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Commentary

No JOAking Around – Participants' Obligations To Meet Operator Expenditure

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[Editor's Note: Ryan Deane, a qualified barrister, with the London office of Haynes and Boone, is a litigation associate who concentrates his practice on international arbitration in the engineering, energy and construction sectors. Any commentary or opinions do not reflect the opinions of Haynes and Boone or LexisNexis®, Mealey Publications™. Copyright © 2019 by Ryan Deane. Responses are welcome.]

Introduction

It is rare to find reported cases on the interpretation of a joint operating agreement (“JOA”) in the oil and gas exploration sector. The majority of disputes involving JOAs are resolved between the parties, with the balance of disputes being fought behind the curtain of arbitration, out of public view. The result is that parties are not readily able to determine, by reference to published decisions, exactly how industry standard wording in JOAs is interpreted in a formal dispute resolution setting.

The recent case in the English Court of Appeal, *Spirit Energy Resources Limited and others v Marathon Oil U.K. LLC* [2019] EWCA 11 is therefore welcome. It provides an insight into how disputes over certain fundamental rights and obligations of parties to a JOA are likely to be determined under English law.

The decision concerns the ability of an operator under a North Sea JOA to call on the non-operating participants to fund a pension deficit in circumstances where the exact amount of the deficit had not been foreseen or approved by the operating committee. It will, however, have an application beyond liability

for pension deficits as it considers the operation of many clauses commonly found in JOAs.

Background

The case involved participants in a joint venture to explore for oil and gas in the Brae fields located in the North Sea. The participants were parties to a JOA, which was described as being “*typical of operating agreements in the oil and gas exploration sector*”.

As readers will be aware, most commonly under a JOA one company is appointed as operator and has responsibility for conducting all project operations. The operator acts on a cost neutral basis; the benefits and burdens of a project are borne by all the participants of the venture who fund the operator, in addition to supervising and directing its operations. That supervision and direction is exercised by an operating committee, made up of the participants. This committee approves operating programmes and sets budgets that the operator must adhere to. The costs incurred by the operator are allocated to the participants in accordance with the terms of the JOA.

In the present case, five parties entered into a JOA in January 1980. Marathon Oil U.K. LLC was named as operator (“the Operator”), alongside four other participants (“the Participants”). The Operator offered its project employees defined benefit occupational pensions as part of their remuneration packages. In the years following the 2008 global financial collapse, a substantial pension deficit arose. This led to calls on the Participants to fund the shortfall. Although the Participants initially agreed to make the necessary payments, they soon reversed course and decided to cease all such contributions.

The Operator argued that it was entitled under the JOA to require the Participants to pay their proportionate share of the pension deficit. The Participants argued that, properly construed, they were not liable under the JOA and the Operator was ultimately responsible for those costs. Their main contention was that under the JOA they were not required to pay for future liabilities which they could not have foreseen when the operating committee approved the budget that included authorising employment of the relevant staff.

The Operator brought a claim against the Participants in the English High Court. Mr Justice Robin Knowles ruled on the construction of the JOA finding in favour of the Operator. The Participants appealed to the Court of Appeal arguing that the judge's interpretation of the JOA was incorrect and should be overturned.

Specifically Authorised Costs

The primary contention of the Participants was that, on a strict reading of the JOA, they were not liable for any part of the pension deficit in the absence of an express decision by the Operating Committee to fund that deficit in an operating programme and budget. In short, costs must be "*specifically authorised*" by the operating committee in order for the Operator to establish any entitlement to reimbursement from the Participants. A number of reasons were advanced in support of this position.

First, while it was accepted that the JOA allowed the Operator to fix the remuneration of its employees, it did not follow that the Operator was entitled to recharge the unforeseen pension deficit costs without being subject to the application of the provisions for approving operating programmes and budgets and, therefore, approval of those costs by the operating committee.

Second, even though no provision of the JOA compelled the Participants to reimburse the Operator for the pension deficit in the absence of approval by the operating committee, the Participants could choose to do so "*for their commercial incentive in ensuring the efficient continuation of operations.*"

Third, there was nothing in the background knowledge of the Participants to indicate the existence of a requirement that the Participants would be expected to bear such unforeseeable costs. There was nothing to suggest that such an interpretation of the JOA provisions were

in the common contemplation of the parties at the date of the contract. The Participants relied on an established tenet of contractual interpretation, namely that when construing multi-party documents no account should be taken of a fact or circumstance known only to one party. The Participants noted that at no time was there any statutory basis for the liability of employers in relation to deficits in pension scheme assets. The costs should therefore lie where they fall – with the Operator.

