# COMMENTS

## PRE-EMPTIVE RIGHTS JETTISONED IN THE NORTH SEA

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*The grant of pre-emptive rights to co-venturers is common in mining and petroleum joint ventures. However, the intentions of the parties are frequently thwarted when a sale is proposed because the clause cannot be applied literally to the circumstances, often because the transferor has deliberately created an artificial situation. Frustration with the uncertainty surrounding these clauses, and the disputes that have arisen, has led to recent intervention by the UK government in respect of North Sea petroleum licences. This article examines the philosophies behind pre-emption clauses and proposes ways of addressing their shortcomings*.

### INTRODUCTION

The United Kingdom government has exhausted its patience with delays and wrangles caused by the purported exercise of pre-emptive rights in respect of off-shore petroleum acreage. The Department of Trade and Industry (DTI) has announced that future licences over offshore areas are not to be subject to pre-emptive rights among participants and that previous licences (issued prior to 30/6/02) should only contain pre-emption clauses in a particular form.[1]

The method of enforcing this is via the Open Permissions system. The creation, amendment or novation of any Operating Agreement (whether Joint or Unit Operating Agreements) is subject to the consent of the Secretary of State. With a few exceptions, automatic approval has been granted in advance to the creation, amendment or novation of most agreements.[2]

One exception, that is where specific approval must be sought, is for the creation, amendment or novation of an agreement relating to an old licence where the agreement does not contain the standard pre-emption clause, in verbatim form, or an agreement in respect of a new licence that contains *any* form of pre-emption. Given that the Open Permission represents DTI policy, and that the department has previously expressed a level of frustration at the way in which disputes over pre-emptive rights have caused joint venturers to become distracted from the business of exploring for and exploiting hydrocarbons, it should be assumed that special permission outside these requirements is unlikely to be given.

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1 www.og.dti.gov.uk/upstream/licensing/joa.

2 Open Permission (Operating Agreements) granted by the Secretary of State on 18 December 2002.

Therefore in practice the new rules are likely to apply to all future assignments of old licences because the holders will be unable to bring in a new party (including an affiliate) unless their agreement complies. Already many Operating Agreements do not include pre-emptive rights because many North Sea licence holders, tired of pre-emption issues causing delays (sometimes spoiling the proposed deal), rancour within the joint venture and often litigation, believe pre-emptive rights are more trouble than they are worth.

The new clause is intended to streamline the process under agreements subject to pre-emption arrangements, particularly where venturers have been given an extended period of time to make up their minds whether to pre-empt or where different rights granted to different parties require several iterations of the process. The clause recognises existing pre-emption arrangements, but imposes an obligation on the other participants to either reserve or waive their rights within seven days of receiving a notice of a proposed bona fide transfer. If the other participants do not reserve their rights, those rights lapse.

Once agreement has been reached with a third party, the disposing party is required to serve, as soon as reasonably practicable, notice on the participants who have reserved their rights. That notice sets out the main terms of the proposed transfer, including the identity of the third party, the effective date of the proposed transfer, the price and all other material conditions. The recipients then have thirty days within which to pre-empt; if more than one party exercises that right they take in proportion to their existing interests, unless agreed otherwise.

Finally, the standard clause establishes liability of the disposing party to the other venturers if it does not follow this procedure.

## BACKGROUND

How did the situation arise where the DTI felt it necessary to take this sort of action, in a country which generally allows parties freedom to contract in a commercial environment?

It must be appreciated that the North Sea acreage is characterised by a multiplicity of mature producing assets, with many players who often hold very small (<1%) interests and frequent swaps of assets, often without formal valuations of the packages. It is not very surprising that this freewheeling environment would come into friction with the delays and uncertainties which have become the hallmark of pre-emption clauses in operating agreements.

Ultimately a joint venture is a creature of contract. Therefore the rights and obligations of the parties, in the absence of egregious behaviour which might assist a Court in granting equitable or statutory remedies[3], should be governed by the drafting that the parties negotiated. It may well be the case that mining and petroleum joint venture agreements represent a high water mark for the willingness of Courts to give effect to the words used by the parties; frequently the Courts will decline to imply terms or fiduciary duties.[4] This attitude is based on the facts that not only are mining and petroleum ventures risky, with every possibility that the participants may lose large

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3 For example, *Dempster & Ors v Mallina Holdings Ltd* [1994] WAR 124; *Idemitsu Qld Pty Ltd v Agipcoal Australia Pty Ltd*, Court of Appeal (Qld), Unreported 24/3/93; but see contra *Mt Isa Mines v Seltrust* Supreme Court (WA), Unreported 5/7/1985.

