Contract Negotiation and Preparation in the Oil and Gas Industry: Drafting Complete and Unambiguous Contracts

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PARTICIPATION, FARMOUT AND PURCHASE & SALE AGREEMENTS

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I. PURPOSES.

Participation agreements define the rights and obligations of parties engaged in joint oil and gas operations. A farmout agreement is a type of participation agreement where a party acquires a defined interest only after carrying out specified drilling activities. Purchase and sale agreements document transactions between buyers and sellers of oil and gas properties and allocate contractual risks inherent in the transfer of assets, equity or business lines from one party to another.

- **The other major type of agreement defining rights and obligations to conduct joint oil and gas operations is the operating agreement, which is not covered in this presentation.**

A. Participation Agreements – an umbrella term for agreements where there is joint participation in (exploration and development) operations. Entering into a participation agreement may help to mitigate risks by spreading the economic burden of an investment among different parties. In addition, as a means to allocate contractual risks, the participation agreement can be used to assign different obligations with respect to the exploration, development or operatorship of an asset to the party best able to handle such risk.

1. The type of participation agreement will vary depending on its application in the domestic or international context.

(a) *In the international context*, a participation agreement often refers to agreements between a state-owned oil company and a privatized oil company for joint equity ownership, to allow the state-owned oil company to participate as a partner or joint venturer. Participants receive income from sales of production in proportion to their percentage ownership and pay their own pro-rata share of expenses.

(i) Participation agreements differ from production sharing contracts (PSCs) because under a PSC, the state-owned oil company is not liable for contributing a pro rata share of costs; instead, the PSC primarily allocates profits between the state-owned oil company and the privatized oil company.

(b) *In the domestic context*, participation agreements can take many forms and can be titled generically, as "participation agreements"; however, "exploration agreements," "development agreements" and "farmout agreements," are all types of participation agreements. What distinguishes one from the other is the scope of upstream operations that will be covered by the subject agreement.

2. This presentation will examine some of the difficult issues parties confront in participation agreements that are commonly used in the industry, with the greatest amount of focus on the farmout agreement.

B. Purchase & Sale Agreements

1. **Purpose** – can be used for all sizes and shapes of acquisitions and divestitures: whole companies, business lines, subsidiaries, assets grouped by geography, individual producing wells or fields (or any combination thereof). In addition, a purchase and sale agreement could be used to document the sale of interests in a participation agreement (*e.g.*, to acquire or divest a working interest in an asset governed by a participation agreement).

2. This presentation will examine some issues unique to purchase and sale agreements and review different deal structures where purchase and sale agreements might be used (*e.g.*, asset acquisitions vs. stock acquisitions).

C. Non-Working Interests as Alternatives to Working Interests and Direct Acquisitions – passive investment with no liability for pro rata cost sharing. The fact that there is no cost sharing (or very limited cost sharing) differentiates non-working interests from other types of interests and rights that inure to those who hold direct investments in oil and gas assets. There are a variety of non-working interests that are common in the industry.

1. **Overriding Royalties** – acquisition of an interest in oil and gas produced at the surface, typically free of the cost of production (though post-production expenses can be included), and typically payable only after exploration costs have been recouped through sales of production. The name refers to the fact that the interest "overrides" or is in addition to, the landowner's (the lessor's) royalty. Overriding royalties usually terminate at the end of an oil and gas lease.

2. **Production Payments** – similar to an overriding royalty but terminates upon realization of a defined volume of production or when a specified sum from a sale of production has been reached.

3. **Net Profits Interest** – a stated percentage of net profits from the operation of the subject leases calculated in accordance with the granting interest.

4. **Carried Interests** – fractional interests in a lease, the holder of which (the "*Carried Party*") has no obligation for operating costs which are to be paid by the co-owners (the "*Carrying Parties*") who are reimbursed first out of the Carried party's share of production. Types of carried interests include:

(a) *Herndon* – Carrying Party owns a production payment payable from the interest of the Carried Party measured by operating expenses incurred by the carrying party on behalf of the Carried Party.

(b) *Manahan* – Carried Party has future interest in a working interest which is to become possessory after the Carrying Party recovers certain costs during payout. In essence, the non-working interest is convertible to a working interest.

(c) *Abercrombie* – Carried Party's interest is subject to a lien to secure advances made by the Carrying Party.

5. Convertible Interest – an interest which is convertible to another type of interest. Usually an overriding royalty can be converted into working interest at "payout"* if specified by the terms of a farmout or assignment.

6. Preferential purchase rights – right of first offer/refusal – to participate in acquisitions of interests in a neighboring or defined geographic area,† or preferential right to acquire an asset triggered upon the sale thereof.‡

II. USING CONTRACT MODELS

A. Industry Association Forms and Variants

1. **Farmout Agreements** – there is a large amount of literature on farmouts. Different forms that are available are:

(a) Association of International Petroleum Negotiators (AIPN) 2004 Farmout Agreement.

(b) Section of Natural Resources Law of the American Bar Association Monograph Series (No. 1), "Drafting Standard Form Farmout Agreements" (see Appendices).

(c) Summers Law of Oil and Gas 2003 Supplement §1352 et seq., "Farmout Agreement".

(d) American Association of Professional Landmen (AAPL) Farmout Agreement Form 635 (discontinued ©1984).

2. **Participation Agreements** – in light of the broad category of agreements that can be construed as participation agreements, there is no one standard form, but one form for conducting joint exploration and development activities is:

(a) Rocky Mountain Mineral Law Foundation (RMMLF) Exploration, Development and Mine Operating Agreement Form 5A.

3. **Purchase and Sale Agreements**

(a) Although not customized to oil and gas operations, two model forms are produced by the American Bar Association's Section of Business Law. They are the Model Asset Purchase Agreement with Commentary (2001) and the Model Stock Purchase Agreement with Commentary (1995).

