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Oil & Gas Asset Acquisitions: Overview

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A Practice Note providing an overview of the key steps and considerations when selling and acquiring oil and gas assets. This Note discusses steps such as identifying the assets, negotiating the letter of intent or term sheet, conducting due diligence, preparing the purchase and sale agreement, and closing the transaction. It also addresses Texas requirements for post-closing matters like recordation and governmental filings.

Purchase and sale transactions in the oil and gas industry are most commonly structured as asset purchases rather than stock or equity purchases. Unlike some other private company transaction agreements that provide for a simultaneous sign and close, in an oil and gas purchase and sale transaction the parties typically first sign a purchase and sale agreement (PSA) and then close at a later time.

The necessary steps to complete one of these transactions generally include:

- Identifying the assets, entering into a confidentiality agreement, and delivering a bid package (see Asset Identification and Sale Preparation).
- Preparing a letter of intent (LOI), sometimes called a term sheet or memorandum of understanding (see Letter of Intent).
- Conducting due diligence before entering into an agreement (see Pre-Agreement Due Diligence Review).
- Entering into a PSA (see Purchase and Sale Agreement).
- Conducting due diligence after entering into the PSA but before the transaction closes (see Post-Signing Due Diligence).
- Closing the transaction (see Closing and Post-Closing Matters).

Asset Identification and Sale Preparation

Identifying the Assets

Typically, the first step in an oil and gas purchase transaction is that a potential seller identifies assets it wants to divest. The assets might include:

- All the seller's assets in an entire region.
- A smaller set of assets.
- An undivided portion of the seller's interests in certain assets.

Once the assets are identified, the seller markets them on its own or with the help of consultants and advisers. For high value assets, the seller often engages a third-party firm to run a competitive bidding process, frequently also called an auction. This bidding process helps attract the highest purchase price for the assets. The advisers' role is to assist the seller and its attorneys with the sale by:

- Preparing certain bid process documents.
- Overseeing a virtual data room.
- Soliciting bids for the assets.

Confidentiality Agreement

Once the seller finds a potential buyer, the buyer is usually required to enter into a confidentiality agreement before it's given access to the bid process documents and virtual data room. Although confidentiality agreements are often viewed as a form document, a potential seller should ensure that the agreement properly covers the disclosed information and holds the potential buyer responsible for any disclosure to third parties.

For further information on confidentiality agreements generally, see Practice Note, Confidentiality Agreements: Mergers and Acquisitions and Confidentiality Agreements for M&A Transactions: A Checklist for Buyers and Sellers. For a general form of confidentiality agreement, see Standard Document, Confidentiality Agreement: Mergers and Acquisitions.

Bid Package

After a potential buyer signs a confidentiality agreement, the potential seller or its representative provides a bid package to the potential buyer. A bid package usually includes:

- An offering presentation with extensive disclaimers and warnings to protect the seller and its advisers.
- Draft transaction documents.
- Access to the virtual data room (see Virtual Data Room).

The bid documents also set out instructions for the next steps potential buyers must take. The instructions should be clear that no transaction or binding commitment to enter into a transaction exists until the parties execute a definitive and binding PSA. Potential buyers then:

- Choose to bid on a portion of the assets or all the assets.
- Submit by a certain date their bid terms for the assets and markup of the PSA.

The seller's hired adviser manages communications with the potential buyers and receives the bids. The seller or its representatives then review the received bids and select one potential buyer (or multiple buyers for different portions of the assets) to proceed with further discussions.

For more information on auctions and the bid process generally, see:

- Practice Notes:
  - Auctions: From the Seller's Perspective;
  - Auctions: From the Bidder's Perspective; and
  - Bid Process Letters.
- Auction Timeline.
- Best Practices in Bid Procedures Checklist.

Virtual Data Room

The virtual data room usually includes:

- Publicly available information relating to the assets such as:
  - information derived from copies of recorded land documents; and
  - production reports submitted to regulatory agencies.
- The draft PSA and other documents relating to the assets.

Depending on the assets being sold, populating the data room with the appropriate documents can take weeks or even months. A potential seller should begin collecting, organizing, and preparing the documents as early as possible.

The seller usually does not make available its sensitive or internal documents and information until the parties enter into a binding PSA. For more information about PSAs, see Purchase and Sale Agreement.

For further discussion of virtual data rooms, see Practice Note, Using a Virtual Data Room for an M&A Transaction.

Communications

Whether a seller is negotiating with one identified buyer or multiple buyers through the auction process, both the potential seller and buyer should be careful not to enter into a binding agreement before it intends to be bound. Any communication from a potential seller or buyer to the other party must be clear that both:

- Any communication from the sending party to the other party is not an offer the receiving party can accept.
- The parties are not bound to any terms before they enter into a definitive agreement.

