MEETING OF THE MINDS ON TITLE DEFECTS

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Meeting of the Minds on Title Defects

I. Introduction

A title defect is a contractual concept found in asset purchase agreements. If a seller merely executes and delivers to a buyer a conveyance (be it a deed or an assignment) of oil and gas properties, then there are no negotiations concerning title defects. If this conveyance contains a general or special warranty, then the seller has undertaken to deliver “good and marketable, marketable, or merchantable” (depending upon the state) title to the buyer. A general warranty protects the buyer from any failure or defect in the seller’s title. A special warranty protects the buyer only from any failure or defect of title arising by, through, and under the seller. For a number of reason, sellers and buyers are not willing to rely only on a conveyance to sell oil and gas properties. One reason is that sellers seldom can deliver merchantable title to oil and gas properties. The title defect provisions in an asset purchase agreement are a negotiated substitute for merchantable title and the remedies for failure or defects of seller’s title provided by the common law. Sellers and buyers create a law unique to their contract that defines acceptable title and the remedies for failure or defects of acceptable title. While custom and usage has developed common title provisions in asset purchase agreements, there are always facets of each contract’s title provisions that are unique to the individual transaction.

Because an asset purchase agreement contains a substitute for common law title protections, it is important to understand what those protections are. Therefore, this paper will first examine the nature of common law marketable title and the remedies for failure or defect of seller’s title provided
by special and general warranty covenants in a conveyance. Then this paper will examine the perspectives of seller and buyer in negotiating a definition of acceptable title and the remedies for failure or defect of acceptable title to oil and gas properties. In this paper, oil and gas properties are oil and gas leasehold estates. Finally this paper will analyze, from both the seller’s and buyer’s perspective, definitions of acceptable title and of title defects, provisions for valuing title defects, remedies for addressing title defects and resolving disputes concerning title matters.

II. Marketable Title

Sellers and buyers of oil and gas properties do not customarily use “marketable title” as the standard for evaluating title defects in asset purchase agreements. Instead, as we shall see, sellers and buyers negotiate a lower standard of acceptable title. If, however, an asset purchase agreement requires the seller to deliver “marketable title,” then the seller will be required to conform to the common law standards for marketable title in each of the states in which the oil and gas properties are located, except to the extent the asset purchase agreement expressly limits the application of such a common law standard.

We must first understand what constitutes marketable title to understand how to apply the lesser title standard contained in an asset purchase agreement. Each state has its own definition of marketable title, but these definitions are very similar. The terms good, marketable and merchantable
title are treated as synonymous.\textsuperscript{1} Mississippi and Oklahoma also equate marketable title with “perfect title.”\textsuperscript{2}

Texas has the most extensive definition. In Texas, “marketable title” is one that (i) is free from reasonable doubt as to matters of law and fact, (ii) will not expose the purchaser to a reasonable probability of litigation, (iii) is free from any outstanding contract, covenant, interest, lien, or mortgage sufficient to form a basis of litigation, (iv) does not depend on estoppel in pais, on a question of presumption of fact, or on extrinsic evidence or parol evidence, unless this evidence is of great probative force and readily available, and (v) a prudent person advised of the facts and their legal significance would willingly accept.\textsuperscript{3}

The Oklahoma Supreme Court held that the term “merchantable title” means “one free from litigation, palpable defects, and grave doubts, and consists of both legal and equitable title fairly deducible of record.”\textsuperscript{4}


\textsuperscript{2} Jones v. Hickson, 37 So.2d 625, 629 (Miss. 1948); Tull v. Mulligan, 48 P.2d 835, 842 (Okla. 1935).

\textsuperscript{3} See Lund v. Emerson, 204 S.W.2d 639, 641 (Civ. App. – Amarillo 1947, \textit{no writ}).

The Alabama Supreme Court stated that a “‘good title’ means a marketable title, a title that can be sold to a reasonably prudent man who might desire the property, or a title that can be mortgaged to a person of reasonable prudence.”

The California Supreme Court held that to be “good,” title must be “free from litigation, palpable defect, and grave doubts; should consist of both legal and equitable titles, and should be fairly deducible of record.” A later case held that “‘marketable title’ means a title which a reasonable purchaser, well informed as to the facts and their legal bearings, willing and anxious to perform his contract, would, in the exercise of that prudence which businessmen ordinarily bring to bear on such transactions, be willing and ought to accept.”

The Colorado Supreme Court defined “marketable title” to be title reasonably free from such doubts as will affect the market value of the estate; one which a reasonably prudent person with knowledge of all the facts and their legal bearing would be willing to accept.

The Supreme Court of Kansas held that a “marketable title” is one that is free from reasonable doubt and will not expose the party who holds it to the hazards of litigation.

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7 *Hocking v. Title Insurance & Trust Co.*, 234 P.2d 625, 626 (Cal. 1951).

8 *Federal Farm Mortgage Corp. v. Schmidt*, 126 P.2d 1036, 1037 (Colo. 1942).

In Louisiana the test for merchantability is if there are “third persons (not parties to the action) who might thereafter make claims of a substantial nature against the property, and hence subject the vendee to serious litigation, . . . the title is deemed not merchantable.”

The Mississippi Supreme Court held to constitute marketable title “. . . the validity of the title must be clear. There can be no reasonable doubt as to any fact or point of law upon which its validity appears.” An earlier case held “marketable title’ means not merely a title in fact, but one which can be sold at a fair and reasonable price to one willing to buy, and one that can be mortgaged to a person of reasonable prudence.”

The Montana Supreme Court held that in determining whether title is marketable, “the most practicable test is as to whether the title is such that a third person may reasonably raise a question after the time the contract would have been completed. If the condition of the title warrants such an attack, the purchaser may reject the title as ‘unmarketable.’” The Wyoming Supreme Court had adopted this test to determine if title is marketable.

11 Jones v. Hickson, 37 So.2d 625, 629 (Miss. 1948).
12 Union Planter’s Bank & Trust Co. v. Corley, 133 So. 232, 237 (Miss. 1931).
The Supreme Court of North Dakota defined “good and marketable title” to mean “a title in fee simple, free from litigation, palpable defects, and grave doubts; that is, a title which will enable the owner not only to hold it in peace, but will enable him, whenever he may desire to do so, to sell or mortgage the land to a person of reasonable prudence and caution.”\(^{15}\)

The New Mexico Supreme Court has defined “marketable title” to be title that is not “subject to such reasonable doubt as would create just apprehension of its validity in mind of reasonable, prudent and intelligent person, and title which such a person, guided by competent legal advice would be willing to take, and pay fair value therefor.”\(^{16}\)

In summary, marketable title generally has the following attributes:

- legal and equitable title deducible of record
- free from reasonable doubt
- will not expose the purchaser to the reasonable probability of litigation
- acceptable to a reasonably prudent buyer or mortgagee.

Some of the specific facts that have been held to render title unmarketable include:

- a recorded oil, gas and mineral lease in a third party, even though it was partially defective.\(^{17}\)
- an outstanding vendor’s lien.\(^{18}\)

\(^{15}\) *Kennedy v. Dennstadt*, 154 N.W. 271, 274 (N.D. 1915)

\(^{16}\) *Campbell v. Doherty*, 206 P.2d 1145, 1148 (N.M. 1949).


