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OIL AND GAS ALERT

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FORFEITURE AS A JOINT OPERATING AGREEMENT DEFAULT REMEDY IN UPSTREAM PETROLEUM OPERATIONS IN SOUTH AFRICA

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THE ISSUE

This article will discuss the controversial remedy of 'forfeiture' available to non-defaulting parties in a JOA. The forfeiture clause is the standard stalwart default remedy clause found in the JOA and is undoubtedly the most common tool used to deal with the defaulting parties. Let us not forget that the other more 'reasonable' default remedies of 'buy-out', 'withering interest', 'suspension of rights' and liens over a party's participating interest, are in themselves lesser or partial forfeiture clauses and that in those scenarios the defaulting party still has no choice but to either pay the amounts due or accede to the default remedy chosen by the non-defaulting parties.

The forfeiture clause, in the Association of International Petroleum Negotiators (AIPN) Model Form JOA, provides that if a defaulting party fails to fully remedy all its defaults by the 30th day (this period may vary in practice) of the default period, then, without prejudice to any other rights available to each non-defaulting party to recover its portion of the total amount in default, at any time afterwards until the defaulting party has cured its defaults, any non-defaulting party shall have the option, exercisable in its discretion at any time, to require that the defaulting party offer to completely withdraw from the agreement and assign all of its participating interest free of costs.

The term 'forfeiture', in this context, brings to mind a penalty for a contractual transgression by the defaulting party and therein lies some of the controversy, but is this really the case? The cash-call is essential to sustain the petroleum operations. Without funding the petroleum operations grind to a halt and the concession, in all likelihood, would be lost. The presumption is that at the time of entering the JOA the parties are of one mind, they want the petroleum operations to succeed and plan the way forward by entering into the JOA. They agree to contractual terms in a particular manner, namely that:

(i) the obligations of the parties under the agreement and all liabilities and expenses incurred in connection with approved joint operations are charged to the joint account and all credits to the joint account shall be shared by the parties, in accordance with their respective participating interests;

(ii) each party shall pay when due its participating interest share of joint account expenses;

(iii) time is of the essence for payments owing; and

(iv) a party's payment of any charge under their agreement shall be without prejudice to its right to later contest the charge.

It is submitted that agreements between consenting entities must be honoured, more especially where parties have equal bargaining power at the outset of negotiations before entering into the agreement. The forfeiture clause should not to be considered a penalty but more as an agreed and accepted compensation toward the non-defaulting parties, who are at the time of the default obliged to cover the

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South African courts will be unfamiliar with the upstream petroleum industry JOA default provisions as our oil and gas industry is in its infancy.

monies not paid in terms of the cash-call and who are also further burdened by the defaulting party's non-payment in respect of further petroleum operations. Even this 'compensation' in itself may be a burden as the remaining non-defaulting parties have the added pressure of having to fork out monies not in their own original budget.

ENFORCING THE FORFEITURE CLAUSE

A party defaults on its cash call and the non-defaulting party chooses to follow the forfeiture route. The period given for the defaulting party to remedy the default, be it 30 or 60 days, passes and no payment is made. The non-defaulting parties issue the defaulting party with a notice of withdrawal and the defaulting party is deemed to have proposed to withdraw and assign, effective on the date of the non-defaulting parties notice, its participating interest to the non-defaulting parties. These terms are contained in a standard JOA, whether the defaulting party will agree to sign all necessary documentation to transfer the participating interest is highly unlikely especially if they claim a dispute in regard to the veracity of the cash call, albeit that they are obliged to "pay now argue later".

South African courts, in dealing with our fledgling oil and gas industry, may be unfamiliar with the upstream petroleum industry JOA default provisions and will no doubt take cognisance of international oil and gas industry standard clauses developed over the past 40 years and the enormity of the amounts of money involved when disputes arise and endeavour to protect non-defaulting parties. English courts have however not enforced the forfeiture provision deeming it to be a penalty clause.

In South Africa the Conventional Penalties Act, No 15 of 1962, as amended, at s1 provides for the enforcement of a penalty clause. In s2 a penalty is defined as:

> Any sum of money for the payment of which or anything for the delivery or performance of which a person may so become liable, is in this Act referred to as a penalty.

If we accept the forfeiture clause as a penalty clause then the South African courts, as opposed to the reluctance of the English common law, bolstered by the 2013 findings of the Court of Appeal England and Wales case of *Talal El Makdessi v Cavendish Square Holdings* towards penalty clauses, hold more appeal (pardon the pun) for petroleum operation joint venture partners in a JOA.

