



**ARLINGTON, TEXAS**

**AAPL 2021 ANNUAL MEETING**

**PROFESSIONAL DEVELOPMENT AND LAND CONFERENCE**

# Stephen Newton



AAPL 2021 **ANNUAL MEETING**

# THE DEVIL IS IN THE DETAILS:

*AVOIDING COMMON PITFALLS IN THE NEGOTIATION AND DRAFTING OF ASSET  
PURCHASE AGREEMENTS*

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# **Part I: Preliminary Agreements**



## PRELIMINARY NEGOTIATIONS AND LETTERS OF INTENT

- Letter of Intent (LOI) –
  - Signed document expressing the parties’ “mutual understanding” on key deal terms
  - Preliminary to the execution of the definitive agreement, i.e., the Purchase and Sale Agreement (PSA)
  - “The basic concept of a letter of intent is to provide the parties with a way to structure their agreement without entering into a binding contract.” John Wood Group USA, Inc. v. ICO, Inc., 26 S.W.3d 12, 19 (Tex. App. – Houston [1st Dist.] 2000, pet. denied).
  - AKA: “Memorandum of Understanding,” “Term Sheet,” “Agreement in Principle” (*this last term is not recommended*)



## PRELIMINARY NEGOTIATIONS AND LETTERS OF INTENT

- Benefits of LOIs
  - Binds the parties in a more formal way than a mere “handshake agreement,” thus giving each party confidence the other is serious about moving forward
  - Defines broad parameters of the deal, providing guidance to parties’ lawyers drafting the PSA
- Downsides of LOIs
  - Not ideal for quick turnaround transactions b/c it could add an extra layer of negotiations when parties could be using precious time working on the draft PSA
  - Seller’s perspective
    - Lost business opportunity during exclusivity period
    - Does a LOI really move the deal forward?
  - Offer and acceptance can result in a contract if other requisite elements of contract formation are present





## PRELIMINARY NEGOTIATIONS AND LETTERS OF INTENT

- Danger of a LOI → unintentional/premature formation of a contract
- Similar danger is present in any communication between prospective seller and buyer prior to execution of definitive agreement
  - Bid transactions.
    - See WTG Gas Processing, LP v. ConocoPhillips Co., 309 S.W.3d 635, 645 (Tex. App. – Houston [14th Dist.] 2010, pet. denied).
  - Email exchange in PSA negotiation.
    - See Chalker Energy Partners III, LLC v. Le Norman Operating, LLC, 595 S.W.3d 668 (Tex. 2020).



## PRELIMINARY NEGOTIATIONS AND LETTERS OF INTENT

- Distinguish concepts of contract and agreement.
  - An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law... BLACK'S LAW DICTIONARY
  - A "Contract," as distinguished from "agreement," means the total legal obligation that results from the parties' agreement... TEX. BUS. & COMM. CODE § 1.201(b)(12).
- Elements of a Binding Contract
  - (1) **OFFER**
  - (2) **ACCEPTANCE**
    - If the terms of the purported acceptance vary from the offer, it constitutes a rejection and counter-offer which gives the original offeror the power of acceptance.
  - (3) **CONSIDERATION**
    - Mutuality of obligation/bargained for exchange of promises
    - See Lynx Exploration and Production Co. v. 4-Sight Operating Co., Inc., 891 S.W.2d 785 (Tex. App. – Texarkana 1995, writ denied)





## PRELIMINARY NEGOTIATIONS AND LETTERS OF INTENT

- Statute of Frauds
  - A contract for the sale of real estate is not enforceable unless the agreement, or a memorandum of it, is (1) in writing; and (2) signed by the party sought to be charged. TEX. BUS. & COMM. CODE § 26.01
- Other key requirements (built into concepts of offer and acceptance)
  - meeting of the minds
  - sufficiency of terms



## PRELIMINARY AGREEMENTS – MEETING OF THE MINDS

- A valid contract requires a “meeting of the minds” (i.e., mutual assent to be bound to the agreed upon terms)
- Condition precedent can delay requisite meeting of the minds until the stated condition is satisfied.



