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Title Defect Issues in Purchase and Sale Agreements

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TITLE DEFECT ISSUES IN PURCHASE AND SALE AGREEMENTS

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I. INTRODUCTION AND SCOPE

This article will highlight a number of common issues pertaining to title matters that should be considered by parties in their negotiation and preparation of a Purchase and Sale Agreement ("PSA") for producing oil and gas properties. It will describe the areas that typically give rise to the most conflict or negotiation between the parties, and discuss some of the common solutions to these conflicts. It will also point out some common pitfalls, and offer some tips on provisions each party should consider including in the PSA.

Examples of title subjects discussed include Allocated Values, the in-house due diligence process, pref rights and consents, the concepts of Defensible Title, Permitted Encumbrances, and Title Defects, the Title Defect process, deductibles, walkaways, and warranties.

II. ALLOCATED VALUES

As a general rule, in theory, the aggregate Purchase Price is based on the net present value of the difference between the Buyer's share of the projected revenues from future production, less the Buyer's share of the projected capital expenditures and operating costs. Projected plugging and abandonment ("P&A") costs and net salvage value should also be considered. The Purchase Price Allocation section provides for the aggregate unadjusted Purchase Price to be allocated among all the Assets being sold. This allocation serves two primary purposes. First, in connection with preferential purchase rights in favor of third parties, the Allocated Values are used in offering the affected Assets to the respective holders of the preferential rights to purchase. Second, if Assets are excluded or reduced in value by title or environmental defects or other mechanisms under the Agreement, the Allocated Values are used in calculating the Adjusted Purchase Price.

Common Issues:

A. Allocating Value to PUDs and Other Assets.

In the simplest case, where all the value is in proved, developed, producing (PDP) wells, the parties simply schedule such wells and agree on an allocation of the Purchase Price among the wells. In many transactions, however, the Buyer places value on the "upside" of exploring or developing new locations or formations. In that case, the Buyer may want to allocate part of the Purchase Price to the undeveloped acreage. If the parties can agree on the proved undeveloped

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(PUD) locations, the Buyer can allocate part of the Purchase Price to the PUDs. In order for the Buyer to be able to assert title defects on the PUD locations, however, the PSA should specify the specific lands where each PUD is located – and, if applicable, any lands pooled or proposed to be pooled with each PUD.

Another issue can arise if the PUD is in a different formation than the existing PDP wells and the Seller's ownership varies among formations. The objective formation of the PUD well should be specified, and the Seller should make sure that the represented interest schedule accurately sets forth the Seller's WI and NRI in the objective formation. A common modern day example occurs when the Seller's PDP wells are in a conventional vertical formation unit and the PUD wells are horizontal wells in a shale formation. Even if the shale horizontal well is to be drilled within the geographical surface boundaries of the existing unit, the unit designation should be checked to ensure that the pooling was not depth-limited (or if it was depth limited, that the target formation for the PUD well was included).

In some transactions, even if no PUDs have been identified, the Buyer may attribute upside value to undeveloped leasehold. In this case, a portion of the Purchase Price can be allocated to the undeveloped leasehold, which would usually be done by agreeing on the amount of represented net acreage and a dollar amount of value per net acre.

B. Preferential Right to Purchase Issues.

In a large package acquisition, it is quite common for some of the assets to be subject to a preferential right to purchase ("PRTP" or "pref right") in favor of third parties. Most often, the pref rights are created under Operating Agreements ("JOAs"). The Seller and Buyer must agree on a reasonable allocation of the Purchase Price to the assets that are subject to each pref right.

1. Limits of the Pref Right

Pref right provisions must be examined carefully to ensure that the value of the affected Assets is accurately reflected in the Allocated Value schedule. For example, suppose the Buyer has allocated value to PDP wells producing in one formation under one JOA, which is limited to that formation, while the shallower or deeper formations are subject to a separate JOA. In such a case, the Allocated Value must be broken down further between the formations, in order to specify the price attributable to the respective pref rights.

2. Negative Values

Occasionally, the estimated P&A liability of a well in a package sale may exceed the remaining projected net revenues from production. This is particularly common offshore, where abandonment costs can be enormous. In such a case, the well will have a negative allocated value.

