Due Diligence in Oil and Gas Acquisitions

Aaron G. Carlson
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Aaron G. Carlson
Counsel, Noble Energy, Inc.,
Houston, TX

I. Introduction

Caveat Emptor: translation, let the buyer beware. Under this doctrine, the buyer cannot recover from the seller for defects affecting an asset. The historical application of caveat emptor gave rise to the need for due diligence. In simple terms, due diligence is a type of investigation. In the context of an oil and gas asset transaction, the process of due diligence is an investigation by which the buyer's initial assumptions regarding the condition and value of the assets are verified. If the buyer's initial assumptions prove incorrect, the buyer may be entitled to an adjustment, damages, termination or rescission.

Once the business decision has been made to pursue a transaction, the lawyer is often asked to plan and lead the due diligence process. The completion or closing of a transaction does not necessarily mean that the due diligence process was effective. An effective due diligence process may uncover defects which lead to the termination of the transaction. However, most transactions close and, while no two transactions are alike, most employ a very similar due diligence process.

This paper is written from the perspective of a lawyer working with the buyer on an oil and gas asset transaction. It provides an overview of the due diligence process from beginning to end. A discussion highlighting some of the features and differences of the due diligence process for an entity transaction is included for comparative purposes.

II. Initial Phase of Due Diligence

Much of the buyer's due diligence can and should be conducted before the execution of the purchase and sale agreement. The lawyer may be less involved during this phase of the process, but others should begin the process of gathering data. Data gathered and decisions made during the initial phase of the due diligence process can have a direct impact on the primary phase. The buyer will usually only lose options once the purchase and sale agreement is executed.

A. Sales Brochures

From the buyer's perspective, most oil and gas asset transactions begin with the screening of a "teaser" or sales brochure. The seller usually prepares the sales brochure with the assistance of an agent or broker.

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Sales brochures vary in content and sophistication but typically include the following:

(i) an executive summary;
(ii) maps of the area;
(iii) leasehold data;
(iv) production data;
(v) reserve data; and
(vi) marketing data.

The sales brochure will usually provide the buyer with enough data to decide whether a visit to the data room is justified. Most of this initial evaluation work will be conducted by the buyer’s business development personnel. Engineers are heavily involved in the evaluation process. They will usually consider the following factors to determine the value of the assets:

(i) discounted cash flows;
(ii) size of reserves;
(iii) transaction payout;
(iv) capital expenditure requirements;
(v) rate of return; and
(vi) price sensitivities.

The lawyer will rarely be involved at this point, but a quick review of the sales brochure may identify some early concerns of a legal nature.

B. Confidentiality Agreements

The execution of a confidentiality agreement is usually required before being granted access to the data room. As the name suggests, the confidentiality agreement imposes a duty of confidentiality on the buyer. The negotiation of this agreement should not be taken lightly because serious consequences can arise due to a breach of the agreement and the term of the agreement can extend for several years. This is usually the point at which the lawyer first gets involved.

The form of the confidentiality agreement is typically submitted by the seller or its broker and tends to follow a similar, “seller-friendly” format. From the buyer’s perspective, it is probably wise to tread lightly on the confidentiality agreement, but there are several issues the buyer should consider.

1. Term

The period of time that the buyer must hold or keep the data confidential should be reasonable. A term of one or two years is not uncommon and probably appropriate; however, longer or shorter terms may be appropriate depending on the circumstances. The burden should be on
the seller to prove the need for a longer term. In most cases, a confidentiality agreement without a stated term should not be accepted.

2. **Definition of Buyer**

As used in the confidentiality agreement, the definition of buyer should be broad enough to include the buyer and its affiliates and the officers, directors, employees, agents, advisors, consultants, lenders, lawyers and representatives of the buyer and its affiliates. The inclusion of a broad definition such as this may cause the seller to insist that the buyer assume responsibility for any breach of confidentiality committed by these additional parties. The seller may request that these parties execute or ratify the confidentiality agreement. However, this may be impractical as there may be numerous parties joining and leaving the due diligence team over an extended period of time.

3. **Definition of Confidential Data**

In an effort to gain as much protection as possible, the seller will want the definition of confidential data to be very broad. The following definition for confidential data was obtained from a more “seller-friendly” form of confidentiality agreement:

Confidential data means all data relating to the transaction disclosed to the buyer by the seller, including any business, technical, marketing, financial or other data, whether in electronic, oral or written form, and all notes, analyses, compilations, studies or other documents prepared by seller which contain or reflect such data. The contents or existence of discussions or negotiations related to the transaction shall also constitute confidential data.

Although broad, a definition such as the above may be reasonable if appropriate exclusions are included.

4. **Exclusions from the Definition of Confidential Data**

Describing the types or categories of data to be excluded from the definition of confidential data is important. Generally accepted exclusions apply to data that:

(i) is or becomes part of the public domain other than as a result of disclosure by buyer;

(ii) is made available to buyer on a non-confidential basis from a source other than seller;

(iii) was in buyer’s possession prior to disclosure of same by seller; and

(iv) can be shown by buyer to have been independently developed by buyer.

In addition to these exclusions, the buyer will often seek to include a “mental impressions exclusion” such as the following:

The buyer is engaged in the oil and gas business and does not wish
to restrict its right to compete in that business by virtue of having reviewed the confidential data. It is acknowledged that any person who receives the confidential data may thereafter have some recollections of portions thereof and it is accordingly acknowledged and agreed that no such recollections shall be regarded as a prohibited use of the confidential data under this agreement.

