Transfers of interest in Joint Operating Agreements

The risks associated with pre-emption rights: from a contractual, legal and political perspective

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1 Introduction

The oil industry is no doubt facing challenges following the low crude price that since mid 2014 have affected the market. This has likely increased the need to monetize assets, vertically integrate businesses or seek other companies (even competitors) for the purpose of deepen market and technical expertise and grow market share. As a consequence, mergers and acquisitions in the oil industry have increased. Participating interest in petroleum projects are also transferred among actors through sale, assignment, encumbrance or other disposition of rights and obligations.

Successfully managing a transfer of a participating interest can be very challenging. Recognizing some specific issues early on in a deal will simplify the process and drive these deals for success.

One of the key elements to address is rights of pre-emption. This preferential mechanism is commonly found in Joint Operating Agreements (JOAs) in order to grant existent parties to the petroleum project a preferential right to acquire the interest being transferred by one of their co-venturers. However, the inclusion of pre-emption clauses requires careful considerations by the parties to the JOA about the risks associated with pre-emption rights. It may very well be that standardised clauses do not cover innovative methods of transferring interests to parties outside of the JOA. In addition, the interference of the governing law in the construction and interpretation of the contract as well as the hindrances associated with political contexts where the contract area resides will be of most importance when a transfer of interest is to take place.

1.1 Aim of study

The aim of this research is to understand the risks of including preferential rights in JOAs, with a focus on how the contract drafting process, the governing law and political context affect transfers of interest. This Thesis analyses more in detail pre-emption rights, in contrast to other types of preferential rights (i.e. right of first refusal), despite the fact that in some occasions, reference to both of them will be made.
While the research could have transferable values for other sectors, it focuses on the oil and gas sector by answering the following research question: **which are the risks associated with pre-emption provisions that actors ought to consider when addressing transfers of interest in JOA?**

The underlying research question drives the author of this Thesis to examine:

- What is the reason behind for including pre-emption provisions in JOA, or for excluding them from the contract?
- How should a pre-emption provision be written and what does the ‘triggering event’ stand for?
- How could the governing law affect the construction and interpretation of such clause?
- How would the political context where the project is developed affect the transfer of interest?

### 1.2 Method, sources and delimitation

This Thesis examines both primary and secondary legal sources from different jurisdictions.

The introduction to pre-emption rights in chapter two, has an academic approach, hence, the main sources that have been used by the author are books and articles. While the books provided information about the rights of pre-emption, the articles provided opinions. As a result, a descriptive -but critical- text has been accomplished.

The research of the drafting process in chapter three is mostly conducted though the analysis of case law. Given the little legal authority in civilian legal systems regarding the
application of pre-emption rights, only cases from different jurisdictions within the US and few from Australia will be discussed\(^1\).

As regards to the interference of governing law in chapter four, the author decided at an early stage to keep an academic approach that served to illustrate the point that the contract is not self-sufficient.

The aim of this Thesis goes beyond a mere legal analysis by also highlighting political implications of pre-emption rights. Chapter five concerning the government’s rights of pre-emption focuses on Kazakhstan, Angola and Norway where the State have secured its right of pre-emption but used it very differently. The research is conducted through the comparison of primary sources of law in each country, supplemented by industry reports and experiences from legal practitioners.

1.3 Disposition

This Thesis is structured in five chapters. In chapter one there is the introduction. Chapter two examines the nature of pre-emption rights, the different formulations and the pros and cons associated with them. Chapter three, reflects on the importance of the language given to the pre-emption right provision by the drafting parties. In doing so, different problematic scenarios, which are likely to happen during the life cycle of a petroleum project, will be analyzed through case law. Chapter four focuses on the interference of the governing law to the JOA, distinguishing between the approach followed in civil and common law tradition, in respect of the principle of good faith. Chapter five discusses the rights of pre-emption, as a tool for governments in financial and political decision making. In chapter six, there is the conclusion.

\(^1\) It should be noted that no pre-emption rights are found in the UKCS (United Kingdom Continental Shelf) since 2002, therefore the author decided not to analyse cases from this jurisdiction. See p. 13 in this paper.
2 Pre-emption rights in JOA

2.1 Introduction to JOA

Joint Operating Agreements (JOAs) are found in the context of upstream petroleum projects, most commonly where the government has awarded a concession that grants the right to explore for and produce petroleum to a group of persons who have come together for that purpose in a joint venture\(^2\). The relationship between these parties towards the Government will mostly be governed by the Licence\(^3\). The JOA is the document that sets out the rights and obligations of the parties amongst themselves\(^4\). According to this, the *vertical relationship* between the grantor of the concession and the concession-holders will be governed by the terms of the concession whereas the *horizontal relationship* of the participating parties will be detailed in the JOA\(^5\).

In the context of Petroleum projects where multiple parties collaborate together, the structure chosen by them to organise their participation (i.e. incorporated and unincorporated joint ventures) in a specific project is an essential aspect of the latter. Joint operating agreements are commonly found in the context of unincorporated joint ventures\(^6\).

Under an incorporated joint venture, there will usually be a limited liability company – called joint venture company- where the parties will issue shared capital. This company will be the holder of any necessary concession and the relationship of the shareholders in

\(^2\) This is not always the case, where petroleum exploration and production projects are not very complex both form a technical and financial perspective, a single company may be the only concession-holder without entering in a joint venture with other companies in order to perform the concession.

\(^3\) Even thought that is the case in most western countries, it should be stated that other forms can be seen in developing countries.


\(^5\) ROBERTS Peter, "*Petroleum Contracts: English Law and Practice*", Oxford University Press, 2013, at para 5.84.

\(^6\) Exceptionally, they may have a mixture of these two.
the Joint Venture Company (that is, the parties that collaborate) will be governed the shareholders’ agreement\(^7\).

In contrast, where a petroleum project is undertaken under an unincorporated joint venture, the parties will not incorporate a separate company as a vehicle which represents their interests, but the relationship between them will be represented by a contract (as regards to upstream petroleum projects, that will be the JOA). Accordingly, when this structure applies, there will be a determined number of companies which will be the holders of the concession by the government (e.g. through the state agency\(^8\)).

Although pre-emption rights are not incorporated into joint operating agreements as frequently as in the past\(^9\) and some states have on occasion caused them to be removed from certain JOAs (e.g. UK)\(^10\), they are still commonly found in joint operating agreements (in the context of incorporated and unincorporated joint ventures, respectively). Thus, it is important for all the parties to be familiar with these provisions and understand how these may affect their business.

There are certain model forms that can be considered by the parties at the time of drafting the JOA. This is in most cases the starting point which can (and should) be amended to meet the interests of all the parties involved and the particularities of their petroleum

\(^7\) ibid at p. 90.
\(^8\) ibid at p. 91.
\(^9\) MARTYN (n 4) at p. 27; SWEENEY David H, "Oil and Gas Joint Operating Agreements: A Comparative World-wide Analysis", LexisNexis, 2015 at para 10.03 [1]: "the use of these provisions in joint operating agreements, at least in North America, has decreased since the 1990s due to the industry's experience with acquisitions and divestitures and the recognition that each party will probably be a seller at some point in an asset's life cycle. In relatively low-cost, low-risk North American onshore projects, preferential purchase rights and similar provisions look more like economic opportunism than the protection of the legitimate self-interest of a solvent party that took the risk of exploring and developing a prospect. Outside of the North America, and with respect to offshore projects, there is a more persuasive basis for the existence of these provisions, as this type of project typically involves greater cost and risk and fewer transfers from the original contracting parties".
project (e.g. pre-emption rights provision is an example of an aspect to be considered whether to include it or not in the contract).

A model form reduces the transaction costs and increases efficiency by limiting the scope of the negotiations\textsuperscript{11}. Rarely a bespoke agreement form is drafted from a standing start\textsuperscript{12}. It is not the aim of this paper to highlight the different variations between the model forms\textsuperscript{13}, but the most widely used JOA standard model forms are the following: AIPN Model; OGUK Model; AAPL Model; CAPL Model; RMMLF Model; The Greenlandic Model; The Norwegian Model and; AMPLA Model.

2.2 Nature of pre-emption rights and its logic

The interests of a party in the concession, the JOA and as a whole, the petroleum project constitute a valuable asset\textsuperscript{14} (participating interest). During the lifetime of a JOA different scenarios are likely to happen: fluctuation of the economic value of the project, discrepancies between the parties, among others. As a result, a party might wish to transfer its interests to another person (either to another participant in the JOA or an external third party).

A JOA represents a ‘collaborative effort’\textsuperscript{15} between two or more parties. Each of these persons at the time of considering whether to enter or not into the JOA most likely took into account the financial and technical capacity of each other person to perform the commitments under the JOA, given the joint and several liability that is imposed in respect

\textsuperscript{12} ROBERTS "Petroleum Contracts: English Law and Practice" (n 5) at p. 363, para 8.21.
\textsuperscript{13} Interesting from the perspective of the treatment given to the non-operators position and their major concerns, read PEREIRA G Eduardo, "Joint Operating Agreements: Risk control for the Non-operator", Globe Law and Business, 2013.
\textsuperscript{14} ROBERTS "Joint Operating Agreements" (n 11) at p.147.
\textsuperscript{15} ibid.
of the obligation to perform the concession. Therefore, it is reasonable that the transfer of
the participating interest is one of the most sensitive issues in JOA.

Parties in a JOA are over the years after its creation, likely to change. In other words, the
interests in the petroleum project may change hands and, therefore, care must be taken at
the time of negotiating the JOA of the viability of including pre-emption rights that limit
the free tradability of the interest to a JOA and more importantly, the specific wording used
in the provision.

Pre-emption rights are considered one of the most delicate issues when negotiating a JOA. These come to apply when the interests in a JOA are held by multiple parties who have expressly agreed on a pre-emption right regime and at one point one (or more) of the parties decides to transfer its participating interest. These rights are intended to restrain the transfers of interests within a JOA, resulting –if exercised- in an internal economic reallocation of interests between the existing parties to the contract.

Pre-emption rights apply to transfers of participating interest at the asset level. Changes of control are generally excluded from the application of provisions restraining transfers of interest. This means that the shareholding interest of a person in a party to the JOA (this latter holding the asset interest in the petroleum project) may be transferred to a third party, such that the pre-emption right in respect of the participating interest (asset level) is not triggered. However, depending on the wording of the clause, pre-emption rights may also comprise that superior interest level or be regulated in a change of control provision, see for instance the AIPN 2012, which contains an optional provision that results in pre-emption rights applying to change of control transactions.

