The International Comparative Legal Guide to: Oil & Gas Regulation 2015

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EDITORIAL

Welcome to the tenth edition of The International Comparative Legal Guide to: Oil & Gas Regulation.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of the oil and gas sectors.

It is divided into two main sections:

Four general chapters. These are designed to provide readers with a comprehensive overview of key issues affecting oil and gas regulation, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in oil and gas regulation in 40 jurisdictions.

All chapters are written by leading energy lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Geoffrey Picton-Turbervill of Ashurst LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The International Comparative Legal Guide series is also available online at www.iclg.co.uk.

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Chapter 2

Oil and Gas M&A – the Eye of the Storm

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1. Introduction

Oil prices in 2014 hit their lowest levels in two years. With much conjecture that this price dip will continue for a prolonged period of time, companies are rethinking their strategies as investors call for greater capital discipline. There remains considerable debate about how the price dip will affect M&A activity. In October 2014, Michael O’Dwyer, co-head of EMEA natural resources at Morgan Stanley was quoted as saying that “[t]he bid-ask between buyers and sellers has widened dramatically”. He predicted that the coming years will see “a lot of difficulty in matching buyer and seller expectations, which is going to lead to a hiatus in the near term”.1 That said, M&A activity will continue. This article examines how, in the current climate, nervous purchasers can protect themselves through comprehensive due diligence and the value gap between seller expectations and purchaser’s appetites can be bridged through innovative structuring of the deal.

2. Understanding the Asset and Associated Risks

There are a number of factors that determine whether an acquisition is ultimately a success or failure, but the most important factor is the quality of the due diligence. The purpose of any due diligence process is to identify any issues that could, in the future, prevent the purchaser from attaining the value that it hopes to capture through the acquisition. Identifying these issues at as early a stage as possible is essential to informing the purchaser’s valuation of the upstream interests as well as any additional protections the purchaser may wish to incorporate in the sale and purchase agreement.

Due diligence is intended to give the purchaser an understanding of the rights and obligations it is acquiring through the sale. Whether structured as a share or asset acquisition, farm-in, earn-in or asset exchange, ultimately what is changing hands in an oil and gas acquisition transaction is an upstream interest. This typically includes petroleum exploration and/or production rights acquired under a concession, a joint operating or venture agreement and any other (upstream, midstream and downstream) ancillary agreements, such as petroleum processing, transportation and sale agreements.

The purchaser will, through the due diligence process, verify that the assets offered for sale constitute the full value chain necessary for the proper operation of the upstream interest post-completion of the sale. Where operated interests are being acquired, the purchaser will be concerned to understand the full extent and nature of the operational obligations it will assume, and how these align with its existing group operations. On the other hand, where the purchaser is acquiring a non-operated interest, the purchaser’s primary concern will be to understand the extent of the financial obligations it will assume as a result of the transfer as well as any controls a non-operator may have over the actions of the operator.

For a number of acquisition transactions, a traditional due diligence process is unlikely to be able to deliver all the information that purchasers need to ensure they are making the right acquisition decision. With growing interest from new investors in North American, South American and African assets, there is a need to take a holistic issues-based approach to due diligence in order to help deal-making companies understand the risks inherent to their target assets and how to best manage such risks.

