

DUE DILIGENCE AND CLOSING ISSUES

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You've hammered out the deal, negotiated and signed the Purchase Agreement and are looking forward to the Closing. Only one detail remains — confirming that your Buyer is going to get what it bargained for and/or not acquire in the process so many problems that the peacock becomes an albatross. Thus starts the due diligence period, at the end of which the deal that closes may bear little resemblance to the one that was struck.

This paper will cover the period commencing with the signing of the Purchase Agreement and ending with Closing, the traditional “due diligence” period. The due diligence process actually begins when the Buyer's representatives first enter the data room or receive the sales material and doesn't end until the post-Closing survival periods expire. However, the same disciplines apply throughout and I have assumed that the pre-signing and post-Closing review will be as diligent and thorough for their respective purposes as that conducted during the period discussed. The paper will not cover two key due diligence areas, environmental and third party dealings, since these will be addressed by others. Also, certain important areas, most notably those dealing with title and corporate and securities matters involved in stock deals, will not receive the analysis they deserve because of restrictions on the length of this paper. However, several of the papers cited in the bibliography deal with these areas in greater depth and hopefully they will serve the needs of those who seek greater guidance. Finally, the usual disclaimer in papers dealing with due diligence — this paper is not intended to be a scholarly treatise since there is very little case law dealing with due diligence and the few cases reported are fact specific; rather it is intended to be a practical guide, a “nuts and bolts” approach to due diligence, based on the author's experience and observations and those of others.

I. Introduction.

Few deals crater because of problems discovered during the due diligence review, but many are renegotiated and it is the rare deal where the purchase price is unaffected. It is important to remember at the outset that the parties have conflicting due diligence goals. While normally both want to retain the deal they've negotiated, the Buyer will want the review to confirm its assumptions, identify and solve problems, reduce the purchase price at Closing, and, ideally, eliminate the “dogs.” On the other side, the Seller, while sharing the Buyer's desire to retain the deal and solve problems as they arise, will want to keep the purchase price intact at Closing,

avoid escrows, argue about defects and breaches post-Closing, and keep the dogs in the deal. It is important to keep these conflicting goals in mind as you organize for the due diligence effort and work through the process.

It also is important to establish your goals for the review. Your job is to see that the Buyer gets what it paid for or may recover against the Seller if it receives something less.

You'll learn quickly that, notwithstanding all you hear about the importance of the due diligence function to the overall process, there are few due diligence heroes and a Buyer's kudos are normally reserved for the negotiator of a favorable Purchase Agreement. If your due diligence effort is successful, i.e., if the Buyer realizes its goals, your reward is the next deal; if the Buyer is disappointed with the result, you're fired. It's as simple as that. One last warning — if you find problems, you'd better have solutions to suggest; and busting the deal is rarely the answer the Buyer wants to hear.

II. Getting Organized.

It may be a cliché, but the time devoted to organizing and structuring your due diligence effort and designating your team is time well spent, no matter how critical the timing. Throughout the process, you should keep in mind the four keys to a successful due diligence effort:

- Know the properties.
- Know the parties
- Know the Purchase Agreement.
- Know your team.

A. The Properties.

Knowledge of the properties, including the price paid for them and their respective values, is a critical component to organizing the due diligence review.

1. Purchase Price.

In a nutshell, the higher the price, the greater the effort. Few Buyers are willing to authorize a comprehensive review for a \$50,000 deal.

2. Number and Value.

The more extensive the properties, the longer due diligence will take, assuming the properties are of equivalent value. Of course, this is rarely the case and if there are one or two high value properties in the deal, you can devote your efforts to these to the exclusion of the others. The rule of thumb is to concentrate on the properties constituting 80% of the value and worry about the remaining 20% after Closing, if at all, particularly if you have a survival period for submitting title defects. But again be cognizant of your Buyer's goals; if there are certain properties it would like to eliminate, even if they're lower in value you'd better include them in your review.

