Subsoil Licenses and Associated Legal Risks

By A. Bardin, *LeBoeuf, Lamb, Greene & MacRae (Moscow)* ***and A. Sapozhnikov,*** *LUKOIL Overseas Service, LTD (Moscow)*

Lately we have witnessed quite heady development of Russian oil companies. This development was mainly caused by the high global prices for oil, which make its production and sales abroad very beneficial for our companies. If previously Russian oil giants endeavoured, above all, to create alliances with foreign partners, currently their general objective is to seek for the new ways of autonomous actions that could allow them not to share profits that they receive in such "high price" conditions.

It is quite natural that for autonomous development of oil fields and elaboration of projects, oil companies require external financing. Taking into account the limited abilities of the national banking sector and extensive amounts of such financing (the price of a sea platform for the oil production may account for billions of US Dollars) only foreign banks are able to provide such expensive financing. The main condition for the provision of financing by the foreign banks is the fulfilment of a due diligence requirement, i.e., full examination of business activities of the company in order to find out how trustworthy the company is.

Checking Licenses: Why?

The main task of due diligence is to check the company's rights to its assets and to determine the grounds on which the company may be deprived of its assets (risks), as well as the likelihood of such risks. Oil companies' peculiarity is that the rights to develop certain perspective oil fields are the most valuable of their assets. The repayment of the loan, in a project finance scheme, is made, as a rule, from the proceeds of the project, in our case it is the proceeds from selling oil. Thus, the main risk to be assessed during due diligence exercise is the risk of a loss by the company of its rights to the oil field, which development is to be financed by the banks. Such rights, in the Russian Federation, are formalized by licenses for subsoil use, hence among the main aspects that should draw the utmost attention of a lawyer checking the validity of the said rights are the following: the manner in which the license has been issued (or re-issued), whether the company in question fulfils the terms and conditions of the subsoil use determined by the license, and whether there might be any grounds for its revocation.This article covers those

snags in legislation that may evoke uncertainty about the validity of licenses for subsoil use and therefore threaten the successful implementation by the oil companies of their projects.

Legal Background

By the onset of the current stage of development of the subsoil use legislation milestoned by the adoption of the Law on Subsoil in 1992, the effective Russian legislation comprised the 1975 Fundamental Principles of the Legislation of the Union of Soviet Socialist Republics and Union Republics on Subsoil and the Subsoil Code of the RSFSR (Subsoil Code) of 1976. The above regulations contemplated that the document providing an entrepreneur with the right to produce oil was the mining allotment act.

On February 21, 1992, the Law No. 2395-1 On Subsoil (the "1992 Law") was adopted, for the first time determining that a special permit in a form of a license formalizes the provision of subsoil for use. The 1992 Law defined the license as a document certifying its holder's right to use a subsoil segment within certain boundaries, during an established term, and subject to the fulfilment by the license holder of predetermined requirements and conditions. Later in 1992, the Supreme Soviet of the Russian Federation, by its Resolution No. 3314-1 of July 15, 1992, passed the Regulations On the Procedure for Subsoil Use Licensing (the "Licensing Regulations"), which covered the basic issues, related to the license issuance mechanism.

The next noticeable change in the subsoil use licensing system was the amendment of the Law On Subsoil in 1995. The amended law (the "1995 Law") established the list of grounds to obtain the right to subsoil use that previously had been reflected by the Licensing Regulations only, as well as the list of grounds for the re-registration of said rights. Later in 1995 (on the18th of May), as a further step in the development of the 1995 Law, the RF Subsoil Committee, by its Order No. 65, approved the Instruction On the Procedure for Re-Issuance of Licenses for Subsoil Use ("Instruction 65").

And finally, the latest stage in the development of the contemporary licensing mechanism was the amendment of the 1995 Law in 2000 and 2001. While these amendments were less comprehensive than the ones in 1995, they did add more specifics to the provisions of the 1995 Law related to the holding of tenders and auctions, issuance and re-issuance of licenses, and termination of the rights to use subsoil.

1992-1995s Risks

With the adoption of the 1992 Law and the Licensing Regulations, the subsoil users were offered the following ways to obtain the rights to subsoil use: first, the opportunity to obtain the license through a tender or an auction established by the 1992 Law.

Second, the opportunities to obtain the license without a tender established by the Licensing Regulation. The latter opportunities arose subject to the location of the subsoil segment in the exclusive economic zone or on the continental shelf of the Russian Federation as well as in those cases, when the enterprises had been using subsoil prior to the implementation of Licensing Regulations on the basis of the mining allotment act. At that time, the legislation made no provision for re-issuance of licenses.