During the data room visit, it is likely that the buyer will form mental impressions about the assets and their development. Recognizing that the buyer cannot simply erase its mind of these impressions, the inclusion of a clause such as the foregoing provides the buyer with protection against a seller arguing that the use of such impressions constitute a breach of the confidentiality agreement. Few confidentiality agreements will initially contain this type of clause, but it is one worth negotiating for.

5. **Representation and Warranty Regarding Disclosure**

Another rare clause is one whereby the seller represents and warrants that it has the ability to disclose the confidential data without violating the rights of or obligations to any third parties. The following is an example of this type of clause:

Seller represents and warrants to buyer that it has the right to disclose the confidential data under the terms and conditions of this agreement without violating the legal rights of, or its contractual obligations to, any third party.

The inclusion of this clause will protect the buyer in the event the seller improperly discloses confidential third party data. The buyer should be uneasy if the seller is unwilling to include such a clause.

6. **Areas of Mutual Interest**

An area of mutual interest or AMI provision tends to be more common on smaller asset transactions. In the context of a confidentiality agreement, an AMI provision typically requires the party bound by the AMI (in this case the buyer) to reassign all or a part of any interest acquired within a defined geographical area. Most AMI provisions require reimbursement for acquisition and out-of-pocket expenses. If presented with an AMI, the lawyer should ensure that:

(i) the term of the AMI is reasonable;
(ii) the AMI does not conflict with any of the buyer's current ownership positions;
(iii) the AMI does not apply to an entity based transaction; and
(iv) the AMI does not cover an unreasonably large geographic area.
C. Data Room Visit

Today's data room may be a room full of documents and evaluations or, more likely, a virtual data room hosted on a password protected web site. Whether traditional or virtual, a data room will contain the same type of data contained in the brochure but in greater detail. The data room will often contain more sensitive and even proprietary data, which can now be disclosed because the buyer has executed a confidentiality agreement. Depending on the nature of the transaction, possible visitors to the data room include engineers, geologists, landmen, lawyers, accountants, marketing personnel and environmental specialists.

An information memorandum is usually provided to the buyer during the data room visit. The information memorandum is important because it typically outlines the bidding procedure and provides a timeline for the transaction. The lawyer should obtain a copy of the information memorandum and calendar any critical dates.

While the lawyer rarely visits the data room at this point, it may be useful to obtain feedback from those that do. This can help the lawyer plan for the later stages of the due diligence process. If the data room is of the virtual variety, the lawyer can view the material posted on the web site. The lawyer may spot a major problem even at this early stage. Although it may be premature to start formal due diligence at this point, there are a few things the lawyer may want to consider in an informal fashion.

D. Lawyer's Informal Investigation

Concurrent with the pre-bid visit to the data room, the lawyer can gather information about the seller on the internet. If the seller is a large public company, a wealth of information can be found on the internet including:

(i) SEC filings (including information regarding the seller's previous transactions);
(ii) news articles;
(iii) press releases (available on the seller's web site);
(iv) annual reports (available on the seller's web site); and
(v) litigation history.

It can be difficult to find information regarding small or privately held companies. If this is the case, consider obtaining a credit report or searching the internet for data about the seller's principals. The buyer will certainly want to know if it is about to enter into a transaction with an unsavory seller.

E. Purchase and Sale Agreement

The form of the purchase and sale agreement is usually provided to the buyer with the information memorandum. The information memo-
randum typically instructs the buyer to include any comments to the purchase and sale agreement with its bid; the idea being that a heavily revised or "marked-up" purchase and sale agreement will result in lost value for the seller. Receiving the bid and the revised purchase and sale agreement together allows the seller to compare competing bids more effectively.

A thorough discussion of the purchase and sale agreement is beyond the scope of this paper, but some discussion is warranted since the purchase and sale agreement can have a direct impact on the due diligence process as it will determine the scope of diligence and set forth the mechanics for any purchase price adjustments due to title and/or environmental defects. Key to the due diligence process will be the thresholds and levels of materiality established by the defect mechanisms. These thresholds and levels will dictate where the buyer will focus its due diligence efforts.

The purchase and sale agreement will also establish the defect notice submittal date. This date usually coincides with the end of the due diligence period. The defect notice submittal date is one of the most critical dates of the transaction. The lawyer should calendar this date in red and design the due diligence process around it. Each individual working on the transaction must be aware of this date.

F. Bid Submittal

As noted above, the seller may require the buyer to provide comments to the purchase and sale agreement with the bid submittal. The buyer should avoid this if possible especially if the bid is not on an exclusive basis. If the seller insists on comments, the buyer should be as general as possible while reserving the right to make changes. In any event, the buyer should not agree to:

(i) due diligence with an unreasonably limited scope;
(ii) an unreasonably short examination period; or
(iii) inequitable or unworkable title and environmental defects mechanisms.

The buyer's bargaining position in this regard will be much improved when it is dealing with the seller on an exclusive basis.

III. Primary Phase of Due Diligence

A. Assembling and Managing the Due Diligence Team

1. **Team Members**

The buyer's due diligence team is initially comprised of the few individuals involved during the review and evaluation of the sales brochure and will grow from that point. As discussed above, the lawyer typically gets involved at the point the confidentiality agreement is executed. By the time the data room visit takes place, numerous in-house personnel
may be involved such as engineers, geologists, landmen, lawyers, accountants, marketing personnel, and environmental specialists. If the transaction looks promising, tax specialists and human resources personnel may also be asked to join the team.

As the level of activity increases, it may be necessary to bring in outside consultants to help with the work. This is particularly true in the land and environmental assessment areas. Outside legal assistance may also be required. Whether in-house or outside consultants, each team member must coordinate with the other team members. There is always too much ground to cover and never enough time. Overlap and redundancy must be kept to a minimum.

