Enforcement of JOA forfeiture provisions following the Supreme Court decision in *Cavendish Square Holdings B.V. v. Makdessi* [2015] UKSC 67

Parties to Joint Operating Agreements ("JOAs") have long been concerned about the risk that the default provisions might prove unenforceable, on the basis that they constitute penalty clauses. Those drafting JOA default provisions have struggled to balance a desire for strong remedies against defaulting parties, with the need to ensure provisions are enforceable. As a consequence, model form JOAs have increasingly included more nuanced default provisions, including call options (at an undervalue) and withering provisions. These have generally come to be regarded as less likely to fall foul of the rule against penalty clauses than simple forfeiture clauses. The recent Supreme Court decision in *Cavendish Square Holdings B.V. v. Makdessi* [2015] UKSC 67 has recast the test for penalties in such a way as to reduce this anxiety and to increase the latitude of parties to agree remedies for default. Risks on enforceability remain, but, in general, JOA default provisions may now be less likely to be deemed unenforceable on grounds that they are a penalty.

Long standing concerns

For centuries, English common law has prohibited the enforcement of "penalty" clauses. Prior to the decision in *Cavendish* (a case in which Clifford Chance acted), the most recent authoritative statements of the tests for identifying penalty clauses stemmed from the House of Lords decisions in *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (in 1905) and *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* (in 1915). These cases emphasised that clauses providing for payment on default would constitute penalties if the specified remedy was extravagant and did not reflect a genuine pre-estimate of the innocent party's loss resulting from the breach.

The rule against penalties has caused significant concern when drafting JOAs. This is because the rule put into question the sorts of decisive remedies preferred by non-defaulting parties. Default under a JOA is rightly regarded as a serious matter. The unincorporated joint venture model creates significant risks for non-defaulting parties if they are saddled with an unreliable JOA partner. The costs associated with exploration and production are very large and it is not reasonable or commercially viable that a party in significant or sustained default of cash calls is allowed to tag along indefinitely.

From a commercial perspective, therefore, parties have developed a very strong preference to be able to eject a defaulting party. In its simplest manifestation, a JOA default provision may achieve this objective by stipulating that (after expiry of a specified default period) the defaulting party will forfeit its entire interest under the JOA if required by the other parties to do so. This is the default option under the AIPN Model Form JOA, which provides as follows:

"*If a Defaulting Party fails to fully remedy all its defaults by the thirtieth (30th) Day of the Default Period…. then, without prejudice to any other rights available to each non-defaulting Party to recover its portion of the Total Amount in Default, at any time afterwards until the Defaulting Party has cured its defaults any non-defaulting Party shall have*

the option, exercisable in its discretion at any time, to require that the Defaulting Party offer to completely withdraw from this Agreement and assign all of its Participating Interest….."

In light of the rule against penalties, however, bald forfeit clauses such as that above rightly came to be regarded as risky to enforce. At first blush, it is difficult to see how a clause requiring a defaulting party to relinquish its entire interest could meet the pre-estimate of loss test in circumstances where the range of possible breaches is unknown. Applying a pure forfeiture clause, a party in default might be required to relinquish an interest worth many millions of dollars on grounds that it has defaulted on a cash call for a fraction of that amount.

In recognition of this risk, the industry has developed more nuanced alternatives to the forfeiture clause. The principal alternative models adopted are:

1. An option to buy out the defaulting party's interest at an undervalue. In the formula adopted in the AIPN Model Form JOA, non-defaulting parties have the right to require the party in default to sell its entire interest in the JOA to such of the non-defaulting parties who wish to buy the interest. If the exercise price is not agreed, it can be determined independently, based on the fair market value ("FMV") of the interest, less the amount of any unpaid cash calls, less a percentage of FMV. The parties can negotiate the amount of this discount to FMV (10% is a typical figure) but in doing so, they again ran the risk of such a clause being deemed to be a penalty. There has been no concrete means of determining the extent of discount that would constitute a penalty.
2. Withering provisions, which are a modified form of forfeiture clause, in which the extent of the interest required to be transferred by the party in default will depend, among other things, on the extent of that party's investment in the project to date. In general, the greater the aggregate level of investment it has made to date, the less the party in default will be required to forfeit to the other parties. The clause is therefore intended to create some link or proportionality between the default and the real consequences for the defaulting party. But again, this structure has suffered from a lack of certainty as to how proportionate this mechanism is required to be, in order to avoid constituting a penalty.

These alternatives represent pragmatic efforts to avoid the blunt effects of the forfeiture clause. But even these provisions have not been regarded as immune to the rule against penalties, especially in light of the longstanding "pre-estimate of loss" test.

Clarification of the penalty clause rule

Against these long-standing concerns, the Supreme Court's decision in *Cavendish* represents both good news and bad news.