4 "Joint Venture Issues" Erin Feros [1998] AMPLA Yearbook 384 and the cases discussed in that article. Note in many cases concerning breaches of pre-emption clauses the plaintiffs plead in the alternative that there has been a breach of fiduciary duty or a "just and faithful" clause

amounts of money, but also the participants are assumed to be companies of some substance who have had the opportunity to fully negotiate the agreement and take specialised advice.[5]

This principle is possibly best depicted in cases concerning whether a forfeiture of an interest on default is a penalty, and whether in those circumstances relief against forfeiture should be granted. In general terms unless the forfeiture is unconscionable it will stand in accordance with the words adopted by the parties.[6] To give another example, it has been suggested that in examining whether a relationship is a joint venture and not a partnership, a statement by the parties to that effect will go a long way to helping a Court reach that conclusion.[7]

Cases involving pre-emption clauses are essentially exercises in interpretation, which means the decision is usually specific to the particular drafting and circumstances, making it difficult to extract generic principles (could this be why so many of the cases cited in this paper are unreported?). Courts should be expected to interpret commercial agreements to give effect to the terms used and, where differing interpretations are possible, assume that the parties intended a commercially workable result. Bryson J summarised this principle in *Noranda Resources Australia Ltd v Lachlan Resources NL*[8] as follows:

> "The construction which I give… enmeshes the parties in a relatively elaborate procedure, but this is not uncharacteristic of the joint venture agreement as a whole which would give the impatient the opportunity to reflect that he who has a fellow has a master. It is I suppose useless to protest against the difficulty of understanding this document, but it is a commercial document, and constructions in which it is meaningless or has a meaning of no practical use in conferring rights of significance on anybody are very unlikely to represent the intentions of the parties."[9]

But can this principle be extended to justify a Court going behind the words used? In her 1998 paper Erin Feros[10] asked the question whether, having regard to some of the more recent cases, it could be said that the Courts are adopting a different approach, that is, by giving effect to the underlying intent of pre-emption clauses. I would answer this question in the negative, as I do not believe it is possible to discern a trend from the handful of cases that have been decided in Australia. It can be said though that there is a clear dichotomy between those cases where the Court has strictly interpreted the language used[11] and those that have employed liberal interpretations to address the mischief that the parties had intended preventing[12].

An interesting decision is that of the English Court of Appeal in *Texas Eastern Corporation v Enterprise Oil PLC*[13]. Texas Eastern wished to sell the shares in its subsidiary T, which owned

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5 *Monarch Petroleum NL v Citco Australia Petroleum & Ors*, Supreme Court (WA), Unreported 29/5/1985; *Auag Resources Ltd v Waihi Mines Ltd*, High Court (NZ), Unreported 25/3/1996.

6 For example *CRA v NZ Gold Field Investments Ltd* [1989] VR 873 and *Monarch Petroleum v Citco*, supra.

7 "Operator of a Joint Venture – Principal or Agent" Dowsett J [1987] AMPLA Yearbook 269. Similarly it is not uncommon for the parties to expressly negate any fiduciary relationship.

8 (1988) 14 NSWLR 1.

9 Ibid at 12.

10 Supra at footnote 4.

11 *Mt Isa Mines v Seltrust; Noranda Australia v Lachlan Resources*, both supra.

12 *Hooper v Commonwealth of Australia*, Supreme Court (NSW), Unreported 16/11/1990; *Auag Resources Ltd v Waihi Mines Ltd*, supra at footnote 5.

13 Court of Appeal (Eng), Unreported 21/7/1989, discussed in "Pre-emption rights in Resource Joint Venture Agreements" H K McCann [1990] AMPLA Yearbook 445 at 464 et seq.

interests in the Montrose field in the North Sea. The sale was subject to pre-emptive rights granted to the other participants in the Montrose field, but the complications were that the different participants owned different parts of the Montrose field in different percentages, plus company T owned interests in other fields. Therefore when the other participants exercised their rights, entitling them to purchase according to their existing "Percentages of Interest", it was almost impossible to stipulate who was entitled to what.

At first instance, Evans J held that the Court could not imply terms to make a pre-emption clause work, i.e. if the language used is not workable, the clause fails. On appeal the Court of Appeal, in overturning this decision, exercised a remarkable degree of judicial creativity by formulating an approach where the differing interests were to be valued by an expert and if that did not deliver an acceptable result the parties could come back to the Court!