As to the often heard admonition that you can have as big a problem with a low value property as with a higher value one, in my experience few Buyers want you to waste precious due diligence time and money scouting for problems on properties that have little or no value associated with them. At best you may be able to scope an environmental review that might identify problems involving these properties. But if you can't, most Buyers are satisfied with assuming the risks of following the 80/20 rule.

3. Producing or Non-Producing.

Producing properties are likely to have prior title opinions and division orders, thereby saving time and money as far as title review is concerned. Of course, the flip side is that producing properties are more likely to have associated baggage, e.g., environmental contamination, royalty claims, litigation, contractual disputes. Thus, the ratio of producing to non-producing properties may not make your life any easier, but it will influence how you scope your review.

4. Operated or Non-Operated.

Operated properties create their own unique problems, such as delinquent accounts, compliance with the operating agreement, environmental compliance, and obtaining approvals of changes in operator. However, the pluses normally outweigh the minuses — easy access to the books and records for the properties, including in all likelihood the most complete title records; expedited equipment inspection and a jump start on environmental review; and the cooperation of field personnel. For non-operated properties, you may have to rely on the cooperation of the operator, which has little incentive to do so. Of course, if you already operate some or all of the properties, your review becomes a lot easier (or non-existent, except for title) and this may also be the case even if all you have is a working interest in the properties.

Another thing that may be significant to your review is the operator of a property. This will not affect your title review, except to the extent that certain operators keep better records and are

more cooperative and forthcoming than others, but it may well influence your environmental review and plans for visual inspection. Many times a Buyer is willing to take the risk as to environmental compliance and equipment condition for a non-operated property if it knows and/or has confidence in the operator.

5. Oil or Gas.

If the properties are primarily oil producing, your environmental hot button will be pushed. But gas producing properties bring their own set of problems, such as the payment of shut-in royalties, gas balancing issues, compliance with transportation and purchase contract provisions, and Section 29 certifications. Again, the classification of the properties is likely to dictate the focus of your review, rather than to lessen the time it takes to conduct it.

6. Location.

The location of the properties may cause you to alter the scope of your review. For example, the 80/20 rule may work in most instances, but if the properties constituting the 20% are located in Louisiana, you may want to consider refocusing your due diligence effort. Location may also be significant as to the difficulty of the title review. Few title examiners (except those with high per diems and unlimited expense accounts) would argue that they prefer to clear title in East/South Texas, with its multitudinous ownership interests and where unrecorded instruments are as much the rule as the exceptions, versus the Rocky Mountain Region, where Federal, State and large land holdings predominate.

B. The Parties.

In determining how to organize your due diligence effort, it is important to know how the parties are likely to facilitate or hinder your effort. I have already discussed the common and/or diverse goals of most Buyers and Sellers, but the philosophy of a particular Buyer or Seller towards this deal or towards acquisitions/dispositions in general may be equally important in establishing your priorities. For example, how anxious are the parties to do the deal? Does one have leverage on the other? Is timing critical to the Buyer? Is it critical to the Seller? Is there a lender involved and, if so, will it be your principal contact? Are there any true "deal breakers"?

1. The Buyer.

The Buyer is your client, so you had better have a clear idea of what it expects from you. But you also need to know your expectations of the Buyer. Is it a deal closer or is it skittish, risk adverse and likely to walk if too many problems surface? Is it a hard bargainer when it has

leverage? Will it want to squeeze every nickel out of a defect or drop the immaterial ones? Does it need financing to do the deal and, if so, does it have it? Could it lose the financing under certain circumstances?

2. The Lender.

If there is a lender in the deal, in most cases substitute it for the Buyer as your primary contact, since normally a lender establishes tougher due diligence standards than does a Buyer. At the very least, the lender is likely to be more skeptical of the overall value of the properties and therefore more inclined to pursue every defect. It also is likely to require a more thorough environmental review. A lender may take a secondary role if it has a long term relationship with the Buyer, but, in any event, it's best to establish at the outset who will call the shots as to issues that arise and it may not be the party that pays your bills.

