# The Devil is in the Details: Avoiding Common Pitfalls in the Negotiation and Drafting of Asset Purchase Agreements

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## I. PRELIMINARY AGREEMENTS AND NEGOTIATIONS

A party engaged in negotiating the purchase and sale of an oil and gas asset might assume it will not be under contract, at least with respect to any obligation to purchase or sell the target assets, until the signing of a formal PSA. This is not a given, however. Under Texas law, "a binding contract may be formed if the parties agree on the material terms, even though they leave open other provisions for later negotiations."[1] The fact that a seemingly preliminary agreement contemplates future documentation does not automatically prevent a contract from forming then and there, as long as the elements of offer, acceptance and consideration are present and the writing contains all terms "material" to the subject matter of the agreement.[2]

Texas courts recognize that "parties may structure their negotiations so that they preliminarily agree on certain terms, yet protect themselves from being prematurely bound in the event they disagree on other terms."[3] A letter of intent—or an "agreement to agree"—can be a valuable tool in this respect.[4] A letter of intent can be defined as "a written document that defines preliminary understandings among the parties who are considering a transaction," the terms of which are expressly made non-binding except as to certain limited areas focused on facilitating further cooperation between the parties—e.g., confidentiality, exclusivity and termination.[5] The goal of a letter of intent is to lay the groundwork for the execution of a purchase and sale agreement

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[1] *John Wood Group USA, Inc. v. ICO Inc.*, 26 S.W.3d 12, 19 (Tex. App. – Houston [1st Dist.] 2000, pet. denied).

[2] See *Domingo v. Mitchell*, 257 S.W.3d 34, 39 (Tex. App. – Amarillo 2008, pet. denied) ("For a contract to exist, there must be offer, acceptance, and consideration"); *Murphy v. Seabarge, Ltd.*, 868 S.W.2d 929, 933 (Tex. App. – Houston [14th Dist.] 1994, writ denied) ("Language contemplating additional written documentation is not conclusive on intent to contract").

[3] *WTG Gas Processing, LP v. ConocoPhillips Co.*, 309 S.W.3d 635, 649 (Tex. App. – Houston [14th Dist.] 2010, pet. denied). It is worthwhile to note the distinction between the concepts of contract and agreement. A contract is an agreement that creates legally enforceable obligations between the parties. See Tex. Bus. & Com. Code § 1.201(b)(12).

[4] See *Feldman v. Allegheny International, Inc.*, 850 F.2d 1217, 1219 (7th Cir. 1988) ("When a deal necessarily is preceded by costly groundwork, a letter of intent may benefit both purchaser and seller. Although much work remains to be done, indeed virtually all of the details remain open, the buyer secures the seller's undivided attention as long as progress continues in ironing out the points of the transaction").

[5] Lee Fanyo, "Letters of Intent – Stories from the Courthouse and Drafting Considerations," *Oil & Gas Agreements: Purchase and Sale Agreements*, Paper 4B, Page No. 5 (Rocky Mt. Min. L. Fdn. 2016). See *John Wood Group USA*, 26 S.W.3d at 19 (stating that "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").

(a "PSA"), which the parties understand will be the definitive agreement with respect to their respective rights and obligations. Even if made legally non-binding, the act of committing overarching terms to a written document, signed by the parties, has real effect, bringing to the negotiation process "a level of formality that establishes for the parties a slightly stronger, albeit loose, commitment that ongoing conversations do not establish."[6] In addition to assuring each party that the other is serious about moving forward, thereby justifying the commitment of time, manpower and money required to consummate the transaction, the broad parameters outlined in the letter provide guidance to the parties' lawyers in negotiating and drafting the PSA.[7]

In many contexts, however, a letter of intent is not part of the deal process. Indeed, sellers are often wary about letters of intent, preferring instead to keep the assets on the market and, thus, pressure on the target buyer to agree to a PSA (the initial draft of which is typically drafted by seller).[8] In a bid transaction, preliminary relationships between seller and multiple bidders are often defined by written communications issued by seller (teaser letters, bid procedures, etc.) and standalone confidentiality agreements. These often serve the same purpose as a letter of intent—i.e., providing structure to preliminary relationships while preventing the premature contract formation.[9] Thus, drafting suggestions applicable to letters of intent, insofar as they relate to provisions expressing an intent not to be bound until the mutual execution of some future agreement, are also applicable in alternative contexts.

The principal danger of carelessly draft letter of intent is that one unlucky party might find itself locked into a contract that it never intended, at least subjectively, to have made and of which only the most basic terms are expressly defined. The same is true in the less formal context of email correspondence between the parties' representatives during PSA negotiations, which can likewise easily result in offer and acceptance.[10] In either context, two possibilities arise: (1) a contract has not been formed, the parties having expressed an intent to be bound only *if and when* the future document is signed by the parties; or (2) a contract has been formed and the future document will summarize material terms previously agreed to and perhaps serve as a secondary agreement on various immaterial provisions. Whether a letter of intent or other preliminary agreement is binding as to any one of its provisions is a question of the parties' intent as expressed by their words and conduct.[11] For an oil and gas asset purchase agreement, which requires a

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[6] Fanyo, *supra* note 5, at 6.

[7] *Id*. at 5-6.

[8] See Arnold J. Johnson, "Land Mines in the Purchase and Sale Transaction Process," *State Bar of Texas: Advanced Oil, Gas & Mineral Law Course* 12 (2000), available at https://www.oilgas.org. (LOIs are generally perceived to be more advantageous to buyers); Bill Laughlin, "Fast-Tract Oil and Gas Divestitures or Lost Weekends and Sleepless Nights," 49 Rocky Mt. Min. L. Inst. 6, 6-15 (2003) (Buyers have a tendency to view a letter of intent as a "release of pressure," reducing its sense of urgency to get the PSA signed).