Quite apart from the uncertainty of how a Court might interpret a clause, there is also great pressure on parties to ensure that they comply with the technical requirements of clauses, for example by spelling out the offer in sufficient detail, or ensuring that an offer is properly accepted.[14]

To give a simple example of a potential technical breach, assume that a party wishes to exit a project and, in addition to its Participating Interest, includes in the proposed transaction its stockpiles and/or sales contracts (which would not be part of the Participating Interest in a joint venture). McCann in his paper[15] was of the view that even though this technically is not an offer of the Participating Interest, a de minimis view should be taken of the add-ons, but the commentator to that paper, Slattery[16], whose view I prefer, regarded this as a non-compliant offer of a Participating Interest.

If the process is so fraught with uncertainty, it begs the question why resource companies are keen to include pre-emption clauses?

## THE DESIRABILITY OF A PRE-EMPTION CLAUSE

Joint venture agreements usually provide that assignments of part or the whole of the Participating Interest of a party to third parties[17] must meet certain conditions, namely:

- it must be of an undivided percentage interest
- the transferee must execute a deed agreeing to be bound by the provisions of the agreement
- any necessary government approvals must be obtained
- often the agreement will stipulate that the transfer must not result in parties holding interests below a certain level eg 5% (to avoid a proliferation of small interests which make administration of the joint venture cumbersome)
- in most cases, satisfaction of pre-emptive rights of the type discussed in this paper. Rights of first refusal are less common as they can lead to an iterative process where if there are any variations in the third party negotiating process from the deal offered to the other venturers, as one would reasonably expect there to be, the revised terms must then again be offered to the

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14 *Tern Minerals v Kalbara Mining*, Supreme Court (WA), Unreported 30/3/1990.

15 Supra.

16 [1990] AMPLA Yearbook 471.

17 On assignments to affiliates see infra. While agreements usually also allow assignments to existing participants, sometimes the specific words do not make it clear who is a "third party" – *Allstate Prospecting Pty Ltd v Posgold Mines Ltd*, Full Court of the Supreme Court (Tas), Unreported 26/5/1995.

co-venturers before the final offer to the third party. Thus the right of first refusal has become, for all practical purposes, a right of pre-emption.

Advocates of the need for pre-emption provisions point out that existing venturers are in a better position than outsiders to evaluate the acreage and it is their right, in view of the risks already assumed by them, to increase their interest if a sale is proposed (and therefore level of control over the project, perhaps becoming operator), particularly to keep out any "undesirables" or competitors[18]. A transfer made contrary to the clause is ineffective.[19]

Opponents of pre-emption clauses[20] state that the clauses:

- are an unreasonable fetter on alienation which is likely to make the interest worth less and more difficult to market
- will delay and possibly spoil any sale
- provoke dishonesty and rancour in the joint venture when a participant employs artificial means to avoid their operation
- create uncertainties which make it harder for new players to enter the market
- could result in years in expensive litigation
- stifle the market in licence interests.

It may sound trite to say so, but the form of a pre-emption clause will often depend on the identity of the parties. A cash-strapped junior that is desperate to farmout to a major company is not going to have a strong bargaining position and is unlikely to jeopardise the deal by insisting on particular provisions. Similarly, in the Australian upstream petroleum environment there are only a small number of major players who deal with each other on multiple joint ventures; therefore the drafting may be a little more relaxed in the knowledge that a party will be unwilling to do the wrong thing because sooner or later that decision will rebound. It is astonishing how many pre-emption clauses do not apply to changes in control of a party, to a large extent emasculating the clause.

The result is that pre-emption clauses have become notoriously easy to circumvent either on technical grounds or through circumstances arising that the original draftsmen did not foresee[21], including cases where those circumstances have been manufactured to avoid the operation of the clause.[22]

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18 McCann, supra. Note the suggestion that risks have already been assumed, which causes McCann to suggest that pre-emption could perhaps restricted to the development and production phases. In practical terms, a proposed assignment at the exploration stage may be by way of farmin, ie the carrying out of work obligations to earn an interest, with or without a premium. While the exercise of pre-emption at a premium may not be of interest to other participants, the point is that the other participants may still want the right to consider whether they wish to accept that deal. Sometimes agreements provide that where a party proposes farming out to a third party, the other participants may join proportionately in the farmout.

