NHAPL
NORTH HOUSTON
ASSOCIATION OF PROFESSIONAL LANDMEN

2015 NHAPL HALF-DAY SEMINAR

"NON-TRADITIONAL UPSTREAM TRANSACTIONS & JOINT VENTURES"

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Topics covered

Multi-Well Farmout Arrangements

- Key Drivers
- Key Components of Consideration
- Key Drafting Considerations

Joint Development Arrangements

- Typical Transaction Players/Investors
- Key Components of Consideration
- Default and Security Provisions
- Development Plans and Budgets
- Secondment

Assignability and Exit Strategies

- Transfer Restrictions
- Preferential Purchase Rights
- Rights of First Opportunity and Offer

Current and Emerging Legal Issues

Multi-Well Farmout Arrangements

Multi-Well Farmout Arrangements

- Key Drivers
  - Cost, financial resources
    - First Eagle Ford Well drilled in a recent matter: Total Drilling, Completion, and Production Facility Costs > $10MM
    - Compare: new Edwards Well total AFE: $1.9MM
  - Technological Expertise – *e.g.*, horizontal drilling, hydraulic fracturing
  - Potential investment vehicle for those looking to own a direct working interest in oil and gas assets rather than providing financing through traditional debt structure (generally structured as “fund-to-earn” rather than “drill-to-earn”)

Key Components of Consideration

- Cash
  - Generally based on total net acres delivered (assuming no production included)
  - May include other consideration such as reimbursement for seismic
- Size of Farmor’s Retained Working Interest
- Carried Working Interest
- Continuous Drilling Obligations
- Retained ORRI (BUT: beware of tax consequences)

Tax Implications of Overriding Royalty Reservations

- Transaction is treated as a lease, rather than a sale, for federal income tax purposes:
  - Ordinary income (not capital gains)
  - Sales proceeds are offset only by cost depletion, rather than the seller's entire basis in the transferred lease
  - Seller cannot use the sales proceeds in a tax-advantaged "like-kind exchange"

Drafting Considerations

- Carefully Define the Prospect Area and Prospect Depths
- Prospect Area Examples:
  - All lands within the geographical boundaries of the pooled units more particularly described on <u>Exhibit “A”</u>, insofar and only insofar as they cover the Prospect Interval.

  Or

  - Those lands outlined on the plat attached hereto as <u>Exhibit “B”</u>, insofar and only insofar as they cover the Prospect Interval
- (Caution: Be aware of statute of frauds issues)

Statute of Frauds

- These agreements generally involve the transfer of leases and are therefore governed by the Statute of Frauds.
- Land descriptions by reference to another agreement, map or plat is ok, provided that the description is sufficiently certain.
- *Westland Oil Dev. Corp. v. Gulf Oil Corp.,* 637 S.W.2d 903 (Tex. 1982).
  - Letter agreement attempted to create an area of mutual interest, and described the lands by reference to an ancillary farmout agreement: “If any of the parties hereto… acquire **any additional leasehold interests affecting any of the lands covered by said farmout agreement, or any additional interest from Mobil Oil Corporation under lands in the area of the farmout acreage**, such shall be subject to the terms and provisions of this agreement.”
  - Texas Supreme Court allowed the first description because the referenced farmout agreement contained an adequate legal description of the lands and was attached to the letter agreement.
  - However, the Court held that the second description (as to “lands in the area”) was not legally sufficient.

Prospect Interval Example

Where possible, be specific and include upper and lower depths by reference to a well-described log from a well-described marker well:

Those subsurface depths located between the stratigraphic equivalents of the top of the Eagle Ford Shale formation, being a subsurface depth of 7,934 feet, and the base of the Buda formation, being a subsurface depth of 8,150 feet, each as seen in the dual induction compensation neutron density log dated March 7, 1982, for the Energy Resources Company #1 well, API # 1111111111, located in the X Survey, Abstract Y, Z County, Texas.

Carried Working Interest Issues

- The Parties should have a detailed meeting of the minds regarding the extent of the carry and what costs are covered by the carry.
  - Examples:
    - “Carry to Casing Point”
    - “Carry to Completion”
    - “Carry to the Tanks”
  - Carefully define what each of these mean.