[9] See Terry N. McClure, "Purchase and Sale Agreements for Oil and Gas Properties," *State Bar of Texas: Advanced Oil, Gas & Mineral Law Course* 2-3 (1995), available at https://www.oilgas.org.

[10] See *Chalker Energy Partners III, LLC v. Le Norman Operating,* LLC, 595 S.W.3d 668 (Tex. 2020), discussed *infra*.

[11] See *Scott v. Ingle Bros. Pacific, Inc.*, 489 S.W.2d 554, 555 (Tex. 1972).

writing signed by the party against whom enforcement is sought,[12] the strongest evidence of intent is the plain language of the written agreement.[13] If the agreement is unambiguous, and the parties have acted consistently with it in their course of dealing, a court may determine the intent issue as a matter of law.[14]

***Meeting of the Minds***

The formation of a contract requires a "meeting of the minds," or a mutual assent to the subject matter and essential terms of the contract. While often represented as a freestanding element of a valid contract,[15] this concept can also be considered a "subpart" of the elements of offer and acceptance, each of which requires an underlying intent to be bound[16] (thus, there can be no offer and acceptance as to form a binding contract without a meeting of the minds).[17]

A court will give effect to the plain language of the parties' signed writing as it pertains to their intent to be bound, as displayed in *Coe v. Chesapeake Exploration, L.L.C.*[18] Chesapeake, wanting to strengthen its position in the Haynesville Shale during a time of high natural gas prices, entered negotiations with Peak Energy Corporation to purchase Peak's deep rights in Harrison County. On July 2nd, Chesapeake sent Peak an "Offer of Purchase" to purchase all of Peak's right, title and interest in "certain oil and gas leases . . . such leases being shown in the map attached hereto as Exhibit 'A,'" limited to depths below the Cotton Valley Formation. Chesapeake's offer stated a purchase price of $15,000 per net acre and a closing date of August 31st. The total purchase price was listed as $81,071,250.00 due to Chesapeake's initial belief that Peak owned 5,404.75 acres in the contract area; however, the agreement provided for the purchase price to be adjusted either upward or downward by stated per acre price if Peak was discovered to own a greater or lesser interest. Chesapeake's offer described itself as a "*valid and binding agreement*."[19]

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[12] A mineral interest is real property. *See Texas Co. v. Daugherty*, 176 S.W. 717, 719 (Tex. 1915). A contract for the sale of real property is subject to the Statute of Frauds, which requires the promise or agreement to be in writing and signed by the party against whom enforcement is sought. See Tex. Bus. & Com. Code § 26.01.

[13] See Fanyo, *supra* note 5, at 16.

[14] See *John Wood Group*, 26 S.W.3d at 16.

[15] The elements of a valid contract are often stated to be (i) offer, (ii) acceptance in strict compliance with the terms of the offer, (iii) meeting of the minds, (iv) each party's consent to the terms and (v) execution and delivery of the contract with the intent that it be mutual and binding. See *Buxani v. Nussbaum*, 940 S.W.2d 350, 352 (Tex. App. – San Antonio 1997, no writ).

[16] *Domingo*, 257 S.W.3d at 40. See *Komet v. Graves*, 40 S.W.3d 596, 601 (Tex. App. – San Antonio 2001, no pet.) ("In determining whether there was a 'meeting of the minds,' and therefore an offer and acceptance, courts use an objective standard, considering what the parties did and said, not their subjective states of mind").

[17] The elements of a valid offer are (i) the offeror intended to make an offer, (ii) the terms of the offer were clear and definite, and (iii) the offeror communicated the essential terms of the offer to the offeree. See *KW Const. v. Stephens & Sons Concrete Contractors, Inc.*, 165 S.W.3d 874 (Tex. App. – Texarkana 2005, pet. denied). An acceptance is valid only if its terms are identical with the offer; otherwise, it is a counter-offer which gives the original offeror the power of acceptance. See *Long Trusts v. Griffin*, 144 S.W.3d 99, 111-12 (Tex. App. – Texarkana 2004, pet. denied).

[18] 695 F.3d 311 (5th Cir. 2012).

[19] *Id*. at 315.

Peak timely accepted. A few months later, however, Chesapeake informed Peak that it considered the deal terminated, an occurrence likely motivated by a sharp decline in commodity prices. Peak sued for specific performance—i.e., for the court to order Chesapeake to purchase the assets from Peak for the agreed price.

Chesapeake argued the July agreement was a letter of intent, but the Fifth Circuit easily concluded that the binding character of said agreement was not in doubt. The offer of July 2nd, which had ripened into a contract upon Peak's acceptance, expressly stated "valid and binding." Chesapeake unsuccessfully argued this language was negated by a no obligation provision in the confidentiality agreement subsequently entered into by the parties, a form agreement insisted upon by Peak (per industry custom) before Chesapeake could access its files.[20] Because the confidentiality agreement did not address the substance of the July agreement, the court determined it was not relevant to question of the parties' intent at an earlier time.[21] The court ordered enforcement despite the fact that Chesapeake's due diligence ultimately revealed that Peak owned only 1,645.917 acres, a figure significantly below Chesapeake's original understanding. The court reasoned this did not prevent judicial enforcement, because the parties' agreement covered all of Peak's right, title and interest in the lands and provided an adjustment mechanism in the event of a failure of title.[22]

Texas law recognizes that a condition precedent, either mutually agreed to or unilaterally imposed by one party during the negotiation process, can delay a meeting of the minds until the stated condition has been met.[23] In other words, either party may dictate the form its acceptance will take or what circumstances must be present before it can be said to have subjected itself to an obligation to perform.[24] If a party does not wish to be prematurely bound, it should include in any preliminary writing exchanged with its counterpart a provision that clearly expresses such an intent.