3. The Seller.

The need to know the Seller may not be as obvious, but in many ways the Seller will be the big difference between a smooth due diligence process and a bumpy one. For example, what's the Seller's reputation? Is it trustworthy? Is it a deal closer or does it have a reputation of pulling out when problems arise? Is it likely to cooperate with you and supply key personnel or play hide-the-ball and hope you miss potential problems? Are the Seller's records organized and reliable? Does it have competent people on its disposition team? Finally, can the Seller support its representations, warranties and indemnifications?

C. The Purchase Agreement.

If you negotiated the Purchase Agreement, you should know the answers to the questions that follow. But even if you do, it is a good exercise to review the relevant provisions and note those that will impact your due diligence review. These may include the following:

1. Key Deadlines.

In most instances there are at least four key dates — that for making pre-Closing title (and other) objections; the Closing Date; the final settlement date; and the date(s) the post-Closing survival periods expire.

2. Timing.

Beyond knowing the Closing Date, you should know if an extension is likely/possible, i.e., when does the transaction have to close? This will establish the outside date for your review if the process slows down.

3. Survival Periods.

The timing of the Closing may depend on whether there are post-Closing survival periods for the representations and warranties and/or to submit title, environmental or other defects. If the Seller has agreed to survival periods in the Purchase Agreement, it will want to close quickly to avoid reductions in the purchase price and start the clock running on the survival periods. Many Buyers will want to delay closing for these very reasons, although in my experience a Buyer is equally anxious to close, particularly on properties it will operate. A lot will depend on your evaluation of whether the post-Closing survival periods will be adequate for your needs. It also may depend on whether the Seller is required to escrow that portion of the purchase price attributable to properties subject to a dispute or for which title has not yet been cleared, in which case the Seller will be less anxious to close.

In addition to survival periods, it is important to keep in mind the timing as to any “baskets” or deductibles provided in the Purchase Agreement, and pay particular attention to whether they are to be submitted on a claims made versus a money spent basis. If keeping track of this area is part of your responsibilities, you had better be certain that you and your team members understand how the process works.

4. Representations and Warranties.

Beyond confirming the Seller's title to the properties, which has been a part of every due diligence effort in which I have participated, the parameters of your review will be dictated by the representations and warranties in the Purchase Agreement. In smaller deals, title may be the only issue, although it is not unusual to have representations and warranties as to material contracts, calls on production, preferential rights to purchase, required consents and pending litigation, liens or similar encumbrances. If these constitute the only items on your due diligence list, your review should be relatively simple. It seems, for no good reason, that the number of representations and warranties increases in direct proportion to an increase in the purchase price. This may or may not make your job more difficult since many of the additional representations and warranties cover areas best characterized as esoteric or are of the motherhood variety, thereby providing the Buyer greater comfort, but not much else. (Of course, if you are their author, you had better take them seriously.)

Once you have familiarized yourself with the areas covered by the representations and warranties, eliminate the rest from the scope of your review. There is no sense wasting time on areas not covered. For example, is there a representation and warranty as to the data room or sales material or is there the usual disclaimer? Similarly, are there representations and warranties as to the reserves, continuous production from the wells to be acquired, and/or the

proper plugging of non-producers? Unless the Buyer wants you and your team to investigate areas not covered to confirm that it made a good deal, you should stick to those items for which the Seller has some exposure.

One aspect of representations and warranties that may require particular attention is the degree to which they are qualified by the Seller's knowledge, e.g., "to the knowledge of Seller, there are no pending claims, etc., affecting the Assets." It is important to determine before you start your investigation and interviews how far down the reporting ladder the knowledge modifier extends. If it stops at the executive level, you're a dead duck; if it extends to field hands, you're in business, although this will expand the scope of your review.

Another critical area in some deals is the extent to which the Buyer is penalized for its knowledge of breaches or potential breaches of representations and warranties discovered either prior to signing or during due diligence. In many cases, the Buyer is required to raise these at or prior to Closing or waive the right to notice them during the post-Closing survival periods. If this is a factor in your deal, you had better keep careful notes of what you find (or don't find) during your investigation.

