

ROCKY MOUNTAIN MINERAL LAW FOUNDATION

OIL AND GAS AGREEMENTS: PURCHASE AND SALE AGREEMENTS

ENVIRONMENTAL DUE DILIGENCE AND DEFECT PROCEDURE

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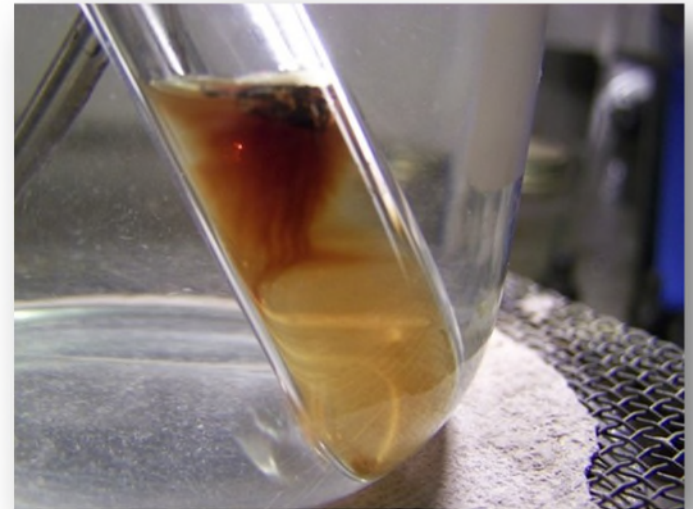
ENVIRONMENTAL ASSESSMENT PROCESS

- Buyer will not rely solely upon Seller's representations and warranties.
- Instead, Buyer will conduct its own environmental investigation of the properties being purchased.
- Scope
 - Balance potential risks with costs of diligence.
 - Site conditions v. compliance audit.
 - Identify sample of sites for inspection.




ENVIRONMENTAL ASSESSMENT PROCESS

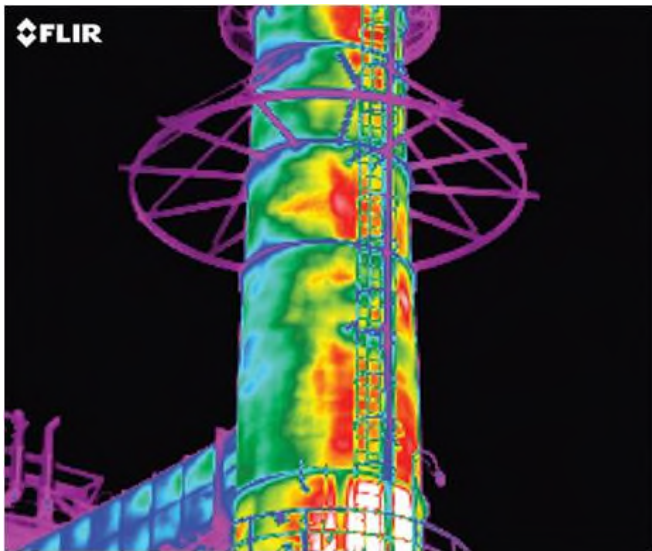
- Types of Assessments
 - Phase I: Records review, site reconnaissance, interviews, etc.
 - Phase II: Sampling
- Purposes
 - ASTM assessments satisfy CERCLA's "all appropriate inquiry" standard, but are too unwieldy to perform at many sites.
 - Establish baseline environmental conditions.
 - Satisfy financiers or mortgagees.



ENVIRONMENTAL ASSESSMENTS WHEN SELLER NOT THE OPERATOR

- Operators and non-operating working interests may face different legal risks.
 - As a result, operators may not want buyers of non-operating working interests to inspect their assets.
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- Seller of non-operating working interest may have to market assets prospective buyers cannot examine.