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* See Section IV.D.2(b), below.

† See Section III.B.1(a), below.

‡ See Sections V.E.1 and V.E.2, below.

(i) The ABA forms do not deal with issues that are unique to oil and gas; however they provide a robust series of representations and warranties that buyers would want to ask for when acquiring a discrete business or asset, especially of industrial businesses or businesses with valuable intellectual property assets. The ABA forms address the mechanics of signing, closing, and post-closing, as well as the instruments for effecting these transfers in a comprehensive manner.

(b) Section of Natural Resources Law of the American Bar Association Monograph Series (No. 17), "Legal Aspects of the Purchase and Sale of Oil Gas Properties," Appendix C (Short Form Asset Purchase and Sale Agreement).

(c) Joint conference proceedings of the AIPN, RMMLF and the Institute for Energy Law (IEL) in connection with International Energy Law, Contracts and Negotiations usually include panels on purchase agreements with model purchase agreements attached. Such conferences are usually convened on an annual basis.

B. <u>Benefits, Limitations and Biases of Forms</u>

1. **Benefits.**

(a) Commentary – to help understand the function of the contract and its various clauses.

(b) Forms address a broad set of issues and offer options to customize transactions according to types of deal making that is most often repeated. This can help both the lawyer and the business person evaluate alternative transaction structures and to understand where their deal might differ from what could be considered "standard." It also alleviates some of the work that might otherwise go into rethinking every aspect of the transaction (*but see "Limitations" below*).

(c) Authority – use of recognized industry forms can decrease transaction costs because both sides will be familiar with the terms and provisions. To the extent that one side is not familiar with accepted terms and conditions, the fact that certain terms and conditions could be deemed to be "industry standard" could help make negotiations more efficient. In addition, the model form provides the basis for a great deal of legal precedent that has been litigated, especially with respect to defining the rights and obligation of one party to the other.

2. **Limitations.**

(a) In any sophisticated transaction, "fill in the blank" documentation will simply not do.

(b) Terms are only limited by the creativity and imagination of the deal makers.

(c) Use forms to make sure that the significant business and legal issues do not fall through the cracks, but do not rely on them to address all issues.

(d) Many issues lie outside of the forms, in other specialized areas of law: *e.g.*, antitrust, employee benefits, securities law, tax*

(e) Choice of law matters. The form may not conform to the applicable laws and regulations of the jurisdiction in which the transaction will take place in or be governed by.

3. **Biases** – as with any agreement, the drafter exercises a degree of control over the outcome of the negotiation. The same is true for industry forms which reflect some of the inherent biases of the sponsoring organization.

(a) AIPN – insofar as the AIPN is the Association of *International* Petroleum Negotiators, its form will be more suited to international transactions, especially those likely to involve state-owned oil companies. A cornerstone of the AIPN forms is the AIPN model joint operating agreement, which supplies many of the key terms and definitions picked up by other AIPN forms. Therefore it is important that users of the AIPN form analyze it in the context of other AIPN form agreements.

(b) ABA – typically pro-buyer/acquirer, which makes the model list of representations warranties very exhaustive and difficult to comply with on the part of the seller.

(c) Summers – short form, simple transaction meant to illustrate a farmout. Based on one model form used by a major oil company many years ago.

C. Prior Transaction Precedents

1. In addition to model forms, being able to use documents from prior deals can provide a useful resource.

2. Sources: outside counsel, your own deal library, EDGAR.

(a) Searching EDGAR (the greatest precedent library available!): many search services are available (e.g., tenkwizard, freeedgar) that allow users to search material contracts filed by public companies as part of their SEC reporting requirements.

3. If the precedent is based on an industry form, compare changes to the base form. Alternatively, be sure to compare the final, negotiated agreement being used as precedent for a new deal to earlier versions (if available) in order to analyze important changes that evolved over the course of negotiations.

D. Relation to Other Agreements

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* See Section V.G, below.

1. Forms and precedents cannot be used without regard to how they interact with a larger contractual matrix.

(a) The AIPN Model Farmout Agreement assumes that a Joint Operating Agreement is necessary, and important capitalized defined terms used in the AIPN's model Farmout Agreement are defined in the Joint Operating Agreement.

2. Besides making sure that defined terms are aligned, it is important to consider how a participation agreement or purchase and sale agreement would interact with other important commercial agreements.* Many of these issues should be addressed during an initial, due diligence review. To varying extents, both parties will want to participate in a due diligence review of the other side's material contracts.

(a) Whether entering into a purchase and sale agreement, participation agreement or farmout agreement, other aspects of legal documentation that should be reviewed include:

(i) Joint operating agreements or unitization agreements.

(ii) Exploration or joint venture agreements.

(iii) Real property documentation such as easements, rights of way, permits.

(iv) General commercial contracts such as gas balancing agreements, transportation/storage/processing agreements, oil/gas sales agreements.

(v) Financing documentation, including loan agreements, mortagages, deeds of trust, security agreements, UCC financing agreements.

III. PARTICIPATION AGREEMENT SPECIFICS

A. A Definition. A participation agreement does not refer to any one specific type of agreement. It is an umbrella term for many agreements whereby parties share in ownership, production and expenses.

1. Legally, a participation agreement is distinct from many forms of joint venture because a separate legal entity is not formed. Co-participants carry out their business through the participation agreement that defines the rights and obligations of the parties and their respective ownership interests.

B. The Subject of the Participation Agreement

* See Section V.F, below.

1. **Exploration Agreements** – if the participation agreement will relate to exploration activities, it is important to define what stage of exploration the agreement will cover. For instance, have seismic surveys commenced or has exploration drilling commenced? Example: to the extent that Party A has already conducted seismic work and is ready to begin exploration drilling, Party B may acquire a participating interest by contributing funds up to a specified dollar amount, to be applied towards acquisition of its participating interest and towards drilling costs.