Therefore, to check the validity of a license issued during the period from 1992 through 1995, the reviewer must determine on which of the above grounds the license has been issued. Despite the opinion of certain experts that the Licensing Regulations could not expand the boundaries of the 1992 Law and provide the RF Geological Committee with the opportunity to issue licenses without tender which was not contemplated by the Licensing Regulations, we believe that the risks related to the above are rather of a hypothetical nature than being real and practical grounds for concern. This is characteristic of both the licenses issued under Clause 19 of the Licensing Regulation to confirm the previously available rights and the licenses issued by the resolution of the RF Government for the subsoil segments in the exclusive economic zone or on the continental shelf of Russia. As a rule, to ascertain the validity of the rights to subsoil use, it is sufficient to have the license itself and a document on the basis of which the license was issued, such as, the resolution of the RF Government, the joint resolution of the RF Geological Committee and the local authority, and the protocol of an expert commission.

But the reviewer should keep in mind that the licenses issued during the period from 1992 through 1995 without tender could have been issued only on the basis of the Licensing Regulations, i.e. as a confirmation of the rights previously available to the subsoil user (with the exception of the cases where the subsoil area was located on the continental shelf or in the exclusive economic zone). Nevertheless, in our practice we have come across certain cases that during the period under review companies obtained licenses for a new oil field without any tender. Naturally, such issuance was not consistent with the effective legislation and may be considered unlawful. However, even in such

cases, the risk of license revocation should not be deemed unconditional.

To terminate the right to subsoil use, the interested party has to file a suit to abrogate the non-regulatory act by a government agency on the basis of which the license was issued. The Determination No. 23 of the Plenum of the RF Supreme Arbitration Court of December 22, 1992 established that a three-year limitation period shall be generally applied to the cases of recognising as invalid the non-regulatory acts of governmental agencies (in connection with the license). Some authors express their disagreement with the above rule established by this Determination, however. The breach of rights in this case, in their opinion, is of a continuous nature and no limitation period may be applicable. Therefore, the question whether a holder of the license may refer to the expiration of the limitation period and thereby protect himself from the risk of license revocation remains controversial. The ultimate resolution of the issue could only be provided by an established judicial practice that does not exist.

In addition, it should be noted that during the period under review the effective legislation made no provision for re-issuance of the license in the event of a change in the subsoil user's name or legal status, i.e., a tender was to be held to re-issue the license. Since the holding of a tender in a case like this was hardly possible, a license reissued without tender is invalid from a theoretical standpoint. We have never come across such cases in our practice, but the risk with regard thereto does not seem more serious than in the event of the issuance of a license (to the former subsoil user) based on Clause 19 of the Licensing Regulations.

1995-1999s Risks

The situation is different with the licenses issued under the 1995 Law (or, to be more precise, during the period from 1995 through 1999). The 1995 Law conferred additional grounds for the acquisition of the subsoil use rights, including re-issuance of the effective licenses in certain cases contemplated by the Law. Such cases comprised changes in the subsoil user's legal status, restructuring of the subsoil user by way of acquisition and merger (if the formal subsoil user would own no less than a half of the newly established enterprise's charter capital), as well as restructuring by way of splitting-up or spinning-off.

As we have mentioned above, the adoption of the 1995 Law was closely followed by the adoption of the Instruction 65. The Instruction restated the grounds for license re-issuance introduced by the 1995 Law. The oil companies' lobby, however, managed to include in the Instruction an additional ground for the transfer of the subsoil user's rights. Clause 17 of the Instruction 65 established that in the event that the subsoil user had founded a new legal entity (including legal entities with foreign capital) for the specific purpose to continue performing a business in accordance with the terms and conditions of the license for the subsoil user's field, the license could be re-issued to such legal entity subject to the former subsoil user owning no less than a half of the newly established entity's charter capital. Even at a glance, it is clear that the Instruction unfairly expanded the list of the grounds for re-issuance determined by the 1995 Law allotting the establishment of a new enterprise a similar status with the restructuring of already existing entities. In the former case, there is no need to either prepare a balance division sheet (or a deed of transfer), or to obtain the consent of the anti-monopoly agency, or to notify the creditors, or to take into consideration the interests of the company's minority shareholders. In other words, it was a procedure which was utterly different from the one established by the 1995 Law. Nevertheless, Clause 17 remained in effect until 1999, and quite a large number of companies managed to use the ground it had established.

In the event, that a license under review has been issued to a company in accordance with the re-issuance procedure under Clause 17 of Instruction 65, the risk of its revocation seems more probable than in any other of the above cases. Considering, however, the mass drive in the license re-issuance under the said Clause, the degree of the risk in each particular instance will depend on the specific conditions under which the license has been re-issued, on the holders of the license and on the fact, whose rights might have been breached by such re-issuance.