If a well with a negative allocated value is subject to a PRTP, then the holder of the PRTP will actually be paid for exercising its PRTP. In one recent transaction for the author's client, the Buyer assigned a negative value of ($2 million) to one offshore property. The PRTP holder

would have received $2 million from the Seller had it exercised its pref right. Further, the Buyer would have needed $2 million more cash to close on the remaining properties in the package. In addition, had the transaction with the Buyer failed to close for any reason, the Seller would have been out $2 million.

In reality, most PRTP holders are not in the business of acquiring properties with P&A liability exceeding the projected net revenues from production. For a cash-strapped pref right holder, however, the opportunity to receive cash now for a liability that may not arise for years may be enticing.

Such a potential outcome raises the question of whether the Seller can condition the closing on the pref right property on the closing of the transaction with the Buyer? Generally, Texas case law is well-settled that once the Seller notifies the PRTP holder of its decision to accept a third party offer to purchase the burdened property, the pref right ripens into an irrevocable, enforceable option exercisable for the specified period of time.[2] Thus, a condition to closing of the pref right property based on closing the underlying transaction may be unenforceable, in the absence of special language in the PRTP provision.

C. Which Party Decides?

The parties may negotiate over whether the Seller or the Buyer will allocate the Purchase Price among the Assets. Generally, regardless of which party proposes the preliminary allocation, the other party should have the right to review and object to the proposed allocations, and the final product should be a schedule achieved by mutual agreement.

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[2] *Durrett Dev., Inc. v. Gulf Coast Concrete, L.L.C.*, No. 14-07-01062-CV, 2009 Tex. App. LEXIS 6787, at 10 (Tex. App.—Houston [14th Dist.] Aug. 27, 2009, no. pet. h.) ("A right of first refusal may ripen into an option contract upon the occurrence of a triggering event, as specified in the parties' agreement."); *FWT, Inc. v. Haskin Wallace Mason Prop. Mgmt., L.L.P.*, 301 S.W.3d 787, 793 (Tex. App.—Fort Worth 2009, pet. filed) ("…when the property owner gives notice of his intent to sell, the preferential right matures or "ripens" into an enforceable option.") (citing *City of Brownsville v. Golden Spread Elec. Coop., Inc.*, 192 S.W.3d 876, 880 (Tex. App.—Dallas 2006, pet. denied); *Navasota Res., L.P. v. First Source Tex., Inc.*, 249 S.W.3d 526, 532 (Tex. App.—Waco 2008, pet. denied) (same); *Collins v. Collins*, No. 13-07-240-CV, 2009 Tex. App. LEXIS 1676, at 1 (Tex. App.—Corpus Christi Mar. 12, 2009, pet. denied) ("…when the rightholder gives notice of his intent to accept the offer and exercise his option, a contract between the rightholder and the property owner is created."). The pref right holder's right to exercise its option is exercisable for the term stated in the instrument from which the right is derived, even if the third party's offer terminates or is revoked, absent language contained in the same instrument conditioning the right holder's exercise on the continued existence of the bona fide third party offer. *See Riley v. Campeau Homes, Inc.*, 808 S.W.2d 184, 188-89 (Tex. App.—Houston [14th Dist.] 1991, writ dism'd); *Henderson v. Nitschke*, 470 S.W.2d 410, 414 (Tex. Civ. App.—Eastland 1971, writ ref'd n.r.e.).

III. THE BUYER'S ACCESS

Most PSAs impose a covenant on the Seller to provide the Buyer and its due diligence team with reasonable access to the Seller's files, records, and personnel to assist the Buyer with its title due diligence process during the period from execution of the PSA through the deadline for the Buyer to assert Title Defects.