(a) *AMI Provisions* – many exploration agreements include provisions creating areas of mutual interest (also known as "AMI" agreements or clauses), whereby all parties to the agreement agree to offer the other parties the reciprocal right to participate in any exploration activities to be conducted in a given area. It is important to clearly define the AMI; attaching a map may not be sufficient if, for example, the AMI is limited to specific sub-surface stratum.

(i) Geographic area covered by the AMI may correspond to the area to be covered by the seismic analysis, but once a prospect is identified and/or a decision is made to commercialize the prospect, the participation agreement, as to the prospect in question, is generally replaced by an operating agreement.

(ii) As an alternative to an AMI, and depending on the size of the parties, the participation agreement could cover all exploration prospects or properties that the parties obtain an interest in during the term of the agreement.

(b) *Seismic Decisions* – if joint seismic work will be conducted, consider whether the parties will be acquiring existing seismic data or shooting their own. This raises decision-making authority questions with respect to: the parameters of the seismic work (to be decided at the outset, or during the course of the seismic exploration), subcontracting to a geophysical company, permitting, seismic interpretation, ownership of raw/reprocessed data, confidentiality and restrictions on transfer.

(c) *Acquisitions of Acreage* – the parties will need to decide who will be responsible for acquiring leasehold acreage and who will make decisions with respect to general leasing terms and royalty payments.

(d) *Relationships to Other Agreements* – there should be a clear understanding in the agreement how the operator of each prospect in a given area will be determined and exactly which activities will be conducted under the operating agreement, as opposed to the exploration agreement.

2. **Development Agreements** – development activities be addressed in exploration agreements, operating agreements, or both. Regardless of the type of agreement that covers this topic, what is important is to define the respective rights and obligations of the parties for varying types of development costs.

(a) It is not uncommon for a participation agreement to contain term sheet like provisions relating to aspects of development that would be more fully addressed in an operating agreement after the parties determine whether or not to commercialize their discovery.

C. Pro Rata Cost Sharing

1. Activities carried out under participation agreements are capital intensive. In some participation agreements, the grant of a participatory right is subject to the payment by the party wishing to acquire that right of a specified sum. However, there are other situations where both parties will contribute their pro-rata share of costs as the exploration or development program progresses. In the latter example the parties will want financial assurances that the other party will continue to have the resources required to perform. One way to provide this form of assurance (in addition to financial guaranties and letters of credit) is through the creation of an "Advances Account". The use of an Advances Account is also prevalent in operating agreements, but the focus in this presentation will be with respect to the types of funding expenditures in the development and exploration context that could be deposited into an Advances Account.

(a) *Advances Account* – financial assurance through up front and periodic prepayments for costs expected to be incurred over the next 30 to 60-day time period, with periodic reconciliation for over and under advances. It is not uncommon to have the advances account be a segregated account so as to not commingle with other funds of the party to whom advances are to be made and for the participation agreement to expressly provide that the advanced funds would be held in trust until properly applied in accordance with the terms of the participation agreement.

(b) *Caps on expenditures* – The parties may wish to set a cap on the amount of funds to be expended; however, if that cap is reached, then the parties must still agree on the next steps.

D. When and How Should Participation Agreements Terminate – participation agreements usually terminate at a date certain, or upon the occurrence of certain triggering events. The difficulty is in addressing how to handle the following types of issues after the participation agreement terminates:

1. Prospects that have not yet been leased or where an exploration well has not been drilled.

(a) In the event that the parties "max out" their agreed upon budget, the participation agreement may terminate solely with respect to any portion of the project not earmarked for development. In this case, the terminating party would want any exclusivity over exploration and development in the AMI or other subject area to survive termination for a reasonable period of time.

2. Treatment of unspent advanced funds

3. Assignment of title to participants

4. Analysis of surviving terms (*e.g.*, AMI, confidentiality, non-compete, indemnification, etc… .)

IV. FARMOUT AGREEMENT SPECIFICS

A. A Definition. A Farmout Agreement is a specialized type of participation agreement whereby one party (the "Farmor") assigns an interest in its lease to another (the "Farmee") which assignment is contingent upon the Farmee's drilling or paying for the duty of drilling one or more wells to a certain depth or condition. As distinguished from an exploration, development or operating agreement, however, the Farmee carries the Farmor with respect to all or a portion of its drilling costs, whereas in the former more generalized examples, costs are shared. Once the farmout agreement is performed, it would not be uncommon for the parties to enter into an operating agreement governing the farmed-out acreage. Farmout agreements can cover single or multiple wells.

B. Farming Out vs. Farming In.

- **The structure of the farmout agreement will reflect the primary concerns of the farmor, since it is the farmor that is giving up its rights. Consequently, the more information the farmee has with respect to the motivations of the farmor, the better both parties will be able to negotiate a deal that matches the commercial reality giving rise the deal. By analyzing the different reasons a party may offer a farmout, the commercial and legal issues that will affect the negotiations and drafting challenges can be understood more clearly.**

1. **Reasons to farm out**: if a company is unable to develop expiring acreage due to budgetary constraints or if it wishes to reduce or eliminate risk and improve economics as a percentage of investment. However, the company would have to be willing to accept in return a reduced acreage position (and thus a reduction in potential aggregate return). The farmor may also wish to maintain its leases or have the area evaluated and tested. This could allow it to secure a cost and risk-free interest in new production. The farmor's initial evaluation of a prospect could also render the prospect unsuitable under its internal standards, but not necessarily as a candidate to be farmed out, and the farmor may desire a farmout arrangement in order to allow someone who has different geological ideas about a prospect to test those ideas. Some of these motivations are discussed in more detail below.