• an unfulfilled covenant in a prior deed to build a bridge and road to benefit adjoining land.\textsuperscript{19}
• judgment of possession failed to include the illegitimate children and did not mention the usufruct in favor of their mother, even though the claims of the illegitimate children and their mother were likely barred by prescription.\textsuperscript{20}
• two oil and gas liens filed against the wells located on the property covered by the mineral deeds.\textsuperscript{21}
• real property records did not establish that landowner owner was not a full-blooded Indian, which was a prerequisite to court’s jurisdiction to judicially partition the land.\textsuperscript{22}
• real property records did not contain judicial determination of deceased landowner’s heirship.\textsuperscript{23}
• the fact that seller did not have record title to land, but the defect could be cured by adverse possession.\textsuperscript{24}
• that federal estate taxes and state inheritance taxes had not been paid, which constituted a lien on the land.\textsuperscript{25}
• a third party had executed a deed of trust covering land, however, the real estate records did not show any conveyance of any interest in land to third party.\textsuperscript{26}
• property descriptions did not comply with an attorney general’s opinion interpreting a statute regarding the requisites for filing property descriptions.\textsuperscript{27}
• the existence of a deed in the chain of title that lacked an attesting witness and an acknowledgement.\textsuperscript{28}

\textsuperscript{19} Buzbee v. Fidelity National Bank, 492 So.2d 15, 21 (La. App. 1st Cir. 1986, writ den’d)
\textsuperscript{20} Parker v. Machen, 567 So.2d 739 (La. App. 2nd Cir. 1990)
\textsuperscript{21} Huckabay v. Keahey, 600 So.2d 97 (La. App. 2nd Cir. 1992)
\textsuperscript{22} Miller v. Scott, 273 P. 363, 365 (Okla. 1928).
\textsuperscript{23} Id
\textsuperscript{25} Darby v. Keeran, 505 P.2d 710, 715 (Kan. 1973)
\textsuperscript{26} Zimmerman v. Wilkson, 290 P. 795 (N.M. 1930).
\textsuperscript{27} McCarthy v. Timberland Resources, Inc., 712 P.2d 1292 (Mont. 1985)
\textsuperscript{28} Messer-Johnson Realty Co. v. Security Savings & Loan Co., 94 So. 734, 735 (Ala. 1922)
Most of the cases dealing with marketable title do not involve the sale of oil and gas properties, because marketable title is not often used as the title standard in asset purchase agreements. If an asset purchase agreement does not use a marketable title standard, then presumably some of the defects noted above would not constitute title defects under an asset purchase agreement using a lesser standard. Confusion and problems of contract construction can be created by the uninformed use of the term “marketable title” in an asset purchase agreement, together with other title provisions that do not conform to a marketable title standard.

III. General and Special Warranty Covenants

In the absence of an asset purchase agreement, a buyer’s remedy for title defects is determined by the warranty covenant contained in the buyer’s conveyance.

A. 1. General Warranty Covenant
The purpose of a covenant of general warranty is to indemnify a buyer against loss or injury that it may sustain by failure or defect in the seller’s title.29 The warranty itself is not “a part of the

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conveyance nor strengthen or enlarge the title conveyed.”30 In other words, the general warranty “does not make the title itself any better,” but it does obligate the seller to pay damages if the title fails.31

In addition to a warranty of title, the covenant of general warranty also provides a warranty against encumbrances.32 The warranty of title protects the buyer from defects in the seller’s title. The warranty against encumbrances protects the buyer from “rights and interests in third parties, which, while consistent with [seller’s title], diminish the value of the estate conveyed.”33 These warranties are separate and distinct. The warranty against encumbrances does not defeat any existing encumbrance but creates a legal duty on the seller to pay and discharge the liens and encumbrances existing prior to the conveyance, unless the buyer assumed the encumbrances.34

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30 Moore, supra at 453. Also see Tropico Land & Improvement Co., supra.


32 Moore, supra at 453. Also see Chicago, Mobile Development Co. v. G. C. Coggin Co., 66 So.2d 151 (Ala. 1953); Wolff v. Woodruff, 61 So.2d 69 (Ala. 1952); Mackey v. Harmon, 24 N.W. 702 (Minn. 1885); Hicks v. Sullivan, 89 So. 811 (Miss. 1921); Upton v. Griffits, 831 P.2d 504 (Colo. Ct. App. 1992).

33 Moore, supra at 453. Also see Wolff, supra.; Nor-Son, Inc. v. Nordell, 369 N.W.2d 575 (Minn. Ct. App. 1985); Mackey, supra.; Century 21 Deep South Properties, Ltd. v. Corson, 612 So.2d 359 (Miss. 1992); 1119 Delaware v. Continental Land Title Company, 20 Cal. Rptr.2d 438 (Cal. App. 2nd Dist. 1993); Evans, supra.; Patel, supra.; Feit v. Donahue, 826 P.2d 407 (Colo. 1992); Upton, supra.

The title protection that the general warranty provides is without regard to the origin of any such defect.\(^{35}\) The general warranty protects against defects arising from acts of the seller, a prior owner, or a third party.\(^{36}\) For instance, in a Texas case, Moore acquired a royalty interest underlying certain lands from the City of Beaumont.\(^{37}\) At the time of the conveyance, the lands were dedicated to use as an airport. In another suit, the Texas Supreme Court held that because of the dedication, which was made by an ordinance by the City, the land could not be used for any purpose that was not consistent with the use of the land for an airport. Therefore, Moore’s royalty interest was worthless. The court held that although the easement that prevented Moore from enjoying his mineral interest did not prevent his fee ownership of the royalty interest, it did constitute a burden on his ownership. Accordingly, the general warranty given to Moore was breached because of an encumbrance that arose through the seller.

In another Texas case, a stranger to title sought to acquire certain property that he thought was unsurveyed land belonging to the public school fund. The stranger filed applications with the Commissioner of the General Land Office seeking awards of this land. The Commissioner issued the awards to the stranger. The awards covered land that had been purportedly conveyed to a prior

\(^{35}\) *FN Moore*, supra; Also see *Lear*, supra.; *Schiff*, supra.; *Colonial Capital*, supra.; *Howard*, supra.; *Wilder*, supra.

\(^{36}\) Also see *Lear*, supra.; *Schiff*, supra.; *Knight v. Clinkscales*, 152 P. 133 (Okla. 1915); *Colonial Capital*, supra.; *Howard*, supra.; *Wilder*, supra.

\(^{37}\) *Moore*, supra
purchaser. Accordingly, the prior purchaser was able to bring an action for a breach of the warranty of title, even though the defect arose either through a stranger in the chain of title.\(^{38}\)

## II. 2. Special Warranty Covenant

The distinction between a general warranty covenant and a special warranty covenant is that, while the general warranty protects the buyer against title defects without regard to their origin, the special warranty limits the protection afforded to a buyer to only those defects which arise by, through or under the seller.\(^{39}\) In other words, unless the seller created the defect in question, the special warranty will not protect the buyer from a defect in title.

Like a general warranty, the special warranty includes a warranty against encumbrances.\(^{40}\) Still, the special warranty against encumbrances protects the buyer only against clouds created by seller. The buyer remains vulnerable to claims by anyone in seller’s chain of title or by any stranger to the title.\(^{41}\)

### A. IV. Breach of Warranty Covenants

\(^{38}\) *Schneider v. Linscomb County Nat. Farm Loan Ass’n*, 202 S.W.2d 832, 834 (Tex. 1947)


\(^{40}\) *Also see Baker*, *supra*.; *Kloeckner*, *supra*.; *Colorado Land & Resources, Inc. v. Credithrift of America, Inc.*, 778 P.2d 320 (Colo. 1989); *Jones v. Metzger*, 96 So. 161 (Miss. 1923).

\(^{41}\) *Also see Kloeckner*, *supra*.; *Credithrift*, *supra*., *State Bank & Trust of Kenmare v. Brekke*, 602 N.W.2d 681 (N.D. 1999); *Metzger*, *supra*. 
A buyer, who has been given a warranty, whether general or special, may sue for a breach of that warranty only when there has been an eviction, either actual or constructive. A constructive eviction occurs when a title paramount to that of the buyer has been asserted against the buyer, and the buyer has yielded to the assertion by either surrendering title or purchasing the title. As a result, a constructively evicted buyer who sues for breach of the warranty must show that the title asserted against him was indeed paramount.

The types of defects for which a buyer may sue for a breach of the warranty of title are those that render the title to not be “good and marketable.” When a seller is to furnish a warranty deed, the

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42 See Schneider, supra at 834. Also see E. de St. Romes v. City of New Orleans, 34 La. Ann. 1201 (La. 1882); Coggins, supra; Blaum v. May, 16 So.2d 329 (Ala. 1944); Colonial Capital, supra.; Wagner v. Finnegan, 67 N.W. 795 (Minn. 1896); Brooks v. Mohl, 116 N.W. 931 (Minn. 1908); Bridges v. Heimburger, 360 So.2d 929 (Miss. 1978); Levitzky v. Canning, 33 Cal. 299 (Cal. 1867); McCormick v. Marcy, 132 P. 449 (Cal. 1913); Peterson v. Reishus, 266 N.W. 417 (N.D. 1936); Patel, supra.; Garcia v. Herrera, 959 P.2d 533 (N.M. Ct. App. 1998); Wilder, supra.; Herrington v. Clark, 55 P. 462 (Kan. 1898).