In *WTG Gas Processing, LP v. ConocoPhillips Co*., Conoco sought to divest itself of various natural gas processing facilities it owned and invited WTG to make a bid in accordance with written bidding procedures.[25] The bid document, made available to and acknowledged by WTG, provided: "*A Proposal will only be deemed accepted upon the execution and delivery by*

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[20] This no obligation clause provided: "Nothing in this Agreement shall impose any obligation upon [either party] to consummate any business transaction with the other." *Id.* at 321.

[21] *Id.*

[22] *Id.* at 323.

[23] See *Energy Transfer Partners, L.P. v. Enter. Prods. Partners, L.P.*, 593 S.W.3d 732, 738 (Tex. 2020) ("Texas courts regularly enforce conditions precedent to contract formation and reject legal claims that are artfully pleaded to skirt unambiguous contract language, especially when that language is the result of arms-length negotiations between sophisticated business entities").

[24] See *Anubis Pictures, LLC v. Selig*, No. 05-19-00817-CV *22 (Tex. App. – Dallas, 3/3/2021) ("[A] party seeking to recover under a contract bears the burden of proving that all conditions precedent have been satisfied").

[25] 309 S.W.3d 635, 645 (Tex. App. – Houston [14th Dist.] 2010, pet. denied).

*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*."[26] After WTG submitted a bid, a December 11th phone conversation occurred during which Conoco's representative told his counterpart at WTG that Conoco had decided to "go forward with" the sale to WTG and the parties had a "deal" except for certain "immaterial" changes that needed to be made to the draft PSA.[27] Soon thereafter, Conoco switched horses to another bidder, Targa, eventually signing a PSA with that party. The Fourteenth Court of Appeals held the bid document unequivocally made the execution of a PSA a condition precedent to the formation of a contract, so WTG had no claim against Conoco for breach of contract.[28] This was the case regardless of Conoco's representations in the December 11th phone call. According to the court, the purpose of a condition precedent is to protect one party from allegations its conduct expressed an intent contrary to such condition or amounted to a waiver of such condition.[29]

The *WTG* court distinguished the disclaimers in Conoco's bid document from the language scrutinized in two earlier cases: *Foreca, S.A. v. GRD Development Co., Inc.*[30] and *Murphy v. Seabarge, Ltd.*[31] At issue in *Foreca* was a handwritten agreement for the sale of amusement park rides which stated: "subject to legal documentation contract to be drafted by [seller's attorney]."[32] The Texas Supreme Court framed the controlling question as whether the referenced future writing was a condition precedent to an enforceable contract or the memorialization of an already enforceable contract embodied in the handwritten agreement. The court held the intent of this provision presented a fact question for the jury, but recognized that "[i]n some cases, of course, the court may decide, as a matter of law, that there existed no immediate intent to be bound."[33] Unlike the meagre language at issue in *Foreca*, the disclaimers in Conoco's document were unequivocal and could be interpreted as a matter of law. In *Murphy*, the general partner of a barge business argued that he was not legally bound by certain management fee provisions in a "Memorandum of Understanding" executed between himself and the limited partners. The memorandum expressly stated it was "not intended to be a binding contract" and made "subject to . . . the preparation of appropriate documentation acceptable to the parties hereto."[34] After it was executed, the general partner acted for a time in conformity with the memorandum, paying himself the correct management per its terms. The court found this post-agreement conduct created

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[26] *Id*. at 638.

[27] *Id*.

[28] *Id*. at 645. Due to this holding, the court found it unnecessary to address the statute of frauds issue.

[29] *Id*. at 649 (stating that "the representations during the December 11th phone conversation cannot alone constitute waiver of the bid procedures and acceptance of WTG's offer when the bid procedures were implemented partly to prevent such representations from constituting acceptance of an offer"). See *Anubis Pictures*, No. 05-19-00817-CV at *24 – 27 (waiver requires conduct "unequivocally inconsistent" with claiming a known right).

[30] 758 S.W.2d 744 (Tex. 1988).

[31] 868 S.W.2d 929, 933 (Tex. App. – Houston [14th Dist.] 1994, writ denied).

[32] *Foreca*, 758 S.W.2d at 745.

[33] *Id.* at 746.

[34] *Murphy*, 868 S.W.2d at 933.

sufficient ambiguity to submit the question of intent to be bound to the jury. Unlike in *Murphy*, there was no partial performance by Conoco that could serve as evidence of a contravening intent; indeed, it had repudiated the agreement and sold the assets to a different party.[35]

The *WTG* court found the facts of the case were closer to *John Wood USA v. ICO Inc.*, which concerned a letter of intent for the purchase and sale of a manufacturing business.[36] In that case, the First Court of Appeals held the following "Binding Effect" provision resulted in 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."[37]

The recent decision of the Texas Supreme Court in *Chalker Energy Partners III, LLC v. Le Norman Operating, LLC*, applies the reasoning of the above cases to the ubiquitous practice of email.[38] Looking to sell all its leasehold assets in the Texas Panhandle, Chalker Energy Partners opened a virtual data room to potential bidders, allowing access to a party only after it had entered into a confidentiality agreement. The confidentiality agreement put forward by Chalker and signed by Le Norman Operating and others contained a "No Obligation" clause which read: "*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 . . .*"[39] The bidding process for the purchase of 100% of Chalker's interest did not bear fruit; however, on November 19th, Le Norman submitted an offer via email to purchase an undivided 67% of the assets for $230 million, adding as a postscript that "[w]e will not be

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[35] See *WTG Gas Processing*, 309 S.W.3d at 646. While partial performance under the terms of the alleged contract is one factor in determining mutual intent to be bound, and this might possibly override the non-binding intent language of a preliminary agreement, it is usually not an issue in the context of an asset purchase agreement. The parties will be primarily occupied with negotiating the PSA, so there will be no attempt by either party to perform in the sense of effectuating the transfer of the assets from seller to buyer. *See* Fanyo, *supra* note 5, at 19-20.