(a) *Lease Preservation.* Oil and gas leases typically expire at the end of a primary term, unless the lessee company is conducting drilling operations. Entering into a farmout agreement could is one way to prevent termination. Under this scenario, the terms of the farmout will generally be more favorable to the farmee because a primary purpose is to induce a potential farmee to drill.

(b) *Lease Salvage.* Farming out makes also makes sense when the farmor, far from being unable to drill because of budgetary and time constraints that

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relate to lease preservation, believes the prospect is unattractive and wants another party to bear drilling costs and risk. If a potential farmee suspects this to be the motivation, it should attempt to secure, as a condition to drilling, the farmor's geologic and geophysical evaluations. Farmout agreements where salvaging the lease is the operative motive may also be structured as options to the farmee, rather than obligations, because the farmor has relatively little to lose if the prospect is not drilled.

(c) *Exploratory Farmouts.* Farmouts structured to induce the farmee to conduct specific exploratory type drilling delineations and tests are good examples of the way that a farmout agreement is a type of participation agreement. Consequently, many exploratory farmouts will be very specific as to the tests to be conducted during drilling, the depth to which wells should be drilled and the formations to be tested during drilling. Where exploration information is a primary motive of the farmor, the farmout agreement will often contain "AMI" provisions which bring the subject property under a joint ownership structure if they are attractive to both parties. Exploratory farmouts also provide a risk sharing mechanism, and could conceivably cover multiple wells. In addition, exploratory farmouts may provide for the farmor to share certain drilling costs and to agree to subject the farmed out prospect to pre-negotiated operating agreement terms. As in all farmouts, the consideration for the interest earned is the performance by the farmee of its obligation to drill in accordance with the specified terms of the farmout agreement.

(d) *Market Access.* Although the farmor may have rights to acreage, it may lack the logistics for processing production or for marketing or transporting production in the market. A farmout agreement with a farmee who has the resources and ability to market production and connect to markets via pipelines and gathering systems is one way of monetizing an oil and gas investment. Where the farmee is responsible for marketing the production, the terms of the farmout agreement may provide either for the farmor to retain an overriding royalty interest or for the farmee to market the farmor's interest on the same terms and conditions as the farmee obtaines for itself.

2. **Reasons to farm in**: if a company's budget can stand the costs of drilling and it is willing to accept greater costs and risks in order to gain or increase its acreage position.

(a) The farmee needs a way to acquire an interest in acreage controlled by the farmor. This is often the case because many oil and gas companies are unwilling to sell potentially valuable undeveloped leaseholds for cash, or because of any the reasons described above (that would induce a farmor to enter into a farmout). For the farmee, the cost to drill the well is option consideration for the interest that it will acquire upon successfully completing the well; nor does the farmee does not have shoulder upfront leasehold acquisition costs have already been incurred by the Farmor.

3. **Farming Out and Farming In**. Since farmouts are peculiar to each prospect or group of prospects, and because the motivations for farming out or farming in, differ for each context, it is not uncommon for an oil company to acquire rights to production as a farmor in some cases and as a farmee in others.

C. <u>Defining the Subject of the Drilling Obligation and the Interest Earned</u>

1. **The subject area** – use legal descriptions of the property as often as possible, and include the source of the legal description, the names of the lessor and the lessee and the recording information for the leases farmed out. Many farmouts themselves are not recorded, however (although interest earned by the farmee upon performance of its obligations under the farmout could and should be recorded).

2. **The depth limitations** – subsurface geography is technically complex. To the extent that the farmee's interest or the farmor's retained interest is subject to limitations based on depth limitations or subsurface structures, these must be clearly identified and be capable of being objectively determined.

3. **The subsurface rights** – are oil and gas rights being farmed out, or just one and not the other?

4. **An option vs. an obligation** – farmouts are either options or obligations to drill on the part of the farmee.

(a) *Option* – if drilling is at the farmee's option, then drilling on the prospect is only a <u>condition</u> to earning an interest.

(i) If drilling is at the option of the farmee, the farmee can abandon or terminate its drilling activities at any time. In this instance, the farmor would desire the right to take over drilling operations, and perhaps assume the drilling contract with the rig owner, if drilling has been subcontracted (as is usually the case). The farmor would also desire any information relating to the well that the farmee would have otherwise been obligated to provide upon completing the well.

(b) *Obligation* – if drilling is an obligation, then drilling on the prospect is a <u>covenant</u>, the failure of which to comply with is a breach. The conditions, timing and circumstances under which a farmee can become legally bound, however, are open to negotiation.

(i) The right measure of damages for failure to drill varies from state to state. The majority of states hold that damages for failure to perform a farmout drilling obligation is the cost of drilling the promised well. A minority of states may still hold that the damages could be the lost royalty that would have been payable to the farmor by the farmee. Other damages could include the value of the retained interest that would have vested with the farmee or the value of the information that would have been developed (especially in an exploratory farmout).

(ii) Because damages will be very hard to prove, the parties may include liquidated damages instead. However, defining the liquidated damages can be very difficult in application. As an example, if liquidated damages are meant to approximate the cost to the farmor to drill the well if the farmee fails to perform, and the farmee performs some but not all of its drilling obligations, the liquidated damages could be vulnerable to attack from an enforceability perspective because the gross liquidated damages that become payable will exceed the actual costs to complete the specified drilling.

(c) Whether a farmout will be structured as an option or obligation is fundamental negotiating point, reflecting primarily, the motivations of the farmor.

5. **Produce to earn vs. drill to earn**

(a) *Under a produce-to-earn agreement*, the farmee's interest is subject to completing a well that is capable of producing in paying quantities (as defined by the agreement).