19 *Noranda v Lachlan Resources*, supra, but it was been suggested by McCann that this case is confined to assignments of contractual rights and that the result may be different in respect of the transfer of proprietary rights. Note the decision in *Reef & Rainforest Travel Pty Ltd v The Commissioner of Stamp Duties* [2001] ATC 4423 where the Queensland Court of Appeal held that a transfer in breach of pre-emptive rights was not void and was subject to duty under the now repealed *Stamp Act* 1894 (Qld).

20 See for example commentary by B C Hung at [1990] AMPLA Yearbook 477.

21 *RMC Holdings (Delaware) Inc v Newcrest Mining,* Supreme Court (WA), Unreported 24/6/1994.

22 *Mt.Isa Mines v Seltrust*, supra.

## WHAT SHOULD A PRE-EMPTION CLAUSE COVER?

In my view it is futile negotiating a clause that does not work. In drafting a clause that does work the following issues need to be considered:

- The definition of "transfer" needs to be very broad to cover "Claytons transfers" (the transfer you have when you are not having a transfer) such as that successfully effected in *Mt Isa Mines v Seltrust*[23]

Even then the clause would not catch a sale of shares in a special purpose company; change of control provisions are needed, but should not extend to the trading in shares of a listed company. Similarly even if a substantial corporation holds the interest along with many other assets, it may attempt to circumvent by transferring to an affiliate and then selling the shares in that affiliate (so it is no longer an affiliate). That is usually addressed by requiring the affiliate to agree that it will reconvey the shares if it ceases to be an affiliate of the original holder. Sometimes the requirement to reconvey expires after a period, for example two years, in recognition that the original transfer may have been part of a legitimate corporate reconstruction.

Pre-emptive rights are less complicated where there is cash consideration in a proposed sale. Thus many agreements provide that the consideration must be in cash or assets readily convertible to cash. However this type of clause denies a participant the ability to negotiate a package deal or swaps, involving different assets, or shares, with or without a cash adjustment. Many companies require the unfettered ability to be able to negotiate these types of deals. The obvious difficulty with translating such a deal for pre-emption purposes is that a co-venturer wanting to pre-empt is unable to match the offer exactly because it does not own those specific assets which form part of the consideration[24]. Therefore for the clause to work the pre-empting venturers must be able to put up equal value in cash, which means that the parties must engage in a valuation process and dispute resolution is required if the valuations cannot be agreed.[25] Quite apart from the delay caused by this valuation process, most corporations would shy away from losing control of the deal by placing an important commercial factor, namely price, in the hands of a third party.

Alternatively there may be a carve-out for package deals, but an unscrupulous transferor may attempt to circumvent by adding minor interests in other assets to dress the transaction up as a package when in reality it is not. Consideration needs to be given to stating whether the clause is applicable only if the additional asset(s) represents a certain minimum percentage value of the entire deal. But again questions of valuation arise.

The fallback is to restrict the carve-out to "*bona fide*" package deals and this language is commonly used[26]. The difficulty is that packages at each end of the spectrum might be easier to classify than those in the middle. For example, a package where a substantial percentage of another asset eg 50%, is also included might well be regarded as bona fide, just as the addition of a .1% interest in the same asset might fail an objective test (even if it is bona fide). Does

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23 Ibid. A draft clause is attached to the Feros article, supra.

24 *Finiston Mining v Western Reefs Ltd*, Supreme Court (WA), Unreported 22/11/1995; *Simsmetal Ltd v Wanless Metal Industries Pty Ltd*, Supreme Court (NSW), Unreported 19/3/1997.

25 Ways in which these types of issues might be handled are set out in the Clause 12 options to the 2002 Model Form Joint Operating Agreement of the American Institute of Petroleum Negotiators (AIPN).

26 Note also the North Sea Open Permission applies where a party "enters into bona fide negotiations to, or otherwise makes a bona fide decision to, transfer the whole or any part of its rights and obligations".

this mean then that, applying the "straw that broke the camel's back" principle, that somewhere between these limits is a magic point which might be identified as the point at which a specific percentage interest in the asset becomes bona fide? Clearly this is illogical.

**PROBLEMS TO BE SOLVED**

In summary, the risks arising from pre-emption clauses which would cause commercial decision-makers concern are:

- Delay and the consequential loss of deals
- Uncertainty in respect of the operation of clauses
- The risk of technical non-compliance
- The delays and uncertainties arising where valuations must be obtained.

