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# Oil and Gas Acquisitions

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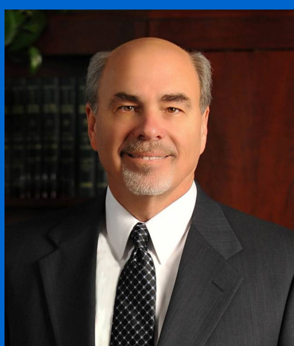

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The Due Diligence Team

- Evaluates title and identifies certain liabilities
- Organizes a review of record titles and unrecorded information

## Due Diligence – 2016

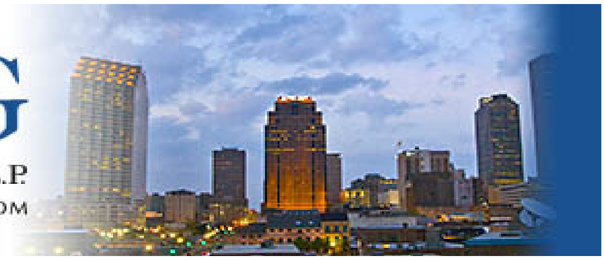
With current commodity prices for oil and natural gas falling below levels needed to support new drilling activities in most areas, we expect to see more oil and gas properties placed for sale in 2016. Sales of producing and non-producing properties will likely result from evaporating funding needed for development or sales forced by creditors (either in or out of bankruptcy court). Some companies with available funding may concentrate on "buying low," even if they curtail further drilling until prices rise. As a result, we expect 2016 to be a year with increased acquisitions and divestures. Below are highlights of just a few critical areas to be aware of in conducting "due diligence" for the buyer. If you represent the seller, additional concerns will apply.

## 1. Role of Due Diligence Team

The role of the land and legal team in acquisitions will generally be to conduct a "due diligence" review, in order to confirm that the buyer is getting what is paid for. The term "due diligence" generally means the measure of diligent review that is expected by a prudent person to confirm title to the major assets and to evaluate the associated risks or liabilities. In the acquisition process, you will need to analyze not only record title, but also unrecorded contracts, accounting information, unitization, processing, sales and transportation issues.

These findings must then be summarized and a report generated to list defects and possible liabilities. Given the short period of time generally allowed for due diligence under the Purchase and Sale Agreement (PSA), a successful review must be well-organized and concentrate on a wide range of issues without getting lost in a maze of details.

Assuming that the PSA has been negotiated, this paper will set out *some* key issues to be evaluated for a successful "due diligence" review, no matter where the properties are located. Next month we will highlight a few additional areas that should be analyzed if the properties are located in the State of Louisiana.



## 2. Keys to an Organized Review

**Appoint Team Leader**

- Official link with seller
- Supervises and Directs work process
- Deals with "brush fires"
- Keep buyers informed

*See the 1994 AAPL paper on *Due Diligence for Oil and Gas Properties*, for more information.

Unless dealing with a small acquisition, a team of professionals will be needed to conduct the review. It is essential that a "team leader" or "project manager" be appointed to organize the review, make any official contact with the seller and funnel information to the client. Some of the duties of the project manager include:

1). Meet with buyer to plan the examination and set out a timeline;
2). Divide the properties for review;
3). Select personnel and instruct them as to their duties;
4). Supervise and direct the review efforts, with information reported to one person;
5). Monitor the progress of all facets of the examination;
6). Confer with buyers keeping them informed as to the status of the examination;
7). Answer questions, which will no doubt include daily "brush fires;"
8). Confirm that all relevant files and records have been reviewed; and
9). Prepare Timely Defect Notice.

One of the major duties of the team leader or project manager is to be certain that the review is moving along in a timely manner and that no portion of the review gets "bogged down." Time is of the essence in finishing the review so that a "Defects Notice" can be created once the review is completed. The Defect Notice will include any number of items, from a defect in title (such as a mortgage to be released) to other operating issues (such as after payout back-ins that reduce the NRI to be conveyed).

## 3. 80% Rule

- Review Major Assets First
- Review Low Value Properties Last if at all
- Understand Deductibles and Thresholds

The PSA will often allow less than 120 days for due diligence to be completed and giving formal notice listing any "defects." Because of the importance of giving a timely Defect Notice, it is often impossible to do a thorough review of all properties to be conveyed. Further, even if defects are noticed, not all are compensable - because deductibles or thresholds must be reached before the price is reduced. Finally, any "defect" that is not timely listed at the end of the "due diligence" period is usually deemed waived. As a result, a quick and timely review of the most valuable properties must be accomplished first.

The general rule of thumb is that we first review the top 80% of properties *in value*. For example, if the PSA covers 20 wells, but 2 of the wells have been allocated (on PSA Schedules) approximately 80% of the sales value, then begin your review with the 2 most valuable wells. Complete the review for these 2 wells before moving on to other wells. Once the top 80% in value have been reviewed, if time permits, move on to the bottom 20% in value. Even if there are defects in the less valuable properties, the total value of those may not meet any deductible or threshold. Consequently, unless other specific reasons exist to examine the lesser-valued properties (for example, PUDs that are undervalued), those low value properties may never be reviewed. The team leader should therefore have a thorough understanding of what constitutes a compensable or noticeable defect before determining which properties to review.