Defining Completion

- These definitions can and should be clear and specific.
- Completion definitions should differentiate between producing wells and dry holes.
- Example: "Completion" means (a) for a well capable of producing, the point at which drilling operations have been completed, all well production facilities have been installed on the unit to enable such well to be placed on production under normal operations, and sales of petroleum (either oil or gas) have begun to be made through such surface facilities; and (b) for an unsuccessful well (*e.g.*, dry or abandoned and plugged hole or a well incapable of producing in paying quantities), that all operations in respect of the well (including for its plugging and abandonment) have been completed.

Example (continued)

- Example: "Costs through Completion" means all actual costs and expenses of drilling a Commitment Well through Completion, including all of the following costs to the extent incurred on or before Completion: all costs associated with the drilling of a Commitment Well that are chargeable to the joint account under the JOA and any third party title review or examination costs; permitting costs; drilling and completion costs; costs for any on-lease facilities (including separation equipment and metering equipment) that are required to enable sales of hydrocarbons from the Commitment Well; and if any Commitment Well is not capable of producing in paying quantities, then the costs of plugging and abandonment, restoration, and reclamation required by Applicable Law or contract and decommissioning and dismantling costs associated with such unsuccessful Commitment Well.

Caution

- The Parties may agree that certain types of expenses are covered by the carry, some of which may not occur until after production has begun (such as disposal of fraccing fluids).

- Make sure the agreement is clear and specific both as to covered costs and, if applicable, the time at which the carry ends.

- Alternatively, many carried interests are defined to terminate when the carried costs reach a certain dollar cap.

Requirements for Earning Wells

- Identify the Objective Depth

Unless otherwise agreed to in writing by the Parties: (a) all wells drilled hereunder … shall be drilled horizontally, meaning drilled in a manner whereby the horizontal component of the completion interval in the "Haynesville Zone", as defined for the XYZ Field in Office of Conservation Order No. 405-H, exceeds (i) the vertical component of such completion interval and (ii) a minimum of three thousand feet (3,000') in the Haynesville Zone; and (b) shall be drilled by Farmee with due diligence, in a workmanlike manner, in accordance with good oilfield practice, and in compliance with applicable laws and regulations to such depth that, in Farmee's sole opinion exercised in good faith, adequately tests the Haynesville Zone (the "Objective Depth").

Requirements for Earning Wells

- Once the Objective Depth has been described, the definition of Earning Well follows:

For purposes of this Agreement, an "Earning Well" shall mean a timely commenced Initial Unit Well that reaches total depth. An Earning Well shall be deemed to have reached "total depth" for purposes of this Agreement when it has been drilled to the Objective Depth and the horizontal component of the wellbore has been drilled to the permitted horizontal displacement, or to such shorter length as may be deemed prudent, in Farmee's sole judgment exercised in good faith, to assure maintaining the integrity and utility of the wellbore, based on factors such as then-existing hole conditions, equipment limitations, geologic factors or other relevant considerations.

Specific Issues Related to AMI Provisions

Will there be an Area of Mutual Interest (AMI) in which the parties agree to offer each other a proportionate share of any newly acquired leases? If so:

- How is the AMI defined? (Statute of Frauds)
- How are leases lying partly in and partly outside the AMI handled?
- If the farmout is depth limited, will the farmor retain any depths in the AMI leases? If so, how are the lease bonus costs to be allocated between the shallow and deep rights?
- What is the term of the AMI?
- If Farmee fails to completely earn the Contract Area, does it forfeit Acquired Interests within the unearned area?

Joint Development Arrangements

Joint Development Arrangements – Case Study Introduction

- Investor ("Asia Gas") is a large gas provider and power producer in a large AP country.
  - It has substantial equity in an approved U.S. LNG export facility ("Asia Gas LNG") along with a liquefaction tolling agreement for the export of over 2 million tons of LNG per year from the U.S. to Asia for 20 years.
  - Ownership of U.S. natural gas interests is essential to ensuring a successful U.S. natural gas export strategy, which is a core component of its LNG value chain integration efforts.
- "American Oil Company" is over weighted on the gas side of its portfolio; wants to monetize some of its gas assets and use the proceeds to acquire and/or further develop liquids.
- American Oil and Asia Gas enter into a joint venture whereby Asia Gas acquires a 50% non-operating share of certain of American's gas assets in a prominent shale gas play. The acquisition is made pursuant to a Purchase and Sale Agreement. At Closing, the parties execute a Joint Development Agreement, which will govern their rights and obligations with respect to the ownership and operation of the applicable properties (including those subsequently acquired under the AMI).
- Parties will often structure these types of joint ventures as a corporate transaction, whereby a "NewCo" is formed, the Operator contributes the applicable assets into NewCo, and the Investor contributes cash. Ownership is then set up through equity in NewCo rather than through record title in and to the assets.

