

KALEIDOSCOPE

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Why International Oil Companies Choose to Enter into Joint Operating Agreement

Introduction

This essay brings forth the nature of Joint Operating Agreement's (JOA) and its key features. The key features of JOA answer the question so as to why do powerful players as international oil companies choose to enter into such agreements. JOA's are used in capital intensive resource industries by those companies who want to restrict their exposure, particularly in limiting cost or liability. Investmental forethought necessitates a mix of participants who contributes towards financing, intelligence, access to market and access to project itself.

The usual form of association establishing the framework within which exploration for, and exploitation of, resources takes place is the JOA which is often considered to be a form of joint venture. The JOA can be considered the joint venture *par excellence* as its structure is found in most contractual joint ventures.¹

Joint ownership of an oil and gas interest can be created through several factual scenarios.² The most common is when owners of respective oil and gas leases pool their interests³ to meet a standard spacing unit that is legislatively prescribed.⁴ Furthermore, another common reason for joint ownership is the economic risk of an unprofitable well.⁵ Mineral depletion has required investors to drill deeper than ever before to obtain production.⁶ This type of drilling operation is an expensive undertaking.⁷ As a result of these costs even the largest companies will seek a joint investor to share the risk and cost of

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¹ Bean, G. M. D.: *Fiduciary Obligations and Joint Ventures*. Oxford, 1995. 3–4.

² Kuntz, E. O. et al.: *Oil and Gas Law: Cases and Materials*. St. Paul (MN.), 3rd ed., 1999. 622. (providing a basic overview of joint ownership and the issues created as a result of multiple ownership).

³ Lowe, J. S.: *Oil and Gas Law*. Eagan (MN), 3rd ed., 1995. 437–438.

⁴ *Ibid.*

⁵ Kuntz: *Oil and Gas Law... op. cit.* 622.

⁶ Hazlett, G. W.: Drafting of Joint Operating Agreements. *Rocky Mountain Mineral Law Institute*, 3 (1957), 277.

⁷ Kuntz: *Oil and Gas Law... op. cit.*

drilling.⁸ These risks are often leveraged by sharing them through joint development agreements, the most common being the JOA.⁹ When investors or operators are considering entering into a JOA there are numerous issues to be considered.¹⁰ A well designed JOA will clearly define each of these issues and will cater to the individual needs of the parties.¹¹ Examples of issues that need to be addressed include: who will act as the operator, what acreage will be covered by the agreement, the distribution of production profits, and how the costs of exploration will be divided among the parties.¹² Failure to properly address any of these important issues could mire the parties of the JOA in expensive and lengthy litigation.¹³ One oil and gas author has cautioned drafters by stating that the cost of correctly drafting “a thousand different agreements may be nominal in comparison to the cost to their client of a major deficiency” leading to litigation.¹⁴

JOAs are commonly created on a standardized form that the parties modify.¹⁵ The American Association of Petroleum Landmen (A.A.P.L.) first developed a model form operating agreement in 1956.¹⁶ This standardized form was created in an attempt to give basic guidance to the attorneys that are involved in negotiation of the development agreements between operators and non-operators.¹⁷ Generally, the operator will be responsible for the day-to-day production duties and the non-operator will only share in the costs and profits from the production.¹⁸ The operator traditionally is a sophisticated party with extensive experience in the oil and gas industry. Therefore, the JOA will generally grant the operator broad rights in production decisions.¹⁹ Typically, operators have a large financial investment in the development and production process.²⁰ Thus, they will commonly make decisions that will benefit both parties.²¹ It is when the interests of the operator and the non-operator diverge that the issue of duty arises between the parties.

1. Scope of the JOA

JOA typically involves two or more legal persons combining property and expertise to carry out a single business enterprise in which they have a joint proprietary interest a joint right to control and share profits and losses.²² Conceptually, a JOA comprises the “constitution”

⁸ Hazlett: Drafting of Joint Operating Agreements. *op. cit.* at 277.

⁹ *Ibid.*

¹⁰ Kuntz: *Oil and Gas Law... op. cit.* at 622.

¹¹ Hazlett: Drafting of Joint Operating Agreements. *op. cit.* at 279–280.

¹² Eyring, H. J.: Comment, The Oil and Gas Unit Operator’s Duty to Nonoperating Working Interest Owners. *Brigham Young University Law Review*, (1987), 1293, 1294–1297.

¹³ *Amoco Prod. Co. v. Wilson*, 976 P. 2d 941, 941 (Kan. 1999). When one considers the attorney fees and legitimate costs that were expended by all of the parties to this litigation, it readily shows the importance of properly drafting a joint operating agreement.

¹⁴ Hazlett: Drafting of Joint Operating Agreements. *op. cit.* at 279–281.

¹⁵ *Ibid.* at 278.

¹⁶ Kuntz: *Oil and Gas Law... op. cit.* at 623.

¹⁷ Hazlett: Drafting of Joint Operating Agreements. *op. cit.* at 278–280.

¹⁸ Eyring: Comment, The Oil and Gas Unit Operator’s Duty... *op. cit.* 1293.

