Covenants in upstream acquisitions and divestitures

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1. Introduction

Upstream sale and purchase transactions are complex. In most instances, they are based not on simultaneous signing and completion, but rather on signing followed by a lengthy period leading to completion. This means that a seller and a buyer can agree on a transaction, enter into a sale and purchase agreement (SPA) and make a public announcement regarding such transaction, if required, but the completion of the transaction (and the transfer of benefits and liabilities) occurs weeks, months or even years afterwards.

As is the case with most other heavily regulated industries and sectors that are reliant on numerous permits and licences, sale and purchase transactions in the upstream sector are frequently subject to regulatory and ministerial approvals, which are required under either the governing laws of the host country where the upstream asset is located or the terms and conditions of the upstream project documents awarded by the energy ministry of the host country. Such regulatory and ministerial approvals (and other required third-party consents and expiry or waiver of any applicable pre-emption rights) are typically structured as conditions precedent under the SPA. Accordingly, it is not uncommon for upstream sale and purchase transactions to require an interim period between signing and completion during which it is the responsibility of the seller or the buyer to satisfy these various conditions precedent. For the purposes of this chapter, the period between signing and completion will be referred to as 'the interim period'.

There is no hard and fast rule about how long an interim period should last; this will depend very much on how many approvals and consents and other conditions precedent are required, and how quickly regulators tend to respond. For example, in many African countries interim periods can last for between six months and 18 months as regulators can be unresponsive; buyers and sellers can thus be held to ransom waiting for regulatory approval, unless the local law or the upstream project documents include provisions of deemed acceptance where the regulator fails to respond within a certain period of time – although these are fairly uncommon. The existence of an interim period will affect a transaction in other ways; for example, sellers will typically require a degree of financial commitment from the buyer, usually in the form of a deposit (to be refunded in certain limited circumstances to be negotiated), or a corporate guarantee and credit support arrangement designed to ensure that a creditworthy entity with deeper pockets than the buyer will also be on the hook for the purchase price at completion.

During the interim period, both the seller and the buyer are contractually committed to proceed to completion. This is obviously in addition to the public market expectations raised by the announcement that the transaction (SPA) was signed and a completed deal would follow in due course. The buyer will, therefore, require adequate protection during the interim period to ensure that what is being purchased is not devalued or otherwise harmed prior to completion. The buyer will want, in particular, some degree of influence and control over operational matters.

There is, however, a balance to be struck between what level of control and influence a buyer may want and what a seller is willing to give; the seller's position will be that until completion occurs, the upstream assets still remain the property of the seller and it is unreasonable for the buyer to place an undue amount of fetters on the seller's abilities to operate the asset. The buyer, by contrast, will argue that completion is a formality, especially if the conditions precedent are within the control of the seller and there is a degree of public and shareholder expectation as a result of a press announcement of the deal. Therefore, the buyer's position will be that:

- the upstream assets are, to all intents and purposes, the property of the buyer during the interim period; and
- the buyer should have a large degree of control and influence over what it is acquiring.

Further factors that will influence the balance of power during the interim period are the type of acquisition structure being adopted and the length of the interim period; the longer the interim period, the less willing a seller will be to agree to fetters over its own controls and decision-making.

2. Transaction structures

Buyers and sellers can elect to implement a number of different transaction structures, each of which will affect the covenant package requested by a buyer.

2.1 Share deal

Perhaps the simplest acquisition structure is a purchase of the shares in the corporate vehicle that holds the upstream asset. Where the upstream asset to be acquired is held in a special purpose vehicle, a corporate sale of the shares in that vehicle is likely to be very attractive to a seller looking for a clean exit; this is because the seller does not retain any liabilities for the asset being disposed of, although where the seller wishes to retain certain of the assets held by the special purpose vehicle, then some form of asset hive-out or interim reorganisation will be required in order to facilitate the desired sale structure.

The obvious downside to a share purchase from a buyer's perspective is that it likely requires a more robust and detailed due diligence exercise than an asset purchase, as acquiring shares in a special purpose vehicle means that all of the present and historic liabilities of that vehicle are assumed by the buyer (as opposed to a cherry-picking purchase where specific assets are acquired under an asset purchase structure). However, the upside is that the buyer will also assume the benefit of any financial assets (eg, historic tax losses) of the special purpose vehicle.