Regulatory risks

In many countries which historically had no or very little oil and gas industry, the petroleum industry is understandably outdated and often ill-equipped to address the complexities of hydrocarbon production from the large discoveries that have been seen in recent years. A prime example of this is Mozambique. Although hydrocarbon exploration in Mozambique dates back to as early as 1904, it was the 2012 offshore discoveries of Eni, Anadarko and their partners that transformed Mozambique into a major new gas province. The authorities recognised that the 2001 Petroleum Law failed to regulate this blossoming gas market suitably and in August 2014 issued a new petroleum law. Most controversially, the new law introduced an obligation to commit 25% of production to the domestic market with the pricing of such sales to be determined by the Mozambican government. Mozambique is by no means alone in this process. A number of other African and Asian countries are also instigating a process of reviewing and supplementing their own regulatory frameworks for oil and gas. For example, the Indian government (whilst defending itself in arbitration issued by Reliance Industries Limited on the subject of cost recovery) set up two commissions to advise it on how the cost-sharing mechanisms in its model production sharing contract should be revised in order to incentivise oil companies to reduce production costs. For a purchaser, this review process and any subsequent regulatory overhauls can represent a double-edged sword. On the one hand, the revision and clarification of the regulatory environment is often welcomed for the certainty it brings to a project. On the other hand, the promulgation of new legislation and new model form concessions, in addition to creating uncertainty, often comes hand in hand with a tightening of the terms of those concessions.

Compliance risk

Investment in any jurisdiction will require an assessment of the potential corruption risks associated with that jurisdiction. Although there have been significant improvements in recent years, bribery and corruption does remain a serious challenge for investors.
in oil and gas-rich regions. Compliance risks exist both at the top end of the scale, with interference from country elites, and at the lower end, with endemic corruption issues typically encountered by investors looking to secure permits or work with local suppliers and employees. Intense scrutiny by authorities in many oil and gas host countries means that bribery and corruption assessments have recently assumed a much higher degree of importance in transaction analysis. Purchasers may seek to manage corruption risks by including contractual protections in the sale and purchase agreement, including warranty protection and, if necessary, specific indemnity rights.

State participation

State participation in an asset can take various different forms. Most African and Asian countries have established a concession structure based on production sharing arrangements whereby the state’s entitlement consists of a cost oil/gas element, a profit oil/gas element plus taxation and royalties. The involvement of the state in any asset will also likely include the participation of the state or a state-owned enterprise in the concession itself. Direct state participation not only allows the state to receive a greater proportion of revenues, but also allows it to share in the ‘upside’ scenario if a project succeeds. Such direct participation of a state or a state-owned enterprise may not be welcomed by an investor as it reduces the equity available to paying participants in the project. However, from a project risk perspective, the involvement and lobbying power of a state entity may be seen as a useful addition to the project. Furthermore, although the participation of a state-owned entity in a development may be financially burdensome, it reduces the likelihood of subsequent expropriation by the state.

Local content

A theme in the legislative changes of most developing countries is the growing level of local content obligations that are being imposed on investors. The UK and Norway, two local content success stories, took an active role in developing local content in the early days of their respective oil and gas industries through initiatives that essentially made it mandatory for international oil companies to transfer technology and expertise to their local counterparts in order to participate in the oil and gas industry. Since 2009, Indonesia has required upstream contractors to source a proportion of their components from local suppliers, with the minimum requirements increasing (farther to a 2013 regulation) from 35% to 45% (offshore) and 70% (land) after 2016. In Africa, Nigeria has led the way with its Oil and Gas Industry Content Development Act 2010 which specifies targets and requirements in respect of local content, alongside detailed implementation and monitoring mechanisms to ensure compliance.

The issue however is that in many host countries the oil and gas industry has developed so rapidly that it has outstripped the locally available skills and infrastructure. Until these local market shortages are resolved, investors may be in the unenviable position of deciding whether to observe their concession based obligations to meet local content requirements or their overriding obligations to ensure petroleum operations are conducted in accordance with good industry practice.

Asset ownership

For a new entrant to a host country, the structuring of its asset ownership will be vital both to ensure the investor obtains and maintains valid title to assets, and to minimise the tax consequences of any investment. Structuring will include such basics as ensuring the proper form of entity is incorporated to own the investment. For example, in Kenya, the Petroleum (Exploration and Production) Act requires such entities to either be incorporated in Kenya or a Kenyan-registered company to be eligible to enter into a petroleum agreement with the government. Similarly in Brazil, international oil companies have to incorporate an entity under Brazilian law with headquarters in Brazil and administered from Brazil to be granted rights in upstream interests.

