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Legal update

Joint operations in stormy markets: strategies to mitigate risk arising from joint-operator insolvency

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The uncertainty in the energy sector understandably has oil and gas companies engaged in joint operations and joint venture projects on edge. Oil and gas producers are under tremendous economic stress, and some are teetering on the brink of insolvency. It is to be expected that many will see partners in joint operations and joint ventures enter formal insolvency proceedings, resulting in uncertainty in the ability to collect amounts owed by the insolvent partner. This is true whether the insolvent partner is the operator or a non-operator. It is therefore important to strategically gird oneself so as to be able to respond effectively to the insolvency of a partner in a joint venture or joint operations. In this article, we will identify some of the risks to which participants in joint oil and gas exploration and production operations and joint ventures are exposed when a partner becomes insolvent, and we will consider possible strategies to mitigate those risks, both in the negotiation of new joint venture and joint operating agreements and in instances where such an agreement already exists.[1]

Overview of risk mitigation strategies

There are a variety of measures that partners, including operators, can take to protect themselves from consequences that may arise from having an insolvent partner or (conversely) that non-operating partners can take to protect themselves from the consequences of an insolvent operator. Upon the insolvency of a partner, there are likely to be many competing claims for the same pool of assets, and unravelling the competing priorities of the various secured and unsecured claims on the insolvent partner's assets can be complex. If insolvency proceedings are commenced against the operator, the other partners are at risk of losing funds that were previously advanced to the operator and the operator was holding on behalf of its partners. In addition, non-operating partners will potentially be exposed to liability to third parties for contractual obligations undertaken by the operator for the joint account that have not been fully satisfied. Imposing as many protections as possible into the relevant joint operating or joint venture agreement at the outset, and exercising these protections as soon as possible, can mitigate these exposures to a significant degree.

From a security perspective, if each partner has granted an operator's lien on its working interest in the jointly operated lands (or on its participating interest in the joint venture) to secure its respective joint venture obligations, and that lien ranks first in priority to other security against such interest, the other partners will be able to access the interest of the insolvent partner to remedy defaults with much greater ease. (Of course, there may be restrictions on the parties' ability to grant such security, including under their loan and security documents with other lenders.) If there is no operator's or joint venture lien, or if there is one but it ranks below the security of other lenders, the ability to recoup losses out of proceeds of enforcement is much reduced. In such a case, the ability to enforce other effective remedies in the face of a default becomes even more important, and the partners will want to have the ability to access these remedies before

any insolvency proceedings are commenced (in order to avoid having those remedies stayed under those insolvency proceedings). In addition to provisions granting security or trust interests to protect amounts owing, it may also be possible at the time of negotiation of the joint venture agreement to negotiate additional remedies, such as a buy-out right or a seize-and-sell remedy.

Practically, it is also important to consider the extent of the credit risk against the anticipated capital expenditure profile for the relevant project or assets. For example, if the assets are conventional producing assets and it is not expected that the partners will need to fund significant capital projects to bring the assets into production, it follows that there will be less insolvency risk. These risks can be further mitigated by imposing tight controls over the cash-call process, or by over-funding of cash calls, or (in more extreme cases) by having partners with undesirable credit ratings provide letters of credit supporting their payment obligations related to operations. These matters are discussed in more detail, below.

Contractual provisions to mitigate insolvency risk

In negotiating joint venture agreements, it is important to consider potential risks that can arise if a partner becomes insolvent and include provisions in the agreement that are appropriate given the nature of the joint venture. Some provisions that should be considered are:

Approval of Expenditures – To protect against operator insolvency, ensure the non-operating partners have adequate control over proposed operations and expenditures. In projects involving significant capital expenditures, ensure that non-operator approval is required for annual work plans and budgets, and include provisions to strictly limit the operator’s overspending allowances, both in the aggregate and for individual line items. Where there is no annual work plan and budget, consider requiring the approval of individual authorities for expenditure (AFEs) and, again, include provisions limiting the operator’s authority to spend more than the amount specified in the AFE without additional partner approval.