A benefit for both the seller and the buyer is that a share purchase may not require regulatory approval because a change of control in an asset-owning special purpose vehicle is not always caught within the transfer restrictions of applicable hydrocarbon laws and upstream project documents. Share purchases are also less likely to trigger pre-emption rights favouring third parties (especially in the context of a package sale where the special purpose vehicle holds a number of other upstream assets to be sold as part of the same package) – this is certainly the case with some of the older joint operating agreements, although less likely for joint operating agreements entered into in the past 10 years or so. Thus, the transaction will impose fewer conditions precedent and be more certain to complete, which is a key concern for sellers these days.

2.2 Asset deal

Buyers and sellers may decide that they prefer an asset level structure where the seller retains the shares in the corporate vehicle holding the upstream asset and only the specific upstream asset itself is transferred to and acquired by the buyer.

This may be preferable where the seller wishes to retain financial assets for the benefit of its group or where the corporate vehicle holds a number of upstream assets which are not to be sold. From the buyer's perspective, the due diligence can be more focused and directed only at the assets being acquired as the buyer will assume neither historic liabilities nor non asset-related liabilities of the corporate vehicle.

However, unlike a share purchase, an asset purchase will inevitably involve a number of conditions precedent and be subject to regulatory approval and, if applicable, pre-emption rights. This introduces an element of uncertainty to the transaction, as some degree of third-party involvement will be required; this will necessarily affect the transaction timetable and elongates the interim period, which in turn will cause the buyer to request a greater degree of control.

It is not uncommon, though, for asset purchase agreements to include an 'our watch/your watch' indemnity which provides that, as at a certain date, all obligations and liabilities prior to the date are borne by the seller and all obligations and liabilities on and after that date are borne by the buyer. Obviously, where this date is expressed as the completion date, then the buyer's need for interim period covenants is somewhat mitigated as the buyer will already have the benefit of the pre-completion date our watch/your watch indemnity covering this period. But where this date is an economic effective date prior to signing (which is not an uncommon structure), then a prudent buyer should still request robust interim period covenants as the our watch/your watch indemnity will not apply during the interim period.

2.3 Asset 'farmout' deal

A farmout deal is similar to an asset deal except that:

- only a part of the upstream asset is sold to the buyer (with the seller retaining a portion of that upstream asset); and
- the buyer agrees that, as part of the consideration for that asset transfer, the buyer will perform some sort of work obligation (eg, a seismic survey or drilling commitment).

In this sense, farmout arrangements are more common in the early stages of an upstream project, when work obligations and capex commitments are still required, than in the later production stage of an upstream project, when revenues have begun to be generated and projects are cash positive with less exploration risk.

Unlike conventional asset deals, transfers of asset level interests under farmout transactions do not necessarily occur when the consideration has been fully funded or performed. For example, the buyer will want to be a licensee before undertaking drilling commitments so that, once the necessary regulatory approvals have been granted, completion may occur under the farmout agreement and:

- the seller will transfer the part of the upstream asset being sold to the buyer with performance of the work obligation by the buyer to follow thereafter; and
- the buyer will transfer the part of the upstream asset acquired back to the seller if the work obligation, or a cash equivalent expense, is not satisfied by a certain date.

2.4 Asset swap deal

An asset swap deal is effectively identical to two asset deals whereby the seller transfers an asset to the buyer and, as consideration, the buyer transfers an asset to the seller. It is, therefore, the same as an asset deal except that the consideration is not settled entirely in cash, but rather by way of a reciprocal asset transfer instead. Accordingly, both parties will be looking for an equivalent set of interim period covenants to regulate and influence the operations over the other asset during the interim period.

2.5 'Locked-box' valuation

In a locked-box deal, the valuation of the target is pegged to a certain date prior to completion; this generates an economic effective date for the deal and means that the buyer essentially takes all the benefits and assumes all the liabilities associated with the acquisition target which arise on or after the locked-box date (which is usually determined by reference to recent historical financial statements of the target). Therefore, the value paid by the buyer is reflective and inclusive of revenues attributable to the target after the locked-box date.