Financing risk

The Gorgon LNG project in Australia recently saw its costs escalate from $37 billion to $54 billion due to higher material and labour costs. Long-term, large-scale investments will typically require external financing, often using long-term debt through a project finance structure. Where project finance or other sources of external financing are involved, the emphasis for any purchaser will be to ensure that the project it is buying into has a ‘bankable’ structure i.e. a structure that carries an appropriate level of risk for those lending to that project. Project risks are manifold and include not only political and country risks but also project-specific risks such as construction, operation, market and production risk. A major mitigant of some of these risks for lenders will be the security package they take over the project assets. In many host countries, land is the property of the state and cannot be sold, transferred, mortgaged or charged. Therefore, a foreign developer must apply to the state for a right to use the land, which makes it difficult for lenders to take an effective security package. An appreciation of the local law restrictions and limitations in granting a comprehensive security package will therefore be required at an early stage of any project structuring process.

Currency and repatriation risks

Investors will be concerned to fully understand any barriers or delays to repatriation of profits that may exist under local law. Uganda is typical of many jurisdictions in imposing an additional tax (15% in Uganda’s case) on profits repatriated to head office. Repatriation issues will be of particular concern where exploration assets are moving into development and production phases and becoming revenue generators. Proper structuring at the outset of the transaction should be supplemented with detailed due diligence into the applicable restrictions and procedures to be followed to enable the repatriation of profits.

Stabilisation

The long-term nature of many oil and gas agreements, as well as the significant upfront capital that investors commit to such projects, means that the risk of change in law or unilateral termination or modification of such agreements is an ever-present concern for investors. The purpose of a stabilisation clause is to protect the relevant agreement from adverse legislative and administrative acts of government. They can therefore act as a means by which an investor can manage political risk. A key issue for investors acquiring interests or looking to develop discoveries is the legal enforceability of such stabilisation provisions. In many common law jurisdictions it is not possible to fetter the executive powers of the state by contract with a private entity. This will be a matter for interpretation under the relevant local laws. It has, however, led to a growing preference from investors for “economic equilibrium”
provisions which are perceived to be more compatible with the notion of the legislative freedom of state because they do not seek to prevent the application of new laws to the agreement; rather, they provide a mechanism by which the consequences of that change can be mitigated.

3. Share Sales and Asset Sales - Making the Choice

Once the key risks have been identified through the due diligence process, the purchaser will need to address the issue of whether the upstream interest will be transferred by means of a share sale or an asset sale. There are various legal, tax and business aspects of the transaction that need to be taken into consideration in order to agree a structure which is commercially acceptable to both parties.

Assets and liabilities

What a purchaser acquires in a share sale and an asset sale are fundamentally different. In a share sale, the sale and purchase agreement effects an indirect transfer of the upstream interest through the sale of the share capital of the target company that holds the relevant upstream interest. The purchaser therefore acquires all of the rights and liabilities of the target company, known and unknown, including those arising prior to the acquisition. In an asset sale there is instead a direct transfer of the relevant upstream interest. The purchaser will acquire only those assets, rights and liabilities expressly transferred to the purchaser in the sale and purchase agreement. There are limited exceptions to this principle: in certain jurisdictions, regulatory requirements impose additional liabilities on the holder of an asset. In the United Kingdom, for example, liability for the decommissioning of an installation can be imposed on any party entitled to derive a financial or other benefit from that installation. Notwithstanding these limited exceptions, asset sales offer the purchaser the advantage of being able to cherry-pick assets that have the greatest financial or strategic value to it and to insulate itself from most unwanted liabilities that may be associated with those assets.

Consents

Asset sales involve a change in the asset holder and generally existing contracts do not automatically transfer to the purchaser. Transfers will invariably require the consent of third parties to the various contracts, adding time to the sale process and creating scope for those third parties to impose new terms to gain advantage from the change, or even to refuse the transfer. In a share sale, the relationship between the target company and its contractual counterparties and suppliers does not change. This considerably reduces the number of third-party consents which may be required to effect a transfer of the target company and consequently reduces the potential for value impairment of the underlying business as a result of the transfer. As a result, share sales are often simpler to implement than asset sales.