16 ROBERTS "Joint Operating Agreements" (n 11) at p.156.
17 ROBERTS "Petroleum Contracts: English Law and Practice" (n 5) at p. 363, para 14.57.
18 SWEENEY (n 9) at para 10.03 [4].
19 ibid at p. 364, para 14.65.
As will be further developed below, pre-emption rights may be formulated in different ways: from fairly simple requirements to notify in advance an intended transfer thereby allowing the other parties to propose offers that may (or may not) be accepted by the party proposing an assignment, to rights to pre-empt (or take over) a negotiated transaction with another party.\(^{20}\)

The benefits of pre-emption rights essentially vest with the non-transferring parties. The preservation of the culture and cohesion of the original joint venture is sometimes mentioned as one of the benefits of this clause. However, the ‘preservation of the culture and the cohesion of the original parties’ is sometimes over exaggerated. As some authors suggest\(^{21}\): “This [...] is less obviously applicable where the JOA is of an age where subsequent transfers of interests have taken place and many, or even all, of the original parties have long since ceased to be associated with the JOA, and yet the pre-emption rights continue to govern the JOA”.

It also rewards the original parties to the JOA in making the initial investment into the petroleum project, through granting those parties a preferential right to increase the level of their interest if they so decide.\(^{22}\) In other words, pre-emption rights assure the original parties to a JOA that those risks, which they undertook in conducting exploratory

\(^{20}\) See 'right of first refusal' and 'matching right' in section 2.3 of this paper.

\(^{21}\) ROBERTS "Joint Operating Agreements" (n 11) at p.157.

\(^{22}\) Hargrave J. In Beaconsfield Gold NL v Allstate Pty Ltd: "Pre-emptive rights are usually included in resource joint venture agreements. Give the importance of the identity, financial capacity and reliability of the participants in a joint venture, pre-emptive rights operate to ensure that existing participants are empowered to exclude new participants by purchasing the outgoing participant's interest if they so desire. They also permit a joint venturer who may take the view that it has expended a significant amount of money in a high risk area to have an opportunity to increase its interest if another joint venture desires to withdraw from the joint venture. This allows an enhanced opportunity to reap the rewards from past-taking expenditures".
operations, will be rewarded insofar they will be able to acquire additional interests in the lease in preference to third parties that did not undertake such risks\(^\text{23}\).

In exercising this right, they can avoid the entrance of external parties with a different ideology from that of the current parties or that may lack the financial or operational capacity to bear its share of costs\(^\text{24}\).

This right can also apply not to block the entrance of an external party but to prevent the transferor from transferring all its participating interest to the same partner party (within the JOA), resulting in a high combined participating interest. How far this right is extended will depend on the wording used by the parties in drafting the clause.

### 2.3 Formulations of the rights and their encumbrances

A number of terms, such as rights of pre-emption\(^\text{25}\), are used to refer to a preferential right mechanism\(^\text{26}\), each of these terms may have its specific mechanic.

This part describes the two main formulations of preferential rights i.e. matching rights (which is equivalent to pre-emption rights) and right of first refusal. Notwithstanding the explanation below, it is important to bear in mind that, in practice, the specific wording of the clause could bring to a hybrid of these formulations.


\(^{25}\) POITEVENT and HEWITT (n 23) at p. 1: other nicknames include 'option of first refusal', "preemptive rights", "preemptive option", "first option" and "conditional or contingent right".

\(^{26}\) idem.
2.3.1 Matching rights

When the party that wishes to transfer its participating interest has negotiated the transfer with the transferee and these two have agreed on the commercial terms of the transaction, including the price payable for the proposed sale of its interests, the transferor is obliged to notify each of the non-transferring parties of those negotiated terms and the identity of the proposed transferee (pre-emption notice). The non-transferring parties will then have, for a defined period of time, the right to acquire the participating interest on the same terms. If one of the non-transferring parties or some of them decide to exercise their right, the third party will be set aside and they will acquire the transferor’s interest in the same conditions that the third party. This is called matching rights, or more commonly, pre-emption rights.

It is a right to acquire the interests 'on the same terms available to the third party', not at an increased price or on terms to be negotiated. According to this, the interested party must respond in unequivocal terms and any attempt to modify the terms of the sale in the exercise of the option will constitute a rejection of the offer. Thus, pre-emption rights essentially allow non-transferring parties to step into the shoes of the potential transferee and acquire the transferor’s interest.

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27 This formulation can be seen in AAPL JOA 24.2; AIPN JOA 12.2.F; AMPLA JOA 14.3; CAPL JOA 24.01B.
28 The AIPN form requires a copy of the actual agreement be distributed to the preferential right holders.
29 Failure to exercise this right within the prescribed period constitutes a waiver of the pre-emptive right.
30 CONINE (n 24) at p. 1323.
31 POITEVENT and HEWITT (n 23) citing CONINE (n 24) at p. 1563 “In some cases, however, the rightholder’s acceptance will be valid despite minor or insubstantial variations from the original offer. In these situations, some courts have recognized limited exceptions to the strict conformity requirements of the “unequivocal acceptance rule.” See, e.g., West Texas Transmission, L.P. v. Enron Corp., 907 F.2d 1554 (5th Cir. 1990). While the Fifth Circuit has not provided a hard and fast rule regarding what constitutes an insubstantial variation, it appears that the court will invoke the exception when a seller imposes an offer upon a rightholder (1) that is commercially unreasonable, (2) that is offered in bad faith, or (3) that is specifically designed to defeat the preferential right.”
32 CONINE (n 24) at p. 1323, citing Hutcherson v. Cronin, 426 S.W.2d 638, 64.
The pre-emption process implies that the non-transferring parties must be provided with the amount of notice specified in the pre-emption clause and the sale to the third party may not be closed prior to the right holders’ rejection of the offer to acquire the transferor’s participating interests or the running of the notice period\textsuperscript{33}.

If there is more than one party interested in exercising its right, the transferor’s interests will be allocated pro rata to their participation in the JOA.

As the reader may anticipate at this point, this formulation has the disadvantage of discouraging prospective assignees who may be reluctant to spend time, money and effort negotiating a transaction if they can be then pre-empted by the other non-transferring parties to the JOA\textsuperscript{34}. A soft formulation of this right would require the transferor to approach the other parties to the JOA as soon as the principal terms have been agreed with the prospective transferee (\textit{partially negotiated agreement}) or to obtain a waiver at the first place. However, others require the transferor to agree final documentation with the prospective transferee before giving the other parties their right to match the deal (\textit{fully negotiated agreement})\textsuperscript{35}.

Sometimes the transferor wants to evade the exercise of the pre-emption right by the non-transferring parties and consequently, does not give a clear and/or true notice of the agreed terms so that party wishing to match them found hard to make it. In doing so, the transferor bears the risk of that notice being declared invalid for not providing full and transparent disclosure. More difficult it would be to challenge the validity of the pre-emption notice when the revealed terms actually reflect the negotiation undertaken by the parties but they

\textsuperscript{33} POITEVENT and HEWITT (n 23) at p. 5.
\textsuperscript{34} TAYLOR Michael P.G, WINSOR T P and TYNE Sally M, \textit{“The Joint Operating Agreement: Oil and Gas Law”}, Longman 1989 at p. 61.
\textsuperscript{35} ibid at p. 61 and 62.
result to be disproportionate and outlandish, because as long as the transferee is capable of matching these terms, the process would indeed be valid\textsuperscript{36}.

The exercise of these pre-emption rights is said to affect the free transferability of petroleum projects interests, as it involves extra costs of contracting associated with their exercise, such as money and time\textsuperscript{37}. At the same time, even when the pre-emption system is procedurally simple and the notice period extremely short, the mere existence of pre-emption rights can be very discouraging for potential transferees who know that the result of their costly negotiations to achieve beneficial terms can be used to co-opt the deal for another party to the JOA\textsuperscript{38}. In that sense, the negative impact is greater for the buyer than for the seller, since the latter will receive the same consideration for the asset on the same terms\textsuperscript{39}.

Moreover, this certainly affects the market value of the interest subject to these rights. As SWEENEY says: "(pre-emption rights) chill the interest of potential purchasers, which can decrease the number of willing bidders and the size of offers"\textsuperscript{40}. BARRY Richard clarifies it by explaining that when a potential buyer wants to acquire the participating interest of a party to a JOA and makes a bid that can yield him or her a worthwhile profit, if that is certainly true, that bid will probably be pre-empted. Contrarily, if the offer is not pre-empted by the other co-ventures, this could be a sign, without being exhaustive, that a too high price has been paid for it. For this reason, many companies avoid bidding against a

\textsuperscript{36} ROBERTS "Joint Operating Agreements" (n 11) at p. 158.
\textsuperscript{37} ibid at p. 157.
\textsuperscript{38} POITEVENT and HEWITT (n 23) at p. 2.
\textsuperscript{39} GORDON and PATERSON (n 10) at para 14.36.
\textsuperscript{40} SWEENEY (n 9) at para 10.03 [1].
pre-emption right\textsuperscript{41}. As a result, the party that wants to transfer its interest will get fewer offers and most likely, a lower price.

In light of the above, some states have on occasion caused them to be removed from certain JOAs. That is the case in the United Kingdom. The UK Government perceived, by the end of the twentieth century, pre-emption rights as a barrier to free trading of participating interests in JOAs and also as an element which delayed and in some occasions prevent the introduction of new founds and resources into the UKCS. The Government was concerned that pre-emption rights clauses under JOAs were discouraging new entrants’ participation in the North Sea and decided to stimulate the industry by adopting new pre-emption arrangement ("Master Deed") in order to promote and facilitate asset transfers under existing licences and give buyers increased confidence and clarity. By the time of the 20\textsuperscript{th} offshore round in 2002 UKCS (licences granted in July 2002) JOAs that contained a pre-emption right provision had to be approved (which would not happened without justification thereof\textsuperscript{42}) and in all instances the pre-existent JOAs had to follow the Master Deed model. As a result, new JOA do not contain pre-emption provisions.

2.3.2 Right of first refusal

Under the right of first refusal, the transferor will be obliged to give notice to each of the non-transferring parties of its intention of transferring its interest and give an outline commercial offer for its interests to them or invite them to make their best offer. If the transferor makes an offer, the price can be determined on the market value of the interests

\textsuperscript{41} ROBERTS, “Petroleum Contracts: English Law and Practice” (n 5) at p. 367, para 14.84: “these concerns are sometimes exaggerated, but the existence of pre-emption rights in a joint operating agreement may be sufficient to put off a possible buyer which has more than one investment opportunity to choose form”.

\textsuperscript{42} GORDON Greg and PATerson John (n 10) at p. 295, ft. 19: “The Open Permission (Operating Agreements) granted by the Secretary of State on 18 December 2002 allows automatic approval of new JOAs for licences granted after 1 July 2002 which do not contain pre-emption arrangements (…)”.
or be based on the monetary value *which may reasonably be ascribed to the transferring party’s interests*\(^43\).

If one or some of them are interested, they have an exclusive right to negotiate a transfer of those interests in their favour. As seen above, if there are more than one party interested in acquiring the transferor’s interests, these will be allocated in the proportion the interest that each party has in the JOA.

