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CONTRASTING OIL AND GAS PROPERTY ACQUISITIONS: BUYING COMPANIES VERSUS ASSETS

Jasper Mason
&
R. Yona Starosta

Womble Bond Dickinson (US) LLP
Houston, Texas

JASPER MASON

Jasper is a member of Womble Bond Dickinson's Corporate and Securities practice group, where he heads the firm's Energy and Natural Resources Oil and Gas sub-sector. He has experience representing exploration and production companies and private equity clients on acquisitions, divestitures, and joint ventures involving upstream and midstream oil and gas assets. Additionally, Jasper has represented clients in matters as diverse as tendering bids for contracts to supply oilfield service equipment in the CIS, acquiring OCS leases in the Deepwater Gulf of Mexico, and attracting investors and industry partners to co-develop acreage on state-owned lands in Alaska. He has assisted clients ranging from individual investors to national oil companies. Jasper is Board Certified in Oil, Gas and Mineral Law by the Texas Board of Legal Specialization, serves as Past-Chair of the Houston Bar Association Oil, Gas & Mineral Law Section, and teaches Oil & Gas Law as an adjunct professor at the University of Houston Law Center. He has served as AIPN secretary and as a member of the board of directors, and co-chaired the AIPN's 2014 Spring Conference. Jasper is also a member of the Texas Bar College and a Life Fellow of the Texas Bar Foundation.

YONA STAROSTA

Yona Starosta focuses her practice on business litigation. In the energy space, she advises clients on transactional matters related to the acquisition and divestiture of oil and gas assets to counseling clients through early dispute resolution and trial or arbitration whether domestically or abroad. In addition to the energy sector, Yona also has experience advising major professional liability, property, and general liability insurers in complex litigation, corporate litigation, indemnity liability, insurance coverage, bad faith litigation, construction litigation, and other commercial matters. Yona speaks Russian, English, and Arabic fluently, and Spanish and Hebrew conversationally. Yona is admitted to practice in both Texas and Washington.

Much of corporate America buys and sells businesses, by means of stock purchases and merger transactions, yet asset sales remain a very popular choice of transaction type in the oil and gas industry. With the recent rebound of commodity prices and the much-rumored intentions of certain types of investors to find ways to orchestrate a hasty exit from the oil and gas arena, is there an opportunity to reconsider whether stock transactions may provide benefits to both sellers and buyers?

Often acquisitions of producing oil and gas properties are structured as asset acquisitions, generally because the target assets do not comprise the entirety of an operating entity or because the buyer is unwilling to take on the seller's corporate liabilities or because asset transactions can be more favorable for buyers from a tax perspective. In some cases, however, it may be more beneficial to one or both of the parties to structure property acquisitions as stock purchases rather than asset acquisitions. There are many factors that will govern the planning decisions in structuring acquisitions, relating to the attributes and objectives of the parties and the nature of the assets. A partial list includes: the extent to which approvals are required from boards of directors, managers, stockholders, members or partners, and issues surrounding the obtaining of any necessary approvals; the federal income tax consequences to seller, buyer, and the stockholders or members of each; the extent to which liability avoidance is a concern of the parties; the extent of third-party consents, preferential rights, debt acceleration, or other restrictions bearing on transferability of key assets; the extent of logistical concerns presented by conveyancing requirements; the extent to which there is disagreement among owners of the seller regarding the desirability of the transaction or its terms; the extent to which federal or state securities laws will require disclosure or registration; the extent to which timing is important, and; the extent to which dissenting stockholders or members will have appraisal rights or other minority protections or may continue to be involved in the ongoing enterprise after conclusion of the transaction.

The purpose of this paper is to give an overview of the issues that are of particular significance in structuring typical transactions involving producing oil and gas properties, and to examine how the agreements governing such transactions will vary depending on the form of transaction selected.

I. Deal Structures

As indicated above, the decision to structure an acquisition as a stock or assets acquisition depends on many factors including: (1) does the buyer want to acquire discrete properties or a business (with employees, a name, financial statements and so on); (2) are all the properties and other assets held by one or more entities or does the buyer want to acquire piecemeal assets; (3) are there liabilities of the business, including potential tax or environmental liabilities, that the seller wants to dispose of, or that a buyer wants to avoid.

In the routine acquisition of oil and gas properties, a parent company (for the purposes of this paper, “Buyer”) – or its subsidiary – will acquire specifically identified assets of a Seller and assume only related liabilities. The allocation of liabilities between Buyer and Seller will be negotiated; and if all goes well Buyer will be burdened only by those liabilities specifically assumed by Buyer. (“Successor liability,” environmental risks that attach to those in the chain of ownership and other arenas that illustrate the limits of contracted allocation of risk will be

discussed later in this paper.) Where Seller holds the desired assets in a separate entity (*e.g.*, corporation, partnership or LLC), Seller may put the entity up for sale, and the leverage created by competition for the deal may result in a sale of the entity rather than assets. There are many scenarios where this may occur, ranging from the sale of a public company to sales of Seller or an entity owned by Seller including a joint venture interest. Properties are almost always held by an entity rather than a natural person, and often properties are held by subsidiaries for various reasons: for ease of administration in a particular state or jurisdiction; for separation of assets for liability limitation; in order to create an entity to hold properties owned by a distinct ownership group; or where separate financing for particular prospects has been sought. And, wherever there was a rationale to hold properties in a separate entity, there are often reasons that it would be beneficial for Seller or its owners to sell the Seller corporate entity rather than Seller's assets. First, it is the best way to avoid Seller's liabilities that may exist or that may arise in the future and transfer them to Buyer. Second, there may be valuable tax advantages to Seller or its owners if it can sell the entity. Third, it can be much simpler to transfer all attributes of the business, including contracts and permits, with substantially reduced need for third party or governmental consents or filings.

A. Stock Acquisitions

The most common form of stock acquisition involves the transfer of shares by Seller's stockholders for cash and/or other property. A variation is the reverse subsidiary merger, in which Buyer’s subsidiary is merged into Seller in a statutory merger so that Seller is the surviving company, Seller's stockholders receive cash or stock for their shares, and Buyer's stockholders convert their ownership of the subsidiary into shares of Seller. The result is the same as that of a direct stock purchase.