The extent to which the relevant state authority has the power to prevent a proposed transfer will vary from jurisdiction to jurisdiction. There are various examples in recent times of state authorities blocking acquisitions for a range of reasons. In 2012, Canada attempted to block the $5.18 billion takeover of Progress Energy Resources by Petronas. The UK may be more successful in blocking the £5 billion recent deal by Russian billionaire Mikhail Fridman to acquire RWE Dea with oil and gas fields in the North Sea. Where a state authority has consent rights over a transfer, it is common for these to be absolute, without any requirement imposed on the authority to act reasonably. Such notification and consent rights may well apply both to direct transfers and to indirect transfers.

Pre-emption rights

Pre-emption raises specific concerns in oil and gas acquisition transactions as joint operating agreements commonly include a pre-emption right to allow existing co-venturers to control the entry of a new participant into the joint venture. Typically, pre-emption rights under a joint operating agreement are triggered only on an asset sale and require the selling party to offer its co-venturers a priority right to acquire the upstream interest offered for sale on the same terms and conditions as those agreed to by a third-party purchaser. If a pre-emption right applies, the purchaser will need to ensure that any co-venturer’s right to pre-empt a transfer under the joint operating agreement is waived as a condition precedent to the purchaser’s obligation to acquire the upstream interest.

While less common, pre-emption may also apply on a share sale where a co-venturer’s right to pre-empt is triggered by a change of control in the asset-holding company. In such a case, the asset-holding company is required to offer its co-venturers a right to acquire the upstream interest offered for a monetary amount equivalent to the value ascribed to the upstream interest in the share sale. The valuation method and a mechanism to resolve any valuation disputes will need to be clearly described in the sale and purchase agreement.

4. Structuring the Sale and Consideration

The consideration to be paid by a purchaser to a seller for an interest sits at the heart of the commercial deal struck between the seller and the purchaser. The drivers for how that consideration will be paid by the purchaser to the seller will vary from one transaction to another. Tax considerations will play a strong part, as will the due diligence carried out by the purchaser and the initial structuring of the acquisition as a share sale or asset sale. In addition, current market conditions will be a key factor in the parties’ decision about how to formulate the consideration for a transaction. In the current depressed market, companies will be incentivised to create more innovative structures.

Sale and purchase - cash upfront

Regardless of whether a transaction is structured as an asset sale or a share sale, the simplest sale and purchase formulation is where the purchaser agrees to pay a lump sum cash consideration to the seller upon satisfaction of all the conditions to the effectiveness of the transfer. There are numerous examples, but one notable transaction in 2014 was YPF’s acquisition of Apache’s interests in Argentina which was effected for an upfront headline cash consideration of $800 million. The sale and purchase agreement will often provide for completion accounts to be prepared, usually under the control of the purchaser, to enable the consideration to be adjusted by reference to a pre-determined target position. The payment of upfront consideration by the purchaser is likely to be the seller’s preferred option. Under this formulation, the seller receives full payment for the sale of its upstream interest at the earliest opportunity: on completion of the transaction. However, the upfront cash consideration that a purchaser is willing to offer, may not meet the expectations of the seller. This will be particularly true in a falling market.
Where the expectations of the seller and the purchaser are different, a deferred consideration structure can bridge the gap between the seller’s aspirations in respect of the value that may be realised from the upside potential of an interest and the purchaser’s concerns regarding any uncertainties associated with that interest.

**Sale and purchase – deferring the consideration**

The basic principle behind any deferred consideration structure is that the consideration will not pass from the purchaser to the seller until a certain condition is met. Common conditions for payment of the deferred consideration include:

1. Reserves enhancement – when an independent third party certifies the existence of certain quantities of petroleum within the relevant interest area.
2. Development milestones – when a certain development milestone associated with the underlying petroleum project has been achieved within a defined timeframe.
3. Production milestones – when a certain volume of petroleum has been produced from the project.