43 See Schneider, supra at 834; and also see Caldwell v. Kirkpatrick, 6 Ala. 60 (Ala. 1844); Wagner, supra.; Bridges, supra.; Norton v. Jackson, 5 Cal. 262 (Cal. 1855); McCormick, supra.; Peterson, supra.; Patel, supra.; Garcia, supra.; Wilder, supra.; Herrington, supra.

44 See Schneider, supra at 834; and also see Colonial Capital, supra.; Nor-Son, supra.; David v. Holifield, 193 So.2d 723 (Miss. 1967); Fowler v. Smith, 2 Cal. 39 (Cal 1852); McCormick, supra.; Peterson, supra.; Patel, supra.; Garcia, supra.; Wilder, supra.

45 See Roberts & Corley v. McFaddin, Weiss & Kyle, 74 S.W. 105 (Tex. Civ. App. 1903); and also see Colonial Capital, supra.; 1119 Delaware, supra.; Evans, supra.; Otero, supra.
law requires that the title to be delivered thereby must be good and marketable.\textsuperscript{46} Therefore, if the title is not good and marketable, then the buyer may have an action for breach of the warranty.

The Texas Supreme Court has held that the warranty against encumbrances is breached when an encumbrance lessens the value of the property, or the title thereto, or interferes with its enjoyment.\textsuperscript{47}

\textbf{1. Damages for Breach of Warranty Covenants}

In the event title fails, the measure of damages is the consideration or purchase price paid by the buyer.\textsuperscript{48} If a deed recites that the consideration was ten dollars and other good and valuable consideration, then the buyer is required to prove the actual consideration given. If there is a finding that the buyer paid no consideration, then even though there has been a breach of the warranty, the buyer is not entitled to recover anything.\textsuperscript{49}

If title to the entire property conveyed and warranted fails, then the measure of damages for the breach of warranty is the purchase price plus interest.\textsuperscript{50} However, if title fails to only part of the

\textsuperscript{46} See McFaddin, supra at 108.

\textsuperscript{47} See Moore, supra at 453-4. Also see Chicago Mobile Development Co., supra.; Wolff, supra.; Nor-Son, supra.; Mackey, supra.; Evans, supra.; Patel, supra.; Feit, supra.

\textsuperscript{48} Tarrant v. Schulz, 441 S.W.2d 868 (Tex. Civ. App. – Hous. [14th Dist.] 1969, ref. n.r.e.). Also see Levenberg v. Shanks, 115 So. 641 (La. 1928); Peoples Finance & Thrift Co. v. Fuller, 162 P.2d 189 (Okla. 1945) and see 23 OKL. ST. ANN. § 25; Wilson v. Downtown Orange Beach, Inc., 641 So.2d 282 (Ala. 1993); Brooks, supra.; Holcomb v. McClure, 217 Miss. 617 (Miss. 1953); McCormick, supra.; Starbird v. Jacobs, 105 P. 872 (Colo. 1909); Otero, supra.; Doom v. Curran, 34 P. 1118 (Kin. 1893); Herrington, supra.

\textsuperscript{49} Tarrant, supra. at 870.

\textsuperscript{50} Hynes v. Packard, 45 S.W. 562, (Tex. 1898)
premises, then the proper measure of damages for the breach of warranty is an amount in the same proportion to the total purchase price as the actual value of that part of the property to which title has failed bears to the total value of the property. 51

If seller breaches the warranty against encumbrances, then the seller is usually obligated to remove the encumbrance. 52 However, when an encumbrance cannot be discharged or removed, the seller may still be compelled to respond in damages. 53 The proper measure of damages for such an encumbrance is governed by the rule applicable to a partial failure of title. 54

(i) 2. Attorney’s Fees for Breach of Warranty Covenants

51 Hynes, supra. Also see Harville v. Campbell, 221 So.2d 273 (La. App. 2nd Cir. 1969); Bone v. Franklin, 163 P.2d 527 (Okla. 1945); Brooks, supra.; Holcomb, supra.; Otero, supra.; Maxwell, supra.

52 Trippett, supra at 947. Also see Housing Authority of the City of Lafayette v. Fidelity & Deposit Company of Maryland, Inc., 309 So.2d 920 (La. App. 3rd Cir. 1975); Hanlon v. McLain, 242 P.2d 732 (Okla. 1952); Wilson v. Downtown Orange Beach, Inc., 674 So.2d 552 (Ala. 1995); Mackey, supra.; Fraser v. Bentel, 119 P. 509 (Cal. 1911); McCormick, supra.; Patel, supra.; Starbird, supra.

53 Moore, supra at 454. Also see Housing Authority of the City of Lafayette, supra.; Wilson v. Downtown Orange Beach, Inc., 674 So.2d 552 (Ala. 1995); Mackey, supra.; Fraser, supra.; McCormick, supra.; Patel, supra.

54 Hynes, supra. Similarly, in Ragsdale v. Langford, 358 S.W.2d 936, 938 (Tex. Civ. App. – Austin 1962) the purchaser acquired title to certain business premises via a general warranty deed. The purchaser later learned that there was a previously existing lease covering the premises. Although title did not fail, the property was encumbered by the lease, resulting in a breach of the warranty against encumbrances. The court held that “the measure of damages . . . is that the damages will bear the same proportion to the whole purchase money as the value of the part to which the title fails bears to the whole premises estimated at the price paid.”
Damages for breach of warranty does not include attorneys’ fees incurred by buyer in an action against the seller on account of the breach.\(^{55}\) However, in some states, courts have allowed a buyer to recover from the seller attorneys’ fees incurred by the buyer in a prior legal action to defend its title, in which the seller failed to defend buyer’s title.\(^{56}\) In other words, while courts have allowed a buyer to recover the fees incurred to defend its title, courts have not allowed buyers to recover their fees in an action against the seller on the warranty.\(^{57}\)

III. V. Advantages and Disadvantages of an Asset Purchase Agreement

There are many advantages, and some disadvantages, to entering into an asset purchase agreement for the sale and purchase of oil and gas properties. This paper will examine only those related to title and title defects. While there are some advantages and disadvantages that may be common to both seller and buyer, in most cases, sellers and buyers see the advantages and disadvantages of an asset purchase agreement from different perspectives. Regardless of whether seller and buyer rely solely on a conveyance with warranty covenants or instead on an asset purchase


\(^{56}\) See Jacobson v. Thrash, 435 So.2d 88 (Ala. Civ. App. 1983); Allis v. Nininger, 25 Minn. 525 (Minn. 1879); First Fiduciary Corporation, supra.; Howard, supra.; McCormick, supra.; Peterson, supra.; Bloom, supra.

\(^{57}\) See Jacobson, supra.; Allis, supra., First Fiduciary Corporation, supra.; Howard, supra.; McCormick, supra.; Peterson, supra.; Bloom, supra.
agreement, a buyer will most certainly conduct some examination of the status of seller’s title prior to paying for seller’s title to the properties. How buyer and seller approach defects in title will likely vary depending on which approach is used.

1. **Why Not a Conveyance with Warranty?**

   A conveyance, with or without a warranty, is what buyers get at an auction, with little or no ability to determine the status of title. A conveyance, without access to title information, also may work for the sale of a single property or where the low value of the properties renders use of a negotiated asset purchase agreement too expensive.

   In all other circumstances, even in the absence of an asset purchase agreement, the buyer will want to determine the status of seller’s title. Without seller’s cooperation, buyer’s examination of title would be limited to the public records. Because title to oil and gas leasehold estates is usually dependant on unrecorded documents, the buyer will seldom get a complete understanding of seller’s title by merely reviewing the public records. It is unlikely that any sophisticated buyer will be satisfied only to examine public records, before paying any significant consideration, unless the seller is willing to provide a general warranty of title. A general warranty covenant would be unacceptable to seller, because a general warranty is an undertaking to deliver marketable title to the buyer. Moreover, under a general warranty a seller agrees to indemnify against both failure or defect of title and against encumbrances created by anyone in the chain of title or by third parties. Unless a seller enjoys a very superior bargaining position, it is unlikely that a sophisticated buyer will be willing to accept a special warranty, if it is only able to examine title to oil and gas leasehold from the public records. Therefore,
if a sale is to occur at all, then the seller will of necessity, provide buyer with access to seller’s title materials.

