

Purchase and Sale of Oil and Gas Producing Properties

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Overview: Kelly Hart Oil & Gas/Energy Group

- Offices in Fort Worth, Austin, Midland and New Orleans
 - *Transactions*—purchase and sale agreements, JOAs, development agreements, surface use agreements, midstream agreements, service agreements
 - *Litigation*—lease termination/maintenance, royalty disputes, pooling disputes, contract disputes, implied covenant disputes
 - *Regulatory*—issues at the RRC in our Fort Worth and Austin offices
 - represent E & P companies, mineral buyers, midstream companies, and large landowners
 - 27 lawyers in Oil & Gas/Energy group, 150 lawyers at Kelly Hart

Initial Considerations

- Does Seller *operate* the properties?
- Does Seller know what they own?
 - trusts, families might have parachuted into ownership
 - currently non-producing depths that are hbp?
 - dangers of county-wide conveyances
- Are there any unusual interests?
 - Relinquishment Act lands (surface owner is agent)
 - Federal/State leases
 - carried interests (under JOAs or unleased minerals)

Initial Considerations (*cont.*)

- How are the properties being valued?
 - producing wells?
 - PUDs?
 - non-producing acreage?
- Age of the properties?
- How long has Seller been owner?
 - can limit value of a special warranty of title
 - can limit value of an indemnity *limited to the actions of the Seller*
- Understand the other side's goals.
 - Do they want to move quickly?
 - Is there competition?
- *"Time is the enemy of all deals."*

What Form of Agreement?

- What type of agreement to use?
 - an assignment
 - a short letter agreement
 - a formal purchase and sale agreement
- Avoid “using a form” without making sure it is a **good fit**.
 - do not start with a previously negotiated form
 - jump at the opportunity to provide initial draft
- Look for copies of prior PSAs signed by the other side.
 - SEC filings for deals with publically traded entities
 - See what the **Buyer** asks for when it is the **Seller**
 - See what the **same lawyers** ask for when they are the Buyer/Seller

The Seller

- Are there multiple Sellers?
 - Buyer wants **joint and several liability** between Sellers.
 - Buyer will want an **agency provision**, designating one Seller as agent.
- Will the Seller entity still be around after closing?
 - Indemnities and representations are “*only as good as the party making them.*”
- Buyer protections for disappearing Sellers:
 - holdback of the purchase price
 - Ideally, a holdback is held in a *third-party* escrow account.
 - Can be released over time.
 - Life of a holdback is often tied to the length of indemnity obligations
 - parent guarantee
 - indemnity insurance policy

The Buyer

- Security from Buyer for indemnities/representations is often considered to be “self-operating” with ownership of the acquired assets.
- After the BP accident in the Gulf of Mexico – many majors started requiring Buyers to post bonds for some PSA obligations.
 - Some recent PSAs include “self-help remedies” allowing a Seller to come in and plug wells if not handled promptly by the Buyer.
 - Such PSAs often include stringent “notification” requirements, imposing heavy-handed reporting requirements related to all environmental and regulatory requirements related to the properties.

What are the Assets?

- Is this just a sale of oil and gas leases? What about **overrides** and **fee minerals**?
- Are you getting everything you want as a Buyer?
 - Ask for **exhibits** as soon as possible.
 - Look for “hidden” depth severances and acreage limitations in exhibits.
- Don’t give up too much as a Seller.
 - You don’t want to give away valuable assets for no value.
- Avoid unknowns concerning the “Assets” through **detail** and use of **catch-all concepts**.

What are the Assets? (*cont.*)

- What about *line-fill* and *oil in the tanks*?
- Are there any *imbalances* burdening leases?
- Is Seller holding any *suspense funds* owed to third parties or the Seller/Buyer?
- Consider seismic and other licensed data.
 - Can it be transferred without a fee?
 - Can the Seller keep a copy of the data?
- Does the Seller need to *retain access to the records* related to the properties?

What about a deposit?

- On larger deals, **market deposit is between 5% and 10%** of the purchase price.
- A deposit is not part of many smaller deals – as it **requires detailed provisions** on termination and retention of the deposit.
- **Buyer** will generally want a **third-party escrow agent** to hold the deposit until closing.
- What happens to the deposit if PSA is terminated prior to closing?
Generally speaking,
 - Deposit should be returned to Buyer, unless Buyer is in breach. Buyer may also seek a **“break-up fee”** to recoup costs involved in the transaction. Buyer may also seek ability to require the Seller to close through a remedy of **“specific performance.”**
 - Depending on the size of the deposit, many Sellers demand more than just retention of the deposit in the event of a Buyer’s breach of a PSA. Limiting the Seller’s recovery to retention of the deposit arguably makes the PSA an **“option contract”** in favor of the Buyer. Specific performance is helpful alternative remedy for a Buyer also.