(i) Defining the standard of production in "paying quantities" can be difficult. Other formulations include "production" or "production in commercial quantities." The extent to which producing revenues must exceed operating costs, or whether production must have a positive gross margin is subject to negotiation based on the motivations of the parties entering into the agreement.

(ii) It may be useful to tie the concept of "paying quantities" to existing production payment definitions or formulations of royalty payments based on producing value that are set forth in the existing lease (which itself should be a subject of rigorous due diligence on the part of the farmor).

(b) *Under a drill-to-earn agreement*, the farmee can earn its interest merely by drilling to the conditions specified in the agreement.

(i) What constitutes "drilling" so as to satisfy the obligation of the farmee is especially important to the drafter and within the commercial negotiation of a farmout agreement. Because drilling will not be tied to an economic outcome, it must be defined to encompass specific performance related tasks. Under some farmouts, merely commencing drilling is sufficient to earn the farmee its interests, whereas under an exploratory farmout, the conditions will be much more onerous.

(c) The produce-to-earn farmout is more common because neither party can maintain a lease without realizing the commercial benefits of production. However, what is at issue is cost. Satisfaction of a drill-to-earn obligation under a farmout may yield information as to development potential and completion costs which could then be subject to a second stage farmout or alternative participation agreement or operating agreement structures.

(d) Standards of performance that are subjective in interpretation (to the "farmor's satisfaction") are difficult to enforce.

6. **Earning a divided interest vs. earning an undivided interest**

(a) A divided interest is where the farmor and farmee wind up owning divided tracts within leasehold acreage. Upon satisfying its drilling obligaiton, the farmee may earn all of the farmor's interest in the drillsite acreage, but the farmor would retain its interest in the leasehold acreage outside of the drillsite. A farmee with negotiating leverage may also seek to obtain divided "checkerboard" interests where upon satisfaction of its drilling obligation, the farmee retains the farmor's interest in each drillsite that is adjacent to the subject drillsite, leaving the farmor with its interest in the remaining tracts outside of the adjacent drillsite tracts.

(b) An undivided interest is where the farmee earns less than 100% of the farmor's interest in the drillsite; however, in return, the farmor would typically be responsible for paying its pro-rata share of costs associated with further exploratory or development drilling operations. Undivided interests are more common when the parties relationship will continue after the farmout is performed, subject, most likely, to a joint operating agreement.

D. <u>Defining the Interest Retained (by the Farmor after the Farmout is Performed)</u>

1. **Who operates?** – usually, the farmee will operate the well or wells that have been farmed out.

2. **Operating vs. Nonoperating retained interests**

(a) For tax reasons (relating to deduction of intangible drilling costs which are beyond the scope of this presentation), the farmor's retained interest can be an operating or nonoperating retained interest. Operating interests are in the form of working interests. Nonoperating interests would usually take the form of an overriding royalty or a net profits interest.

(b) Some farmouts may also provide that a nonoperating interest can convert (on a mandatory, conditional, or optional basis) to a working interest once the farmee has recovered all of its intangible drilling costs from production (also referred to as "payout").

3. **Calls on production and options to purchase**

(a) A Farmor may retain rights to control the purchase and disposition of production from a farmed-out well, either on an exclusive basis, or in the event the farmee does not desire to produce or sell its production.

E. <u>Liability between Farmor and Farmee</u>

1. **Farmor and Farmee are potentially at risk for the acts of the other**. There is no single concept of liability that can be applied in farmout agreements because the extent of joint interest in the property, operation and share of profits will always vary from deal to deal. While disclaimers of joint venturing status, where applicable may help, carefully crafted indemnification provisions and proper insurance coverage are the best means to protect against liability for the acts of another under a farmout.

V. PURCHASE & SALE AGREEMENT SPECIFICS

A. A Definition. The legal documentation in connection with the acquisition or divestiture of legal entities, business lines or assets will vary in size and complexity from deal to deal. As distinguished from a participation agreement where the focus is on joint interests in, and rights to, exploration or production, a purchase and sale transaction is a more comprehensive deal representing the complete entry or exit of a party with respect to a particular aspect of oil and gas operations.

B. Deal Structure

1. **Asset acquisition** – what assets are being acquired? Substantially all of the assets from a legal entity, or only a portion of that entity's business? When acquiring assets, it is always critical to understand and define which liabilities of the seller, if any, will be assumed by the buyer.

2. **Stock** – is the buyer acquiring all or only a portion of the equity from the seller? Depending on the amount of stock to be acquired, the purchase may involve a change of control. Alternatively, a seller may capitalize a new entity with assets to be sold and sell all of the stock of the newly capitalized entity (also known as a "drop-down" transaction). Because all liabilities in a stock deal are transferred to the buyer, if any liabilities are to be retained by the seller, the buyer may negotiate to have the seller indemnify the buyer in connection with those retained liabilities.

3. **Merger – creature of state law**. Equity ownership in the target company is transformed by operation of law into the right to receive "merger consideration" (cash, stock, cash + stock, debt securities, etc…).

4. **Security for performance obligations** – an integral part of purchase and sale legal documentation could include a guaranty of a buyer's obligations under the purchase and sale agreement if and to the extent that the seller is uncomfortable with the buyer's creditworthiness. This is not just a question of whether the buyer has the financial resources to purchase the assets or equity; it can also relate to the ability of a buyer to perform all of its conditions to closing, such as interfacing with third parties and governmental authorities.

C. Defining the Subject Assets and Liabilities – in an asset deal, it is important to define what assets are being purchased and what liabilities are being assumed by the buyer and/or retained by the seller.