Common Issues:

A. What is reasonable access?

In a rush transaction, disagreements can arise over the extent of the Buyer's access to the Seller's files and the Seller's obligations to accommodate same. To avoid such disagreements (or to ensure that they have a favorable outcome), each party should attempt to include specific parameters in the PSA. The Seller, for example, should try to include language specifying that the access is "reasonable," "during Seller's regular hours of business," "by appointment," and so forth. The Seller will also want to exclude certain confidential material from disclosure to the Buyer. Conversely, the Buyer can try to include such language as "full and complete access" and language expressly requiring the Seller to extend the Buyer's access beyond the Seller's regular hours of business, including weekends.

B. What if the Buyer wants to begin before the PSA is signed?

In many transactions where both parties desire a quick closing, and/or the PSA negotiations are drawn out, the Buyer may request to begin its review of the Seller's records before the PSA is signed. Assuming the Seller is willing to take the risk that the Buyer could make a discovery causing it not to sign the PSA (and assuming a confidentiality agreement is already in place), it is nevertheless advisable for the Seller to at least require the Buyer to submit its draft Allocated Value schedule before beginning. Otherwise, an unscrupulous Buyer who discovers Title Defects or pref rights before submitting its proposed allocations could be tempted to inflate the Allocated Values of Assets that either have Title Defects or are subject to pref rights, or both. If the Buyer is allowed to begin before submitting the Allocated Value schedule, the Seller will need to carefully review the schedule and satisfy itself that neither type of inflation has occurred, before agreeing to the Buyer's proposed allocations.

IV. PREFERENTIAL RIGHTS TO PURCHASE AND CONSENTS

The PSA should expressly cover how preferential rights to purchase and required consents to assignment should be handled.

Generally, the Seller assumes responsibility for sending out all required pref right notices and requests for consent to assignment within a reasonable period of time after execution of the PSA. The Seller should prioritize notices for those pref rights that have the longest periods in which to exercise, in order to best ensure that the option periods expire before Closing.

A. Pref Rights.

If a pref right is exercised prior to Closing, the affected Assets are excluded from the Closing and the Purchase Price is adjusted downward by the Allocated Value of the affected Asssets. (Of course, if the pref right is waived before Closing, the affected Assets will be included among those conveyed at Closing.)

Common Issues:

A commonly negotiated issue concerns the treatment of pref rights that have been neither exercised or waived prior to Closing, where the time period in which the pref right holder has to exercise his right has not yet expired. Sellers often take the position that a pref right that has not been exercised by Closing is likely to be waived, either affirmatively or by the passage of the deadline to exercise; therefore, the affected Assets should be conveyed, and paid for, at Closing. If the PRTP holder subsequently exercises its pref right, the Buyer can convey the affected Assets to the holder and receive the consideration due from the holder. The Buyer is made whole, and the parties avoid multiple closings.

The Buyer will generally prefer to withhold the affected Asset from the initial Closing and reduce the amount paid at Closing by the Allocated Value of the affected Asset. If the pref right is subsequently waived or expires without being exercised, it would then be sold to the Buyer and paid for in a subsequent Closing. Under this process, the Buyer avoids being in the chain of title to the affected Asset as well as the inconvenience of taking over operations for only a brief period of time. In addition, most pref right holders will require a PSA identical in substance to the PSA between the Seller and the Buyer, entitling the pref right holder to the benefit of the Seller's reps, warranties, covenants, and other obligations. The Buyer is never in the same position as the Seller to make the same reps and warranties that the Seller made.

B. Consents.

In most transactions, the Assets will include some Leases or Contracts that have restrictions on assignment such as requiring the prior approval of the lessor under the Lease or the counterparty to the Contract. The Seller usually undertakes to identify and request such consents prior to Closing.

Common Issues:

The parties may negotiate over the effect on the transaction if the Seller is unable to obtain a required Consent. Usually, the Buyer will want the option to either exclude the affected Assets and obtain a downward Purchase Price adjustment, or waive the Consent and proceed to close on the affected Assets.

