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Strategic Considerations for Bridging the Bid-Ask Spread in Upstream M&A During Oil Price Volatility

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While it is certainly a buyer's market, a bid-ask spread continues to be a sticking point in many transactions. Despite pressing circumstances, potential sellers looking to boost liquidity may hesitate to sell low and miss the increase in value associated with an eventual price rebound. Conversely, potential buyers remain cautious, or even pessimistic, on the timing and magnitude of the rebound. However, parties who do not see eye to eye can explore the following options to bridge the gap and facilitate a transaction:

- Earnouts/Contingent Payments. In a contingent payment's simplest form, the parties could negotiate a contingent payment based on the increase in commodity prices post-closing. This can be an effective way to alleviate valuation concerns with respect to both buyers and sellers. By proposing a contingent payment, a prospective buyer can trade a portion of its short-term upside on an acquisition to address a seller's reluctance to sell at a possible price floor. The time horizon, target price and payment amount for the contingent payment can be tailored to provide a level of shared benefit if oil prices rise. However, parties should carefully consider the interplay of such post-closing payments with other aspects of the transaction. For example, a buyer should consider whether payments should be contingent upon key employees continuing to operate the assets.
- Retaining a Minority Interest. Similar to an earnout/contingent payment, a seller retaining a minority position in the asset will be able to participate in the upside with respect to its retained share when prices rebound. For example, a seller may choose to retain a minority working interest or an overriding royalty interest in a lease. While a retained working interest allows a seller to retain a portion of the upside in a property,

such working interest also requires an owner to bear a share of the cost for operating the property. Thus, a cash-strapped seller may not be inclined to retain a working interest in a property that is subject to significant short-term operating costs. Parties may attempt to address such price sensitivities by providing for a carried retained working interest whereby, after the sale, the buyer will bear the seller's share of costs on the properties for a period of time or up to a certain dollar amount. However, such "carry consideration" will affect a buyer's valuation, and any carry amount will likely lead to a decrease in the buyer's cash offer. Alternatively, a retained overriding royalty interest will allow a seller to maintain a cost-free share of revenues from the properties. However, there may be a significant tax impact if a seller retains an overriding royalty interest when selling an oil and gas lease, because the transaction would be treated as a lease, rather than a sale, for federal income tax purposes. As a result, the sale proceeds would be treated as ordinary income rather than capital gains. A seller should carefully consider the tax impact of any such transaction with counsel.

- Escrow/Holdback. Although an escrow/holdback arrangement does not directly address the valuation issue, it is likely to facilitate a deal by giving the seller comfort with respect to the financial impact of certain risks identified during its diligence process. For example, the parties may deposit into an escrow account or hold back funds if there is ongoing material litigation with respect to the conveyed assets. Such funds would be released to the seller only if the issue were to be resolved in favor of the buyer post-closing.
- Risk Shifting. Typically, the higher the risk, the lower the amount the buyer would be willing to pay for the subject assets. In this regard, motivated sellers seeking to maximize the sale price might consider covenants, reps and warranties, and indemnification provisions that favor the buyer in an effort to boost the sale price. This can prove to be a win-win, especially if the seller is confident about the quality of its internal recordkeeping and the quality of the conveyed assets. In some cases, a seller's need for immediate cash infusion may make a lengthy escrow holdback period unpalatable. For such parties, insurance policies for the seller's representations and warranties are an increasingly viable option in upstream asset sales. A buyer may purchase a policy (or request the seller to purchase a policy on the buyer's behalf) to protect the buyer against risk without the need for a holdback. Likewise, a seller may prefer to bear the cost of purchasing an insurance policy and get paid in full immediately, rather than put a portion of its purchase price at risk for a period of time after the sale.

Parties exploring the above and other creative means to bridge the valuation gap will undoubtedly deviate from their tried-and-true forms. Despite exigent circumstances, both buyers and sellers must be mindful that hastily drafted ambiguous and inadequate language could potentially lead to future disputes and only exacerbate problems being faced by owners and operators in the current times. Careful discussion and drafting after consultation with accountants, legal counsel and financial advisors is therefore of paramount importance.

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