

A Liber Amicorum: Thomas Wälde

Law Beyond Conventional Thought

Edited by
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Thomas Wälde
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Bifurcation of Title in International Oil & Gas Agreements

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I. Introduction

Owners of oil and gas rights often want to transfer all or part of their rights and obligations to other parties. They transfer these rights and obligations for a number of reasons; including to raise capital and to spread risk. They use different kinds of contracts to carry out such transfers; such as farmout, participation, swap and transfer agreements. They employ a number of legal mechanisms in these contracts to effectuate these transfers; one of which is the splitting or bifurcation of title in the oil and gas rights.

Bifurcation of title results in the splitting of the oil and gas rights into a 'legal' interest or title and a 'beneficial' interest or 'equitable' title. Title to any property, including oil and gas rights, is normally defined as the '... union of all elements (as ownership, possession, and custody) constituting the legal right to control and dispose of property'.¹ Legal title is '... title that evidences apparent ownership but does not necessarily signify full and complete title or a beneficial interest'.² It is the title that is usually registered with and formally recognized by a government. Equitable title is '... title that indicates a beneficial interest in property and that gives the holder the right to acquire formal legal title'.³

In an oil and gas transaction, such as a farmout agreement, a holder of the oil & gas rights may split the title into a legal title and a beneficial interest and subsequently transfer the beneficial interest (but not the legal title) to a transferee at the time of the transaction. The transferor usually holds the title in trust until the transferee meets certain, specified conditions; at which time the beneficial interest is usually converted into a fully recognized legal title in the oil and gas rights. Before bifurcating title in such transactions, parties need to be aware that the risk associated with such title bifurcation can vary widely depending on the jurisdiction where the oil and gas rights are issued and governed.

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¹ *Black's Law Dictionary*, 1622 (Bryan A. Garner ed., 9th Edition, West 2009).

² *ibid* at 1622.

³ *ibid* at 1622.

II. Ownership and Applicable Law of Oil & Gas Rights

The original ownership of oil and gas rights is held and granted by governments in most countries in the world:

Virtually all mineral ownership regimes are based on the jurisprudential theory of state sovereignty. The sovereign of a defined geographical area has exclusive legal dominion over the area, including its natural resources. ... the most common global regime places ownership of minerals in the government... Energy resources... are subject to the government-ownership regime in virtually all countries except for North America. Today private ownership of all types of natural resources is possible only in the United States, Canada, and perhaps a few other countries. Even in the United States and Canada, the bulk of mineral reserves is owned by the government.⁴

The governments of those countries establish and determine the legal basis on which those rights are granted and assigned. When governments issue and grant a host government contract (HGC), such as a production sharing agreement (PSA), risk service agreement (RSA) or a lease/licence under a tax/royalty system to an international oil company (IOC) or a consortium of IOCs, they transfer the rights and obligations under their HGC to the IOCs pursuant to the law stated in that HGC or under the umbrella of the country's hydrocarbon law. It is therefore that contract and that law that determine the rights and obligations granted to the IOCs and the legal basis upon which the IOCs can make future assignments of those rights and obligations.

III. Split Title in Oil & Gas Agreements

In North American jurisdictions, grantors of oil & gas rights often split the title they grant. Even if the original grantors of the oil & gas rights do not do so, grantees sometimes subsequently bifurcate the title granted to them in the assignments that they make to third party assignees.

The title to oil and gas rights can be split in many different ways. Government grantors in North America often split the title by the type of mineral rights granted; e.g., oil, gas, coal, associated gas, oil sands, methane, etc. They also can split the title at the top or bottom of a particular geological formation or by the depth a well is drilled. When grantees of such oil and gas rights split the title in their subsequent assignment documents, they normally bifurcate it into a 'legal' title that is registered in some form of government registry and a 'beneficial' title

⁴ EE Smith, 'World Energy Resources: Ownership, Control & Development', in *International Transactions* at 28 & 38 (EE Smith et al. eds., Rocky Mountain Mineral Law Foundation, 2nd ed., 2000).

that is held in trust by the assignor. This title bifurcating mechanism is commonly used in farmout agreements in North America. This legal practice has migrated into international oil & gas agreements. However, many countries' legal systems (particularly civil law jurisdictions) make no distinction between a 'beneficial' interest and a 'legal' title. One has to look to various sources to determine the legal validity of this practice.