[36] 26 S.W.3d 12 (Tex. App. – Houston [1st Dist.] 2000, pet. denied).

[37] *Id*. at 15.

[38] 595 S.W.3d 668 (Tex. 2020).

[39] *Id*. at 670.

modifying or accepting any changes to the base deal described above."[40] Chalker's agent emailed his Le Norman counterpart the next day, on November 20th, to inform him that Chalker was "on board to deliver 67% subject to a mutually agreeable PSA."[41] A few days later, Jones Energy came in with a better offer. After having discovered of the PSA between Chalker and Jones Energy, Le Norman sued to enforce the contract allegedly created by the email exchange of November 19th and 20th.

The *Chalker* court recognized the no obligation clause of the confidentiality agreement as having created a condition precedent to contract formation, endorsing the reasoning of *WTG Gas Processing* and *John Wood USA*.[42] Thus, the central question before the court was whether the scrutinized email exchange could possibility be (so as to submit the question to a jury) a "definitive agreement" within the meaning of the confidentiality agreement. For purposes of analysis, the court defined two mutually exclusive concepts. A preliminary agreement was a "precontractual understanding [that did] not specify all the important terms of the deal." In contrast, a definitive agreement was final, authoritative and purportedly-exhaustive.[43] The court determined: "The emails here are more akin to a preliminary agreement than a definitive agreement, and the parties' dealings suggest that they intended that a more formalized document, like a PSA, would satisfy the definitive-agreement requirement."[44] The fact that the substance of the emails left "much to the imagination" weighed in favor of this determination.[45] Moreover, the email exchange took place in the process of the parties swapping redlined drafts of an unexecuted PSA. According to the court, the obvious purpose of the no obligation clause was to provide the parties "with the freedom to negotiate without fear of being bound by a contract."[46] According to the court, this standard feature of confidentiality agreements and other preliminary agreements would be rendered practically useless if it could be triggered by the "distinctly conversational, informal medium" of email.[47]

**To avoid premature contract formation, a party should unequivocally communicate in writing to its counterpart that it does not intend to be bound until the execution of a PSA or similar comprehensive agreement. The *WTG*, *Chalker* and *John Wood* cases provide good examples, in an assortment of contexts, of language that will prevent contract formation as a matter of law, thus allowing the parties to negotiate freely without fear of incurring unintended liability. To be safe, the term "Non-Binding" should appear in the caption of the**

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40 *Id*. at 671.

41 *Id*.

42 *Id*. at 673-74 (stating that "language that no contract will arise until a formal agreement is executed makes clear the parties' intent that the contemplated formal document is a condition precedent to contract formation").

43 *Id*. at 674-75 (citing BLACK'S LAW DICTIONARY).

44 *Id*. at 675.

45 *Id*.

46 *Id*. at 676.

47 *Id*. at 670.

**document and the non-binding intent clause should appear in conspicuous language (uppercased and in bold font) in a prominent area of the document.**

***Sufficiency of Terms***

An additional requirement of a valid contract is that it be "sufficiently definite in its terms so that a court can understand what the promisor undertook."[48] A written agreement can constitute an enforceable contract although it provides for certain terms to be agreed upon by the parties at a later date, so long as such deferred terms are not "material" to the agreement. Therefore, the failure of the parties to stipulate to the precise form of the closing documents will not automatically preclude enforceability of an otherwise complete agreement.[49] However, if a material term is left open for future negotiation, there is no binding contract on the grounds of indefiniteness.[50] The result is a letter of intent (practically speaking, no agreement at all).[51] The scope of material terms will vary from agreement to agreement.[52] The most fundamental terms of an asset purchase agreement are the property, price and time of closing.[53] However, the parties to a high value, complex transaction would likely consider the areas needing to be agreed upon as a preliminary matter to include more than such bare-bones terms.

Where a written agreement identifies one or more areas of concern as significant, but leaves such areas undefined, there is nothing of enough substance to enforce. The court will not write the litigants' contract for them. In *Lynx Exploration and Production Co., Inc. v. 4-Sight Operating Co., Inc.*, Lynx sent a three-page letter to 4-Sight in which Lynx offer purchase certain mineral properties owned by 4-Sight for $5 million.[54] 4-Sight signed the letter to evidence its acceptance of its terms. After 4-Sight refused to close, Lynx sued for breach of contract and sought specific performance. The letter agreement stated Lynx's offer was subject to its approval of "Assignment, Purchase and Sale Agreement and other instruments associated with the purchase contemplated by this offer" and went on to list, in broad terms, various areas such instruments would address.[55] The court reasoned Lynx would have stood a better chance of enforcing the agreement had it, rather than including such open-ended provisions, been quiet on such matters and stipulated only as to the price to be paid and the property to be conveyed.[56] However, by recognizing the material terms of the parties' contract encompassed such things as "environmental conditions," "over/under-

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48 *T.O. Stanley Boot Co., Inc. v. Bank of El Paso*, 847 S.W.2d 218, 221 (Tex. 1992).

49 See *Coe*, 695 F.3d at 322.

50 See *Lynx Exploration and Production Co., Inc. v. 4-Sight Operating Co., Inc.*, 891 S.W.2d 785, 789 (Tex. App. – Texarkana 1995).