Although it is possible, it is rare for a seller to allow prospective buyers access to seller’s land files with the uncertain prospect of receiving an offer to purchase certain oil and gas properties, which seller can either reject or accept by delivering a conveyance with a covenant of special warranty. Access to seller’s land files raises issues concerning confidentiality of seller’s information relating to existing properties and opportunities, which need to be addressed by seller in a writing signed by the prospective buyer.

Without an asset purchase agreement, neither buyer nor seller are bound to close a sale. The seller can continue to market its properties to other prospective buyers and can perhaps use buyer’s offered price as the basis for negotiating a sale with another buyer. Buyer can merely walk away if buyer finds potential problems with seller’s title or if seller will not accept buyer’s best price. Both parties can continue to negotiate the terms of a proposed sale, including the purchase price, until the closing, if there is one. However, without a signed asset purchase agreement, both parties risk incurring large transaction costs in terms of capital and human resources without assurance that the process will lead to Closing. Without an agreement to buy, a seller will normally be unwilling to take its properties off the market and a buyer will normally be unwilling to incur the costs of examining seller’s title.

With only a conveyance and warranty it is unlikely that title defects will be addressed in advance. Buyer will either decide to rely on the warranty or to not buy the properties. If buyer
purchases seller’s properties subject to some title defects, then buyer’s only remedy for these title defects is litigation to recover the purchase price, plus interest. If there is more than one property included in the sale, then buyer will have to show the amount of the consideration allocable to the property on which a title defect has resulted in title failure. This may entail two separate suits, i.e. one to defend title and another suit against the seller on the warranty, if buyer is evicted from the property. Only the attorney fees to defend title are recoverable by buyer. If there is more than one property included in a conveyance, then buyer will have to prove the amount of the consideration allocable to the property on which a title defect has resulted in title failure. In the absence of an asset purchase agreement, it is unlikely that the seller and buyer will have agreed upon the allocation of the purchase price among the various properties. Therefore, the allocation will be a fact question to be decided by the jury, based on the evidence presented.

2. **Why an Asset Purchase Agreement?**

Most often a seller is seeking to sell a package of properties by either sealed bid or negotiated sale to a limited number of qualified prospective buyers, who make offers to buy based on limited due diligence, but contingent upon a more thorough review of seller’s title as provided in a proposed form of asset purchase agreement. The asset purchase agreement is the outline of how seller and buyer will reach closing. At a minimum, it will provide (i) a definition of acceptable title and what constitutes a title defect; (ii) an allocation of the purchase price among the properties included in the sale, and (iii) remedies for title defects discovered. The remainder of this paper will address achieving a meeting of the minds on the title provisions of an asset purchase agreement and implementing that agreement.
VI. Negotiating Title Provisions of the Asset Purchase Agreement

1. Why Address Title

The value being transferred in the sale of oil and gas properties is the value of the oil and gas reserves yet to be produced. Title to these oil and gas reserves is obtained by the seller conveying title applicable to the oil and gas leasehold estates to buyer. While the sale of oil and gas leasehold estates may also include the sale of associated personal property and equipment, their value does not usually represent a significant portion of the purchase price. Personal property and equipment are normally transferred “AS IS, WHERE IS, WITH ALL FAULTS” and without any Uniform Commercial Code warranties of “merchantability, fitness for a particular purpose, or conformity to models of samples of materials.” Therefore, title provisions are included in an asset purchase agreement to preserve both the seller’s and the buyer’s economic objectives with respect to the ownership of the real property interests in oil and gas leasehold estates in the properties being sold, which represent the oil and gas reserves yet to be produced.

It is increasingly uncommon for buyers to undertake the expense of having attorneys prepare title opinions on the seller’s interest. Therefore, because there are not usually intervening title opinions, each buyer must review title from at least the effective the date that the seller acquired the properties and will often review title from the date of the oil and gas leases. Title to these oil and gas leasehold estates is more often than not very complex and in the absence of title opinions cannot be verified without thorough review of a myriad of both publicly recorded and unrecorded instruments, such as: oil and gas leases, assignments of oil and gas leases, assignments of overriding royalty interests.
interests, pooling, consolidation and communitization agreements, regulatory commission orders, judgments, deeds of trust and mortgages, affidavits of lien, probate and guardianship proceedings, consensual and judicial partition proceedings, affidavits of heirship, mergers, name changes, production payments, net profits interests, operating agreements, exploration agreements, participation agreements, farmout agreements and other unnamed documents that affect the ownership of the oil and gas leasehold estate in a particular tract of land.

Review of title is more important to a buyer than a seller. The seller is more likely to view as remote the likelihood of liability on the title, because he no longer owns the properties. Any liability will normally arise out of the contract seller signs with buyer, over which the seller has some control. A buyer is concerned that title defects will result in the loss of ownership of part or all of one or more properties or will expose the buyer to litigation or will reduce the value of the properties below the purchase price. Buyers are also concerned about potential liability to shareholders, limited partners and/or its financial institutions if the ownership and economic basis upon which the properties were valued was not verified with due care.

2. Seller’s and Buyer’s Competing Objectives

Sellers and buyers have inherently different objectives with respect to title matters. It is important to recognize these different objectives in order to find ways to reach a mutually satisfactory compromise between these competing objectives in the asset purchase agreement.

Let us start with the premise that (i) sellers desire to sell their properties “AS IS” without representations and warranties as to title, either express or implied, and to retain no obligations or
liabilities with respect to title to the properties after Closing; and (ii) buyers desire the strongest possible representations and warranties as to title from the seller and the ability to look to the seller for indemnity against any loss arising from failure or defects of title for an indefinite period of time after the Closing. The seller wants to sell whatever it is he owns and the buyer wants seller to represent what it is he owns and to guarantee that ownership in buyer. It is from these opposing viewpoints that sellers and buyers negotiate the mechanisms used to define, value, assert, cure and resolve disputes over title defects incorporated in the final asset purchase agreement. Whether or not the initial draft of a proposed asset purchase agreement reflects these disparate objectives, seller’s and buyer’s negotiating posture will, subconsciously at least, be affected by these opposing viewpoints on title matters. There are several factors that will influence each party’s objectives, their negotiating posture and how far they are willing to move toward the other party’s position to reach agreement.

a. Factors Affecting Seller’s Negotiating Posture

Seller’s motivation for selling the properties is a factor. A Seller may have been required by its shareholders, limited partners or lenders to receive a minimum purchase price for the properties, or it may be under pressure to raise cash to pay down debt or re-deploy capital. In either instance, a seller will resist title defect provisions that have the potential to reduce the purchase price below its minimum requirements. In addition, sellers will seek to include provisions that allow the seller to terminate the asset purchase agreement if purchase price adjustments arising from title defects will decrease the consideration seller is to receive below a stated value or percentage of the purchase price.
Whether a seller feels it is selling its properties at a premium, or at a heavily discounted price, will affect seller’s tolerance for purchase price adjustments for title defects.

Seller’s knowledge of the properties is another factor. If the seller has owned the properties since the first wells were drilled, then seller may not feel strongly about representations and warranties concerning title and will agree to a broader definition of title defects for which purchase price adjustments can be made. On the other hand, if the properties being sold are lower valued properties included as part of a larger prior acquisition by the seller, then title to the properties has probably not been extensively reviewed by seller. Because less is known by seller about potential title problems with respect to these properties, seller will be more reluctant to make representations and warranties concerning title to the properties and will insist on a narrower definition of title defects.