The announcement in July 2014 by Salamander that it was disposing of a 40% interest in the Greater Buahuang Area in Thailand to SONA Petroleum Berhad is a prime example.

The consideration for the sale comprised a number of elements but included a contingent payment of up to $15 million which will become payable in the event that there is a commercial discovery in the concession.

An objective mechanism for determining that the condition has been met should be included in the sale and purchase agreement together with a procedure, such as expert determination, for the quick and effective resolution of disputes between the parties in respect of the satisfaction of the condition.

Where a deferred consideration structure is included in the sale and purchase agreement, the seller will also be exposed to credit risk on the payment by the purchaser of the deferred part of the consideration. Typically, the seller will therefore require the purchaser to provide some form of paper credit support (for example, a parent company guarantee or bank guarantee) or to pay some or all of the deferred consideration into an escrow account.

The sale and purchase agreement may also include a mechanism which allows the seller to unwind the transaction if the purchaser fails to make payment when due of the deferred consideration.

The parties to the sale and purchase agreement will also need to consider what role they will play after the completion of the sale:

- Where the seller loses management control of the interest (either by selling the entirety of its interest to the purchaser or by selling a substantial part of its interest to the purchaser), the seller should demand a robust set of performance covenants in the sale and purchase agreement. This prevents the purchaser manipulating the performance of the interest in a way which avoids or defers the satisfaction of the defined condition and the payment of the deferred consideration.
- Where the seller sells only part of its interest in the concession to the purchaser and retains significant management control of the interest, the purchaser will need to ensure that the terms of either the sale and purchase agreement or the joint operating agreement prevent the seller developing the concession in a way which is unduly focused on the early achievement of the condition (particularly where that undermines optimal petroleum production from the concession).

The negotiation of these provisions is often controversial. An operator (whether the seller or the purchaser) will generally be reluctant to accept restrictions on its freedom to make decisions about operational matters. A balance will need to be struck between operational flexibility and long-term value protection.

**Farm-in/farm-out and earn-in/earn-out**

Where the seller and the purchaser have agreed that an acquisition will be structured as an asset sale, they may choose a farm-in/farm-out or an earn-in/earn-out formulation (the choice of terminology will depend upon the party’s perspective). In general terms, such arrangements are a form of asset sale where the seller (or farming-out party/earn-out party) agrees to transfer part of its interest in an upstream interest to the purchaser (the farming-in party/earn-in party) while continuing to retain part of the upstream interest. The farm-in/earn-in construction reduces the seller’s exposure to an upstream interest and allows it to finance the work commitments it is obliged to deliver under the terms of the underlying concession and joint operating agreement.

What distinguishes a conventional farm-in/earn-in from a sale and purchase agreement is the link between the consideration due from the purchaser and the ongoing obligations (or work commitments) of the seller as defined under the terms of the underlying concession and joint operating agreement. The consideration due from the purchaser for such transfer can be structured either as:

- a performance obligation: the actual performance of certain work commitments that would otherwise be required of the farming-out party; or
- a payment obligation: the payment of a defined share of the costs that would otherwise be incurred by the farming-out party in respect of those work commitments.