## PRELIMINARY AGREEMENTS – MEETING OF THE MINDS

- There are two possibilities when the parties have a signed written agreement which contemplates the parties' executing a future document:
  - (1) No contract at present: Execution of referenced future document is intended as **condition precedent** to contract formation;
  - (2) Contract has formed: Execution of referenced future document is intended as **memorialization** of already formed contract (by virtue of present agreement)
- Determining factor → intent of the parties
  - Objective expressions of intent (subjective intent immaterial)
  - Question of fact v. question of law



# PRELIMINARY AGREEMENTS – MEETING OF THE MINDS

- Factors re: intent to be bound:
  - (1) Whether a party expressly reserved the right to be bound only when a written agreement is signed;
  - (2) Whether there was any partial performance by one party that the party disclaiming the contract accepted;
  - (3) Whether all essential terms of the alleged contract had been agreed upon; and
  - (4) Whether the complexity or magnitude of the transaction was such that a formal, executed writing would normally be expected.

Texaco, Inc. v. Pennzoil, Co., 729 S.W.2d 768, 788-89 (Tex. App. – Houston [1st Dist.] 1987, writ denied) (applying substantive law of New York).



## PRELIMINARY AGREEMENTS – MEETING OF THE MINDS

- 2 non-oil and gas cases holding intent to be bound was question of fact for the jury:
  - Foreca, S.A. v. GRD Development Co., Inc., 758 S.W.2d 744 (Tex. 1988): Written agreement for sale of amusement park rides stated *“subject to legal documentation contract to be drafted by [seller’s attorney]”*
  - Murphy v. Seabarge, Ltd., 868 S.W.2d 929, 933 (Tex. App. – Houston [14 Dist.] 1994, writ denied): Memorandum of Understanding between general partner and limited partner of barge business defining compensation of the former stated *“[it] was not intended to be a binding contract”* and *“subject to...the preparation of appropriate documentation acceptable to the parties thereto”*



# PRELIMINARY AGREEMENTS – MEETING OF THE MINDS

John Wood USA v. ICO, Inc., 26 S.W.3d 12 (Tex. App. – Houston [1st Dist.] 2000, pet. denied). Court held the following provision contained in LOI for sale of manufacturing business meant no contract as a matter of law:

*“This Letter Agreement constitutes a summary of the principal terms and conditions of the understanding which has been reached regarding the sale of certain assets to Purchaser. It does not address all of the terms and conditions which the parties must agree upon to become binding and consummated. The Purchaser, however, does intend to move forward with its due diligence and expects to expend considerable sums to review Seller’s Business. In consideration therefor, the parties have agreed to make certain covenants in this letter binding upon the parties notwithstanding the fact that not all details of the transaction have been agreed upon. Accordingly, it is understood and agreed that this letter is an expression of the parties’ mutual intent and is not binding upon them except for the provisions of paragraphs (4), (7), (9), (10), (11), (12), (13), and (14) hereof.”*

\*This language is cited with approval in William B. Burford, 7 WEST’S TEXAS FORMS: MINERALS, OIL & GAS § 9.6 (2015)





## WTG Gas Processing, LP v. ConocoPhillips Co.

- Prospective sale of natural gas processing facilities b/w Conoco, as seller, and WTG, as purchaser
- Bid transaction brokered by investment bank: teaser letter; confidentiality agreement (requisite for access to seller's data room); written bid procedures
- Confidential Information Memorandum: *“Morgan Stanley and ConocoPhillips reserve the right to...negotiate with one or more parties at any time...”*
- Written bid procedures: *“A Proposal will only be deemed accepted upon the execution and delivery by ConocoPhillips of a PSA(s)”* and *“Until the PSA(s) for this transaction is executed by ConocoPhillips and a purchaser, ConocoPhillips...shall not have any obligations to any party with respect to the contemplated transaction”*



## WTG Gas Processing (Cont'd)

- Two issues citing by trial court in ruling for Conoco: (1) meeting of minds; and (2) statute of frauds. The
- COA only addresses the first issue.
- Held: Written documents promulgated by Conoco to WTG imposed a condition precedent to contract formation.
  - No meeting of the minds = No contract
- Cites John Wood USA for support
- Distinguishes Foreca and Murphy



## Chalker Energy Partners III, LLC v. Le Norman Operating, LLC

- Prospective sale of leasehold assets b/w Chalker, as seller, and Le Norman, as purchaser
- Le Norman signs Chalker's form confidentiality agreement as condition to access Chalker's data room
- "No Obligation" clause: *"The Parties hereto understand that unless and until a definitive agreement has been executed and delivered, no contract or agreement providing for a transaction between the Parties shall be deemed to exist and neither Party will be under any legal obligation of any kind whatsoever with respect to such transaction..."*



