textual analysis unless a provision lacks clarity or is apparently illogical or incoherent."*
>
> *"Where detailed, professionally-drawn contracts exist, it is more difficult to imply terms because there is a strong inference that the parties have given careful consideration to all the terms by which they agree to be bound"*

- This case concerns an express – and, on its express wording, unconditional - right on the part of the non-operators remove the Operator.
- The Commercial Court was forced to confront the applicability of the *Braganza* doctrine, which impliedly limits the exercise of an unconditional right.

TAQA Bratani – Background To The Vote

- Until 1 July 2019, Operator of the Brae Fields in the North Sea was Marathon Oil UK LLC, a owned sub of Marathon Oil Corporation a well-known company with substantial worldwide oil and gas operations experience, both on and offshore.
- On 1 July 2019 RockRose Energy plc completed the purchase of 100% of the share capital in MOUK, which was then renamed RockRose UKCS8 LLC.
- TAQA and the other non-operators formed the view that RockRose might not be up to Operator role from an operational or financial perspective.
- TAQA proposed that it should become Operator. The other non-operators agreed that this was in their best interests. TAQA agreed to indemnify the other non-operators in respect of any transition costs above a specified cap.
- Non-operators voted unanimously voted to substitute TAQA as Operator.
- No procedural defects with the vote which RockRose could rely on.

TAQA Bratani – The Operator's Argument

- The Operator argued that removal of the Operator was subject to a number of qualifications, which limited the circumstances in which the non-operators can properly exercise that power.
- The Operator argued this on the basis of the express wording of the clause, and also on the grounds that the court should imply terms into the JOA which qualify the circumstances in which the power could be exercised.
- The Operator based its implied term argument on two grounds:
  - Where a contract allocates power to a party to make a decision which has an effect on both parties, that decision must be exercised with honesty, good faith and genuineness, avoiding arbitrariness, capriciousness, perversity or irrationality (often called a "***Braganza***" duty); and
  - Similar obligations arise from the mutual trust, confidence and loyalty said to arise in long term joint venture and similar agreements (often called "***relational contracts***").

TAQA Bratani – The Court's Approach To Construction Of JOAs

"The starting point in determining the meaning and effect of the JOAs is the language used by the parties…

This is of particular importance with contracts such as the JOAs, because they are sophisticated and complex agreements drafted by skilled and specialist professionals. That being so, contracts such as the JOAs are to be interpreted principally by textual analysis unless a provision lacks clarity or is apparently illogical or incoherent.

In such a case therefore, the starting point and in all probability the end point in the construction exercise will be:

a) The natural and ordinary meaning of the provision being construed,

b) Any other relevant provisions of the contract being construed, and

c) The overall purpose of the provision being construed and the contract in which it is contained."

TAQA Bratani – The Express Terms Of The Contract

Applying this approach, the court held that it was "*clear*" that the JOA conferred non-operators an unqualified right to terminate the Operator:

1. Clear and unambiguous language: "*In one sense, that is the end of the construction exercise since the language used in my judgment is clear and unambiguous and where the parties have used unambiguous language, the court must apply it*".

2. The language used elsewhere – in particular, the qualifications placed on the non-operators ability to remove the Operator for cause under Article 19(1)(b) – shows that the parties could have imposed qualifications on the right to remove the operator but chose not to.

3. Operator removal by a simple vote is consistent with the nature of the JOA – it is not a partnership, and the parties are entitled to vote in accordance with their own interests.

4. There was no evidence of an industry standard practice that the right to remove the operator was qualified.

TAQA Bratani – The Implied Term Arguments Failed

1. It was not **necessary** to imply a *Braganza* term into the contract.
2. A *Braganza* term would be inconsistent with the express terms of the JOA, under which an operator could only continue with the consent of the other parties.
3. The *Braganza* doctrine has no application to unqualified rights within expertly drafted complex commercial agreements. Unqualified termination provisions take effect in accordance with their terms.
4. Whether or not a JOA is a "*relational contract*", that would not allow the court to imply a term into the JOA in circumstances where:
    a. On its true construction the right to remove is unqualified.
    b. It is impermissible to imply a term that conflicts with the express agreement.
    c. Such a term is not necessary to make the contract work as the parties intended.