Most of the publicly available case law on oil & gas transactions and agreements comes from U.S. (primarily Texas), Canadian (primarily Alberta) and English courts. These cases (including those concerning farmout agreements and title bifurcation) deal with disputes arising from O&G operations in their own domestic jurisdictions. International disputes over oil & gas agreements are mostly decided by international arbitration tribunals, which reflects the dispute resolution forums chosen in those agreements.⁵ International arbitration awards are not widely available in the public domain. Therefore, the best way of determining what is normally included in those international agreements and what is considered best practice is to look at the model contracts developed by the industry.

Model contracts are developed by industry organizations over many years and reflect commonly accepted industry practice. They provide a good starting template for companies negotiating such transactions. They are drafted to be flexible enough to allow the parties to pick and choose the alternatives and options that work best for them.⁶ The relevant international model farmout agreement and joint operating agreement (JOA) for international transactions are those that have been developed by the Association of International Petroleum Negotiators (AIPN). The AIPN issued three versions of its model JOA in 1990, 1995 and 2002 and is presently drafting a new version. It issued only one version of its model farmout agreement in 2004.

IV. Farmout Agreements

IOCs will often raise capital for exploration work programs by finding joint venturers through a farmout. This helps them spread both the

⁵ The 2002 AIPN Model JOA drafting committee sent a list of questions to all AIPN members asking them how they used the existing JOA and what revisions would be most beneficial. The survey confirmed that few disputes arose under the 1995 model JOA, that international arbitration was the preferred forum and that English law was widely chosen (with Texas and New York law being chosen less often than once thought). See P Weems and M Bolton, 'Highlights of Key Revisions – 2002 AIPN Model Form International Operating Agreement' (2003) 6 *Int'l Energy L & Tax'n Rev* 169, 171.

⁶ See AT Martin, 'Model Contracts: a Survey of the Global Petroleum Industry', Vol 22 No 3 *Journal of Energy & Natural Resources Law*, at 281 (August 2004) for a more complete analysis of model contracts in the international O&G industry.

risk and cost associated with exploration. The following explanation describes how a typical oil and gas farmout works in the United States:

[A farmout is an] agreement by one who owns drilling rights to assign all or a portion of those rights to another in return for drilling and testing on the property. The individual or entity that owns the lease, called the 'farmor' or 'farmoutor' is said to 'farm out' its rights. The person or entity that receives the rights to drill [is] referred to as the 'farmee' or 'farmouttee'.... The primary distinction between an operating agreement and a farmout agreement is functional. A farmout agreement is a contract by which one party earns an interest in an oil and gas lease owned by another, while an operating agreement is entered into to define the rights and duties of parties who already own joint interests in a lease or a drilling unit and to combine those interests for joint operations. Another distinction is that the farmee 'carries' the farmor for all or a portion of the drilling costs in a farmout, while the parties to an operating agreement generally share the costs of drilling. Typically, those who enter into a farmout agreement also will execute an operating agreement to govern their rights after they have performed the farmout contract.⁷

Farmouts are usually structured in one of two ways with regards to when a farmor assigns a part of its interest to the farmee:

Farmout agreements traditionally have taken the form either of an agreement to convey or a conditional assignment. The essential difference in the two is the point in time when the farmee acquires an interest in the farmed-out property. When the farmout is in the form of an agreement to convey, the farmee obtains its rights only if it performs the conditions made prerequisite by the contract. When the farmout is in the form of a conditional assignment, the farmee obtains an interest in the farmed out property when the agreement is made, subject to an obligation to reconvey or to automatic termination if the conditions subsequent are not performed.⁸

Parties use the technique of bifurcating title in agreements to convey. The farmor conveys an initial beneficial interest to the farmee with the right to earn legal title upon fulfilling the conditions in the farmout agreement.

