

TEXAS LAWYER

An **ALM** Publication

texaslawyer.com | March, 2019

IN-HOUSE FOCUS



Earnouts in Oil and Gas Transactions

The Risk and Rewards of O&G Commodities

BY DAVID SWEENEY AND SAVANNAH RAYMOND



EARNOUTS ARE USED IN ACQUISITIONS AND DIVESTITURES

to bridge the gap between competing valuations created by the uncertainty in the oil and gas industry. This uncertainty depresses valuations which lead to fewer transactions. While the mitigation of all uncertainty is not achievable, conceptualizing an earnout as a tool to combat market inefficiency can assist practitioners in drafting appropriately tailored earnout provisions that allow transactions to take place and reward risk-taking.

An earnout is a form of consideration that is payable post-closing contingent upon the satisfaction of specified facts or conditions. It affords a seller a higher potential purchase price with a quicker closing and reduces the chances that a buyer will “overpay” or be left with insufficient liquidity after closing. However, it comes at a cost. Both parties maintain exposure to the asset and each other, increasing

the risk of disputes regarding the earnout. For earnouts to reduce market inefficiency, they must be tailored to the assets, risks, and businesses involved.

Earnouts can be categorized into one or more of the following categories: commodity price, operational, or geological. Category are generally better suited to a specific stage of an asset’s life cycle.

COMMODITY PRICE EARNOUTS

Earnouts based on commodity prices typically peg the payment of additional consideration to a published, easily verifiable, pricing metric, generally over some period of time. It uses the chosen metric as a proxy for the value of an asset as a whole on the theory that an asset will be worth more when the commodity it generates costs more.

This type of earnout is commonly-used, straightforward to draft, and unambiguous in its application. In practice, businesspersons calculating an asset’s worth would use far more sensitivities than commodity prices. Further, even if increased commodity prices would raise the value of assets in the same class, generally, they may not for the particular asset or buyer in question. For example, a WTI-based earnout would likely not be appropriate for a gassy asset, and a 60-day test for prices might not help a purchaser whose reserve-based loan determines a price deck based on strip or requires that the purchaser hedge a high percentage of its reserves at closing. In some of these instances, an operational earnout, such as one based on actual profitability, may be more appropriate. While a commodity price earnout has its advantages, parties should understand and embrace its limitations.



OPERATIONAL EARNOUTS

Operational earnouts are generally a better proxy for mitigating market inefficiency and capturing actual value, but are burdened by their subjective nature, difficult application and the complicated drafting and negotiating involved. If structured properly, operational earnouts align the parties' interests by incentivizing each party toward the same goal—successful and economic development. Common examples of operational earnouts include initial production rates for a subset of wells, increases in production from a stipulated baseline level, reductions from baseline levels of certain costs, operational cycle times, and performance versus a stipulated AFE.

Operational earnouts should be drafted using objective and measurable targets that are clear, concrete and fit for the particular phase of the project. Including specific well sites and types of wells to be drilled, specifying the types of costs that relate to the earnout and using examples of criteria that do and do not satisfy the earnout are common methods of avoiding disputes. For example, an operational earnout based on reduction of specific costs from a pre-determined baseline and level of activity could be workable, whereas an earnout based on profitability is likely to generate a protracted negotiation, litigation, or both. The use of expedited expert determination relating to key factors within the earnout may further reduce costly litigation.

Control is a critical consideration in structuring this earnout. The purchaser will own the asset after closing and will want to control operations. A seller whose compensation is tied to operations may want some level of control. The result is generally post-closing operational covenants that incorporate mechanisms providing the seller with oversight and the buyer with reasonable discretion over the asset. Specificity is a virtue. A covenant regarding the use of certain contractors or purchasers is less likely to result in a dispute than the import of generic “past practices” or “reasonably prudent operator” standard.

GEOLOGICAL EARNOUTS

Geological earnouts are based on subsurface characteristics and are typically used in the exploration or appraisal phases.

OPERATIONAL EARNOUTS SHOULD BE DRAFTED USING OBJECTIVE AND MEASURABLE TARGETS THAT ARE CLEAR, CONCRETE AND FIT FOR THE PARTICULAR PHASE OF THE PROJECT.

They mitigate market inefficiency by allowing a seller to retain some exposure to an asset that it initially, and partially, de-risked, without requiring the purchaser to pay for a fully de-risked asset. As conventional reservoirs have not been the focus of recent activity onshore, geological earnouts have become relatively rare. However, in the Gulf of Mexico this type of earnout is more frequently encountered. Examples of geological earnouts include oil-water contact depth, volume of hydrocarbons in place, gross hydrocarbon volume, and estimate of remaining recoverable reserves for enhanced oil recovery projects.

Geological earnouts may capture the flexibility of an operational earnout and the objectivity of a commodity price earnout. However, drafting such earnouts requires a sophisticated appreciation of the assets and an open dialogue between negotiators and technical subdisciplines. Often, it is the strength of this dialogue that determines success or failure.

CONCLUSION

As the landscape of the oil and gas industry continues to evolve, understanding how to navigate the risks and uncertainties of transacting in this industry is becoming increasingly important. By understanding a client's business and the risks involved, lawyers can use earnouts to forge deals, create value and increase efficient development of oil and gas assets.

David Sweeney is a partner in Akin Gump's in Houston. He has advised on mergers and acquisitions with an aggregate value of over \$65 billion, energy finance transactions with an aggregate value of over \$3 billion, and operational matters spanning the entire hydrocarbon value chain. Savannah Raymond is an associate in Akin Gump in Houston. Her practice encompasses acquisitions and divestitures, capital markets, finance and private equity transactions, with a particular focus on the energy sector.