If the parties to the JOA are unable to reach any agreement, the transferor will be free to seek a transferee outside the parties. There is however a limitation. The external agreement cannot be ‘materially different’\(^44\) from that offer given to the non-transferring parties or may not sell to a third party for a lower price than that offered by the non-transferring party\(^45\). According to this, the terms of the transaction with the third party must be equal or more favourable to the transferor than those offered by the other parties to the JOA\(^46\).

Non-transferring parties to the JOA sometimes find themselves that they are simply used to verify or set a price which may actually help the assignor to market the interest to third parties at higher price\(^47\).

\(^{43}\) ibid at p. 363, para 14.99.
\(^{44}\) ROBERTS, "Joint Operating Agreements" (n 11) at p.160.
\(^{46}\) TAYLOR, WINSOR and TYNE (n 34) at p. 62.
\(^{47}\) ROBERTS, "Petroleum Contracts: English Law and Practice" (n 5) at p. 363, para 14.102; TAYLOR, WINSOR and TYNE (n 34) at p. 62.
2.4 Conclusion

All in all, when reflecting on transfers of interest, as Martyn discusses that “there are two main (and conflicting) trains of thought (...) on the one hand that the License is an asset and should be, therefore, freely tradable and, on the other hand, that the Joint Venture is a group relationship that should be protected\textsuperscript{48}.

If a JOA is viewed primarily as a relational contract\textsuperscript{49}, like a traditional partnership, with a significant element of \textit{delectus personae}, then pre-emption right provisions\textsuperscript{50} would appear to be reasonable because a party to a JOA is not just buying equity in a project. It is also becoming liable for his share of expenditure and the rest of the JOA participants would like to be reassured as to the solvency of the incoming member. However, if one views the JOA primarily as a proprietary contract granting a right to restrain interests in production from the area of operations, then pre-emption rights can be seen as unjustifiable restrain\textsuperscript{51}.

When considering the incorporation of such provisions, drafting parties should weigh their interests in the project, bearing in mind that most parties might, at some point during the life cycle of the contract area, be a transferor. Therefore, the language of the provision, if included in the JOA, should try to balance both divergent interests (of the transferors and non-transferring parties) and provide for an equitable mechanism for when an assignment of interest is to take place.

\textsuperscript{48} Martyn (n 4) at p. 26.
\textsuperscript{49} For a discussion, see Gordon and Paterson (n 10) at p. 273-301.
\textsuperscript{50} As this chapter shows, the rights of pre-emption can adopt different formulations that will limit the transfers of the participating interests in one specific manner. On the following chapters, different language, such as: “right of first refusal”, “right of first offer”, “preferential right” will be used interchangeably to refer to the pre-emption right mechanism that has been introduced here, bearing in mind that their specific application could be slightly different. See subsections 1.3.1 and 1.3.2 above.
\textsuperscript{51} Gordon and Paterson (n 10) at para 11.11.
3 Importance of the drafting process: the wording of the clause matters

3.1 Hindrances of specific transactions’ mechanic

In the previous chapter it has been explored what pre-emption rights are, the logic behind them, the main formulations and the disadvantages associated with them. That overview highlighted the importance for the parties to reflect on different pros and cons before including pre-emption rights provisions, as opposed to blindly incorporating them into their contracts.

In this chapter, we will assume that the decision has been made towards the incorporation of such a clause, and the drafting of these clauses will be analysed more in-depth. When drafting these provisions, parties sometimes use boilerplate language found in sample agreements such as the AIPN Model Form, without recognizing the impact that this will have at the time of disposition of their participating interests. As will be seen in this chapter, the wording used in a pre-emption clause is very important and parties should bear in mind that each clause will need to be looked at very carefully when drafted.

Below three problematic scenarios (namely: non-cash consideration, package sale and two-step transaction), which are the origin of many disputes, will be examined with the aim to illustrate the importance of the drafting process. The methodology followed consists on: (i) introduction of the problem, (ii) clarification that might be given by the parties in their contract, (iii) the Court's interpretation when a dispute has arisen.

3.1.1 No Cash consideration

3.1.1.1 Hypothetical Scenario and concerns

The two main examples that can be found in this section are:

i. Company A is a party to a JOA and wishes to transfer its participating interest to party B, which is a drilling company, in exchange for party's B performance of a drilling-related service.
ii. Company C is a party to JOA 1 and company D to JOA 2 and they wish to swap their interests in a single transaction, whereby party C acquires party D's participating interest in JOA 2, and Party D obtains Party C's participating interest in JOA 1.

When the transaction does not have the configuration of an outright sale of an interest for cash, but instead presents a more complex structure with a non-cash consideration, such as a service or swap of properties, co-ventures to the JOA will never or rarely be able to match the consideration offered by the third party.

3.1.1.2 Clarification by the parties

The scenarios explained above shows how a transferor and transferee could avoid a deal being pre-empted by the other parties to the JOA. Therefore, this aspect could be taken into account at the time of drafting the JOA and provide a method by which a cash value can be attributed to the affected interests, such that the pre-emption rights can still be exercised by co-ventures.\(^{52}\)

Very often an indicative cash value of the interest will be allocated by the transferor, as part of the notice to be given to the non-transferring parties. Later on, these co-ventures may, during a period of time, be able to signal their objections regarding the validity of that valuation.\(^{53}\)

If no agreement concerning the valuation of the interests to be transferred is achieved by the parties, an independent expert can be appointed by them in order to settle the issue. The expert's valuation will be final and binding, which means that, if nothing to the contrary is

\(^{52}\text{ROBERTS, "Joint Operating Agreements" (n 11) at p.158.}\)

\(^{53}\text{ibid.}\)
stated by the parties into their contract, they will then be obliged to continue with the transfer at the price fixed by the expert.\textsuperscript{54}

The costs of that expert will be born by either the transferor or transferees, according to the assessment result. That is, if the transferor has submitted an unreasonably high valuation, in contrast to that one asses by the expert, he or she will bear the costs. Contrarily, if the transferees had raised unreasonable objections to the transferor's valuation to defeat the process, they will cope with that expense.\textsuperscript{55}

Nonetheless, it is as well for the parties to decide whether to include a 'get-out' provision by which they can decide not to proceed with the transaction, if the price assessed by the expert is too high (so the transferees can not afford it) or too low (so the transferor prefers no to assign it).\textsuperscript{56}

\textit{3.1.1.3 Judicial interpretation}

When the contract is silent about this issue or the language is not clear enough, Courts will have to interpret the contract and determine a solution. However, as will be seen below, Courts in different jurisdictions have addressed the issue with different results; some of them construe the pre-emption rights provision expansively, encompassing other agreements such as exchanges and farm-outs, whereas others will interpret it narrowly to merely include a sale (being a transfer of a participating interest in exchange for a price in money).

\textsuperscript{54} ibid.
\textsuperscript{55} ibid.
\textsuperscript{56} ibid.
3.1.1.3.1 Examples pre-emption right provision construed narrowly

Some Courts, where no obligation to allocate a cash consideration is required in the provision, would see the unmatchable deal route as it has been well by the parties to the JOA and therefore pre-emption rights will not be applicable with respect to a proposed transfer in exchange for non cash consideration.

In *Panuco Oil Leases, Inc. v. Conroe Drilling Co.*\(^57\) (hereinafter, *Panuco vs. Conroe Case*) and *LeBreton v. Allain-LeBreton Co.*\(^58\) (hereinafter, *Le Breton Case*), the Texas Court of Appeal and the Louisiana Third Circuit Court of Appeal, respectively, held that pre-emption rights applied merely to sales. Hence, an exchange of one party’s interests in consideration of an obligation to the other party or an exchange of an interest in one partnership for an interest in another partnership, were not considered a "sale"\(^59\) and no pre-emption rights were triggered.

The pre-emption rights provisions read as follows:

(... should Operator desire to sell all or any part of its leasehold estates covered by this agreement, it will notify Owner as hereinabove provided of any bona fide offer that it has to sell such interest ... after the expiration of ... of its election to purchase said interest at the price proposed, then Operator shall be free to sell such interest ...)\(^60\) in *Panuco vs. Conroe Case*.

\(^{58}\) LeBreton v. Allain-LeBreton Co. 631 So.2d 662 (La. App. 3 Circ. 1994).
\(^{59}\) below it will be discussed what is to be considered a “sale” for these Courts.
\(^{60}\) Panuco Oil Leasees, Inc. v. Conroe Drilling Co. (n 57) at p. 110, para VIII of the Farm-Out Agreement. Emphasis added by the author of this Thesis.
(...) should any certificate holder desire to sell his share of the partnership or any portion thereof he shall first offer the same to the partnership through its management at its book value
... shall ... accept or reject this offer (...) in Le Breton Case.

In Panuco vs. Conroe Case, there were two letter-form agreements between Conroe and Marine and Feldman and Marine, providing for an exchange of working interests, respectively, in consideration of Marine’s agreement to drill a well deeper. The Court reasoned that under the language in the pre-emption right provision in the Farm-Out Agreement (see above), those exchanges could not be considered "sales" and therefore Panuco never acquired any right of the option or right of refusal clause set forth in paragraph VII of the Farm-Out Agreement.

In Le Breton Case, the Louisiana Court took a step further and analysed what a sale was considered to be. In this case, there was a company called The Allain-LeBreton Company ('Company') which was formed by members of two families, the Allains and LeBretons. LeBreton family at some point decided to transfer their interest in the Company in exchange for interests in the newly created LeBreton Family Partnership. The Court understood that transaction as an exchange, in contrast of a sale.

The Court held that the transaction did not fall within the wording of the pre-emption clause (which only applied to sales), thus, no preferential rights were activated. It is interesting to read the reasoning followed by the Court:

"The right of first refusal applies if a certificate holder wants to sell his share of the partnership. A sale is defined in La.Civ. Code art. 2439 as: Art. 2439. Sale, definition

The contract of sale is an agreement by which one gives a thing for a price in current money, and the other gives the price in order to have the thing itself.

61 Panuco Oil Leases, Inc. v. Conroe Drilling Co. (n 57), at p. 666, art. 7 of the Partnership Agreement. Emphasis added by the author of this Thesis.
62 idem at p. 115 at para 9.
Three circumstances concur to the perfection of the contract, to wit: the **thing sold**, the **price** and the **consent**.

An exchange is defined in La.Civ. Code art. 2660 as: Art. 2660. Exchange, definition

Exchange is a contract, by which the parties to the contract give to one another, one thing for another, whatever it be, except money; for, in that case it would be a sale.

The transaction the LeBreton partners attempted was an exchange, not a sale. The right of first refusal does not apply to transfers (...)

In conclusion, careful drafting is essential, in *LeBreton Case*\(^{64}\), for instance, if language used by the parties would have been "transfer" instead of "sale", the decision would have possibly been different.