5. Indemnity.

If you were skillful (or lucky) enough to negotiate a post-Closing indemnity in the Purchase Agreement, you should refresh yourself as to the areas and time periods covered. However, it is likely that this will have little effect on your review since there are few Buyers who are willing to forego a due diligence investigation simply because they have a comprehensive indemnity. As Messrs. Morgenthaler and Pharo once put it, "[I]ndemnification is not a substitute for diligent investigation of hidden exposures, particularly when your indemnitor is financially weak."

6. Interim Period.

Most Purchase Agreements contain a representation and warranty as to how the properties have been operated since the Effective Date, if such date precedes the signing date, and an affirmative covenant as to how they will be operated between the signing date and the Closing Date. If the Seller is the operator and is to continue to operate all or certain of the properties following Closing, there will also be a covenant (with an associated disclaimer) as to these post-Closing operations. You should establish whether it is your responsibility to investigate, monitor and/or enforce these representations, warranties and covenants and, if it is, you'd better set up a protocol for doing so. Hopefully, the Purchase Agreement provides for the compensation the Seller is to receive for operating the properties from the Effective Date to the date it turns over operations; if it doesn't and the Seller is to receive compensation in addition to that specified in the applicable operating agreement, you'd better hope that it's not also

your job to negotiate this additional compensation. In my experience, the Seller and Buyer rarely think alike when it comes to “fair” compensation for these interim services.

7. Closing Conditions.

Besides the usual conditions to closing, e.g., Board approval, representations and warranties being true and correct, no restraining order, H-S-R Act approval, and the like, there may be “outs” for both the Buyer and the Seller if a specified amount of title defects have been noticed or a significant environmental issue has been raised. These may apply to a single property and/or to the entire deal and usually the threshold is high enough so that the removal of the property or properties or the resultant reduction in the purchase price would be so significant as to deprive the parties of the bargain they made. This is the event most likely to cause Closing to be postponed or the establishment of a significant escrow if Closing proceeds. The attitude of the parties is hard to predict in this situation. Normally both Buyer and Seller have assumed that Closing is a mere formality and it may come as a shock to them that the deal may collapse or, at the least, be substantially changed. If there's a lender present, it is more likely to be clear-eyed about the problem; there is always the next deal to turn to.

Your ultimate role in avoiding this disaster scenario will be unclear at the commencement of the due diligence process. You're probably going to be the messenger of the bad news that could kill the deal, although if it is an environmental problem you can probably blame it on the consultant. In any event, you should keep careful track of the cumulative defect amounts and if the aggregate starts to approach a significant level, you had better alert the Buyer. Keeping in near daily contact with the landmen/attorneys reviewing title to establish an early warning system if problems arise is also a good idea, particularly if you're using local counsel for the first time and you don't know whether they will call you when a potential defect surfaces or let you know for the first time when you read the draft title opinion. Similarly, you'd better keep tabs on the environmental investigation and instruct those in charge to keep you advised on an ongoing basis. Environmental problems can be particularly tricky since most Buyers (and all lenders) are loath to close into escrow on problem properties for which they may thereafter be responsible.

As I indicated earlier, you shouldn't feel that your role begins and ends with identifying the problems which endanger the deal. Assuming there are any, propose solutions to your Buyer (and lender) at the same time you present the problems. Particularly in the case of title issues, the Buyer is likely to seek your opinion as to the significance of the problem and whether it is manageable. I have found it to be extremely helpful in assessing and solving such problems to have established a good working relationship with Seller's counsel or team leader, thereby enabling you, where appropriate, to work through the problem with him or her and present your joint recommendations for its solution to the parties.

8. Dispute Resolution.

Many Purchase Agreements now provide for arbitration in the case of disputes over defects, particularly those relating to title. Maybe I've been lucky, but to date I've never had a dispute go to arbitration, much less litigation. In other words, if you have such a provision, ignore it as far as trying to resolve the problems that arise during due diligence. The last thing either the Buyer or Seller want is to go to the time and expense of arbitration/litigation. However, if this is the ultimate route, you'd better be sure that your defects have been submitted strictly in accordance with the format and protocol set forth in the Purchase Agreement or that if you've been given any slack in this regard by the Seller's representatives, it is documented as a formal amendment to the Agreement.

