

# The Other, "Other" Two-Step: Dancing Around Transfer Restrictions in A&D Transactions Using Divisive Mergers

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The current optimism for increased deal activity in 2024 has upstream and midstream companies reevaluating their portfolios and strategy for the year ahead. As has been common in the industry, many asset packages contain properties and rights that are subject to contractual restrictions on their transfer. In certain circumstances, however, companies may employ a corporate dance (or two) to streamline transactions, with the added benefit of potentially avoiding those restrictions, customarily in the form of preferential rights to purchase and required consents, triggered by the sale of assets.<sup>1</sup>

The "Texas Two-Step" is a familiar dance move in Texas honky-tonks. In the context of oil and gas acquisitions and divestitures, it is a moniker for a technique that traditionally involves a two-step process, with a seller first forming a wholly-owned subsidiary and then transferring the applicable assets to the new subsidiary. Because dispositions to an affiliate are typically exempt from transfer restrictions, and this first step involves an assignment to a subsidiary (and not a third party), restrictions on transfer are not often applicable. Under the second step, the seller sells its equity interests in the subsidiary to a third-party buyer. Because the equity sale does not constitute an assignment of the assets directly, courts in many oil and gas producing regions have found that restrictions on direct transfer are not triggered.<sup>2</sup>

While Texas law has found that these direct transfer restrictions can be avoided under the traditional Texas Two-Step, other states look for evidence that the parties' dance steps were not solely chosen for the purpose of avoiding the restrictions. For example, a Louisiana appellate court in *Fina Oil and Chemical Co. v. Amoco Production Co.* followed the Texas position and allowed a structure that avoided the application of a preferential right to purchase. The case, however, noted that the structure was not used to deliberately circumvent the preferential right. Additionally, in *Citgo Petroleum Corp. v. Occidental Chemical Corp.*, the Tenth Circuit, applying Louisiana law, upheld a two-step transaction stating that the terms of the preferential right to purchase were clear, unambiguous and negotiated between sophisticated parties. Furthermore, under the relevant facts, the parties specifically defined "dispositions" to include only a direct sale of the property, and not the equity interest of the property holder (i.e., an indirect transfer). Therefore, the court found that the arm's length transaction was not a sham agreement designed to avoid the application of a preferential right. Other jurisdictions are not so welcoming of the two-step structure. In *Williams Gas Processing--Wamsutter Co. v. Union Pacific Resources Co.*, the Wyoming Supreme Court found that the Texas Two-Step could not be used to circumvent a preferential right expressly applicable to a direct transfer, even with respect to a merger (an indirect conveyance that was not specifically prohibited by the underlying agreement), because the dance move was being used to specifically avoid the preferential right.

When determining whether a disguised third-party asset transfer has occurred, courts may look to see whether a legitimate business purpose exists with respect to the first step of the transaction—the initial transfer of the assets to a subsidiary of the seller. The court in *Fina Oil and Chemical Co.*

relied on evidence of Amoco's legitimate reorganization that contemplated the transfer of its interest in the lease to a subsidiary and the fact that the buyer only submitted an offer for the stock of such subsidiary, and not for the properties such subsidiary owned. Courts have found that restructuring plans with the primary intent of consolidating or reorganizing assets (and the relevant title holder) based upon operating costs, financial performance or basin or area are all legitimate business purposes, so long as there is no evidence that the transfer was effected with the intent to circumvent transfer restrictions.

Instead of dancing the Texas Two-Step, a company may be able to "do-si-do" around limitations and adverse case law applicable to the Texas Two-Step using a divisive merger. A divisive merger, unlike a traditional merger that combines two entities into a single entity, is a transaction where a single entity divides into multiple entities. A divisive merger may be used as an alternative transaction structure for acquisitions and divestitures, and because the allocation and vesting of assets and liabilities is not considered a transfer or assignment, it is particularly beneficial to a sale where material assets and liabilities contain transfer restrictions. Although acquisitions and divestitures using a divisive merger may be structured in different ways, one structure involves (i) the seller divisively merging and allocating the assets and liabilities of the business it wants to retain to itself, as a surviving entity, and the assets and liabilities of the business it wants to dispose to a newly formed entity, and (ii) after the divisive merger, a third party purchasing the equity of the newly formed entity.

Only a few states permit divisive mergers, notably Delaware and Texas. Texas law provides that when a Texas entity divisively merges, the dividing entity's assets and liabilities are allocated to and vested in the dividing entity (if it survives) and each new entity without any transfer or assignment having occurred. In *Plastronics Socket Partners, Ltd. v. Dong Weon Hwang*, the court found that a patent that was allocated and vested through a divisive merger did not violate a provision in an agreement that stated the patent could not be transferred without consent. The court explained that the allocation and vesting occurred by operation of law and no prohibited transfer occurred. The court also observed that if the parties wanted to provide that a merger violated the transfer restriction, they could have done so.

In a bankruptcy context (more commonly when liabilities, rather than assets, are placed in a newly formed entity that then files for Chapter 11 protection), courts have permitted companies to use Texas's divisive merger statute. In *In re LTL Mgmt., LLC*, the court found that a legitimate business purpose exists when a company restructures itself to manage pending litigation liability and provide flexibility in addressing the claims. A ruling regarding Johnson & Johnson's divisive merger to shield itself from talcum powder litigation had a bankruptcy court put one extra hurdle for divisive mergers, placing a good faith requirement on the financial distress of a company filing for bankruptcy.

Outside of bankruptcy, courts have sparingly, if ever, addressed the issue of divisive mergers. Time will tell whether, in the acquisition and divestiture arena, courts will require a legitimate business purpose to exist when a divisive merger occurs and assets are allocated to the newly formed entity, and whether the narrower or more cynical views regarding the Texas Two-Step will also be applied if the holder of a consent or preferential right challenges a divisive merger that precedes an indirect transfer. Divisive mergers are already being utilized in structured oil and gas transactions, including recent oil and gas securitizations, to facilitate the transfer of assets into new, special purpose entities. Those entities can either be sold to a third party or maintained as a new, bankruptcy-remote vehicle to issue indebtedness. Analogous to a Texas Two-Step, the divisive merger simplifies the transaction by ensuring all relevant assets transfer without application of some restrictions that may burden the assets.

While the law continues to evolve, companies may employ divisive mergers to effect reorganizations and corporate restructurings more efficiently, with one convenient byproduct being the ability to dance their way to more certain or expeditious outcomes with regard to applicable direct transfer restrictions.

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<sup>1</sup>Although transfer restrictions are popular encumbrances on oil and gas assets, arguments have been made regarding the enforceability of such restrictions that prohibit the ability of a property owner to sell its interests. Total restraints on the ability to freely sell or otherwise transfer property are disfavored and commonly voided by courts as against public policy. Typically, Texas courts will allow partial restraints on alienation that are deemed to be reasonable (e.g., the restraint is limited in duration, allows for a variety of transfers or is limited in the number of prohibited transferees).

<sup>2</sup>Note that although this alert focuses on limitations affecting a direct transfer of the underlying assets, other limitations may exist with respect to indirect transfers. For example, a change of control or similar contractual restriction may be triggered in the event the equity of a parent company (an entity sitting above the company that owns the assets) is sold to a third party. Therefore, it is important to review all contractual restrictions, direct and indirect, prior to divesting any interests.