Earn-ins are a further formulation of the farm-in/farm-out structure for upstream interest sales. As with the conventional farm-in/farm-out structure, the consideration due from the purchaser is inherently linked to the performance of work commitments associated with the underlying concession and joint operating agreement. The distinction of an earn-in structure, however, is that title to the upstream interest will not transfer to the purchaser until it has fully performed the work commitments. This is a seller-friendly structure but rather than being driven by commercial dynamics, it is more often driven by the inability of the parties to obtain the necessary government consents for a transfer where the transfer is conditional upon the performance of work commitments. That said, the earn-in structure provides a clear benefit for sellers in that it removes the need to address potentially complicated re-transfer arrangements if the purchaser subsequently defaults on its obligations under the earn-in arrangements.

i. **Promote**

Where the consideration for a farm-in/earn-in is structured as a monetary amount, the sum paid by the purchaser will consist of a number of different elements: the recovery of costs already expended on the interest, the deflection of costs that will need to be incurred on the interest in the future and the generation of a pure profit element from the interest. This pure profit or premium element is often expressed as a ‘promote’ and represents the ratio between the proportion of the expenditure that will be assumed by the seller and the proportion of the interest it will receive as a result of the farm-in. In a depressed market, the proportion of the consideration paid by a purchaser that represents a pure profit element to the seller may be reduced.

ii. **Carry**

Where a seller is disposing of part of its interest in an asset, the rationale for the disposal may be to reduce the seller’s capital commitments in respect of that asset or to free up capital to be used elsewhere in its portfolio. In these circumstances, the seller may prefer to structure the transaction as a carry arrangement.
In a carry formulation, the purchaser carries the share of the costs of defined future works (such as the costs associated with conducting seismic or other survey work or of drilling exploration wells or further appraisal works) which would be payable by the seller. Cairn Energy structured its September 2014 divestment of a 10% interest in the Catcher development on the UKCS as a carry. Its purchaser, Dyas UK, agreed to fund Cairn’s exploration and development costs up to a cap of $182 million. For Cairn, this arrangement enabled it to reduce its capital expenditure to the end of 2017 by approximately $380 million (inclusive of the carry) to $200 million.10

Where the parties choose to structure a transaction as a carry, the farm-in agreement should address:

- the specific definition of the costs to be incurred;
- the extent of the carry offered by the purchaser to the seller (including a possible cap on the intended carry costs); and
- whether any part of the carried costs which are unspent should still accrue to the seller or should remain with the purchaser.

A further structural issue to consider will be whether or not all or part of the carried costs paid by the purchaser are later repayable (from the proceeds of sale of produced quantities of petroleum) to the purchaser by the seller. If the purchaser is ultimately entitled to recover the carried costs then the carry is popularly described as ‘soft’; if the carried costs are not so recoverable by the purchaser then the carry is described as ‘hard’. A hard carry is effectively a further element of consideration payable by the purchaser, whereas a soft carry is analogous to a form of loan by the purchaser to the seller. This will be a matter for negotiation between the seller and the purchaser.

**Performance obligation**

Where the consideration for a farm-in/earn-in is structured as a performance obligation of the work commitments under the underlying concession, the work obligation may take a number of different forms. A common formulation is to require a purchaser to perform certain drilling obligations, for example the drilling of a well to a certain number of metres (true vertical depth or true horizontal length). The agreement may also recite further specifics regarding the nature of the work obligation, including the location of the well to be drilled (or a mechanism by which the parties will agree the location of the well) and the timeframe for such drilling operations to be completed by the purchaser.

The work obligation formulation creates the potential for dispute between the parties as to whether the purchaser has fully performed its work obligation. In turn, this opens the door to debate as to whether such partial performance amounts to a breach by the purchaser of the obligations it has assumed under the farm-in/earn-in agreement. If so, does such breach result in the loss by the purchaser of any entitlement it may otherwise have had to an interest in the concession or does the breach merely limit the entitlement of the purchaser to a correspondingly reduced interest in the concession?