If Seller has a limited number of stockholders, parties generally prefer to use a stock purchase agreement instead of merger to acquire Seller. In a stock purchase agreement each stockholder is party to the agreement and the buyer has the opportunity to obtain direct recourse against Seller's stockholders for breaches and representations, or at least those stockholders who were active in the business. While an escrow or other holdback mechanism may be available, having the selling stockholders as parties to the agreement provides a better chance of recourse. Also, dissenters' rights do not apply. The stockholders may elect the majority or largest stockholder to serve as the stockholders' representative for certain mechanical issues such as purchase price adjustments and escrow arrangements.

B. Asset Acquisitions

Asset acquisitions involve the direct acquisition of Seller's assets for cash and/or other consideration such as stock of Buyer. Seller can either maintain the cash in the business, distribute the cash and/or other property to its owners and continue its business, or liquidate and distribute the sales proceeds to its owners as a liquidating distribution. Logistically, conveyances of the assets must be utilized which require preparation of detailed property descriptions, comprehensive descriptions of assets to be conveyed, and compliance with filing requirements in governmental offices to put third parties on notice of property transfers and obtain any necessary governmental or tribal approvals.

C. Mergers

A merger involves the merger of Seller into Buyer under applicable state merger laws, with Seller's stockholders obtaining cash, securities of Buyer, or other property for their ownership interests. As a matter of law, Seller's assets and liabilities are assumed by Buyer without the need for assignments, bills of sale or assumption agreements. The stockholders of both companies must approve the transaction, which may involve an expensive and time-consuming proxy statement and a registration statement filed with the SEC in the case of a public company issuing stock. Dissenting stockholders of Seller will typically have the right to be cashed out of their shares of buyer's stock. This form of transaction can be used to accomplish a reorganization that is tax-free in whole or in part to Seller's stockholders. By using "triangular" mergers that may qualify for tax-free treatment, which involve the creation of a subsidiary of the Buyer, either to merge into Seller or for Seller to merge into, the parties can avoid the necessity of obtaining stockholder approval of the buyer, and the liabilities of Seller can be isolated in a subsidiary of Buyer.

A merger is a particularly flexible acquisition device. Mergers are statutory creatures that allow Seller either to become part of Buyer, become part of a subsidiary of Buyer, or survive and continue with new ownership. Mergers where Seller does not survive are referred to as "forward mergers" and mergers where Seller survives are referred to as "reverse mergers." The "reverse triangular merger," where a subsidiary of Seller merges into Seller, and Seller's stockholders receive Buyer stock, is particularly popular because Seller survives intact with significantly less need for consents, there is no need to convey assets, and Seller's liabilities remain segregated below Buyer.

Other reasons to use a merger may include a desire to avoid extensive conveyancing that would result from an asset transaction (although the preparation of extensive property descriptions may not be avoidable if buyer is financing its acquisition with bank debt or other secured debt requiring mortgaging of the properties); disagreement among the ownership group itself about the advisability of a sale, where acquisition of the shares of a control group can support a statutory merger subject to dissenters' rights; or the ownership of Seller by a widely dispersed ownership group whose individual stock holdings would not be easily purchased. The list is not exhaustive; there can be many different situations where mergers become the vehicle of choice for a variety of tax and non-tax reasons.

II. Stock vs. Asset Acquisition: Third-Party Rights and Liability Considerations

A. Avoidance of Third-Party Approvals and Participation Rights

A major reason why the parties may wish to structure a transaction as a stock acquisition rather than an asset acquisition is to avoid third-party approvals, preferential rights, governmental filing requirements or other restrictions affecting key assets. The primary issues affecting oil and gas properties are discussed below.

1. The Right to Operate

Most joint operating agreements provide that the transfer of the operator's interest in the

joint property triggers a vote of the working interest owners to select a new operator. Typical is the language of Article V.B. of the AAPL Form 610 Operating Agreement:

1. "… If Operator … no longer owns an interest hereunder in the Contract Area … Operator shall be deemed to have resigned without any action by the Non-Operators, except the selection of a successor … A change of a corporate name or structure of Operator or transfer of Operator's interests to any single subsidiary, parent, or successor corporation shall not be the basis for removal of Operator."

2. "…Upon the resignation … of Operator under any provision of this agreement, a successor Operator shall be selected by the parties. The successor Operator shall be selected from the parties owning an interest in the Contract Area at the time such successor Operator is selected. The successor Operator shall be selected by the affirmative vote of two (2) or more parties owning a majority interest based on ownership as shown on Exhibit "A"…"

Previous versions of the AAPL form 610 contained similar provisions, the primary difference being in whether the successor operator obtained the right to vote and whether transfers to affiliates were exempted from the deemed resignation provisions. Many unit agreements and unit operating agreements contain variations on this language, such as the language of section 8 of the federal secondary recovery unit agreement form, which provides that upon resignation of the unit operator, a successor operator will be selected by a majority of the working interest owners.[1]

Thus, in an asset transaction, the buyer risks loss of the ability to take over as operator on the properties operated by the seller. Although there are cases which appear to recognize that the right to operate is assignable,[2] other decisions cast doubt on that result given the "deemed resignation" language of the operative agreements.[3] So, if operation of the target assets is a significant consideration and if a buyer will not control the necessary voting majority, acquisition of ownership of the operator via a stock transaction may be a preferable alternative since it should not ordinarily be triggered by operator approval clauses. There are operating agreement forms,

[1] See *Meritage Energy Partners*, 165 IBLA 204 (2005), which held that a sale of operator's interest in a secondary recovery unit constituted a deemed resignation for purposes of this provision.

[2] See *Santa Fe Energy Operating Partners, L.P. v. Universal Resources Corp.*, No. 07-95-0342-CV 1996 Tex App.LEXIS 3540 (Tex. Civ. App. -- Amarillo Aug. 14, 1996)(unpublished opinion) (right to operate under the 1982 Form 610 operating agreement does not involve a high level of personal trust and confidence and is therefore assignable like other aspects of the agreement); *Producers Oil Co. v. Gore*, 437 F. Supp. 737 (D. Okla. 1977) (dicta; duties of the operator not sufficiently personal to render them nonassignable). It could be argued that the operator can assign the right to operate so long as it does not assign its entire working interest, i.e., does not trigger the "deemed resignation" language by a loss of interest. Even if this passed judicial muster, it is not generally a practical solution for a seller desiring to divest. There is authority that nonoperators may be estopped to deny assignment of operatorship if they do not timely object to the successor operator's taking over operations and functioning as operator. *Oklahoma Oil & Gas Exploration Drilling Program 1983-A v. W.M.A. Corp.*, 877 P.2d 605 (Okla. Ct. App. 1994); see also *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741 (Tex. Civ. App. -- El Paso 2000).