Another factor is seller’s risk tolerance. Seller’s risk tolerance often mirrors seller’s knowledge of the properties. Sellers desire to undertake as little title risk as possible, by severely limiting or excluding any title representations and warranties and by limiting or excluding any downward adjustments to the base purchase price resulting from title defects. To reduce title risk, both before and after the Closing, sellers desire to narrowly define title defects, to provide for large title defect deductibles and thresholds and low caps on total title defects, and to control remedies for title defects asserted by then the buyer.

b. Factors Affecting Buyer’s Negotiating Posture

Perhaps the primary factor influencing buyers is risk tolerance. Some of the factors that affect buyer’s risk tolerance are the size of the transaction, whether the purchase will be financed by debt,
whether the buyer is a private company or publicly held and the concentration of value, i.e. how much of the transaction value is concentrated in what percentage of the properties. For example, if a substantial portion of the value of the transaction is concentrated in a very few properties, then buyer’s risk tolerance will likely be less than if the transaction value is spread fairly uniformly over a large number of properties. To reduce title risk, buyers desire to broadly define title defects, provide for the small title defect deductibles and thresholds, and high caps on total title defects, and to control remedies for the defects they assert.

Another factor is buyer’s perception of his title due diligence obligation. If the buyer is a publicly held company or a general partner or if the purchase will be financed with debt, then buyer may perceive that he has a higher title due diligence burden than, for example, a private company financing the purchase out of cash flow. An existing positive business relationship or trust between a buyer and seller may cause buyer to rely on less extensive due diligence. If the buyer is familiar with the properties he is acquiring, then this may also cause buyer to rely on less extensive due diligence. For example, if the buyer already owns an undivided interest in the properties being acquired, or properties in the same fields or interests in other of seller’s properties in the area, then the buyer may have more confidence in the title status of the properties.

Another factor is buyer’s perception about whether the purchase price represents a premium or a discounted price for the properties. If a buyer feels that it is paying a premium for the properties, then buyer may feel it should be afforded greater latitude for purchase price adjustments for title defects. If,
on the other hand, a buyer feels it is receiving the properties at a discounted price, then buyer may be willing to factor some risks for title defects into his purchase price.

c. Factors Affecting Both Parties’ Negotiating Posture

The financial strength of each party plays an important role in the confidence each party has about the other party’s ability to perform. The seller’s financial strength gives the buyer confidence that it can perform on its post closing obligations concerning title, which are most often indemnity obligations. The buyer’s financial strength gives the seller confidence that the buyer can pay the purchase price at closing and that the buyer will not nitpick seller on post closing issues.

If the properties are in an area widely known to have difficult title, then both seller and buyer will be seeking additional protection from loss. The negotiation of the allocation of risk in such a situation will be difficult at best.

One of the most important factors that will affect both parties’ negotiating posture is the presence or absence of mutual cooperation. For example, if the seller, declines to list known preferential rights, and instead insists it is the buyer's responsibility to discover any preferential rights, then there will likely be an adversarial relationship between seller and buyer that will affect all aspects of the transaction. If, on the other hand, buyer demands an unqualified representation by seller in the asset purchase agreement that all preferential rights to purchase and all consents to assign have been listed, then again there will likely be an adversarial relationship.

The importance of a cooperative exchange of information between the seller and buyer during the negotiation of the asset purchase agreement should not be underestimated. Such an exchange can
build trust between the parties and uncover potential issues and problems relating to title that can be specifically addressed when negotiating the provisions of the asset purchase agreement. It is much easier to draft provisions to deal with specific issues and how they will be resolved, rather than later attempting to resolve the issue by interpreting provisions of the asset purchase agreement that do not quite fit. A cooperative exchange of information further permits each party to better understand the other party’s issues and how a mutually acceptable accommodation can be reached that will permit both seller and buyer to achieve their respective economic goals within the context of an asset purchase agreement that will avoid rather than foster litigation.

VII. Asset Purchase Agreement Title Provisions

Title matters may be addressed in several different sections of an asset purchase agreement, e.g. Seller Representations and Warranties, Conditions to Closing, Title Warranties, Indemnification and Title Defect provisions. Title defects may arise from any or all of these different sections. Therefore, rather than review title provisions by reference to any particular section, this paper will review the type of title provisions that commonly appear in a typical asset purchase agreement.

1. Acceptable Title Standard

The description of the title standard can appear in Seller’s Representations and Warranties, or in a section called merely Title Matters – the location is unimportant. The statement of an acceptable title standard is the starting point for all other title matters, i.e. if buyer’s due diligence examination of title indicates that seller’s title conforms to the title standard in all respects, then the other title
provisions have very little effect. Title defects are instances where the seller’s title does not conform to the stated title standard.

Unless the parties intend “marketable title” to apply, it is not advisable to use the term “marketable title” in the description of acceptable title, because to the extent the definition of marketable title used is not complete or clear, the courts may construe the title standard in light of the common law “marketable title” standard.

The most common description of the acceptable title standard in asset purchase agreements is “good and defensible” or merely “defensible title.” However, without including a definition of what constitutes “defensible title,” there is not a title standard. There is no legally or commonly accepted meaning for “defensible title” so it must be defined in each asset purchase agreement. The following is a typical “Defensible Title” definition:

**“Defensible Title”** shall mean, as to a Property, that record or beneficial title of Seller which:

(a) Entitles Seller, throughout the duration of the estate constituting the Property, to receive and retain, without suspension, reduction or termination, from the Property not less than the interest shown on Exhibit A as the Net Revenue Interest of all Hydrocarbons produced, saved and marketed from the Property and wells associated therewith and of all Hydrocarbons produced, saved and marketed from any unit of which the Property is a part and which are allocated to such Property;

58 This phrase may also be expressed in numerous other ways, e.g. “through the plugging, abandonment or salvage of all wells comprising or included in a Property and all wells now or hereafter producing from a Property;” or “through the productive life of the wells now located on the Property or lands pooled therewith, whether producing, shut-in or temporarily abandoned.”

59 Sometimes the phrase is expanded as follows “without suspension, reduction, termination or indemnity, except for customary division order indemnities.”
(b) Obligates Seller throughout the duration of the estate constituting the Property to bear its percentage of the costs and expenses relating to the maintenance and development of, and operations relating to, the Property and wells associated therewith not greater than the Working Interest shown on Exhibit A, unless such greater Working Interest is accompanied by a proportionate increase in Seller’s Net Revenue Interest for such Property or related well; and

(c) Is free and clear (except for Permitted Encumbrances which are hereinafter defined) of liens, encumbrances, obligations or defects.60

This definition, or some form of it, is usually acceptable for the sale of producing oil and gas wells, where the Property is equivalent to the proration or spacing unit for a well producing from zone or formation identified in the attached Exhibit A. To avoid the claim of a title defect it is imperative that Exhibit A accurately describe the quantum of seller’s net revenue interest and working interest, and disclose any reductions to the represented interests that may arise because of payout under operating agreements or other contracts affecting the Property, which should, if possible, be described on Exhibit A. A common error is to list on Exhibit A the net revenue interest shown in the accounting or engineering records, and to forget to show a reduced interest after payout of a non-consent penalty under an operating agreement.

It is increasingly common for sellers and buyers to negotiate a purchase price based not only on existing production, but also based on behind pipe reserves and proved undeveloped locations (“PUD locations”). The seller’s net revenue and working interests in a producing well located on the leases

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60 These two words are an example of a buyer-oriented phrase, which could be the basis of a claim for title defect that might not otherwise be expected under the more traditional phrase “liens and encumbrances.”
described in Exhibit A may not be the same net revenue and working interests at different depths in the
well included in a Property or at a different location on the leases being sold. It is very likely that the
seller has not examined title to anything but the drill site for the producing well on the Property and
that seller has no or very little information about the lands held by production by that well. If title is
not uniform throughout the lands covered by the lease(s) included in the Property, then this description
of Defensible Title will not be sufficient unless the PUD locations are specifically identified on Exhibit
A with the applicable net revenue and working interests. Often, however, the buyer is unwilling to
specifically identify its PUD locations, because the buyer does not want to disclose what it deems as
proprietary information to the seller in case the transaction does not close.

