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THE JOINT OPERATING AGREEMENT – ENFORCEABILITY OF THE FORFEITURE CLAUSE

The Oil and Gas industry and in particular the exploration and production sub-sector is incredibly capital intensive and attracts a great deal of risk, such that a reasonable forecast of financial expenditure and certainty as to how to meet this is a key consideration for any forward-thinking investor in its pursuit of profit. This consideration and the often reluctance to embark on the journey of oil and gas exploration alone encourages or even demands collaboration and risk-sharing. Joint ventures are therefore formed to share not only the costs and risks associated with exploration and production, but also to pool respective skills, knowledge and property in an effort to achieve a profitable outcome. As is the case with business partnerships, each partner is expected to contribute to the running of the business and in the event of a default, adequate remedies should take care of this to ensure that the business continues to run.

The case of joint ventures in the exploration and production of oil and gas is no different, and for this reason, the joint operating agreements ("JOA") executed between the joint venture partners include: robust and resilient measures to ensure that the parties comply with their financial obligations; and should a default occur, remedies that would ensure that the development of the asset is not halted and that non-defaulting parties ("NDPs") are effectively and adequately compensated in the event that they step in to cure the default. These measures are many and varied and parties would typically include in the JOA the negotiated terms for dealing with a default, but this short article simply spotlights one of the more stringent terms, being the forfeiture of the interest of the defaulting party ("DP") in the asset.

Generally, where a financial default is not remedied within a specified time, the NDPs may effect the forfeiture of the interest of the DP in the asset in accordance with the laid down procedure in the JOA, which consequently brings about the distribution of the forfeited interest amongst the NDPs who have remedied the DP's default, in proportion to their respective percentage interests in the project.

While courts are generally reluctant to interfere in contractual agreements of commercial parties where there is no unconscionable inequality of bargaining power, where a forfeiture clause is adjudged to amount to a penalty, the courts would step in and usually not enforce the same. English common law has a long and storied antipathy towards penalty clauses. It is established law that a provision that constitutes a 'penalty' is unenforceable in English courts and a clause that is included solely to deter breach will in ordinary circumstances constitute a penalty. The traditional approach in determining what will be enforceable has been to distinguish between a liquidated damages clause, which is enforceable if it is a genuine pre-estimate of loss and a penalty, which is unenforceable. There is plenty to lean on to get a sense of the attitude of the English courts towards forfeiture clauses and generally a penalty clause that is too oppressive will be regarded as a penalty and thus unenforceable[1][2]. The case of Cavendish Square Holdings BV, Team Y & R Holdings Hong Kong Ltd.

[1] In the case of Jobson v Johnson, Johnson had contracted to buy shares in a football club from Jobson for a sum to be paid in installments. The agreement provided that if Johnson defaulted on the payment of any installment he would retransfer the shares to Jobson at a significant undervalue. The court held that this provision was a penalty and unenforceable.

v. Talal el Makdessi (2015)[3] outlined a new modern approach that has been affirmed by the Supreme Court of England and Wales. The court in that case held that the determination of whether a provision is a penalty or not depends on the commercial rationale for including the provision in question as opposed to whether it constitutes a liquidated damages clause. Thus, a provision may not be a penalty clause if its inclusion can be commercially justified and its primary purpose is to protect a legitimate commercial interest and/or compensate for loss and not to deter or punish breach.

Nigerian courts have typically taken a decidedly hands-off approach to interpreting contractual provisions and have generally allowed sophisticated commercial entities to deal on their own terms to the extent that the terms do not reveal fraud, duress, misrepresentation or illegality, but where it comes to penalty clauses, the Nigerian courts have stepped in to determine that the same are unenforceable. The notable case of Oyeneyin v. Akinkugbe[4] affirms that a penalty clause is a contractual provision that assesses against a DP an excessive monetary charge unrelated to actual harm, and goes on to assert that penalty clauses are 'generally unenforceable', particularly where they are intended to frighten or terrorize a party into performance.

Conclusion

In summation, whilst the forfeiture of interest clause remains a staple of the JOA, it is important for the parties to bear in mind that the forfeiture of interest clause should be commercially justifiable with a view to ensuring the enforceability of the same. The primary purpose must be to protect a legitimate commercial interest and/or compensate for loss and not to deter or punish breach, nor must it be intended to frighten or terrorize a party into performance.

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[2] Further, a provision which is oppressive or unduly extravagant, is likely to be a penalty. In the case of Dunlop Pneumatic Tyre Co. v. New Garage and Motor Co., the court held that an innocent party would be entitled to enforce a clause which enabled it to recover "the greatest loss that could conceivably be proved to have followed from the breach", but a clause which provided compensation over this would be "extravagant or oppressive" and thus, a penalty. Accordingly the principle of proportionality comes into view and the court, it is clear, will consider how proportionate the remedy is to the loss suffered by the NDPs.

[3] [2015] UKSC 67
[4] [2010] 4 NWLR (Pt. 1184) 265