Funding – Careful consideration should be given to funding provisions. A balance must be struck between, on one hand, requiring sufficient funding to provide the operator with the funds required to conduct approved operations as and when required (and ensuring that all partners are able to fund their respective share of expenditures) and, on the other hand, avoiding funding provisions that will leave surplus joint venture funds in the operator’s account for long periods of time (and thereby exposing such funds to the risk of operator insolvency). The timing of funding obligations (e.g., monthly, quarterly or at irregular intervals on an “as needed” basis) should be matched to the timing of expenditures by the operator, and provisions should be included requiring the operator to return unexpended funds over a specified amount to the funding partner if those funds are not expended on approved operations within a specified period. In addition, the agreement should require the provision by each partner of adequate security (such as a stand-by letter of credit from partners with a credit rating below a pre-defined acceptable level) to secure funding by such partner of its respective share of such costs – particularly where the nature of the joint venture project requires significant financial commitments.

Trust and Commingling of Funds – Establish a trust in favour of the non-operating partners for joint venture funds held by the operator. This would cover funds received by the operator from the partners as well as joint venture revenues received by the operator. To provide the best protection of joint venture funds from operator insolvency, the operator should be expressly prohibited from commingling joint venture funds with the operator’s own funds, and a separate bank account should be established to hold joint venture funds. Adequate monitoring to ensure the operator is actually following these steps may also be required to ensure that the protection afforded by this trust structure is not lost. Many operators balk at taking on the additional administrative burden of holding joint venture funds in separate accounts and prefer the administrative efficiency of commingling funds. This commingling may make it impossible to identify the funds held for the joint account, thereby possibly defeating the partners’ trust claim to those funds. It should be noted that the Canadian Association of Petroleum Landmen (CAPL) model Operating Procedures specifically permit the operator to commingle its own funds with funds received for the joint account, although the 2007 and 2015 forms of the Operating Procedure provide that the right to commingle funds may be terminated by the non-operating partners where the operator is subject to specified insolvency events and cannot be immediately removed as operator. Timely exercise of this right is critical.

Joint Venture Lien – Each partner should grant to the other partners a lien, ranking in priority to all other encumbrances on such partner's working interest and production from the joint lands or joint venture interest, as applicable, to secure such partner's proportionate share of joint venture costs, expenses and liabilities. Where practical, this joint venture lien should be registered as a security interest. The joint venture agreement should include language pursuant to which each partner grants to each other partner a power of attorney authorizing each other partner to exercise the lien and any other remedies set out in the joint venture agreement in the event of a default by the granting partner.

Take in Kind – Agreements relating to production should grant to the partners the right to take their proportionate share of production in kind and, where the operator appears to be at imminent risk of insolvency, partners should exercise their right to take in kind as soon as possible. If partners permit the operator to sell production on their behalf and the operator enters into a formal insolvency proceeding, the ability of partners to subsequently take their production in kind following the commencement of such insolvency proceedings may arguably be prevented by the stay that arises by virtue of such proceedings.

Marketing Production – Where the operator is permitted to market product on behalf of the joint venture, the non-operating partners should be entitled to approve the contractual terms (e.g., price, contract term, renewal rights and credit provisions applicable to the buyer).

Events of Default and Cure Periods – Include in the agreement a detailed list of breaches and financial events that entitle the other partners to issue of a notice of default, and if unresolved, exercise remedies. Events of default should include all the standard defaults (such as breach of the agreement, failure to pay amounts as and when due, and the creation of a lien over joint venture interests), but additionally consider including cross-defaults under other agreements (e.g., credit facilities and other material agreements), insolvency events, and a drop in credit rating (unless acceptable security is provided within a specified time period). For specific financial defaults (e.g., insolvency events, failure to pay material amounts, failure to provide required security), remedies should be exercisable either immediately or very quickly. Include short notice and cure periods for financial defaults, and specify that remedies are exercisable immediately upon the occurrence of events of insolvency.

Remedies on Financial Default or Insolvency – The joint venture agreement should provide for a suite of remedies, any or all of which may be invoked by the non-defaulting partners upon financial default or insolvency of a partner, including:

- the right to set-off the defaulting partner's share of proceeds of production or joint venture revenue against amounts owed by the defaulting partner, the right to charge interest on outstanding amounts owed by the defaulting partner, and the right to institute claims against the defaulting partner for amounts owing and the costs of enforcing such rights;

- if the defaulting partner is the operator, permit the immediate removal and replacement of such partner as the operator;

- suspend the defaulting partner's right to vote on joint venture matters until the default is cured;

- provide for an optional "buy-out" remedy whereby non-defaulting partners are entitled to buy out the defaulting or insolvent partner's interest free and clear of all encumbrances for an amount equal to the fair market value of its interest, discounted by an appropriate percentage, with proceeds of such sale first going to satisfy amounts due and owing by the defaulting partner to the joint venture;

- permit the operator (or, where the operator is in default, any other partner) to take possession of the defaulting partner's interest, with the right to sell any or all of such interest to off-set amounts owed by the defaulting partner; and

- make the defaulting partner responsible for any and all reasonable costs and expenses incurred by the non-defaulting partners in exercising their rights and enforcing their remedies as a result of the default or insolvency of the defaulting partner.