Locked-box deals are often subject to simplified adjustment mechanics as, unlike a completion accounts valuation method, a locked-box deal includes pre-agreed determinations of cash, debt and working capital by reference to the historic financial statements. Locked-box deals are, therefore, typically adjusted only for leakage and capital contributions. Leakage comprises cash that is extracted from the target after the locked-box date and paid to the seller (ie, this cash should have belonged to the buyer as it is taken out after the locked-box date), which constitutes a deduction to the purchase price – although the exact scope of what constitutes leakage and what is considered to be permitted leakage (ie, does not reduce the purchase price) will be vigorously negotiated. Capital contributions are payments by the seller to the target after the locked-box date (ie, this is cash that should have been funded by the buyer as it is injected after the locked-box date), which constitutes an increase to the purchase price.

Given the historic reference point which operates as an economic effective date for the transaction, interim period covenants are fundamentally important to buyers under a locked-box deal as buyers will want to exercise as much control and influence from that date as is possible – not only from an operational perspective, but also to preserve the value that the buyer is paying for.

2.6 Completion accounts valuation

In a completion accounts deal, the economic effective date of the deal is at completion and the buyer will purchase the assets and liabilities of the target with effect from completion. The value paid by the buyer is calculated from completion only and is, therefore, not inclusive of revenues attributable to the target before completion. Accordingly, while interim period covenants will still be very important to a buyer in a completion accounts deal, they are more of an operational control than a value adjustment to the purchase price.

2.7 Relationship with other SPA terms

Aside from providing the buyer with influence and control over the target's operations prior to completion, interim period covenants also affect SPAs in a number of other ways. For example, the buyer may include a condition precedent that all covenants have been complied with (which would typically be qualified by a materiality threshold requested by the seller). In that case, if the seller breaches an interim period covenant and this breach rises to the materiality threshold, then the buyer does not have to proceed to completion (unless it waives said breach).

In addition to the typical operational interim period covenants discussed later in this chapter, SPAs will contain other covenants prior to completion such as covenants to use reasonable or best endeavours to procure that the conditions precedent for which a party is responsible are satisfied. For example, where a shareholder approval is required for the seller or the buyer in order to complete the transaction, then the seller or the buyer, as appropriate, will covenant to use reasonable or best endeavours to obtain such shareholder approval.

There is also a close relationship between interim period covenants and seller warranties. Most sellers will therefore resist repeating any of the operational warranties at completion where the SPA already includes a robust list of interim period covenants, and will argue that the buyer is already adequately protected. The difference between covenants and warranties, however, is that covenants are narrower than warranties, as a warranty about any particular state of facts can be given whereas a covenant can be given only to do or not to do something; so for instance, warranties will cover circumstances where third parties make claims against the target whereas an equivalent covenant can deal only with whether or not the seller can respond to such claims. However, in a locked-box deal where the buyer has the economic benefit of the target before completion, it is uncommon for the entire warranty slate to be repeated at completion; rather, only the key title warranties are repeated – thus, the need for a thorough slate of interim period covenants becomes even more imperative.

Additionally, the extent to which a buyer can recover for breaches of covenants may or may not be limited pursuant to the limitations on warranty recovery set forth in the SPA. For example, where the limitations on recoverability apply to all claims under the SPA, as opposed to warranty claims only, then recovery for breaches of covenants will also be capped and limited. This, however, is another matter of negotiation.

2.8 Tax covenants and environmental covenants

Certain identified matters relating to the target may also require specific bespoke covenants. These matters are typically tax-related issues and environmental issues, and tax and environmental covenants are sometimes also called tax and environmental indemnities. These are not day-to-day operational controls exercisable by the buyer during the interim period. However, where the financial and tax due diligence and the operational and environmental due diligence identify issues with the target, outside of the customary warranty protections, that the buyer will need to address through specific recourse, then tax and environmental covenants will be key provisions in the SPA.

For example, where the operational and environmental due diligence identifies a number of missing environmental permits which the target should have maintained, then the buyer will undoubtedly require a specific environmental covenant protecting it from liabilities post-completion for the failure by the target to obtain such permits. Alternatively, as is often the case with upstream projects operated under production sharing agreements, cost recovery calculations may be audited for up to six or seven years from when the cost recovery occurred, so buyers will want any tax covenant to cover any historic cost recovery calculations prior to completion.

