

# **The Art of the Deal: Evaluating, Allocating, and Mitigating Risk in Oil and Gas M&A Transactions**

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# Framework of the Presentation

- Addressing more complex acquisitions/divestitures requiring professional advisors and highly negotiated agreements
- Domestic E&P
- Today's marketplace and conditions
- Decision to buy has already been made
- The period just preceding the letter of intent through preparation of the definitive agreement and the decision of whether to close

# Key Considerations of Risk in Oil & Gas M&A Transactions

- I. Risk is Not Generic
- II. The Parties
- III. The Assets
- IV. Market Conditions
- V. The Letter of Intent
- VI. The Definitive Agreement
- VII. Due Diligence
- VIII. To Close or Not to Close

# I. Risk is Not Generic

- Risk is the probability of occurrence of foreseeable and unknown events
- Risk analysis is the process determining that which is foreseeable and unknown
  - as to the specific assets, not global unknowns such as geopolitical and commodity pricing risks
- Risk allocation is about the distribution of risk between buyer and seller
- Risk mitigation is about limiting exposure to risk
- Risk avoidance is about managing the risks you assume to lessen the probability of occurrence
- Business objectives drive the degree of risk a party is willing to assume
- Risk is not generic; one size does not fit all
  - Risk is a function of the number of drivers comprising the risk and the complexity of each driver
    - Each asset class constitutes a different risk profile
- How you analyze risk itself has risk
- Analyze risk granularly, but treat risk holistically

## II. The Parties

- Buyers are bullish by definition and sellers are risk averse
- Sellers objectives are always clear
  - Want the money
  - Do not want any risk post-closing
- Buyers, on the other hand, have to get comfortable (or comfortable enough) to trade a fully known and understood quantum of interest (money) for a partially understood set of tangible and intangible property interests and rights
- Who is the other party?
  - Are they experienced; competent
  - What is their reputation
  - Are their advisors (lawyers, CPA, investment banker) experienced in oil and gas acquisitions and divestitures
  - What is the source of their funding
  - What are their business objectives

## II. The Parties (cont'd)

- How are you funded, especially if you're the buyer
- What are your business strategies and objectives?
- What are the other side's fears?
  - If you're the buyer, how do you eliminate or reduce the seller's anxiety about the post-closing period
  - If you're the seller, how badly does the buyer need to close the deal
- Who has the greater need to close?
- Who is better positioned to walk?
- On whose side is time?
  - Time is always the enemy of a buyer (and friend of the seller) at inception of the deal
    - If an acquisition is good for you it is good for one of your competitors – and the seller likely knows it
  - But a miscalculation by seller can shift leverage to the buyer
  - Time likely becomes the buyer's ally as the deal moves toward closing

# III. The Assets

- What are the drivers of risk
  - Asset Type
    - Upstream
      - Leases—developed or undeveloped
      - Wells
      - Working Interests, Mineral Interests, Royalties, etc.
      - Equipment
    - Mid-Stream
      - Pipelines and facilities (e.g., compression and treatment)
  - Geological
    - Shallow
    - Deep
    - Conventional
    - Unconventional
  - Geographical
    - e.g., Rocky Mountains or the Permian Basin

# III. The Assets (cont'd)

- Operational
  - Current operations
  - Location
  - Infrastructure availability
  - Available delivery systems
  - Age
  - Current condition of the assets
- Calibrate each risk driver with its related complexity
- What is really being acquired, and what are the true risks associated with those specific assets
- Analyze risk granularly, but treat risk holistically

## IV. Market Conditions

- Model is an unconventional play
- Stage of the Market
  - Early—Acreage Play
    - Few competitors
    - Most opportunistic
    - Buyer's market
    - Minimal volatility
  - Middle Stage—Proof of Concept (Drilling of Science Wells)
    - Many competitors
    - Rising prices
    - Leverage shifting to sellers
    - Average, but increasing, volatility

## IV. Market Conditions (cont'd)

- Late stage—Full Development and Consolidation of Undercapitalized Players
  - Maximum number of competitors
  - Highest prices
  - Seller's market
  - Maximum volatility
  - Consolidation driven by size and scale of play
- The stage of the market, and a party's relative position in it combined with its business objectives, ultimately determine how much transactional risk a party will accept

# V. The Letter of Intent

- Must be considered in light of market conditions
- Opportunity for the buyer to reduce barriers to consummation of the deal while building barriers for the competition
  - Alleviate the seller’s anxiety
- Sets a framework for managing expectations
  - The purchase price, and potential adjustments thereto
  - Terms related to the purchase price, if any
  - The “effective date” of the transaction
  - The due diligence period
  - Timing of the closing
  - Assumed liabilities of buyer
  - Retained liabilities of seller
  - Escrow and indemnification