The position under English law is not clear. If the work obligation is construed to be an ‘entire obligation’ (i.e. an obligation which must be completely performed before the right of the performing party to counter-performance from the other party arises) then the partial performance of the work obligation by the purchaser will entitle the purchaser to nothing. This interpretation clearly favours the seller: it would be unfair for the seller to have to transfer a substantial portion of the interest defined in the farm-in/earn-in agreement where a purchaser has not fulfilled its obligations set out in the farm-in agreement. This will be particularly apparent where the work obligation specified in the farm-in/earn-in agreement reflects the requirements of the host government in respect of the work commitments to be performed under the concession. However, the English courts have struggled with the unfairness of this principle when looked at from the purchaser’s perspective. The purchaser may have expended considerable time, effort and money in performing a large part of its obligations under the farm-in/earn-in agreement, and still not receive any part of the interest described in the farm-in/earn-in agreement. In a number of cases the courts have therefore sought to rely on the so-called ‘doctrine of substantial performance’. This doctrine provides that where a party has substantially performed an entire obligation (but has not completed full performance) it is entitled to bring an action to recover the consideration payable, subject to admitting a counterclaim from the paying party which reflects the uncompleted portion of that entire obligation.

Where the commercial dynamics of a transaction permit, the seller should try to minimise the ability of a purchaser to bring a claim for substantial performance. The seller should therefore seek to include an express provision in the farm-in/earn-in agreement which excludes the rights of the purchaser to bring a claim for substantial performance. However, a commercially powerful purchaser will resist such a stance.

The parties may alternatively choose to incorporate a commercial construction into their farm-in/earn-in agreement which further mitigates the impact to the parties of a performance failure by the purchaser.

- Alternative performance – the farm-in/earn-in agreement may recite an alternative set of work obligations which can be performed by the purchaser if it cannot perform the primary set of work obligations. This formulation enables the seller to achieve at least one of its commercial objectives in return for the dilution of its interest to the purchaser. It also offers greater comfort to the purchaser that its efforts in earning an interest from the seller will not be unreasonably frustrated.

- Milestones – both parties may also take comfort in the certainty of knowing from the outset that the farm-in/earn-in agreement has been formulated on the basis of a series of divisible obligations. The farm-in/earn-in agreement should provide that the interest earned by the purchaser will be proportionate to the amount of work it has completed. At a pre-agreed point in time, the parties (or, in the absence of agreement, an independent third party) will assess the amount of work completed by the purchaser (either by reference to defined milestones or value). The purchaser will receive a pre-agreed interest under the farm-in/earn-in agreement corresponding to the amount of work it has completed. This formulation offers the purchaser the comfort of knowing that the interest received by it will be commensurate to the extent or value of the works that it has performed and allays the concerns of the seller that it might be required to dilute its interest in the concession to a disproportionate extent.

**Asset exchanges**

Where the purchaser is concerned about making an upfront cash commitment in respect of a transaction, an asset exchange structure may be a further alternative to a traditional sale and purchase arrangement. An asset exchange involves the exchange of upstream interests between the contracting parties as mutual consideration.

Where a transaction is structured as an asset exchange, there is no clear delineation between the seller and the purchaser. Each party will act as seller of its respective asset and purchaser of the other’s asset. This mutuality of roles means that the asset exchange agreement will need to address the giving of reciprocal warranties, representations and
indemnities between the parties and contain an appropriate mechanism for reconciling any claims arising in respect of an interest, with an ability for the parties to net off their respective claims. It may also be that the exchanged assets are not equal in value, in which case additional cash payment may need to be factored into the completion mechanics of the transaction.

Another concern for both parties will be to ensure that completion of the transaction occurs simultaneously in respect of all the assets being exchanged. Where the asset exchange is documented under one agreement, this can be achieved by reciting matters such as third-party consents as conditions to completion. Where the transaction is documented as two separate agreements, this could be achieved by expressing the consideration due under one agreement to be the completion of the transaction under the other agreement (and vice versa).

5. Conclusion

In its annual capital confidence barometer for 2014, EY reported that “larger and transformational M&A is on the strategic growth agenda”. While deal volume may decline, the view from EY’s report is that companies are now looking at “quality rather than quantity”. In this environment, greater importance will be given by companies to due diligence process and companies will more willingly endorse a more innovative approach to transaction structuring in order to achieve a mutually satisfactory deal for both parties.

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