2. Due Diligence Checklist

The due diligence checklist is the backbone of the due diligence process. It guides the lawyer and the due diligence team through the process. Much of this paper is simply a discussion of or an expansion on the many different areas covered by the due diligence checklist.

The preparation of the due diligence checklist is usually left to the lawyer. A search of CLE articles or the internet will yield numerous forms. The lawyer can begin with one of these checklists and tailor it to fit the specifics of the transaction. It will also be necessary to modify the checklist as the due diligence effort progresses. A well prepared and carefully followed checklist will result in a successful due diligence effort. A sample due diligence checklist for an oil and gas asset transaction is attached hereto as Appendix A.

3. Gate Keepers and Data Logs

As the diligence process moves forward and the team begins to take shape, the buyer and the seller should each appoint a “gate keeper” or point person. All data requests and responses should go through these individuals. Each point person should maintain a data log documenting data requests and responses. The data log can prove time consuming to maintain and may cause delays in data exchanges, but its evidentiary value can be very helpful especially if the seller is unresponsive and the end of the examination period is nearing. The buyer may be able to point to delays evidenced in the data log to help support an argument for an extension of time.

4. Working Lists

Another helpful tool is the working list which sets forth the name and contact information for each team member of both the buyer and the seller. It is important that the list be updated as team members are added. Unfortunately, it will probably be necessary to provide alternate contact information for the team members such as home and cell telephone numbers since the team members will be working late nights and weekends until the transaction is closed.
The working list can also help maintain confidentiality. The buyer and the seller will usually have internal confidentiality concerns. Knowledge of the transaction is usually on a "need to know" basis only. The working list identifies every member of the team thereby minimizing the chance of inadvertent disclosures. The working list can also help ensure compliance with the confidentiality agreement by identifying the individuals that might need to execute or ratify the confidentiality agreement.

B. Data Request Letter

The data request letter should be presented to the seller at the time the purchase and sale agreement is executed. It puts the seller on notice as to the types and categories of data the buyer needs to review. A copy of the data request letter should be attached to the data log. The lawyer should review the data request letter to ensure that it specifies that the request may not be complete and that the buyer is reserving the right to amend it.

C. Areas of Diligence

1. Engineering

As discussed above, the engineers have been involved in the due diligence process since the buyer first received the sales brochure. Prior to the submittal of the bid, the engineers and other data room participants were busy arriving at a value or purchase price for the assets. The engineers will continue to refine the valuation as economic conditions change and new data becomes available through the due diligence process. This work will continue right up to closing.

In many cases, the engineers will be responsible for determining the purchase price allocation for the assets. The results of this allocation are included on a schedule attached to the purchase and sale agreement. As the name suggests, the allocation of the purchase price is the process by which the total purchase price is allocated or distributed across all the assets in the transaction. Data uncovered during the initial phase of the due diligence process is used to complete the purchase price allocation. Most purchase and sale agreements require a purchase price allocation to address valuation issues concerning:

(i) title and environmental defects;
(ii) casualty loss; and
(iii) preferential rights of purchase.

Preferential rights of purchase usually cause the most controversy. Disputes may arise over the purchase price allocation and its impact on a party seeking to exercise a preferential right of purchase. It may be prudent to have the purchase price allocation prepared by an individual unfamiliar with the preferential rights of purchase and the assets they affect.
The engineers also help with the operational and facilities evaluation of the assets. They need to understand how the product is gathered, processed/treated, transported and ultimately sold. The engineers will inspect the facilities to ensure that all major equipment is in good repair and all inventories are verified. They will also verify that all asset retirement obligations are fully understood. Incorrect assumptions regarding these obligations can negatively impact the economics of the transaction.

The engineers working on this aspect of the due diligence process must promptly communicate problem areas to the other members of the team. A defect or issue may qualify for an adjustment under the purchase and sale agreement or may be a breach of a covenant requiring the seller to operate the assets to a specified standard. Failure to timely raise a defect or issue may constitute a waiver.

2. Land

In the context of an oil and gas asset transaction, land due diligence is usually the broadest and most time consuming part of the process. Although the lawyer will be involved, most of this work is performed by the buyer’s in-house and consulting landmen. The primary goal of land due diligence includes verifying that:

(i) the seller is entitled to receive a stated share or percentage of revenue;

(ii) the seller is not bearing expenses in excess of a stated share or percentage;

(iii) there are no unpermitted encumbrances affecting the assets; and

(iv) the assets have been maintained in accordance with all legal and contractual obligations.

Before beginning the land due diligence process, the buyer’s landmen will need to develop a list of the assets ranked by value. The value ranking will help keep efforts focused on the more valuable assets. If financing is involved, most lenders require title verification on eighty percent of the total value of the assets. This sounds onerous, but, as a rule of thumb, eighty percent of the aggregate value is concentrated in twenty percent of the assets. Additional assets can be reviewed as time and resources permit. Once the value ranking is available, the land due diligence can begin. It will take place on two fronts, inside the seller’s offices and out in the field.

a. Internal File Review

The visit to the data room usually gives the buyer’s landmen a preview of what they can expect to find in the seller’s offices. The landmen conducting this portion of the due diligence process should develop a form of title report, which will serve as the basis for the internal file review. When developing the form of title report, the landmen should con-
sider the data they gleaned from their visit to the data room and what type of data the lawyer may require. Like the due diligence checklist discussed above, the form of title report must be tailored to fit the transaction. At a minimum, the form should contain the following:

(i) asset value rank;
(ii) asset identification with legal description;
(iii) the seller’s working and net revenue interests;
(iv) identity of operator;
(v) basic terms of the joint operating agreement;
(vi) unit data;
(vii) schedule of title opinions;
(viii) division order data;
(ix) material contacts such as farmouts;
(x) litigation or claims; and
(xi) obvious title defects.

