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English Court of Appeal Confirms that an Operator Entitled to be "held neutral"

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Case Commented On: *Spirit Energy Resources et al Marathon Oil UK LLC*, [2019] EWCA Civ 11.

In a decision that will be of interest to the energy bar in all oil and gas jurisdictions in the common law world, the English Court of Appeal, in a unanimous decision, has confirmed the principle that operations conducted by an operator under the terms of a joint operating agreement are conducted for the joint account and for the shared risk of all working interest owners and that an operator is not an insurer for those other working interest owners. The Court did so in the somewhat unusual context of a liability for unfunded defined pension benefits.

The appeal involved a joint venture in the Brae Fields in the North Sea. The relationship between the parties was governed by two joint operating agreements (JOA) said to be (at para 3) "typical of operating agreements in the oil and gas exploration sector." However, unlike the CAPL (Canadian Association of Petroleum Landmen) form for conventional operations in western Canada, the agreement provided for an operating committee to "ensure that the participants exercise control over the operator, including its expenditure". As the Court stated at para 3, the

> …operating committee is … comprised of representatives of the participants. The operator submits draft operating programmes and budgets to the committee on a periodic basis but always in advance of the actual operations contemplated in the draft. The committee then reviews the programme and budget and approves or disapproves them, as the case might be. If the programme and budget are approved, then the operator is authorised to incur the necessary expenditure to implement the programme. Thereafter, the costs incurred by the operator are allocated as between the participants according to an agreed formula. In this way the operator is financially held-neutral and the participants share the benefits and burdens.

In this case, the operator (Marathon), with the approval of the committee, hired employees to work on the property (at para 4) "offering them defined benefit occupational pensions as part of the remuneration package…As matters turned out, due to macroeconomic volatility in interest rates, bond markets, equities etc, a substantial pension deficit arose …". This led to calls on the working interest owners in the property (the Participants) to cover the deficit. Initially the Participants agreed to do so but later most balked at this. The Participants argued (at para 7) that, "under the JOA they are not required to pay for future liabilities which … they never foresaw nor contemplated when the Operating Committee approved and authorised the programme and budget which included the employment of staff to work on the relevant operations."

The trial judge rejected that proposition and so too did the Court of Appeal.

Much of the Court of Appeal's judgment is taken up with reproducing sections of the JOA emphasizing the role of the Committee in the prior approval of operations, the Operator's duty to report and the Operator's its duty of care. On the allocation of costs and expenses the Court quoted (at para 20) Article 10.1 of the JOA:

> 10.1 All costs and expenses of all operations under this Agreement in or in respect of the Contract Area or the Licence, including the handling, treating, storing and transporting, whether within or outside the Contract Area, of Petroleum produced from the Contract Area, and all costs and expenses properly incurred by the Operator in its performance of the relevant provisions of the Decommissioning Security Agreement except for costs and expenses which are solely attributable or relevant to a Party, shall be borne by the [p]articipants in proportion to their respective Participating Interests from time to time except as herein otherwise specifically provided. Furthermore, the costs of all assets, including materials and equipment acquired for the Joint Account of the [p]articipants shall be for the account of the [p]articipants in accordance with their Participating Interests from time to time, and, similarly, liabilities shall be borne in such proportions. [The emphasis is the Court's.]

The settlement of costs and expenses was to be governed by the terms of the Accounting Procedure attached as Exhibit A and deemed to be part of the JOA. The Court chose to emphasize the statement of purpose found in the accounting procedure (at para 23, emphasis is that of the Court)):

> The Exhibit starts with a statement of overarching "purpose". This has two substantive components. The first relates to the establishment of "equitable" means of determining charges and credits. The second establishes an Operator hold-neutral principle whereby the operation of accounting procedures is intended to prevent the Operator either making a gain or sustaining a loss.
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> > "The purpose of this Accounting Procedure is to establish equitable methods for determining charges and credits applicable to [all operations conducted in accordance with the Agreement by or on behalf of any party with a Participating Interest] under the Agreement and to provide that Operator neither gains nor loses by reason of the fact it acts as Operator. In the event of a conflict between the provisions of this Accounting Procedure and the provisions of the Agreement, the provisions of the Agreement shall control."

In his analysis, Lord Justice Green for a unanimous bench noted that (at para 36):

> … the scheme set up under the JOA once the operations and budget have been approved on an annual basis by the Operating Committee the Operator is entitled (authorised) to charge the related costs to the Joint Account and these costs are then to be borne by the Participants. … [T]he DRC was a cost which was consequential upon the prior approval

> by the Operating Committee of the operations. Several articles in the JOA make clear that the Participants are required to pay the pensions costs.