[3] E.g., *Meritage Energy Partners*, 165 IBLA 204 (2005), upholding the selection of a successor operator by majority vote of unit interest owners in a federal secondary recovery unit notwithstanding the operator's purported assignment of the right to operate to the purchaser of operator's unit interest.

however, which do provide for a vote on the appointment of a new operator in the event of a change of control of operator.[4]

2. Preferential Purchase Rights

Section VIII.F. of the 1989 AAPL form 610 operating agreement contains an optional provision granting to the joint interest owners a preferential right to purchase the interests of a transferring owner. Most forms of operating agreement contain similar provisions, often deleted. Many joint venture, exploration, or entity operating agreements (e.g., limited liability company operating agreements) contain similar language. Although arguments have been made that "package sales" or large-scale acquisitions should not be subject to such provisions because the holder of the preferential right cannot match the terms and conditions of such sales in exercising the right only with respect to individual assets, such arguments have not generally been successful and are undercut not only by the language of these provisions but also by the general practice of allocating value to each property.[5]

The 1989 AAPL form 610 does contain an exemption for sales of all or substantially all of the transferor's properties. In the absence of such a large-scale divestiture by a seller, a buyer will be able to avoid the application of preferential purchase rights only by application of the exemption consolidation or by transfers to subsidiaries, parents, or sister companies. Under any of these provisions, acquisition of stock of the property owner should not trigger the application of preferential purchase rights burdening the property.[6]

Some Indian tribes have enacted ordinances requiring that they be given the right of first refusal to meet the terms of any proposed assignment of interest in Indian leases.[7] Presumably the acquisition of stock in the transferor contained in the 1989 form and in most operating agreements for dispositions by merger, reorganization, or would avoid the application of such enactments, unless the enactments by their terms apply to changes in control of the ownership entities.

3. Approval of Lease Assignments: Fee, State, Federal

Although most fee leases are freely assignable, some leases do contain provisions requiring lessor consent to assignment. Although such provisions may be strictly construed, they are

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[4] See, e.g., optional provision § 4.10(D) of the 1995 AIPN Model Form International Operating Agreement, discussed in Bjella, *Removing the Operator Under the Joint Operating Agreement: Breaking Up Is Hard To Do*, 46 Rocky Mt. Min. L. Inst. 11-1, 11-29 (1999).
[5] See *McMillan v. Dooley*, 144 S.W.2d 159, 160 O&GR 488 (Tex. Civ. App. - Eastland 2004); Cooney, *Recent Developments Concerning Joint Operating Agreements -- Preferential Rights and Exculpatory Clauses*, 55 Ann. Inst. on Oil & Gas L. 11-1, 11-7 to 11-8 (2004) (hereinafter "Cooney"); Dowd, *Preferential Rights To Purchase in Oil and Gas Transactions*, 49 Rocky Mt. Min. L. Inst. 5-1, 5-18 to 5-22 (2003) (hereinafter "Dowd"); Dowdy at 13-13; Irish at 2-37.
[6] See Dowd at 5-11, 5-13; Dowdy at 13-15 to 13-16.
[7] See Hendrix & Clark, *Perfecting and Enforcing Liens and Other Impediments to Lending in Indian Country* 4-1, 4-20, in RMMLF Special Institute on Natural Resources Development in Indian Country (2005) (hereinafter "Hendrix & Clark"). Under Section 605 of the Navajo Nation Code, the Nation is given the option of acquiring the transferred interests within 120 days after submission of the completed assignment application on the same terms offered to any other proposed assignee. 18 N.N.C. §§ 605.A., B., C.

generally enforceable.[8] Attempting to assign a lease without obtaining the required consent may be enjoined and may even provide grounds for terminating the lease.[9] However, such provisions may be avoidable by mergers or stock acquisitions of the lessee.[10]

Most states require that assignments of oil and gas leases covering state lands be filed for approval by the appropriate agency, generally on a state form. Approval is usually ministerial in nature.[11]

Assignments of record title or operating rights interests in federal onshore leases must be filed on the requisite form with and approved by the Bureau of Land Management ("BLM").[12] Transferees must meet the qualifications to own interests in federal leases, such as U.S. citizenship, compliance with federal acreage limitations, and compliance with federal reclamation requirements on all federal leases in which the transferee and its affiliates have interests.[13] There is no provision of the regulations expressly requiring the filing of any notice or request for approval in the event of acquisition of the stock of a company owning federal leases. Stock acquisitions or mergers may thus be the only vehicle by which non-U.S. citizens can acquire interests in federal leases.[14] Mergers of companies owning interests in federal leases are not required to be approved, but a notice of merger must be filed with the BLM identifying all leases affected.[15] A transferee of a federal lease must comply with all federal bonding requirements and the amount of existing bonds can be increased by the BLM as a condition of approval to cover what it regards as an increased risk from the transferee's operations, just as the BLM can increase the amount of any existing bond to cover a perceived risk from the existing operator.[16] Acreage limitations apply to a party holding, owning or controlling more than the specified amount, so acquisitions by direct purchase or by stock acquisition or merger may be equally affected by those limitations.[17]

Acquisitions of interests in offshore federal leases are subject to similar restrictions and requirements.[18] However, separate instruments must be filed for each lease being transferred, and

