THE SELLER'S DILEMMA: POST CLOSING CONCERNS AND LIABILITIES

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The Seller's Dilemma: Post Closing Concerns and Liabilities

1. **Assumptions.**

A. The sale concerns a set of several dozen offshore properties, most of them OCS leases, though some are in state waters. The seller wants to close the transaction as quickly as possible - and the buyer agrees, recognizing that it could lose the sale if it doesn't concede to the seller's schedule. With the sale price at several hundreds of millions of dollars, the buyer needs to finance the transaction.

B. Note that the parties have significantly different motivations. Both are publicly traded companies, but the seller, with a market cap considerably in excess of the buyer's market cap, has been told by its financial analysts that it needs to improve its share price. The only way to do this, say the analysts, is to exit the Gulf of Mexico, where development costs are high and the richer reserves are in the deeper waters, and focus of the Rockies and Canada. The Board listens, management acquiesces, and the properties go on the market.

C. The buyer, on the other hand, wants to move up in class. With the price of oil seeming to hold at a much higher level that it has in the past decade, the buyer sees an opportunity in the seller's properties - there is both on-going production and the potential for deep water development.

Comment: Note that the spur to this entire process is Wall Street's concern about the seller's share price. Which is to say that this sale really has little to do with the properties and prospects that the seller has developed. Nor does it reflect on the efficiencies with which the seller operates these properties and markets their production. But it has everything to do with share price.

2. **Before the PSA: Assessment of Reserves/Engineering Report, Investment Banker Review, Negotiations Between the Principals**

A. In anticipation of this transaction, the seller has commissioned an updated reserve report on the properties that it intends to include in the package. Ryder Scott has prepared the report, say, and has opened a data room for the buyer and other interested parties to review its calculations, its method, the production reports from the properties, and the baseline information that RS has relied upon.

B. If the buyer believes that the package is attractive and if its own engineers are able to confirm the RS assessment, then it probably involves its investment bankers to assist in the valuation of the properties and to initiate financing, at least preliminarily. And if the buyer is concerned that there may be roundhouse bidding on these properties, it may begin negotiations with the seller immediately.

C. It's at this point where the principals agree to general terms: price; properties included; deposit; assumption of p&a liabilities; assumption of employees; closing date.

Comment: Perhaps the most important document in this transaction is the Ryder Scott reserve report. The buyer's lenders rely on this report to assess producing reserves, the cash flow that the properties generate, the potential for development of the deep water properties. The lenders need some level of confirmation that these properties provide sufficient security for a sizeable loan - one that they can syndicate among several financial institutions. One of the conditions to the loan: the buyer needs to verify clean title to at least 90% of the reserves scheduled on the Ryder Scott reserve report. (This also becomes an issue for the seller, as I'll show later.)

Comment: The terms the principals establish set the tone for the transaction. (While obvious, this is still worth noting.) In this case, the principals agree to a very quick closing date - within a month after the parties execute the PSA. This means that the buyer will have to complete its due diligence review in just a few weeks. It also means that the buyer will need to provide its lenders an acceptable level of comfort with the status of title - such that the lenders are willing to provide financing at closing. Finally, it means that the closing may occur before the seller receives responses to some of the pref rights notices that it needs to issue. It's also worth noting that the principals agree that the buyer will not need to provide a deposit.

3. PSA Negotiations: How The Seller Protects Itself

A. General Concerns

i. In negotiating the PSA, the seller wants to limit any further responsibility for these properties. And although the buyer has agreed to assume all p&a liabilities and all obligations associated with the properties after the effective date, that’s not the end of the seller’s concerns, particularly with respect to p&a liability.

ii. There are a couple of reasons for this: a) the MMS always has the flexibility to look to a prior lessee to answer for p&a liability even with the supplemental bond that the current lessee has in place and b) recent case law suggests that, at least in Texas, the seller is not off the hook to the operator for leasehold obligations, including p&a obligations, unless the operator has specifically releases the seller. Apart from these issues, the seller also needs to be mindful of its obligations under any standing pref rights clauses. And, finally, there is the question of the scope of the indemnification that the seller might provide – with respect to the type of claims that it indemnifies and with respect to the period of time during which it provides this indemnification.

iii. These are daunting problems for the seller. The question is how to address these – and other problems – in the PSA.