1. **Stock sales** – in an acquisition of all of the stock of an entity, the sale of the stock will be effective to convey all that is owned by the entity. Therefore, due diligence is the only way to assure the buyer that the assets it intends to acquire, are in fact owned by the selling stockholders, and that in so acquiring the stock from the sellers, the buyer is not acquiring unexpected assets or assuming unwanted liabilities from present or past operations or holdings.

2. **Asset sales** – what is being acquired: all of the assets or a portion of the assets of the selling entity?

(a) If all of the assets are to be conveyed, a simple granting clause backed up by exhibits identifying specific assets (including intangible assets such as intellectual property and rights under contracts) attached to the purchase and sale agreement may be sufficient.

(b) If less than all of the assets of a selling entity are to be conveyed, care should be taken on the part of both parties to determine whether the business intended to be sold can function with the discrete assets that are covered by the purchase agreement.

(i) The seller may also wish to retain certain assets such as nonoperating interests it retains in certain producing properties.

(ii) If, after closing the buyer discovers that it has not aquired all of the assets that were necessary or useful to operate the acquired assets in the same manner as the seller, the buyer will frequently invoke a "further assurances" clause in the purchase agreement, requiring the seller to take such steps as are necessary to implement the transaction contemplated by the agreement. In addition, the seller may be liable for breaching a representation and warranty that the buyer may have asked for that would address whether the assets to be sold would enable the buyer to operate the business in the same manner as then conducted by the seller.

D. <u>Allocating Contractual Risks</u>

1. **Title** – many sellers will not warrant title. However, where the acquisition is of producing oil and gas reserves, the buyer will want the seller to represent (at least) that the seller has not taken any actions that would prevent the buyer from enjoying good title in the form of a special, rather than a general warranty deed. Consequently, the buyer will have to undertake a robust due diligence review of all aspects of the title to the property that is being conveyed, and prior to closing obtain title opinions from counsel, and where available and desired, title insurance.

(a) To the extent that defects in title are found, purchase price adjustments may be warranted if the seller cannot remove the title defection prior to closing, or for material defects, the buyer may seek the right to terminate the agreement.

2. **Environmental** – an environmental risk assessment can be carried out to varying degrees, depending on the willingness of the seller to cooperate. For instance, not all sellers or surface right owners will permit the buyer to conduct a Phase II environmental assessment on their property. Environmental risk can be allocated and shifted either by:

(a) requiring the seller to remedy a problem that has been identified,

(b) outright adjustments to purchase price,

(c) through damages for failure of a carefully drafted representation to be true (typically, when made or deemed made), or

(d) through obligations to indemnify the buyer against specified types of environmental claims (discussed below).

3. **Representations (generally)** – during the negotiation process, representations can help focus discussion on both parties' underlying assumptions regarding allocation of risk, because each side has an opportunity to determine the extent to which the other side is willing to make a requested representation. After closing, representations provide the mechanism to give effect to the negotiated allocation of risk between the parties, because the failure of a representation to be true (when made or deemed made) would be a breach of the contract, for which the breaching party could become liable for damages.

(a) *Representations to be made by the seller* – the buyer would like to be able to use representations made by the seller as a means to verify the accuracy of information provided or made available to the buyer and that the buyer has used to develop its purchase price.

(i) Rather than going through all standard warranties in a purchase and sale agreement, this presentation will focus on some unique representations that could be given in favor of the buyer by a seller of acquiring producing oil and gas reserves.

(1) Reserves (for an upstream acquisition) – what type of information has the buyer used to evaluate the reserves? Has the buyer made its own evaluation of well logs and production histories, used a third party reserve engineer's report, or relied on the report of a reserve engineer hired by the seller? Each of these different sources of key reserve information comes with different levels of imbedded subjectivity and completeness. Representations can be used to force the seller to stand behind the accuracy (or at leas the completeness) of the information provided to the buyer.

(2) Producing wells – the buyer may seek assurances by requiring the seller to make representations regarding the proper

classification of the wells in accordance with producing categories; proper permitting of each well; proper unitization, if any; no adverse claims, including claims relating to payment of royalties and other economic interests; and other aspects.

(3) Ownership and operation – the buyer may also seek the following types of representations that relate to aspects of the seller's operations that affect the assets being acquired: that the seller is in compliance with all lease terms; seller has no prepayments for future deliveries of production to be made without payment; the condition of the property and equipment; liability for specific environmental and pollution related regulations; disclaimer of and compliance with the terms of all operating agreements; and that the seller is receiving the contract price for the sale of its production.

(b) *Representations to be made by the buyer* – are much simpler and usually relate to corporate due authorization and enforceability. To the extent that the deal is structured as a stock purchase, the seller may also seek representations regarding the buyer's compliance with securities laws.

(c) *Effectiveness and survival* – representations are usually made at signing and "brought down" (*i.e.,* made again) at the closing. On both of these dates the representations must be true and correct. Representations are said to "survive" the closing if they must remain true and correct after the closing, usually for a period of time. Regardless of whether representations survive the closing or not, buyers are not normally given an endless period of time in which to bring a claim for damages for failure of a representation to be true or a claim for indemnity as a result of damages suffered for failure of a representation to be true; this time period is usually limited.

4. **Pre-closing Covenants** – how much time will elapse between signing and closing? From an operational point of view, varying degrees of control (that are both permitted under law and desired as a commercial matter) over the seller's undertakings through closing are an important aspect of any purchase and sale agreement.

(a) *Access to information and properties* – buyer will want access to all pertinent books and records, including operational, revenue and expense records. Buyer will also want on-site inspection rights and access to personnel.

(b) *Operational covenants* – seller should covenant to operate the property in the ordinary course of business (*i.e.*, restrictions on asset sales and expenditures other than authorizations for expenditure (AFE) that have been approved by the buyer).