The traditional use of the term 'farmout' is normally applied to a 'drill to earn' arrangement. What normally happens in the North American O&G industry is that the farmee in its own capacity undertakes to either shoot seismic or drill a well or several wells (or both) on the farmor's O&G lease. Once the farmee completes that undertaking, it has earned its interest in that O&G lease. The farmee usually continues to operate

⁷ John S Lowe, 'Analyzing Oil and Gas Farmout Agreements' (1987) 41 *Sw. L.J.* 759, 763-64.

⁸ *ibid* at 796.

that lease; rather than the farmor re-assuming its former operator role. These types of arrangements are relatively straightforward in North American operations where the land registry systems are efficient and government approval is not required for the transfer of mineral rights. The international O&G industry also uses the term 'farmout', but the mechanics of the transaction are handled differently. Quite often, the farmee agrees to provide the funds to the farmor so that the farmor can carry out the agreed upon operations; while the farmee retains the ability to approve or not approve what the operator (i.e., the farmor) does. This reflects the legal, political and operational challenges encountered in the international O&G business. Most governments want to control who manages their national resources and Ministries of Energy are often reluctant to accept a new party. As a result, many international farmout agreements include a condition that government approval must be obtained for an assignment of rights as required by the HGC.

V. Government Approval

The AIPN model farmout agreement is illustrative of what is typically found in international O&G farmout agreements and HGC title transfers. It is drafted for a relatively simple scenario in the exploration phase of a PSA, RSA, or Concession License. The consideration provided by the farmee can be either a work program, sometimes called a 'drill to earn', or cash. It also provides for the option to pay a premium or 'promote' which occurs in many farmouts. The model contract provides for the assignment of an interest by way of a separate assignment document. This assignment document can either be executed along with the farmout agreement and submitted to the government for approval shortly after signing the farmout agreement, or alternatively, the assignment document can be executed after satisfaction of the conditions precedent and government approval being obtained. If the first alternative is chosen, a mechanism is built into the agreement to unwind the transaction if the conditions are not met. This is quite often done by having the farmee grant the farmor a power of attorney to cancel the assignment after the fact. Alternatively, many farmout agreements simply provide that the parties will obtain the government's approval as required under its HGC or hydrocarbon law.

The AIPN model farmout agreement recognizes the difficulty of obtaining government approval to an assignment by providing an optional provision for the farmee to terminate the agreement at that time without any further obligation or liability. The guidance notes to the model explain the impact of failing to obtain the necessary government approvals:

In some jurisdictions, a failure of the Government to approve within a specified amount of time may be deemed to be approval or rejection of the proposed Assignment. In some jurisdictions, it is possible for Farmor to hold the interest of the Farmee in trust. However, it is likely that the establishment of a trust implies a transfer and could be considered a breach of Contract for not obtaining government approval. In addition, the legal regimes of some jurisdictions may not recognize a beneficial trust. Finally, there may be tax consequences associated with a trust.⁹

In July 2004, the drafting committee for the AIPN model farmout agreement presented the final approved AIPN Model Farmout Agreement to the attendees of the AIPN's annual Model Contracts Workshop, which is the primary venue for the development of its model contracts. A Question & Answer session was held that captured industry wide concerns and best industry practices with regards to international farmout agreements and the related assignment of interests under HGCs:

Comment: In some jurisdictions, the Assignment document cannot be signed until governmental approval has been obtained.

Comment: An attendee cited one case in Africa where government approval of an assignment was not required but was sought.

Q: Is there an equitable assignment if the Farmout Agreement is signed but the Parties do not yet have government approval?

A: Possibly.

Q: If the government consents to an Assignment, don't we still need a document referencing the agreement of the Parties?

A: An equitable interest could be created but this would only be effective between the Parties.

Q: If the Host Government requires approval prior to making an assignment, then the Government could terminate your contract if a party made an assignment without prior government consent.