As a general rule, a reasonable restraint on a party's ability to assign a Lease or Contract (*e.g.*, "Lessee will not assign this lease in whole or in part without lessor's consent.") is enforceable.[3] However, such "consent to assign" clauses are strictly construed against the party seeking enforceability of such a restraint.[4] Moreover, many Consent provisions expressly provide that consent shall not be unreasonably withheld. Courts will generally enforce such provisions. In Texas, unreasonably withholding such a consent exposes a party to damages for breach.[5] However, a withholding of consent for economic reasons is considered reasonable in Texas.[6]

Notwithstanding the enforceability of these provisions, the failure to obtain such consents generally does not invalidate the assignment. Rather, an assignment made without the required consent will only give rise to a cause of action for damages – to the extent, if any, that damages can be shown.[7] As a result, many Sellers will dispute that the failure to obtain a consent should constitute a Title Defect. Further, even where the PSA provides that an unobtained consent constitutes a Title Defect, many Buyers will choose to waive such a Defect and close on the affected Assets, rather than having them be retained by the Seller.

V. DEFENSIBLE TITLE; TITLE DEFECTS

In most transactions, the Seller represents that it has good title to certain specified interests in the producing wells or PUDs. The Buyer's offer is based on an assumption that this representation is accurate, subject to confirmation by the Buyer during the Buyer's due diligence review of the Assets. Typically, with respect to each Well having value, the Seller specifies the working interest ("WI") and net revenue interest ("NRI") that it owns. The Seller then represents that it has good title to those interests. Usually, the representation includes a defined term regarding the quality of the Seller's title, such as "Defensible Title," or, less commonly, "Marketable Title." In general, the definition includes such elements as the following:

A. It means record title;

B. It is subject to certain negotiated encumbrances, commonly defined as "Permitted Encumbrances";

C. It entitles the Seller to receive, without reduction, not less than the specified NRI;

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[3] See, e.g., Martin & Kramer, Williams and Meyers Oil and Gas Law, § 402 (2010) and cases cited therein; Cross, The Ties that Bind: Preemptive Rights and Restraints on Alienation that Commonly Burden Oil and Gas Properties, 5 Tex. Wesleyan L. Rev. 193, 222 (1999).
[4] *See, e.g., Knight v. Chicago Corp.*, 144 Tex. 98, 188 SW.2d 564 (Tex. 1945); *Outlaw v. Bowen*, 285 S.W.2d 280 (Tex. Civ. App.—Amarillo 1955, writ ref'd n.r.e.); *Palmer v. Liles*, 677 S.W.2d 661 (Tex. App.--Houston [1st Dist.] 1984, writ ref'd n.r.e.).
[5] *See, e.g., Mitchell's Inc. v. Nelms*, 454 S.W. 2d 809 (Tex. Civ. App.—Dallas 1970).
[6] *Id.*
[7] *See, e.g., Haskins v. First City National Bank of Lufkin*, 698 S.W.2d 754 (Tex. Civ. App.—Beaumont 1985, no writ); *Palmer v. Liles*, 677 S.W.2d 661 (Tex. App.—Houston [1st Dist.] 1984, writ ref's n.r.e.).

D. It obligates the Seller to bear no greater share of the working interest than the specified WI, unless the increase is accompanied by a proportionate increase in the NRI;

E. It is free and clear of all encumbrances (usually a defined term); and

F. It is free of any imperfections that a reasonable prudent purchaser of oil and gas properties would not normally waive.

Any matter causing the Seller not to have Defensible Title to a Property is commonly defined as a "Title Defect."

Common Issues:

A. Record Title.

Many Seller's forms omit the record title component. The Buyer should be sure this is included, using specific language such as "that title which is filed, recorded, or otherwise referenced of record in the records of the applicable Governmental Body in a manner which under applicable Legal Requirements constitutes constructive notice of ownership of such Asset to third parties acquiring an interest in or an encumbrance against such Asset……"

B. Reductions after Payout.

It is not unusual for the Seller's current interest in a Well to be subject to reduction or increase after some type of payout occurs in the future. For example, the Seller may have picked up an additional interest in a Well due to a co-working interest owner having elected not to consent in a the drilling or a subsequent operation. After the applicable nonconsent penalty has been recovered, the Seller's interest will be reduced, due to the nonconsenting party coming back in.

The Seller must take care to include columns in its represented interest schedule to show both its Before Payout ("BPO") and After Payout ("APO") interests.