Obviously, however, another way of dealing with these types of issue (instead of requiring specific covenant protection) is to quantify the anticipated expected loss as best as possible and factor this into the valuation, thereby reducing the purchase price that is actually paid to the seller.

3. AIPN Model Form Farmout Agreement

The following is taken from the Association of International Petroleum Negotiators (AIPN) Model Form Farmout Agreement.[1] In the absence of any other available examples of interim period covenants, the AIPN model form is as good a place to start as any and offers a fairly balanced list of covenants. For the avoidance of doubt, references to the 'farmor' and 'farmee' mean the seller and the buyer respectively.

Each clause will be examined in more depth further below, but the AIPN model form is essentially divided into the following main sections:

- a list of positive covenants requiring the seller to do various things;
- a list of negative covenants requiring the seller not to do various things;
- a list of things which the seller is permitted to do in any case (ie, exclusions to the covenants); and
- a list of mutual covenants on both the seller and the buyer.

[1] The model form that is cited in this chapter is the AIPN Revision Draft, dated 13 May 2015, which is a proposed update to the 2004 model form set forth at www.aipn.org.

In the context of a share transaction where shares in a special purpose vehicle (which holds the upstream assets) are being acquired, the special purpose vehicle itself should give certain covenants, particularly those relating to operational matters affecting the upstream asset. Similarly, the restrictive covenants should apply to the target group of companies, as well as to the special purpose vehicle.

3.1 Positive covenants

From the Effective Date until the Completion Date, and subject to the terms of this Agreement, Farmor shall:

(a) maintain [OPTION – and operate] the Farmout Interests (A) in a good and workmanlike manner in the ordinary course of business consistent with past practice, and (B) in accordance with all Specified Instruments and Laws, in each case, [OPTION 1 – to the extent required to operate in accordance with the standards set forth in the Contract and the Joint Operating Agreement] [OPTION 2 - in all material respects];

(b) maintain its books of account and records relating to the [Farmout] / [Participating] Interests in the usual, regular and ordinary manner, in accordance with the usual accounting practices of the Farmor;

(c) maintain in full force and effect any (A) material license, permit and other approval from a Government Authority related to the [Farmout] / [Participating] Interests and (B) bond, letter of credit or other similar credit support instrument maintained by the Farmor with the Government or other third party with respect to the [Farmout] /[Participating] Interests;

(d) timely make any and all filings, reports and notices to the Government with respect to the [Farmout] / [Participating] Interests;

(e) maintain insurance coverage on the Interests, and the assets related thereto, in the amounts and types currently in force;

(f) give prompt written notice to Farmee of (A) the Farmor's receipt of written notice any material claim asserting any breach of contract, tort or violation of Law relating to the [Farmout] / [Participating] Interests, (B) any investigation, suit, action or litigation by or before the Government relating to the [Farmout] / [Participating] Interests, (C) any material spills or other material environmental contamination events occurring with respect to the [Farmout] / [Participating] Interests and (D) any material damage to or destruction of the [Farmout] / [Participating] Interests operated by the Farmor.

Clause (a) is the most fundamental covenant during the interim period and cuts to the heart of the transaction by requiring that the seller maintain and, if it is also the operator, operate the upstream assets being acquired to a certain standard and, most importantly, in accordance with applicable laws. Buyers will insist that this covenant be included and may also require that the covenant refer to good-faith activities and elevate the standard of performance from "good and workmanlike manner" to "good international oilfield practice". Depending on the scope of the definition of 'specified instruments', the seller may limit this by materiality or refer to the specific joint operating agreement (JOA) instead. It would be difficult for any seller to justify not giving this covenant in some form or another, and any refusal to give such a covenant would no doubt ring alarm bells for the buyer.

Where the compliance with law covenant in limb (B) of Clause (a) is included, the covenant in Clause (b) is somewhat less material. A seller would typically claim that this is already covered by Clause (a), although it is arguable, to the contrary, that Clause (a) applies to physical operation of the asset only, whereas Clause (b) goes further than simple physical operation and applies to back-room management of books and records too. However, similarly to Clause (a), a seller's refusal to give this covenant would be difficult to justify as it is purely a procedural requirement (ie, to maintain books and records – which presumably the seller is doing in any case).