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[8] See 2 H. Williams & C. Meyers, *Oil and Gas Law* § 402 at 261-62 (2004).
[9] *Id*. at 262 n.5.
[10] See *Santa Fe Energy Resources, Inc. v. Manners*, 430 Pa. Super. 621, 635 A.2d 648, 128 O.&G.R. 593 (1993).
[11] See Irish at 2-39 to 2-40.
[12] 43 C.F.R. § 3106.4-1 (2005). "Mass transfers" of interests in large numbers of leases can be accomplished by filing a single assignment form with an exhibit listing the interests covered. 43 C.F.R. § 3106.4-3 (2005).
[13] 43 C.F.R. §§ 3102.1, 3102.5 -1, 3106.2 (2005).
[14] Such acquisitions may not, however, be used to circumvent the requirement that the acquirors not be citizens of countries whose laws, customs or regulations do not deny similar ownership privileges to citizens or corporations of the U.S. 43 C.F.R. § 3102.2 (2005).
[15] 43 C.F.R. § 3106.8-3 (2005).
[16] 43 C.F.R. §§ 3104.5(b), 3106.2, 3106.6 (2005). Although there is no provision in the regulations requiring a bond review when there is a transfer of ownership of a lessee, the BLM can increase bond amounts when it determines that the operator poses a risk. 43 C.F.R. § 3104.5(b) (2005). Ongoing periodic reviews by the BOEM of a lessee's financial statements can accomplish the same result with respect to offshore operations. See Waddell, *Minerals Management Service Gulf of Mexico Region Adjudication and Leasing Procedures* 12-1, 12-8, in RMMLF Special Institute on Oil and Gas Development on the Outer Continental Shelf (2002) (hereinafter "Waddell").
[17] 43 C.F.R. § 3101.2-1(a) (2005). The regulations provide 180 days for divestment of excess acreage where the excess is acquired by merger or acquisition of controlling stock interest. 43 C.F.R. § 3101.2-4(a) (2005).
[18] See generally 30 C.F.R. §§ 256.62 et seq. (2005). See also *Oil and Gas Leasing Procedures Guidelines*, Gulf of Mexico OCS Region, U.S. Dept. of Interior -- Minerals Management Service (OCS Report 2001-076) (hereinafter *Oil and Gas Leasing Procedures Guidelines*).

as a general matter, the procedural requirements for assignments of offshore leases are more exacting and particular, and thus parties may wish to avoid the risk of delay and expense of multiple filings by utilizing stock acquisitions.[19] The regulations do not require filing any instrument in connection with acquisition of stock or ownership interests of entities owning interests in offshore leases, and it is the practice of the BOEM regional offices not to require approval of transfers occurring by merger, although the BOEM does require the filing of certificates of name change or of merger with a list of leases affected and the required designation of operator, among other items.[20]

4. Intellectual Property and Contract Rights

The primary intellectual property generally of concern in an oil and gas asset transaction are seismic licenses and other nonproprietary geological and geophysical data. Also of interest may be software licenses for technical programs, land data systems, and the like. If a seismic license provides only that the data may not be "sold, traded, disposed of or otherwise made available to third parties," it is clear that the data cannot be transferred by assignment, but the transfer of controlling interest in the stock of the licensee will not violate this restriction,[21] nor will a merger of the licensee with an unrelated third party.[22]Most modern seismic agreements not only restrict transfer of licensed data or even the showing of licensed data but also restrict the transferability of data in connection with mergers or corporate acquisitions. Under these agreements, even the transfer of data to an affiliate for eventual sale of the affiliate will not suffice to prevent the assessment of a transfer fee. Most seismic companies are aggressive in asserting their right to obtain transfer fees upon the transfer of their data directly by assignment or indirectly by transfer of corporate ownership. Thus, as a practical matter, structuring a transaction as an asset sale or a stock sale may make little difference with respect to key non-proprietary seismic licenses.

Software licenses may or may not provide for restrictions on transferability through stock acquisitions.[23] Even if such licenses are assignable, generally they are restricted as to numbers of users and cannot be assigned without consent of the vendors. Whether key software licenses will also contain restrictions on transfer resulting from changes in corporate control will depend on individual vendor approaches. Generally a buyer will have its own software licenses for comparable or even the same software so it is not usually an issue; if more licenses are required because employees transfer to the buyer, they are easily obtained. If a new license is required in order to run the seller's software, it is acquired as part of the transaction.

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[19] See 30 C.F.R. § 256.67 (2005). E.g., there are specific requirements for use of decimal interests and specifying depth limitations, execution by persons in the exact form shown by the qualifying documents filed with the BOEM, evidence of corporate or entity authority to hold federal leases, and evidence of authority and incumbency of persons executing on behalf of entities. See *Oil and Gas Leasing Procedures Guidelines* at 57-59. The slightest deviation from these requirements will cause the assignment package to be returned.
[20] See *Oil and Gas Leasing Procedures Guidelines* at 10-12.
[21] See *M.D. Mark, Inc. v. Nuevo Energy Co.*, 988 S.W.2d 463 (Tex. Civ. App. -- Houston 1999).
[22] See *TXO Production Co. v. M.D. Mark, Inc.*, 999 S.W.2d 137 (Tex. Civ. App. -- Houston 1999).
[23] See Hendrix & Hansen, *Dealing with Intellectual Property in Mergers and Acquisitions*, 47 Rocky Mt. Min. L. Inst. 8-1, 8-31 (2001).

5. Permit Transfers

There are a myriad of operational, environmental and land use permits required for oil and gas operations.[24] Generally these transfer automatically upon transfer of operations or can be transferred by routine filing. State and federal regulations generally require approval of the right to serve as operator pursuant to routine regulatory filings.[25] As indicated above, changes of operator on federal lands must be notified to the BLM on the appropriate form and bonding requirements must be satisfied in connection with transfers of interests and operations.[26] These are generally non-burdensome requirements but obviously they could be avoided by sale of stock if desired.

Offshore the rules are more complex. Transfers of operations require BOEM approval of the new operator and compliance with bonding requirements. All record title and operating rights holders must submit executed Designation of Operator forms any time there is a change of operator, which can be quite burdensome and carry the risk of non-approval from particular working interest owners.[27] Stock acquisitions may thus be useful in avoiding this process.

Environmental permits run the range from underground injection permits for disposal wells[28] to NPDES discharge permits for produced water discharges[29] to air permits for compressor stations and processing plants. Although such permits are generally transferable to third parties, often they are transferable only upon satisfaction of conditions imposed by the issuing agency or authority, which may reflect more stringent standards applied by the agency than when the permit was issued, or they may be transferable only after an inspection of the affected properties or facilities by the reviewing agency.[30] Transfer of a large number of permits may, of course, present logistical issues, but ordinarily the transfer of these permits should not be problematic in the typical oil and gas asset transaction.