B. The MMS Problem

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i. The MMS has always taken the position that, as lessor, it has recourse against any lessee in the chain of title, at least for p&a obligations. The regulations are not entirely clear on this, but they certainly do give the MMS the flexibility to seek recourse against any lessee in the chain of title for those obligations that "accrued" when that lessee held its leasehold interest. Here is 30 CFR 256.62(d), which addresses the lessee's responsibility:

> You, as assignor, are liable for all obligations that accrue under your lease before the date that the Regional Director approves your request for assignment of the record title in lease. The Regional Director's approval of the assignment does not relieve you of accrued lease obligations that your assignee, or a subsequent assignee, fails to perform.

ii. The MMS reads this provision somewhat broadly: any lessee in the chain may be answerable for p&a liability, even if there were no facilities constructed during the lessee's tenure of ownership. That said, the MMS's historical practice has been to look first to the supplemental bonds in place and, then, if there is insufficient funding to complete the work, to look up the chain. For instance, where the standing p&a obligations are $30 million and the lessee's bonds are in the amount of $25 million, the MMS will look up the chain for the remaining $5 million – or, alternatively, for a commitment to complete the work. It's important to remember that the MMS is much more interested in having the p&a work done than it is in actual cash.

iii. The problem for the seller – an assignor – is that it cannot necessarily rely on the supplemental bonds that its assignee has provided to the MMS as security for p&a liability. For one thing, these bonds run in favor of the MMS, not in favor of a prior lessee. For another, there's no way of knowing whether the level of supplemental bonding will cover all p&a costs at lease termination. The seller needs to protect itself against the possibility that the MMS will seek recourse against it for at least a portion of the p&a costs.

iv. The current practice, at least among sellers of properties with significant p&a liabilities, is to require the buyer to provide some form of security that runs in favor of the seller rather than the MMS. From the buyer's perspective, this looks like it is securing the same obligation twice, once through the supplemental bonds that it provides the MMS and once again through the security that it provides the seller. The truth is that

it is securing the same obligation twice – just to different parties, in one case to its lessor, in another to its assignor.

v. So what might the seller require in the PSA? Even though the MMS does, in theory, have recourse against the seller for the full amount of p&a liability outstanding at lease termination, the current approach among sellers is not to anticipate the worst case. Sellers are now mandating a form of escrow agreement that requires a combination of letters of credit and pre-funded escrow accounts that protect the seller against those p&a expenses that are not covered by the assignee's supplemental bonds. In other words, the liability that sellers are protecting against is the delta between the amount of standing supplemental bonds and the actual p&a cost at lease termination.

vi. How might this work in the context of the transaction that I've described - one where the sale involves dozens of offshore properties, all with different measures of p&a liability, some of the properties being ones where the buyer plans to construct additional facilities, some of the properties being ones where the buyer intends no further development and the p&a obligation, with respect to the existing facilities, is imminent.

a. There are really two time periods that are of concern to the seller: the periods before and after the MMS approves the assignments and, in that connection, determines p&a liability on a property-by-property basis and establishes the supplemental bonding requirements for each such property.

b. For the short term, the seller might require a letter of credit in a significant amount, say $100 million, to provide security until the MMS establishes the applicable p&a liability and supplemental bonding requirements.

c. But, following the MMS's determinations, the seller might adjust these requirements: the letter of credit would be reduced by the difference between the level of bonding that the MMS requires and the estimate of p&a liability that the buyer and seller establish. At the same time, the seller might also require the buyer to begin making quarterly contributions to an escrow account, which would also serve to further reduce the amount of the p&a letter of credit. Note, though, that the combined value of the cash contributions and the standing letter of credit will always equal the delta between the value of the buyer's supplemental bonds and the parties' current estimate of p&a liability.

d. These are complicated arrangements but there are a couple of notable aspects:

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1. These arrangements recognize that MMS estimates of outstanding p&a liability may not be current, depending on when the buyer constructs or removes facilities. The standard Escrow Agreement will call for an annual estimate of outstanding liabilities, with both buyer and seller needing to be in agreement on this estimate.

2. These arrangements also recognize that the amount of security needs to fluctuate in tandem with the fluctuations in the level of outstanding p&a liability.

3. The accrued escrow funds are specifically designed to provide security to the seller in the event that the buyer fails to meet a p&a obligation. These funds are not available to the buyer for actual p&a costs.

4. The need for the letter of credit depends entirely on whether the combination of the supplemental bonds and the accrued escrow funds match or equal the outstanding p&a liabilities, as determined by the parties. To the extent that these combined amounts do equal the outstanding p&a liabilities, then there is no need for the letter of credit. On the other hand, if the amount of the outstanding p&a liabilities increases above the combined amount of bonds and escrow funds, then the letter of credit needs to be resurrected to cover the gap.