9. Third Party Dealings.

This subject will be covered by another paper, but I'd like to make one brief observation as to how this area impacts the organizing of your due diligence effort. The Purchase Agreement may assign the responsibility for obtaining third party consents, waivers of preferential rights, assignments of permits and licenses, letters-in-lieu, and the like to the Seller, but you may want to treat it as a shared responsibility for purposes of establishing your team assignments. For one thing, by participating in the process you or your team members will see that it's done and done right. But it's also an opportunity to learn more about the properties and the parties and agencies the Buyer will be dealing with once it acquires them.

10. Lists, Schedules, Exhibits.

Normally your Purchase Agreement will contain certain schedules as exhibits, including in almost all cases a description of the properties to be acquired and the Seller's working interests and net revenue interests therein. There may also be attached forms of certificates, counsel's opinions, conveyance documents; schedules of pending litigation and claims, NOPV's, and administrative proceedings; exceptions to the other representations and warranties; and lists of the equipment to be acquired and the material contracts associated with the properties. If the Seller is allowed to supplement these schedules, as is almost always the case with those applying to the representations and warranties, you must pay particular attention to the method and timing for providing such supplements. Hopefully the Purchase Agreement places some restrictions on the Seller providing you at Closing with supplements which allow it to notice the Buyer for the first time of matters which, if not listed, would have constituted a breach. If there is a deadline for supplements, keep track of it and be prepared for an expedited investigation of the items noticed; if the Closing Date is the deadline, you'd better so advise the Buyer (and be prepared to duck if you negotiated the provision). Of course, your

relief may lie in how the matter is treated post-Closing. If you have a strong indemnification that covers it and if you can rely on such indemnification (see Morgenthaler and Pharo), you can relax or worry about other things.

As to the items previously referenced, I am particularly fond of obtaining a list of the equipment to be conveyed. If there isn't one attached as an exhibit, ask for it. I believe such a list helps both parties avoid a dispute at Closing or shortly thereafter when the Buyer takes possession of the properties as to the equipment included in the deal. The definition of "Equipment" in most Purchase Agreements, e.g., "incident or attributable to" the wells or leases, is purposefully vague and if the equipment is not scheduled, you're in for an argument. In my experience, many field people, once a deal is done, find that equipment they once claimed was essential to their operations may now be removed and transported to other Seller owned properties because it really has no utility to the operations of the property being sold. A definitive list avoids these problems, although negotiating such a list may prove to be cantankerous and time consuming and a job you'd best leave to others.

A material contracts list may be even more difficult to obtain. Many Sellers view the preparation of such a list as doing the Buyer's job for it and exposing the Seller to an argument as to what is, or is not, "material." This is usually one of the more hotly contested items in negotiating the Purchase Agreement and assuming that you haven't been lucky enough to have a list attached as an exhibit or skillful enough to persuade the Seller to provide you with one after the signing, I suggest that you prepare such a list in the course of your due diligence review and attempt to get the Seller to buy into it prior to Closing.

11. Valuation Schedule.

The valuation schedule is prepared by the Buyer and is usually attached as an exhibit to the Purchase Agreement or submitted shortly after the Agreement is signed. It allocates the purchase price among the properties and assets to be acquired. While it may have some relevance for tax allocation purposes, it's used mainly to establish values for title defects purposes and to discourage the exercise of preferential rights. I find this to be the consistently most interesting document supplied pursuant to the Purchase Agreement. If the Seller (who should be indifferent) accepts the Buyer assigning inordinately high values to certain properties in order to avoid the exercise of preferential rights, it runs the risk of seeing these values reappear in title defect notices. On the other hand, if the Buyer depreciates the value of a property so that it can use part of its true value for preferential right properties or assets, it may have occasion to revisit the wisdom of its actions when it later turns out that this is the property with the most serious title defects. Even more fun is where there are no preferential rights involved and the Buyer and Seller engage in a guessing game as to which properties are most likely to have defects. Your role in this drama is likely to be a passive one, unless you are