ENVIRONMENTAL ASSESSMENTS WHEN SELLER NOT THE OPERATOR



- Drones: An alternative way to inspect operator's assets.
- Can carry inspection tools like high-resolution or infrared cameras, and leak detection instruments.
- Proposed FAA rules may limit inspection applications.
 - Cannot fly out of pilot's sight.
 - Cannot fly over persons not involved in drone's operation.

ENVIRONMENTAL ASSESSMENTS WHEN SELLER NOT THE OPERATOR



ENVIRONMENTAL ASSESSMENTS WHEN SELLER NOT THE OPERATOR

Vented Gas Visible Through an Infrared Camera
from Two Sources

OVERVIEW OF ENVIRONMENTAL LIABILITIES

- Resource Conservation and Recovery Act
 - E&P exemption for drilling fluids, produced waters, and certain other E&P wastes.
 - Exemption does not apply to general industrial wastes.
- CERCLA
 - Also exempts certain petroleum products, but does not exempt general industrial wastes used at upstream facilities.



OVERVIEW OF ENVIRONMENTAL LIABILITIES

- Clean Water Act
 - Establishes SPCC program and NPDES and stormwater permitting programs.
 - Stormwater program regulates contaminated stormwater discharges, including stormwater discharges with an oily sheen.
- Oil Pollution Act
 - Responsible parties liable if oil discharges to navigable waters or adjoining shorelines.
 - Potential liabilities: Removal costs, property damages, natural resource damages, and more.



OVERVIEW OF ENVIRONMENTAL LIABILITIES

- Clean Air Act
 - August 2012: EPA issued NSPS for upstream and midstream.
 - September 2015: EPA proposed NSPS for oil and gas sector's methane and VOC emissions.
 - Proposal would redefine “source” to aggregate more facilities into one source.
 - This would mean more facilities need Title V permits.



OVERVIEW OF ENVIRONMENTAL LIABILITIES

- Clear Air Act (cont.)
 - October 2015: EPA lowered NAAQS for ozone.
 - More areas will become non-attainment areas.
 - More difficult to construct or modify sources in non-attainment areas.
 - GHGs: Certain large emitters must inventory and report their GHG emissions.
- Local conditions like wetlands and endangered species may also affect operation and development.



STANDARD DEFINITIONS OF CERTAIN ENVIRONMENTAL TERMS

- “Environmental Defect”
 - Sample definition:
 - “Any violation or failure to comply with applicable environmental laws; any release or presence hazardous substances with respect to which remediation may be required; and any condition or circumstance for which applicable environmental laws require reporting, correction or response.”
 - Broader than cleanup costs. Concept includes costs of retrofitting facilities, obtaining permits, and more.
 - Typically does not include:
 - End-of-life asset retirement obligations like asbestos or NORM.
 - “Retained Liabilities” Seller expressly retains, including in personam liabilities such as tort claims or criminal sanctions.



STANDARD DEFINITIONS OF CERTAIN ENVIRONMENTAL TERMS

- “Remediation”
 - Sample definition:
 - “The implementation and completion of any remedial, removal, response, construction, closure, disposal, or other corrective action, including monitoring, reporting, permitting and/or the installation of any necessary pollution control equipment, to the extent required under Environmental Laws to correct, eliminate, or remove an Environmental Defect.”
 - Broader than cleanup costs. Includes permitting, equipment modifications, etc.
 - Typically limited to expenditures necessary to comply with Environmental Laws. Prevents Buyer from pursuing gold-plated remediation costs.



STANDARD DEFINITIONS OF CERTAIN ENVIRONMENTAL TERMS

- “Remediation Cost”

- Sample definition:

- “The cost of implementing and completing the most cost-effective remediation reasonably available to address and resolve any Environmental Defects.”

- Determines which costs Buyer may recover, and therefore value of Buyer’s claim.

- Common disputes:

- Whether Buyer selected the most cost-effective remediation strategy.
 - Buyer’s estimated costs. May includes speculative, remote costs Buyer will never incurs.