5. Where the combined amount of escrow funds and bonds exceeds the amount of outstanding p&a liabilities, the buyer may request that the seller approve a disbursement of any excess escrow funds.

6. The purpose of any escrow arrangement like this is flexibility: allowing for increases and decreases in p&a liability, requiring additional escrow contributions, distributions of excess escrow amounts, all in keeping with the status of the outstanding p&a liabilities. The parties may agree to terminate this arrangement – and return all escrowed funds to buyer – when the outstanding level of p&a liabilities, as determined by agreement of the parties, falls below a certain level, say, $25 million.

7. Here’s a sample clause that wraps much of this together:

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At any time that (a) there is an MMS Bonding Differential and (b) the Estimated P&A Liability is greater than the Non-LC P&A Security, then Buyer shall maintain a P&A LC in favor of Seller in an amount equal to the lesser of (A) the MMS Bonding Differential and (B) the amount by which the Estimated P&A Liability exceeds the Non-LC P&A Security. During any period of time that there is not an MMS Bonding Differential, Buyer shall not be required to maintain a P&A LC. If the Total P&A Security exceeds the Estimated P&A Liability, Buyer may reduce the amount of the P&A LC by all of such excess. The parties acknowledge that the amount of the Initial P&A LC was $____ because the MMS had not yet determined the amount of Performance Bonds that it would require Buyer to post. Buyer and Seller agree that, in connection with the issuance of the Performance Bonds following the Closing, the amount of the P&A LC shall be reduced by the amount of said Performance Bonds.

C. The Seagull Problem

i. From the seller's perspective, the problem of MMS recourse is not the end of its concerns about p&a liability. Until a year ago, a seller could rely on the buyer's assumption of p&a liability to protect itself from any p&a contribution claims from other lessees in the chain of title. Then came Seagull Energy E&P, Inc. v. Eland Energy, Inc., 207 S.W.3rd 342 (Texas 2006).

ii. The question here was whether Eland was answerable to the operator for any obligations under the operating agreement, including p&a obligations, after it conveyed its leasehold interests to Nor-Tex Gas in a conveyance where Nor-Tex assumed all of Eland's rights and obligations under the operating agreement. Put more directly, was Eland still answerable to the operator for obligations under the operating agreement even after it had divested itself of its leasehold interests? The Texas Supreme Court said that it was because it failed to obtain a release of its obligations from the operator. Here's how the Texas Supreme Court frames the issue:

> In this case, we must determine whether the sale of an oil and gas working interest., which was subject to an operating agreement, released the seller from any further obligations to the operator. We conclude that, despite selling its working interest, the seller remains liable under the operating agreement, unless released by the operator or the terms of the agreement.

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iii. This case has spurred a good bit of comment, much of it befuddled, some of it animated. Note that this is quite different from the MMS problem. The MMS situation concerns p&a claims by the lessor. The Seagull situation concerns p&a claims (and other claims under the operating agreement) by the operator, Seagull, who was also a co-lessee. Again, the difference is one between the claims of the lessor and the claims of a co-lessee/operator.

Comment: Best, probably, for the seller to treat this case as a warning. For any property where the seller is a co-lessee, then the seller should make sure that it obtains a release of any obligations under the operating agreement from the operator and, if appropriate, from any other co-lessee. This is not necessarily something that the seller and buyer can address in the PSA. The buyer's assumption of the seller's p&a obligations won't insulate the seller from the claims of the operator, short of a release. The seller needs to address this at the same time that it is preparing for the sale to the buyer.

D. The Pref Right Problem

i. With the dozens of offshore properties involved in this transaction, it's quite likely that the seller will need to issue numerous pref right notices. Note that the seller will not be able to issue these notices until the parties agree to make value allocations for each of the properties – a process that doesn't usually begin until the parties have completed and executed the PSA. It may be a week, even longer, before the parties agree to the allocations and the seller issues the pref right notices.

ii. Remember that the seller's management wants to close this transaction quickly. As a result, it's possible that the transaction will be scheduled to close before some of the pref right parties are obligated to respond. In that situation, the seller really cannot convey a property until the pref right recipient either declines to exercise its pref right or fails to issue a timely response. If the pref right recipient elects to exercise the pref right, then the property is not available for conveyance.

