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Forfeiture Clauses in JOAs (Joint Operating Agreements) – New Law, Old Problems

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The recent case of ***Talal El Makdessi v. Cavendish Square Holdings***[1] considered whether the English common law's antipathy towards penalty clauses would apply where forfeiture of interests against a defaulting party was the prescribed contractual remedy. Although not focused on the oil and gas sector, the principles behind the court's decision will have an impact upon the application of forfeiture clauses in joint operating agreements ("JOAs")**.**

Makdessi v. Cavendish

In the *Makdessi* case the seller of part of its shareholding in a company gave certain covenants to the buyer which were intended to protect the continuing value of the company. These covenants principally obliged the seller not to compete with the business of the company after completion of the sale. The sale and purchase agreement ("SPA") between the parties provided a form of forfeiture remedy (in that the seller would forego significant future payments due for the shares sold and would also be obliged to sell its remaining shares in the company to the buyer at a significantly discounted value) in the event of a breach of the covenants by the seller.

The seller later admitted to breaching the covenants and the buyer sought to apply the SPA's forfeiture remedy against the seller. The seller issued proceedings in court, seeking a declaration that the forfeiture remedy was a penalty and so unenforceable.

At first instance the court was asked to consider whether the forfeiture remedy was penal in nature and would be unenforceable against the seller. The seller's arguments in favour of the allegation of a penalty related principally to the lack of proportionality between the loss suffered by the buyer because of the seller's breach of covenant and the seller's exposure under the forfeiture remedy.

The court held that the forfeiture remedy was not penal in nature. In arriving at its decision the court focussed on whether the remedy was commercially justifiable in all the circumstances, rather than on the more 'traditional' English law approach to the analysis of penalties of whether the alleged penalty clause constituted a genuine attempt to pre-estimate loss.[2]

The seller then appealed against the decision of the court at first instance. The Court of Appeal concluded (unanimously) that the same legal analysis would be applied but also concluded that in all

the circumstances the forfeiture remedy was penal in nature. Two particular aspects of the Court of Appeal's judgment were key:

1. Firstly, the magnitude of the degree of forfeiture of interests faced by the seller (relative to the buyer's likely loss, which was negligible) was quite disproportionate. This was based in part on recognition also that the forfeiture remedy would apply entirely despite the extent of the seller's breach. This was not of itself conclusive in determining that the forfeiture clause was penal however.

2. Secondly, the forfeiture remedy so lacked a justifiable commercial or economic function that it must be penal in nature and so would be unenforceable by the buyer against the seller. The Court of Appeal upheld the principle from *Lordsvale Finance v Bank of Zambia*[3] that a contractual remedy which fails to represent a genuine pre-estimate of loss may nevertheless be enforceable if it has sufficient commercial justification. The forfeiture remedy in the *Makdessi* case was not commercially justifiable since its principal purpose was to deter the seller from breaching the SPA.

The decision of the Court of Appeal in the *Makdessi* case confirms that the proposition that a forfeiture clause could, depending upon how it is intended to be applied (rather than simply the fact that it exists in principle), be rendered unenforceable on the grounds that it constitutes a penalty.[4] Consequently, the efficacy of forfeiture clauses under JOAs should be looked at carefully in light of this decision.

Forfeiture and the JOA

The function of a forfeiture clause and the manner of its operation in a JOA is well understood. For the purpose of analysis in light of the *Makdessi* case, the following features will be particularly relevant in determining whether or not a forfeiture clause constitutes a penalty:

(a) Proportionality of loss to remedy

Some forfeiture clauses provide that in the event of their exercise the entirety of the defaulting party's interests in the JOA are forfeited in favour of the non-defaulting parties and at no cost to them; some forfeiture clauses provide that only such part of the defaulting party's interests in the JOA as is proportionate to the default will be forfeited in favour of the non-defaulting parties; and some forfeiture clauses oblige the non-defaulting parties to pay a market price (less the amount of the default) to the defaulting party for the forfeited interests. The latter two formulations edge the forfeiture clause towards making the remedy afforded to the non-defaulting parties more proportionate to the loss which they have suffered because of the default and modifies the remedy such that it is less obviously a single remedy applicable to all breaches of contract, regardless of loss.

(b) Commercial justification of the remedy

The forfeiture remedy is defended by the oil and gas community on the basis that it is essential to preserve the economic cohesion of the joint venture which the JOA represents. That each party pays its proportionate share of the operating costs of the venture on time and in full is critical to ensuring the success of the underlying project and also to ensuring that the risk of loss of the concession to which the JOA relates is reduced. The risk to a party of the loss of its interests in the JOA, the concession and the project through the exercise of the forfeiture remedy acts as a very powerful

behavioural tool which is intended to ensure the survival of the joint venture. The forfeiture remedy also applies equally across all parties to the JOA and not in favour of any particular party. Together (so says a party seeking to apply the forfeiture remedy) this gives the remedy its essential commercial justification.

Conclusion

The decision of the Court of Appeal in the *Makdessi* case confirms that English law's traditional antipathy towards penalties will apply equally to a forfeiture clause if there is a suggestion that it is penal in nature. That decision also continues the current trend in English law towards examining the efficacy of a potentially penal clause by reference to the intended manner of application of such a clause, with particular consideration of the wider economic justification for its application.

Forfeiture clauses in JOAs will need to be drafted and applied carefully if they are to have any chance of success. Even if the forfeiture clause is upheld on the grounds expressed in the *Makdessi* case, however, issues around securing relief against forfeiture and the application of anti-deprivation rules will also still have to be considered – but these are stories for another day.

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1. *Talal El Makdessi v. Cavendish Square Holdings BV*, *Team Y&R Holdings Hong Kong Ltd*[2013] EWCA Civ 1539.

2. So continuing a trend in analagous recent court decisions (*Cine Bes Filmcilik ve Yapimcilik & Anor v. United International Pictures &* Ors [2004] 1 CLC 401; *Euro London Appointments Ltd v. Claessens International Ltd* [2006] 2 Lloyds Rep 436; *General Trading Company Holdings Ltd v. Richmond Corporation* [2008] 2 Lloyd's Rep 475).

3. *Lordsvale Finance v. Bank of Zambia* [1996] QB 752.

4. *Jobson v. Johnson* [1989] 1 WLR 1026 (although this case also recognized the difference of approach which the English courts adopt to the enforcement of penalty clauses and forfeiture clauses: *"in the case of a penalty clause in a contract, equity relieves by cutting down the extent to which the contractual obligation is enforceable...in the case of forfeiture clauses equitable relief takes the form of relieving wholly against the contractual forfeiture provision",* per Nicholls LJ).

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