Clause (c) is another fundamental covenant (although it too is in part potentially covered by limb (B) of Clause (a) as maintaining permits and credit support would no doubt constitute compliance with specified instruments and laws). A seller could request that limb (B) also be materiality qualified, consistent with limb (A), although any such credit support arrangements would necessarily be required to be released at completion as the seller will no longer wish to be providing financial support to an asset that it no longer holds. Where the due diligence process identifies that any such credit support arrangements are maintained by an affiliate of the seller, the buyer should ensure that the seller confirms that this covenant is applicable to those affiliates too (so that the obligation to maintain such permits and credit support is not somehow diminished or alleviated).

Clause (d) focuses on the relationship between the seller and the host government and requires that the seller maintain any and all filings required by the host government with respect to the upstream asset. This is a key value driver for any buyer as, in the context of upstream operations, title to any upstream assets is derived from licences with the host government. Accordingly, maintaining a good relationship with the host government is key from the buyer's perspective. A buyer should consider enhancing this covenant by including the words 'properly' or 'accurately', and requiring that such filings be in good faith. A seller will try and argue that this is already covered by limb (B) of Clause (a), as government filings will be a matter of law. However, given the importance of the relationship with the host government, it is not uncommon to see this as a specific further covenant.

With respect to Clause (e), while the seller's insurance policy coverage in respect of the target will terminate upon completion (unless maintained at the target company level under a share deal and assumed by the buyer), the buyer will want to know that the target remains suitably insured during the interim period; this is because, pending completion, the buyer will have no way to implement its own insurance at the upstream asset level. The buyer may also want:

- to take an assignment of the benefit of any insurance claims which the seller may have during the interim period; or
- to include a casualty loss condition precedent in the SPA which enables the buyer to elect not to complete where an insured loss exceeds a certain figure.

As with Clauses (b), (c) and (d), the seller could argue that this is also already covered by limb (B) of Clause (a), as maintaining a minimum level of insurance will in most cases also be a matter of law. The buyer, by contrast, should also require that the assets are either "adequately insured" or "insured to their full replacement value", and that the standard of insurance is to "good international oilfield practice".

Clause (f) will be extremely important to a buyer from a relationship management standpoint as it relates to problems and issues that have arisen, which the buyer will have to deal with on and after completion – unless the buyer has the right to elect not to complete (eg, for a failure to satisfy a condition precedent). Some of the matters identified in this Clause (f) may well be outside of the control of the seller (eg, spurious claims by third parties), so the best that a seller can really do in these circumstances is to inform the buyer of the facts so that the buyer can take these things into account in its decision-making over the deal. The buyer should seek to enhance this covenant with a 'catch-all' provision requiring the seller to disclose anything material in the context of the target or by reference to some pre-determined amount.

3.2 Negative covenants

From the Effective Date until the Completion Date, and subject to the terms of this Agreement, Farmor shall not:

(a) except in the case of any contracts that are Hydrocarbons purchase and sale, gathering, transportation and/or marketing contracts entered into in the ordinary course of business which can be terminated without penalty on 90 Days or less notice, (A) enter into any contract that, if entered into on or prior to the Signature Date, would be required to be listed in Schedule ____ or (B) materially amend any contract that, if so amended before the Signature Date, would have been required to be listed in Schedule ____ provided, however, that Farmor shall promptly provide Farmee a copy of any such Hydrocarbon purchase and sale, gathering, transportation and/or marketing contract, any other contract or material amendment that Farmor enters into in pursuant to this Article [ ] or in connection with the activities set forth in Schedule ____;

(b) transfer, sell, mortgage, pledge, encumber or dispose of any portion of the Farmout Interests, other than the sale and/or disposal of Hydrocarbons in the ordinary course of business and sales of equipment that [OPTION 1 - are no longer necessary in the operation of the [Farmout] / [Participating] Interests or for which replacement equipment of equal or greater value has been obtained] [OPTION 2 - has a value less than $ ______];

(c) other than with respect to the matters described on Schedule ___, settle any suit or litigation or waive any material claims or rights of material value attributable to the [Farmout] Interests and affecting the period after the Accounting Date;