3.1.1.3.2 Examples pre-emption right provision construed expansively

There are some Courts that have arrived to the very opposite conclusion. When the contract is silent about non-cash transfers, imposing the holder of a pre-emption right the obligation to match the third party's offer without any material variance, would be illusionary. It would render this right valueless. In addition, they argue that this would permit the seller to always defeat the pre-emption right by requiring a unique property in exchange. Furthermore, some Courts explain that by allocating an equivalent cash consideration of the property exchange offer (that is, offers which arguably leave the property owner "as well off" as does the third party offer, but which vary materially from it), a different contract would be imposed by the Court and this would seriously infringe the right of the owner to dispose of the property. As a result, these Courts have provided a more balanced solution, which takes both interests into account.

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\(^{63}\) LeBreton v. Allain-LeBreton Co. (58) at p. 666, emphasis added by the author of this Thesis.

In *Prince v. Elm Inv. Co., Inc.*\(^{65}\), the Supreme Court of Utah had to consider whether a transfer of property from Elm to Boyer-Gardner in exchange for an interest in a Partnership was considered a sale, and in such case, if the offer from Boyer-Gardner could be matched by Trolley, the other party to the agreement.

As regards to the first issue, the Court said that for the purpose of the right of first refusal a sale would occur upon 'the transfer (a) for a value (b) of significant interest in the subject property (c) to a stranger to the lease, (d) who thereby gains substantial control over the leased property'\(^{66}\). Since these four elements were met, the Court answered positively to the first question.

The second concern was more complex. Trolley had a right to purchase the leased property or an interest therein on terms that matched (or exceeded) those offered by the prospective purchaser. However, what this latter had offered was an interest in a Partnership, which is unique and 'cannot be duplicated as a matter of law'. In order to answer this, the Court followed the reasoning in *Weber Meadow-View Corp. v. Wilde*\(^{67}\), where the Court exemplified the dilemma as follows:

“[N]ot entirely without reason the argument that its holding would permit a property owner to demand one particular finger ring, an old hat, or any other unique item which the [promisee] could not obtain, and thus defeat the promisee's right of first refusal. (...) On the other hand, the property owner's prerogative to insist on payment with a unique object is enforceable only so long as she acts in good faith and without any ulterior purpose to defeat the right of the [promisee].”\(^{68}\).


\(^{66}\) idem at 823.


\(^{68}\) idem at 1054.
The Court continued, when a seller’s decision is challenged as arbitrary or lacking good faith, the seller must articulate a “reasonable justification” for its actions. Whether or not a justification is reasonable will be determined in light of the circumstances of each particular case. In sum, these are the three elements required to the seller in order to transfer a burdened interest: (1) give the right holder notice of the third party’s offer and his intention to accept it; (2) allow the right holder to submit a competing offer; (3) reject the that offer, if any, only in good faith and on the basis of a reasonable justification.

The Court found the three requirements fulfilled, and therefore, recognized the transaction between Elm and Boyer-Gardner.

A very similar result was reached by the Court in Matson v. Emory. In balancing the interests of the two parties in the dispute (i.e. a transferor and a holder of a pre-emption right), the Court said that there was a middle course by implying a duty of reasonableness and good faith in non-cash consideration offers.

As it has been shown, this is an unresolved issue. However, one should bear in mind that Courts rely heavily on the language of the parties' agreement, and therefore, this uncertainty and disparity could be avoided by the inclusion of appropriate language in the agreement.

For instance, some JOAs simply make it compulsory to make the offer in cash and thereby make non-cash offers a breach of the terms of the agreement. Others require the seller to allocate a cash consideration where non-cash consideration is envisaged.

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69 “For example, where the third-party offer includes a house that the seller intends to use as a personal residence, the seller's personal preference for that house as a basis for rejecting the promisee-rightholder's offer might be eminently reasonable. On the other hand, if the seller intended to use the offered house as a rental property, an explanation in commercial terms is probably required to meet the reasonableness standard”.


71 idem at 686.
This was the case in *Sanrus Pty Ltd & Ors v Monto Coal 2 Pty Ltd.*\(^{72}\), where the pre-emption right clause contained a requirement that the offer had to be made for specific cash consideration. The Australian Court found the pre-emption notice sent by Monto Coal 2 Pty Ltd to sell its participating interest to be invalid, since it was not made for specific cash consideration as provided in the Agreement.

In this section it has been analysed a mechanism by which pre-emption rights could be circumvented. Legal authority, in different jurisdictions within the US, is not homogeneous. This being the case, it is for the parties to guide the interpreter by providing a clear wording of their intention.

3.1.2 Package Sale

3.1.2.1 Hypothetical Scenario and concerns

Company A wishes to sell many oil and gas interests, including its participating interest in a JOA, which is burdened by pre-emption rights of other co-ventures to the JOA. Therefore, the interest in the contract area, subject to pre-emption rights, is only a part of the properties being sold in this multi-interest sale.

This company has allocated a price for the total sale, instead of pricing the individual tracts in the package.

As a consequence of this transaction's mechanic, the following uncertainties arise: Is the right of pre-emption applicable to a package sale and if so, to what extent? That is, is the right holder entitled or forced to acquire the entire package or only the burdened portion alone? If the package sale, which includes burdened interests, does not activate the pre-emption right at all, what privilege does this right confer to its holder?

\(^{72}\) Sanrus Pty Ltd and Ors v Monto Coal 2 Pty Ltd and Ors QSC 282, 2014.
3.1.2.2 Clarification by the parties

As illustrated above, the transferor offers to transfer an apparently indivisible package of assets that cannot be split. Hence, the other parties to the JOA cannot pre-empt in respect of one asset as there is no separate ascertainable consideration for that interest.

The confusions associated with package sales could easily be remedied by the parties through a clear provision in the agreement addressing the consequences and requirements of such transactions. For instance, requiring a fair value to be apportioned to the asset(s) burdened by the right of pre-emption and allowing the right holder to purchase that portion at a reasonable price. That would be a good solution, in terms of fairness and efficiency. Nonetheless, some authors hold that 'even if a prorated allocation is made, it is unlikely that the resulting price will accurately reflect the true market value of the particular mineral interest'\(^73\).

Be that as it may, if the transferor, who exchanges its participating interests in a JOA (as part of a wider package of non-JOA-specific assets), identifies the specific interests under the JOA and ascribes a cash value to them, this may preclude any ingenious suggestion from the non-transferring parties that their pre-emption rights under the JOA have given them a right to match the entire package of assets that the transferor is transferring\(^74\).

Relevant matters for negotiation at the time of drafting the contract are whether the pre-emption right can voluntarily be extended to the other assets, thereby acquiring the whole package, or in the other way around, whether a party can be required to acquire any asset other than a participating interest. Provisions in that respect would reduce confusion about the application of pre-emption rights in this context. Nonetheless, in many circumstances, the costs of agreeing to a provision that addresses a hypothetical and remote dispute

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\(^73\) CONINE (n 24) at p. 1321.
\(^74\) ROBERTS, "Joint Operating Agreements" (n 11) at p.159.
concerning the package deal outweigh its benefits and, as a consequence, the contract will remind silence about it.

3.1.2.3 Judicial interpretation

If nothing is said in the contract, a consistent and uniform judicial treatment of the package deal is desirable. Most decisions on the subject have held that pre-emption right provisions will apply to package sales because the majority of these clauses do not expressly prohibit its application to package sales and the seller should not be able to defeat the preferential right provisions simply by transferring the burden interests along with other properties in the package. However, they will differ on whether the right must be exercised against the unit interest alone or against the entire property package.

3.1.2.3.1 Towards a unit interest alone

Several Courts in United States, especially in Texas and California, have held that right holders may select the specific interests against which the right will be exercised. That was the case in McMillan v. Doole, where the Texas Court of Appeal held that a holder is

76 There are, however, few exceptions. See Crow-Spieker #23 v. Helms Construction and Development Company 731 P.2d 348 (Nev. 1987), where the Supreme Court of Nevada held that: “[T]here was no breach of the contractual right of first refusal and that Crow-Spieker was not entitled to any relief. The rationale employed by the court was that the "terms of the right of first refusal (...) applied only to offers to purchase [the burdened property] alone. A third party's offer to purchase a package of properties was simply a different transaction from the one contemplated by the right-of-first-refusal agreement. The Supreme Court of Nevada reasoned that so long as the owner, in good faith, is only willing to sell the burdened tract as part of a larger parcel, the right of first refusal is "totally inapplicable” in DASKAL 2004 at p.473.
78 SEAN Murphy P., (n 77), at p. A-14.
not required to accept other property not covered by the pre-emption right in order to exercise its right\textsuperscript{81}. In \textit{Navasota}\textsuperscript{82} and \textit{Comeaux}\textsuperscript{83}, the Court of Appeal added that the grantor cannot require the holder of a preferential right to purchase multiple assets in addition to the burdened property, even if a term requiring the purchase of additional assets is imposed "in good faith, commercially reasonable, and not designed to defeat the preferential right"\textsuperscript{84}.

It is interesting the discussion in \textit{Brown v. Samson Resources Co.}\textsuperscript{85}, hence a more detailed analysis will be given in this paper.

In this case, one of the parties to the JOA wanted to transfer a package of participating interest in different wells, two of them burdened by right of pre-emption. It was not disputed that pre-emption rights apply to package sales and that the right holders are not permitted to expand his right to additional properties nor required to accept additional uncovered properties. Rather, the Oklahoma Court went a step further and questioned the following: if the package sale contains interests in several wells, all of them burdened by rights of pre-emption, and other properties outside the JOA, is the right holder entitled to exercise its right to some but not all of the burdened properties?

Brown, Huber and Samson were all parties to a JOA that covered several properties (included the ones disputed Cummings and Lance wells) and contained a pre-emption right provision that reads as follows:

\begin{quote}
\end{quote}

\textsuperscript{81} However, he was required to take affirmative steps within the time period specified to preserve the viability of his option, such as notifying the property owner that he intended to exercise his preferential purchase right subject to his objection to the disputed terms, filing a declaratory judgment action prior to the date required for acceptance with regard to the disputed terms, or demanding that the right of first refusal be honored and depositing earnest money as tender of intended performance.

\textsuperscript{82} \textit{Navasota Resources, LP v. First Source Texas, Inc.}, 249 S.W.3d at 543 (2008).

\textsuperscript{83} \textit{Comeaux v. Suderman}, 93 S.W.3d at 221 (2002).

\textsuperscript{84} \textit{Navasota Resources, LP v. First Source Texas, Inc} (n 78) at 543; \textit{Comeaux v. Suderman} (n 79) at 221.

\textsuperscript{85} \textit{Brown v. Samson Resources Co.} 229 F.3d 1162, 2000 WL 1234851 (10th Cir. 2000).
"Should [transferor] desire to sell **all or any part** of its interests under this contract, ... [right holder] shall then have an optional prior right ... to purchase **on the same terms and conditions** the interest which [transferor] proposes to sell.\(^{86}\)

At some point Hubber decided to sell many of its oil and gas leasehold interest to Coda, including the Cummings and Lance wells. The purchase agreement between Huber and Coda attached a schedule allocating values to the individual properties, so the purchase price could be decreased if any properties were excluded from the deal as a result of an exercise of pre-emption rights. Samson, one of the right holders, attempted to exercise its right as regards one of the properties, using the value established in the aforementioned schedule. Hubber understood that as a breach of the pre-emption right's provision and decided to sell the interests in that well to Brown.