## Chalker Energy (Cont'd)

- Original bid process covering 100% of seller's interest broke down, but Le Norman remained interested and later made offer for to purchase an undivided 67% of seller's right, title and interest in the assets for \$230M
- Email responding to Le Norman's offer stated Chalker was "on board to deliver 67% subject to a mutually acceptance PSA."
- Chalker eventually accepts Jones Energy's bid and signs a PSA with that party



## Chalker Energy (Cont'd)

- Texas Supreme Court finds “no obligation” clause created a condition precedent to contract formation
- Next question – Was email exchange a “definitive agreement” within meaning of confidentiality agreement?  
No.
  - Terms of Le Norman’s offer left “much to the imagination” in terms of containing all terms necessary for definitive agreement
  - Specific context: Parties were exchanging redlined drafts of unexecuted PSA
  - General context: Email is a “distinctly conversational, informal medium.”
- Policy concerns – Frequent use of no obligation provisions in LOIs, confidentiality agreements and other preliminary communications between prospective participants to a transaction.



## DRAFTING CONSIDERATIONS

- Consider language which tracks that analyzed in WTG, Chalker and John Wood cases
- Put “Non-Binding” in caption of LOI, email, etc.
- Make non-binding intent provision conspicuous (i.e., uppercase and bolded).





## **Part II: The Title Defect Mechanism of an Asset Purchase Agreement**



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## ANATOMY OF A PSA

- Factors influencing length and complexity of a PSA
  - Value of the transaction
  - Sophistication of the parties
  - Are the assets *producing or non-producing*?
  - If producing, is the seller *operator or non-operator*?



## **ANATOMY OF A PSA**

- Assets/Excluded Assets
- Purchase Price/Performance Deposit/Adjustments to Purchase Price
- Representations and Warranties
- Covenants
- **Title Defect Procedure & Remedies (our focus)**
- Environmental Defect Procedure & Remedies
- Closing Conditions
- Closing
- Indemnification/Assumed & Retained Liabilities
- Termination
- Miscellaneous
- Schedules/Exhibits (attached to PSA)



## THE TITLE DEFECT MECHANISM

- WHY NEEDED?
  - Purchase price is based quantum of seller's title, as understood (perhaps incorrectly) on the execution date of the PSA.
    - Due diligence occurs during "interim period" (i.e., b/w signing of the PSA and Closing).
  - PSA covers the sale of all seller's right, title and interest in the properties
  - Without a contractual mechanism allowing for an adjustment to the purchase price, buyer will not get the benefit of the bargain if seller does not own the amount of interest originally believed (conversely, same is true for seller in the event a title benefit is discovered)



## THE TITLE DEFECT MECHANISM

- WHY NEEDED? (CONT'D)
  - Limited protection under warranty b/c seller will not accept long-term, contingent liability
  - Special warranty of title (“by, through or under assignor, but not otherwise”) in closing assignment only covers title defects created by the seller
  - PP adjustment is preferable to indemnity if it is doubtful that seller or seller’s guarantor, if any, will remain creditworthy in the foreseeable future.



## THE TITLE DEFECT MECHANISM

- 2 MAIN WAYS THE TDM INTERACTS WITH REMAINDER OF THE PSA
- (1) Purchase Price Section
  - A qualifying title defect will cause downward adjustment to purchase price, *subject to* any threshold and deductible qualifiers
  - Quantifying the value of a title defect derives from allocated value assigned to that property (usually found in a schedule attached to the PSA).
- (2) Conditions to Close/Termination Sections
  - If net aggregate value of all qualifying title defects (not counting those cured by seller prior to closing) exceeds a certain percentage of the total unadjusted purchase price, either party may terminate the PSA without liability.
  - Might be lumped together with environmental defects for this purpose.





## THE TITLE DEFECT MECHANISM

- MAJOR CONCEPTS & DEFINITIONS
  - Title Defect
  - Defensible Title
  - Permitted Encumbrances



## **TITLE DEFECT**

- An issue with seller's title that meets following two requirements:
  - Procedural: Brought to seller's attention in strict compliance with the procedures and deadlines set forth in the PSA
    - Form of title defect notice
    - Title defect deadline (usually a week or so prior to closing)
    - Non-asserted title defects are deemed waived by buyer
  - Substantive: Causes seller's title to one or more of the allocated value properties, as of the closing date, to fall below the standard of title defined in the PSA (usually termed "Defensible Title")