Accounting Issues

- Often, the “Effective Date” of the PSA is months before the closing date, creating a need to allocate expenses and revenues before and after the Effective Date.
 - If you want to remain on speaking terms with the accountants, ***never set an effective date in the middle of the month.***
- Be sure to specifically provide for any expenses that should not be split before and after the Effective Date.
 - For example, costs for the drilling of a well that is being drilled across the Effective Date should arguably be borne by the Buyer (since only the Buyer will benefit from the well’s future production).
 - Be careful with seismic costs, as Buyer may be responsible for a separate “transfer fee” for such data.
- ***Overhead charges*** should be ***quantifiable*** and not open to abuse.
 - Limit overhead to the agreed upon rate in applicable JOAs or rate agreed upon in PSA.
 - Limit operating expenses to ***out-of-pocket costs*** actually paid to unaffiliated third parties.

Seller's Representations

- Representations **offset the Buyer's risk**.
- Buyer should make the representations survive closing (potential for **merger** into the assignment).
- Representations typically cover items that are difficult to due diligence (*consents and preferential purchase rights, imbalances, litigation, suspense funds, royalties*).
- Special treatment for “*fundamental representations*” (e.g., authority, organization and existence)
 - Often, there are no claim thresholds, deductibles or survival periods for fundamental representations.
- **Use schedules**. They help (i) the Seller avoid breach claims, and (ii) the Buyer avoid surprises.
- Pay attention to “*knowledge*” qualifiers.
 - “*Knowledge*” is arguably proper when information to Seller is limited (e.g., Seller is a non-operator), but effectively it is just an allocation of risk.

Title Defects

- Sellers should attempt to limit Title Defects to only the Assets on which the Buyer is placing value.
 - e.g., if the Buyer is purchasing producing wells from a certain formation, a Title Defect could be limited to that formation
- Buyers should be careful about aggressive lists of “*Permitted Encumbrances*.”
 - Buyers should avoid open-ended references to all schedules or exhibits.
 - Often, an unusual “Permitted Encumbrance” can signal a potential Title Defect that may concern the Seller.
- Pay attention to the procedures.
 - Often, a Seller wants the right to cure a Defect. Careful consideration should be given to whether a cure is possible or if it will “stir-up” a potential claim.
 - Buyer should be weary of tying the Title Defect amount to the theoretical cost to cure the Defect – avoid the “*case of beer for the landowner will get this one cured*” argument.

Title Defects (*cont.*)

- *Title Benefits*
 - **Buyers** often try to limit to an **offset** of Title Defects.
 - Buyer may want to seek a representation that the Seller is not aware of any Title Benefits.
- What is a **Title Defect Threshold**?
- What is a **Title Defect Deductible**?
- Be careful with assuming meanings. The express words of the agreement will control. Deductibles are sometimes styled as “thresholds” to get the other side’s guard down.
- A Seller should consider using thresholds and deductibles on Title Benefits.
- Sellers sometimes push for deductibles and thresholds to apply to special warranty claims after closing.

Special Warranty of Title

- A special warranty of title covers title claims by, through and under Seller only.
 - Traditionally, it is seen as providing protection of Buyer in the limited circumstance that the Seller previously sold the same Assets to another party.
 - failure to maintain a lease by production during a Seller's period of ownership?
 - Could also arguably be extended to overrides that terminate on the Seller's "watch."
- Be sure to tie the special warranty to a known minimum quantum of interest.
 - Since most assignments are of "all of Seller's right, title and interest" in the Assets, the Buyers should tie the special warranty to a quantum of interest (e.g., WI, NRI, NMA).
- Time limits on the special warranty (and insertion of PSA time limits)
- NOTE: A special warranty **runs counter** to standard warranty disclaimers in a PSA and the exclusive remedy provision in the Title Defect section.

Environmental Defects

- Many PSAs provide for a pre-closing ***environmental due diligence process*** and a related ***environmental defect mechanism***. This is part of the reasoning behind pushing environmental liability onto the Buyer.
- Buyer should resist an attempt by Seller to limit the environmental defect value to the allocated value of the subject asset.
 - What if the clean-up costs greatly exceed the allocated value of the well/lease?
 - Buyers may want the right to push certain properties back onto the Seller.
- Consider a ***walk right*** if environmental defects result in a reduction of the purchase price exceeding a certain threshold. This could be critical for a Buyer or a Seller.

Allocation of Liabilities

- What about the “*light switch deal*” (a/k/a our watch/their watch)?
 - Years ago, these were common.
 - Today, they are hard to find in substantial transactions for producing properties.
 - Still found in certain situations:
 - small deals, non-producing leases, mineral sales
- The “new normal” favors the Seller.
 - All environmental conditions and Title Defects (except for breach of the special warranty of title) are assumed by Buyer – subject to the environmental and Title Defect mechanisms in the PSA.
 - Other pre-closing liabilities are assumed by Buyer, subject to negotiation (e.g., royalty claims, unpaid JIBs, personal injury claims, employee claims, gross negligence claims, offsite disposal of waste)

Questions?

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