A: Good Point.

Q: Could you get government approval for an assignment subject to certain conditions, i.e., reassignment if not comply?

A: Uncertain but possible.¹⁰

The concerns raised in this industry dialogue underline that parties must obtain timely government approval for their farmout if such approval is required; failing which the HGC may be at risk.

Even though bifurcation of title regularly occurs in North American farmout agreements, this title transfer technique is not commonly used in international farmout agreements because of the risk associated with not getting the necessary government approval at the beginning of

⁹ AIPN Model Farmout Agreement User Manual, 4 (2004).

¹⁰ Papers from AIPN 2004 Model Contracts Workshop available at www.aipn.org

the transaction. Parties can reduce, if not eliminate, this legal risk by obtaining the government's prior written approval to an assignment while imposing an obligation on the farmee to reconvey or provide for automatic termination of the farmout agreement if the farmee fails to fulfill its obligations. The reason for favouring this more common practice in international farmout agreements is simple. Even though there may be a problem getting the farmee to reconvey its interest back to the farmor if it fails to complete its earning obligations, it is better to get the government's approval to the transfer at the beginning of the earning period rather than at the end in order to meet the requirements of the HGC or hydrocarbon law. No IOC wants to have a dispute. But if a farmor has to pick a fight between an uncooperative farmee or a displeased government, the farmee is a better choice.

VI. Support for Bifurcation in International O&G Agreements

If parties to an international farmout agreement choose to split the interest in a HGC into a 'legal' title and a 'beneficial' interest and then transfer the beneficial interest to the farmee, such actions could imply a transfer of the rights and obligations under the HGC. Where it is and where a required government approval has not been obtained, such title bifurcation and transfer may not be recognized by the government and, more significantly, may be considered a breach of the HGC or the hydrocarbon law.

In response to such allegations, parties that bifurcate the rights and obligations in HGCs and enter into a farmout agreement without obtaining prior government approval cite a number of legal justifications for their actions.

A. Governing Law of Farmout Agreement

The parties to an international farmout agreement usually choose a governing law for their contract with which they are familiar and comfortable. That law is most likely the law of their home jurisdiction and not the law of the country where the HGC is granted. If that chosen law is from the United States, Canada or England, it would recognize the concept and validity of title bifurcation. The farmor and the farmee would therefore want to rely upon this law to declare that the bifurcation and transfer of title under their farmout agreement were legally valid.

Even though this law is the proper law to apply in any dispute between the farmor and the farmee concerning their farmout agreement, it is not the correct law to apply in determining whether the rights and obligations under the HGC were properly assigned or even assigned at

all. The only law that can be applied in determining whether a proper assignment of an interest under the HGC was or could be completed is the law in the HGC or the hydrocarbon law that granted the original title. That law is usually the law of the host government and it is that law that will determine the requirements for transferring interests under the HGC.

In addition, neither the government, its designated ministry nor its national oil company (NOC) can be bound by a farmout agreement and the law that governs that farmout agreement if they are not parties to that farmout agreement. Invariably, they are not.

B. International JOAs Recognize Bifurcation

The most significant and long term contract used amongst IOCs in the upstream O&G business is the joint operating agreement (JOA). It sets out the fundamental and overarching relationships in a joint venture consortium from the initial exploration to the ultimate production of hydrocarbons. Proponents of title bifurcation in international O&G agreements argue that the practice is well recognized and is customarily included in international JOAs; as shown in Articles 8.4 and 13.7 of the AIPN Model JOA,¹¹ which is the industry standard for international JOAs.

Article 8.4 (F) of the Model JOA reads: 'In the event all Government approvals are not timely obtained, the Defaulting Party shall hold the assigned Participating Interest in trust for the non-defaulting Parties who are entitled to receive it'. Article 13.7 of the Model JOA states: 'If the Government does not approve a Party's withdrawal and assignment to the other Parties, then the withdrawing Party shall at its option either (1) retract its notice of withdrawal by notice to the other Parties and remain a Party as if such notice of withdrawal had never been sent or (2) hold its Participating Interest in trust for the sole and exclusive benefit of the non-withdrawing Parties with the right to be reimbursed by the non-withdrawing Parties for any subsequent costs and liabilities incurred by it for which it would not have been liable, had it successfully withdrawn'.