(c) *Personnel and contract retention* – the buyer may desire for the seller to covenant not to discharge or transfer key personnel, and to make efforts to retain existing commercial contracts that may terminate upon a change of ownership or that are not assignable.

(d) *Approvals* – both sides will seek covenants from the other to support the consummation of the transaction and to cooperate in connection with any consents from governmental authorities, substitution or security for operating or reclamation/abandonment duties, or other consents or waivers of preferential rights from private third parties.

(e) *Antitrust considerations* – the scope of interim operating covenants imposed by the buyer on the seller is subject to antitrust laws that affect the manner in which parties can agree to restrict competition.

5. **Conditions to Closing** – both parties are entitled to insist that certain conditions be met before becoming obligated to close.

(a) *Hart-Scott-Rodino Antitrust Improvement Act (HSR)*[*] – applicable to transactions valued at over $50 million; however, acquisitions of oil, natural gas, shale or tar sands, and certain associated exploration or production assets are exempt from compliance with HSR, so long as the total value of the assets being acquired does not exceed $500 million.[†]

(i) If required, a transaction cannot close until the HSR waiting period has expired or concerns expressed by the DOJ or FTC, as applicable, have been resolved.

(b) *Other antitrust laws*

(i) Sherman Act – limits the ability to coordinate commercial activities prior to closing.

(ii) Clayton Act – prohibits business combinations that substantially lessen competition.

(iii) Analogous state antitrust laws.

(c) Based on the level of due diligence expected to occur, the parties may also negotiate closing conditions tied to satisfaction of certain diligence items such as absence of title defects and adverse environmental conditions.

(d) Other typical closing conditions include: that all representations and warranties be true and correct; all governmental consent (in addition to HSR, above) have been obtained; no orders or injunctions preventing the closing; consents and waivers of all preferential rights; receipt of legal opinions.

6. **Indemnities** – allocate liabilities arising in connection with the purchase and sale agreement or the assets themselves after closing. Indemnities can

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[*] See 15 U.S.C. §18a.

[†] See 16 C.FR. 802.3(a). The extent to which "associated exploration and production assets" are exempt from HSR is discussed in greater length in the federal regulations.

create remedies that do not exist at law and can limit the scope of claims that could be made at law and the time period for making them.

(a) *Topics covered by indemnities.*

(i) Breach of representation or non performance of covenants and other obligations.

(ii) Liabilities relating to prior operation of the business, including with respect to taxes and environmental liabilities (Arising when? Caused by whom?).

(iii) Title.

(iv) Claims for development and operation expenses.

(1) Buyer can indemnify seller for claims in connection with operations after the closing, such as plugging and abandonment costs.

(2) Seller can indemnify buyer for claims in connection with operations arising prior to the closing.

(v) Claims for injuries to third party people and property.

(b) *Losses covered by indemnities and caps on damages* – generally defined by what is excluded (*e.g.*, consequential damages, punitive damages, lost profits, lost business opportunities, etc…)

(i) For losses attributable to breach of title, losses may be limited to the value of the affected property, less the value of the proceeds received by the purchase of the property.

(ii) Not all losses are eligible for indemnity. Sellers often negotiate minimum thresholds regarding the size of the claim or claims that must be met before an indemnity claim can be made, and similarly, negotiate caps to their overall limit of liability.

(c) *Survival and time limitation* – all subject to negotiation and time limitations may vary for different indemnification obligations. Buyers seek longer periods, and sellers, quite obviously, prefer shorter periods.

(d) *Procedures* – how will claims and disputes be settled. The indemnitor will desire to control resolution of disputes with third parties, and to a certain degree, this is justifiable because the indemnitor is paying the costs of the indemnitee's defense. However, there are limits to this control, such as in connection with the selection of counsel, whether there are legal conflicts of interest between the indemnitor and the indemnitee and the ability to compromise or settle claims that could affect the indemnitee without the indemnitee's consent.

(e) *Security for indemnification obligations* – the value of the indemnity depends on the creditworthiness of the indemnitor. The greatest risk and unknown liabilities usually surface within a short period of time after closing or when the buyer is going through a routine audit cycle. In the absence of a creditworthy indemnitor, or in order the for the buyer to avoid having to make a claim against the seller for an indemnifiable loss, buyers may wish to hold back a portion of the purchase consideration "in escrow" to be released in accordance with a schedule, but only to the extent that the held back amount is not required to be applied toward satisfaction of any indemnification claims.

E. <u>Assessing Third Party and Governmental Interests</u> – oil and gas estates are subject to multiple interests: between lessor and lessee, among joint operators, among unitized production facilities, and with nonoperating interest holders. Due to the inter-relationship among these different stakeholders, owners desire the ability to protect their interests, primarily through preferential rights to purchase and consents to assignment.

1. **Preferential right to purchase** (or "right of first refusal," "preemptive right," "contingent right"). Preferential rights vest with stakeholders and are exercisable in an owner elects to sell.

(a) *There are three basic types*:

(i) Owner desires to sell, notifies right holder, right holder bids and sets the price; only higher offers can be accepted.

(ii) Owner sets a sales price, offers at that price to the right holder who may accept or reject; if rejected owner may only sell at a higher price to a third party within a limited period of time; however, if the owner receives a counter offer from a third party at a price that is lower than the price offered by the right holder, the owner must offer that lower price to the right holder.

(iii) Owner receives a bid from a third party; owner must first offer at that price to the right holder before consummating a transaction with the third party.

(b) *Problems of administration* – there may be no simple answers; what is important is foreseeing the issues and then negotiating upfront resolutions to any perceived problems, rather than having to address unforeseen issues after a deal signs when the parties are under intense time pressure to close.

(i) When a seller desires to sell a bundle of assets, some of which are subject to preferential rights, some of which are not.