Joint Ventures where the Investor is not the Operator

- These types of joint ventures traditionally occur where the Operator already has the land position, but brings in a financial partner ("Investor").

- In addition to Asia Gas, other typical Investors include:
  - Other industry players with no prior foothold in the applicable play
  - Private equity, funds or similar financial institutions looking for high upside
  - Foreign companies looking to invest in the US
  - Foreign companies seeking to acquire first-hand knowledge and experience with unconventional drilling and operations

Key Differences from Multi-Well Farmouts

- Carried Interest: The Operator (i.e., American Oil Company) is now the carried party, not the Non-Operator.

- The parties typically agree on a specific dollar amount for the total consideration and split it out between the "Cash Consideration" and the "Carry Consideration."

  - Example: $400 Million Total Consideration
    - Cash Consideration = $100 Million
    - Carry Consideration = $300 Million

- The Parties will need to specify all parameters of the Carry.

Case Study: Carry Consideration

- Example – Asia Gas acquires 50% interest, Carry will cover ½ of American Oil Company's 50% Retained Working Interest

  "Asia Gas will fund 50% of American Oil Company's Retained WI share of total Qualified Costs with respect to drilling and other operations relating to the jointly owned acreage constituting the Subject Property and any other jointly owned acreage acquired pursuant to the terms of the AMI until the Drilling Carry is fully utilized."

  "Qualified Costs" will include all costs associated with the development of the jointly owned acreage or well(s) thereon, including any taxes, costs attributable to third-party title review or examination, permitting, drilling, completion, initial production infrastructure and equipment, plugging and abandonment costs and reclamation and related costs.

  Note→ the inclusion of post-production costs (such as transportation costs) in "Qualified Costs" is often a key point of negotiation.

Default and Security Provisions to Secure the Carry

- Since the Investor will usually be receiving a present assignment at Closing, the Seller will negotiate for terms that provide security for the Carry Obligation. Alternatives include:
  - Liens and security interests covering the Investor's interest pursuant to a JOA or otherwise (such as the standard Operator's lien)
  - Mortgages on the Investor's interest
  - Re-assignment obligations
  - Letters-of-credit/Performance bond
  - Investor's obligation to make advance payments for estimated development expenditures
  - Parent guaranties
    - May or may not be capped

Development Plan

- Joint Development Agreements will typically contain an initial drilling program (of some specified time), which is intended (at a minimum) to facilitate the full utilization of the Drilling Carry.
- Note that the agreements should be drafted so that there is enough flexibility for the parties to modify Development Plans and corresponding budgets if needed (as they are merely estimates), but also so that the parties can have a reasonable expectation of receiving the benefit of the bargain.
  - Note also that there is often inherent tension between Investors and Operators as to the Development Plan, as each has different economic motivators.
- Some Joint Development Agreements call for an Operating Committee (sometimes called a Management Committee) in which the Investor will have some influence. The Operating Committee will generally be authorized to make modifications to Development Plans as may be necessary.
  - Rarely will the Investor have a controlling vote on the Committee.

Case Study: Development Plan

- Purpose of the Development Plan between Asia Gas and American Oil Company: to optimize the timing and scale of gas production so as to achieve a long-term, stable production profile balanced against the need to hold acreage, secure leases, and American Oil Company's production needs and goals.
  - Asia Gas Motivator- when Asia Gas LNG becomes operational in 2-3 years, there should be a sufficient source of gas supply to meet Asia Gas' export strategy.
  - American Oil Company Motivator- hold acreage and leases with minimum costs during times of depressed gas prices.
- Note: To ensure timely development, Investors will want any unused Carry Consideration to be forfeited at the end of the Carry Period. Operators will want to ensure that all Drilling Carry costs are spent.

Variances from the Budget

- The Operator will want some discretion to deviate from and amend the budget (remember: these budgets are rough estimates). The Parties will negotiate various limits on the Operator's unilateral authority to deviate from the budget.