Risks and Precedents

It must be mentioned, that a precedent of a license re-issued under Clause 17 of the Instruction 65 rendered invalid by the court has already been set. The precedent is a well-known case when an arbitration court recognized as unlawful the license re-issuance protocol on the basis that the 1995 Law did not contemplate the ground for license re-issuance established by the Instruction 65. Following is a brief history of those proceedings. Early in 1997, OJSC Tyumenneftegaz had its licenses for the development of Kalchinskoye and Northern Kalchinskoye fields re-issued in favor of CJSC Tura Petroleum Company established jointly with a Cypriot company Great Planes Petroleum Limited ("GPP Limited"). After a certain period, OJSC Tyumenneftegaz's management changed its policy, and the company filed a suit with the Arbitration Court of the Tyumen Province

against the Administration of the Tyumen Province and the RF Committee for Geology and Subsoil Use represented by the West-Siberian Regional Geological Centre to render the non-regulatory act by a government authority (i.e. License Re-issuance Protocol No. 1 dated January 8, 1997) as invalid. Tura Petroleum and GPP Limited were drawn to participate in the case as third parties with no individual claims regarding the subject of the dispute. By the decision of the Arbitration Court, the Protocol was recognised as invalid. In the course of the subsequent consideration by the court of appeals (cassation), this part of the decision was left unchanged. The ruling of the appellate court pointed out that the decision of the lower court had evaluated correctly the arguments of the claimant because the re-registration of rights to use the subsoil under the Clause 17 of the Instruction 65 contradicts Articles 10.1 and 17.1 of the 1995 Law. Acting on the basis of the RF Constitution, the RF Arbitration Procedure Code, and having found an inconsistency between Clause 17 of Instruction 65 and the 1995 Law, the court substantiated inapplicability of this Clause.

In view of the above, there is a risk of the invalidation of the license re-issuance, but the principal factor in these cases will be the will of the person whose license was re-issued under Clause 17 of Instruction 65. At the same time, one should keep in mind that chances to refer to the expiration of the period of limitation under the circumstances, same as in any other of the above cases, are questionable.

1999 up to Now Risks

By the Order No. 89, the RF Ministry of Natural Resources abrogated Clause 17 of Instruction 65 on April 22, 1999. Starting from that date, the subsoil users lost the opportunity to re-register their rights to use the subsoil without restructuring, and such a situation continued until the next amendment to the Law On Subsoil on January 2, 2000 (the "2000 Law"). This amendment repeated the abrogated Clause 17 of Instruction 65 nearly word for word with one important exception: the prospective legal entity in whose favor the license may be re-issued must be established under the laws of the Russian Federation. Certain authors treated the introduction of this provision as the actual confirmation of the consistency of the licenses issued under Clause 17 of Instruction 65 to the spirit of the law. In the formal aspect, however, it is not so, and, we believe that the court may hardly accept such an argument as a basis for its decision.

After the 2000 amendment, the subsoil users acquired a much larger field for maneuver in respect of the licenses. Having established that the share of the legal entity – former subsoil user in the charter capital of the new legal entity in whose favor the license is being re-issued should be no less than one half at the time of transfer of the rights to use the subsoil segment, the 2000 Law contains no provisions with regard to the extent of that share after the transfer of the said rights. Therefore, in the absence of the limitations on sale of the shares (interest) of such new legal entity the same may be sold by the former subsoil user literally on the next day after the re-issue. In fact, the 2000 Law gives to the subsoil users an opportunity to circumvent its own provisions.

How to Avoid the Risks

Presently, we may say that the legislation related to the issue and re-issue of a license for subsoil use tends to become more detailed and developed. Let us compare, for example, such factors as the number of grounds for granting the rights to use subsoil. The 1992 Law conferred only one such ground while the current edition of the Law on Subsoil contains as many as 14 of them. Nevertheless, numerous issues of licensing still constitute legislative gaps. For instance, the legislation does not regulate certain practical aspects of the mechanism of license revocation. Some of those partially unregulated issues became the subject of a number of draft regulations recently prepared by the RF Ministry of Natural Resources. They include a new edition of the Instruction On the Procedure for Re-issuance of Licenses for Subsoil Use and the Rules for the Adoption of Decisions on Early Termination, Suspension or Limitation of the Right to Use a Subsoil Segment.

In conclusion, it seems expedient to discuss practical ways of resolving the complications raised by the license revocation risks. It is worth mentioning that the banks providing funds for all projects react very morbidly to any, even hypothetica,l risks. Since the licenses to use subsoil are nearly always related to risks, there is a need for certain instruments sufficient to soothe the banks' worries. From our experience, we can assert that the role of such instruments may be successfully performed by a guarantee (or suretyship) of a reputed company (including the parent company of the entity receiving the financing) covering exclusively those risks, which are related to the violations made at the time of issuance (re-issuance) of the license. Russian companies issue this kind of guarantee (suretyship) quite willingly because it covers rather a narrow sphere of risks. At the same time, such guarantee (suretyship) is capable of assuring foreign banks that their rights are not going to be violated.□