The data necessary to prepare the title report will reside in a number of different files. The names will vary but most sellers maintain the following types of files:

(i) lease files;
(ii) well files;
(iii) title files;
(iv) contract files;
(v) division order files; and
(vi) transaction files.

At the risk of oversimplifying the task, this stage consists of the preparation of a title report for each asset based upon the data contained in the above-noted files. Material documents such as title opinions, joint operating agreements, unit declarations and farmout agreements should be attached to the report. At the end of the process, the lawyer will compare the results of the title report with the results of the field review.

b. Field Review

The field review involves an examination of the public records of the jurisdiction where the assets are located. Field landmen will examine the county, state, or federal records and prepare a runsheet listing all documents of title affecting an asset. Most runsheets are prepared from an examination of the official public records of the county clerk’s office. The runsheet is furnished to a title attorney for the preparation of a title opinion. In a perfect world, it would make more sense to complete the review of the seller’s internal files before going out to the field. However, time is usually short, requiring both stages to be executed in paral-
lel. In fact, the field work requires more time to complete and should be the priority if resources are scarce.

The field review is more difficult to manage because of logistical and human resource challenges. Some oil and gas asset transactions cover multiple counties and states requiring the management of numerous landmen and title attorneys, assuming title opinions will be prepared. In today's market, it is difficult to locate and recruit experienced field landmen and title attorneys, so the search should begin early.

The lawyer must ensure that the field landmen get started as quickly as possible but not without direction. Runsheets should be prepared on assets in the order of their appearance on the value ranking, and the form of runsheet, like the form of title report, should be decided upon in advance.

While the field landmen are in the process of preparing the runsheets, the title attorneys should start their work by reviewing all available documents. The title attorneys should be familiar with the lease schedules attached to the purchase and sale agreement and plats and legal descriptions of the assets. The title attorneys should also review any title opinions discovered during the internal review.

The form of title opinion should be decided upon before the runsheets arrive. If a lender is involved, it should approve the form. In most transactions where a lender is involved, the title opinion is addressed to and for the benefit of the lender even though the buyer pays for it. This is the practice because lenders require privity of contract with the title attorney.

The title attorneys should begin preparing the title opinions as soon as the first runsheets are completed. The buyer should be informed of any major title defects as they are uncovered. The field landmen and title attorneys should work together to cure these defects if possible. If they cannot be easily cured, they should be added to the buyer's defect notice. As the title opinions are completed, the results should be cross-checked with the title reports produced during the internal review. Any discrepancies should be reconciled. Due to the lapse of time between the cut-off date of the runsheets and the closing date, the buyer or its lender may insist that the public records be verified right up to closing. This is accomplished by having landmen stationed in the field as closing occurs.

3. Legal

Legal due diligence is closely related to land due diligence and is primarily concerned with title opinion review, pending or threatened lawsuits and regulatory matters. These areas are usually covered to some degree during land due diligence. In fact, much of the data required for the legal due diligence will come from the individuals conducting the land due diligence.
One of the first decisions the lawyer should make is whether to have title opinions prepared. Factors influencing this decision include:

(i) the value of the transaction;
(ii) the number of assets;
(iii) the buyer’s familiarity with the assets; and
(iv) the requirements of the buyer’s lender (if involved).

If the decision to prepare title opinions has been made, the lawyer may need to analyze the title issues set forth in the opinions in the context of the title defects mechanics of the purchase and sale agreement. The lawyer may also be required to make decisions regarding the waiving or curing of title defects.

As part of the legal due diligence, the lawyer should prepare a schedule of all lawsuits and threatened lawsuits associated with the assets. This schedule should include:

(i) the lawsuit or matter name;
(ii) the type of controversy;
(iii) the jurisdiction where the lawsuit or matter is pending;
(iv) the amount in controversy;
(v) whether insurance coverage is available; and
(vi) the name of counsel, if any.

It may take some probing to identify all threatened litigation as evidence of these matters may be located in various correspondence files. All correspondence provided to outside auditors regarding the liability associated with lawsuits and threatened lawsuits should also be reviewed, as well as any settlements and judgments to determine how the future operations of the assets might be impacted.

Regulatory requirements can prove difficult to maneuver due to complexity and jurisdictional differences. In some cases the sequence of applications can be critical. Getting an early start is a good idea because substantial time will be spent waiting on others to process paperwork. Closing can be delayed because bonding and permitting requirements can prevent the transfer of ownership and the ability to operate an asset.

4. Accounting

Financial due diligence is conducted by the buyer’s in-house accounting personnel and financial consultants and includes an investigation into the following:

(i) working interest expenses;
(ii) net revenue receipts;
(iii) royalty payments;
(iv) ad valorem, production and severance tax payments;
(v) well payout status;  
(vi) gas imbalances; and  
(vii) suspense accounts.

A report should be prepared outlining any discrepancies between the working and net revenue interests the seller represents in the purchase and sale agreement and that which can be verified by the joint interest billings and the revenue decks. This report should be cross-checked with the results of the working and net revenue interests set forth in the title report.

Verifying that the seller is current on all royalty and tax payments is a relatively straightforward although time consuming exercise. The results of this investigation should be compared with the litigation and lien search conducted during the legal due diligence. Royalty litigation and tax liens may confirm issues uncovered by the accountants during the accounting due diligence. All royalty owner correspondence files should be reviewed to learn of any royalty disputes.