- Example of limits on Operator's discretion:
  - Operator will consult with Investor with respect to any material changes in the Development Plan and when and if Operator becomes aware that expenditures will be more or less than 10% of the budgeted amount in a given year, Operator will promptly distribute to Investor a supplemented or amended budget that reflects such variance for Investor's prior approval.

- As for operations that are provided for in the Development Plan, or any subsequent approved budgets, the Operator will generally want to provide that the Investor may not go non-consent in any such operations until the Drilling Carry has been spent.

Secondment

- Investors (particularly foreign investors looking to acquire first-hand knowledge and experience with unconventional drilling and operations) often want to enter Secondment Agreements with the Operator so they can send employees to observe and participate in the joint operations.
- The AIPN has a Model Form Secondment Agreement
- If the Parties agree to a secondment, they should address the following issues:
  - Who will pay the Secondee while the Secondee is working with the Operator?
  - What will be the extent and scope of the Secondee’s activities while with the Operator?
    - Is the secondment an accommodation to the Investor, or will the Secondee be doing valuable work for the Operator?
  - How many Secondees can the Investor send at one time and can they be replaced?
  - NOTE- the recent trend is moving away from secondments and towards informal training methods (such as scheduled site visits, tutorials, meetings and conference calls)

Case Study: Secondment

- American Oil Company was opposed to providing any type of secondment arrangement. However, it was very important for Asia Gas to obtain first-hand knowledge and experience (and remain involved) with unconventional drilling and operations. Thus, the compromise was for American Oil Company to schedule the following:
  - At least one quarterly in-person meeting/program to be held at American Oil Company's offices principally designed to provide technical and operational training with respect to the Subject Assets to certain Asia Gas representatives
  - At least one monthly conference call to be hosted by American Oil Company so that representatives of the Parties can discuss the status of Development Operations, expenditures under the applicable Annual Plan and Budget, and any operating reports or other data that have been distributed by American Oil Company
  - One weekly, informal conference call hosted by American Oil Company, so that the Parties are able to discuss any follow-up issues relating to the Subject Assets

Assignability and Exit Strategies

Assignability and Exit Strategies (the “Pre-Nup”)

- Usually, this is restricted during the Development Period.
  - From the Investor’s point of view, he has entered the JV specifically due to the Operator’s expertise within the exploration area.
  - From the Operator’s point of view, he may be concerned about the ability of an assignee of the Investor to satisfy the carry obligation.
  - Exceptions may be made with respect to “fully developed” sections.
  - An exception may also be negotiated for the Investor to be able to exit by prepaying the remaining Carry Consideration in a lump sum.
    - In some agreements, this right is only triggered by slower-than-anticipated expenditures or development.
    - At a minimum, such pre-payment rights are usually not available until at least a minimum set time (for example, 2-3 years) has passed since Closing.
- Once the Development Period is up or the Carry Consideration has been fully satisfied, assignability is usually governed by the applicable JOA.

Standard JOA Preferential Right to Purchase Provision

- Should any party desire to sell all or any part of its interests … in the Contract Area, it shall promptly give written notice to the other parties, with full information concerning its proposed disposition, which shall include the name and address of the prospective transferee …, the purchase price, a legal description … and all other terms of the offer.
- The other parties shall then have an optional prior right, for a period of ten (10) days after the notice is delivered, to purchase for the stated consideration on the same terms and conditions the interest which the other party proposes to sell….
- However, there shall be no preferential right to purchase in those cases where any party wishes to mortgage its interests, or to transfer title to its mortgagee in lieu of or pursuant to foreclosure…, or to dispose of its interests by merger, reorganization, consolidation, or by sale of substantially all of its Oil and Gas assets to any party, or by transfer of its interests to a subsidiary or parent company or to a subsidiary of a parent company, or to any party in which such party owns a majority of the stock.
- Source: AAPL Form 610 - Model Form Operating Agreement –1989

Case Study

- 2 parties, 50-50 owners under a JOA
- Party A's parent company forms a new wholly-owned LLC (Party "A-1"). Party A assigns all its 50% interest in the Contract Area to Party A-1. (Step 1)
- Party A notifies Party B that it has decided to market the property as a sale of all of the shares of Party A-1, not as an asset sale. (Step 2)
- Party A claims:
  - Step 1 did not trigger the PRP because "there shall be no preferential right to purchase in those cases where any party wishes to … dispose of its interests … by transfer of its interests to a … to a subsidiary of a parent company."
- Step 2 will not trigger the PRP because "there shall be no preferential right to purchase in those cases where any party wishes to … dispose of its interests … by merger."
- Can Party A do this?