A seller must also comply with its own bidding procedures and ensure that its representatives' actions do not unintentionally create a binding agreement before the parties sign a PSA.

Letter of Intent

After a potential buyer submits an offer with its comments to the draft PSA, the parties may negotiate a letter of intent (LOI) (sometimes called a term sheet). Parties enter

into an LOI before further negotiating a fully detailed PSA to reach agreement on the main points of the proposed transaction. If the potential seller does not hold an auction process, the parties often negotiate an LOI to document their intent to make a deal.

An LOI may contain provisions addressing:

- The purchase price, including any deposit.
- The assets being purchased.
- The transaction's effective date.
- The scope of due diligence.
- The conditions to closing and required consents or approvals.

The parties also typically state that the binding PSA will contain usual and customary representations and warranties and covenants.

Non-Binding Commitment

Parties generally want an LOI to be a nonbinding expression of their understanding before entering into a future agreement. Because parties to an LOI do not want to be bound by deal terms before signing a PSA, the LOI should explicitly state that executing the LOI does not impose any binding obligations on either party (except for those the parties explicitly agree are binding) (see Binding Provisions). The final terms often vary drastically from those first set out in the LOI, and the parties do not want to be inadvertently held to those initial terms. As due diligence moves forward and negotiations take place regarding "usual and customary" provisions, the agreement's terms evolve.

There are still risks to signing an LOI. Even with adequate disclaimers in place, some parties may argue that the LOI imposes a duty to negotiate in good faith. A jilted party might also argue promissory estoppel if it relied on the LOI to its detriment.

Binding Provisions

Sometimes the parties want certain provisions of an LOI to be binding. The LOI's confidentiality provisions are usually binding, especially if the parties cannot rely on a previously executed confidentiality agreement. Other provisions that parties may want to be binding include:

- **Exclusivity.** If the parties agree to an include an exclusivity provision in the LOI, the buyer likely wants it to be binding on the seller. For more information on exclusivity, see Practice Note, Exclusivity Agreements. For an example of an exclusivity agreement, see Standard Document, Exclusivity Agreement.
- **Access.** If the parties agree that the buyer has some access to the seller's property while negotiating the PSA, the seller wants any provisions governing the buyer's access to be binding, including any requirement to:
  - provide evidence of insurance; and
  - indemnify the seller for any injuries or damages.
- **Expense reimbursement.** Any agreement that one party must bear the other party's out-of-pocket expenses relating to the PSA's negotiation should be binding.

If an LOI fails to include any legally binding provisions, the document has little legal purpose. An aggrieved party to a fully nonbinding LOI may allege an equitable theory for the recovery of damages. From this perspective, the time taken to negotiate the LOI may be better allocated towards negotiating the final form of the PSA itself.

For more information on LOIs, see Practice Note, Term Sheets. For an example of a general form of a letter of intent in an asset acquisition, see Standard Document, Letter of Intent: Asset Acquisitions.

Pre-Agreement Due Diligence Review

If time and resources permit, both parties to the transaction should conduct an extensive due diligence review before soliciting bids or making a bid, as applicable, or entering into a PSA. The sophistication of the parties and each party's familiarity with the assets also determine how extensive the pre-agreement diligence should be. A buyer unfamiliar with the particular region or type of assets should familiarize itself with the assets as much as possible before beginning negotiations so that the buyer is not surprised by an issue it had not considered. The nature of the assets, such as undeveloped acreage versus producing assets, is also a factor of how extensive the pre-PSA diligence process should be.

Conducting due diligence before signing a PSA helps a party determine if it should move forward with the transaction and how to negotiate the transaction terms. Assuming the parties enter into the transaction, this diligence has great value because it helps them:

- Intelligently negotiate representations and warranties addressing the issues discovered during diligence.
- Identify the issues impacting risk allocation between the parties.

- Streamline and potentially shorten the time periods needed to conduct title and environmental diligence after they sign the PSA.
- Identify early in the process any approvals or consents required to move forward with the transaction, including:
  - intra-company approvals;
  - entity approvals, such as director and shareholder approvals for a corporation or manager and member approvals for a limited liability company;
  - governmental agency approvals; and
  - previous owner, co-owner, lessor, or other third-party approvals.

For more information on due diligence in M&A transactions generally, see Practice Note, Due Diligence for Private Mergers and Acquisitions. For information on due diligence in oil and gas transactions, see Upstream Oil & Gas Asset Acquisitions Due Diligence Checklist and Practice Note, Due Diligence for Upstream Asset Acquisitions.

Purchase and Sale Agreement

A well-drafted PSA is a complex and interwoven agreement. Changing one provision often impacts another. For example, adding an asset to the list of excluded assets that the seller retains may result in the buyer losing related contracts it intended to assume as part of the transaction. This small change may also cause the seller to retain unlimited liability and expose itself to indefinite indemnification for the excluded asset.