The status of well payouts should be examined carefully. The seller is usually asked to prepare a well payout schedule. From this schedule the buyer should verify the following:

(i) before and after payout decimal interests;  
(ii) the percentage of any non-consent penalty; and  
(iii) the payout balance.

Inaccurate well payout records can have a significant negative impact on future revenues.

The buyer's marketing personnel are frequently asked to help the accounting personnel review the seller's gas imbalance position. This area of the accounting due diligence is important since large liabilities can result if the seller is in an overproduced position. Conversely, the seller may be in an underproduced position and mischaracterize this as a meaningful accounts receivable when in fact it is not.

Both overproduced and underproduced positions should be examined for each well. The applicable joint operating agreement or gas balancing agreement for each well should be reviewed to determine the seller's true position. These agreements are not always clearly drawn making it difficult to place a value on an imbalance. Such being the case, the buyer may wish to take a conservative position and assume that it will pay for all overproduced volumes at current (higher) prices and further assume that it will not receive compensation for the underproduced volumes.

Finally, the seller's suspense accounts should be reviewed. As part of this process, the buyer should verify that:

(i) the seller's internal control of the suspense accounts is sound;
(ii) all necessary unclaimed asset reports have been filed;
(iii) all required payments have been made;
(iv) the production cut-off dates conform with state reporting re-
quirements; and
(v) verify that multiple asset suspense accounts are properly allo-
cated between sold and retained assets.
This review will help avoid an assumption of liability under unclaimed
asset laws.

5. Environmental

Environmental due diligence has grown increasingly important over
the last couple decades due to the implementation and enforcement of
stricter environmental laws. The discovery of a single environmental
problem can doom an entire transaction. To make matters worse, the
greatest environmental liabilities are often associated with lower valued
assets. Realizing this, the environmental personnel should conduct their
review accordingly.

The level of due diligence required will be dictated by the nature of
the assets. Older oil assets require more scrutiny than newer gas assets.
Spills occur on even the best operated assets. The difference is usually
the manner in which the spills are addressed. The environmental due
diligence personnel will quickly get a sense of what type of operator the
seller is. This will shape the balance of the review. It should also be
noted that permitting and reporting issues encountered during environ-
mental due diligence may be as significant, if not more so, than physical
environmental conditions.

At a minimum, the buyer should insist on the right to conduct a
Phase One Environmental Assessment on the assets. This should be ex-
pressly provided for in the purchase and sale agreement. A Phase One
Environmental Assessment typically includes:

(i) a physical inspection of the assets;
(ii) interviews with persons having knowledge about the assets;
(iii) review of state and federal lists of known contaminated sites,
hazardous materials users, and spills;
(iv) an evaluation of nearby oil and gas operations for their poten-
tial to affect the assets;
(v) an interpretation of topographic maps and aerial photographs;
(vi) review of any existing environmental documents for the assets;
and
(vii) an examination of the current and past use of the assets.

The Phase One Environmental Assessment is usually conducted by
a consultant and provides a general overview of the environmental condi-
tion and history of the assets with an emphasis placed on uncovering the presence of any hazardous materials. It does not include the taking of core or ground water samples. These are taken and analyzed as part of a Phase Two Environmental Assessment. Unless the Phase One Environmental Assessment uncovers a problem, most purchase and sale agreements will not permit a Phase Two Environmental Assessment. If a Phase Two Environmental Assessment is conducted, the buyer will usually have to agree to take split samples (with one going to the seller) and to keep the test results confidential (subject to any mandatory disclosure requirements).

6. *Marketing*

As discussed above, the buyer's marketing personnel will frequently help the accounting personnel examine the seller's gas imbalance position. In addition, the marketing personnel will help identify liabilities associated with transportation, storage, processing and marketing contracts. Many of these contracts are terminable upon thirty, sixty or ninety days notice and rarely present a problem. Contracts with longer terms can be problematic, particularly if the seller committed to long term contracts with unfavorable rates or sometimes worse, rate redeterminations and escalators. Contracts such as these can negatively impact the overall economics of the transaction.

In the event the buyer is anticipating new or increased gas production, the marketing personnel must determine if economical gas transportation is available. Securing pipeline capacity can be challenging and expensive in many regions of the country. This is especially true for poor quality gas. Gas containing carbon dioxide, hydrogen sulfide and/or water may require expensive processing and treating before entering a pipeline. Incorrect assumptions regarding the availability and cost of gas transportation can have a major impact on the transaction.

D. *Defects Notice*

As discussed above, the purchase and sale agreement will establish the deadline for submitting the defect notice. The lawyer should be involved in this process to ensure that the defects notice complies with the requirements set forth in the purchase and sale agreement. All team members must submit their reports timely so that all qualifying defects can be included in the notice.

E. *Hart Scott Rodino*

Larger transactions may be subject to the Hart Scott Rodino Antitrust Improvements Act of 1976. The lawyer must analyze the transaction to determine if it is subject to the Act's filing requirement. A filing will be required if the value of the transaction and, in some cases, the size of either the buyer or the seller, exceed certain thresholds. These
thresholds change periodically requiring the lawyer to research the current filing thresholds.