asked to determine before the signing or the submission of the schedule which properties have preferential rights associated with them. If you are asked for such a list, make sure that the Seller agrees with the list before giving it to your Buyer's valuation team, assuming that you weren't shrewd enough to obtain a schedule of such properties as an exhibit to the Purchase Agreement. You may become an active participant in the process if the Seller's valuation of the properties differs markedly from that of the Buyer. Not only will the Seller be nervous about accepting inflated values from a title defect standpoint, it may not be keen on defending a breach of contract action brought by an outraged holder of a preferential right. If you do get involved, I suggest you try to sensitize your Buyer to the Seller's concerns and get it to take a more conservative approach in assigning values. Of course, if the jewel of the deal is plucked out by a preferential right holder and the Buyer is still required to close pursuant to a Purchase Agreement you drafted, it may be prudent for you to seek other employment.

12. Pending Litigation.

Usually the Seller retains responsibility for pending litigation, arbitrations, administrative and other proceedings affecting the properties, although I've done deals where the Buyer has accepted such responsibility on the theory that it will control the properties after closing and the books and records related thereto. Obviously, the Buyer in such a case will seek to quantify its exposure and reduce the purchase price accordingly, thereby discouraging most Sellers from pressing for it. However, if the Purchase Agreement does make the Buyer responsible for pending litigation and if it's described on an accompanying schedule or exhibit to the Purchase Agreement, it will be part of your due diligence responsibility to confirm the accuracy of such descriptions and that there are no other pending matters for which the Buyer might inadvertently have accepted responsibility. House counsel and the legal files, if they exist, will be your best sources for information, as well as a check of the county records, which will be part of your title review anyway.

13. Conveyance and Other Closing Documents.

Many times the Purchase Agreement will contain as an exhibit the form of assignment to be delivered at Closing and the forms of other Closing documents. If these documents are not exhibits or if the exhibited set is incomplete, you will be responsible for negotiating and preparing such documents during the due diligence period. In such a case, it may be useful, particularly where there is a tight Closing schedule, to prepare a preliminary Closing memorandum so that you can focus on the documents you need to prepare while you juggle the other due diligence balls.

D. The Due Diligence Team.

Getting a competent team of due diligence specialists in place, organized for a maximum effort, and with everyone aware of his or her role and its associated responsibilities will be your chief priority if you want the due diligence effort to be a success.

Generally, the team will include legal, land, engineering and accounting/financial personnel. I recommend designating an individual to be responsible for each such discipline, with the designees reporting to the team leader, usually the attorney. A brief resume of the team members' responsibilities follows.

1. Attorney.

The primary responsibilities of the attorney will be to coordinate the overall effort; work with the landmen and outside counsel on title examination and prepare the title (and other) defects letter; investigate the corporate books and records and SEC compliance documents if it's a stock deal; review the legal files pertaining to the properties and discuss any questions with house counsel; keep lender's counsel advised as to the status of the review; negotiate (if necessary) and prepare the conveyance documents and other closing documents (certificates, opinions and the like) for which Buyer is responsible and review those closing documents the Seller is to provide; draft the escrow documents, if a portion of the purchase price is to be escrowed as an earnest money deposit, or because of pending disputes or defects or for a like-kind exchange; coordinate the Closing (including confirmation of the wire transfer arrangements); act as a clearinghouse for problems that arise; and keep the parties from getting into arguments that might kill the deal.

2. Landman.

The landman is usually the busiest member of the team. He or she will be responsible for reviewing all of the well, lease, land, and other contract files; confirming the rights-of-way and easements; coordinating with the attorney the title and county records review by local counsel and land brokers; and working on the preparation of the defects letter. The contracts review function can be staggering and it is essential that the landman use a worksheet or checklist for conducting such review similar to the one attached to this paper in order to identify and keep track of items that need to be checked and confirmed.