Article 10 quoted above made it clear that "*all* costs and expenses" were for the joint account. And equally important was the statement of objectives found in the accounting procedure (at 40):

> When the draftsperson of a contract goes to the length of explicitly setting out guiding purposes to facilitate purposive construction it is incumbent upon the courts to attach weight to that expression of common purpose. The hold-neutral purpose supports the conclusion that nothing in the accounting procedures should lead to the Operator bearing a loss. The principle of equitable distribution applies to "charges and credits" ie burdens and benefits and covers costs, such as pensions costs. This is consistent also with Article 2.1 JOA which is an introductory provision concerning effective date, term and scope. It is stated there that the JOA remains effective until there is a "final settlement" as between Participants and "*t*o the end that each of the Participants shall have shared all benefits and burdens …" in accordance with the agreement. The reference to "burdens" would include unexpected pensions costs. (the emphasis is that of the Court)

The statement of purpose also served as a statement of the commercial rationale of the JOA and made it easy for the Court to reject the argument of the Participants that the provisions of the JOA with respect to future liabilities simply provided a basis for negotiating as to the responsibility for those costs. That, not surprisingly, was not (at para 43):

> … a commercially sensible construction of a joint operating agreement of this type to leave such an important issue as who bears the costs of operations to be resolved though the inherently uncertain mechanism of future negotiations, an agreement to agree. If this had been the intention of the parties upon contracting, then they would surely have said so. But instead they chose the sensible mechanism of prior approval of the Operators "programmes and budgets" as the means by which they supervised and expressed approval of related expenditure by the Operator which they would, under the JOA, be required to bear in the future. Indeed, the present dispute is signal proof that the appellants argument does not lead to commercial reconciliation. It has not been settled. The intention of the appellant Participants is to make the Operator and their fellow Participant (Marathon) pay all the costs of the DRC. The facts speak for themselves. (emphasis is that of the Court)

The statement of purpose also made it easy for the Court to reject the Participants' argument to the effect that the Operator must bear some responsibility since it had the ability to (at para 44) "ameliorate pension liabilities" and had failed to do so. That met with the response that the Participants had approved of these arrangements through the Operating Committee and that therefore they must assume their share of responsibility. Furthermore, the position of the Participants defied commercial logic (at para 45):

> In this case not only do I find the Participant's purported rationale to be counterintuitive and lacking in commercial logic but, more importantly, the optic through which to construe the JOA is that decided upon by the parties themselves and articulated in Exhibit

> A. There is no identifiable logic whereby the Participants can take the benefits but avoid the risks. On the appellant's analysis having approved the Operator's operations and its budget, and thereby induced the Operator to expend money including on pensions, the Participants, or each of them according to their own narrow self-interest, can refuse to agree to pay (bear) their allotted portion of the costs leaving the portion they would otherwise bear to be borne by the Operator (who also happens to be a Participant). Indeed, Mr Newman QC for the appellants accepted that if his analysis of the JOA was correct they were entitled to compel their fellow Participant, Marathon, qua Operator, to bear the full costs of the DRC. They could take the benefit but none of the burden. With respect I was unpersuaded that this could ever be considered commercially rational in the context of an agreement of this sort. (underlining is that of the Court)

The Operator did not have a "blank cheque" to do what it liked. The roles and responsibilities of the Operating Committee afforded the Participants significant protections, as did the common law, since Participants would not be liable (at para 47(c)) "for any cheque written by the Operator in bad faith or dishonestly."

That was more than enough to dispose of the case in favour of the Operator. Marathon had an alternative argument based on the indemnity clause in Article 5.7 of the JOA, but the Court found it unnecessary (at para 49) to address the "scope and effect of this clause".

The decision is not binding on an Alberta court but it will be persuasive. The decision is completely consistent with the jurisprudence of the Alberta courts, especially such leading authorities as *Renaissance Resources Ltd v Metalore Resources Ltd*, 1985 ABCA 58 (CanLII) and *Adeco Exploration Company Ltd v Hunt Oil Company of Canada, Inc*, 2008 ABCA 214 (CanLII) . While, as noted above, JOAs for conventional operations do not normally make provision for an operating committee, offshore and non-conventional operations typically do. In any event, just as approval by an operating committee constitutes approval of expenditures incurred in giving effect to that operation, the same can also be said as to the effect of an AFE (authorization for expenditure) issued under the CAPL form (with the possible exception of drilling AFEs issued under the defectively drafted provision of the 1981form of the CAPL Operating Procedure).

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