If a filing is required under the Act, the buyer and seller must each complete and file a “Notification and Report Form” with the U. S. Federal Trade Commission and the U. S. Department of Justice. The filings will describe the business of each party and the nature of the transaction. Along with the filings, each party will be required to include all studies, reports, surveys and analyses that were prepared for the purpose of evaluating the transaction with respect to market shares, competition, future sales or expansion into other markets. Gathering these documents can be the most time consuming part of the process. Once the filing is made a waiting period begins during which time the agencies determine if the transaction violates antitrust laws. Most oil and gas transactions pass through this process without any opposition from the agencies.

iv. Entity Transaction

As opposed to an asset transaction discussed thus far, some oil and gas transactions are conducted at the entity level. This typically involves a merger between two companies or a stock purchase. Entity transactions require a slightly different approach to the due diligence process. In addition to the areas previously discussed, the lawyer should also investigate the entity’s:

(i) structure;
(ii) ownership and control; and
(iii) employment practices.

As mentioned above, a wealth of data can be found on the internet if the entity is a large public company. This is an inexpensive, time efficient way for the lawyer to quickly gather data. Like an asset transaction, a due diligence checklist is also critical to a successful entity transaction. A sample due diligence checklist for an entity transaction is attached hereto as Appendix B.

A. Structure

The lawyer should review all documents related to the creation and organization of the entity. Much of the data necessary to understand the organization of the entity can be obtained from the internet. Data relevant to the entity’s organization not available on the internet will have to be obtained from either the data room or the offices of the entity. Regardless of the source, the lawyer should:

(i) determine the entity’s jurisdiction of formation;
(ii) verify good standing;
(iii) identify all jurisdictions where the entity is qualified to conduct business;
(iv) review the articles of incorporation, by-laws and charter;
(v) review the minute books for at least the last five years;
(vi) identify the entity's directors and officers;
(vii) locate organizational charts; and
(viii) understand any parent and subsidiary relationships.

The lawyer should prepare a data sheet summarizing this data.

B. Ownership and Control

Data concerning the entity's ownership and control will generally not be available on the internet. The lawyer will need to search the data room or the entity's offices for this data. As part of this effort, the lawyer should:

(i) examine the entity's capitalization including all capital stock, convertible securities, options and warrants;
(ii) review stock ledgers;
(iii) review any change of control agreements; and
(iv) obtain copies of voting agreements, stockholder agreements, proxies, transfer restriction agreements, rights of first refusal and registration agreements.

Understanding the entity's ownership and control is crucial because some of its features may make it difficult, or in some cases impossible, to conclude the transaction as originally contemplated.

C. Employment Practices

The lawyer should review all data relating to the entity's employees, officers and directors. This data will be located in the data room, the entity's offices or, in some cases, district and field offices. To complete the employment practices portion of due diligence, the lawyer should:

(i) examine all pension, profit sharing, stock bonus, ESOPs and health plans;
(ii) examine all employment contracts, material consulting agreements, severance agreements, and non-compete agreements;
(iii) review the entity's code of conduct;
(iv) obtain a copy of the employee handbook; and
(v) identify any current or potential labor disputes.

Understanding the entity's employment policies, plans and practices is vital and usually requires legal specialization beyond that of the typical transactional lawyer. For that reason, it may be necessary to enlist the help of employment law experts. An investigation into the foregoing areas can reveal significant impairments and liabilities.

V. Conclusion

As hectic and overwhelming as the due diligence process can be, it eventually comes to an end. The process leaves behind it a mountain of
documents, notes and reports that no one really knows what to do with. All of it will eventually be filed away and forgotten about until a problem surfaces, usually years later. The buyer invariably wishes it had more time to look at everything on the checklist, but feels comfortable that all the important areas were covered. The seller is exhausted from the buyer’s endless barrage of questions and unrelenting prying and now realizes how little it knew about the assets it just sold. Upon reflection, the process went well and both parties are relatively pleased. There were likely a few problems and surprises along the way, but usually nothing that a motivated buyer and seller could not solve.

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APPENDIX A
ASSET TRANSACTION
DUE DILIGENCE CHECKLIST

I. ENGINEERING
A. Geological/geophysical data
   1. Location identification
   2. Maps (base maps and Isopach maps)
   3. Seismic lines
B. Engineering data
   1. Reservoir studies
   2. Reserve figures by category
      a. Proved developed producing (PDP)
      b. Proved developed non-producing (PDNP)
      c. Proved undeveloped (PUD)
      d. Possible
      e. Probable
   3. Production data (gas/oil/water)
      a. By zone
      b. Monthly historical
      c. Cumulative
      d. Number of days on production by month
      e. Pipeline or gathering system pressure
      f. BTU content
   4. Drilling and completion history
   5. Workover history
   6. Well logs
   7. Well test data
   8. Operator listing by property
   9. Operating costs
  10. Cash flow

II. LAND/LEGAL
A. Working interest (WI)
   1. WI represented by seller
   2. WI from joint interest billing
   3. WI from engineering report
   4. WI from title opinion
B. Net revenue interest (NRI)
   1. NRI represented by seller
   2. NRI from title opinion
   3. NRI from revenue decks
   4. NRI from division orders
   5. NRI from engineering report
C. Seller’s lease files
1. Type of lease
   a. Fee
   b. State
   c. Federal

2. Lease status
   a. Rental/paid-up/HBP
   b. Expiration date

3. Lease data:
   a. Lessor
   b. Lessee
   c. Lease dated
   d. Lease recorded
   e. Legal description
   f. Consent to assign
   g. Pooling
   h. Pugh clause
   i. Shut-in clause
   j. Rentals
   k. Royalty

D. Division orders
   1. Purchaser of oil/gas
   2. Seller making distribution
   3. DO basis – tract/unit
   4. Preparation of letters in lieu

