



STRUCTURING SUCCESSFUL CARBON PROJECTS: LEGAL AND CONTRACTUAL ESSENTIALS

The success of carbon projects hinges not only on ecological factors but also on the legal and contractual frameworks that govern them. This article delves into the legal and contractual aspects of carbon projects, outlining the importance of clearly defined agreements, the roles and responsibilities of parties, revenue distribution, rights to carbon credits, and benefit-sharing mechanisms.

Legal Rights in a Project Area

Before any carbon project can be carried out in a designated area, the project owner or proponent must demonstrate the necessary legal authority to conduct project activities on the land in question. Carbon projects require validation and verification by independent auditors to ensure compliance with specific standards and criteria for generating carbon credits.

Part of this process involves confirming the existence of the required land rights. Rights over a particular project area can be acquired through various means, such as ownership, leases, or agreements with the landowner. For instance, in the Kuamut Rainforest Conservation Project in Sabah, although the project area is legally owned by the Sabah State Government, Permian Malaysia Sdn. Bhd., as the project proponent, is granted the sole license for the project area. This license entails a range of rights and responsibilities, including the right to generate and sell carbon offset credits derived from forest protection and regeneration, as well as preventing any other organisation from applying for concessions in the project area.[1]

Ownership of the Carbon Rights

In addition to establishing ownership or use rights over the land where a carbon project is

implemented, it is crucial for the project proponent to have ownership rights over the greenhouse gas (“**GHG**”) benefits including carbon credits generated by the project activities. While some countries might have laws or regulations explicitly granting ownership of carbon credits, many lack a specific legal framework for this. In such cases, guidance is often derived from verified carbon standards. The Verified Carbon Standard (“**VCS**”) used by Verra requires clear “proof of title” of the project proponent’s “right of use” of GHG benefits generated by the project.[2] Similarly, the Climate, Community and Biodiversity (“**CCB**”) Standards require project proponents to demonstrate that the project proponents have clear, uncontested title to the carbon rights, or provide legal documentation demonstrating that the project is undertaken on behalf of the carbon owners with their full consent.[3]

Determining ownership of carbon rights typically depends on project ownership. This ownership can be grounded in statutory, property, or contractual rights associated with the land, the plant, or the equipment and processes responsible for generating greenhouse gas emission reductions and/or removals. For example, in projects involving forest carbon credits, rights to these credits are often considered part of the participants’ broader rights in the land, forest, and natural resources within the project area.

However, carbon rights may also belong to the entities responsible for generating GHG benefits, such as the carbon project developer. In some cases, there may be several parties involved in a carbon project, each with a potential claim to the carbon credits generated. [4] For example, this could include the landowner, project developers, investors, local communities, or government agencies. To avoid confusion and disputes, it is crucial for all involved parties to establish clear ownership rights over the carbon credits through explicit contractual agreements. These agreements should outline who has the right to claim and use the carbon credits generated by the project.

Project Governance

Project governance plays a pivotal role in planning carbon projects due to their multifaceted nature. These projects involve a diverse array of stakeholders, ranging from project developers who design and manage the project to landowners who provide the land for the project, local communities who may be affected by the project, and investors and financiers who provide the necessary capital. To ensure the smooth operation of these projects, it is crucial to define the roles and responsibilities of each stakeholder in contractual agreements. This includes determining who will ultimately own the project (i.e., project proponent) and how decisions will be made on a daily and long-term basis. It also involves determining who takes on what risks and how benefits are shared among stakeholders.

This is particularly important because while the landowner or project developer might legally

own the carbon rights, the revenues might be shared with other stakeholders. For example, an investor who finances a project might receive a portion of the revenues in return for their investment. Furthermore, crucial questions also need to be addressed in the contractual agreements, including who will take responsibility for selling the carbon credits on the market. Decisions about whom to sell to and at what volume also require clarity and mutual written agreement. While formal agreements like collaboration or joint venture agreements may be necessary, informal agreements such as a memorandum of understanding can also ensure mutual understanding among parties. For instance, in the Kuamut Conservation Project, agreements between Permian Malaysia, the State Government of Sabah, and Rakyat Berjaya Sdn. Bhd. laid out the project's parameters and responsibilities, ensuring clarity and alignment among the involved parties.

Termination and Exit Clauses

In the context of a carbon project agreement, termination and exit clauses are crucial provisions that outline what happens if any party fails to fulfil its obligations as outlined in the agreement. These clauses are particularly important because a failure by one party could potentially jeopardise carbon revenues for all participants and even lead to the failure of the entire project.

Firstly, the agreement must clearly define what constitutes an "event of default" or a significant breach of the contractual terms. Common events of default in a carbon project agreement may include:

- (a) bankruptcy of a party or any event that causes a business entity to dissolve;
- (b) making a significant false statement of fact in the agreement. For example, if a party provides false information about the project's carbon sequestration potential or its compliance with environmental regulations;
- (c) failure to deliver carbon credits as promised, unless excused by force majeure, changes in law, or other provisions;
- (d) failure to make payments on time, unless excused by force majeure, changes in law, or other provisions; and
- (e) failure to comply with validation, verification, and monitoring obligations outlined in the agreement.[5]

Importantly, the termination clause should address the distribution or management of carbon credits that have already been generated or are in the process of being verified at the time of termination. It should specify whether the exiting party retains any rights to these credits or whether they revert to the remaining parties. In some cases, the rights to the carbon credits may revert entirely to one party, typically the project developer or the landowner, especially if the termination is due to the breach of the agreement by the other

party. This would mean that the defaulting party forfeits their rights to any carbon credits generated.

Additionally, the termination clause should also specify the treatment of any future revenue from the sale of carbon credits generated, including how it will be shared. If the carbon credits have already been sold or are under contract to be sold in the future, the agreement may delineate how the proceeds from these sales are to be divided among the parties after termination. This could involve a proportional division based on each party's contribution to the project or a lump-sum payment to non-defaulting parties as compensation. These contractual provisions ensure that parties are held accountable for their commitments and provide a mechanism for addressing breaches of the agreement.

-
1. Verra, "CCB & VCS Project Description: CCB Version 3, VCS Version 3" (Verra Registry Project Database).
 2. "VCS Standard v4.2" (Verified Carbon Standard, 20 January 2022) <https://verra.org/wp-content/uploads/2022/02/VCS-Standard_v4.2.pdf>.
 3. Slayde Hawkins, "Legal Guidance: Legal and Contractual Aspects of Forest Carbon Projects" in Johannes Ebeling and Jacob Olander (eds), Building Forest Carbon Projects (Forest Trends 2011).
 4. "VCS Standard v4.2" (n 2).
 5. Slayde Hawkins, "Legal Guidance: Legal and Contractual Aspects of Forest Carbon Projects" (n 3).

Written by:



Norhisham Abd Bahrin
Partner
norhishame@azmilaw.com



Nur Hashima Edhan
Associate
hashima.edhan@azmilaw.com

Corporate Communications
Azmi & Associates
4 September 2024

The contents of this publication are for reference purposes only and do not constitute legal advice.