51 See *Coe*, 695 F.3d at 320.

52 See *T.O. Stanley Boot Co.*, 847 S.W.2d at 221 ("Each contract should be considered separately to determine its material terms").

53 See *Coe*, 695 F.3d at 321 ("Essential terms generally include the time of performance, the price to be paid and the serve to be rendered").

54 891 S.W.2d 785 (Tex. App. – Texarkana 1995, writ denied).

55 *Id.* at 788.

56 *Id.*

produced gas wells," "accounting matters," etc., all the while failing to define them in substance, the letter agreement was fatally defective. The court concluded:

> "Lynx does not want the document presently before this Court to be enforced. Rather, it wants this Court to enforce this document along with a 'reasonable' purchase agreement that would address each of the concerns set out by the offer and to adjust the price accordingly. Some terms will be implied in contract analysis. Where, however, material terms of the contract were not agreed to, but were left for future adjustment, as in this case, enforcement cannot be granted."[57]

**Therefore, where the parties intend to enter into a binding agreement, the agreement should include, as attached exhibits, the form of conveyance for seller to execute and deliver to buyer at closing and any other closing documents. This ensures the written agreement contains all "material" terms, thus allowing judicial enforcement if something goes wrong down the road.**

***Mutuality of Obligation***

In addition to offer and acceptance, the formation of a valid contract requires consideration, defined as a "bargained for exchange of promises that consists of benefits and detriments to the contracting parties."[58] In the law of contracts, consideration means "mutuality of obligation"—each party must be bound, by virtue of its promise to the other, to do or not to do something.[59] Thus, one party cannot invoke judicial process to force its counterpart to perform under an alleged contract that imposes no reciprocal obligation on it. This is not an issue as it regards a signed writing meant to express the preliminary understanding of the parties (i.e., a letter of intent); in such case, the document should expressly disclaim any obligation on the part of either party to consummate the transaction. But the consideration/mutuality of obligation requirement does come into play with an agreement evidencing a mutual intent to be bound (i.e., a PSA).

*Lynx Exploration and Production*, the facts of which are discussed above, concerns an agreement which, at first glance, appears to have heavily favored the purchaser.[60] According to the court, one problem with Lynx's demand that 4-Sight proceed to closing was the letter agreement gave Lynx "the absolute right" to avoid doing the same.[61] Various provisions made Lynx's obligation to perform subject to its approval of 4-Sight's reserve reports and joint billing statements. The court noted "satisfaction" provisions such as these were not in themselves fatal to enforcement. Rather than allowing the benefitted party to withhold approval on a whim,

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57 *Id*. at 789 [internal citations omitted].
58 *Domingo*, 257 S.W.3d at 40.
59 See 2-5 CORBIN ON CONTRACTS § 5.10 (2015).
60 891 S.W.2d 785 (Tex. App. – Texarkana 1995, writ denied)
61 *Id.* at 787.

however, the law imposes a standard of reasonableness and good faith on that party's conduct. However, the letter agreement went further by providing: "In the event Lynx E & P does not execute the Purchase and Sale Agreement by February 1, 1993, the Letter Agreement will expire and neither party will have any obligation to the other thereafter."[62] Thus, unlike 4-Sight, Lynx was given "total discretion to avoid the sale."[63] The court found no basis within the agreement to impose an objective standard upon Lynx's conduct had it been the one who tried to walk. Indeed, the court found the arrangement contemplated by the letter agreement was more akin to an option contract—one that, because it lacked consideration flowing from Lynx to 4-Sight (i.e., money paid to purchase the option), was unenforceable.[64] As one commentator notes: "While such [non-reciprocal] agreements provide broad cover for buyers wishing not to close, they may leave buyers powerless against sellers who develop cold feet or receive better offers."[65]

**If buyer wants to tie up seller's property through a set future date without incurring any obligation to close, it will need to put some skin in the game—either by purchasing an option outright or depositing earnest money with seller.[66] Otherwise, the practical result will be a letter of intent, allowing either party to walk away free and clear.**

## II. THE TITLE DEFECT MECHANISM OF A PSA

The total unadjusted purchase price, as represented in the PSA, is based on the parties' imperfect understanding of seller's title. The typical PSA contemplates the transfer of all or a certain percentage of seller's "*right, title and interest*" in the assets, even if it is less or more than the specific amount of interest represented in the agreement. The purpose of a title defect mechanism of the PSA is to allow the final purchase price to accord with seller's true interest, as revealed by the due diligence conducted by buyer after execution of the PSA.

The title defect mechanism is usually be the only meaningful recourse available to buyer for shortcomings in seller's title to the properties to be transferred at closing.[67] The parties will specify a certain period during the "interim period" (i.e., between the execution of the PSA and the closing date) during which buyer may assert one or more "Title Defects" discovered from its due diligence review of seller's internal files and the county records.[68] Buyer's right to assert title

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62 *Id.*

63 *Id.*

64 *Id*. at 787-88.

65 *Id*. at 3.

66 See Clifton A. Squibb, "Title Issues in Mineral and Royalty Transactions," *State Bar of Texas: Oil, Gas & Mineral Title Examination Course* 2 (2020), available at https://www.oilgas.org.

67 See David M. Patton, "The Future After Closing a Purchase and Sale Agreement – Who is Responsible for What?," *State Bar of Texas: 35th Annual Advanced Oil, Gas & Energy Resources Law Course* 10 (2017).