These articles do not provide for the bifurcation of title or speak of 'legal title', 'equitable title' or 'beneficial interest'. Instead, these articles attempt to deal with an unplanned, difficult situation where the remaining parties in the JOA and the HGC are forced to deal with a party that is not paying its share of the costs. These articles do not apply to the

¹¹ Article references are for the 2002 AIPN Model JOA. There are similar articles in prior AIPN models.

situation where a party to a HGC is considering transferring a part of its interest under a farmout agreement to a new third party. These are situations where the JOA parties request the government's approval to the transfer of an existing party's interest that is either defaulting or withdrawing and the government fails to provide it. These are not of the JOA parties' making. The parties are simply attempting to set up a trust arrangement where they have limited, if no options. And the party that has to hold its interest in trust under these two articles is a party (the defaulting or withdrawing party) that already holds legal title in the HGC.

Even though the AIPN Model JOA does not mention the bifurcation of title, it does recognize the importance of obtaining government approval prior to transferring an interest in a HGC. Article 3.2 (B) of the AIPN Model JOA provides that a transferee is not entitled to any rights under the HGC and JOA until Government approval has been obtained and the consent of the other Parties has been received: 'If a Party transfers all or part of its Participating Interest pursuant to the provisions of this Agreement *and the Contract*, the Participating Interests of the Parties shall be revised accordingly'¹² (emphasis added). As a co-chair of the 1990 model drafting committee has pointed out: '... the transfer document is not just an assignment, it is rather a novation that must be executed by all Parties and the host government'.¹³

C. Privity of Contract

Parties that bifurcate title without first obtaining a required government approval have argued that the government need not worry since it only has to look to the original HGC contractor for the fulfillment of its obligations. They point out that a farmee with no legal title does not take the place of the contracting party and does not in any way reduce the government's ability to have the HGC obligations fulfilled or to seek redress from the contractor if they are not fulfilled. As long as the farmee is not a party to the HGC, the farmee cannot exercise any rights directly against the government and therefore the government is not put at risk of having to deal with an unknown party. The underlying argument is that neither the farmor nor the farmee can be in breach of the HGC since the HGC obligations are being fully met. It does not matter where the funds are coming from or how decisions are being made under the farmout agreement or the JOA. The government only has privity of contract with the HGC contractor (i.e., the farmor) and

¹² The AIPN Model JOA defines 'Contract' as the HGC in Article 1.14 and the initial recitals of the JOA.

¹³ Andrew B. Derman, *Model Form International Operating Agreement: An Analysis and Interpretation of the 1995 Form*, ABA Monograph Series Number 23, 43 (1997).

not the farmee, and therefore the government need only look to the named contractor. Since the work obligations under the HGC are being met, ergo the bifurcation of title and the agreement to convey under the farmout agreement must be valid.

The problem with this argument is that many HGCs and hydrocarbon laws specifically require prior government approval to the transfer of an interest in a HGC and they do not recognize or allow for the unauthorized bifurcation of title. Many governments have decided for their own policy reasons to restrict who operates or invests in their country. These restrictions are intended to prevent undeclared transactions in which the contractor has agreed to undertake joint operations with an unknown third party, while continuing to hold itself out to the government as the sole party involved in operations. It therefore does not make sense to allow a contractor to invoke privity of contract as an argument to avoid the very restriction against such transactions. If that argument had any substance, there would never be a situation in which the sanction could apply.