A savvy Buyer will want to see the Payout balance in order to calculate how much of the remaining reserves it will own both BPO and APO. Sometimes, this takes the form of a Payout Schedule accompanied by a corresponding representation in the Seller's Reps and Warranties section.

The Buyer should also include express language to specify that the interests represented by the Seller are for the life of the Well, unless otherwise reflected in the schedules. Such language ensures that the Buyer will be able to claim an APO reduction as a Title Defect, if such reduction is not reflected in the interest schedule.

VI. PERMITTED ENCUMBRANCES

"Permitted Encumbrances" is a defined term encompassing a laundry list of items that the parties agree do not result in a breach of the Defensible Title rep. Many items on the list are often negotiated, but the following are common examples of Permitted Encumbrances:

1. Liens for taxes which are not yet delinquent;

2. Normal and customary liens of co-owners under operating agreements, unitization agreements, and pooling orders relating to the Assets, which obligations are not yet due and pursuant to which the Seller is not in default;

3. Mechanic's and materialman's liens relating to the Assets, which obligations are not yet due and pursuant to which the Seller is not in default;

4. Liens created by or arising out of leases, assignments, operating agreements, farmout agreements, oil and gas sales contracts, or similar agreements that are of the nature customarily accepted by prudent purchasers of oil and gas properties, and that do not adversely affect the WI or NRI or materially affect the value of any Property encumbered thereby;

5. Approvals required to be obtained from governmental entities that are lessors under the leases that are customarily obtained post-closing;

6. Easements, rights-of-way, and other surface agreements that do not materially interfere with operations; and

7. Rights of reassignment triggered by an intent to abandon or release a lease and requiring notice to the holders of such rights.

Common Issues:

A. Issues for the Buyer:

The Buyer should carefully review the Seller's proposed laundry list of Permitted Encumbrances, and negotiate to revise or strike those that it finds objectionable. Common issues and traps for the Buyer include the following:

1. A common item included by Sellers is the terms and conditions of all leases and contracts affecting the Assets, but only to the extent that they do not, individually or in the aggregate, operate to reduce the Seller's NRI below the represented NRI or increase the Seller's WI above the represented WI without a proportionate increase in the NRI. Such language has the potential for unforeseen traps for the Buyer. A simple example would be an undeveloped Lease having a primary term that is about to end, causing the Lease to expire before the Buyer has an opportunity to commence operations to extend it. Thus, the Buyer should add an additional qualifier such as "only to the extent they do not adversely affect the ownership and/or operation of the affected Assets (as currently used or owned) in any material respect." (In fact, in the undeveloped leasehold example, the Buyer should go further and specify that remaining terms shorter than some specified length of time can be asserted as Title Defects.)

2. Many Seller's lists include tax liens or mechanics or other liens that are being contested in good faith. The Buyer may argue that a good faith contest can still be lost, leaving a lien on the property. For the Buyer, it is better to be able to fully evaluate these matters in the Defect process, and, if warranted, waive them at that point, than to waive them up front. However, most Sellers will push back on this argument by a Buyer.

B. Issues for the Seller:

The Permitted Encumbrances section presents an opportunity for the Seller to identify specific problems that it discloses up front, on the understanding that they cannot be claimed as Defects later. The idea is "here they are, look them over now, but once we sign, don't complain." Examples would be a latent defect or a tenuous claim that has little risk, or a "sleeping dog" type problem that is better left alone. Often, these type issues may pop up during the course of the disclosures the Seller must make in complying with the Buyer's required reps and warranties. The Seller may decide, as long as these items are on the table as exceptions to its reps, why not flush them out now, and avoid a fight over validity of the Defect or the Defect Amount later. For example, suppose the Seller is in a dispute over the sufficiency of certain past royalty obligations, under a lease in which the correct payment of royalty is a condition, rather than a covenant. To cure the potential defect would require a compromise of the Seller's position in the dispute. In this situation, the Seller may wish to disclose all the facts to the Buyer up front, and get the Buyer on board with the Seller's position in the dispute. If that can be accomplished, the Buyer should agree to the inclusion of the dispute as a Permitted Encumbrance, and avoid a later debate over the existence of a Defect or the amount of the Defect Value.