The Commercial Rationale Of A JOA

Lord Justice Green, giving the judgment of the Court of Appeal, first identified the key provisions of the JOA. Under Article 5.2, the Operator was given exclusive charge and conduct of all operations under the supervision and direction of the Participants who approved (or rejected) the operating programme and budget. Article 5.3 gave the Operator the right to hire employees and determine their terms of employment, including pension rights.

Article 7.2 instituted a procedure whereby actions of the Operator were subject to a system of authorisation and approval. The Operating Committee was under a duty to both agree and adopt an operating programme and budget for the Operator. This was to be done on an annual basis and in advance of the performance of the Operator of the matters authorised. Article 10.1 provided that "*all costs and expenses of all operations. . . shall be borne by the Participants in accordance with their Participating Interests*".

The way in which the Operator was to account for authorised expenditure was set out in Exhibit A to the JOA, entitled "Accounting Procedure". The exhibit began with a statement of overarching purpose, as follows:

"The purpose of this Accounting Procedure is to establish equitable methods for determining charges and credits applicable to [all operations conducted in accordance with the Agreement by or on behalf of any party with a Participating Interest] under the Agreement and to provide that Operator neither gains nor loses by reason of the fact it acts as Operator."

Importantly, it was clear from the JOA that the preponderance of the information in the operating programme and budget would comprise estimates backed

up by assumptions and general contingency provisions. This was unsurprising, given the volatile nature of both the work and expenditure typical in the oil and gas exploration industry.

With that framework in mind, Lord Justice Green made clear that he could not accept any of the Participants' arguments. He was in full agreement with the Operator.

His starting point was the natural meaning of the words in the JOA. The judge analysed the specific provisions that imposed liability on the Participants for costs incurred by the Operator. Those clauses were expressed in mandatory language, which was inconsistent with the Participants' argument that they had discretion over which expenses they were under an obligation to reimburse the Operator for.

Nothing in the relevant clauses differentiated between different types of cost, in particular whether a cost is uncertain in scope as at the date of approval and authorisation by the operating committee. Indeed Article 10.1 specified that the Participants were to bear "all costs and expense of all operations".

Further, the Participants' arguments did not make sense when one considered the overall purpose of the JOA. Lord Justice Green remarked that it was straightforward to determine the purpose of the JOA because the parties had included an Exhibit A to record their intentions. The overriding principle expressed by the parties was the equitable allocation of costs and benefits between the parties, with the Operator acting on a cost neutral basis.

In summary, the natural and ordinary meaning of the words of the JOA, including by reference to its stated purpose, compelled the conclusion that the Participants were liable for their share of the pension deficit.

The judge dismissed two rival commercial rationales of the JOA that had been advanced by the Participants. First, they had argued that there was nothing problematic with a construction of the JOA that led to an impasse between the parties, as had in fact occurred, concerning who was responsible for future liabilities. In those circumstances the parties would simply deal with issue through negotiation and agreement, amending

the terms of the JOA if necessary. Lord Justice Green had little time for this argument, remarking that:

"It is not in my view a commercially sensible construction of a JOA of this type to leave such an important issue as who bears the costs of operations to be resolved through the inherently uncertain mechanism of future negotiations, an agreement to agree. If this had been the intention of the parties upon contracting, then they would surely have said so. But instead they chose the sensible mechanism of prior approval of the Operators "programmes and budgets" as the means by which they supervised and expressed approval of related expenditure by the Operator which they would, under the JOA, be required to bear in the future. Indeed, the present dispute is signal proof that the appellants argument does not lead to commercial reconciliation. It has not been settled. The intention of the appellant Participants is to make the Operator pay all the costs of the [pension deficit]. The facts speak for themselves."

The Participants' second attempt at a commercial rationale for their interpretation of the JOA fared no better. They argued that there was a commercial logic in the Operator being held liable for the pension deficit because it had always been open to the Operator to take steps to reduce the pension liabilities. As the Operator was in control of the pensions from which the deficit arose, it was fair and commercial that it should be held responsible for its failure to curb the runaway costs.

Again, the judge was distinctly unimpressed by this argument. The Operator was required to submit its proposed operating programme and budget in advance in order to enable the operating committee to consider and, if appropriate, revise it, before giving its approval or disapproval. Having exercised that judgment it was not open to the Participants to argue that the Operator was at fault for the unexpected extent of those approved liabilities. If anyone was 'at fault' it was the operating committee for approving the budget in the first place.