3. Engineer.

These days one of the engineer's main functions is to coordinate the environmental investigation if the Buyer does not have an environmental services person or an environmental attorney who has this responsibility. The engineer also will conduct the physical inspection and

inventory of the personal property and equipment to be acquired and will check the condition of the producing wells, the status of any non-producers and whether those previously plugged were plugged properly, particularly if there are representations and warranties covering these areas. Even without a specific representation and warranty, many times an anxious Seller may be persuaded to accept responsibility for non-productive or improperly plugged wells prior to (or even following) Closing so that the Buyer avoids this headache. The engineer also will be responsible for conducting the field interviews and may be assigned responsibility for reviewing reports filed with the state to confirm production volumes, verifying compliance with local and state regulations, and obtaining the transfer of regulatory licenses and permits.

4. Accounting/Financial.

This individual or, more likely, group of individuals will review the joint interest billings, lease operating statements and revenue desks, all with the goal of confirming that the expenses paid and revenues received are consistent with the Seller's scheduled net revenue interests and the results of the title review. They will also check the suspense accounts to confirm the amount and identify the basis for the funds placed in suspense and the gas balancing statements pertaining to individual wells, particularly if they are subject to representations and warranties. They also will confirm the payment of ad valorem and other production taxes and may be assigned responsibility for review of the sales contracts if the Buyer does not have a marketing staff to handle this job. The accounting/finance group is usually responsible for integrating the new properties into the Buyer's computer systems, holding the lender's hand while the process unfolds, preparing the preliminary closing statement and arranging for the wire transfer and the escrow of funds. Again, the use of a worksheet or checklist is essential for keeping track of the tasks assigned and the status of these tasks.

III. Conducting the Review.

A. The Checklist.

As noted, attached to this paper is a worksheet/checklist that we use in conducting our due diligence review. Another good form is that used by Randy Pharo, which is found in the Bate, et al., paper cited in the bibliography. There is nothing magic about either of these forms or any of the others included in the cited articles. Once you've settled on a form you like to use, don't hesitate to modify it to fit your style or the deal you're working on. Make sure each of your due diligence team members has a copy of the checklist and knows the items for which he or she has responsibility. Hold status meetings as you go along to make sure that the review is proceeding on schedule. Encourage the team to bring problems to your attention as they are discovered, even if it's before they have a solution to propose.

Most of the items listed are self-explanatory and may or may not have application to the deal you're working on. There are a number of items that may apply but are not included since we use the checklist primarily for confirmation and verification and these items fall in other categories. The items include:

1. Complete unfinished schedules or exhibits.
2. Draft conveyance instruments.
3. Prepare Buyer required Closing documents and review those to be provided by Seller.
4. Prepare escrow agreement(s) and make necessary arrangements.
5. Strap and gauge storage tanks and record meter readings.
6. Conduct environmental investigation and audit.
7. Conduct field interviews.
8. Review corporate books and records and SEC filings.
9. Finalize lending arrangements, if any, and arrange for wire transfer at Closing.
10. Coordinate the transfer of all computer and other data which is to be transferred.
11. Coordinate Hart-Scott-Rodino filing and SEC filings and confirm H-S-R approval or expiration of waiting period.
12. If any employees of the Seller are to be hired, make the necessary arrangements.
13. Confirm that all required preferential right to purchase notices have been sent.

Again, this is not intended to be a definitive listing. Each deal brings it's own unique requirements and you've got to stay flexible; but the one constant is that you operate at your peril if you try to do the review without using a checklist or its equivalent to identify the tasks to be done and to confirm when they have been completed.

B. Unique Problems.

Every veteran of the due diligence wars has experienced problems that he or she didn't anticipate and that were particularly difficult to solve. To me, this is what makes the process interesting, the hoped for pearl among the swine (so to speak). A few of my favorites follow.

1. Valuation of Easements and Rights-Of-Way.

Valuation schedules rarely place a value on the easements and rights-of-way that are included with the properties and there may not be a representation and warranty as to their existence and continuity. What happens if you can't confirm Seller's title? If there are no associated values, what's the defect worth and how do you notice it? How do you expect the Seller to cure

the problem, assuming it is inclined to do so? Approaching the landowner for a critical easement you assume exists but can't confirm is asking for trouble, but ignoring the problem is not the answer. Best of luck if you think you can get local counsel to give you an opinion that will ease your anxiety. The resolution that is usually reached after much posturing is a Seller indemnification. Many times the negotiations over the extent and duration of the indemnification take as long as those involving the indemnification itself. Most Sellers insist, at the very least, that the Buyer agree not to stir up trouble with the landowner and thereby trigger the indemnification.