The district court recognized Samson's motion based on the grounds that Huber had proposed to sell two separate and distinct interests (Cummings and Lance well respectively) and therefore, two separate rights of pre-emption were activated. However, the Tenth Circuit Court of Appeals reversed.

The Court, in accordance with the district court, reasoned that the language in the pre-emption right provision "**to sell all or any part of its interests**" only addressed the transferor, who thereby was given an 'unfettered discretion to sell "any part of its interest"'\(^{87}\). As consequence, the Samson's preferential right was limited to the very interest Huber had proposed to sell. Once the language was clear, the divergence between the Courts was in determining the interest that Huber had proposed to sell.

The allocation schedule attached to the purchase and sale agreement, according to the Tenth Circuit Court did not change the conditions that the right holder had to meet, which was the Huber-Coda transaction (a package sale of all the interest included). The

\(^{86}\) Emphasis added by the author of this Thesis.

\(^{87}\) Brown v. Samson Resources Co. (n 81), at p.11.
attachment of schedule was merely in recognition that some properties were subject to right of pre-emption and others did not. These specifications did not change the fundamental character of the sale: 'Huber entered into a proposed sale of both properties together, for a listed price. In order to offer Huber the identical terms, Samson was required to match the offer (...)\textsuperscript{88} Since Samson could not unilaterally reduce its obligation under the preferential right to purchase provision, to exercise its rights, Samson was entitled to either accept or reject the offer (that Huber had proposed to sell) in its entirety\textsuperscript{89}.

The Court concluded that the seller was free to transfer the tendered properties to the third parties pursuant to the purchase and sale agreement, since the offer made by him (concerning the two wells subject to pre-emption rights) was not accepted in its entirety.

3.1.2.3.2 Towards an entire property package

There are few Courts have gone a step further from the approach in \textit{Brown v. Samson Resources Co.}, and have reasoned that the holder of the right must exercise it against all interests included in the sale, subject or not, by pre-emption rights. This should be considered a \textit{rara avis}, but at least two Courts in two different jurisdictions reached that decision.

In \textit{First National Exchange Bank v. Roanoke Oil Co.}\textsuperscript{90}, the First National Exchange Bank of Roanoke and R. H. Thomas (hereinafter, the executors) owned several parcels of real estate in the city of Roanoke. The Roanoke Oil Company, Inc. (hereinafter, the Oil Company), wanted to establish a gasoline station for filling service purposes and obtained a lease of a parcel of that estate. The lease contained a pre-emption right provision, granting the lessee (the Oil Company) an opportunity to purchase the said property at the price and upon the terms of the offer received by the Lessor for the sale of

\textsuperscript{88} idem at p. 11, para 7.
\textsuperscript{89} idem at p. 15, para 8.
\textsuperscript{90} First National Exchange Bank v. Roanoke Oil Co., 192 S.E. 764 (Va. 1937).
the premises. As soon as the Oil Company took position of the property covered in its lease, constructed and equipped a gasoline filling station. In an adjoining parcel on the east, owned by the executors, there was a building leased to and occupied by the Roanoke Steam Laundry.

At some point during the period of the leasing, Roanoke Steam Laundry sent an offer for the purchase of both parcels (occupied by themselves and the Oil Company) to the executors and, right after, a pre-emption notice to the Oil Company that read as follows:

"(...) we have received an offer of $20,000 cash for the property standing in Paul Massie’s name, which is occupied by the Roanoke Steam Laundry and yourselves.

"Clause Eight of lease ... provides that the lessor shall have the right to terminate the said lease provided they give the lessee an opportunity to purchase the said property at the price and upon the same terms of said offer. The lessors are willing to accept the above-mentioned offer and we hereby notify you thereof. ... In the event you fail to notify us within five (5) days, this lease shall forthwith terminate and you shall be entitled to retain possession for a period not longer than ninety (90) days."

The Virginia Supreme Court interpreted that, until a later stage, the Oil Company had ‘construed and treated the option clause as requiring notice of an acceptable offer for the entire property to be given to the lessee’ and ‘never took the position that it could not be required to buy the entire property, or that the notice was not in accordance with the provisions of the lease’. The Court reasoned that the practical construction put by the parties upon the terms of their contract is not the only aspect to be regarded, but, where there is any doubt, it must prevail over the literal meaning of the contract. Accordingly, the Oil Company could not choose now the properties that it wished to purchase selectively.

91idem at p. 105. Emphasis added by the author of this Thesis.
A similar result was held by the NY Supreme Court in *Capalongo v. Giles*\(^{92}\), where the Court indicated: "where an owner does have an offer from a third party to purchase a piece on which he has given a first refusal option, but on terms which specify inclusion of the piece in a larger parcel (...) he thereupon has a duty to offer the whole parcel to the option holder on the same terms".

In transfers of interest which include multiple assets (i.e. package sales), despite the disparity among legal authority, the most likely approach, as well as reasonable, will be to allocate value to each asset such that pre-emption can be exercisable individually based on a single price for the assets that they burden\(^{93}\). It will be of most importance to set guiding terms\(^{94}\) on the assessment of the interest price. Otherwise, this will usually result in a party wishing to exercise its pre-emption right, but who finds itself being defeat by an unreasonable allocation of the burdened interest\(^{95}\).

### 3.1.3 Two-step transaction

#### 3.1.3.1 Hypothetical Scenario and concerns

The mechanic in a two-step transaction (or "affiliate route") is usually as follows: Company A, party to the JOA, transfers its participating interest to a newly and wholly owned affiliated. Under most JOAs, the transfer of assets between affiliated will usually not trigger the right of pre-emption. The idea behind is that companies should be free to re-organise their groups for many commercial and tax reasons and this, in principle, would not have a negative effect on other parties to the JOA\(^{96}\). At a second stage, Company A sells that affiliate to a third party by way of a corporate sale.

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\(93\) *Sweeney* (n 9) at para 10.03 [2].

\(94\) *Sweeney* (n 9) at para 10.03 [2].

\(95\) *such as the one provided – optionally – in the AIPN model form.*

\(96\) *Gordon and Paterson* (n 10) at para 14.42.
3.1.3.2 Clarification by the parties

In order to avoid this affiliate mechanism that makes the pre-emption right inoperative, restrictions in that respect might be included in the clause. As regards to the “affiliate” condition, it could be stated that such a transfer to an affiliate would be allowed, provided that this affiliate does not cease on that condition for a definite period of time. Therefore, if such affiliate ceases to be an affiliate of the transferor before that, the other parties may require to go back so they can exercise their pre-emption right.

Financial capability is sometimes required even when the transaction is to take place between affiliates. If that vehicle company has no other assets at the time of the transfer, the transaction could be pre-empted by the co-venturers.

3.1.3.3 Judicial interpretation

The leading case in this matter is *Tenneco Inc. v. Enterprise Products Company*97. Tenneco and several other companies98 (hereinafter "the Enterprise Companies") owned interest in a natural gas plant that was governed by a JOA called the "Restated Operating Agreement" (ROA). This agreement granted the plan owners a right of pre-emption. At some point Tenneco Oil did the following transactions:

- Transaction (1): Tenneco conveyed its share to Tenneco Natural Gas Liquids Corporation (wholly owned by Tenneco Oil).
- Transaction (2): Tenneco Oil sold all of Tenneco Natural Gas Liquids' stock to Enron Gas Processing Company, and Tenneco Natural Gas Liquids' name was changed to Enron Natural Gas Liquids Corporation.

98Enterprise Products Company, Texaco Exploration and Production, INC., Meridian and Union Pacific (from the originals El Paso Hydrocarbons Company and Champlin Petroleum Company), collectively called “the Enterprise Parties”.

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- Transaction (3): Enron Gas Processing sold Enron Natural Gas Liquids' stock to Enron Liquids Pipeline Operating Limited Partnership.

The pre-emption clause in the JOA expressly allowed transfers to wholly owned subsidiaries (such as occurred in the First Transfer), which did not constitute triggering event. However, nothing regarding the second and third transactions (i.e. stock transactions) was mentioned in the clause.

The Enterprise Companies claimed that the second and third transfers invoked the right of first refusal provisions of the ROA. Tenneco and Enron Defendants contended that the second transaction (sale of Tenneco Natural Gas Liquids' stock from Tenneco Oil to Enron Gas Processing) it was merely a stock sale, that is, a transfer of ownership in an entity, not a sale of assets or ownership interest in a plant. In addition, since it was the Tenneco Natural Gas Liquids' stock, rather than Tenneco Natural Gas Liquids' ownership interest in the plant, what it was transferred to Enron Gas Processing, the transfer could not trigger any preferential rights\(^9\).

Conversely the Enterprise Parties sustained that regardless of how the parties structured the transaction, it was, in essence, a transfer of an ownership interest. Therefore, one should look at the intent of the parties in order to determine the nature of the transaction. The Enterprise Parties based their grounds on the *Galveston Terminals, Inc. v. Tenneco Oil Co.*\(^10\), in which the First District Court of Appeals in Houston reasoned that it was imperative to examine the substance of the transactions to determine the parties’ true intent and purpose. The Court viewed the intent of the two-step process used by the seller and buyer as an attempt to circumvent the preferential purchase rights of other co-venturers, and thus, declined to recognize the transaction.

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\(^9\)Tenneco Inc. v. Enterprise Products Company at p. 645; see p. 11, last para in this paper.

\(^10\) *Galveston Terminals, Inc. v. Tenneco Oil Co.* 904 S.W.2d 787 (Tex.App.- Houston 1st Dist. 1995).
Notwithstanding the above, the Texas Court disapproved the court's reasoning in Galveston Terminals by referring to consolidated jurisprudence that come to stress that rights of first refusal and other provisions that restrict the free transferability of stocks should be construed narrowly by the courts. Hence, viewing these three separate transactions as a single transaction so as to invoke the pre-emption right provision would compromise 'the law's unfavourable estimation of such restrictive provisions'.

Furthermore, the Court sustained that the plain language of the ROA provides that only a transfer of an ownership interest triggers the preferential right to purchase, not a change in stockholders. The Enterprise Parties could have included a change-of-control provision in the agreement (such as the one in the AIPN Model Form) that would trigger the preferential right to purchase, but they did not do that. The Court reminded that it is not the courts’ task to 'rewrite agreements to insert provisions parties could have included or to imply restraints for which they have not bargained'.

In conclusion, the purchase of stock in a corporate (that has the ancillary effect of transferring its assets) was not to be considered a transfer of interest in the plant, and therefore, no rights of pre-emption were triggered, regardless of the intent and purpose of the parties.