(ii) When the time period for the right holder to elect to exercise its preferential right exceeds the shorter time frame in which buyer is willing to consummate a transaction with the owner.

(iii) Sale of substantially all the assets of an enterprise – are normally excluded from preferential rights because it would make it too difficult to acquire an entire company if various preferential rights had to be waived or exercised.

(c) *Waivers* – from the right holder can be used to avoid the preferential right, but are not always forthcoming, and may come only with payment of a fee.

2. **Consents to assignment** – more often held by lessors who wish to restrict assignment of the lease to a new lessee in order to prevent who has access to the property, or farmors who wish to restrict assignment of a farmout by the farmee in order to control who is conducing drilling operations. Unlike preferential rights, where the property will be sold, either to a third party or to the right holder, consents to assignment, if not given, would be considered a title defect that could prevent the seller from providing an truthful representation if it were to sell property without receiving the requisite consent.

3. Governmental interests

(a) Consents to assignment – assignment of leases on federal land or offshore federal waters, may require governmental consent. Usually, it is a question of the assignee (or purchaser) having the right permit.

(b) Exon-Florio Amendment to the Defense Production Act. Applicable only to the extent that there is an acquisition of "control" by a foreign person of a U.S. person that threatens to impair U.S. national security. Whether such person presents a threat is made through a "CFIUS" filing with the Committee on Foreign Investment in the United States.

(c) International Investment and Trade Services Survey Act. Requires reporting on foreign direct investment in the United States, including real estate. Exemptions are available if the total assets are less than $1 million and the U.S. enterprise owns less than 200 acres of land.

F. <u>Connecting to other Commercial Relationships</u> – In addition to a detailed due diligence review to determine the adequacy of title to the subject properties to determine what it is that one is truly purchasing, one must be aware of the myriad of other commercial relationships that are involved in upstream activities and the contracts that mediate these relationships. The purpose of this section is not to analyze the different parts of the contracts that are referred to, but to highlight some of the important provisions that could be contained therein, and that are relevant to a buyer in a purchase transaction.

1. **Joint Operating Agreements** – if the seller does not own 100% of the operating interests in each producing property being sold, that property will be subject to a joint operating agreement. Or, a subject property may be being developed jointly

with adjacent and neighboring sites. Therefore, the buyer must understand who is the operator and the nature of the relationship among the non-operators with working interests. How have the accounting procedures been applied and what has the nature of any disputes been? Most form operating agreements contain standard clauses for preferential rights so it is almost inevitable that the consent of third parties under the operating agreement will have to be sought.

2. **Production Sales Contracts** – this is more of an issue for gas that may be under long term sales to pipelines. But for either gas or oil, it is important to know who and where the production will be sold to, the pricing arrangements, if any, and whether sales are on a "take or pay" basis or not. Longer term gas sales contracts will likely contain consents to assignment.

3. **Gas Balancing Agreements** – regulate compensation between working interest holders when one working interest owner is taking or marketing gas in a ratio which is different from the working interest owner's pro-rata share. After finding out which wells/properties are subject to gas balancing agreements, the buyer must ascertain whether if the seller is over-produced or under-produced.

4. **Pooling and Unitization Files** – there are two common forms of pooling: pooling of acreage from adjoining leases and pooling of fields, mostly in connection with advanced oil recovery techniques or secondary recovery. When adjoining leases have pooled together, buyers should confirm that the actual pooling is in accordance with the declaration of pooling and that the pooled unit complies with applicable laws and regulations. In addition, the buyer will need to understand the actual economics of how production from the pooled unit is treated relative to each lease over the pooled area. For field-wide unitizations, some unitization agreements change unit tract participation at different stages of production depletion, and a buyer would want to know at what stage in the production profile the field is at if the buyer's tract participation is subject to change.

5. **Transportation and Tariffs** – the buyer must understand the commercial terms for gathering and transporting production into the market (both in terms of price and minimum shipping requirements) as well as any unique aspects of the tariffs that govern such transportation (*e.g.*, interruptible or firm transport).

G. Reflecting Specialty Concerns

1. **Environmental** – although crude oil and natural gas are not classified as "hazardous substances," under most federal environmental laws, many other materials used in oil and gas operations are, as are some of the by-products of drilling deep into the surface. Under CERCLA (Comprehensive Environmental Response, Compensation and Liability Act) any property on which hazardous substances have been deposited, stored, disposed of, or placed, are subject to remediation, and any current owner or operator is jointly and severally liable for the cost of the clean up. Consequently, an environmental inspection is very important in order to determine the potential scope of any "superfund" liability.

(a) Other applicable California and federal environmental laws that could be implicated in an oil and gas purchase are:

(i) Clean Water Act and Safe Drinking Water Act that are designed to protect surface and subsurface water supplies. Is any production seeping through casing and into ground water supplies? How is reinjected water treated? How is discharge treated and what permits are in place to allow such discharge?

(ii) ESA/CEQA/NEPA – CEQA (California Environmental Quality Act) and NEPA (National Environmental Policy Act) not triggered by change of title; generally triggered if a public agency needs to approve a transaction in connection with project expansions and upgrades. ESA (Endangered Species Act) would be also be triggered if there were an endangered species affected in connection with the transaction or as part of a NEPA or CEQA review.

(iii) Migratory Bird Treaty Act that is designed to protect migratory birds by making it illegal to maintain pits, tanks or facilities into which a migratory bird might land or be harmed (such as drilling pits).

(b) To the extent that an environmental problem is known, the purchase and sale agreement can include covenants regarding the seller's obligation to remedy the problem, the buyer's rights for failure to remedy the problem and the scope of any indemnity obligations for future environmental claims stemming from prior acts of the seller.

2. **ERISA (Employee Income Security Act of 1974).**

3. **Securities laws.**

4. **Tax.**