If the acquisition involves interstate gas transmission facilities (which can include gas storage facilities) and depending upon the structure of the acquisition, approval of the Federal Energy Regulatory Commission ("FERC") may be necessary. A seller seeking to sell a FERC-jurisdictional facility through sale of the asset itself must secure authority from FERC to

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[24] A good summary is contained in Kaiser & Wurtzler, *The New Frontier -- Oil and Gas Exploration, Drilling and Production Permits*, Paper 2, in RMMLF Special Institute on Environmental Regulation of the Oil and Gas Industry (1993). For a summary of environmental permits, see Freeman, Nagle and Flynn, *Environmental Checklist for Oil and Gas Operators*, 48 Rocky Mt. Min. L. Inst. 6-1 (2002) (hereinafter "Freeman et al.").

[25] See, e.g., Colorado Oil and Gas Conservation Commission Rule 312 (Certificate of Clearance and/or Change of Operator) (hereinafter cited as "COGCC Rules").

[26] See 43 C.F.R. § 3162.3 (2005).

[27] See *Oil and Gas Leasing Procedures Guidelines* at 56-59; Waddell at 12-5.

[28] See Irish at 2-45 to 2-46; Temkin & Larson, *Overview of Federal Underground Injection Control Program* 61, 6-8, in RMMLF Special Institute on Environmental Regulation of the Oil and Gas Industry (1993).

[29] See generally *Buyer Beware: Evaluating Environmental Liabilities in Oil & Gas Transactions*, Ch. 15 (Robertson ed. PennWell 1995)

[30] See Hayes, *Environmental Liabilities in Mergers and Acquisitions of Natural Resource Companies* 9-1, 9-15 to 9-16, in RMMLF Special Institute on Mergers and Acquisitions of Natural Resources Companies (1994) (hereinafter "Hayes"); Watson, *Environmental Due Diligence: State of the Art of Negotiating Environmental Issues in Energy Industry Purchase and Sale Agreements*, 55 Ann. Inst. on Oil & Gas Law 14-1, 14-4 to 14-5 (2004).

"abandon" that facility. The buyer must secure FERC authorization, in the form of a "certificate of public convenience and necessity."[31]

6. Step Transactions: The "Texas Two Step" and Other Creative Avoidance Moves

There is a judicially created doctrine in tax law, the "step transaction," that permits the reviewing authority to look through the form of a transaction to its substance to determine if the applicable rules were satisfied. The question here is whether this doctrine has relevance in analyzing the effect of transactions structured as stock acquisitions to avoid assignment approvals or preferential purchase rights. The answer generally appears to be that it does, at least outside Texas.

In a famous Texas case, a multiple transfer transaction – popularly dubbed the "Texas Two Step" – was utilized to avoid a right of first refusal and was upheld by the Texas Supreme Court. In *Tenneco Inc. v. Enterprise Products Co.*,[32] the parties co-owned a natural gas fractionation plant that was subject to an operating agreement containing a right of first refusal triggered by a "sale" of a party's interest. Transfers to subsidiaries were excluded from the application of the provision. One of the owners, Tenneco Oil Company, began negotiating a sale of its interest in the plant to Enron Gas Processing Company. Ultimately, instead of an asset sale, Tenneco first conveyed its interest in the plant to its newly formed and wholly owned subsidiary, Tenneco Natural Gas Liquids, and then sold its stock in the subsidiary to Enron. The holders of the right of first refusal sought to exercise their rights to purchase their proportionate shares of the transferred interest, arguing that it in fact the sale of an interest in the plant although ostensibly structured as a stock sale. They relied on a Texas Court of Appeals case, *Galveston Terminals, Inc. v. Tenneco Oil Co.*,[33] which had been decided just the year before and had reviewed a similar two-step transaction, finding in a ruling on a motion for summary judgment sufficient evidence to support the claim that the transfers were intended as a single transaction to effect an asset sale and thus that the transaction was subject to the preferential right provision. The Texas Supreme Court in *Enterprise Products* expressly disapproved the reasoning in *Galveston Terminals* and held that the two-step transaction did not trigger the preferential right. The court indicated that such restrictions should be narrowly construed and that the parties could have included change of control restrictions but had failed to do so.[34]

Similarly, in the Louisiana case of *Fina Oil and Chemical Co. v. Amoco Production Co.*,[35] a multiple transaction involving the conveyance of operated working interests in three fields by Amoco to its wholly owned subsidiary, and the subsequent conveyance of the stock in that subsidiary to Apache Corporation nine months later, was held not to trigger the preferential purchase rights of the operating agreements burdening the properties. The court determined that the initial spin-off of assets from Amoco to its subsidiary was a reorganization exempted from the preferential right provision and that the subsequent sale of stock did not trigger the provision. The

[31] *Id*. § 717f(c).
[32] 925 S.W.2d 640 (Tex. 1996).
[33] 904 S.W.2d 787 (Tex. Civ. App. 1995 - Houston), *set aside without reference to the merits*, 922 S.W.2d 549 (Tex. 1996).
[34] 925 S.W.2d at 646.
[35] 673 So. 2d 668 (La. Ct. App. 1996), *writ denied*, 679 So. 2d 1353 (La. 1996).

court went on consider whether the circumstances justified piercing the corporate veil and treating the subsidiary as an alter ego, created merely to circumvent the preferential purchase right. The court relied on evidence in the record that Amoco had a legitimate business purpose in creating the subsidiary beyond simply avoiding preferential purchase rights. The reorganization had as its goal to maximize the economic benefits of the non-core assets through a spin-off to a new subsidiary, which was created before Apache was on the scene. So, although the multiple transaction was upheld, the decision does suggest that the existence of another legitimate business purpose (other than circumventing the preferential right provision) is an important factor in the analysis.

In *Citgo Petroleum Corp. v. Occidental Chemical Corp.*,[36] the Tenth Circuit, in an unpublished decision applying Louisiana law, upheld a transaction in which the seller of an interest in a plant specifically structured a transaction to avoid a preferential purchase right by first leasing the burdened property to an affiliate which assigned the lease to the buyer and subsequently formed a partnership with the buyer in which the seller retained a 50.1% interest to take title to the burdened property but the buyer had full management control of the property. The court held that the transaction on its face did not trigger the preferential purchase right and that it would not look to the "economic substance and practical effect" of the transaction as requested by plaintiff to justify application of the preferential right.