Similar results are found in different jurisdictions. In Louisiana, for instance, a two-step transaction will not trigger the right of pre-emption provided that the transaction did not take place merely to circumvent the other parties' preferential right to acquire the

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101 Tenneco Inc. v. Enterprise Products Company at p. 646, letter c.
102 Idem.
transferor's participating interest. Therefore, as long as there is a 'legitimate business purpose'\textsuperscript{104} for the first step of the transaction, the result will be the same as in \textit{Tenneco}.

This certainly is an innovative method for transferring participating interest to parties outside the JOA, without the realisation of the triggering event. Defining in detail in the agreement what activates the burned interest, would reduce the cost and uncertainty associated with the exercise of such rights.

3.2 \textbf{Detailed wording enhances predictability: The Santos v Apache case}

A recent decision of the Supreme Court of Western Australia (\textit{Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd}\textsuperscript{105}) regarding the meaning and operation of a pre-emption rights clause in a JOA\textsuperscript{106} (named Spar JOA) illustrates how a very detailed and sufficiently clear provision is capable of being applied on its own terms. In the present section, this clause will be analysed with the aim to show how some of the mechanics, studied in the section above, can be addressed by the parties.

3.2.1 The Spar JOA

Santos Offshore Pty Ltd entered into a JOA ("Spar JOA") with three other parties: Apache Oil, Apache East Spar and Apache Kersail\textsuperscript{107} ("Santos" and "the Apache parties", respectively). The Spar JOA was an agreement in relation to the operation of a joint venture to exploit the production License for the production of petroleum.

\textsuperscript{104} Fina Oil and Chemical Company v. Amoco Production Company (n 98), at 646.
\textsuperscript{105} Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd, WASC 242 (2015).
\textsuperscript{106} Very similar to the provision contained in the AIPN 2012 form.
\textsuperscript{107} all of the issued share capital and voting rights in these three, being held by Apache Energy Ltd.
Under the Spar JOA, in the event of a proposed Change in Control of a Party to the agreement or a Transfer of the Participating Interest, Cl. 12.2 and Cl. 12.3 confer rights on the other Parties to the Spar JOA to first acquire the Participating Interest in question.

3.2.2 Analysis of the pre-emption provision

3.2.2.1 Change in control

The thesis followed in this paper is that rights of pre-emption apply to transfers of participating interest, being changes in control excluded from the triggering event. According to this statement, when the shareholding interest of a person in a party to the JOA (which holds the asset interest in the petroleum project) is transferred to a third party, the pre-emption right in respect of the participating interest is not activated. However, it was also indicated that pre-emption rights provisions could, nevertheless, apply to changes in control, if so is expressed in the JOA. This is what Santos and the Apache parties agreed to do when negotiating the Spar JOA.

12.3 (B) any Change in Control of a Party shall be subject to the following procedure. (B) once the final terms and conditions of a Change in Control have been fully negotiated, the Acquired party shall disclose the final terms and conditions (…) (D) and each other party shall have the right to acquire the Acquired Party’s Participating Interest on the terms and conditions (…).

At one point during the life cycle of the petroleum project, Apache Energy Ltd. and Viraciti Energy Pty Ltd. entered into an agreement, by which Viraciti agreed to purchase, among others, all of the shares in Apache Energy. This transaction resulted in a change of control pursuant to Cl. 12.3 Spar JOA and therefore, Apache parties were contractually obliged to follow the pre-emption procedure set in the provision.²⁰⁸

²⁰⁸ 12.3(B) Any Change in Control of a Party shall be subject to the following procedure. 12.3(C) Once the final terms and conditions of a Change in Control have been fully negotiated, the Acquired Party shall...
3.2.2.2 Package sales

One of the hindrances identified in the subsection 3.1.2 above (i.e. package sales) was whether the right of pre-emption could be extended to other assets in addition to the participating interest being transferred.

Parties to the Spar JOA, gave the following wording to cl. 12.2 (F):

"No Party shall have a right under this Clause to acquire any asset other than a Participating Interest, nor may any Party be required to acquire any asset other than a Participating Interest, regardless of whether other properties are included in the Transfer" or "subject to the Change in Control", in cl 12.3 (D)\textsuperscript{109}.

This clause was read by the Pritchard J. as a limit for the transferor/acquired party from seeking to impose a condition that the other Parties acquire other assets or interests, in addition to the Participating Interest\textsuperscript{110}. The judge, quoting Chesterman J.\textsuperscript{111} said:

"Conditions of that kind (imposing the co-venturers to acquire other assets) have the potential to impede the other parties to a joint venture agreement from exercising their rights of pre-emption".

On the other hand, the right of co-venturers was also restrained to merely acquire the burned participating interest.

disclose the final terms and conditions as are relevant to its Participating Interest, including the date of the Change in Control, and its determination of the Cash Value of that Participating Interest in a notice to the other Parties. The notice shall be accompanied by a copy of all instruments or relevant portions of instruments establishing such terms and conditions and which will constitute, subject to this Clause 12.3, an offer to sell such Party's Participating Interest to the other Parties. 12.3(D) Each other Party shall have the right to acquire the Acquired Party's Participating Interest on the terms and conditions described in Clause 12.3(C) if, within sixty (60) Days of the Acquired Party's notice, such Party delivers to all other Parties a counter-notification that it accepts such terms and conditions without reservations or conditions (subject to the terms of this clause 12.3, where applicable, and other than the attainment of any necessary Government approvals) (...).

\textsuperscript{109} Emphasis added by the author of this Thesis.
\textsuperscript{110} Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd (n 100) at para 46.
\textsuperscript{111} in THL Robina Pty Ltd v The Glades Gold Club Pty Ltd [2004] QSC 461 [45] - [50].
3.2.2.3 Non-cash value

As regards to offers with non-cash consideration, it was observed in subsection 3.1.1 above (i.e. non-cash consideration) that it is unlikely that the terms of the offer will be matched by the right holders, when no cash value is provided in the notice.

Pursuant to cl. 12.3 (F) of the Spar JOA, the right to acquire the Participating Interest was a right to acquire that Participating Interest 'for cash' rather than for some other form of consideration. Therefore, where the proposed transfer was not for cash, or involved other properties, the notice was to include 'the transferor's view of the Cash Value' so that each non-transferring party to the JOA could acquire such participating interest on the same final negotiated terms and conditions.

The 'Cash Value' was defined in cl 12.1(B) as the market value (in US dollars) of the Participating Interest being transferred that was 'based upon the amount in cash a willing buyer would pay a willing seller in an arm's length transaction', and was to yield the transferor the same after-tax proceeds that it would have obtained.

The cash value set out in the notice was to be deemed correct unless a disagreeing party gives notice to the transferor/acquired party, following the process set out in cl 12.3(G) of the Spar JOA. In case that no agreement was reached by the parties on the applicable cash value, this was to be determined by an independent expert.

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112 Santos Offshore Pty Ltd v Apache Oil Australia Pty Ltd (n 100) at para 51.
113 Cl 12.3(G): "The Cash Value proposed by the Acquired Party in its notice under clause 12.3(F) shall be conclusively deemed correct unless any Party (each a Disagreeing Party) gives notices to the Acquired Party with a copy of the other Parties within twenty one (21) Days of receipt of the Acquired Party's notice stating that it does not agree with the Acquired Party's statement of the Cash Value, stating the Cash Value it believes is correct, and providing any supporting information that it believes is relevant. In such event, the Acquired Party and the Disagreeing Parties shall have fifteen (15) Days in which to attempt to negotiate an agreement on the applicable Cash Value. If no agreement has been reached by the end of the twenty-one (21) Day period, either the Acquired Party or any Disagreeing Party shall be entitled to refer the matter to an independent expert as provided in Clause 18.3 for determination of the Cash Value".
3.3 Conclusion

When this sort of detail seen in the Spar JOA is not provided in the agreement, parties may find mechanics to avoid the realization of the triggering event (i.e. non cash considerations, package sales and two-step transactions).

It was also observed in this chapter that using standardised model forms, without any posterior negotiation among the parties involved, is not capable of ensuring an ideal regulation. Firstly, because each and every project differs from each other and the agreement may not contemplate the specific interests of the actual parties. Secondly, because the more room for interpretation is left to the Court, the greater disparity of results is determined. Therefore, it is essential to use standard models as guides for the parties' agreement, and tailor the provisions to the extent that the governing law allows it\(^\text{114}\), so as to meet the particular needs of the parties involved.

To that, Pirtchard J. stated:

"Having regard to the purpose of pre-emptive rights clauses, the courts have recognised that there is a need for caution in adopting a construction which would restrict their operation or which would permit their application to be avoided and thus which would erode the benefit conferred by the grant of a right of pre-emption. For the same reason, pre-emptive rights clauses have been construed so as not to render it impossible for a joint venturer to satisfy the requirements of the offer\(^\text{115}\)."

\(^{114}\) For instance, Norwegian joint ventures are intensely subject to the terms of the mandatory Norwegian Standard JOA; in the UK, even if the parties are free to negotiate the terms of JOAs amongst themselves, pre-emption right provisions cannot be included in the JOA since the 20\(^{th}\) round in 2002, and the previous drafted provisions have been redirected to the Master Deed form.

\(^{115}\) idem at para 35. Emphasis added by the author of this Thesis.
4 The interference of the governing law

As the reader may anticipate at this point, drafting the contract with great degree of detail may avoid the problematic situations explained above and provide for a more predictable result, when a dispute has arisen. Nonetheless, assuming that the contract will be merely applied on the basis of its own terms would be an oversimplification. A sufficiently detailed contract will not be able to prevent the external interference of the rules and principles of the governing law of the legal system where it operates.

The aim of this chapter is to illustrate the effect that the governing law may have on the construction of the contract and its interpretation. This consideration is especially important where international parties have come together in a joint venture for the purpose of a petroleum project in a particular location.

4.1 Adjusting the provision to the governing law

In the context of commercial law practice, where two or more professional parties have drafted their contract, no difficulties will often arise in case of conflict with provisions in the governing law, since the dispute will be most likely solved by applying the regulation contained in the contract, as long as the derogated rules of the governing law are not mandatory (which are a minority).

Having said that, the governing law of that particular contract will determine its interpretation in light of the desirability of ensuring a fair balance between the parties’ interests, the role that the interpreter is expected to take in respect of obligations that are
not spelled out in the contract, the existence of a duty of loyalty between the parties and the extent of a general principle of good faith\textsuperscript{116}.

On a general level, parties under the common legal system are expected to spell out all obligations among themselves in detail, because the judge's function (or arbitrator's), as Cordero-Moss explains\textsuperscript{117}, is not to imply terms, consider negotiations or subsequent conducts. Fairness means predictability. Hence, a literal interpretation is desired and it is not for the judge ‘to substitute for the bargain actually made by the parties, one which the interpreter deems to be more reasonable or commercially sensible\textsuperscript{118}'. For the same reason, the judge is not expected to integrate the contract with good faith or loyalty, since that would introduce an element of discretion and uncertainty, which is deemed unattractive in business and commerce.