It should also be specifically provided that all remedies may be exercised by a non-operator if the operator is the partner that is insolvent or in default.

Credit Support – Establish that each partner's responsibility for any third-party credit support is limited to its respective joint venture interest and, if guarantees are required to be provided to a third party, provide that a letter of credit in lieu of a guarantee is required to be provided by any party whose credit rating drops below a specified acceptable level.

Oversight – Reporting and approval requirements are perhaps the most important means for non-operators to mitigate the risks attendant on operator insolvency. In addition to budget and expenditure approvals discussed above, the agreement should limit the scope of the commitments being made by the operator for the joint account by requiring partner approval for contractual commitments over specified amounts or terms and for non-arm's length contracts. Periodic reporting requirements should be included and should cover results of operations, financial reporting (including information on delinquent accounts receivable and accounts payable), regulatory matters and other issues material to the partners. For large joint venture projects, consider including provisions in the agreement granting non-operating partners the right to second employees to the operator. Seconded employees often have greater visibility into operational and financial matters impacting the operator and the joint venture.

Risks: implications of CCAA or receivership filings

Whether a producer is a non-operating working interest partner or the operator in a joint venture, it is important to consider the implications of a counterparty entering insolvency and to ensure that one has positioned oneself to rank as highly as possible in the ranking of creditors with respect to whatever claims might be advanced against the insolvent counterparty.

Obviously, whether in the context of a CCAA proceeding or a receivership proceeding, it is critical that partners have as much security as possible (including an operator's lien or a joint venture lien) with respect to the defaulting partner's outstanding obligations. It is also important that the insolvent partner be given as little opportunity as possible to control the cash, production, and other assets of the other partners, which is particularly an issue where the insolvent partner is the operator. As noted above, it is critical that trust relationships be established wherever possible and appropriate procedures be implemented to ensure that interests held in trust can be clearly identified in the event of insolvency, as the claims of partners to funds and other assets that are determined to be held in trust by the insolvent partner on behalf of the joint venture will be given priority over the claims of the insolvent partner's other creditors (even secured creditors) to such assets. Thus, a non-operating partner will want to ensure that joint venture funds are held by the operator in trust in a separate account without being commingled with other operating funds, so that the non-operating partners' trust interests in those funds can be established in the event of the operator's insolvency.

Caution is also required when it comes to permitting the operator to market production or other joint venture products on behalf of the joint venture or its partners. If the operator markets the production or other joint venture products and enters insolvency proceedings while in possession of sale proceeds attributable to its partner's respective interest, it may be difficult to establish the partner's claim to those proceeds. Further, the stay that arises at the commencement of CCAA or other insolvency proceedings may prevent partners from electing to take their proportionate share of production or joint venture products in kind.

Similarly, partners need to be vigilant where a non-operating partner is on the brink of insolvency. In such a case, while the other partners may have lien rights against the non-operating partner's assets for unfunded operating expenses under the joint operating agreement, such lien rights may be subordinate to other security, and may therefore have little or no value. A letter of credit and the right to make frequent cash-calls in advance would be much preferred.

Conclusion

Sometimes platitudes should be heeded. In today's economy, it really is better to be safe than sorry. Risk awareness coupled with strategies to protect oneself are vital. In addition to ensuring that these various protections are included in the joint operating agreement, it is equally important to invoke these protections as soon as possible to ensure that their benefit is not lost as a result of contractual rights being stayed by an insolvency filing. Armed with the strategies identified above, parties to joint venture agreements can enter fruitful partnerships, while simultaneously being adequately prepared for a worst case scenario.

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Footnote

[1] While we recognize that, in the Canadian oil and gas industry, the term "joint operations" is typically used to describe the relationship between parties that hold working interests in the same conventional production assets and the term "joint venture" is typically used to describe joint ownership of projects such as midstream facilities, alternative energy projects and oilsands facilities, since many of the same principles apply to joint operations and joint ventures, for simplicity and ease of reference, in this article we refer to joint venture agreements (including construction, ownership and operation agreements) and joint operating agreements generically as "joint venture agreements," to the parties to such agreements as "partners," and to the joint venture or joint operating relationship as a "joint venture."

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