68 The deadline for the submission of title defects is often set a week or so prior to closing to allow seller adequate time to address or dispute them. See Steven B. Richardson, "Title Aspects of Purchase and Sale Agreements: Defects, Adjustment Mechanisms, and Remedies," *Oil & Gas Agreements: Purchase and Sale Agreements*, Paper 7, Page No. 27 (Rocky Mt. Min. L. Fdn. 2016).

defects is purely contractual, arising under the express provisions of the PSA. The title defect section interacts with the remainder of the agreement in two fundamental ways. First, to the extent seller does not exercise its contractual right to cure the underlying title issue, a valid and properly asserted defect will trigger a downward adjustment to the purchase price, subject to any threshold and deductible hurdles. Second, it is usually a closing condition that if the aggregate value of all qualifying title and environmental defects exceeds a certain percentage of the total purchase price (e.g., 10%), either party has the option to terminate the PSA prior to closing, without further liability.

Except for the special warranty of title included in the assignment executed by seller at closing, a provision which affords only limited protection in that it does not cover defects arising prior to seller's period of ownership, the PSA will typically contain an express disclaimer of any warranty or post-closing commitment by seller with respect to title.[69] Any title defect not raised before the title defect deadline, whether then known or later discovered, is deemed waived by buyer; provided, the drafter should ensure such waiver does not negate seller's special warranty of title.[70] Thus, unlike the representations and covenants made by seller, some of which will survive closing and be incorporated into seller's indemnity obligation, either indefinitely or for a limited "survival" period, the title defect mechanism is designed to run its course prior to or soon after closing.[71] This customary arrangement "takes into account the seller's desire to complete the deal with minimal ongoing title liability and the purchaser's desire to have meaningful rights in the event a title issue is identified and quantified."[72] Limiting buyer's remedy to adjustments in the purchase price makes sense. The real value in an A&D transaction is the oil and gas reserves under the land, which buyer can exploit only to the extent of the title it receives from seller. Thus, the quantum of interest that seller purports to own in a property (whether lease, unit or well) is the primary factor in determining the allocated value of that property—and by extension, adding all the allocated properties together, the total unadjusted purchase price.[73] Moreover, if a right to indemnification were substituted for a reduction in the purchase price, the former would be valuable to buyer only to the extent seller (or the guarantor of seller, if any) remained a creditworthy entity into the future, which is often very much in doubt.[74]

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[69] See Christopher S.C. Heasley & David M. Wildes, "Applying Title Defects Under a Typical Purchase Agreement," LANDMAN 27, 38 (January/February 2020).

[70] See Richardson, *supra* note 68, at 18.

[71] See Michael De Voe Piazza & David A. Aaronson, "Protecting Value and Mitigating Risk: Typical and Atypical Purchase Price Adjustments in Oil and Gas Transactions," *Oil & Gas Agreements: Purchase and Sale Agreements*, Paper 12, Page No. 9 (Rocky Mt. Min. L. Fnd. 2016).

[72] Heasley & Wildes, *supra* note 69, at 27.

[73] See Allen D. Cummings, "Meeting of the Minds on Title Defects," 48 Rocky Mt. Min. L. Fnd. 27, 6 (2002).

[74] See Richardson, *supra* note 68, at 27-28; Stephen C. Szalkowski & Talia G. Jarvis, "Oil and Gas Purchase and Sale Agreements: Crafting Indemnification Provisions and Allocating Liabilities," *Oil & Gas Agreements: Purchase and Sale Agreements*, Paper 11, Page No. 3 (Rocky Mt. Min. L. Fdn. 2016).

Therefore, under the system outlined above, the burden rests on the buyer to determine whether seller has good title to the assets prior to closing. If a review of 100% of the properties is impossible or impracticable due to a short due diligence timeframe, as is often the case with larger transactions, buyer will usually focus on confirming title to the highest-valued properties as to account for the largest percentage of the total allocated value possible. Indeed, a targeted review might be buyer's preference in any case. If the allocated value a certain property is so insignificant in relation to the total value of the transaction, the expenditure of money and manpower proving seller's title to that property might be uneconomic.

***Title Defect***

The clashing perspectives of buyer and seller with respect to title matters become crystallized during negotiations over the title defect mechanism to be included in the PSA. This is especially true as it pertains to the scope of matters that will qualify as a "Title Defect."

A potential title defect arises whenever it is discovered that seller's title to a property does not conform to the standard of acceptable title defined in the PSA. In the typical PSA, a title defect is an issue with seller's title that (1) buyer brings to seller's attention in strict accordance with the procedures and deadlines set forth in the PSA; and (2) causes seller to lack sufficient title—usually, but not always, subsumed under term "Defensible Title"—to one or more of the allocated value properties as of the closing date.

The operative definition of a title defect will be impacted if the PSA includes a title defect threshold, title defect deductible or both. A title defect threshold is an amount of money which an individual title defect must equal or exceed for it to constitute an actionable title defect under the PSA. If the value of the title defect falls below the stated threshold amount, it is not a title defect within the meaning of the agreement. If the threshold is met, however, the *entire value* of the defect qualifies for recoupment, subject to a title defect deductible, if any. A single title defect might affect multiple leases. The value of the defect as calculated against one or more of the affected properties might not clear the threshold amount, while its value as calculated against all affected properties will do so. This occurrence will be a source of contention between the parties unless the PSA specifies whether the threshold is to apply on an individual property basis (preferred by seller) or an aggregate basis (preferred by buyer).[75]

A title defect deductible comes into play after all title defects exceeding the title deductible threshold, if any such threshold exists, have been added together. For buyer to receive a reduction in the purchase price, the cumulative value of all qualifying defects must exceed the deductible, which is usually expressed as a percentage of the total purchase price. Buyer will receive a purchase price adjustment only for the amount *over and above* the deductible. Where the

[75] See Richardson, *supra* note 68, at 21-22; Heasley & Wildes, *supra* note 69, at 35.

deductible is expressed as a percentage of the purchase price, the total purchase price used to calculate the monetary value of the deductible should not include the allocated value of properties that are excluded from the sale due to an outstanding preferential right/third party consent or at the election of seller.[76]