Contrarily, a civilian judge would interpret the contract according to its purpose and parties' intentions. In doing so, the judge would imply terms; consider negotiations and subsequent conducts, if needed, in order to prescribe a reasonable and fair solution, balancing the interests involved in the particular case\textsuperscript{119}.

As a result, an identical provision may be interpreted differently by a Common Law Court and Civilian one. Even within the same legal family, there are significant differences, e.g. between the US and English law, or as it has been shown above, within the same system, there may be divergences, since the same pre-emption clause may have different legal effects in the different states within the US.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{117} in its book: "International Commercial Contracts Applicable Sources and Enforceability", Cambridge University Press, 2014.
\item \textsuperscript{118} CORDERO-MOSS “Boilerplate Clauses, International Commercial Contracts and the Applicable Law” (n 116) at p. 347.
\item \textsuperscript{119} CORDERO-MOSS Giuditta, "International Commercial Contracts Applicable Sources and Enforceability", (117) at p. 84-86.
\end{itemize}
\end{footnotesize}
4.2 Application to pre-emption rights

As the reader might have observed in the previous chapter, a basic tool used by all common law judges is the wording of the contract. That is, if the parties used a particular language, its precise meaning was expected to be enforced and if the contract was silent about a specific provision, that was indeed, the parties’ intention.

Most internationally distributed publications collecting model contracts in different fields such as maritime law, finance, insurance, etc. are written on a Common Law style\textsuperscript{120}. That is the case in Joint Operating Agreements with the AIPN Model Forms. The Association of International Petroleum Negotiators (AIPN), being aware of the consequences that using English-based model forms might have in civil law jurisdictions, published guidance notes concerning some specific issues such as the pre-emption rights, that should be considered when using this model form.

As regards to rights of pre-emption, the Notes suggest\textsuperscript{121}:

"In certain Civil Law jurisdictions, pre-emption rights may result from statutory law. For instance, in some Civil Law jurisdictions, the co-owners of property and the co-holders of contractual rights may pre-empt by law transfers of any of such properties and/or contractual rights to third parties. If the Parties wish not to have pre-emption rights at all, it is advisable to include a clear exclusion provision in the Operating Agreement".


\textsuperscript{121} Guidance Notes of the 2002 Model, Art. 12, at p. 5 and Guidance Notes of the 2012 model, Art. 12.2.E, at p. 6.
As a consequence of the externalization of the Common Law drafting-style practice, professional parties in different jurisdictions learn to draft international contracts on the basis of these models, which unavoidably drives the author of this Thesis to reflect on the following:

If the pre-emption provision drafted in detail by the parties could bring to an unsatisfactory result in terms of fairness and reasonableness, would that clear clause still be enforced?

The starting point is that no harmonized approach exists between legal traditions. The approach followed by two different jurisdictions - English Law in the Common Law system and Norwegian Law in the Civil Law system - will be considered to illustrate the point, but no generalization should be made in that respect. In each specific case, the party will have to look at the particularities of each state's legal tradition.

4.2.1 English Law

It would be unusual for an English court to correct the wording of a contract in order to reach a fairer result. The literal meaning of the wording in the contract is mostly enforced by the judges – as long as it does not contradict the mandatory rules of the governing law -, while at the same time admitting that they consider the result unsatisfactory. English law is not concerned with the motive behind why parties act as they do - often exemplified with the Latin expression caveat emptor, which comes to stress that every party should take care of their own interests, and do not expect the other to do that.

Fairness in this context stands for predictability. Therefore, by giving effect to the reasonable expectations of the parties, the objective requirement of good faith is

\[^{122}\text{ibid at p. 7.}\]

\[^{123}\text{CLARKE Mark and CUMMINS Tom, "Governing law and dispute resolution clauses in energy contracts", Ashurst London briefing, 2011, at p. 1.}\]
achieved\textsuperscript{124}. For a common law interpreter, a fair solution would be that one enforcing the provisions voluntarily drafted by the parties\textsuperscript{125}.

4.2.2 Norwegian Law

Under the Norwegian system, such a clause would be interpreted in accordance with the parties’ objective intention\textsuperscript{126}, but the wording of the contract, would be supplemented by principles of good faith and fair dealing. This is often referred to as the 'Nordic rule on reasonableness' (in coordination with other Scandinavian countries). According to that, a Norwegian Court would, contrarily to an English Court, but similarly to any other civil judge, interpret the contract in light of good faith and would correct the literal interpretation of a contract to avoid an unfair result.

In addition, and differing from other civilian judges’ role\textsuperscript{127}, a Norwegian Court would even go a step further and 'would correct the wording of the contract to achieve a better balance of interest between the parties, even if the contract regulation did not lead to unfair results'\textsuperscript{128}.

4.3 Conclusion

The conclusion in Chapter II was that special attention should be placed in the drafting process in order to reduce uncertainty in future disputes and guide the Court to reach the


\textsuperscript{125} CLARKE and CUMMINS (n 123) at p. 1.

\textsuperscript{126} CORDERO-MOSS Giuditta, “International Contracts between Common Law and Civil Law: Is Non-State Law to Be Preferred? The Difficulty of Interpreting Legal Standards Such as Good Faith” (n 120) at p. 15.

\textsuperscript{127} idem.

\textsuperscript{128} ibid at p. 15, where she exemplifies it with the following case: “In a long term lease agreement between a landlord and a mining company, for example, the Supreme Court interpreted a clause that gave the mining company the option to renew the lease for a further period ‘at the same conditions’, as if the landlord was entitled to renegotiate the price (and this in spite of the fact that the contract contained a clause for the indexing of the price, therefore providing for an automatic adjustment of the price and avoiding gross unfairness”.
desired result. However, as it has been explained here, the wording of the contract cannot be detached from the governing law where the contract operates and the legal tradition of the final interpreter. That is to say that even when the parties have spent long hours negotiating and have finally included detailed provisions in their contract, which regulate each and every controversy that it is likely to occur, they can not mistakenly believe that their contract is self-sufficient or tend to ‘elevate the contract to the level of law’129. Hence, a key element to take into account by the parties is the legal tradition where the JOA will operate and draft the contract accordingly.

5 Government’s rights of pre-emption

It has been explained that pre-emption rights are a mechanism that parties to a JOA may use to restrict transfers of interest under a license, and therefore it is critical for the party that wishes to transfer its participating interest to consider these rights together with co-venturers and potential buyers.

As this chapter will show, there might be other third parties’ consents or waivers required in order to complete the transaction i.e. the government’s pre-emption right. Therefore, it will be essential to understand the specific political landscape where the project is developed and the impact that the acquisition might have, as a foreign buyer.

Three different jurisdictions will be analyzed, namely: Kazakhstan, Angola and Norway, through their regulation of transfers of interest and change of control and experiences that each state has with pre-emption rights.

5.1 Kazakhstan

5.1.1 Regulation

The regulation of exploration and production of oil and gas in Kazakhstan is mainly contained in the Law of the Republic of Kazakhstan No. 291-IV, dated 24 June 2010 'On Subsoil and Subsoil Use' (hereinafter “the Subsoil Law”), amended by the No. 271-V 'On the Introduction of Amendments to Some Legislative Acts of the Republic of Kazakhstan on Subsoil Use Issues', signed on 29 December 2014 and in force since January 2015. It should be noted that a new Subsoil Code is being developed at the moment and it is expected to be enacted during 2016.

130 For the purpose of Chapter IV, no difference will be made between transfers of interest and change of control, except when deemed necessary.
The Subsoil Law regulates the full range of upstream oil and gas activities, as well as the procedure for granting subsoil use of rights, the termination and requirements for transfers of such rights, among others.

As regards to transfers of subsoil use rights and objects connected therewith the Subsoil Law prescribe in its Article 36 certain restrictions and requirements that the parties will have to comply with.

The first paragraph of Article 36 spells out a list of different scenarios that could entail a transfer of subsoil use rights and objects related to subsoil use right. The wording "objects related to subsoil use rights" stands for participating interest or shares in a legal entity holding subsoil use rights, as well as interest in a legal entity that has the power to directly or indirectly determine the decisions and or influence decision of subsoil used, if the main activities of such legal entity are connected with subsoil use in Kazakhstan. When one of this scenarios is to take place (without differentiating if its an oil or gas field with strategic importance, and the relevance of this will be shown below), the parties must obtain the consent of the Ministry of Energy before the completion of the transaction. This consent is to be issued within the next 20 days. If the transaction is completed without the aforementioned consent, the Ministry of Energy can unilaterally declare the transaction invalid. It is also important to mention that Article 37.10 states that Subsoil use rights (such as direct interests in a subsoil use contract) for petroleum may not be transferred within two years from the date of signing the contract, subject only to limited exceptions (e.g. the transfer or acquisition of subsoil use right to national company or its subsidiaries).

Article 12 recognizes the right of pre-emption that the government has to acquire subsoil use rights with respect to oil and gas fields, however, with the last amendment, only those

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which are considered to be "deposits of strategic importance", and objects connected with the latters. The government has adopted a list with the deposits with strategic importance, which includes the Karachaganak and Kashagan fields.

The priority right extends to vis-à-vis other contracting parties or parties to a legal entity possessing the right of subsoil use, and other persons to acquire (either on compensated or gratuitous basis): 1) the direct interest in a subsoil use contract (subsoil use right); 2) objects associated with the subsoil use rights.

Last paragraph of Article 12, by referring to the cases covered by Article 36.5, prescribes few exceptions to the application of this right. These exceptions include, for example, transactions concluded on a stock exchange, provided that the relevant consent from the competent authority has already been obtained for the listing of stocks (Article 36.5.1) or transactions between 99.9% affiliated entities (Article 36.5.2), when these affiliated entities are not registered in a state with preferential taxation system (i.e. offshore jurisdictions).

The procedure for implementing pre-emption rights by the state is regulated in Article 13. The State can exercise its right of pre-emption either through a national management holding company, a national company or an authorised state body. Obtaining the waiver of the state from its priority right under the law requires 50 business days.