Based on the above definition, if the net revenue interest of seller in a Property is stated on
Exhibit A as 0.875, and buyer’s due diligence examination shows seller’s net revenue interest in the
Property to be 0.865, then the seller does not have defensible title in the Property, at least to the extent
of an 0.010 interest, or 1.14% of its value. If the Property is valued at $1,000,000, then it appears that
buyer will not receive $11,400 of that value. If the Property is valued at $10,000,000, then it appears
that the buyer will not receive $114,000 of that value. Sellers are concerned that buyers will aggregate
a number of small mathematical discrepancies, about which there may be disagreement between seller
and buyer, into a large dollar value title defect. Therefore, sellers desire to include some form of
materiality limitation on the literal terms of the definition of Defensible Title. These materiality
limitations will be discussed below under Title Defects.
It is increasingly common for parties to include in the definition of Defensible the following: “[title] that is free from such reasonable doubt that a prudent person engaged in the business of the ownership, development and operation of producing oil and gas properties with knowledge of all of the facts and their legal bearing would be willing to accept same.” This language may, in fact, have two different effects. On one hand, this language is very similar to the definition of marketable title, so it perhaps narrows the definition of Defensible Title so it is similar to the definition of marketable title. On the other hand, this language may perhaps expand the definition of Defensible Title by introducing the concept of title satisfactory to a prudent oil and gas businessman.

2. Permitted Encumbrances

Incorporated in the definition of Defensible Title is the concept of permitted encumbrances. An encumbrance is a defect of title. However, because of the nature of oil and gas leasehold estates, certain encumbrances that might otherwise constitute title defects are excepted from the definition of Defensible Title as “permitted encumbrances.” Once again, there is no legal definition or commonly accepted definition of “permitted encumbrances.” However, the following is a typical “Permitted Encumbrance” provision found in an asset purchase agreement.

“Permitted Encumbrances” with respect to Seller’s interest in a Property shall mean the following:

(a) Landowner royalties, overriding royalties, production payments, reversionary interests and other payments out of production if the net cumulative effect
of such burdens does not operate to cause the Net Revenue Interest of any Property to be less than the Net Revenue Interest set forth in Exhibit A,\textsuperscript{61}

(b) Sales contracts covering oil, gas or associated liquid or gaseous hydrocarbons, which are terminable upon less than 90 days notice;

(c) Preferential rights to purchase and required third party consents to assignments and similar agreements with respect to which, prior to Closing, (i) waivers or consents are obtained from the appropriate parties, or (ii) required notices have been given to the holders of such rights and the appropriate time period for asserting such rights has expired without an exercise of such rights;

(d) Liens for taxes or assessments not due or not delinquent on the Closing Date or, if delinquent, that are being contested in good faith;\textsuperscript{62}

(e) Inchoate liens of operators relating to obligations not yet due or pursuant to which Seller is not in default, and inchoate materialmen’s, mechanics’, repairmen’s, or other similar liens or charges arising in the ordinary course of business incidental to construction, maintenance or operation of the Properties that are not delinquent or, if delinquent, that are being contested in good faith;

(f) All rights to consent by, required notices to, filings with, or other actions by governmental agencies in connection with the sale or conveyance of oil and gas leases or interests therein or sale of production therefrom if the same are customarily obtained subsequent to such sale or conveyance; and

(g) Easements, rights-of-way, servitudes, permits, surface leases, and other rights in respect of surface operations in favor of a third party on or over any of the Properties, which do not operate to interfere with current or proposed operations on the Properties;

(h) The agreements set forth on the attached Exhibit “_____”; and

\textsuperscript{61} If the seller’s net revenue interest is correctly described on Exhibit A of the asset purchase agreement, then there is really not a reason to include this exception to defensible title.

\textsuperscript{62} Care must be taken to ensure that Seller retains all liability with respect to any matters "being contested in good faith." See also (e) above.
(i) Title Defects waived by Buyer pursuant to the terms of this Agreement.

This “Permitted Encumbrance” provision is one that would be favored by a buyer, because it includes a minimum number of exceptions to the Defensible Title standard. Sellers are likely to seek additional protection from circumstances common to the ownership of oil and gas leasehold estates that may give a buyer an opportunity to assert title defects. For example, the scope of item (h) is limited to enumerated agreements listed in the asset purchase agreement. Such a narrow provision would require the seller to do enough due diligence prior to the execution of the asset purchase agreement to attach a specific listing of all contracts, most of which are not of record, that affect ownership of the Properties, including operating agreements, participation agreements, area of mutual interest agreements, exploration agreements, unitization agreements, farmout agreements, and the like. Any agreement not listed could potentially be the basis of a title defect. Sellers argue that is an undue burden, because it requires the seller to do the buyer’s due diligence. Sellers would rather list such agreements generically. Buyers on the other hand, particularly if the asset purchase agreement provides for a short due diligence period, argue that unless the agreements are listed they are at a disadvantage in trying to locate all of the applicable contracts that might affect ownership. One example of a compromise provision, which is not without its own problems, is the following:

(x) the terms and conditions of all operating agreements, unit agreements, unit operating agreements, pooling agreements and pooling designations, farmout agreements, exploration agreements, participation agreements and other like agreements affecting the Properties, to the extent that such terms and conditions (i) do not decrease Seller’s Net Revenue Interest below the Net Revenue Interest shown in the attached Exhibit A, (ii) which are customarily accepted in the oil and gas industry, and (iii)
which do not materially and adversely interfere with Buyer’s ability to operate and produce oil and/or gas from the Properties.

While the seller has avoided preparing a listing of contracts, the seller may have opened the door to title defects being asserted because the terms of an agreement are claimed to be “not customary” or to “materially or adversely interfere with” buyer’s operations. Often sellers seem to believe that the lack of precision in provisions affecting title benefits the seller. However, if the buyer has decided it does not want to close the contemplated sale, this lack of precision may permit the Buyer a convenient escape, without risk of liability.

There are at least two additional permitted encumbrances that sellers customarily want included in an asset purchase agreement. The first is usually not controversial and is commonly included in negotiated asset purchase agreements.

(y) conventional rights of reassignment requiring notice and/or the reassignment of a leasehold interest prior to surrendering or releasing such leasehold interest.

The other is, however, subject to more controversy.

(z) other encumbrances, defects and irregularities affecting any Property the enforcement of which is barred under applicable statutes of limitation, or that do not require the payment of money and are commonly waived by prudent purchasers of producing properties, such as failure to recite marital status in documents, omission of heirship or succession proceedings and the failure to record releases of liens, production payments or deeds of trust that have expired according to their own terms.

This provision is clearly intended to exclude from the class of title defects matters in the chain of that, while technically a defect of title under a marketable title standard, represent very little likelihood of risk of loss. Application of this provision can be problematical and can result in an impasse in the
resolution of title defects. Whether a defect is barred under the applicable statute of limitations, does not require the payment of money and is commonly waived by prudent purchasers can be subject to considerable disagreement. Therefore, if such a provision is included it is also important to provide for workable and practical dispute resolution procedures.

3. Definition of Title Defect

Having defined Defensible Title, and its exceptions as Permitted Encumbrances, we still have not defined “title defect.” Often an asset purchase agreement contains no formal definition of what constitutes a title defect. Rather, the buyer is required to notify seller of any matter that would cause seller’s title to any of the properties not to be Defensible title. If a definition is included it may typically be something like the following:

Except for Permitted Encumbrances, any lien, charge, contract, agreement, obligation, encumbrance, preferential purchase right, consent to assign, defect, claim, or irregularity of title that in accordance with standards generally accepted in the oil and gas industry would cause Seller’s title to any Property not to be Defensible Title shall be a Title Defect.

The question is whether this adds any additional certainty to determining what constitutes a title defect.

Another method of defining a title defect is to provide that if any of a series of statements about seller’s title are untrue, then a title defect exists. The following is an example of such a provision:

A. A Property shall be deemed to have a “Title Defect” if any one or more of the following statements is untrue with respect to such a Property as of the Effective Time and as of the Closing Date:

1. Seller has Defensible Title thereto.

2. All royalties, rentals, Pugh clause payments, shut-in gas payments and other
payments due with respect to a Property have been properly and timely paid, except for payments held in suspense for title or other reasons which are customary in the industry and which will not result in grounds for cancellation of Seller’s rights in such a Property.

3. Seller is not in default (and there exists no event or circumstance which with notice or the passage of time or both could constitute a default by Seller) under the terms of any leases, farm-out agreements or other contracts or agreements respecting a Property which could (a) interfere in any material respect with the operation or use thereof, (b) prevent Seller from receiving the proceeds of production attributable to Seller’s interest therein, (c) result in cancellation of Seller’s interest therein, or (d) impair the value of Seller’s interest therein or cause Buyer to incur any liability as a result of the transactions contemplated hereby.