E. Contracts
   1. JOA
      a. Form
      b. Current operator
      c. Lands covered
      d. AMI
      e. Preferential right
      f. Maintenance of uniform interest
      g. Cash calls
      h. Gas balancing agreement
      i. Call on production
      j. Non-consent penalty
      k. COPAS
      l. Change of operator
   2. Farmouts/farmins
      a. Parties
      b. Terms
      c. BPO & APO interests
      d. Current status of payout
      e. Consent to assign
      f. Drilling or other obligation
3. Exploration/joint venture agreements
   a. Lands covered
   b.AMI
   c. Current parties
   d. Obligations
   e. Other

4. ROWS, easements & permits
   a. Parties
   b. Legal description
   c. Rental due
   d. Consent to assign

5. Unit agreements
   a. Type
   b. Lands covered
   c. Effective date

6. Communitization agreements
   a. Lands covered
   b. Effective date

F. Land well files
   1. Verify operator
   2. Status of well
   3. Type of well (oil/gas)

G. Leins/lis pendens
   1. Type
   2. Parties
   3. When filed

H. Mortgages/deeds of trust
   1. Parties
   2. Amount
   3. Due date

I. UCC financing statements
   1. Parties
   2. What is covered
   3. Date of filing

J. Reviews for surface acquisition
   1. Type
      a. Drillsite
      b. Plant site
      c. Road ROW
      d. Pipeline ROW
      e. Power line ROW
      f. Disposal well
      g. Water source well
      h. Agricultural tract
i. Industrial tract
j. Residential tract
k. Other

2. Surface ownership
   a. 100% fee simple
   b. Joint tenancy
   c. Adverse possession

3. Encumbrances
   a. Liens
   b. Mortgages/deeds of trust
   c. UCC financing statements

K. Review of surface use restrictions
   1. Leases
      a. Oil & gas lease
      b. Agricultural
      c. Residential
      d. Other
   2. Access
      a. Limitations
      b. Maintenance
      c. Need permit to cross

3. Non-drilling areas
4. Subject to ROW or easements
5. Zoning regulations

L. Review pending and threatened litigation
   1. Style of case and cause number
   2. Jurisdiction
   3. Parties
   4. Properties involved
   5. Amount in controversy
   6. Status

M. Review of regulatory matters
   1. Required bonds, permits, licenses
   2. Required pre-closing governmental approvals

III. ACCOUNTING
A. Review of the following materials
   1. Joint interest billings for WI
   2. Lease operating expenses
   3. Revenue decks for NRI
   4. Gas balancing statements
   5. Transportation agreements
   6. Processing agreements
   7. Gas sales agreements
   8. Oil sales agreements
   9. Payout statements
10. Tax payments
   a. Ad valorem
   b. Production/severance

B. Preparation of interest discrepancy report

IV. ENVIRONMENTAL
A. Phase One Environmental Assessment (Phase Two if necessary)
B. Records in relevant state and federal agencies to assure no pending actions or proceedings
C. Compliance with federal statutes
   1. CERCLA
   2. RCRA
   3. Clean Water Act
   4. Oil Pollution Act of 1990
   5. Safe Drinking Water Act
D. Compliance with relevant state statutes
E. NORM

V. OPERATIONAL
A. Physical inspection of properties and discussions with field personnel to assure equipment is in good working order and to assure there are no other anomalies
B. Preparation of equipment inventory and valuation of same
C. Review existing and potential asset retirement obligations
D. Review pending operations including all JOA’s and all outstanding AFE’s

VI. MARKETING
A. Review gas imbalance statements
B. Review gas balancing agreements
C. Review transportation/storage/processing agreements
D. Review gas sales agreements
E. Review oil sales agreements
F. Review sales agreements for other products

VII. OTHER DUE DILIGENCE AND CLOSING MATTERS
A. Change of operator
   1. Check all relevant state requirements
   2. Prepare resignation of operator letter for seller and all necessary consents for buyer to assume
B. Bonding
   1. Check all relevant state and federal requirements
   2. Coordinate with bonding agency and insurance carrier regarding changes in property ownership
C. Seismic data: consent to assign or proprietary
D. Notifications
File all necessary notices with state, federal, tribal and taxing agencies regarding the change of ownership and change of operatorship for the properties.

E. Letters-in-lieu of transfer orders

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APPENDIX B

CORPORATE TRANSACTION
DUE DILIGENCE CHECKLIST

I. ENTITY ORGANIZATION

A. Articles of incorporation and charter
B. By-laws
C. Minute books for stockholders, board of directors and other committee meetings
D. Stock books and stock transfer ledgers
E. Corporation organization charts
F. Change of ownership and voting agreements
G. Partnership or joint venture affiliates
H. Qualifications to do business
   1. Domestic
   2. Foreign
I. ESOP, stock bonus, option, shareholder or other agreements to issue shares with respect to seller or any subsidiary, and the aggregate number of shares subject thereto

II. ASSETS

A. Real properties
B. Personal property
   1. Lists of machinery and equipment
   2. Existence of chattel mortgages, financing statements, conditional sales contracts, or other liens.
   3. Leases, including automobiles, computer hardware and software, machinery, etc.
C. Intellectual property (patents, trademarks, copyrights, trade secrets)
   1. Schedule of patent registrations and applications identifying each patent by title, registration (application) number, date of registration (application) and country
   2. Schedule of trademark (service mark and trade dress) registrations and applications identifying each mark and including date of registration (application), registration (application) number, status, that is, registered, renewed, abandoned, Section 8 and 15 affidavits submitted, etc., and country or state where registered. In those instances where registration has not been sought, identify the mark, trade dress or trade name and its date of first use anywhere in the U.S.
3. Schedule of copyright registrations and applications identifying each copyright by title, registration number and date of registration
4. Manual or other written document detailing the procedures for maintaining the secrecy of trade secrets
5. Confidentiality agreements
6. Licensing agreements, merchandising agreements (naming seller as licensee or licensor) or assignments relating to patents, technology, trade secrets, trademarks (service marks), trade dress and copyrights
7. Communications to or from third parties relating to the validity or infringement of seller’s patents, technology, trade secrets, trademarks (service marks), trade dress and copyrights
8. Studies or reports relating to the validity or value of seller’s patents, technology, trade secrets, trademarks (service marks), trade dress and copyrights and the licensing or merchandising thereof