Finally, in *Williams Gas Processing--Wamsutter Co. v. Union Pacific Resources Co.*,[37] the Wyoming Supreme Court also addressed this issue. In this case, Union Pacific Resources Company ("UPRC") transferred its interest in a gas plant and associated gas gathering system, along with other assets, in a two-step transaction. In step one, UPRC transferred its interests in the assets to a newly formed second tier subsidiary, Fuels Acquisition Company ("FAC"), which had been created pursuant to the terms of a merger agreement between UPRC and the buyer, Duke Energy Field Services. In step two, UPRC sold all of its stock in Union Pacific Fuels, Inc., a first tier subsidiary of UPRC and the parent of FAC, to Duke. The assets were subject to two agreements containing identical preferential right provisions similar to the provision found in the Form 610 joint operating agreement. Each of the provisions was triggered by a "sale" and contained exceptions for transfers to an affiliate and transfers by merger. Williams was a co-owner of the assets and complained that their transfer really amounted to a sale and had been structured as a two-step transaction to circumvent its preferential rights. The district court found that the transaction was a merger and not a sale triggering the preferential right provision. However, the Wyoming Supreme Court reversed the district court's decision and held that, for purposes of the preferential right provision, the transaction was a "sale." Relying on prior Wyoming case law, the court refused to construe the preferential right provision narrowly in the context of stock transfers because UPRC's position rested upon a "highly tortured and technical reading of the contract terms."[38] The court stated that, while it found the decisions in *Tenneco* and *Amoco* instructive, it could not erase the rights Williams had bargained for and received when UPRC sold certain assets packaged in the form of an affiliate.

[36] 29 Fed. Appx., 2002 U.S. App. LEXIS 1053 (10th Cir. 2002)(unpublished).
[37] 25 P.3d 1064 (Wyo. 2001).
[38] 25 P.3d at 1072.

Under this state of the law, it can only safely be said that Texas courts will not be inclined to look through multiple-step transactions intended to avoid preferential purchase rights or other third-party rights and that courts in other states may be more inclined to do so, at least in the absence of other business purposes attending the transactions. This suggests that structuring a transaction as a stock acquisition instead of an asset acquisition only or primarily to avoid third-party rights may not always be effective.

B. Assumption and Avoidance of Liabilities

From a buyer's point of view, the reason most commonly advanced for preferring an asset transaction over a stock transaction, other than tax, is to avoid assuming unknown or unwanted liabilities. In a statutory merger, the surviving corporation will succeed to the liabilities of the target company by operation of law.[39] In a stock acquisition the buyer would ordinarily have no direct liability for obligations of the target company in the absence of active involvement that might qualify the buyer as an "operator" under statutes like CERCLA or an "owner" where circumstances justify piercing the corporate veil,[40] although of course the buyer's investment in the acquired company could be devalued by the existence of unforeseen liabilities. In an asset acquisition, by contrast, it is generally the case that liabilities not expressly assumed remain with the seller unless they run with the land pursuant to principles of property law or are imposed on successors by statute or regulation or are continuing at the time of transfer.[41]

For example, generally a buyer would not be liable, in the absence of statute, to plug wells on its leases that had been abandoned before it acquired its interest. However, statutes imposing liability on the "owner or operator" can authorize holding a subsequent owner liable for plugging wells he did not use.[42] While it is true that a buyer can achieve some level of protection from unwanted liability in a stock transaction through effective due diligence, comprehensive representations and warranties, and post-closing indemnities, such protection is imperfect at best, given the limitations on the due diligence process (often under severe time constraints with short time periods between agreement signing and closing) and the difficulty of enforcing post-closing remedies due to factors such as limited post-closing security, limited post-closing seller collectability,[43] and the risks inherent in post-closing litigation, not to mention the inherent difficulty in drafting and negotiating protection against all contingencies. Thus an asset acquisition is generally safer for a buyer from a liability perspective.

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[39] See Hayes at 9-21 to 9-22, 9-34 to 9-35; Hyman & King, *CERCLA Litigation: Hot Topics in Cost Recovery and Contribution Actions*, Paper 3 at 3-17, in RMMLF Special Institute on Natural Resources and Environmental Litigation II (1996) (hereinafter "Hyman & King").

[40] See Hayes at 9-27 to 9-28.

[41] See Irish at 2-46 to 2-47; Clark, *Continued Liability of Seller After a Sale of Producing Oil and Gas Properties*, 41 Inst. on Oil & Gas Law & Tax. 5-1, 5-3 to 5-5 (1990) (hereinafter "Clark on Seller's Liability"). The existence of a nuisance on the property in the form of ongoing pollution caused by past activities can support abatement or damages actions against the buyer. See Barnes, *Tort Liability for Past Mineral Development Activities*, 44 Rocky Mt. Min. L. Inst. 17-1, 17-15, 17-33 (1998) (hereinafter "Barnes").

[42] See Hager & Shaw, *Idle and Deserted Wells: Who Plugs and Who Pays?*, 45 Rocky Mt. Min. L. Inst. 12-1, 12-11, 12-21 to 12-22 (1999)(hereinafter "Hagen & Shaw"); Lansdown, *A Checklist for the Abandonment of Properties (Or, "Turn Out the Lights, the Party's Over")*, 47 Ann. Inst. on Oil & Gas Law & Tax. 2-1, 2-4 to 2-5 (1996).

[43] See Ebner, *Advanced Purchase Agreement Issues* 5-1, 5-28 to 5-31, in RMMLF Oil & Gas Acquisitions (hereinafter "Ebner"), and Hayes at 9-29 to 9-31, for a discussion of collectibility issues relating to dissolution of the seller.