4. All consents to assignment or notices of assignment which are applicable to or must be complied with in connection with the sale, assignment or transfer contemplated by this Agreement, or any prior sale, assignment or the transfer, of such a Property have been obtained and complied with to the extent the failure to obtain or comply with the same could render any such sale, assignment or transfer (or any right or interest affected thereby) void or voidable or could result in Buyer incurring any liability as a result of the transactions contemplated hereby.

5. No provision or obligation exists under any contract or agreement affecting a
Property which is both (x) not customary to currently accepted oil and gas industry standards and (y) could interfere materially or have a material adverse economic effect on the exploration, development, operation or use of such Property or impair the value thereof to Buyer in any material respect.

6. No provision or obligation is contained in any contract or agreement affecting a Property, which grants a preferential right or option to purchase the same at a purchase price other than the portion of the Purchase Price allocated thereto in this Agreement.

7. There exists no adverse claim asserted or threatened (or which with notice or the passage of time or both could be asserted or threatened) with respect to any of the matters set forth in items (1) through (6) above which is of such significance that a reasonable and prudent operator would be unwilling to accept and pay for a Property without a reduction in the Purchase Price.

It is immediately apparent that this provision is very favorable to the buyer, and that except for item Nos. 1, 4 and 6, the remaining provisions are only indirectly related to seller’s title. More often than not many of these matters are dealt with as seller’s representations and warranties, which also affect seller’s title.

VIII. Identification of Title Defects

An asset purchase agreement defines certain standards for what constitutes acceptable title. The question is then who will make the judgment whether the seller’s title is subject to title defects. Obviously, this is a matter of judgment and there can be varying judgments between seller and buyer
about whether a matter constitutes a title defect, even under the most tightly drawn definitions. Once it was common for a third party attorney to be engaged to examine the seller’s title. If there is a title opinion an argument can be made that only the matters shown in the attorney’s opinion should be the basis of a title defect. On the other hand, if the attorney only examines seller’s record title, the title opinion may not cover matters shown by the seller’s land files that are title defects. Today, more often than not, the buyer hires a team of due diligence landmen, who review the seller’s record title in the public records and seller’s title as reflected by the seller’s land files. Often the due diligence team is not given or does not exercise any discretion or judgment in determining whether an apparent defect is, in fact, a title defect under the applicable asset purchase agreement. Unfortunately, it is not uncommon that the members of the due diligence team have never seen the asset purchase agreement or even the definitions applicable to title. Therefore, it is possible that the buyer will notify seller of every defect noted by the due diligence team no matter how insignificant.

To deal with such an approach to title defects by buyers, sellers seek to include in the asset purchase agreement devices to limit (i) the number of defects that can be identified by the buyer, (ii) the dollar amount that can be claimed, and (iii) to provide for procedures to resolve disputes about whether a title defect identified by the buyer is, in fact, a title defect under the terms of the asset purchase agreement.

1. **Thresholds, Caps and Deductibles**

   These terms can be used fairly loosely during negotiation of an asset purchase agreement. Therefore these devices will be defined and illustrated for the purposes of this paper. A “threshold” is a
minimum dollar amount or percentage attributable to all title defects that must be reached before
adjustments to the base purchase price can be made. In some instances, if the threshold is exceeded,
then the seller must adjust for the total value of the title value of title defects asserted. More
commonly, however, the seller is required to adjust for the value of the total title defects asserted that
exceed the stated threshold. For example:

. . . provided, however, seller shall not be required to adjust the Purchase price unless
the total value of Title Defects asserted by buyer and accepted by seller exceed
[$250,000 or one percent (1% ) of the purchase price], and then only to the extent that
the total value of such Title Defects exceeds said amount.

A “deductible” is a minimum dollar amount or percentage attributable to a title defect for an individual
property that must be reached before a title defect can be claimed even though it otherwise meets the
contractual provisions of the asset purchase agreement for a title defect. For example:

. . . provided, however, that Seller's title shall nevertheless be deemed to constitute
Defensible Title if the difference between Seller's actual interest as determined by
Buyer and the interest set forth in Exhibit A for each unit or well included within an
individual Property is one-half percent (1/2%) or less (by way of example, if the Net
Revenue Interest shown in Exhibit A for each unit or well included within a Property is
87.5%, Seller will have Defensible Title to such Leasehold Interest if it is entitled to
receive not less than 87% of all oil and gas produced from such Property).

Or

provided, however, that Seller's title shall nevertheless be deemed to constitute
Defensible Title with respect to any Property if the Allocated Value of any Title Defect
asserted with respect to a Property is less than $10,000.00.
A “cap” is the maximum dollar amount or percentage attributable to title defects asserted by a buyer above which either the buyer or the seller has an option to terminate the asset purchase agreement without penalty. For example:

provided, however, this Agreement and the transactions contemplated hereby, may be terminated by either Seller or Buyer, prior to the Closing, if the aggregate Defect Value, determined in accordance with Sections 3.6 and 3.7, of Title Defects, which cannot be cured by Seller prior to Closing or for which Seller will not or cannot indemnify Purchaser pursuant to Section 3.5(b)(i), will reduce the Purchase Price by an amount greater than fifteen percent (15%) of the Purchase Price;

This type of “cap” provision is usually accepted by buyers, with negotiations focusing on the amount of the cap. However, “threshold” and “deductible” provisions are strongly resisted by buyers as being, in effect, an agreement to pay more for the properties than they are worth when the title defects are taken into consideration.

2. Determination of Title Defect Amount

While it is difficult enough to agree on what a title defect is, it is often just as difficult to agree on the actual value of a title defect. Just as the asset purchase agreement should contain carefully drafted provisions defining what constitutes a title defect, the agreement should also contain carefully drafted provisions for determining the value of a title defect.

A typical provision for determining the value of a title defect is as follows:

Each Title Defect asserted by Buyer that is not cured by Seller as of the Cure Date, the Purchase Price allocated to such Property shall be reduced by an amount determined as follows: (i) if the actual net revenue interest of Seller in the Property affected by the Title Defect is less than the net revenue interest set forth for such property on Exhibit A, then the portion of the Purchase Price allocated to such Property shall be adjusted downward by an amount equal to the difference between the Allocated Value for such
Property and the Allocated Value for such affected Property multiplied by a ratio, the numerator of which is the actual net revenue interest in the Property after giving effect to the Title Defect and the denominator of which is the net revenue interest reflected for such Property on Exhibit A and (ii) if the actual working interest of Seller in the affected Property is greater than the working interest set forth for such Property on Exhibit A (without a corresponding proportionate increase in the net revenue interest), then the portion of the Purchase Price allocated to such Property shall be adjusted downward by an amount equal to the difference in the Allocated Value for such Property as set forth on Exhibit A and the re-determination of the Allocated Value for such Property using the same production rates, price forecasts, and discount factors used by Buyer to obtain the initial Purchase Price allocated to such Property but adjusting such determination to account for the diminution of the net present value of the future cash flows that result from the higher working interests.

However, sometimes the typical title defect formula described in the provision above is not the most appropriate means by which to calculate the value of a title defect. For example, where the represented net revenue interest of a property decreases as a result of a third party back-in after payout at some future projected date, a re-engineering of the property's value may be more appropriate using the actual or projected date of payout. If payout will not occur until much later in the reserve life cycle, the value of the defect may be diminimus. For encumbrances which are the basis of a title defect, the most appropriate measure of its value may be the actual cost of removing such lien or encumbrance rather than adjustment of the allocated value for the property by the amount of seller's interest affected thereby.

3. Remedies for Title Defects

The seller will want to have control of the options available for curing title defects. From the seller’s point of view, if the buyer is identifying what is a defect, then the seller should have the option
to chose what to do about these defects. For example, the following is a typical seller’s remedy provision:

(a) Seller shall have the right but not the obligation to cure any Title Defect with respect to which it has received notice from Purchaser prior to the Notification Deadline and which Seller determines, in its sole discretion, reasonably exercised, is capable of being cured within sixty (60) days after the Closing.

