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Part 1

WHY DO OIL COMPANIES DO FARM-OUTS AND FARM-INS?

Part 2

WRONGFUL ARREST OF A SHIP

Oil and Gas, Shipping & Maritime Law

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Part 1

OIL & GAS

WHY DO OIL COMPANIES DO FARM-OUTS AND FARM-INS?

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I suspect that it is not obvious to non practitioners in the oil and gas business what the terms "farm-out" and "farm-in" mean. Apparently, these terms of art derived from a nineteenth century American practice in which sharecroppers were given an opportunity to earn a living by working land for farmers in return for a share in the proceeds of the crops.

Farm-out defined.

The established textbook on oil and gas, Daintith & Willoughby - United Kingdom Oil and Gas Law (Second Edition), has the following definition: "A farm-out is an agreement whereby a third party agrees to acquire from one or more of the existing licensees an interest in a production licence, and in the operating agreement relating to it, for a consideration which, in oil industry practice, will normally consist of the carrying out of a specified work obligation, known as the earning in obligation, used in the drilling of one or more wells. "

In the notes for editors to the text of a Department of Energy (before it was taken over by the Department of Trade and Industry) press release dated 27th November 1990 entitled "New Statement on Guidelines for Oil and Gas Farm-in Deals", farm-ins are described as follows: "Farm-ins are the oil industry term for deals where a company, not at present a licensee on a particular licensed area, can acquire an interest from one of the existing licensees. The transfers of interest are generally made in return for exploration or other commitments, for exchanges of licence interests, or for cash".

The Nigerian Petroleum (Amendment) Decree 1996 (Decree No.23) provides that "farm-out" means "an agreement between the holder of an oil mining lease and a third party which permits the third party to explore, prospect, win, work and carry away any petroleum encountered in a specified area during the validity of the lease".

You will see therefore that farming-in is a way of acquiring a licence interest and, conversely, farming-out is a way of disposing of a licence interest. In this article, I am using the term "licence interest" or "concession interest" loosely to include the bundle of rights which a participant in an oil and/or gas joint venture owns.

Touching briefly on the other methods of buying and selling licence interests, these are as follows:-

a) Share Acquisitions. In terms of documentation this is usually an easier method of acquiring a licence interest because the buyer is acquiring the shares in the company which owns the licence interest. On the other hand, with an acquisition of assets, there will be a whole raft of documentation (which will increase depending on the number of licence interests that are being transferred), including assignments of interests, assignments of licence, novations of operating agreements, transportation agreements, pipeline agreements, lifting arrangements, oil and gas sales contracts, novations or amendments of unitisation agreements (if the field has been unitised) etc. If the buyer decides to make a share acquisition the nature of the acquisition will depend on the form of the target. If the company is a private company then a relatively straightforward private company acquisition can take place if the shareholders of the target company are willing to sell, although in practice the mechanics of the transaction, as opposed to the legal issues, will be more complex the more widely spread the shareholding in the company is.

   Additional considerations will apply where the legal interest of the shares is separate from the ownership of the beneficial interest. If the target company is a publicly listed company, the acquisition can take the form of either a "recommended takeover", if the board of directors of the target company recommends to the shareholders of the target company that they accept the offer by the buyer, or alternatively a "hostile takeover" (contested takeover), where an offer is made by the buyer to buy the target company and the terms of the offer are rejected by the board of directors of the target company.

   An obvious difference between a share acquisition and a farm-in is that in the share acquisition, the buyer is buying everything within the target company which may include a number of subsidiaries involved in any range of activities apart from oil and gas exploration and production, its tax history, its assets and liabilities etc. In other words, it buys the lot.

(b) Swaps. This involves the swapping of assets (with or without a cash element) as opposed to, say, a cash consideration. This method of acquiring a licence interest is particularly popular where the parties involved are short of cash and it is also a popular way of rationalising an assets portfolio in order to concentrate on areas of particular strategic importance to a company.

