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## Oil price volatility - risks and opportunities in 2015

February 19, 2015 | Written by Stewart Perry

### Update 4 – JV Counterparty distress



The slide and volatility in the oil price over the past few months has been dramatic and whilst many companies will be well positioned to weather the current climate, it has already become clear that there are some players in the industry for whom insolvency is a very real risk.

An important issue to consider is the situation where one party to a Joint Operating Agreement (**JOA**) enters into an insolvency process. Although all JOAs are tailored for the relevant asset, certain standard

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clauses are prevalent throughout the market; we consider some examples of these below by reference to the insolvency of an Operator and a Non-Operator.

## Operator insolvency

Do the other parties have the ability to replace the Operator?

Some standard clauses only use the undefined term “insolvency” as a trigger to replace an Operator. This has a number of meanings (eg *cash-flow insolvency* or *balance sheet insolvency*) and there have been many expensive court battles on what this term means. Ideally, therefore, the parties would rely on other triggers. Some clauses will describe insolvency processes. However, one we recently reviewed did not include *Administration* or *Chapter 11* proceedings, and recent case law would suggest their omission would mean such a process would not trigger a replacement right. Also, what if the Operator enters a process specific to its home jurisdiction? Is the term, for instance, defined to include “or other similar processes wherever situated”? Also, would the insolvency of a parent company trigger a replacement? This will be particularly important if the Operator relies on its parent for funding. The change of control provisions in a JOA we recently reviewed would not be triggered by the *liquidation* of a parent.

If a replacement is possible, what assets will the successor Operator be able to control?

The ability of a court to recognise a distinction between the physical possessor or named owner of an asset, and the beneficial owners, varies around the world. English law, for instance, would recognise the ability of the Operator to hold money on *trust* for the other parties, whilst some other continental European countries would not. If the Operator is validly holding Joint Property on *trust* for the parties, it may be possible to ensure the successor takes control of them. However, if no valid *trust* is created, or the local jurisdiction does not recognise *trusts*, the Non-Operators may be left with only a contractual claim against an insolvent entity (which is likely to be worthless). It may therefore be worthwhile ensuring Joint Property is held in a *trust*-friendly jurisdiction. This is perhaps easiest to arrange for the Joint Account. However, the parties should also ensure the Joint Account is operated in such a way that the *trust* would be given effect. In England, for instance, if the Operator was permitted to comingle the Joint Account funds with his own, this may defeat the *trust*.

What would be the position of a successor Operator in relation to the continuation of any dedicated work force?

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In some jurisdictions, including England, certain insolvency processes automatically terminate contracts of employment. In addition, some jurisdictions (including any member state of the EU) have laws to protect employees such that any successor may also be considered liable for the predecessor's employment contracts and liabilities.

What if the JOA specifically requires the Operator to enter into contracts such that only the Operator can be liable to the contractor?

This may work both ways, such that the contractor has no liability to the other parties. What then if the Operator enters liquidation and the contract contains a non-assignment clause? The Non-Operators may be left with no action against the contractor and may not even be able to rely / sue on that contractor's insurance policy. The contracts may also be terminable by the counterparty on the Operator's insolvency.

Whatever happens to the Operator, the other parties will want to ensure any insurance policies are continued. If a policy is nearing its renewal date this may lend urgency to the appointment of a successor.

## Non-Operator insolvency

What triggers your rights against an insolvent Non-Operator?

In a JOA we recently considered, the trigger for default was only non-payment of sums due. What if nothing is due and that party had a blocking right for any future works? The *liquidation* of that party could effectively stall the project.

What if the JOA includes a provision for the purchase of the defaulter's interest?

In England, if the non-defaulting parties wish to (1) pay less than the market value, or (2) set-off against the market value sums due from the defaulting party, they could be open to challenge as *preferences*, *transaction at an undervalue* or contrary to the *anti-deprivation principle* and advice should be sought.

What risk does this pose to the Operator?

Operators should also be concerned that the value of any indemnity provided by the insolvent Non-Operator is now likely to be worthless. Any clauses seeking to defeat set-off rights of the insolvent entity are also likely to become redundant as statutorily imposed insolvency set-off automatically takes effect.

An insolvent counterparty has the potential to be extremely problematic

if not handled correctly. However, it also provides a possible opportunity to acquire the full rights to a strategic asset. The primary considerations for any JOA partner should be to ensure the documents provide for a rapid and cost free replacement of any distressed Operator and that the continuing JOA partners are given the ability to continue the project if one of its members fails, including the ability to take all the future benefit. Consideration should be given now to any concerns as to the availability of triggers and the location of Joint Property.

Please [click here](#) for our *Insolvency glossary* defining the italicised words above.

This update is the fourth in our series on the impact of oil price volatility. To read the previous update please [click here](#).

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