(b) With respect to any Title Defect that Seller receives the required notice from Purchaser on or before the Notification Deadline and which Seller determines, cannot reasonably be cured or which Seller is unwilling or unable to cure within sixty (60) days after the Closing, Seller may elect from among the following options:

(i) if the Title Defect is not of a nature that results in immediate economic loss to Purchaser, Seller shall have the right, but not the obligation, to indemnify Purchaser against all liability, loss, cost and expense resulting from such Title Defect, in which event the Purchase Price shall not be reduced and the Property subject to such Title Defect shall be sold to Purchaser hereunder (it being understood and agreed, however, that in no event shall Seller's liability under any such indemnity exceed the Defect Value of the Title Defect to which such indemnity relates or survive beyond the period provided in Section [on survival and limitations on liability]);

(ii) at or prior to the Closing, Seller shall have the right, but not the obligation, to exclude the Property subject to such Title Defect from the sale hereunder, in which event the Purchase Price shall be reduced by the Allocated Value of such Property; or

(iii) if any of the foregoing are not applicable, or if Seller fails to elect any of the foregoing, the Property subject to such Title Defect shall be sold to Purchaser

Buyers are often uncomfortable with a remedy that gives the seller an unlimited right to exclude properties subject to a title defect from the sale. Buyers argue that this remedy has a chilling effect on their right to assert title defects and permits the seller to retain potentially valuable properties. One mechanism that could be used to address this concern is to give the buyer an option to take any property seller intends to exclude from the sale, subject to the title defect, without an adjustment of the purchase price.
hereunder and, subject to the limitation set forth in Section [on survival and limitations on liability] (which limitation shall be taken into account after application of the terms of the proviso clause of this sentence), the Purchase Price shall be reduced by the Defect Value for such Title Defect.

The buyer will want more certainty in the remedies for title defects. For example, a more balanced remedies provision is as follows:

If Buyer notifies Seller of any Title Defect as provided in Section ___, and Seller refuses or is unable to cure the Title Defect before [insert date], then Buyer and Seller will have the following rights and remedies with respect to the uncured Title Defects, unless the Parties otherwise agree in writing.

(i) Buyer may waive the uncured Title Defect and proceed with Closing.

(ii) If an uncured, unwaived Title Defect reduces the value of the Interest affected in an individual property by an amount less than Ten Thousand Dollars ($10,000.00), Seller and Buyer will be obligated to proceed with Closing as to the affected Interest without adjustment to the Base Purchase Price.

(iii) If an uncured, unwaived Title Defect reduces the value of the Interest affected in an individual property by an amount equal to or more than Ten Thousand Dollars ($10,000.00), the Parties will attempt to agree on the value of the Title Defect. If the Parties are unable to agree as to whether the Title Defect exists or the value thereof, Seller and Buyer may refer the matter to a mutually agreeable third party expert for determination. The determination of such expert shall be binding on the Parties. Seller and Buyer shall reduce the Base Purchase Price by the positive difference, if any, between (i) the value agreed upon by the Parties or determined by the expert (as applicable) and (ii) Ten Thousand Dollars ($10,000.00) and proceed with Closing.

(iv) If an uncured, unwaived Title Defect reduces the value of the affected Interest in an individual property by an amount equal to or more than fifty percent (50%), Seller, in its sole discretion, may exclude the affected Interest from the transaction under this Agreement, in which case Seller and Buyer will adjust the Base Purchase Price by the value of the excluded Interest, and proceed with Closing as to the balance of the Interests.
4. To Assert or Not to Assert

Buyers must carefully consider whether to assert or not to assert a title defect. Does the title issue meet the contract definition for a title defect? Does it meet the deductible, threshold or cap provisions and what are the consequences for exceeding those limits? Does the seller have the right to terminate the transaction? Buyer should carefully evaluate the risks of each title defect and carefully develop a strategy for delivering such defects to the seller. Future relations with the seller should be considered especially if a continuing relationship is important to the buyer after Closing.

5. Evaluating Risks Associated with Title Defects

It is not enough to simply know what is a title defect is according to the provisions of the asset purchase agreement, because often the agreement is negotiated and signed before the title due diligence examination is either started or completed. Every title issue cannot be contemplated in advance and an asset purchase agreement cannot be drafted to deal with every possible circumstance related to title defects.

The parties, particularly the buyer, may have difficulty evaluating and quantifying the risks associated with a title defect where the asset purchase agreement is not specific about how to measure the value of the property affected by the Title Defect. The process of evaluating such risks often includes the input of lawyers, engineers, accountants and other technical and business personnel. Several factors to consider are: (i) the nature of the issue, (ii) the source of title and the length of time a property has been producing, (iii) whether a title defect may have been cured by adverse possession,
and (iv) what is the likelihood a claim may be asserted by third parties, such as missing or unknown heirs or entities that no longer exist because of merger or dissolution.

In some cases a title matter that meets the technical definition of a title defect under the asset purchase agreement may not be curable by reasonable and economic means. For example, assume that a small portion of seller’s interest was derived under a farmout agreement many years ago and that the seller earned a right to receive, but did not receive, an assignment of its interest. Also assume that the farmor was a large limited partnership that has since been dissolved. Obtaining the assignment from the dissolved farmor is not be feasible. The buyer in such a case should consider the likelihood of the loss of revenues associated with this title defect and whether, by asserting the defect, seller may exercise its option to remove the property from the sale. A general rule of thumb is that sellers will not willingly acquiesce to a purchase price adjustment when buyer will continue to receive the revenues associated with the affected property. The buyer may also want to consider using an offer to waive the defect in exchange for bargaining power elsewhere in the process.

6. Resolving Disputes Over Title Defects

The typical ways that parties to an asset purchase agreement resolve disputes over title defects are (i) to apply one of the remedies for title defects contained in the asset purchase agreement, such as adjust the purchase price or exclude the property from the sales package, (ii) through alternative dispute resolution, such as binding arbitration, or (iii) through litigation.

There are often disputes about (i) whether a defect identified by the buyer is, in fact, a title defect according to the terms of the asset purchase agreement and (ii) whether the value assigned by
the buyer to an asserted title defect is reasonable. Unless the asset purchase agreement contains a mechanism to resolve such disputes, the contemplated sale and purchase of properties can end up in legal limbo.

One drastic mechanism is to provide that (i) agreement on the existence of title defects and their value is a condition to closing, and (ii) if closing has not occurred within a stated number of business days after the date provided in the asset purchase agreement, then either party has the option to terminate the asset purchase agreement. Such a provision puts both parties at risk of loss of the sale. By the time the parties have reached resolution of title defects, both parties have a lot invested in closing the sale. However, this provision also allows a party to sabotage the sale by simply refusing to reach agreement. For example, a buyer faced with a sudden drop in the price of oil or gas, or a seller who has received a substantially better offer for the properties, could use such a provision to their advantage.

Therefore, because an agreement to agree on title defects and their value is not usually a satisfactory way to resolve disputes over title defects, asset purchase agreements often contain an arbitration provision. While arbitration is a way to resolve disputes, it can be time-consuming and expensive, particularly if three arbitrators are used. A seller may not want its properties to be tied up waiting the outcome of arbitration. A buyer may not want to remain committed to purchase pending the outcome of arbitration, because it will lose its financing or it may want to go on to other acquisitions rather than spend time and money trying to close one that has stalled. Therefore some form of streamlined arbitration procedure should be agreed upon. For example:
1. Agree on and name in the asset purchase agreement an experienced oil and gas attorney to arbitrate disputes concerning whether a title defect asserted by buyer is, in fact, a title defect.

2. Agree on and name in the asset purchase agreement an experienced reservoir engineer to arbitrate disputes concerning valuation. This may be particularly important when the sales package contains PDNP and PUD properties.

3. Provide for simple and informal arbitration procedures that do not require the application of the rules of evidence or the participation of the American Arbitration Association.

4. Provide for an expedited time period for completion of arbitration. You should, of course, call the named arbitrators and make sure they are available to assist in an expedited arbitration.

IX. Conclusion

We have explored the who, what, when, where and why of title defects in the context of oil and gas asset purchase transactions. What we have seen is that in the end it is the relationships and interactions of the buyer and seller that put the issues of title in perspective and determine whether title issues will be treated adequately and fairly for both parties. Although every asset purchase agreement involves substantial effort in the crafting of the title defect provisions, that effort is necessary. It is essential that the asset purchase agreement clearly set forth a meeting of the minds on title defects if there is to be a successful closing of the transaction.
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