The bad news is that the rule against penalty clauses remains. There had been optimism in some quarters that the *Cavendish* decision would effectively consign the penalty clause rule to history. Moreover, the Supreme Court has confirmed that an obligation to transfer assets (e.g. at an undervalue or for nil consideration) can constitute a penalty clause just as much as an obligation to pay monetary "damages". Following the *Cavendish* decision, any clause that imposes pre-determined consequences for breach of contract will be a penalty clause, if it constitutes a secondary obligation (i.e. is a pure remedy for breach) "*which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest*" pursued.

More helpfully, however, the Court has substantially recast the test for identifying penalty clauses.

Firstly, the Supreme Court has confirmed that "*[t]he fact that the clause is not a pre-estimate of loss does not ... at any rate without more, mean that it is penal.*"

Further, a clause will only constitute a penalty if it is a secondary obligation (i.e. a pure remedy for breach). A clause constituting a primary obligation cannot, by its nature, constitute a penalty clause. This distinction is especially relevant for alternative style forfeiture clauses which entitle non-defaulting parties to buy out the defaulting party at an undervalue. In the *Cavendish* case, the Supreme Court determined that a clause specifying a discounted price at which a party could acquire the shares of the defaulting party constituted a primary obligation and could not, therefore, amount to a penalty.

The Supreme Court also placed emphasis on whether the clause in question serves an ostensible and legitimate commercial purpose. For the avoidance of doubt, simply punishing the defaulting party is not to be regarded as a legitimate commercial purpose. But there may be many other kinds of legitimate commercial purposes that are well served by a clause that imposes a detriment on the party in breach.

The Supreme Court also added two further useful points of clarification:

1. *Firstly*, a clause does not offend the rule against penalties simply because it is intended to deter another party from breaching its primary obligations. It seems that deterring breach is a legitimate commercial objective and, in this regard, a clause having deterrent effect is no different to a contractual inducement.
2. *Secondly*, the Court concluded that "*[i]n a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.*"

Implications for forfeiture clauses

On balance, the new guidance for identifying penalty clauses would appear to reduce the risk that JOA forfeiture clauses will fall foul of the penalty rule. Parties seeking to enforce such clauses will now be less concerned about the rule on pre-estimation of loss, and will seek to stress:

1. That the forfeiture clause serves the legitimate commercial interest of ensuring that parties can avoid the liabilities and uncertainties of continuing a costly and high-risk joint venture with an unreliable joint venture partner (this argument has the virtue of being true in most instances, in so far as it reflects the predominant reason why parties are in favour of various species of forfeit clauses).
2. That JOAs are sophisticated agreements that are invariably the product of arm's length negotiation between well advised parties.

Arguments of this kind are even stronger in the case of clauses that provide for buy out at a discount to FMV or withering forfeiture. In respect of buy out clauses in particular, it now seems arguable that such clauses constitute primary obligations of the parties that are agreed to have effect in specified circumstances. On that basis, it may be that parties will be emboldened to negotiate larger discounts to FMV to be applied on a buy out.

The decision in *Cavendish* does not, however, mean that parties can be certain that forfeiture clauses will be enforced in all circumstances. The tests of proportionality and commercial purpose entail a high degree of discretion on the part of judges (or, more likely, arbitrators) who may be called upon to determine whether such clauses are penal. It remains possible to imagine, in certain circumstances, that a clause providing for the total forfeiture of a valuable upstream interest might be regarded as penal by some tribunals. And because JOAs invariably provide for resolution of disputes in arbitration, it remains unlikely that any of the standard form forfeiture provisions will be definitively tested in the Courts any time soon.

Other limitations on the right to forfeit

Certain additional considerations also arise when assessing the enforceability of forfeiture clauses. Although the risk of falling foul of the rule against penalties is now diminished, any party seeking to enforce a forfeiture clause may face other obstacles. In particular:

1. The party in default might seek equitable relief from forfeiture. Courts and arbitral tribunals in common law jurisdictions have demonstrated a particular willingness to grant such relief in circumstances where the default mechanics have not been scrupulously applied or the non-defaulting parties have otherwise behaved badly.
2. A forfeiture provision may prove especially difficult to enforce if the defaulting party is insolvent. In such circumstances, the defaulting party's administrators or liquidators are liable to challenge the enforceability of the forfeiture right, to the extent that this is being used to trump the rights of ranking creditors (on the basis that a simple contractual right under the JOA cannot displace the laws of insolvency).

Conclusion

Parties to JOAs should have increased confidence that forfeiture rights in their JOAs will prove enforceable as a matter of English law. The new test for penalties is less formalistic and places a greater emphasis on the commercial rationale for the clause and emphasises the freedom of sophisticated parties to agree default provisions. It is unlikely, however, that in negotiating new JOAs in future, parties will wish to revert wholesale to absolute forfeiture clauses. There remains a risk, in certain circumstances, that draconian forfeiture clauses will be held to be penalties, and there remain other potential barriers to enforcement of such clauses. More nuanced forfeiture clauses have become familiar in the industry and continue to represent a more certainly enforceable remedy for breach, especially in light of the distinction now to be drawn between primary and secondary obligations.

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