D. Licenses:
1. Licenses, permits and registrations for operation of each of seller’s properties and/or facilities issued by federal, state, local or foreign authorities
2. Compliance with various acts and regulations including:
   a. The Occupational Safety and Health Act.
   b. The Environmental Protection Act
   c. The Employee Retirement Income Security Act of 1974, as amended
   d. Equal Employment Opportunities Act
   e. Labor practices regulation
   f. Special requirements for regulated industries
   g. The Age Discrimination in Employment Act of 1967, as amended
   h. Title VII of the Civil Rights Act of 1964, as amended

III. CONTRACTS AND COMMITMENTS
   A. Contracts with suppliers (long-term, open end, discount or quantity) and list of major suppliers
   B. Consulting contracts
   C. Loan agreements
   D. Encumbrances
   E. Mortgages, indentures, security agreements and guarantees
   F. Maintenance contracts

IV. INSURANCE
   A. General liability
   B. Fire, theft and other casualty
C. Workers’ Compensation
D. Unemployment
E. Life insurance
F. Insurance of key employees
G. All outstanding insurance claims
H. Agreements relating to indemnification

V. PENDING AND THREATENED CLAIMS AND LITIGATION
A. Complete litigation list of actions, suits and governmental or regulatory proceedings
B. Pending or threatened proceedings or investigations
C. Regulatory compliance
D. Labor disputes
E. Antitrust issues
   1. Any pending or threatened action, either governmental or private
   2. Any agreement with or requests by the FTC or Antitrust Division with respect to disposition of seller or its assets
   3. Any consent decrees or existing orders with respect to pricing, policy dispositions, or acquisitions

VI. TAXES
A. Federal, state, local and foreign income tax returns for latest closed and all open tax years
B. Material non-income tax returns (e.g., sales tax and real property tax) for prior three years
C. Audit and revenue agents’ reports for all tax audits pending or in progress
D. Settlement documents and any correspondence with taxing authorities for prior three years
E. Agreements extending time for filing tax returns or waiving statute of limitations
F. Powers of attorneys with respect to tax matters
G. All tax sharing agreements

VII. ENVIRONMENTAL
A. All current environmental permits, licenses and other authorizations, and all applications therefor, which are required under federal, state and local law, and in the case of national pollutant discharge elimination system permits, the permit immediately preceding the current one
B. All environmental studies and reports made in last five years, including audit or inspection reports, whether performed by or on behalf of seller, a governmental agency or others
C. All pollution control capital expenditure reports (including budget requests) for the last five years
D. All monitoring reports covering any hazardous substance, material or waste including, but not limited to, water discharges, consistent with all applicable laws, regulations and requirements.
(one year of underlying laboratory reports) sewer discharges and air emissions, and remedial investigation studies, corrective act on program reports and reports on tests of underground storage tanks, for the past five years

E. All correspondence with environmental regulatory authorities and all notices to and from environmental regulatory authorities including notices of violation, notices of spills, releases or discharges, and notices of deficiency over the past five years

F. All annual reports, manifests or other documents relating to hazardous waste or pesticide management over the past five years

G. All documents relating to clean up of hazardous substances, oil, pollutants or contaminants as those terms are defined in the National Oil and Hazardous Substances Pollution Contingency Plan, 40 C.F.R. § 300.6 at any facilities which seller owns or owned or at any facility at which seller has notice of or has reason to believe it may be required to pay for cleanup costs under federal or state statutes or the common law

H. All documents relating to equipment using PCBs, spills or PCBs or worker exposure to PCBs and all documents relating to the existence or removal of asbestos

I. All documents relating to civil, criminal or administrative actions, suits, demands, or citizens suit notices, claims, hearings or investigations concerning environmental issues

J. All documents submitted to environmental agencies or other governmental agencies pursuant to Title III of the Superfund Amendments and Reauthorization Act, and all similar findings required by state or local law

K. All documents relating to compliance with laws regulating underground storage tanks, including, but not limited to, all registration forms

L. Site and facility plans or maps

M. Any public records reflecting existing and recent environmental problems

VIII. EMPLOYMENT POLICIES AND PERSONNEL

A. Contracts with employees
   1. Management and employment agreements
   2. Confidentiality agreements
   3. Outstanding loans
   4. Employee handbooks and manuals

B. Policies
   1. Severance pay
   2. Moving expenses
   3. Vacation and holidays
   4. Tuition reimbursement
5. Salary review
6. Loans
7. Advances and expenses

C. Employee benefit plans, plan documents, and trust agreement for each of the following:
1. Pension program or retirement benefits
2. Profit sharing plan or bonus arrangements
3. Savings plan
4. Insurance
5. Medical, health and dental
6. Employee stock ownership
7. Deferred compensation
8. Death benefits
9. Individual or group bonus
10. Stock option arrangements
11. ESOP and stock bonus plans and arrangements

D. Labor history
1. Collective bargaining agreements
2. Requests for arbitration, grievance proceedings, etc. in labor disputes

E. OSHA and Workers’ Compensation history

F. Age, sex, disability, national origin and race discrimination claims