**THE WAY FORWARD**

It seems to me that a company wishing to address these risks has four options:

1. Forget pre-emption clauses completely. As demonstrated from the North Sea experience this can be a valid commercial decision. However it is a decision that cannot be taken unilaterally because the terms of the Joint Venture Agreement must be negotiated with parties who may not be of a like mind.
2. Draft to cover every eventuality. As demonstrated by the cases cited, this is virtually impossible, firstly because of circumstances which will arise that are outside the scope of the clause and secondly, to the delight of lawyers, clauses will always turn on the meaning of particular words. In practice too, this is but one clause to be considered in an agreement; commercial negotiators who are trying to do a deal in a hurry will not want to dwell for long while lawyers debate theoretical situations which might arise many years hence. In addition, I believe this approach only exacerbates the problem as the more detailed the drafting, the more likely a Court is to strictly interpret the clause and thus allow circumstances not expressly covered to escape its operation.
3. Rely on a clause which enables co-venturers to withhold their consent, not unreasonably, to any assignment. There are two schools of thought concerning the place of these clauses in agreements which have pre-emptive rights. The first view, for which I have some sympathy, is that once a party has been through the pre-emption process and no-one exercises their rights, it is unfair and adds further delay to make the offeror go through a second process of obtaining consent from the other participants. The opposing view is that it is essential that each participant has financial and technical capacity to perform its obligations under the licence and the agreement; therefore it is legitimate to object if there is doubt about a proposed party.

   It has been suggested that if the over-riding aim of pre-emption clauses is to keep out "undesirables" then this clause will meet that aim and there is no need for pre-emption, particularly if there are minimum percentage holding provisions which prevent the joint venture from becoming administratively unworkable. [27] What this overlooks is that often parties want to keep out a particular competitor, who may have excellent credentials. In practice the Courts will not closely review the reasons for a party withholding consent[28]. This is still not good enough for some and I have seen wording recently where the existing

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[27] Hung, supra.

[28] *Noranda v Lachlan Resources*, supra, but see *Cyprus Gold & Ors v Top End Mining Ventures* [1990] NTSC 16 where the Judge found that the consent was withheld to obtain "collateral advantages" and this was held to be unreasonable.

venturers have the ability to withhold consent in their "reasonable discretion". Normally a properly drafted pre-emption clause would not be construed as a restraint on alienation at common law[29], but in my view use of stronger wording raises a real prospect of having the clause declared void because it offends that rule.

Finally, it should be noted that in the North Sea context, a clause subjecting assignment to the consent of the other parties would not fit within the definition of "pre-emption arrangements" and therefore the parties are free to agree on whatever wording they wish without having to obtain special permission from the DTI.

4. Instead of drafting in minute detail to cover every possibility, insert a more general clause stating what the intent is. This will invite a Court to follow the creative lead of the Court of Appeal in the *Texas Eastern Corporation* case[30]. I envisage that this would take the form of an over-riding statement of intent that the parties will deal with each other in good faith in offering interests to each other first. Non-exhaustive examples could then be given of the types of transactions that would be caught by the provision. It will take a few brave drafters to head down this path, but I believe in time this is the type of clause most likely to provide the type of liberal interpretation the parties originally intend, that is, an emphasis on substance over form. It should be noted that drafters have already stepped in this direction by adopting the "bona fide" rider in respect of package deals.

## AIPN 2002 MODEL FORM JOINT OPERATING AGREEMENT IN OIL AND GAS JOINT VENTURES

Cátia Malaquias Miles*

The "Joint Operating Agreement" is the standard commercial agreement that governs the relationship between joint venturers in oil and gas exploration and developments.

The Association of International Petroleum Negotiators ("AIPN") has published a 2002 version of its international Model Form Joint Operating Agreement ("2002 Version"), which was first published in 1990 ("1990 Version") and was followed by a revised version in 1995 ("1995 Version"). Like its predecessors, the 2002 Version is the result of a co-operative effort by a number of companies, lawyers, engineers, geologists, geophysicists, accountant and consultants in the oil and gas industry.

In publishing the Model Form Joint Operating Agreement, the AIPN has sought to provide a model for joint venture operations. The model aims to be a flexible one, to accommodate the preferences of individual parties and the different legal regimes that may govern the joint venture operations. It achieves this by providing text alternatives for many of its provisions as well as drafting and guidance notes which call attention to legal issues that may be relevant to the context in which the document is proposed to be used.

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29 *Allstate Prospecting Pty Ltd v Posgold Mines Ltd*, supra; "The Effect of the Rule against Perpetuities on Pre-emptive Rights in Joint Ventures" by P J Allen and R Cottee [1982] AMPLJ 190.

30 Supra at footnote 13.

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