



# Wait, What Am I Buying?

## *Severance and reservation issues in Texas oil and gas asset transactions*

**This article focuses on transactions that cover only portions of an underlying oil and gas asset.** Examples include transactions that convey (or reserve) a wellbore interest, transactions that are depth-limited and transactions that include only some (but not all) of the tracts covered by an underlying oil and gas lease or mineral interest. This article discusses certain issues raised by these kinds of transactions and provides some practical tips to avoid potential pitfalls.

### WHAT TYPE OF INTEREST IS BEING CONVEYED/RESERVED?

#### Wellbore Interests

Wellbore conveyances / reservations are nothing new; however, wellbore reservations have become particularly common in acreage trade transactions. These transactions raise the issue of what type of interest is being assigned or reserved and what appurtenant rights are included. While questions and disputes involving the scope of wellbore conveyances have existed in Texas law for many years,<sup>1</sup> we have observed a recent trend whereby certain sellers try to reserve all interest in the leases attributable to the conveyed well.<sup>2</sup> In our opinion, this type of conveyance assigns only a contractual interest in the production from the applicable well and thus would not be afforded all of the legal protections that accompany a real property interest. Therefore, a buyer should typically insist that the wellbore interest include associated leasehold title. Using the following sample language (or something similar) will ensure that a real property interest is conveyed:

Assignor hereby SELLS, ASSIGNS, TRANSFERS, GRANTS, BARGAINS and CONVEYS unto Assignee all of Assignor's right, title and interest in and to: (i) the wellbore of the oil and gas well described on Exhibit "A" (the "Wellbore"), attached hereto; (ii) the associated oil, gas and other associated hydrocarbons produced from the Wellbore; and (iii) the oil, gas and mineral leases described on Exhibit "A," INsofar AND ONLY INsofar as they cover the Wellbore or are necessary to entitle Assignee to the production of hydrocarbons from the Wellbore and to participate in operations with respect thereto and to any pooling rights associated therewith.<sup>3</sup>

Understandably, a seller will want to ensure that it does not convey rights beyond what the parties have agreed. However, using this sample language makes it clear that any conveyed leasehold interest is limited solely to the wellbores of the applicable wells and does not include rights to produce from other portions of the leases.



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1 See, e.g., *Petro Pro, Ltd. v. Upland Res., Inc.*, 279 S.W.3d 743 (Tex. App. — Amarillo 2007); *Unit Petroleum Co. v. David Pond Well Serv.*, 439 S.W.3d 389 (Tex. App. — Amarillo 2014).

2 "Seller reserves and retains one hundred percent (100%) of the leasehold estate upon which the Subject Well is located and Buyer acknowledges and agrees that nothing in this Wellbore Assignment will be construed or interpreted to include or convey any of Seller's leasehold ownership related to the Subject Well, whatsoever, such being expressly reserved to Seller."

3 Conversely, if a seller is retaining a specific well(s), then the reservation should specifically reserve the right to consent to the formation of or amendment to any pools or units that may cover such well(s).

### Conveyances/Reservations of Specific Depths

Another common theme is to identify specific depths that the buyer will acquire or that the seller will reserve. Typically, such depths have a defined term in the purchase agreement, which should identify those depths with a reference to the type log from a specific oil and gas well, for example:

“\_\_\_\_\_ Formation” means the stratigraphic equivalent of the [formation name] as shown between the depths of [top and bottom footage marks] in that certain [type of log] log dated [\_\_\_\_] for the [insert well operator and well name], API# [\_\_\_\_\_].<sup>4</sup>

Even where the buyer is acquiring all depths, such a definition is still sometimes used in the purchase agreement for purposes of limiting the seller's exposure to title defects to a specific target formation, such as the currently producing horizon for producing wells, and/or some other formation the buyer intends to test. Thus, for purposes of asserting title defects, a buyer will be limited to asserting only those defects affecting that formation. If the parties contemplate using two or more target formations, the parties should allocate the applicable lease (or unit or development section) value among such formations. Doing so will ensure that there is a clear agreement between the parties as to how to value a title defect that may affect one target formation in a given lease but not the other(s).<sup>5</sup>

### POTENTIAL IMPACT ON THE TERMS OF AN UNDERLYING OIL AND GAS LEASE

Segregating an oil and gas lease (horizontally, vertically or by wellbore) may trigger various obligations that the parties may not have intended or considered. For example, contemporary oil and gas leases that cover large amounts of acreage typically contain some form of continuous drilling obligation. When a buyer acquires only a portion of the tracts covered by such a lease, the seller may or may not be conducting operations on its retained portion of the lease necessary to comply with an existing continuous drilling obligation. In many instances, a buyer is not in a position to quickly begin drilling operations on newly acquired leases (particularly when a buyer acquires numerous leases in a single transaction). A related issue is ensuring that a segregated lease in its secondary term continues to produce in paying quantities. As an example, a seller assigns an oil and gas lease but reserves its interest in all then-existing wells. After closing, unless the buyer can immediately drill its own wells, it will have to rely on the production from the seller's retained wells to maintain the lease. Should the parties be faced with these (or similar) issues, there are a few different options to consider.