It is common for title defects and environmental defects to be lumped together, creating a single deductible larger than that which would exist for either category alone. This "basket deductible" might be advantageous to seller. If it is confident in its title or environmental, but not both, it essentially creates an inflated deductible as to the category in which serious defects are more likely to be discovered.[77]

***Allocated Value Schedule***

For a title defect to effectuate a purchase price adjustment, it is first necessary for the total unadjusted purchase price to be allocated amongst the assets in some manner. For producing assets, the value of each property is determined independently using some type of discounted cash flow model that considers, amongst other factors, the performance of existing wells and the quantity of proven reserves.[78] Each property is paired with its allocated value in a schedule attached to the PSA. By contrast, where the transaction concerns undeveloped acreage, the parties often arrive at the total unadjusted purchase price by a simpler method: multiplying the negotiated cost per-acre by the total number of net acres across all properties subject to the agreement. Each individual property is treated the same for the purpose of value allocation, the only difference between one property and another being their respective contributions of net acreage.[79] In either case, the cumulative title defect value of each property should be capped at the monetary value allocated to it.

The allocated value schedule deserves scrupulous attention to ensure seller's interest is accurately represented as of the execution date. (The section of the PSA containing seller's pre-closing covenants will address ownership changes occurring after the execution of the PSA.) In preparing the allocated value schedule, seller might correctly represent its present interest in a lease, well or unit while failing to account for the future reduction of such interest upon "payout" under an operating agreement, farmout agreement or other contract.[80] This omission of after payout ownership would give buyer a slam dunk title defect, as seller would have inaccurately represented the higher BPO net revenue interest as remaining intact for the entire duration of the

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[76] *Id.* A PSA might give seller the right to exclude a property subject to an alleged title defect if the seller disputes its validity. This right might be conditioned on the defect amount equaling or exceeding a certain percentage of the property's allocated value.

[77] See Richardson, *supra* note 68, at 23.

[78] *Id*. at 19-20.

[79] See Squibb, *supra* note 66, at 9.

[80] See Cummings, *supra* note 73, at 23.

lease. Seller could defeat this only if buyer had actual knowledge of the BPO/APO divide and the definition of permitted encumbrances, discussed below, included title defects known by seller prior to the execution of the PSA.

The allocated value schedule should also account for any differences in seller's interest as between producing wells or units and the undeveloped portions of the underlying lease(s). If seller's ownership varies between wellbore and PUD, each should be assigned a separate value. This will prevent confusion in calculating the value of a title defect.

***Defensible Title***

The definition of "Defensible Title" is tied to seller's ownership interest in each allocated value property. Thus, defensible title in relation to a specific leasehold property will mean: (i) seller is entitled to receive not less than the net revenue interest for such property represented in the applicable schedule to the PSA; (ii) seller is obligated to bear not more than the working interest for such property represented in said schedule; and (iii) except for the "Permitted Encumbrances," the property is free from all liens, encumbrances and defects. Where the applicable metric is acres, rather than WI & NRI, defensible title is judged in reference to the quantity of net acres specified in the PSA.

The definition of defensible title might also express a standard for determining whether the strength of seller's title is acceptable. In contrast to marketable title, which the Texas Title Examination Standards define as "record title that is free from reasonable doubt such that a prudent person, with knowledge of all salient facts and circumstances and their legal significance, would be willing to accept it,"[81] defensible title has no commonly accepted meaning, either legally or as a matter of industry custom.

Although marketable title is the watchword for title opinions, the incorporation of this standard into a PSA is not recommended. Most, if not all, of the title opinions and abstracts reviewed by buyer will evidence some degree of imperfection that renders seller's title unmarketable.[82] Also, the concept of marketable title, which looks at title *deducible of record*, will also fail to account for the various ways a seller's interest can be shaped by payments, agreements, orders, etc. not ordinarily evidenced in the county records. For example, if the assets include a lease subject to a joint operating agreement, seller's ownership schedule should account for any adjustments to seller's leasehold interest resulting from the non-consent status of itself or other working interest owners (showing both BPO and APO interests); however, this could not be gleaned from a review of the county records alone.

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[81] Texas Title Examination Standard § 2.10 (Vernon's 2018). See *Lund v. Emerson*, 204 S.W.2d 639, 641 (Tex. Civ. App. – Amarillo 1947, no writ.) (providing a more extensive definition of "marketable title").

[82] See Laughlin, *supra* note 8, at 6-19; Cummings, *supra* note 73, at 3.

**In order to prevent a flood of defects that relate to either insubstantial title defects, seller might push for a definition of Defensible Title that falls below marketable title—for example, title "which is deducible of record or evidenced by documentation which, although not constituting perfect, marketable title, is probable to be successfully defended if challenged."[83] At the very least, the PSA should expressly provide that Defensible Title, as defined therein, is not to be equated with marketable title.**

***Permitted Encumbrances***

A permitted encumbrance is a liability attached to a property which the parties have agreed cannot constitute a title defect or deprive seller of defensible title to the affected property. The precise list of permitted encumbrances will differ from agreement to agreement; however, the overarching purpose of this concept is to identify issues of a ubiquitous and noncontroversial nature that would be considered frivolous if asserted as title defects. Standard permitted encumbrances include, without limitation: royalties, production payments, reversionary interests and other burdens on production that do not reduce seller's net revenue interest below that stated in the applicable schedule[84]; liens that have been discharged prior to closing; liens for taxes not yet delinquent; easements, rights-of ways, surface leases and similar burdens on the surface estate that do not materially interfere with oil and gas development; sales contracts terminable by either party without penalty upon thirty day notice; rights reserved by or vested in government authorities; preferential rights of purchase that have been waived, or deemed waived, prior to closing; required third party consents that have been satisfied, or deemed satisfied, prior to closing; nonconsent penalties applied against seller's interest that have been reflected in the calculation of seller's interest in the applicable schedule; and rights of reassignment under oil and gas leases *to the extent not already triggered*.[85]

In various schedules attached to the PSA, seller will disclose certain types of encumbrances on the assets—litigation, material contracts, preferential rights of purchase and third party consents. These encumbrances are often addressed by other sections of the PSA, and thus should be included as permitted encumbrances to the extent necessary to prevent dissonance between the title defect mechanism and such other sections.[86] For example, the list of permitted encumbrances

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[83] Heasley & Wildes, *supra* note 69, at 30.