Conversely, from the seller's perspective for liability purposes it would generally be preferable to sell the company owning the target assets and monetize the value of those assets without further exposure to lingering problems through ongoing post-closing liability except for whatever limited protection a buyer may be able to negotiate. Further, even obtaining broad post-closing liability assumption from a buyer in an asset transaction will not afford a seller complete protection. If the buyer becomes financially incapable of satisfying such liabilities, or further disposes of the properties to other buyers who may not be as financially solid as the original buyer, the seller becomes increasingly exposed to nonperformance which could ultimately circle back to him. Obtaining an assumption of liability from a buyer does not by itself release a seller from contractual liability, tort liability resulting from continuing activities or regulatory liability accrued at the time of sale without a corresponding release from the seller's obligee. Assignment of a contract by an obligor, even with consent of the obligee, does not release the obligor of liability for obligations previously accrued or possibly even subsequently incurred without the express release of the obligee. Current federal regulations impose continuing liability on the assignor of record title in federal oil and gas leases for lease obligations that accrue before the approval date, including responsibility for plugging and abandoning wells drilled, installed or used before the effective date of the transfer, even after approval of the assignment. Some state statutes impose liability on prior owners or operators to plug abandoned or orphan wells or clean up oilfield wastes[44] or to make up severance tax deficiencies of non-operating co-owners.[45] Bankruptcy or anti-indemnity laws can limit the effectiveness of buyer indemnities to a seller, and courts will often construe them narrowly.[46] It may not always be possible to distinguish between environmental liability existing on a property at the time of the sale and liability created or enhanced by a buyer after the sale, thus exposing a seller to potential continuing liability for activities on the property conducted long after the sale.[47] So a seller desiring to offload property liabilities may prefer structuring a transaction as a stock acquisition even if the post-closing protection negotiated by the buyer would presumably be the same in either case.

Even from a buyer's perspective, in today's climate at least the conventional construct on liability avoidance begins to break down on closer scrutiny. For one thing, in the current seller's market of high commodity prices and limited property availability, sellers often demand and receive broad-ranging liability assumption from buyers. It is not unusual in this climate for buyers to assume most or all liabilities, including environmental, relating to the acquired assets regardless whether the liabilities arose before or after the effective time of the transaction, or at least to do so after only a limited period following the closing. Often the seller's representations and warranties with respect to the acquired properties survive for only limited periods following the closing, and the seller's liability under post-closing indemnities may be capped or subject to thresholds and deductibles. Although such liability assumption does not generally extend to seller's corporate liabilities, such as liabilities for income taxes, liabilities under labor and employment laws or

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[44] See *Sewall v. Phillips Petroleum Co.*, 197 F. Supp. 3d 1160 (W.D. Ark. 2002) (suit against oil company that conveyed leasehold interest in 1943 for improper disposal of oil field waste under Arkansas Solid Waste Management Act not barred by limitations statute); Hager & Shaw at 12-7, 12-9 to 12-11, 12-21 to 12-22.

[45] See *BHP Petroleum v. State of Wyoming*, 784 P.2d 621 (Wyo. 1989).

[46] See Brown & Grandy, *Risk Apportionment in Natural Resources Transactions Through Indemnification Clauses and Releases*, 49 Rocky Mt. Min. L. Inst.4-1, 4-13 to 4-25 (2003) (hereinafter "Brown & Grandy").

[47] See Barnes at 17-33. In *Anthony v. Chevron USA, Inc.*, 284 F.3d 578 (5th Cir. 2002), the court upheld judgment as a matter of law in favor of defendant oil company successor lessee for lack of proof that defendant had caused the pollution from oil spills around wellsites when several other oil companies had operated the wells.

agreements, or liabilities relating to retained assets or assets previously disposed of, where the transaction covers all or substantially all of a seller's assets even corporate liabilities can be deemed to have been transferred if the transaction is held to be a de facto merger or a “mere continuation” of the seller under applicable state law. Further, there may be liabilities which a buyer assumes by law, such as the obligation of the assignee of record title or operating rights under a federal lease to “remedy all environmental problems in existence and that a purchaser exercising reasonable diligence should have known at the time.”[48] In the typical oil and gas acquisition, the liabilities generally of most concern to both seller and buyer are environmental and royalty. Each carry the potential for large exposure, each may not always be apparent even after intensive due diligence, and each can attach to property ownership regardless of the intention of the parties to the transaction. Following is an overview of how those liabilities may impact the respective concerns of seller and buyer.

1. Royalty Liabilities

The traditional rule has been that failure to pay royalty does not of itself support lease forfeiture but creates only a contractual breach enforceable against the defaulting payor, i.e., not against the defaulting party's successor in the absence of an express assumption of that liability.[49] Original lessees will not generally be liable for future unpaid royalties because of language in the typical fee lease form permitting assignment and releasing the assignor from liabilities accruing after the effective date of the assignment.[50] In the absence of express assumption language, an intervening assignee of a lease will generally not be liable to the lessor for unpaid royalties accrued prior to his acquisition of interest or for unpaid royalties accruing after his disposition of interest, since his relationship with his lessor is one of privity of estate rather than privity of contract.[51] However, sophisticated lessors can create sui generis lease provisions which may impose liability on successor lessees for past breaches of their assignors, or may not release assignors from liability for future royalty obligations. Further, given the explosion of royalty litigation over the past decade, based in part on statutes like the Wyoming Royalty Payment Act,[52] assignees of fee leases have much greater exposure currently to claims for past defaults, and assignors may find themselves defending claims many years after their assignments for alleged defaults occurring many years before.

With respect to federal leases, although the regulations do not appear to obligate an assignee to take on responsibility for unpaid royalties accruing during the ownership of his assignor, the United States does have the potential remedy of lease cancellation available under the Mineral Leasing Act for failure of the lessee to pay royalties. That threat could clearly induce a successor to assume the liability of his predecessor in order to protect his own leasehold interest, if the bona fide purchaser defense under the Mineral Leasing Act is not available to him.[53] An assignor of operating rights under a federal lease who retains record title will not only retain liability for royalties accruing prior to the assignment but could also be held liable for those

[48] 43 C.F.R. §§ 3106.7-6(a) (record title), (b) (operating rights) (2005).
[49] See Ebner at 5-19 to 5-20. But a lease provision terminating the lease for breach of covenants can support cancellation for nonpayment of royalties. See *Sowell v. Natural Gas Pipeline Co.*, 789 F.2d 1151 (5th Cir. 1986).
[50] See Ebner at 5-20; Williams, supra note 90 at 3-3.
[51] See Williams, supra note 90 at 3-5.
[52] Wyo. Stat. Ann. §§ 30-5-301 et seq.
[53] See 30 U.S.C. §§ 184(i), 188(a) and (b); Ebner at 5-21.