Another important aspect of swaps is that they are a way of avoiding the standard pre-emption clause (pre-emption rights are essentially rights which entitle each partner in an oil and gas joint venture to require any of its co-partners that wants to sell or otherwise dispose of its licence interest to a third party instead to transfer the licence interest to it).

By standard pre-emption clause is meant those pre-emption clauses which do not address the question of what happens if the consideration for an asset is not entirely in cash. Such a pre-emption avoidance technique is referred to as procuring "the unmatchable deal". The idea is that the seller and the buyer are able to strike a deal which the seller's partners will not be able to match or which is impossible to compare with what the pre-empting partners are able to offer, if the pre-emption provision says that the transfer may only go ahead to an outside third party on terms which are better for the transferor than those proposed by its partners. The principle is that you cannot compare pineapples with mangos.

(c) Licensing rounds. The most straightforward way, perhaps, is through the licensing rounds conducted by the host government (the Ministry of Petroleum Resources in Nigeria or the Department of Trade and Industry in the United Kingdom). However, due to various reasons, some of them political, which may come into play in the decision about who gets what, this is not a very reliable way of obtaining a decent acreage.

I now turn my attention to farming-out/farming-in.

A farm-in has four basic characteristics. Firstly, one company (the seller) has a licence interest. Secondly, another company (the buyer) agrees to pay the seller's costs for a particular activity, usually a well, perhaps a seismic programme. Thirdly, in return the seller transfers to the buyer part of the seller's interest. Fourthly, the seller retains part of its interest .

What are the motives of a company for farming-in or farming-out?

In general, companies farm-in for the opposite reasons to those for farming-out. One reason is that the buyer has funds and a shortage of acreage and prospects and, conversely, the seller has acreage and is short of funds.

A second reason is rationalisation. The seller may want to get rid of acreage which is peripheral to its main operations. This may be instigated following a change of management or when one company takes over another company and inherits a diverse portfolio of acreage which may require consolidation in particular areas. An additional motivation to rationalise can be that the seller has a small equity holding in a concession which will take almost as much management time as a much larger holding. Often companies will dispose of assets which consume time and effort to an extent which they regard as disproportionate to their value in order to concentrate on acreage where they have reasonably sized interests.

Thirdly, the buyer may want the operatorship of the joint venture. This can be achieved by buying the interests of a licence holding operator or by increasing the size of one's participating interest to a level whereby one will become the operator.

Fourthly, proximity to local production infrastructure, platforms and pipelines is also a strong motive for seeking a farm-in in a particular vicinity, especially if the farming-in party has an interest in the infrastructure, platforms or pipelines. The farming-in party can use its vote to ensure that future development on the concession will use the nearby facilities and so provide additional income for it and its partners owning the nearby facilities. In a situation where the party farming-in has an interest in an adjoining concession there is an additional advantage that, as a co-owner of the data concerning the adjoining concession, it has information which could be very valuable to its neighbouring interest and, even though it will be subject to confidentiality restrictions in the joint operating agreement, in practice it will be very difficult to prove that the data is being used for a purpose not permitted by the joint operating agreement.

Fifthly, a company may wish to acquire a "marginal oil field". This is now a topical issue in Nigeria due to a situation where the government would like to see more exploration activity in areas which, due to available data and/or size, may not be attractive to the major oil companies (see advertorial for Nigerian National Petroleum Corporation in The Guardian, Saturday, August 24, 1996). The Honourable Minister of Petroleum Resources, Chief Dan Etete estimates that marginal oil fields are capable of producing approximately 800 million barrels of crude oil. However, the draft "Guidelines for Farm-Out and Operation of Marginal Fields", issued by the Department of Petroleum Resources in September 1996, recognises that "The term "Marginal Field" has a complex definition as it means different things to different people or corporate bodies" .... "Marginal Fields shall be defined as fields having the following characteristics: (i) low stock tank oil initially in place and therefore low reserves (ii) long distance from existing production facilities thereby making them economically unviable to be put on stream (iii) fields not yet considered for development because of marginal economics under the current market and fiscal conditions (iv) fields with crude characteristics that are different from current streams (such as crude with very high viscosity and low API gravity) which cannot be produced through conventional methods (v) all fields with one or more wells which have not been developed by the operating companies as a consequence of the companies' ranking. This in effect would include all unappraised discoveries and undeveloped fields but excludes fields with high gas and low oil reserves (vi) producing fields which have become uneconomical to produce when close to or past abandonment limits".