## 4. PSA Schedule showing Ownership %'s and Values

Every PSA should have one or more Schedules or Exhibits attached to define (a) the Working Interest (WI) and Net Revenue Interest (NRI) to be conveyed and (b) the dollar value of each well or property being conveyed. These exhibits contain some of the most critical information for the review. One of the major purposes of due diligence is to confirm that the Schedules show the correct % of ownership or interest to be conveyed. Specifically, you will need to confirm that the stated <u>*WI does not exceed* the %</u> listed on the Schedule and that the stated <u>*NRI is not less than* the listed %</u>. If a defect is found, the values shown on the Schedule for each well (unit, etc.) will be used to determine whether any deductibles or thresholds are met for a price adjustment. Additionally, the values placed on each property will be used to determine the properties to be reviewed (the above 80% Rule). These Schedules or Exhibits will be critical to your review and any Defect Notice that may be prepared. Accordingly, this should be one of the first pieces of information utilized in your due diligence review.

- Confirm WI not <u>more</u> than listed %
- Confirm NRI not <u>less</u> than listed %

## 5. Public Records

Your starting point in confirming title is determined by what leases, assignments, mortgages and other documents are recorded in the public records where the properties are located. In Louisiana, like many other states, ownership of mineral leases and encumbrances (such as mortgages and overriding royalties) is determined by what is recorded in public records, because third parties are not put on notice of

- Confirm Record Title
- Don't Rely on Data Room Documents Alone

unrecorded documents. Do not assume that the seller recorded all title documents properly, or that the seller has provided all recorded documents for review. Specifically, do not rely exclusively on copies of documents, recorded or unrecorded, that the seller provides. Instead, confirm good title by your independent examination, often referred to as a Working Interest examination, which covers the period of time from the date leases were issued to the date of Closing the sale.

If the assets are located offshore in State or Federal waters, the public records in the adjacent County or Parish should also be examined. To determine which County or Parish is applicable, project the lease boundary lines onshore. This can often lead to the possibility that more than one County or Parish is covered by the leased premises. In this situation, the best practice is to examine the public records in each County or Parish that is potentially relevant.

- Data Room Files
- Other Files
- “Buyer Beware”
- It is the due diligence team's responsibility to look at all relevant title documents (whether or not recorded in the public records). and to uncover any rights, obligations or liabilities that may impact title.

## 6. Company Files and Reports to be Reviewed

Generally, the seller will place copies of the following documents in a "data room" for your review:

1. Title Opinions,
2. Company Reports (Reserve Reports),
3. Divisions of Interest (DOI’s”),
4. Leases, Participation Agreements, Farmouts, or other Exploration Agreements,
5. Operating Agreements and other agreements for processing, etc.,
6. Documents containing any AMI’s, Back-In’s and Non-consent Penalties,
7. A list of any Preferential Rights to purchase and Consents to Assign,
8. Electronic files.

These documents should always be reviewed. However, they should <u>not</u> be treated as “gospel.” There is no warranty that the data room contains all relevant documents. The doctrine of “Buyer Beware” still applies, and it is the duty of the buyer’s team to uncover any relevant title defects. For example, the seller’s title may be subject to a Back-in after payout of well costs (“APO BI”). Often APO BI’s are buried in prior title documents, which may or may not be provided. Accounting information may not be provided to show when (if ever) the APO BI is expected to payout. The seller may not even be aware of the APO BI or other burden. A proper review will require access to all of the seller’s files, not just the limited information contained in the data room.

The team leader should ask that his team be given access to the actual company file room, so that the team can confirm no important documents were left out of the data room or electronic files provided. If electronic files are utilized, it is helpful to have an IT person on the team, to determine if the electronic files are comprehensive. The accuracy and completeness of these files should be verified.

- The bottom line is to generate a proper "Defect Notice"

## 7. Due Diligence Report / Defect Notice

Each person reviewing an area or property should prepare a summary that the team leader can use in his/her report to the buyer. The team leader will then prepare and submit a written summary or report of title to the buyer. This report will not be provided to the seller and may contain confidential information. As noted above, the report should concentrate on assets constituting the top 80% in value, and should attempt to put a value on any noted defects.

After the buyer reviews your confidential report, a formal Defect Notice will be tendered to the seller listing all actionable defects. For example, if a preferential right to purchase is found, you should list that defect even if the seller has sent a written request to the party holding the right asking for a waiver. Until waived in writing, it should be assumed that the right would be exercised and a title defect exists. If the preferential right is not properly waived, assert the "defect" and assign a value based on the Schedule of Values attached to the PSA.

After the Defect Notice is officially provided, the seller will have a period of time to either object or cure defects that are asserted. The due diligence team can then help the buyer determine whether any of the noticed defects were properly cured. Once all noticed defects are either cured or valued for a price reduction, the team's job is largely completed, and the sale can move toward closing. The team leader may remain in place to help organize closing documents, and confirm that lease descriptions (etc.) are correct on the assignments.

Next month we will examine three specific issues that apply to properties located in the State of Louisiana.

**Louisiana Specific Topics in Next Issue**

- Mineral Servitudes
- Forced Pooling
- Legacy Lawsuits

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