D. Joint Liability

Another argument put forth by parties that bifurcate and transfer title under farmout agreements without obtaining prior government approval is that a farmee does not undertake any liability under the HGC and therefore can have no obligation towards the government or the NOC under the HGC, and vice versa. They point to the standard language in international JOAs that expressly disclaims joint and several liability amongst the parties. This standard language is found in Article 14.1 of the AIPN Model JOA. That language reads: 'The rights, duties, obligations and liabilities of the Parties under this Agreement shall be individual, not joint or collective. It is not the intention of the Parties to create, nor shall this Agreement be deemed or construed to create, a mining or other partnership, joint venture or association or (except as explicitly provided in this Agreement) trust'.

The language in Article 14.1 of the AIPN Model JOA and thus in many international JOAs is an attempt to limit the joint and collective liability of JOA parties against the default of one of the parties in the agreement and the tax consequences of creating joint ventures or partnerships. This kind of provision is almost universally ignored by governments around the world. Governments take the position that since they are not parties to these agreements, they are not subject to their contractual provisions. Governments also consistently take the position that the only thing that matters in establishing liability in such circumstances is their own law and regulations, regardless of whether a party has failed to enter into

a contract with the government. Those laws and regulations usually impose joint and several liability on the parties.

Interestingly Article 14.1 states that the parties are not creating a trust, even though Articles 8.4 and 13.7 of the Model JOA say otherwise. This article also does not mention bifurcating title or the creation of legal or equitable titles and therefore does not lend any support to the use of bifurcation in international JOAs or farmout agreements.

E. Farmee Does Not Influence or Impact HGC

The final justification for the legitimacy of title bifurcation is that a farmee cannot direct either the day to day management or long term development strategy of a HGC under the terms of an international farmout agreement and JOA. The reasoning behind this argument is that a farmor, as the sole party to the HGC and as the sole operator under the JOA, retains final decision making authority over a block's operations. If that were the case, a farmee cannot influence or impact the long-term objectives of the HGC, the daily operations on a block or the completion of the HGC obligations.

It is normal practice in international JOAs for an operating committee to delegate substantial authority to an operator. That is what operators are expected to do. But that does not diminish a non-operator's ability to approve or not approve development plans, work programs and budgets, relinquishments or amendments of a HGC under a JOA. An operator usually prepares the work programs and budgets and long term development strategy. But it is the operating committee that ultimately approves and provides the funds for those work programs and budgets and long term strategies. This is clearly stated in Article 5.2 of the AIPN Model JOA, which is common language in many international JOAs: 'The Operating Committee shall have the power and duty to authorize and supervise Joint Operations that are necessary or desirable to fulfill the Contract and properly explore and exploit the Contract Area in accordance with this Agreement and in a manner appropriate in the circumstances'. All important decisions of the Operating Committee are made according to the pass mark set in Article 5.9 of the AIPN Model JOA: '... all decisions, approvals and other actions of the Operating Committee on all proposals coming before it shall be decided by the affirmative vote of – or more Parties which are not Affiliates then having collectively at least – percent of the Participating Interests'.

What matters is not whether the farmee (and non-operator) is in charge of operations, but whether it is able to participate in an operating committee whose decisions the operator is obliged to carry out. If the

farmee's vote is required to meet the designated pass mark, then the operator can only carry out Joint Operations with the concurrence of the farmee. The only conclusion that can be reached is that a farmee in an international farmout agreement and JOA does in fact participate in decisions that directly impact the strategy and daily operations in a HGC block.

VII. Conclusion

The law that applies to the transfer of an interest or title in a HGC is the law provided in the HGC or in the hydrocarbon law of the country granting the original title. Even though bifurcation of title is regularly used in farmout agreements in North America where it is legally recognized and valid, that is not always the case in international farmout agreements in other parts of the world. If the HGC or hydrocarbon law does not recognize the bifurcation of title and requires prior government approval of a title transfer in the HGC to a third party, there is significant risk in not obtaining prior written government approval to a farmout agreement and the bifurcation and transfer of title. This could possibly result in a breach of contract and the unilateral termination of the HGC by the government. The facts of each case will determine the validity of a transaction; nevertheless, IOCs need to be careful in bifurcating title in international oil & gas agreements.