¹⁹ Kuntz: *Oil and Gas Law... op. cit.*

²⁰ *Ibid.*

²¹ *Ibid.*

²² *Maliss v. Bankers Trust Co.*, 717 F 2d 683 (1983).

which governs the joint venture, akin to partnership or to the “Memorandum and Article of Association” of a company.²³ JOA’s is typically specific that among the parties the relationship is one of tenants in common and not one of partnership.²⁴ JOA is a specified project hence it is clearly defined and limited in scope.²⁵ A JOA is often preceded by a joint binding agreement or an area of mutual interest agreement (AMI) such agreement seeks to facilitate co-operation between oil companies and prevents them from undertaking activities with others. The area of mutual interest is often incorporated as a term of JOA.²⁶ Moreover, the limited scope of a JOA is vital in setting limits to the co-ventures’ potential fiduciary duties.²⁷

2. The parties to a JOA

JOA can only fully exist when there is a degree of surrendering of control. For that reason the choice of co-ventures’ is very vital. The free choice of a partner is important because it involves the trust and confidence of other parties; this is called *delectus personae*.²⁸ This free choice of associates in JOA is very significant as it involves a longterm relationship and enormous amount of financial contributions by each member. Pertinently, JOA’s places restrictions on the sale of interests in the venture to outsiders. This type of *delectus personae* forms the basis of mutual trust which in turn gives rise to the collaborative fiduciary relationship and corresponding fiduciary responsibilities on the co-venture.²⁹ Furthermore, this kind of participation in management of the venture brings to light the abilities and performance of each co-venturer. Moreover, under JOA it is the percentage of interests which determines each party’s entitlements to ownership and benefits, liability to cost, expenses and risks.³⁰

3. Property Interest

Common ownership of assets is a feature of joint venture, it amplifies the sharing of risk, makes the relationship more intimate. In an incorporated joint venture, corporation is owned by the co-ventures’ and they own the assets indirectly whereas in a contractual joint venture the assets are owned as tenants in common.³¹ A co-venturer has different proportional interest in the assets and they arrange separate funding of its interest in the JOA, and also

²³ Taylor, M. P. G.–Winsor, P. P.: *The Joint Operating Agreement: Oil and Gas Law*. London, 1989.

²⁴ Model Clause 42 (5) Petroleum (Production) (seaward Areas) Regulations 1976 (S.I 1976/1129).

²⁵ Harding Boulton, A.: Finance in the “single venture” Consortium. *Journal of Business Law*, 1961, 368.

²⁶ *Great Northern Petroleum and Mines Ltd. v. Merland Explorations Ltd.* (1983) 43 AR 128, 130 (Alta. Sc).

²⁷ Bean: *Fiduciary Obligations and Joint Ventures*. *op. cit.* at 12.

²⁸ Shaw, S.: Joint Operating Agreements. In: David, M. R. (ed.): *Upstream Oil and Gas Agreements*. 1996. chapter 2, 16.

²⁹ Bean: *Fiduciary Obligations and Joint Ventures*. *op. cit.* 11.

³⁰ *Maliss v. Bankers Trust Co.* *op. cit.*

³¹ *BP Exploration Co (Libya) Ltd. v. Hunt* (No. 2) (1982) 1WLR 925.

give security to its lender over its interest in the assets.³² Pursuant to JOA, co-venturers' have interest in the mutual undertakings which form choose in action.³³ Under jurisdictions where co-venturers' agree not to *partition* their interest strengthens the ties between the co-venturers' and the *delectus personae*.³⁴ A joint venture entails common ownership where in the parties contribute to the venture both in terms of services and finances which are used for production purposes, which creates mutual reliance and keeps the contribution forthcoming.³⁵

4. The Operator

The Operator is in regard to other joint ventures than joint operating agreements often known as the manager. In a JOA, the parties will appoint an Operator to act on the behalf of the joint venture. Efficiency demands that one person conducts the operations rather than each exercise its separate rights.³⁶ The Operator plays a key role in taking the work forward by proposing budgets and plans and running meetings. *Also it acts* as the agent of the parties in relation to third parties, including government liaison with the consent of the other parties.³⁷ As a party to the JOA, the Operator has the liabilities as the other parties; i.e. its percentage interest share of joint obligations.³⁸

5. The Operating Committee

The committee exercises over all control of, the joint operations in four stages: exploration, appraisal, development and production.³⁹ It is composed of co-venturers or their representatives.⁴⁰ Decisions are usually made on the bases of majority votes, the percentage is specified in the JOA.⁴¹ A co-venturers voting right is in proportion to its interest. The Authorization for Expenditure (AFE) is granted by the committee. The collaborative fiduciary relationship levy's fiduciary constrains on co-venturers in voting, thus where such constrains apply co-venturers are to act honestly and in best interest of the venture. The courts determine this requirement by taking into consideration the motivations of the co-venturers'.⁴²

³² Willoughby, G. D. M.: Financing the Development of the North Sea Oil Fields. *Law Society Gazette*, 72 (1975), 10.

