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INSIGHTS

JOAs and the Operator's "blank cheque" – UK Court of Appeal upholds decision on budget overruns

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*By: **John Gilbert** and **Robert Meade***

The UK Court of Appeal in ***Spirit Energy Resources Limited & Ors v Marathon Oil U.K. LLC [2019] EWCA Civ 11*** has affirmed the February 2018 decision of Mr Justice Robin Knowles of the High Court.*1* Knowles J's decision concerned the ability of the operator under a North Sea JOA to call on the non-operating participants to fund a pension deficit in circumstances where the exact amount of the deficit had not been foreseen or approved by the operating committee.

This is an important decision for the industry which has application beyond liability for pension deficits and which considers the operation of clauses commonly found in JOAs and UUOAs.

The key points arising from the decision are:

1. Contractual interpretation requires the "*natural and ordinary meaning*" of the words of the JOA to be ascertained by reference to the individual clauses in question, the JOA as a whole, and a purposive construction of the JOA taking into account and applying the principles which the parties have expressly incorporated.

2. The courts will attach weight to express language setting out guiding principles to facilitate a purposive construction, such as an agreement that the Operator under a JOA should be held neutral and neither suffer a gain nor a loss.

3. Where the JOA permits programmes and budgets to be submitted on the basis of estimates and the operating committee approves the work and expenditure contained therein, the amount of that work and expenditure is inherently uncertain and subject to change. Absent express language to the contrary, such approval therefore authorises an operator to write a cheque to cover those amounts, whatever they might turn out to be.

CASE SUMMARY

Who were the parties?

The appeal was brought by Spirit Energy Resources Limited (formerly Centrica Resources Limited), Taqa Bratani Limited, and Taqa Bratani LNS Limited (the "**Participants**"). The Appellants were all non-operating participants under a JOA and UUOA concerning the Brae

Fields in the North Sea.

The respondent was Marathon Oil U.K. LLC, which was appointed as the Operator under the JOA and UUOA (the "**Operator**"). The Operator also held a participating interest in the JOA and the UUOA.

What was the dispute about?

The dispute concerned the ability of the Operator to charge the Participants their appropriate share of deficit recovery charges ("**DRCs**") in respect of a defined benefit pension scheme of which staff employed by the Operator (through an affiliate) were beneficiaries.

Knowles J's judgment held that:

"*the Participants had approved the incurring of the disputed pension costs by virtue of the inclusion in the [Brae Management Plans] of operations which were approved and the consequential expenditure authorised. They were therefore precluded from subsequently withholding approval and refusing to pay their allotted proportion of the DRC. This applied even if the extent of the deficit was not foreseeable at the point in time of approval of the peratins.*"[2]

In reaching this decision, the High Court found that: (a) the relevant programmes and budgets had been approved by the Participants; (b) the employees in question were properly employed for the purpose of the operations; (c) the pension arrangements of the employees were properly agreed; and (d) the Participants were aware of the possibility of a deficit arising.[3]

What were the key issues for the Court of Appeal to decide?

The Participants sought to overturn the decision of Knowles J by seeking a declaration that:

1. they were not liable for any part of the DRC absent a decision of the Operating Committee approving the DRC as part of a programme and budget; and

2. the members of the Operating Committee cannot be compelled to give that approval.

In deciding whether to grant the appeal, the Court of Appeal was required to determine the proper operation of a number of the provisions of the JOA.[4] In particular, those which provided for the: right of the Operator to conduct operations; oversight by the Operating Committee; prior approval of operating programmes and budgets; authorisation of expenditure by the Operator; Participants to bear the costs incurred by the Operator; and principles governing the accounting for costs and expenses incurred by the Operator.

What was the result?

The Court of Appeal unanimously dismissed the Participants' appeal.

Delivering the leading judgment, Lord Justice Green stated that the appeal concerned a "*short point of construction of the JOA*" and applied the English law principles of contractual construction as set out by Lord Neuberger in ***Arnold v Britton***.[5] This required the "*natural and ordinary meaning* " of the words of the JOA to be ascertained by reference to: (a) the individual clauses in question; (b) the JOA as a whole; and (c) a purposive construction of the JOA taking into

account and applying the principles which the parties have expressly incorporated.

Following a forensic analysis of the language of the JOA, Lord Green concluded that "*the normal and ordinary meaning of the JOA, including by reference to its purpose, compels the conclusion that the Participants must bear the DRC*".[6] Emphasis was placed on the mandatory and all-encompassing nature of the language used (i.e., the use of the words "*shall*" and "*all*") and the fact that the JOA included express language setting out guiding principles to facilitate a purposive construction (including that the Operator should be held neutral and neither suffer a gain nor a loss). Lord Green said that where the parties have taken such an approach "*it is incumbent upon the courts to attach weight to that expression of interest*".[7] In addition, Lord Green found that the JOA expressly permitted the operating programmes and budgets to be based on estimates, reflecting that "*work and expenditure approved and authorised by the Operating Committee is, by its nature, uncertain and prone to change*."[8]

Lord Green also considered the overarching commercial purpose of the JOA. He dismissed the Participants' arguments in this respect on a number of grounds, including that the JOA must be construed through the optic of the guiding principles agreed on by the parties themselves. That being the case, Lord Green was unpersuaded that the suggestion that the Participants could take the benefit of the work conducted by the Operator's employees (which had been approved) but not take the burden of the DRC "*could ever be considered commercially rational in the context of an agreement of this sort*".[9]

Finally, Lord Green dismissed the Participants' arguments that the High Court's decision conferred upon the Operator a "*blank cheque*", allowing it to spend with impunity. Although it might be the case that a blank cheque was given, Lord Green found that it was subject to a number of controls. First, the ability of the Operator to write cheques and expenses was contingent on it first having received the authorisation of the Operating Committee via the approval of operating programmes and budgets. Second, absent express language to the contrary, such authorisations covered costs which, at the time of approval, might be uncertain and so the authorisation permitted the Operator to write a cheque covering the amounts, whatever they might turn out to be. Third, the Operator in this case accepted that the common law implied a duty on it to exercise its contractual discretion genuinely, honestly and in good faith.

What conclusions can be drawn from this case?

The Court of Appeal's decision is an example of the application of the English law of contractual interpretation and acts as a reminder of the proper test to be applied. It will likely be of interest to parties to joint operating agreements across the oil and gas industry, whether operators or non-operators.

As is so often the case, the decision turned on the specific language used and the underlying factual circumstances. The result might have been different, for example, if the JOA contained an express provision allowing for limited budget overrun (as it did in respect of decommissioning expenditure). Nevertheless, it comments on language and principles common to many JOAs and UUOAs, in particular those based on the UK model, and provides guidance on their application.

[1] ***Marathon Oil U.K. LLC -v- Centrica Resources Limited & Ors [2018] EWHC 322 (Comm)***

[2] Paragraph 9 of the judgment of Lord Justice Green in the Court of Appeal.

[3] Ibid at paragraph 25.

[4] The JOA and the UUOA were materially identical and so both the High Court and Court of Appeal judgments focus on the terms of the JOA.

[5] [2015] UKSC 36, at paragraphs 14 – 23.

[6] Paragraph 41 of the judgment of Lord Justice Green in the Court of Appeal.

[7] Ibid at paragraph 40.

[8] Ibid at paragraph 17.

[9] Ibid at paragraph 45.