The Court of Appeal, in the *Makdessi* case, determined that the forfeiture remedy was indeed a penalty against the defaulter, that with this remedy the degree of loss by the forfeiting party relative to the loss by the non-forfeiting party was (for the most part) imbalanced and the remedy lacked a justifiable commercial purpose.

When default raises its head, either unintentionally, or blatantly where a party wants out of the petroleum operations for whatever reason, the non-defaulting parties have to be protected. Though it is arguable that the exercise of a forfeiture clause may be disproportionate and unconscionable, South African courts will undoubtedly look at the circumstances of each case before making a determination. The reasonableness of the enforcement and the surrounding actions of the parties will be significant determining factors in reaching an equitable solution. The size of

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the outstanding default amount weighed against the value of the defaulting parties participation interest in the petroleum licence will be a consideration a court will deliberate before making its decision to enforce the forfeiture or not. This sentiment is in tandem with s3 of the Conventional Penalties Act, No 15 of 1962 (Penalties Act). The section provides for a reduction of excessive penalty provisions if upon the hearing of a claim for a penalty, it appears to the court that such penalty is out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated, the court may reduce the penalty to such extent as it may consider equitable in the circumstances. With the proviso "that in determining the extent of such prejudice the court shall take into consideration not only the creditor's proprietary interest, but every other rightful interest which may be affected by the act or omission in question". The South African situation is thus not totally at odds with the English law position.

In the 1969 South African case of *Van Staden v Central SA Lands and Mines* the court said that the goal of the Penalties Act was to remove any doubt that a contractual penalty stipulation was enforceable, prevent unfair and excessive penalties being stipulated in agreements, and prevent an additional claim for damages.

The challenge is that the enforcement of the forfeiture clause through the courts may entail a lengthy process and thwart the likelihood of a speedy resolution. Parties to petroleum operations have a responsibility to each other and to the host government to adhere to the agreed work programme and budget. This entails periodic and necessary adherence to the minimum agreed work programme and a lengthy transfer of the participating interest to any potential farm-in partner could delay such obligatory fulfilment and hence threaten the petroleum licence.

In South Africa the requisite s11 application required by the Mineral and Petroleum Resources and Development Act, No 28 of 2002 (MPRDA) to transfer the participating interest in the petroleum licence has no time limit within which the government's decision must be made and until such time the non-defaulting parties have to cover the cash-call obligations of the defaulting party. There is also the risk that the s11 application may not be granted as the host government is not a party to the JOA and is not obliged to adhere to its provisions. Though the provisions of the MPRDA are quite clear in regard to s11 applications and one would think that in the circumstances the Minister of Mineral Resources should favour the non-defaulting party to the joint venture. However, the situation may well arise that the ministry will 'wash its hands' and force the non-defaulting party to approach the court for an appropriate declaratory order and mandamus.

A SOLUTION?

A defaulting party refusing to adhere to the terms of the forfeiture clause - and why would they considering they have not abided their cash-calls - may hold the non-defaulting parties at their mercy. The non-defaulting parties' saving grace may be the proper implementation of a well drafted forfeiture clause.

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The unexpected oil price slump in 2014 and the looming amendments to the MPRDA have forced oil companies involved in upstream exploration to reconsider and prioritise their exploration funds.

It is suggested that parties need to implement a cohesive forfeiture clause that:

(i) is implemented only during the early part of the exploration phase, so as to limit the disagreeable issues of disproportionality, unconscionability and unfairness when considering the amount of monies already expended by the defaulting party, the value of the petroleum licence and the default amount;

(ii) incorporates a binding and exercisable power of attorney simultaneously signed with the time of signing the JOA and annexed thereto so as to eliminate the need to approach a court or tribunal for relief in the event of default of a cash call. The onus would then be on the defaulting party to attempt to halt the transfer;

(iii) is implemented with all due haste so as to prevent unnecessary losses for all parties; and

(iv) includes a deed entered into and signed by all parties, including the host government, acknowledging the exigencies of a default and that the contracting parties have with full knowledge and understanding entered into an agreement whereby a power of attorney has been granted to the other to be used in the event of a default (the terms and extant of which would have been negotiated earlier).

These assurances should make the forfeiture of the participating interest of a defaulting party during the exploration phase of petroleum operations an achievable remedy for non-defaulting parties to the JOA.

The unexpected oil price slump in 2014 and the looming amendments to the MPRDA have forced oil companies involved in upstream exploration to reconsider and prioritise their exploration funds. This may well lead to the increased risk of default on cash-calls by smaller players in the industry, making default remedies very relevant. A proper assessment of the efficacy of the forfeiture clause is needed. It is not enough to have it in JOAs as the 'sword of Damocles' for tardy joint venture partners in operations. Its bark needs to have a bite.

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