# V. The Letter of Intent (cont'd)

- But should the LOI be vague or specific
  - Must consider the experience and competence of other party and its professionals
    - Buyer and seller have a mutual interest in insuring compliance by their respective professionals with the business timeline
  - Must consider the other party's reputation
  - How complex are the assets
  - How complex is the deal
  - How volatile is the market
- Keys in all cases are the exclusivity period and access to the properties
  - Must get the assets off the market
  - Must have unfettered access to properties and records for due diligence examination
- What is the walk-away date for both parties if no definitive agreement executed

## VI. The Definitive Agreement— Allocation of Risk Between the Parties

- Assuming sign and later close
- Should be aligned with buyer's risk analysis to date, including market conditions
- A critical moment in the entire process
  - Parties must work closely with, and if required reign in, their professionals
- How do the parties allocate risk
  - The essential negotiation between buyer and seller is about each side wanting to maximize its mitigation of risk while determining (through negotiation) the limits of an acceptable tolerance
- Must be flexible to accommodate, and anticipate, the unknown that will be discovered during due diligence
- What liabilities will the buyer assume
- What liabilities will the seller retain

## VI. The Definitive Agreement— Allocation of Risk Between the Parties (cont'd)

- Adjustments to Purchase Price
  - Defects
    - Title
    - Environmental
    - Easements/Rights-of-Way
    - Pipeline
    - Deductibles and Thresholds?
- What mechanisms enable the curing of defects
- What representations and warranties should buyer seek from seller
  - More if the parties are unknown to one another, or there is concern about the seller
  - Title
  - Environmental
  - Litigation (actual or pending)
  - Liens, encumbrances, and security interests
  - Compliance with agreements

# VI. The Definitive Agreement— Allocation of Risk Between the Parties (cont'd)

- Compliance with laws
- Bankruptcy
- Unrecorded documents
- Preferential rights
- Reversionary interests
- Production imbalances
- Buyer should provide as few representations, warranties, and covenants as possible
- Covenants and Agreements – What should a buyer seek
  - Pre-Closing; affirmative and negative
    - Compliance with contracts and other agreements
    - Maintain insurance
    - Keep buyer informed if changed conditions, such as lawsuits, governmental orders, if reps. and warranties become untrue, etc.
    - Pay bills timely
    - Maintain leases

## VI. The Definitive Agreement— Allocation of Risk Between the Parties (cont'd)

- Maintain equipment
- Not release or modify any existing leases
- Not commence operations without buyer consent
- Not create liens, encumbrances, or security interests
- Not sell any of the assets
- Not enter into any new term contracts
- Not enter into pre-payment arrangements
- Not take any action that would reduce the NRI
- What is the survival period of the representations, warranties, and covenants
- Is buyer buying “where is, as is”
  - Disclaimers as to condition do not equal a per se assumption by buyer of liability

# VI. The Definitive Agreement— Allocation of Risk Between the Parties (cont'd)

- Indemnification
  - Scope
    - Only as to representations and warranties
      - Or more, such as pre-closing operations
  - Basket/Cap
  - Escrow amount—how much, if any
  - Is indemnification the exclusive remedy of each party
    - Seller wants, buyer does not
- What “outs” does the buyer have
  - Reduction of too great a percentage of the purchase price because of title or environmental defects
    - Buyers should always try to make this out their exclusive right
  - Appraisal does not meet expectations
  - Breaches of the agreement, force majeure, inability of seller to close, etc.
- The definitive agreement is the roadmap; the executive tool to enable prioritization of the due diligence

# VII. Due Diligence

- Most important part of the acquisition process
- Essential to risk mitigation
- Begins the true transfer of “institutional” knowledge (of the assets)
- Should identify the most critical risks of the transaction
  - Title
    - Ownership
    - Liens, Encumbrances, and Security Interests
  - Environmental
  - Contracts affecting the assets
    - JOAs
    - Drilling agreements
    - Unit agreements
    - AMIs

## VII. Due Diligence (cont'd)

- Participation agreements
- Gathering contracts
  - Condition of the assets
- Is the acquisition team (employees, bankers, CPAs, lawyers, geoscientists) properly staffed and aligned in purpose
  - Is the team focused on the various risks of the transaction in alignment with each risk driver and its related complexity
- Should make the most critical mitigation provisions of the definitive agreement “come to life”

# VIII. To Close Or Not To Close?

- With proper risk analysis of the assets
- With a fully understood holistic view of the risk profile of the specific assets being acquired
- With well-conceived, flexible, and clear deal documentation that accurately reflects the negotiated allocation of risk
- With the completion of detailed, prioritized due diligence
- In the face of still imperfect, if not incomplete, information
- Given the market conditions at hand
- To Close or Not to Close: That is the Question