Parties should be careful when they revise a PSA to evaluate and consider how the change affects the whole agreement. The interconnectedness of the agreement makes it important to fully understand the scope of the assets as much as possible before drafting and negotiating the PSA. Major last minute structural changes to a PSA can lead to uncertainty and litigation.

Key provisions of the PSA typically include:

- A description of the assets (see Assets).
- The representations and warranties (see Representations and Warranties).
- The title defect process (see Title Defects).
- The assumed and retained liabilities (see Liabilities).
- The exhibits and schedules (see Exhibits and Schedules).
- The disclosure schedules (see Disclosure Schedules).

For more information on PSAs in the oil and gas industry, see Practice Note, Purchase and Sale Agreement Commentary: Oil & Gas.

Assets

The parties should clearly define both the assets and related interests being purchased. Exhibits to the PSA typically list the following assets:

- Leases, easements, and wells.
- Related equipment, facilities, and permits.
- Either:
  - specific contracts; or
  - all contracts related to the other assets.
- All data, records, and potential claims related to the other assets.

The parties should also consider how certain assets that initially fall under the definition of assets might become excluded assets. For example, a PSA's consent and preferential right provisions may deem that an asset is excluded from the sale if the seller fails to receive by closing a consent to transfer. Similar provisions may exist in the title and environmental sections of the PSA.

For information on defining the assets, see Practice Note, Purchase and Sale Agreement Commentary: Oil & Gas: Defining the Assets and Properties.

Representations and Warranties

Seller

The PSA's representations and warranties are often the most heavily negotiated provisions. Both the buyer and seller make representations and warranties in a PSA, with the seller's representations and warranties being much more fulsome. Because the seller is the party most familiar with and knowledgeable of the assets, the seller should expect to represent and warrant about the assets' specific characteristics. The seller is usually unwilling to provide specific representations about title or lease status, arguing that the buyer should instead rely on the title defect process (see Title and Environmental Defect Process).

For similar reasons, the seller usually seeks to limit environmental representations.

Buyer

If a buyer is not given sufficient opportunity to investigate the assets before signing the PSA, it often pushes for extensive representations and warranties from the seller. A PSA typically includes broad waivers of any warranties implied by law and any oral representations or warranties. The buyer must be certain that the information it is relying on from the seller is covered by the seller's representations and warranties in the PSA.

Title Defects

Parties typically address title through a title defect process rather than addressing the seller's title to the oil and gas properties in the representations and warranties section. The PSA sets out an extensive defect process where:

- The buyer has a certain amount of time between signing and closing the PSA to identify any assets for which the seller does not have defensible title.
- The seller may also require the buyer to identify during its title review any interest additions where the seller may be conveying more than defensible title.

For a discussion of defensible title, see Practice Note, Purchase and Sale Agreement Commentary: Oil & Gas: Defining Defensible Title.

Liabilities

Dividing liabilities between the parties after closing is usually a key negotiating point. If a seller is exiting an area, it usually wants the buyer to assume all (or nearly all) liabilities. A buyer typically prefers a "your watch, my watch" approach to liabilities. Under this approach:

- The seller remains responsible for liabilities arising while it was the owner of the assets.
- The buyer is responsible for liabilities arising thereafter.

The "your watch, my watch" philosophy does not tie exactly to either the effective date or the closing date. For certain operational liabilities, the "watch" switches over at the closing date. However, for certain financial or bookkeeping liabilities, the "watch" may switch over at the effective date. The parties should keep this distinction in mind while negotiating.

The parties typically deviate from the "your watch, my watch" approach for plugging and abandonment (decommissioning) liabilities and environmental liabilities.

Exhibits and Schedules

When finalizing a PSA, some parties prepare the exhibits and schedules last. The exhibits and schedules should receive the same level of attention and review as the PSA. For example, failing to thoroughly prepare or cautiously review the exhibits and schedules may:

- Give the buyer a clear right to terminate the PSA.
- Result in the buyer not acquiring what it thinks it is buying.

The exhibits to the PSA typically list out the leases, wells, easements, and contracts being purchased. If these exhibits are not accurate, the buyer may get more or less than it intends to purchase. A buyer may also inadvertently agree to acquire a lease that has significant liabilities or defects.

Because exhibits define the scope of the transaction, the parties should carefully draft and review them.

Disclosure Schedules

The disclosure schedules to the PSA serve as carve outs to certain provisions of the PSA. For example, if Section 4.1 of the PSA states "except as otherwise set forth on Schedule 4.1, the assets have been operated in accordance with all applicable laws," the seller should list on Schedule 4.1 any infraction notices it has received relating to the assets. Otherwise the seller may be in breach of the agreement. The buyer wants items included in the disclosure schedules because a listed item may be significant to the buyer. Depending on what a seller includes on a disclosure schedule, it may substantially or even entirely erode the value of having the seller make the associated representation.

