Legal services for oil and gas clients structured for the current environment

Since 1887, Thompson & Knight LLP has been at the forefront of groundbreaking litigation and transactions, counseling oil, gas and energy clients through highs and lows in the market. Our Oil, Gas and Energy Practice is supporting clients with strategic solutions to meet their changing legal needs. Presented here are four topics that address legal challenges caused by current market conditions.

How to handle legal liabilities in decommissioning

Downturns in the oil and gas industry often result in an increased focus on asset retirement obligations (ARO). For Federal leases in the Gulf of Mexico, the ARO is not limited to current lease owners. Former lessees are also jointly and severally liable to the U.S. government for plugging the wells and decommissioning the facilities that existed on the lease at the time of their ownership. Therefore, a former lessee may end up paying for the ARO tied to a working interest it never owned.

Bankruptcies in 2020 brought this issue to the forefront for many former lessees, who for years assumed they were protected by indemnities from their purchasers and ARO bonding required by the government. Turning to 2021, we are seeing more companies focusing on their ARO weak spots.

In the international sector, we foresee a heightened focus on decommissioning financial security arrangements. JOAs commonly contain obligations to put in place security at a certain point in time based on the projected future value of the field vs. projected decommissioning costs. We expect owners to commence a discussion on decommissioning security earlier than scheduled, given the plummeting Net Present Value of JV oil and gas interests. This process will be accelerated by asset divestments. As with the U.S., a number of jurisdictions place potential liability for decommissioning on previous asset holders, so those wishing to sell will want to ensure watertight security agreements are in place prior to any sale. Thompson & Knight can help limit your legal exposure during the decommissioning of your current and previous oil and gas assets.

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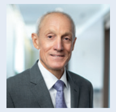

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Discussion of key considerations for water logistics companies and midstream service providers

Given the recent volatility in energy prices, exacerbated by the global economic uncertainty brought on by the COVID-19 pandemic, it is crucial that water logistics companies and other midstream service providers work closely with counsel when drafting midstream service contracts to help ensure such contracts are not executory, and thus subject to rejection in bankruptcy.

The Bankruptcy Code provides a mechanism for debtors to reject executory contracts, relieving the debtor from its future performance obligations thereunder and leaving the contractual counterparty with a prepetition claim against the debtor for breach of contract. The ability to reject contracts allows exploration and production debtors to restructure burdensome obligations, so water logistics companies and other midstream service providers should draft their contracts to guard against such contracts being deemed executory and thus subject to rejection in bankruptcy. Additionally, prior to acquiring a company or assets, conducting proper due diligence on the underlying contracts is necessary to ensure they are properly structured.

The Bankruptcy Code does not define "executory contract," but most courts hold that an executory contract is one under which both parties have unperformed obligations and where the failure of either party to complete performance would be a material breach excusing the performance of the other party. Importantly, contracts containing real property covenants that "run with the land" are generally not executory contracts that can be rejected. Thus, water logistics companies and other midstream services providers should carefully consider whether their agreements contain real property covenants running with the land.

As illustrated by the *In re Sabine Oil and Gas Corp.* line of court cases, the fact that a covenant in a contract purports to be one "running with the land" is not dispositive. The question of whether a covenant "runs with the land" is a fact-intensive matter that varies from state-to-state, and the legal principles guiding the inquiry are complex and may be unsettled. In Texas, for example, a covenant runs with the land and thus the related contract would *not* be deemed to be executory when (i) it touches and concerns the land, (ii) it relates to a thing in existence or specifically binds the parties and their assigns, (iii) the original parties intended it to run with the land and (iv) the successor to the burden has notice. In *Sabine*, for example, the court emphasized that the covenants at issue did not "touch and concern" the land, but were personal in nature, noting that the covenants concerned minerals extracted from the ground, and are thus deemed to be personal property under Texas law. Therefore, to ensure a covenant runs with the land, it is important when drafting to tie the covenant not to the produced water or minerals, but to the underlying real property. Given the fact-intensive nature of the issue, water logistics companies and other midstream service providers should work closely with counsel when drafting agreements to help ensure covenants run with the land and are not subject to rejection in bankruptcy.

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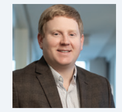
Attractive options in the use of DrillCos

Over the past several years, many operators have utilized a transaction structure called a "DrillCo" as a means of financing oil and gas operations. In a DrillCo, the parties do not actually form a new company – an operator contributes leasehold acreage, and an investor commits to fund the majority, or in some cases all, of the drilling and completion costs for a set group of wells. Often, the investor's capital commitment will be capped at a negotiated amount. In exchange for funding development costs, the investor receives a working interest in the underlying wells and/or leases. The working interest assigned to the investor is typically subject to a partial reversion to the operator upon the investor achieving a specified internal rate of return. Operators have looked to DrillCos as a means of developing acreage, while at the same time preserving cash flow and avoiding taking on additional debt. A DrillCo also allows the operator to retain the upside in wells via the reversionary interest. For the investor, there are advantages to the DrillCo structure, including the ability to deploy capital in specific, predetermined wells, which are usually within a tested prospect in a competitive basin. This structure also eliminates the need for investors to fund G&A expenses while the operator searches for prospects. Furthermore, the investor receives a real property interest, which will leave it better protected if the operator enters bankruptcy.

Commodity prices of late have had a chilling effect on transactions, including DrillCos. That said, we expect DrillCo transactions to remain popular in the future. As commodity prices improve and development ramps back up, we expect operators facing budget constraints to look to DrillCos as a means of offsetting the costs of development. The DrillCo's flexibility as an alternative to traditional debt or equity offerings will continue to present it as an attractive transaction structure for operators and investors alike. New technologies resulting in better well designs will require increased investment. Therefore, all sources of financing, including the DrillCo, will remain important.



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How to manage earnouts in acquisitions and divestitures

The 2020 drop in oil prices, resulting from a combination of actions by OPEC and the effect of the COVID-19 pandemic on demand, has significantly impacted the acquisition and divestiture of oil and gas assets. Given the uncertainty of commodity prices, sellers and buyers find it difficult to reach agreement on the valuation of assets. Sellers are concerned that prices will significantly increase after a sale, and therefore, they will have received far less than if they had waited a bit longer to sell. Buyers, on the other hand, do not want to overpay and want to price an acquisition based on commodity prices in effect at the time of the purchase. To help bridge this divide, sellers and buyers may include provisions for contingent consideration, often referred to as earnouts, in their purchase and sale agreements.

Earnouts are amounts that the buyer will pay the seller after the closing of an acquisition based on some future performance. Earnouts can be based on whatever timing and mechanism that the parties decide. For onshore transactions, earnouts are generally based on either commodity prices or operational milestones. Earnouts based on commodity prices tie the contingent payment to a published pricing metric over a period of time. If commodity prices increase over certain thresholds, the buyer pays the seller additional consideration. Earnouts based on operations attempt to capture the actual increase of value based on the development of the properties. Examples of operational earnouts include payments based on initial or increased production from certain wells or a reduction of costs.

Sometimes parties agree to geological earnouts. This type of contingent payment is generally seen in offshore transactions that involve assets still in the exploratory phase. With geological earnouts, the seller is able to benefit from the buyer undertaking operations to confirm agreed upon subsurface characteristics, such as the volume of hydrocarbons in place. Thompson & Knight can help you negotiate the most beneficial earnout within the specific circumstances of your transaction.

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