In the context of the North Sea, a number of farm-outs have taken place, involving so called "fallow acreage" which are akin to the Nigeria marginal oil fields and where the Department of Trade and Industry are interested in promoting some exploration activity.

Lastly, farming-in can be a good way of building knowledge, particularly if the company is a small company with no operatorship and it has staff to train.

What are the main types of farm-ins?

The different forms of farm-in turn principally on what is perhaps the most important provision in a farm-in agreement, which is the nature of the obligation of the party farming-in. There is the "exploration farm-in", which would typically involve the carrying out of seismic work, which can be done by a third party or the operator or might be done by each company separately or only one of them, and also the drilling of an appraisal well or wells. There is the "appraisal farm-in", where the work obligation will aim to establish the size and nature of the indicated deposit and will include the drilling of an appraisal well or wells. The key feature for the party farming-in is to become a party to the joint operating agreement, and also to be able to participate in any eventual development and to be able to influence the development through the decision-making process established in the joint operating agreement. There is also the "development farm-in". The commercial dynamics will determine who gets what in this type of farm-in because it is essentially a sharing of risk and reward. The party farming-out will have established that there are commercial oil and gas deposits and it will be selling some of its interest to the party farming-in where typically the obligation of the party farming-in will be to perform all or part of the development work.

The farming-out party's retained interest is usually referred to as the "carried interest" or the "development carry".

Lastly, in the context of the United Kingdom oil and gas industry, there is the "earn-in", which is a form of farm-in but differs from a normal farm-in only in the timing of the consent of the Secretary of State for the farming-in party to become a licensee. Under the terms of such an agreement, the party farming-in will perform whatever obligation it is required to perform but will not receive governmental approval until the work obligations are complete. The rationale for this is that the original licensee must ensure that the work programme it submits to the host government when bidding for the licence is completed before it can use the licence for trading purposes. If the Secretary of State does not give consent, the agreement will provide that the farming-out party will reimburse the farming-in party all of its costs in the abortive transaction. The position of the party earning-in is obviously inferior to that of the party farming-in from a legal viewpoint in that the legal interest comes at a later date.

Finally, as a practical matter for those involved in farming-in and farming-out, it can be seen that since the whole farm-in/farm-out transaction is dependent on government consent, it is advisable to consult the relevant arm of the government at an early stage when negotiating this sort of agreement. The government will be interested in the identity of the farm-in party (in some cases, its nationality), its financial strength and its technical ability. In the draft Guidelines for Farm-Out and Operations of Marginal Fields, the conditions for entry prescribed by the Nigerian Department of Petroleum Resources include the requirement for the operating company to show evidence of technical competence and financial capability, the party farming-in must be a citizen of Nigeria but may have a foreign technical partner who must not have more than forty per cent. equity participation in the venture vehicle, and the prior consent of the Honourable Minister of Petroleum Resources is required on the payment of a prescribed fee.

Part 2

SHIPPING

WHEN IS A PARTY WHO WRONGFULLY ARRESTS A SHIP DUE TO "MALA FIDES" OR "CRASSA NEGLIGENTIA" LIABLE TO PAY DAMAGES?

INTRODUCTION

Before dealing with the principal aspects of the case which this article reviews, I will briefly state the background facts. The case, abbreviated as the **"Kommunar"**, is fully entitled - **Centro Latino Americano De Commercio Exterior S.A. ("CLACE") V. Owners Of The Ship "Kommunar" (3)** (Lloyd's Law Reports 1997 Vol. l page 22).