Post-Signing Due Diligence

Under many PSAs, a due diligence period exists between signing and closing. This due diligence period typically lasts 30 to 120 days depending on the transaction size and any unique issues regarding the assets. During the due diligence period the following typically occurs:

- The buyer obtains access to the assets after meeting certain conditions (see Access to Assets).
- The seller gives the buyer access to the seller's title records, and the buyer conducts a title review of the assets. The buyer also identifies any environmental defects (see Title and Environmental Defect Process).
- The seller requests any necessary consents and, if necessary, preferential right waivers (see Consents and Preferential Rights).

For more information on due diligence in M&A transactions generally, see Practice Note, Due Diligence for Private Mergers and Acquisitions. For information on due diligence in oil and gas transactions, see Upstream Oil & Gas Asset Acquisitions Due Diligence Checklist and Practice Note, Due Diligence for Upstream Asset Acquisitions.

Access to Assets

The buyer can access the assets after obtaining adequate insurance and indemnifying the seller for any injuries or damages arising from the buyer's access. The seller may permit the buyer to conduct certain environmental testing but typically denies invasive testing without the seller's prior written consent. This avoids inadvertently triggering potential regulatory obligations. The seller also often requires the buyer to promptly provide copies of any reports or studies prepared on the buyer's behalf.

Title and Environmental Defect Process

The seller usually provides the buyer in-person or virtual access to its title records within days of signing the PSA. Depending on the assets, the buyer may engage a team of contractors to conduct the title review and prepare the information required to assert a title defect notice. The buyer and the seller may work together to resolve potential title defects as they arise, or the buyer may assert all title defects at one time. Asserted title defects may lead to:

- A purchase price adjustment.
- Curing the title defect before or after closing.
- Dispute resolution.
- In extreme cases, terminating the PSA and the transaction.

The environmental defect process usually follows a similar timeline and process as the title defect process.

Consents and Preferential Rights

The seller often identifies the third-party consents that are required to transfer the assets before signing a PSA. It then sends out requests for those consents as soon as the PSA is signed. If a required consent is not obtained before closing, the parties may agree to either:

- Exclude the asset from the transaction.
- Temporarily exclude the asset while they cooperate in good faith to obtain the consent.

Similarly, the seller typically sends notices to all preferential right holders to either obtain a waiver of the preferential right or to allow the time period for the third party's exercise of its preferential right to expire. If a third party exercises its preferential right to purchase as to certain assets, those assets become excluded assets.

Closing and Post-Closing Matters

The closing occurs on satisfaction of all conditions precedent. The parties agree to a preliminary settlement statement before closing that reflects any adjustments to the purchase price and the payment due from the buyer at the closing (with a final settlement statement usually prepared and agreed to 60 to 180 days after the closing date).

The PSA requires each party to provide its closing deliverables to the other party when the transaction closes. Post-closing the buyer is typically responsible for:

- Promptly recording assignments (see Recordation).
- Making necessary filings with governmental authorities (see Governmental Filings).
- Giving the seller copies of all recorded assignments and filed governmental forms.

Recordation

After closing, the buyer must promptly record assignments in the property records for each applicable county. In race-notice jurisdictions like Texas, the document recorded first, or earlier, controls for putting third parties on notice. If the buyer doesn't promptly record the assignment, title issues can arise if assignments drafted after the buyer's assignment are filed before the buyer's. Fixing these title issues requires a stipulation of interest to clarify the error in the order of recording.

Each county records and maintains its own records separately. Recording in one county doesn't give notice for property located in another county, even if the property in the other county is listed on a recorded exhibit to an assignment.

Governmental Filings

Post-closing the buyer must also ensure it makes filings with the applicable governmental authorities. In Texas this authority is the Railroad Commission of Texas (RRC). For all oil and gas properties, the RRC issues and controls permitting and maintains records of all wells, pipelines, and related oil and gas properties.

It requires notice of the current operator so that it can impose certain bonding and subsequent reporting requirements. Failure to timely report a change of ownership or other required notice to the RRC may result in fines or revocations of permits.

For certain land whose minerals are owned by the State of Texas, the leases are managed by the Board for Lease of University Lands. All proceeds generated from those state lands fund the University of Texas and Texas A&M University Systems. University Lands requires notice of, and must approve, all changes of ownership or operators regarding those state lands. Failing to provide the proper notice can result in fines and penalties for both the assignor and assignee. For more information, see Practice Note, Leasing State-Owned Lands for Oil & Gas (TX): Board for Lease of University Lands.