accruing afterward as well under current expansive interpretation of federal regulations by the Department of the Interior.[54] Further, a purchaser can assume (wittingly or not) the obligation for underpaid royalties by its predecessor.[55]

2. Environmental Liabilities

There are certain liabilities that may run with the properties and which the buyer will therefore be unable to avoid. Foremost among these are environmental liabilities. Even if a buyer succeeds in obtaining an allocation of liability which reserves to the seller all liabilities arising with respect to the properties prior to the effective time of the transaction, the buyer may still be taking on significant environmental liability simply by assuming ownership of the properties. Many papers have discussed the kinds of environmental liabilities potentially impacting oil and gas properties and how those liabilities impact acquisitions and divestitures of such properties. The most significant concern for a buyer is the extent to which there are existing conditions on the acquired assets which are causing ongoing violations of federal or state environmental law for which the buyer as the owner or operator will become responsible. These can include: liability under the Resource Conservation and Recovery Act ("RCRA") as a "generator" or as a "treatment, storage, or disposal facility" for the presence of exploration and production wastes that are either not exempt under RCRA; liability under state law for exploration and production waste management including spill remediation, pit permitting, operation, and closure requirements, produced water management, and groundwater protection; liability under the Clean Air Act for failure to have required operating permits for major sources such as compressor stations, dehydrators, or treatment facilities; liability under the Clean Water Act,[56] Oil Pollution Act of 1990,[57] or state law for discharges of oil or of waste water or other pollutants into navigable waters without required permits; liability for violation of the Safe Drinking Water Act for lack of required permits or mechanical integrity testing for injection or disposal wells; liability under state regulation or common law tort or nuisance theories for soil or groundwater contamination from produced water discharge or other waste disposal;[58] liability for leaking underground storage tanks or above ground storage tanks; liability under state or federal law or under the terms of acquired leases or under tort law for unplugged wells or for improperly plugged wells, and for failure to perform required reclamation or other surface restoration; liability under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") for remediation of previous releases of "hazardous substances" on acquired property as an "owner" or "operator";

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[54] See *Monahan v. Department of the Interior*, No. 04-205 (D. Wyo. Filed July 20, 2004), *appeal pending*, No. 05-8068 (10th Cir.) (assignor of operating rights who retained record title retained liability for plugging and site restoration obligations accruing after the assignment of operating rights). See also 30 U.S.C. § 1712(a) (record title holder secondarily liable for royalty payments not made by operating rights owner).

[55] See *GPM Gas Corp.*, 147 IBLA 314, GFS (Oil & Gas) 9 (1999)(successor gas purchaser liable for royalties underpaid by its assignor by reason of assignor's agreement in division order to disburse all payments due payees including Indian lessors).

[56] 33 U.S.C. § 1321; see Zachos, *Liabilities Arising from Ownership or Operation of Dead and Dying Oilfields*, 42 Rocky Mt. Min. L. Inst. 17-1, 17-27 to 17-29 (1996).

[57] 33 U.S.C. § 2702.

[58] See, e.g., *Howard v. Totalfina E&P USA, Inc.*, 899 So. 2d 882 (Miss. 2005); Barnes at 17-3 to 17-12; Dancy and Harrison at 8-29 to 8-31; DeLa Fuente, supra note 103 at 56 -- 58; Hayes at 9-9 to 9-11. For a comprehensive survey of litigation involving claims under state and federal law for pollution damage, see Joyner et al., *The Last Phase of an Oil Field: Getting Sued*, 54 Ann. Inst. on Oil & Gas Law 4-1 (2003).

and liability under Section 404 of the Clean Water Act for dredging or filling property classified as "wetlands" without the required permit from the U.S. Army Corps of Engineers.

The foregoing is not intended as an exhaustive list but is illustrative of the range of environmental exposure faced by a buyer. If the conditions giving rise to these liabilities exist when a buyer takes over ownership and/or operation of the properties, the buyer may assume liability for the violations they represent or the damage they are causing even if the conditions arose prior to the effective time of the transaction. Under CERCLA, for example, passive migration of hazardous substances initiated from acquired assets can establish liability of the current owner.

There are defenses available to asset purchasers under these statutory or regulatory schemes, such as the exclusion of petroleum, crude oil and natural gas and related substances from the definition of "hazardous substances" under CERCLA; the "innocent purchaser" or "bona fide prospective purchaser" defenses under CERCLA, or the defense that ownership of an oil and gas lease is not the ownership of an interest in the property such that liability for past acts is assumed, but these defenses are not easily established. Even containing the potential liability in a subsidiary may not be effective protection, since the cases recognize that a parent that exercises control over the operations and financial affairs of its subsidiary may be held liable for the subsidiary's CERCLA obligations.[59]

Buyers will negotiate for protection against these and other potential environmental liabilities whether the transaction is structured as an asset acquisition or a stock acquisition. A principal advantage of an asset acquisition is the opportunity to negotiate for the right to exclude from the sale properties which are found to present environmental liabilities whose remediation cost may exceed the value allocated to the property in the transaction. From a seller's perspective, an indemnity from a buyer will not necessarily release the seller from statutory liability if the buyer is ultimately unable to respond.[60]

III. CONCLUSION

With some luck, this paper will provoke those advising sellers and buyers to reconsider the stock sale and merger forms of acquisition. Buyers are facing erosion of their protection from historical liabilities in the newly-hazardous acquisition market, and sellers may start thinking that selling the entity that owns the properties may provide advantages worth pursuing. The authors believe that sales of corporate entities offer interesting alternatives to the traditional property transaction. Time will tell if industry agrees.

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[59] See, e.g., *State of Idaho v. Bunker Hill Company*, 635 F. Supp. 665 (D. Idaho 1986); but see *United States v. Bestfoods*, 524 U.S. 51 (1998) (parent not liable for subsidiary's CERCLA obligations in the absence of grounds for piercing the corporate veil).

[60] See CERCLA § 107(e), 42 U.S.C. § 9607(e) ("[n]o indemnification … shall be effective to transfer liability imposed under this chapter from a responsible party … to any other person"); Brown and Grandy at 4-13; Haas & Roska, supra note 119 at 22-37 to 22-43; Pierce at 134.