Tenneco v. Enterprise Products Company
925 S.W.2d 640 (Tex. 1996)

- Tenneco Oil Co. and Enterprise co-owned a natural gas liquids fractionation plant.
- The parties were under an Operating Agreement that contained a right of first refusal. The right of first refusal was limited to asset sales, but did not apply to transfers to wholly-owned subsidiaries.
- Tenneco Oil Co. conveyed its interest in the plant to its wholly-owned subsidiary, Tenneco Natural Gas Liquids.
- Tenneco Oil Co. then conveyed all of the stock of Tenneco Natural Gas Liquids to Enron Gas Processing Company, which changed the name of the company to Enron Natural Gas Liquids.
- Tenneco had first offered the assets for sale before settling on the stock sale.
- For tax purposes, Tenneco and Enron treated the transaction as an asset sale.
- Enterprise's lawyers argued: no matter how the parties structured the transaction, it was, in substance, a transfer of an ownership interest which invoked the right of first refusal.

Tenneco v. Enterprise Products Company (Tex. 1996) (cont.)

- The Texas Supreme Court ruled in favor of Tenneco.
- "Sound corporate jurisprudence requires that courts narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock…. Viewing several separate transactions as a single transaction to invoke the right of first refusal compromises the law's unfavorable estimation of such restrictive provisions.... Moreover, the plain language of the Restated Operating Agreement provides that only a transfer of an ownership interest triggers the preferential right to purchase; it says nothing about a change in stockholders. The Enterprise Parties could have included a change-of-control provision in the agreements that would trigger the preferential right to purchase. None of the agreements among the parties contained such a provision. We have long held that courts will not rewrite agreements to insert provisions parties could have included or to imply restraints for which they have not bargained."
- This process has become known as the "Texas Two-Step."

Rights of First Opportunity

Gives a Party the right to preempt a sale to a third party by having the first opportunity to buy the other Party's interest.

- Right of First Negotiation
  - Typically requires a Party wishing to sell all or part of its interest in the Contract Area to notify the other Party of the price and other terms under which it is willing to sell its interest. The Non-Selling Party then has a limited time to elect to enter into negotiations to purchase the Selling Party's interest. If the Non-Selling Party elects to pursue such negotiations, the Parties shall undertake good faith negotiations to agree to mutually acceptable terms and conditions for the sale of the Selling Party's interest to the Non-Selling Party, and upon such agreement, shall exercise good faith in consummating such sale in a timely manner. If the Parties fail to reach agreement within some specified period of time (or if the Non-Selling Party elects not to enter negotiations), the Selling Party shall be free to sell its interest to any third party, provided that the total consideration received cannot be less than the offered price, terms and conditions described by the Selling Party in its notice to the Non-Selling Party.
- Right of First Offer
  - Like a Right of First Negotiation but without the negotiation covenant – *i.e.*, the Non-Selling Party may only accept the price and other terms first proposed by the Selling Party.

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Current and Emerging Legal Issues

Emerging Legal Issue

- Back to our case study: American Oil Company and Asia Gas anticipate selling gas directly to Asia Gas LNG for prevailing market prices (estimated between $3 and $5/mcf). Back at home, Asia Gas expects to sell this gas for $20+/mcf.
  - As a landman for American Oil Company, is there anything here that concerns you?

Emerging Legal Issue

- Sample royalty clause:

Lessee agrees to pay lessor the following royalty: (a) twenty-five percent (25%) of the market value at the well of all oil and other liquid hydrocarbons produced and saved from the Leased Premises as of the day it is produced and stored; and (b) for natural gas, including other gaseous substances produced from the Leased Premises and sold or used on or off the Leased Premises, twenty-five percent (25%) of the price <u>actually received</u> by lessee for such gas . . . . *The royalty reserved herein by Lessor shall be <u>free and clear of all</u> production and <u>post-production costs and expenses</u>, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred <u>between the wellhead and Lessee's point of delivery or sale of such share to a third party</u>.*

Marathon Oil Company v. United States Cook Inlet Region, Inc. 807 F.2d 759, 765-66 (9th Cir. 1986).