³³ Bean: *Fiduciary Obligations and Joint Ventures*. *op. cit.* at 13.

³⁴ Forbes, J. R. S.—Lang, A. G.: *Australian Mining and Petroleum Laws*. 2nd ed., Sydney, 1987. para. 1907.

³⁵ *Page One Records Ltd. v. Britton* (1968) 1 WLR 157.

³⁶ *Jefferys v. Smith* (1820) 1 Jac. and W 298, 302-3:37 ER 389, 390–391.

³⁷ *Maliss v. Bankers Trust Co.* *op. cit.*

³⁸ *Ibid.* 17.

³⁹ Taylor, M. P. G.—Tyne, S. M.: *Taylor and Winsor on Joint Operating Agreements*. 2nd ed., London, 1992.

⁴⁰ *Ibid.*

⁴¹ Bean: *Fiduciary Obligations and Joint Ventures*. *op. cit.*

⁴² *Ibid.* at 17.

6. Fiduciary Duties

When the operator in trust for the parties makes profit for the parties or performs a job, the operator shall be subject to fiduciary obligation.⁴³ It is pertinent to note that a fiduciary relationship affects the relationship of that other person in a legal or practical sense.⁴⁴ Consequently under the JOA the operator has the following obligations:⁴⁵ to disclose any personal interest that he may have in the property, account for the money invested, to exercise the account procedure in accordance with the principles of JOA, to protect and maintain the property without misuse and finally not to misuse the information imparted.

7. Default Clause

In a JOA a project is funded by the operator making calls upon the co-venturers to advance their respective shares of the expenditure in accordance with the terms of their agreements.⁴⁶ Where a party fails to meet a call and causes a default, JOA provides that non-defaulting parties take up the short fall pro rata.⁴⁷ Various sanctions can be applied on the defaulter including loss of voting rights or of product rights and ultimate abetment or more drastically, forfeiture of its interest.⁴⁸

8. Sole Risk and Non-Consent provisions

Joint ventures are seldom an association of equals.⁴⁹ Therefore leaves enough room for diverging opinions. In order to avoid such conflicts “Sole Risk” and “Non-Consent” clauses are included in the JOA. A participant who has voted for a program but has been overruled by the majority and still wishes to proceed with the program represents the classic “Sole Risk” situation. The second situation where a dissenting participant does not wish to participate in the majority approved program—is generally referred to as “Non-Consent”. The function of these clauses is to allow those co-venturers’ who wish to proceed with certain work to do so without dissenters. Effectively, a sole risk project redefines the scope of the venture. The wells developed under this clause fall into the ambit of a sub-venture, the venture consist of those who join in it. So, also a non-consent operation can be treated as a sub-venture of a larger kind. The sole risk parties share the risk, costs and rewards of the operation between themselves in proportion to their interest in the sole risk venture. On occasions when such a venture is successful others can join upon paying a substantial premium, whereas under a non-consent venture late participation is possible with or without the payment of premium, depending on the provisions of the JOA.

⁴³ *Reading v. R*, 2KB 232 (1949).

⁴⁴ *Hospital Products Ltd v. United states Surgical Corporation and others*, 55 ACR 417, 454. (High Ct. Australia 1984.)

⁴⁵ *Boulting v. Actat*, 2QB 606 I All.E.R 716 (1963).

⁴⁶ Smith, E. E.: International Petroleum Development Agreements. *Journal of Natural Resources and Environmental Law*, 8. (1993), 62.

⁴⁷ *Ibid*.

⁴⁸ *Mosaic Oil NL v. Angari Pty Ltd*. (No. 2) (1990) 20 NSWLR 280 (NSW SC).

⁴⁹ See Black, A. J.—Dundas, H. R.: Joint Operating Agreements: An International Comparison from Petroleum Law. *Journal of Natural Resources and Environmental Law*, 8 (1992).

Conclusion

Joint venture embodies an agreement between the parties for an enterprise created for a single project, involving a sharing of project risk. Together with the participation in the management and control of the venture, the co-venturers' contribution creates a common interest in the success of the project. The JOA is widely used as a legal structure for natural resource exploration and development.⁵⁰ There is co-ownership of property of the venture and input in its management. The fact that the venture is limited to a defined geographic area as it sets the boundaries of relationship between the co-venturers'. The JOA's main difference from the joint venture is the possibility of sub-ventures being formed through the sole risk and non-consent operations. JOA's are the contractual nexus balancing exploration and production expectation interests against conflict with a particular regulatory regime. JOA is a flexible document that can be moulded to meet expectations and desires of parties. It encourages exploration and development, while neither forcing a party to participate inexpensive risk venture non-prohibiting a party from prospering and conducting ventures when the requisite operating committee pass mark vote is not attained. JOA offers the oil and gas industry a flexible, well written document to govern international oil and gas operations.

⁵⁰ Reagan, P. W. O.—Taylor, T. W.: Joint Ventures and Operating Agreements. *Victoria University of Wellington Law Review*, 14 (1984), 85, 87.