The ship was arrested in an action in rem (this means an act, proceeding or right available *against the thing* as opposed to actions in *personam* i.e against the person). An Admiralty action in *rem* in which the ship itself was arrested and adjudicated upon was brought by CLACE as the Plaintiffs. In the earlier proceedings it had been held that the Defendant owners of the vessel (AOL), the privatised Russian legal entity at the time of the arrest by the Plaintiffs, were not the same legal entity as POL, the charterers, or party in possession of the vessel Kommunar when the cause of action arose against them in 1991/1992. Accordingly, the writ was set aside and the Kommunar was released.

In the present case, the Defendants contended that the court should exercise its powers under section 51 of the Supreme Court Act, 1981 (an English Statute) and make an order that the Plaintiffs' parent company, Sovrybflot, should be jointly and severally liable for the costs of the earlier application and hearing. Under section 51 of that Supreme Court Act, 1981 the court can exercise its discretion to make a non-party liable as the section provides that "Subject to the provisions of this or any other Act and to rules of court the costs of and incidental to all proceedings in the Civil Division of the Court of Appeal and in the High Court, including the administration of estates and trusts, shall be in the discretion of the court, and the court shall have full power to determine by whom and to what extent the costs are to be paid".

The Defendants submitted that Sovrybflot had been the party controlling the conduct of the action throughout the proceedings.

The Defendants further claimed that the arrest of the vessel was wrongful on the grounds that the Plaintiffs knew that POL had been privatised and should have appreciated that the beneficial owners at the time of the arrests were a legal entity distinct from POL. Accordingly, the Plaintiffs wrongly evoked the jurisdiction of the English courts when they ought to have appreciated by reason of the words of section 21(4) of the Supreme Court Act, 1981 that no such jurisdiction existed. Damages were therefore claimed for wrongful arrest.

APPLICATION FOR A COSTS ORDER UNDER SECTION 51

Mr Justice Coleman sitting in the Queen's Bench Division (Admiralty Court) ruled that Sovrybflot had not supported the proceedings in bad faith and therefore there was no justification for a costs order against them.

THE CLAIM FOR DAMAGES FOR WRONGFUL ARREST

The Defendants submitted that the Plaintiffs were guilty of *crassa negligentia and/or mala fides* when they arrested the vessel. They contended that Sovrybflot knew all the relevant facts about the privatisation of POL, the owners, charterers or party in possession of the vessel when the cause of action arose and that from those facts Sovrybflot should have realised that the beneficial owners at the time of the arrest was a different legal entity from POL (as the judgement later justified). Accordingly, they initiated and pursued the case (up to the hearing of the motion for release) without reasonable or probable cause and that this amounted to *crassa negligentia* and Coleman J was asked to compensate the Defendants in damages.

Mr Justice Coleman then considered the basis of the principles governing the recovery of damages for wrongful arrest of a ship in **The Evangelismos (1858) 12 Moo. PC 352**. The facts of that case were that a vessel had collided with the Plaintiff's vessel while the latter was at anchor. *The Evangelismos* was wrongly arrested because the Plaintiff mistakenly thought that it was the errant vessel that collided with the Plaintiff's vessel. The guilty vessel had made good its escaped after being chased by boats from the Plaintiff's vessel. Dr Lushington held in that case that the arrest was bona fide and that there had been no mala fides in the proceedings and therefore dismissed the claim for damages for the three month arrest. On appeal to the Judicial Committee of the Privy Council, The Rt. Hon T. Pemberton Leigh in giving judgement said "Undoubtedly, there may be cases in which there is either mala fides, or that crassa negligentia, which implies malice, which would justify a Court of Admiralty giving damages, as in an action brought at Common law damages may be obtained... The real question in this case ...: is or is there not, reason to say, that the action was so unwarrantably brought, or brought with so little colour, or so little foundation, that it rather implies malice on the part of the Plaintiff, or that gross negligence which is equivalent to it?" Their Lordships decided against the Appellant's proposition.