VII. NOTICES OF TITLE DEFECTS

PSAs usually contain a specified deadline, often defined as the "Title Claim Date" or "Defect Notice Date," by which the Buyer must complete its title review and notify the Seller of any Title Defects. During this time, the Buyer is usually allowed to have access to the Seller's files during normal business hours (and often, reasonable hours outside of normal business hours) to review the Seller's title. This "in-house due diligence" is usually supplemented by a review of the public real property records in the counties (or parishes) in which the Properties are located.

Common Issues:

1. To assert a Title Defect, the Buyer must notify the Seller on or before the Defect Notice Date. How much detail and supporting evidence must be included in the Title Defect Notice is often the subject of negotiations. In most cases involving equal bargaining power, the Notice must (i) be in writing, (ii) identify the affected Property or Properties, (iii) describe the Title Defect in reasonable detail, and (iv) indicate the amount by which the Buyer, in good faith, believes the value of the affected Property or Properties should be reduced by the Defect (the "Title Defect Value").

2. Regardless how much detail and supporting evidence must be provided with the Notice, an issue may arise during a dispute over an asserted Defect as to whether the Defect Notice can be supplemented with additional supporting documents after the Defect Notice Date. The Buyer should beware of language that results in a permanent waiver of

a Defect for which all supporting documentation has not been included with the original Defect Notice. So long as the Defect Notice provides sufficient detail and reasonable supporting documents to accurately identify the Defect, the Buyer will argue that it should not be precluded from supplementing the Notice with additional supporting documentation during the course of negotiations over the asserted Title Defects.

VIII. TITLE DEFECT VALUES

PSAs usually include guidelines or formulas for the calculation of a Title Defect Value. For example:

1. If the Title Defect results from an NRI shortage, and there is a corresponding decrease in the WI, the Title Defect Value is usually calculated by multiplying the Allocated Value of the affected Property by the percentage reduction in the NRI.

2. If the Title Defect results from a lien or a liquidated amount, the Title Defect Value shall equal the amount required to fully discharge the lien or liquidated amount.

3. If the Title Defect results from any other matter, many PSAs provide that the Title Defect Value shall be an amount equal to the difference between the value of the affected Property with such Title Defect and the value of such Property without such Title Defect (taking into account the Allocated Value of the affected Property).

Common Issues:

A. Many PSAs apply the formula set forth in (1) above to any NRI reduction, regardless of whether accompanied by a corresponding WI reduction. This approach takes into account the loss in projected revenue, but fails to account for the disproportionate cost-to-revenue ratio. When the WI stays the same, the asset will become uneconomic long before the NRI falls to zero. In this situation, rerunning the entire economic analysis using the corrected NRI will result in a more accurate assessment of the Defect Value than the formula.

B. The Seller should make sure to provide that the aggregate Title Defect Value for any single Property cannot exceed the Property's Allocated Value.

IX. THE SELLER'S RESPONSE

If the Seller agrees with a Title Defect, the Seller may usually either cure the Title Defect prior to Closing, or reduce the Purchase Price by the applicable Title Defect Value. Many PSAs also allow the Seller to cure the Title Defect after Closing. In that case, the parties may negotiate over whether the affected Asset is included in the Closing, and at what value, or held back until the Title Defect has been cured to the Buyer's reasonable satisfaction. A common compromise is to include the affected Asset at its Allocated Value less the Title Defect Value; if the Title Defect is then cured, the Purchase Price reduction is credited back to the Seller in the Postclosing or Final Accounting.

An aggressive Seller's form PSA may also authorize the Seller to retain any Property affected by an asserted Title Defect – which can serve as a disincentive to a Buyer to assert even a clearly valid Title Defect. As a middle ground, this right may be limited to cases where the asserted Title Defect Value of the affected Property exceeds a threshold equal to some negotiated percentage of the Allocated Value.

Some Seller forms may also give the Seller the option to indemnify the Buyer from any losses resulting from the Title Defect. This option can be appropriate to address certain defects such as latent defects that cannot be easily cured or for which the risk of materializing into an actual loss of title is extremely low. However, the Buyer should negotiate to have the right to approve or reject this option if the Seller insists on including it.