## TITLE DEFECT HURDLE RATES

- **FIRST TIER: TITLE DEFECT THRESHOLD**
  - Applicable to an individual title defect
  - Usually expressed as sum of money
  - Tipping Basket: If value of the defect  $\geq$  threshold amount, entire value is counted
- **SECOND TIER: TITLE DEFECT DEDUCTIBLE**
  - Cumulative value of all qualifying title defects (if there is a threshold, only title defects that meet threshold requirement)
  - Usually expressed as % of purchase price
  - True Deductible: Only the value over and above the deductible is deducted from the original purchase price



## DEFENSIBLE TITLE

- No default meaning, either legally or as matter of industry custom
- Tied to seller's purported ownership in the allocated value properties
- If WI/NRI is applicable metric, "Defensible Title" usually means:
  - (1) Seller is entitled to receive throughout the duration of the estate constituting the property (or throughout the productive life of the well, if applicable), without suspension, reduction or termination, not less than the NRI for the property described in the applicable schedule;
  - (2) Seller is obligated throughout the duration of the estate constituting the property (or the productive life of the well, if applicable) to bear no more than the WI for the property described in the applicable schedule;
  - (3) Except for the "**Permitted Encumbrances**," the property is free from all lien, encumbrances and defects.



## DEFENSIBLE TITLE

- **Ensure interests shown in the AV schedule are correct**
  - **BPO/APO**
  - **Wellbore/PUD**
  - **Target Depths**



## DEFENSIBLE TITLE

- Incorporate standard for determining whether the strength of seller's title is adequate into definition of Defensible Title?
- “Marketable title” standard
  - Not preferred
    - Oil and gas titles are rarely marketable in the strict sense
    - Based on title deducible of record
- **Drafter should ensure the definition of Defensible Title is not equated with legal definition of marketable title.**





## PERMITTED ENCUMBRANCES

- A liability attached to a property which, under the terms of the PSA, cannot constitute a title defect or deprive seller of defensible title to the affected property.
- Major Theme → Things an experienced purchaser would expect to encounter and do not (i) lessen seller's title, as of the closing date, or (ii) materially interfere with future operation of the premises
- **HOTSPOT OF NEGOTIATION B/C THIS DEFINES SCOPE OF TITLE DEFECTS ASSERTABLE BY BUYER**
  - Seller wants expansive list of permitted encumbrances.
  - Buyer wants permitted encumbrances narrowly defined.



## **COMMON PERMITTED ENCUMBRANCES**

- Royalties, production payments, reversionary interests and other burdens on production that do not reduce seller's NRI in a property below that stated in the applicable schedule
  - Note: This PE should be drafted differently if seller's interest is represented as quantity of net acres.
- Liens for taxes not yet delinquent
- Inchoate liens
- Sales contracts terminable upon 30 days notice to purchaser
- Easements, rights-of-way, surface leases and similar surface burdens that do not materially interfere with oil and gas development
- Pref rights and 3P consents that are waived or satisfied prior to closing
- Title Defects that buyer has waived or released or is deemed to have waived or released pursuant to the PSA



## COMMON PERMITTED ENCUMBRANCES (CONT'D)

- Pattern: Disclosed/scheduled encumbrances are included as permitted encumbrances to the extent necessary to ensure harmony b/w TDM and other sections of PSA which address said encumbrances.
  - E.g. – Litigation
- Customary rights of reassignment in oil and gas leases.
  - Qualifier: ***To the extent not already triggered***
- Title Defects that do not affect the target depths/formations (however defined)
  - Alternatives to addressing this issue.



# TITLE RELATED PERMITTED ENCUMBRANCES

- Minor title defects are either incorporated into the definition of “Permitted Encumbrances” (although not technically encumbrances) or stated as separate carve outs from the definition of a “Title Defect.” The result is the same in either case.
- These cover technical title defects which pose such a low risk of title failure that it would be frivolous for buyer to assert them as such.
- E.g. –
  - Chain of title defects such as minor name discrepancies, failure to recite marital status, omission of heirship or probate proceedings; lack of a survey; lack of corporate authorization; etc.
  - Add qualifier: ***Unless buyer provides affirmative evidence that such issue results in another party’s superior claim of title to the property or any portion thereof***
  - Unreleased oil and gas leases, the primary terms of which have expired
  - Add qualifier: ***Unless buyer provides affirmative evidence that any such lease is still valid***
- Additional considerations weighing in favor of classifying a title issue as a PE: applicable statute of limitation, “ancient document” rule, issues commonly waived by prudent purchasers



# Continued Education Component Code

- ARTX-10



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