[84] For a sale based on net acreage, seller's net revenue interest will not be stated so the relevant permitted encumbrance should be defined as royalties and similar burdens on production that do not reduce seller's net revenue interest below an expressly stated level (e.g., 75%).

[85] The italicized language clarifies the preceding phrase will not encompass a partial termination under a pugh clause that has already occurred and causes seller to own less title than stated in the PSA. See Heasley & Wildes, *supra* note 69, at 33.

[86] See Josila Melton Dobbs & Debra J. Villareal, "Getting What You Paid For: Representations and Warranties," *Oil & Gas Agreements: Purchase and Sale Agreements*, Paper 10, Page Nos. 33-34 (Rocky Mt. Min. L. Fdn. 2016).

should include scheduled litigation if such litigation is also a retained liability covered by seller's post-closing obligation to indemnify buyer. If this were not done, buyer would have two non-exclusive avenues of redress for the same issue. Similarly, scheduled contracts should be included as permitted encumbrances to the extent the terms thereof do not cause a failure in seller's title or materially and adversely interfere with seller's ability to operate the assets. It is common for the section containing seller's representations to include a statement that, at least to seller's knowledge, the applicable schedule discloses all contracts defined as "material" and seller is not in default under any such contract; moreover, seller's representations will usually be incorporated into the conditions to close section, providing buyer with the walk rights in the event any such representation is immaterial as of the closing date and such inaccuracy meets some specified level of materiality.

The parties will likewise agree that certain title issues of a de minimis nature should be taken off the table. These are usually put under the rubric of permitted encumbrances (despite them not being encumbrances in a technical sense), but sometimes they are listed as separate carve outs from the definition of a title defect. The practical effect is the same in either scenario. Such title related-encumbrances pertain to issues frequently encountered in title examination which, although they might not satisfy a marketable title standard, do not pose significant risk to a purchaser absent evidence of a claim adverse to the purported title holder—e.g., the failure of a deed to recite a party's marital status; the absence of probate or heirship proceedings; the lack of a power of attorney or similar documentation establishing agency authority; and unreleased leases, production payments, etc. that have expired in accordance with their own terms. In the list of permitted encumbrances, these matters might be qualified by the following language, added to the end of each: "***unless the buyer provides affirmative evidence that this issue has resulted in another person's actual and superior claim of title to the allocated property***."[87] Moreover, seller might favor the following catch-all description: "***any other encumbrances, defects, or irregularities affecting the assets the enforcement of which is barred under applicable statutes of limitation, or that do not require the payment of money and are commonly waived by prudent purchasers of producing properties***."[88] However, buyer might object to the language "commonly waived by prudent purchasers" as overly vague.

The parties should also consider providing a carve-out for title defects that affect only non-target depths or formations.[89] Even where the PSA covers all depths, the real economic value of a lease or unit will lie in one or more formations, being those already produced by seller's wells or marked by buyer for future development. Seller should not be forced to discount a lease because

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[87] This language is based on PSA forms § 9.3 and § 9.8 of William B. Burford, 7 WEST'S TEXAS FORMS: MINERALS, OIL & GAS (Thomson Reuters, 2015).

[88] This language is discussed in Cummings, *supra* note 73, at 27.

[89] This suggestion is especially relevant in traditional plays like the Midland Basin, where depth severances resulting from either a horizontal "Pugh" clause in an oil and gas lease or an express depth limitation in an assignment are common.

of a title defect that will not impact buyer's bottom-line. This limitation can be imposed in various ways. As previously mentioned, the allocated value spreadsheet can allocate the total value of each property to the target depths, however defined. The same result can be achieved by including "insofar and only insofar [as to the target depths]" in definition of Defensible Title. Otherwise, permitted encumbrances could include any title defect that does not affect the target depths.[90]

To help ensure the title defect mechanism is the exclusive remedy for title defects, the list of permitted encumbrances should include title defects waived or deemed waived by the buyer—e.g., "***All Title Defects that Buyer has waived or released or is deemed to have waived or released pursuant to the terms of this Agreement.***"[91]

**Considering that a permitted encumbrance is ipso facto not a title defect and the title defect mechanism of the PSA is almost always buyer's sole tool to ensure it gets what it pays for, it is not surprising that permitted encumbrances can be a hotly contested aspect of the parties' negotiations—seller wanting more, buyer wanting fewer. Buyer should review seller's proposed list of permitted encumbrances with great care to ensure that nothing of a significant nature is included in the final, executed agreement. On the other hand, seller should seek to incorporate reasonable safeguards to disallow, insofar as possible, the assertion of unsubstantial title defects.**

[90] See Richardson, *supra* note 64, at 8. A third method is for the allocation schedule of the PSA to show the entire value of a given lease as allocated to the Target Formation(s).

[91] This language is based on PSA forms § 9.3 and § 9.8 of William B. Burford, 7 WEST'S TEXAS FORMS: MINERALS, OIL & GAS (Thomson Reuters, 2015).