X. CONTESTED TITLE DEFECTS

PSAs have a variety of ways to address disputes over the validity of an asserted Title Defect or the amount of the Title Defect Value. The following is a common methodology:

1. The Seller must give notice (a "Title Defect Rejection Notice") by a specified deadline.

2. The parties will then have a limited time period to try to resolve the dispute.

3. If the parties are unable to resolve the dispute within the specified time period, one or the other party may elect to submit the dispute to arbitration.

Common Issue:

There is rarely enough time to hold the arbitration before Closing. The parties may negotiate on whether the affected Asset is to be withheld from the Closing or included, pending the results of the arbitration. If the Asset is withheld, then the Purchase Price is reduced by the Allocated Value of such Asset, pending the arbitrator's ruling. If the Asset is included, the parties may further negotiate over whether the Purchase Price is to be reduced by the asserted Title Defect Value.

In any case, once the arbitrator makes a decision, there may then be additional postclosing purchase price adjustments, conveyances of a withheld Asset or reconveyances of an included Asset, and/or an opportunity for the Seller to cure, followed by the appropriate price adjustment, conveyance, or reconveyance.

XI. INTEREST ADDITIONS

Sellers often negotiate for a provision for a purchase price increase if it is determined that the actual NRI of a Property is *greater* than represented (often defined as an "Interest Addition" or "Title Benefit"). Usually the method for calculating the amount of the price increase is reciprocal to the method for calculating the Title Defect Value.

Common Issue:

If the Buyer agrees to such a provision, it should try to limit the aggregate Purchase Price increase for Interest Additions to no greater than the aggregate decrease for Title Defects, and subject the increase to the same deductibles (discussed in the next section) as are applied to Title Defects.

XII. DEDUCTIBLES AND THRESHOLDS

In most cases, Purchase Price adjustments for Title Defects are subject to certain deductibles or thresholds. These amounts can be stated either in actual dollar amounts, or as a percentage of the Purchase Price. In either case, the amounts are almost always a negotiating point.

A. Rationale.

The Seller will rationalize these limitations based on the logic that it does not make sense to spend time on small matters, and/or that the Purchase Price is inherently an inexact measurement of the future economic value of the reserves upon which the Purchase Price is typically based. The Buyer, however, will argue that by including these limitations, the Seller is seeking to be paid for something it doesn't own.

B. Deductibles vs. Thresholds.

The parties will sometimes negotiate over whether these limitations are true deductibles – meaning the price adjustment is limited to any amounts thereover, or merely thresholds, which, once they are met, enable the Buyer to deduct the full amount of the aggregate Title Defect Value (or the individual Title Defect Value, in the case of thresholds applying to individual Properties).

C. Individual and Aggregate Limits.

PSAs often include thresholds or deductibles both on an individual Property basis (sometimes defined as a "De Minimis Title Defect") and on the aggregate amount of all Title Defects ("Aggregate Title Defect Value"). Either one can be a deductible or a threshold, regardless of how the other one works.

D. Pitfalls for the Buyer.

If both an individual or "de minimis" deductible and an aggregate deductible are used, the Buyer should try to define these terms carefully to avoid being "double-dipped" – that is, it should seek to have any amounts not counted under the individual property deductible or threshold added back into the calculation of the Aggregate Title Defect Value.

In addition, if pref rights and unobtained consents to assign are treated as Title Defects, the Buyer should exclude such items from the deductibles. Otherwise, the Seller essentially gets paid twice for the affected Assets.

XIII. "WALKAWAYS"

At some point, downward Purchase Price adjustments can make the adjusted Purchase Price so low that either or both parties would prefer to cancel the transaction. To address this situation, a provision called a "walkaway" may be included. In general, such a provision allows a party to terminate the transaction if the aggregate amount of downward Purchase Price adjustments for Title and Environmental Defects exceeds some specified amount – usually stated as a percentage of the unadjusted Purchase Price. In some deals, only the Seller has this right, but often the Buyer will have a reciprocal walkaway right.