In analysing the case of **The Evangelismos,** Justice Coleman said that there are two types of cases on which a proper claim for damages can be brought:

1. "....Cases of mala fides, which must be taken to mean those cases where on the primary evidence the arresting party has no honest belief in his entitlement to arrest the vessel".

2. Cases of gross negligence... "in which objectively there is so little basis for the arrest that it may be inferred that the arresting party did not believe in his entitlement to arrest the vessel or acted without any serious regard to whether there are adequate grounds for the arrest of the vessel".

The second case involves "crassa neligentia" or "gross negligence" which, according to Justice Coleman, implies malice or the equivalent thereof.

Coleman J. went on to consider five subsequent nineteenth century decisions which he had been referred to.

The Cheshire Witch (1864) involved a plaintiff who applied that the arrest continue for twelve days after his substantive claim in rem was dismissed - to permit him time to consider an appeal. Dr Lushington held the plaintiff liable in damages as the application for time to consider whether the plaintiff would appeal "was for his own convenience only". Justice Coleman distinguished this case reasoning that although he could not ascertain the strength of the plaintiff's case it must be the case, that following judgement against the plaintiff, an appeal was manifestly so hopeless as to deprive the plaintiff of all reasonable grounds for continuing the arrest.

I submit that circumstances may exists whereby it is proper for the plaintiff to hold onto his security without liability and damages, if there is a reasonable prospect of a successful appeal.

Coleman J went to consider Dr. Lushington's judgement in **The Cathcart** (1867). In that case, the plaintiff mortgagee arrested the ship on the grounds that

(1) the mortgagor was in default regarding payments due and

(2) the ship was about to sail in an unseaworthy condition in breach of the plaintiff's marine insurance obligations. In fact, neither ground was tenable. Dr. Lushington held, distinguishing **The Evangelismos** (1858), that the plaintiffs had full knowledge of the facts and should have known that they had no right to arrest the ship and, in addition made false allegation of fraud. Coleman J. summarised that the substance of the decision is that it should have been obvious to the plaintiffs that they had no right to possession by

reason of default in payment and that there were no grounds for their allegation of intended fraud in sending the vessel to sea when unseaworthy.

In **The Margaret Jane** (1869) where salvers had rejected the valuation of a receiver of wreck, the salvers were held liable for damages for bringing proceedings based on an unjustified valuation even though there were no mala fides.

In the decision of the Judicial Committee of the Privy Council on an appeal from New Zealand, in **The Strathnaver**, it was held that damages were not recoverable in respect of a mere error of judgement.

In **The Walter D. Wallet** (1893) it was also held that the test was whether there was want of reasonable or probable cause for the arrest. It is submitted that this appears to be a more objective test than that proposed by Justice Coleman.

Justice Coleman, after dealing with the nineteenth century decisions, concluded that although Sovrybflot who controlled the proceedings at all material times were aware of the facts relating to the privatisation of POL, but because of the complexity of the privatisation and the fact that they relied on London Solicitors, who are very experienced in this field and who did not overlook any obvious defect in the proceedings, the arrest of the vessel was held not to be malicious nor was there mala fides nor crassa negligentia.

Justice Coleman also rejected the Defendant's argument that they were entitled to damages in respect of the six day period following the first judgement during which an appeal was under consideration. He however gave leave to appeal. Therefore, a relatively short delay to consider and take up an appeal in such circumstances, in Coleman's view, was not unjustifiable.

Following the principles laid down by our Supreme Court in UDE v. UWARA (1993) 2 NWLR (Part 278) 638 at P. 659 B-C per Nnaemeka - Agu, it is submitted, that the principles of law settled in the above cases will be followed by our courts with little or no hesitation.

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