As a final role of the dice, the Participants argued that, because there were several competing commercial

rationales for the operation of the JOA, they cancelled each other out. The judge pointed out that although there were competing arguments, not all arguments are equal. The Participants' rationales were counterintuitive and lacking in commercial logic, while the Operator's rationale had been articulated by the parties themselves in Exhibit A to the JOA.

Having dismissed the Participants' proposed commercial rationales for the JOA, Lord Justice Green addressed their remaining arguments. The Participants had tried to convince the court that the Operator's analysis of the JOA would lead to the Operator being able to write a blank check on any any estimated item of expenditure in the budget with impunity, free from any control or limitations.

Lord Justice Green was unmoved. He repeated the point that even if one viewed this as a blank cheque, it was one which the operating committee had underwritten by approving the relevant operating programmes and budgets. In any event, it was not truly a blank cheque, as the Participants were afforded certain protections under English common law. In particular, they would not be liable for any cheque written by the Operator dishonestly or in bad faith. On the contrary, the Operator was under an implied duty to operate its contractual discretion genuinely, honestly and in good faith (*Socimer International Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116).

The Participant's final argument was to pose a hypothetical. What if the pension scheme had been in surplus instead of in deficit? Article 10.1 provided only that "*all costs and expenses*" of the operation were to be paid by the Participants. Given that the JOA did not expressly provide for the Operator to transfer any net benefits it accrued from the operation, didn't this undermine the supposed absolute nature of the cost neutral provisions, such that those provisions should accorded less weight in the interpretation of the JOA as a whole?

The judge did not express a conclusion on whether the Operator would be in fact liable under the JOA to transfer any net benefits to the Participants, as this argument had not been pleaded or fully argued before him. He did, however, give some indications that the point was not as powerful as the Participants believed.

A prolonged pension surplus was improbable because the operating committee had the power to annually revise budgets. Any such surplus could readily be accounted for and addressed. In any event there was a good argument that a term could be implied to the effect that the Operator was under an obligation to account to the Participants for any net benefit accrued, including a pension surplus, at least in a final reconciliation on termination of the JOA. The judge thought that such a conclusion would be consistent with the commercial logic and purpose behind the JOA.

Lord Justice Green concluded that there was no identifiable logic whereby the Participants could take the benefits of the operation but avoid the risks. On the Participants' analysis, having approved the Operator's operations and its budget, thereby inducing it to incur expenditure, including on pensions, the Participant's could refuse to agree to pay their allotted portion of the costs, leaving that portion to be borne by the Operator. The judge stated that he was "*unpersuaded that this could ever be considered commercially rational in the context of an agreement of this sort*".

Orthodoxy Reaffirmed

The judgment of the Court of Appeal reaffirms the orthodox interpretation of the 'no profit/no loss' principle for operators in the oil and gas exploration sector. Provided the parties' obligations are clearly defined, English courts will not be readily receptive to arguments that certain types of costs fall outside the contemplation of the parties and as such require some sort of specific authorisation before an operator is entitled to reimbursement.

The decision also serves as a reminder of how important it is for parties to a JOA, or indeed any commercial contract, to spell out the commercial rationale underpinning their contractual rights and obligations, either in the recitals or, as in this case, in a separate exhibit. The fact that the parties did so in this case meant that the Participant's alternative constructions of the JOA, based on competing commercial rationales, never got off the ground. One result of the decision may be that operating committees deem it prudent to require more detailed information and conduct greater financial scrutiny of the operation of the project.

Of course, the decision turned on the specific language used and the underlying factual circumstances. The result might have been different, for example, if the

JOA contained an express general provision allowing for limited budget overrun. The only budget overruns that were authorised in this particular JOA were in respect of decommissioning expenditure.

That means that the JOA did not contain the clauses found in many JOAs, including the AIPN Model Form and Oil & Gas UK Model Form, which specifically authorise limited cost overruns by the operator for the budget as a whole and/or specified line items of the budget. The Court of Appeal was therefore not required to ask whether recovery of such cost overruns by the operator was limited to the extent permitted by such clauses in the absence of additional approval. That may well be the subject of a future dispute.

Finally, operators will now be put on notice that express provisions must be included in their JOAs if they wish to share the risk of a pension deficit arising, which is hardly an uncommon occurrence in the industry. Indeed, that consideration will apply to any potential cost overrun that the operator wishes to protect itself from. By contrast, non-operators will wish to consider whether the absence of the usual provisions dealing with operator cost overruns in the JOA in *Spirit Energy* means that the pronouncements of the Court of Appeal are limited in their application to the facts of the case. All parties involved will save a great deal of potential uncertainty, and the possibility of a dispute, if they focus their minds on this important issue when drafting the terms of their JOA. ■

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