In general, the following items may count toward the walkway threshold: (a) the Aggregate Title Defect Value, (b) the Aggregate Environmental Defect Value, (c) the aggregate value of Assets requiring consent to assign for which a consent has not been obtained by the Closing Date, (d) the aggregate value of Assets subject to pref rights that have not been waived by the Closing Date, and (e) the aggregate cost to repair or replace any portion of the Assets subject to a Casualty Loss or condemnation that occurs between execution of the PSA and the Closing Date.

A. Pitfalls for Both Parties.

Both the Seller and the Buyer will want to provide for exceptions to the walkaway provision. From the Seller's standpoint, it will want to have the right to cure or contest any Title or Environmental Defects to get under the threshold, such that only the final Title and Environmental Defect Values (not the asserted Defect Values) are counted in calculating the Buyer's threshold. Otherwise, the Buyer could create its own walkaway rights merely by asserting Defects, valid or not, in excess of the threshold.

From the Buyer's standpoint, it will want to provide that Assets subject to pref rights that have not been waived do not count toward the Seller's walkaway threshold. The rationale for this exception with respect to the Seller only is that the Seller still receives the expected value if a pref right is exercised, it just receives it from the pref right holder instead of the Buyer. The Buyer may also negotiate to exclude from the Seller's walkaway threshold any Assets retained by the Seller due to the failure to obtain required consents, on the same rationale – *i.e.*, even though the Seller isn't paid for such Assets, it retains their full value by retaining the Assets.

A walkaway provision may benefit the Seller even if it would not exercise its right to terminate. The threat of the Seller terminating can serve as a disincentive to assert legitimate Defects in amounts exceeding the threshold, for fear that the Seller (who conceivably could have received a better offer by this time) would use the walkaway provision to terminate. The result can be an overstated Adjusted Purchase Price.

XIV. TITLE WARRANTIES IN THE CONVEYANCE

In addition to its rights to assert Title Defects before Closing, most Buyers require a warranty of title in the Conveyance. Usually, the Seller is able to limit such a warranty to a special warranty (that is, the Seller warrants title by, through, and under itself, but makes no warranty regarding title failures resulting from defects existing when it acquired title).

Common Issues:

1. The Seller should make sure that it does not get nicked with a downward Purchase Price adjustment for a Title Defect asserted by the Buyer and then again on a warranty claim for the same Title Defect.

2 The Seller may also negotiate to limit any warranty of title to the Buyer only, but not its successors or assignees.

3. If the transaction includes all (or some specified undivided percentage) of the Seller's interest in the Assets, the Buyer must make sure that the warranty is somehow tied to specified interests. A warranty of title with respect to a conveyance of merely all or a specified portion of the Seller's interest in an Asset is essentially worthless, because it is impossible to breach such a warranty. Thus, such a conveyance is merely a quitclaim deed. In one such case, the Eastland Court of Appeals held that the grantee was not entitled to the protection of the recording acts, and awarded the property to the prior grantee even though she had not recorded her deed at the time of the conveyance to the subsequent grantee.[8] To avoid this result, the Buyer should make sure that the warranty clause refers to the interests represented by the Seller in an exhibit to the conveyance (or the applicable exhibit to the PSA). Alternatively, the granting language in the Conveyance can be bifurcated into two parts – one part conveying the specified represented interests, and another conveying any remaining interest of the Seller in the Assets.

XV. ARBITRATION OF TITLE DISPUTES

With respect to the procedures for arbitration of title disputes, rather than traditional means of selecting an arbitrator, it is advisable to require that the arbitrator be a specialist in title examination in the area where the Properties are located. In addition, many PSAs also provide for arbitration of disputes over environmental defects. Since it may become necessary to arbitrate both title and environmental disputes, the parties should consider providing for the selection of two arbitrators – a title specialist to arbitrate the title disputes and an environmental specialist to arbitrate the environmental disputes.

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[8] *Enerlex v. Amerada Hess, Inc.*, 302 S.W.3d 351, 354 (Tex. App.—Eastland 2009, no pet.)

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