TAQA Bratani – Implications For JOA Parties

- Implications broader than just the removal of operators.
- The main takeaway is that a JOA will mean what it says. Terms which are clear, unambiguous and coherent will be enforced. There is little room to get around clear wording with clever legal arguments around implied terms, or constructions which are not supported by the normal meaning of the words used.
- Subject to any requirements written into the contract, participants are entitled to act in their own perceived self interest. There is no industry practice that requires a party to look to the joint interests of the parties when exercising unqualified contractual powers, or to give reasons for any decision it makes.
- Although the court resoundingly rejected Operator's attempt to impose a *Braganza* duty, this is a developing area of law parties are likely to continue to use in future.
- It may be worth expressly excluding any such duties from JOAs to give maximum certainty in future.

Brazil - The Legal Framework

- 1953 – Creation of the state-owned Petrobras
  - Over 40 years of monopoly in the exploration and production of O&G
- 1995 – Constitutional Amendment No. 9 broke up Petrobras monopoly
  - O&G market opening
- 1997 – Enactment of Law No. 9,478
  - Creation of the National Agency of Petroleum, Natural Gas and Biofuels ("ANP") — O&G regulator
  - Regulatory framework sets up concession contracts for E&P activities
- 1998 – ANP's 1st license round for E&P activities
- 1999 – ANP signed the concession agreements with international oil companies
  - 12 contracts were signed with 10 foreign firms

Brazil - Enforceability Of JOA Default Provisions

- Is the JOA forfeiture provision valid under the Brazilian law?

- The waiver of the right to set-off is valid under the Brazilian law?
  - No right to set-off provision
  - *Exceptio non adimpleti contractus* principle is mandatory under Brazilian Law?
  - *Solve et repete clause* may override the *exceptio non adimpleti contractus* principle?

- The withdrawal of a defaulting party pursuant to the forfeiture clause may be characterized as a penalty clause under Brazilian law?

Brazil - Enforceability Of JOA Default Provisions

- Is the forfeiture provision valid under the Brazilian law?
  - Freedom of contract principle / party autonomy: the party is at liberty to dispose of its economic rights unless the law provides otherwise
  - The existence, validity and enforceability of any contract provision under Brazilian law require three conditions: capacity of the parties, legality of the subject matter and compliance with any statutory formal requirements
  - A party is free to undertake under the JOA the obligation to transfer its property to another party under the conditions agreed
  - The forfeiture should not be construed as deprivation of assets without due process because the defaulting-party is granted under the JOA a specific time limit to cure the breach
  - There is no unjust enrichment cause of the non-defaulting party because the basis of the forfeiture is set on the JOA as one of the mechanisms of allocation of benefits, costs and liabilities amongst the contracting parties

Brazil: Enforceability Of JOA Default Provisions

- The withdrawal of a defaulting party pursuant to the forfeiture clause may be characterized as a penalty clause under Brazilian law?
  - The forfeiture clause is an option granted to the non-defaulting party — which may exercise it at its own discretion — to terminate the JOA with respect to the defaulting party
    - the option is a potestative right (*direito potestativo*)
  - The exercise of the forfeiture clause operates as a termination clause ("*cláusula resolutiva expressa*") for breach , which exercise entails the termination of the JOA between the defaulting party and the non-defaulting parties
  - Under Brazilian law the penalty clause has a two-fold function: (i) to compensate the non-performance of an obligation and to compensate the delay
  - The JOA forfeiture clause does not fulfils any of these roles

Brazil – ANP's Position

- The Brazilian O&G regulator position on the forfeiture provision
  - Opinion No. 100/2018/PFANP/PGF/AG
    - Limited Scope of Assessment

      (i) default of cash calls for a period that exceeds the agreed cure period

      (ii) exercise of the right of forfeiture (i.e., proper issuance of the Withdrawal Notice)

      (iii) proof of defaulting-party failure to cure the breach within cure period

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