2. Liabilities for Which Seller Retains Responsibility.

This is another definitional problem. Many Purchase Agreements allocate responsibility for “all costs, expenses, accounts payable and accrued liabilities attributable to the Assets” as of the Effective Date. This may be fine for most purposes, but every so often a post-Closing dispute arises as to what constitutes an “accrued liability.” If it's not accrued on the Seller's books, is the Buyer out of luck? Most Buyers don't think so (naturally), and take the position that if it should have been accrued, it's covered. The resolution varies with the specific facts involved, so my only advice is to be aware of this as a potential problem and consider drafting a more precise reference.

3. Seismic.

Many Purchase Agreements will include in the definition of the assets to be conveyed “all geographical, seismic and other technical data specifically related to the Assets.” It's the “specifically related to” language that can cause a problem once the Seller's geophysicists focus on it. For some reason, geophysicists hate to part with seismic data even though its only application is to the property being sold. Rather than argue about this, if you anticipate it will be a problem I suggest that seismic data be excluded from the sale, but that the Seller agree to provide the Buyer with a seismic license of such data if the Buyer so requests and agrees to pay the Seller's costs of reproduction.

4. Imbalances.

The signings of many Purchase Agreements are delayed while the parties argue over how to treat gas imbalances. It is not unusual for the parties to resolve the impasse by providing that agreement will be reached prior to the Closing, a Solomon like solution if there ever was one. This leads to protracted negotiations, which I've tried my best to stay out of, but miraculously the parties always reach an agreement of sorts by Closing. As messy and time consuming as these negotiations may be, I prefer this process of reaching a dollar amount the parties can live with versus trying to resolve the imbalances through the operator and other affected third parties. Of course, one way to avoid the problem is to only buy and sell oil properties.

5. Non Revenue Title Defects.

In some of the Purchase Agreements we've drafted we have included a provision for dealing with "non-revenue title defects" i.e., title defects which do not result in a decrease in the Seller's net revenue interest in a property which has an assigned value, but which could affect the Seller's use of such property. Many times the defect at issue is more theoretical than practical and may never mature into an adverse claim, in which case the Seller is naturally reluctant to credit the Buyer for the defect amount. If this becomes an issue, I suggest the Seller consider indemnifying the Buyer against any losses it may incur as a result of such defect. Of course, the Buyer may prefer a credit, in which case let them argue about it.

6. Buyer's Plans for Enhanced Value.

If your Buyer has plans for enhancing the value of the properties that are not readily apparent and are based on certain assumptions respecting the wells, leases, contracts or other documents constituting or pertaining to the properties, you'd better determine these plans in advance and include the assumptions they're based on as part of your due diligence review. You also should consider disclosing the plans and their underlying assumptions to the Seller and, if you're not able to get them covered by a representation and warranty in the Purchase Agreement, try to get the Seller to stand behind them as part of the give and take of the due diligence negotiations process. Otherwise you may become involved in a post-Closing argument when the Buyer's plans are frustrated because its assumptions are proven to be incorrect.

IV. Conclusion.

As I noted at the beginning of this paper, in many cases and in almost all of the larger transactions the due diligence process doesn't end at the Closing. You and certain members of your team may be responsible for continuing to pick and probe up to the last day of the last survival period, although in reality there's a natural tendency to lower your due diligence antennae, except for the preparation of the post-Closing defects letter, following the Closing dinner, particularly if there is another deal brewing. Also, once you close, unless a substantial portion of the purchase price has been escrowed, the Buyer has lost much of its leverage over the Seller. So even with survival periods, it is prudent to do as thorough and as comprehensive a due diligence review as possible during the period prior to the Closing. Hopefully, some of the observations and suggestions made herein and in the cited articles will facilitate this review.

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