iii. So, for purposes of the closing, the buyer will only acquire and pay for the allocated value of those properties a) that are not burdened with a pref right and b) where the pref right recipient has declined or failed to exercise its purchase right. That leaves the uncertain set of those properties where the recipient has not yet notified the seller of whether it elects to exercise its purchase right.

iv. How is this handled? The buyer wants those properties if they become available and the seller certainly wants to sell them. This is

another situation where the seller should include a clause in the PSA requiring the buyer to provide a letter of credit. In this case, the letter of credit would be in the amount of the combined allocated value of those properties where the pref right election remains outstanding. This letter of credit would work this way: For any property where the pref right recipient declines to exercise the purchase right or fails to give a timely response to the pref right notice, the seller would convey the property to the buyer and, then, draw down the allocated value of the property against the letter of credit. This letter of credit would remain in effect for a few days beyond the latest date that a pref right recipient is obligated to respond.

v. Here's a sample clause:

> If at the time of Closing, the requisite period of time within which a Preferential Right must be exercised (the "Pref Right Period") has not elapsed and the holder of the Preferential Right has not exercised or waived such right (an "Unexercised Pref Right"), then at Closing, Buyer shall provide a duly executed letter of credit in a form and from a financial institution or similar entity reasonably acceptable to Seller (the "Pref Rights LC") in an amount equal to the aggregate Allocated Value for all interests burdened ("Burdened Interests") by Unexercised Pref Rights and the Burdened Interests will be held by Seller for the benefit of Buyer (and Seller will provide Buyer, if Buyer ultimately purchases such Burdened Interest, with the economic benefits of such Burdened Interest) until (i) the holder of the Subject Pref Right has exercised the same or (ii) the Pref Right Period has elapsed. In the former case, the Pref Right LC will be reduced by the Allocated Value of the Burdened Interest. In the latter case, Seller shall convey the Interest to Buyer and, in connection with this conveyance, draw against the Pref Right LC in an amount equal to the Allocated Value of such Interest.

Extended Comment:

i. The pref right situation requires a significant degree of caution on the part of the seller. The right usually arises under an operating agreement, where the seller is required to offer other parties to the agreement the right to purchase a particular property under the same terms that the buyer has offered.

ii. One recent case, Fordoche Inc., et al. v. Texaco, Inc., et al., No. 05-30857 (5th Circuit), illustrates the problems that a seller creates when it veers from the terms that the buyer has offered. Fordoche involved a situation where TEPI had accepted EnerVest Energy's offer to purchase a

package of Gulf Coast properties. Four of the properties in the package were burdened with preferential rights in favor of Forodche. Following the negotiation with EnerVest, TEPI offered the properties to Fordoche, using the allocated value that EnerVest had developed. However, in making this offer to Fordoche, TEPI a) stated that it's offer did not include any of the facilities, rights-of-way, or pipeline rights-of-way that EnerVest had agreed to purchase and b) failed to identify the specific forms of property interest (meaning leasehold interest, a form of mineral interest, or something else) that it was offering to Fordoche. The Fifth Circuit determined that TEPI's failure to include the facilities and rights-of-way actually made the price offered to Fordoche greater than the allocated value that EnerVest had developed - because the EnerVest value include the facilities and rights-of-way.

iii. There are several lessons from Fordache. The first, of course, is that the seller must not veer from the terms of the buyer's offer in making the pref right offer. The seller's notice should be clearly expressed, neither vague nor evasive, and should rely quite strictly on the terms of the buyer's offer. The second point, though not nearly as apparent, is that the seller must be comfortable that the allocation is reasonable. If the seller makes a pref right offer that uses an allocation that doesn't make sense, then the seller may open itself to a challenge from the pref right holder. Note, though, that while the seller and buyer need to agree on the allocation, it's always in the buyer's interest to develop a sensible allocation. The buyer's proposed allocation should be value neutral – that is, the value of any particular property should be such that the buyer believes that the general value of the transaction properties is not diminished by the loss of that property.

iv. A curious problem arises when the allocated value is in the negative – as would be the case with a property that is no longer productive and now requires that its facilities be plugged and abandoned. These properties are often included in sales packages – and that's certainly true of the properties in this example. Assuming that there is a pref right on a property that has been allocated a negative value, does this mean that the seller has to offer to pay the pref right holder to take the property? What if the pref right holder believes that it can p&a the property for a cheaper price than the seller offers to pay? I don't know the answer to this – but it is something to consider.

v. Other concerns. Does the sale of stock, rather than the sale of the actual leases, trigger a pref right clause? Maybe not. See Fina Oil and Chemical Co. v. Amoco Production Co., 673 So.2d 668 (La. App. 1st Cir. 1996). What if the pref right clause contains an exception for the sale of all or substantially all of the seller's properties in, say, the Gulf of Mexico? How do you know when this exception applies? Is it based on the

number of properties sold? On the value of the properties sold? On a combination of these factors?