First, if the parties decide that they are in need of a longer term solution, they should consider executing a form of lease maintenance and cooperation agreement. Typically, these types of agreements remain in force for the life of the applicable

lease and cover a litany of lease maintenance and operational issues. In the context of the examples described here, the agreement should provide that, after closing, the seller will continue operations necessary to comply with any applicable continuous development obligations (in the first example) or to produce hydrocarbons in paying quantities (in the second example). Typically, the seller's obligations will terminate on the earlier occurrence of (1) a specific period of time after closing (commonly from six to 24 months) or (2) when the buyer has begun operations on the lease necessary to comply with any continuous development obligation or to produce hydrocarbons in paying quantities (as applicable).

Alternatively, instead of a firm obligation to continue operations, the parties could agree that they only have an obligation to provide such operations until proper notice is given to the other party. For example, the agreement could obligate the seller to provide notice to the buyer (typically from 60 to 120 days in advance) that the seller intends to cease conducting the operations as described. This option gives the seller more flexibility while still providing some protection to the buyer to give it time to take the necessary steps to maintain the lease on its own. In addition to providing notice, where the seller has retained the only producing well(s) on a lease, the buyer should also seek to have the option to take over and acquire such retained well from the seller should it decide to cease operations.<sup>6</sup>

4 A reservation of depths in and to oil and gas leases are commonly included in the list of “Excluded Assets” agreed by the parties. To the extent that there are otherwise no defined “Excluded Assets,” the above language (or something similar) will ensure that a seller retains its rights in the applicable oil and gas leases outside the target formation.

5 Relatedly, a seller should also try to include language in the purchase agreement that will address the situation where a title defect affects some but not all of a defined “Target Formation.” In such a situation, the value calculation of an applicable title defect should account for the fact that it does not affect the entirety of the applicable “Target Formation.” Although this scenario could create a potential conflict between the parties, the inclusion of this language should allow the valuation of this type of title defect to be based on the actual production, engineering and geological data applicable to the lease(s) in question.

6 If the parties have entered into a traditional farmout agreement, the farmor should insist that it retain a similar right whereby it would have the ability to take over operations if the farmee fails to conduct operations necessary to perpetuate an applicable lease.

Second, if the parties decide that only a temporary solution is needed, they could either incorporate the necessary operations into a transition services agreement or include them directly into the terms of the applicable purchase and sale agreement as a post-closing covenant. If the former option is used, the parties will have more flexibility to include a variety of different operations that may be necessary, depending on the situation. If the parties do not plan on otherwise using a TSA post-closing, then including a post-closing covenant in the purchase and sale agreement would likely be the best option.








## OTHER POTENTIAL ISSUES

### Concurrent Use of the Surface

When a lease is severed (particularly by depth), use of the surface estate can create numerous operational and logistical problems. Some common issues include (1) joint use and maintenance of roads; (2) joint use of facilities or well pads; (3) conflicts between different operators over concurrent operations and the availability of drillsites; and (4) joint use of gathering and disposal systems. As with lease maintenance concerns, these issues can all be addressed in a lease maintenance and cooperation agreement, pursuant to which the parties agree at or before closing as to how these (or similar) issues will be handled in the future.

### Maintenance of Uniform Interest Provisions

To the extent that any of the segregated leases are subject to an AAPL model form operating agreement, the assignment of depths or specific wellbores would likely violate the terms of the maintenance of uniform interest provision commonly found in such agreement. From a buyer's perspective, the ideal

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solution would be to make the seller obtain an appropriate waiver from the applicable co-working interest owners prior to closing. Alternatively, the buyer could close without such waiver but should require that the seller provide an indemnity to the buyer in the event a third party makes a claim for damages due to a breach of the provision.

### Regulatory Hurdles

In Texas, SWR 40 prohibits the double allocation of surface acres to more than one well producing from the same field.<sup>7</sup> This could potentially prohibit a buyer from drilling wells on a segregated lease to the extent a seller has already drilled wells on the lease in the same field and has allocated all of the available surface acreage. Prior to March 2020, a buyer would be required to apply for an exception to SWR 40 and go through a formal hearing process in order to receive an allowable on any wells it has drilled. Post March 2020, SWR 40

has been amended to help alleviate this issue to the extent certain criteria are satisfied.<sup>8</sup> However, this remains an issue that a buyer should consider and analyze if it is not acquiring all depths covered within a field. ▲

## ABOUT THE AUTHORS

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<sup>7</sup> See 16 Tex. Admin. Code §3.40.

<sup>8</sup> See *id.* at §3.40(e).