- Facts
  - Marathon owned federal oil and gas leases in Alaska.
  - Sold 84% of its gas under a long term contract with Alaska Pipeline Company.
  - Transported the other 16% to an LNG plant co-owned by Marathon and Phillips.
  - Marathon then transported the LNG in tankers to Japan where it was sold.
  - All royalties were calculated on the price received under the long-term contract with Alaska Pipeline Company.

Marathon Oil Company v. United States Cook Inlet Region, Inc.

- Facts
  - Leases provided for 12.5% royalty on the reasonable value of production from the lease lands "computed in accordance with the Oil and Gas Operating Regulations."
  - Regulations provided, "Under no circumstances will royalty be computed on less than the gross proceeds accruing to the lessee or operator from the sale of leasehold production."
  - The MMS required Marathon to calculate the royalty based on the price received in Japan, less certain actual costs.
  - Marathon appealed the MMS ruling to the U.S. District Court in Alaska. The District Court upheld the ruling, and on appeal, so did the U.S. Court of Appeals for the Ninth Circuit.

Another look at that Royalty Clause

- …. twenty-five percent (25%) of the price actually received by lessee for such gas . . . . *The royalty reserved herein by Lessor shall be free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred between the wellhead and Lessee's point of delivery or sale of such share to a third party.*

- Not just Asia Gas's issue. American Oil has joint and several liability for payment of the lease royalty. *Sharp v. Beacon Oil & Ref. Co*., 108 S.W.2d 870 (Tex. Civ. App.—Texarkana 1937, writ dism'd).

What's the Solution?

- Amend the Leases? (Good luck!)

- Not sell the gas to Asia Gas LNG?

  - Theory: same economic effect for Asia Gas (*i.e.*, Asia Gas sells the produced gas to other markets but Asia Gas LNG replaces that gas with third party gas at roughly equivalent prices)

  - But: Lessor will argue that this is a breach of the implied duty to market at the best price. The implied duty to market is two-pronged: the lessee must (1) market the production with due diligence and (2) obtain the best price reasonably possible. *Cabot Corp. v.Brown,* 754 S.W.2d 104, 106 (Tex. 1988)

  - Does this mean Asia Gas is obligated to sell through its affiliates in order to maximize the lessor's royalty? Wouldn't a reasonably prudent operator do so?

Implied Duty to Market to Asia Gas LNG?

Is there any law directly on point to address the risk?

- An operator does not owe royalty owners a fiduciary duty and is not required to place the interests of the royalty owner before its own. *Hurd Enterprises, Ltd. v. Bruni* (Tex.App.-San Antonio 1992, writ denied).
- In addition, the reasonably prudent operator standard explicitly protects the lessee's profit motive in other contexts such as development and drainage cases. *Clifton v. Koontz,* (Tex. 1959); *Grayson v. Crescendo Res., L.P.,* (Tex. App.-Amarillo 2003, pet. denied).
- The simple fact that higher priced sales take place in the market does not by itself constitute a breach of the duty. *Union Pac. Res. Group, Inc. v. Hankins,* (Tex. 2003)

Other Possible Solutions

- Could Asia Gas sell down its equity in Asia Gas LNG to less than a controlling interest? Would this make the sale to Asia Gas LNG an unaffiliated transaction?
  - Could depend on how the Leases define “affiliate.”
- Could the Parties have Asia Gas LNG contract with an aggregator to buy gas in the marketplace?
  - Query: Should the Parties prohibit the aggregator from purchasing gas from the JV?
  - No – taking extraordinary measures to avoid affiliated transactions is not a good fact in a lawsuit.
- American Oil should seek a strong indemnity from Asia Gas.

Other Joint Venture Emerging Legal Issues

- A and B are independent E&P companies who are acquiring leases in the same areas.
- The parties commence discussions regarding a potential agreement to jointly acquire leases and develop new gathering lines. These discussions are ultimately abandoned.
- Nevertheless, A and B agree on a Memorandum of Understanding to jointly bid on four leases at upcoming BLM auctions.
  - Under the MOU: (a) only A will bid at the auctions; (b) the parties set a maximum price that A can bid; and (c) if A acquires the leases, B will receive a 50% interest at cost.
- Thereafter, A and B complete their negotiations and enter into a formal agreement to jointly acquire and develop leases and gathering lines within a Contract Area.
- Any problem here?