ENVIRONMENTAL DEFECT PROCESS

- Representation and Warranty
 - A snapshot in time pertaining to various factual issues, such as past operations, conditions of properties, lawsuits, compliance and remediation liabilities.
 - May look back in time to cover prior periods.
 - Knowledge Modifier: Whose knowledge?
 - Seller's reps and warranties typically linked to environmental defect process. Breaches delineate Seller's responsibilities to Buyer.



ENVIRONMENTAL DEFECT PROCESS

- Notice of Defect
 - Must be in writing.
 - Identify affected assets.
 - Describe defect in reasonable detail.
 - Include substantiating documentation.
 - Estimate Remediation Cost.
- Parties will negotiate whether notice includes additional details, like itemized Remediation Cost calculation (e.g. net present value) and allegedly violated legal standard.



ENVIRONMENTAL DEFECT PROCESS

- Thresholds
 - Provide that Seller must cover certain claims only after Buyer incurs a specified amount of costs.
 - Can include separate thresholds for individual claims and aggregate amount claims must reach.
 - Threshold for individual claims prevents disputes over immaterial issues.
 - Aggregate threshold limits environmental defect process to situations where alleged defects materially affect deal value.



ENVIRONMENTAL DEFECT PROCESS

- Addressing Contested Defects
 - Remove affected assets from closing.
 - Seller will reduce purchase price to reflect allocated value of removed assets.
 - Include assets in closing subject to certain conditions or purchase price adjustments.
 - Reduce purchase price by value of asserted Environmental Defects.
 - Remediation Cost placed in escrow until defect is cured.
 - Arbitrate.
 - Walk Away.
 - Allows Seller to kill deal if negative adjustments to purchase price exceed a specified amount.



CURE RIGHTS

- Pre-Closing Cure Rights
 - Seller will cure defects it can address quickly and easily.
 - Ex: Closing pits, installing secondary containment or safety signs, removing oily surface soil.
 - Seller should notify Buyer in writing of intent to cure, with proposed plan and schedule.
 - Plan may be subject to Buyer's re
 - Seller should notify Buyer in writing when it has cured defect, and provide reasonable supporting documentation.



CURE RIGHTS

- Post-Closing Cure Rights

- Sometimes Seller may cure alleged defect during post-closing cure period.
- Final accounting, usually 90 to 120 days after closing, will adjust purchase price per value of cured and uncured defects at end of cure period.
- Parties will negotiate whether to include affected asset in closing, who will possess asset during cure period, and more.
- Post-closing cures more complicated than pre-closing cures.



CURE RIGHTS

- Curing Assets Seller No Longer Owns
 - If affected assets included in closing and Seller may cure defects after closing, then Seller may cure assets it no longer owns.
 - Commonly leads to disputes, especially if there is an extended cure period, limited pre-closing diligence, or Seller lacked information about predecessor operations.
 - Post-closing uncertainties: Higher costs, unknown contaminants, and more.
 - Parties must agree on goal of any cure.
 - Seller should include this information in its notice of intent to cure.



SPEAKER PROFILE



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Larry, a partner in Vinson & Elkins' Houston office, has been practicing environmental law full-time since 1981 and has an exceptionally broad range of environmental law experience that makes him particularly well suited to advise clients with multi-faceted environmental problems, such as those frequently encountered in large business transactions. Larry currently serves as the Environmental and Natural Resources Practice Group Leader, Co-Chair of the firm's Energy and Infrastructure practice group and Chair of the Shale and Hydraulic Fracturing Task Force. He is also a member of the firm's Climate Change practice group.

Larry has been recognized as the top environmental lawyer in the United States for the past eight years by *United States Lawyer Rankings*. He has also been recognized as one of the best environmental lawyers in the nation in the most recent edition of *Best Lawyers in America*®; one of the best environmental law attorneys in Texas on the "Texas Super Lawyers" list published in *Texas Monthly*, and by *Chambers & Partners* in its recent guidebook on *America's Leading Lawyers for Business*.