5.1.2 Experience with pre-emption rights

In March 2003, CNOOC (China National Offshore Oil Corporation) announced its intention to buy a 16.67% stake in the North Caspian Sea Project from Britain’s BG Group US$1.23 billion. Western partners, including ENI, ExxonMobil, Royal Dutch/Shell, Total, ConocoPhillips and Inpe, could have pre-empted CNOOC’s purchase by offering the same price to BG within 60 days of the offer, but decided not to do it, since they had good experience working with CNOOC on other projects. Contrarily, the government of Kazakhstan, wishing to increase its interest in the project, refused to approve the transaction. The reasoning behind its action was that, since the government owned all
subsoil rights, it also had a pre-emptive option to acquire it\footnote{OVERLAND Indra, KJAERNET Heidi and KENDALL-TAYLOR Andrea, “Caspian Energy Politics: Azerbaijan, Kazakhstan and Turkmenistan”, Routledge, 2010 at p. 128.}. Right after, Law No 2-III was introduced to amend Article 71 of the Law on the Subsoil and Subsoil use:

“\textit{With the aim to preserve and strengthen the reserves and power resources of the economy in new and existing contracts for subsoil use the State shall have a pre-emptive right} over any other party to the contract or participants in a legal entity having a subsoil use right, or other persons to buy an alienated subsoil use right (or part thereof), or part of a share (stockholding) in a legal entity having a subsoil use right, on the conditions not worse than those offered by other buyers”.

The change was regarded as ‘highly controversial’, since it allowed the government to pre-empt any sale of subsoil use rights, even where this had not been incorporated in the original contract\footnote{ibid.}. The Kazakhstan Petroleum Association said that this new law would ‘undermine investors’ confidence in the republic’s commitment to providing a stable and predictable legal and contractual regime’\footnote{ibid.}.

After extensive negotiations, an agreement was reached whereby Kazmunaigaz (the state-owned oil and gas company, hereinafter KMG) acquired half of the BG Group’s in the project (8.33%), while the other half was split among the other consortium members.

This mechanic has been repeated during the following years. For instance, in 2012, ConocoPhillips announced that it had reached a deal to transfer 8.4% stake in Kashagan to India’s ONGSC Videsfh for US$ 5billion. Nonetheless, the government exercised its pre-emption right to block the transaction and Conoco’s share in Kashagan was sold to the state-run company KMG, one year later being transferred to CNPC (China National Petroleum Co) for the same price. At that time, China had already emerged as a major
investor in the Kazakh oil sector, having invested US$30 billion in a 2013 visit in Kazakhstan.

As these experiences show, pre-emption rights also become highly political tools that governments use for different reasons, such as to prevent the entrance of foreign investors.

5.2 Angola

5.2.1 Regulation

The main Angolan law regulating the activities of the oil sector, such as prospection, search, development, concession, among others, is the Law No. 10/04 of 12 November 2004 "Petroleum Activities Law" (hereinafter "PAL"). This act recognizes in its preamble the fundamental principle stated in the Constitution, whereby the Angolan State is the owner of the petroleum resources and the regimes of a sole concessionaire and mandatory association for petroleum concessions.

The national concessionaire, "Sociedade Nacional de Combustíveis de Angola" (hereinafter, Sonangol), is, according to Article 4 PAL, the holder of the mining rights and has the competence to conduct, execute and ensure oil operations in Angola.

Article 16 of the PAL regulates the transfers of interest under the heading "assignments". First paragraph establishes that the associates of the National Concessionaire (i.e. Sonangol) may only assign part or all of their contractual rights and duties (including the transfer of shares and participations to third parties representing more than 50% of the share capital of the assignor) to third parties of recognized capacity, technical knowledge and financial capability, after obtaining the prior consent of the supervising Minister (i.e. Minister of Petroleum), which must be published in an Executive Decree.

Nonetheless, when there is a transfer between affiliated companies, provided that the assignor remains jointly and severally liable for the duties of the assignee, the transaction will not be subject to the aforementioned Minister authorization.
In both cases, the approval of Sonangol will be necessary. In addition, the latter has a right of pre-emption (namely “right of first refusal”) when a transfer of contractual rights to third parties occurs, provided that these rights are not assigned to an affiliate of the assignor. Nonetheless, if Sonangol decides not to exercise its right of first refusal, it will be immediately transferred to the National Associates\textsuperscript{135}, which enjoy the special status of “national company” and have been granted in specific rights and duties (Articles 16.3 and 31.3 PAL).

5.2.2 Experiences with pre-emption rights

In October 2008, China Petroleum and Chemical Corporation (SINOPEC) and China National Overseas Oil Company (CNOOC) negotiated with US Marathon Oil Corporation (Marathon) and agreed to buy a 20% stake in Angola's offshore deep water block Block 32 for $1.3 billion\textsuperscript{136}. However, in October 2009 Sonangol decided to exercise its right of first refusal and announced its intention to acquire it, being the Chinese purchase blocked. The sale was finalized in February 2010\textsuperscript{137}.

Sonangol did not offer a full account of its grounds but some issues might have had been growing unease over the Chinese investment. In 2004 SINOPEC had been in negotiations with the Angolan government to develop a huge oil refinery (Sonaref) at Lobito, which was, at that time, a key target for the government. The deal was nevertheless called off because of a disagreement between the parties concerning the size of the refinery and the destination of the refined product (Beijing wanted the oil in China). Moreover, some reports suggested the disinclination in Angola over the Chinese participation, considered a

\textsuperscript{135} Art. 2.3 of the PAL: "National Associate – a corporate entity which is formed under Angolan law, with registered office in Angola which in such capacity associates itself to the National Concessionaire in any of the forms set forth in Article 14, paragraph 2".


latecomer that lacked expertise for ultra-deep-water drilling\textsuperscript{138}, and which involved the presence of 'low-skilled and temporary workers and shopkeepers'\textsuperscript{139}.

5.3 Norway

5.3.1 Regulation

The main regulations concerning the petroleum activities in Norway are the Petroleum Act of 29 November 1996 No 72 (hereinafter “the Petroleum Act”) and the Regulations of 27 June 1997 No 653.

The state participates in the license and the corresponding joint venture in the same way as any other licensee and participant. According to Section 11-1 of the Petroleum Act, the State reserves a specified share of a license and in the joint venture established by the Joint Operating Agreement in accordance with the license.

To directly or indirectly transfer a license or participating interest in a license, the approval of the Ministry is required (Section 10-12). In special cases, the transfer will be subject to a fee.

Pursuant to the standard JOA\textsuperscript{140}, a party may assign its participating interest or a part thereof. However, when the obligatory work commitment has not yet been carried out, transfers of participating interest or part thereof to others than an affiliated company will require the consent of the management committee.

Under clause 23.2 of aforementioned JOA, the State has a pre-emption right in the event that other participants agree to assign their participating interests (except those assigned to

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\textsuperscript{138} SHINN and EISENM (n 136) at p. 341.
\textsuperscript{139} ibid at p. 342.
If exercised, the state has to acquire the participating interest at the agreed price and terms with the buyer (in that respect, a party may include a clause in the assignment agreement to the effect that the agreement will be terminated if the pre-emption right is exercised\textsuperscript{142}). The notice of exercise of the pre-emption right is due no later than 40 days after the receipt of the notification.

5.3.2 Experiences with pre-emption rights

As far as it is known, the state has never exercised its pre-emption right. There is no clear explanation for this, but practitioners seem to be of the idea that there simply had not been a need for it and possibly that the cost would be too high. They also argue that Norway already has a lot of revenues from the Oil industry in form of taxes, thus no need for these rights to be on the table. This gives the impression that rights of pre-emption have the primary purpose of securing and optimizing monetary assets that which may only be ultimately exercised if there is a sporadic and exceptional need.

5.4 Conclusion

This chapter pointed to an additional risk that actors are exposed to. Transferors and potential buyers will sometimes be not only subject to the consents or waivers of the other parties to the JOA, but governments. There are multiple factors directly and indirectly connected to political rights of pre-emption. The most visible are the commercial and political interests of the governments in the contract area.

Norway is a neutral political state that has been consistent with the idea that there is little need to interfere in the industry through politics. They may have other ways to meet their interests, for instance, placing a strong focus on the licensing system. From an economic

\textsuperscript{141} Artikkel 23 (Overdragelse av deltakerandel) “(...) 3. Forretningsføreren/[Staten, ved Departementet,] kan overta hele andelen til den pris og vilkår som er avtalt (...)”.

\textsuperscript{142} Standard Joint Operating Agreement, 23.3, para 3.
perspective, there is no need either to secure the national interests through the exercise of these rights, since the tax system already serves this purpose. However, one could assume that if there was a serious economic reason (e.g. the value has heavily increased) or a critical political situation involved (e.g. a potential player with a very bad reputation), the state has this right, as a safeguard tool, in order to not be left behind.

By contrast, the tendency in developing countries shows that governments have less concerns in interfering in the industry, both for political reasons (e.g. preventing the entrance of an unwanted foreign investor) or commercial reasons (e.g. increasing the state participation in the contract area).

In sum, in some developing countries e.g. Angola and Kazakhstan the uncertainty might be higher as compared to developed countries such as Norway, which might be explained due to the greater political stability in the latter.

Be that as it may, it is critical for the parties and more specifically, as a foreign investor to consider the specific political landscape where the project operates and the risks associated with the exercise of pre-emption rights in that specific context, and decide early on in negotiations who will bear the cost of such government’s waivers and consents.
6 Conclusion

The research conducted in this paper was meant to explore critical aspects related to pre-emption rights in the context of transfers of interest within petroleum projects. The author believes that by identifying specific issues early in stage, the transfer process will be simplified, both in terms of time and expense, and the transaction successfully closed.

One of the core aspects that has been highlighted is the importance of the drafting process of pre-emption provisions.

A transfer of upstream interest is a very sensitive issue within the life cycle of a petroleum project. Parties, at the time of disposal, might disagree and in last instance, it will be for the judge or arbitrator to interpret the contract. If special attention is placed in the drafting process, uncertainty in future disputes will be mitigated and the wording will possibly guide the interpreter to reach the desired result.

In addition, it is important to understand that each upstream project has its singular characteristics; hence, the parties should adjust each provision to meet their specific needs. Using model form’s clauses without any further negotiation between the parties is not desirable and leaves the parties with a high degree of uncertainty. As explained in chapter three, several scenarios are likely to occur, such as a package sale, a restructuring transaction or an asset swap, that might render the pre-emption mechanism being circumvented. If that is not the original intention of the parties, a clear wording to that respect would favour their intentions.

All in all, drafting the contract with great degree of detail may avoid the problematic situations explained above and enhance predictability, as it was observed in the Santos v. Apache case.

Nevertheless, the insistence of the author on the importance of a clear and detailed language cannot lead to assume that the contract will be merely applied on the basis of its own terms, since that would be an oversimplification. A sufficiently detailed contract will
not be able to prevent the external interference of the governing law applicable to the contract. Chapter four illustrated the most distinguished differences between common law and civil law systems as regards to the interpretation of the contract, which is also an essential element to be considered by the parties.

Finally, pre-emption rights are not merely a tool that parties to the JOA can use to restrain the transferability of participating interests, resulting –if exercised- in an internal economic reallocation of interests between the non-transferring parties, but also a right that is sometimes granted to governments. Therefore, as a potential foreign buyer, having a broad understanding of the political landscape where the project is being developed is critical, particularly in terms of risk allocation; the mere knowledge of this risk will leave room for discussion on who will bear the cost of such government’s waivers and consents.
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