U.S. v. SG Interests and Gunnison Energy

- The Justice Department Antitrust Division filed a civil suit under the antitrust laws and the False Claims Act.
  - Antitrust: the Justice Department charged that A and B engaged in unlawful bid-rigging.
  - False Claims Act: the Justice Department charged that A and B falsely certified that the bids were “arrived at independently” and “tendered without collusion with any other bidder for the purpose of restricting competition.”
  - The MOU was not ancillary to the later JV Agreement.
- A and B signed consent decrees requiring each company to pay $275,000 in penalties.
- The Justice Department brought a civil case, not a *criminal case*, despite the fact that the Justice Department very often pursues criminal charges over bid-rigging in auctions.
- Perhaps this case was civil because the parties were discussing a broad collaboration and apparently eventually entered into one.
- Does this mean that bid-rigging in lease auctions is unlikely to be pursued criminally?

Criminal Case Example - *Michigan v. Encana*

- In March 2014, the Michigan Attorney General filed **criminal bid-rigging charges** against Encana Oil and Gas USA and Chesapeake Energy Corporation.
- The AG alleged that Encana and Chesapeake conspired in 2010 not to bid against each other at public oil and gas lease auctions and in private negotiations for oil and gas leases. The AG alleged that the agreement stopped a “bidding war” and caused lease prices to “plummet.”
- Multiple incriminating e-mails were discovered among top executives of the 2 companies, including:
  - “Should we throw in 50/50 together here rather than trying to bash each other’s brains out on lease buying?”
  - A note projecting that the two companies could “save billions of dollars in lease competition.”
  - An internal e-mail from the CEO to a VP stating that it was “time to smoke a peace pipe” with Encana “if we are bidding each other up.”

Criminal Case Example - *Michigan v. Encana (continued)*

- On May 5, 2014, Encana settled, agreeing to pay the State of Michigan a fine of $5 million and to plead no contest to one criminal antitrust violation.
- Chesapeake has not settled and is continuing to fight the criminal antitrust charges.
- On June 5, the Michigan AG filed additional criminal racketeering and fraud charges against Chesapeake, alleging that Chesapeake lied to Northern Michigan landowners to obtain gas leases on their land.
- Northstar Energy has sued Encana and Chesapeake in the Western District of Michigan, alleging violations of both the Sherman Act and state antitrust laws, collusion, civil conspiracy, and various other tort claims.
  - Northstar owned 9,838 acres in Utica/Collingwood shale in Northern Michigan, and had received lease offers from both.
  - Suit claims Encana withdrew its lease offer, and CHK then drastically reduced its offer.
  - On March 10, 2014, the Court denied Encana's and CHK's Motion to Dismiss on the all antitrust counts.

Practical Joint Venture Take-Aways

- Unless the NewCo structure is used, a joint venture is generally not construed to be a partnership from a legal perspective. However, from a practical perspective, **joint ventures are more successful when everyone operates as if the parties truly are partners**.
  - From a drafting perspective, try to make this win-win for all parties involved. Determine what the key motivators are for each party (economic or otherwise) and address them. Any remaining issues are likely to work themselves out without much brain damage.
- Spend time critically analyzing the other party to the JV. Think through whether your company is prepared to become "partners" with them (consider foreign investor and competitor issues). Ultimately, if the comfort level is not there, your company will be better off not entering into the joint venture.
- For both parties, it is often more convenient to avoid formal secondment arrangements. However, ensure that the mutually agreed informal arrangements are fully understood by both parties and clearly set forth in the definitive transaction documents.
- If, as an Operator, you are transacting with a foreign investor owning capacity at a U.S. LNG export facility, and the foreign investor will have a direct ownership interest in the underlying assets or an equity ownership interest in a NewCo that will own the underlying assets, you should note that there are risks regarding potential royalty obligations. If this occurs, **further legal analysis should be conducted**.
- Do not participate in an AMI or other joint lease acquisition program that is based solely on a Memorandum of Understanding, Term Sheet, or other non-binding agreement.

Thank you!

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