E. Seller Indemnifications

i. There are two aspects to the seller's indemnification: the classes of claims for which the seller agrees to provide indemnification and the period of time during which the obligation to indemnify remains in place.

ii. With respect to the classes of claims, the seller usually agrees to indemnify the buyer for breaches of reps/warranties and for specific categories of claims that relate to the period before the effective date of the acquisition – such as personal injury claims, property damage claims, royalty claims, payment of vendors and operators, and certain environmental claims. Where the buyer has assumed the obligation to p&a the properties, this is usually specifically excluded from the set of claims that are subject to the seller's indemnity.

iii. With respect to the period of time during which the indemnity remains in place, the seller may agree to a shorter period from breaches of reps/warranties and a longer period for breaches of other claims. How long depends on the negotiation – maybe a year for breaches of reps/warranties and three years for other claims. However, I understand that in some of the more recent transactions, sellers have been able to limit the indemnity of all categories of claims to periods ranging from three to six months.

Comment: A seller may want to address the scope of indemnification at the outset, when the principals negotiate the general terms of the transaction. Otherwise, the terms of the indemnification become an issue that the parties address in the PSA negotiations. It goes without saying, perhaps, that the buyer will want the seller's indemnity to stay in place for as long as possible, regardless of how many properties are involved in the transaction.

4. **Due Diligence Period**. Involves a number of parallel/interrelated activities, mostly concerning the buyer.

i. The allocation of values that the buyer and seller develop is important for several reasons, two principal ones: it sets a value for the pref right notices; and it sets a value for purposes of the financing. Generally, the lenders will require the buyer to encumber properties representing approximately 90% of the total value - so the allocation provides a handle for measuring value – which is important when some properties may be lost to third-parties who exercise their pref rights.

ii. At the same time that the buyer makes these allocations, it also engages in title/environmental due diligence. When there are dozens of

properties and there is a quick closing schedule, this can become a challenge. The most difficult case, from a title standpoint, is one where the seller hasn't relied on title opinions in its acquisitions and hasn't maintained the public records. Because the buyer's lenders will want clean title, the buyer will need to i) bring the chain of title current on the public/MMS records, ii) determine whether the seller's working interest in each property is consistent with the interest shown on the seller's reserve report, and iii) determine how to resolve any inconsistencies. The buyer's official moment to raise and resolve title problems is in the title defect notice - though, the more efficient practice is raise these issues as they arise.

iii. Note that the process of bringing the chain of title current can be a labored one: it involves obtaining certifications from the MMS and, perhaps, the county/parish records. Where a significant number of properties are involved, this can be difficult to achieve by closing. Also, the buyer should use the title review process to create a title report, giving a description of each property and stating seller's working interest in each such property. This report really serves several purposes: it gives the lender's counsel a document to compare to the reserve report, for purposes of determining whether there is consistency between the property valuation and the actual title interest; it provides the basis for a mortgage exhibit; and it serves as a title summary for the buyer.

iv. The parties should be working together to prepare all assignment documents. There will be different versions of the assignment: those on MMS forms, those forms specific to state lease assignments, and the general form of omnibus assignment. The parties may even tailor the assignments for the recordation locales: a general form of assignment for Texas, a general form of assignment for Louisiana, for instance.

5. **Closing of Transaction/Closing of Financing**. In the end, this is all tied to the title review. The lenders will not disburse loan proceeds until lender's counsel is satisfied that the working interests the buyer has been able to verify are consistent with the reserve values that the reserve report reflects. Often, the buyer does not present the final title report until the morning of the closing – which, if there are no title issues, allows for late morning/early afternoon funding.

6. **Post-Closing Concerns**. From time to time, lenders will impose conditions/expectations regarding MMS approval of assignments. This is not realistic - the MMS approval process really can't be managed. However, the buyer can certainly commit to time deadlines for filing assignments for approval with the MMS and for recording the general assignments/mortgages in the county/parish records.

7. **True-Up**. Often six months out of the closing.