(d) commit to and/or commence any operation on the [Farmout] / [Participating] Interests anticipated to cost [(net to the [Farmout] Interests)] in excess of $_________ per operation that was proposed by a third party under an operating agreement with respect to the [Farmout] / [Participating] Interests without first forwarding the applicable AFE or other notice to the Farmee as soon as reasonably practicable following receipt thereof for Farmee's review;

(e) consent to waive any rights of first refusal;

(f) propose any operations on the Farmout Interests anticipated to cost in excess of $_________ per operation;

(g) consent to a change of operator under an operating agreement;

(h) elect to non-consent or not participate in any operation proposed by a third party under an operating agreement with respect to the Farmout Interests;

(i) propose or implement any sole-risk operations;

(j) make, change or revoke any tax election, change an annual accounting period, adopt or change any accounting method, file any amended tax return, enter into any closing agreement, settle or compromise any tax claim or assessment or consent to any extension or waiver of the limitation period applicable to any claim or assessment, in each case, with respect to taxes affecting the [Farmout] Interests;

(k) commit to do any of the foregoing.

Clause (a) is a material contract covenant which prohibits the seller from entering into any other contracts material in the context of the target (except for ordinary course petroleum sales contracts terminable on 90 days' notice or less). This is a key concern for the buyer as it will not want the target entity to be encumbered by further obligations under additional material contracts which it would not have entered into had it been operating the asset. The buyer should also enhance this covenant to refer to no waivers being granted under the existing material contracts (as the buyer will not want to be deemed to have waived a breach by a third party for which the buyer would ordinarily have pursued a claim). The seller, by contrast, will need to be able to enter into and amend whatever contracts it would otherwise have entered into and amended, and will not want its decision-making to be fettered in this respect (especially if there is an abundance of completion conditionality which creates opportunities for the buyer to elect not to proceed with completion of the transaction – as any failure to complete will mean that the target is retained by the seller). At the very least, this covenant should capture licences and production sharing agreements with the host government, joint operating agreements and other asset title arrangements; any pushback from the seller against a covenant applying to these contracts should be a red flag to the buyer.

Clause (b) is as important as Clause (a) as it prohibits the seller from dealing in the target to be acquired and devaluing the asset or creating a third-party interest over the asset which the buyer then has to deal with or otherwise assume the burden created by such third-party interest. In a cash-free/debt-free deal, the buyer will want to take the target unencumbered and be able to do what it wants with it. As with Clause (a), any refusal by the seller to grant a form of this covenant should be a red flag to the buyer – unless either:

- some form of corporate reorganisation is required during the interim period to transfer the targets to the correct special purpose vehicle; or
- a pre-emption right exists in favour of a third party by which the seller is bound.

Clause (c) is also a key relationship issue which the buyer will need to control as it relates to litigation and claims by third parties. The buyer will normally seek to enhance this covenant and broaden it to restrict also any commencement, defence or compromise of claims and specifically refer to litigation, arbitration and any form of dispute proceeding – whether they are active, pending or threatened. The buyer should also seek to group together series of related claims which in isolation do not rise to the level of materiality but in the aggregate do exceed the materiality level. Additionally, the buyer should agree on a cash value for the materiality level to avoid any potential doubt and minimise any uncertainty as to whether the covenant has been breached. The seller has the option to exclude from this covenant certain claims which it has identified; this list of exclusions will no doubt be heavily negotiated.

The expenditure covenant in Clause (d) is a key operational control requirement and prohibits the seller from incurring and ramping up significant costs associated with the asset. For example, under a locked-box valuation these costs would likely be funded either by capital contributions from the seller (which increase the purchase price) or out of cash receivables for the upstream asset (which decreases the working capital being assumed by the buyer at completion). The crux of the buyer's argument here is that the buyer does not want the seller to be incurring costs which the buyer itself would not have incurred had it been in the seller's position (eg, the buyer may not regard the expenditure as cost effective or may want to direct costs towards a different discovery). The buyer will also want to re-design the covenant so that instead of requiring notification only, the expenditure is also subject to the buyer's prior approval. However, the seller will resist this and one compromise may be to have two thresholds – beneath the lower threshold, the seller can incur the expenditure; between the lower threshold and the higher threshold, the seller must inform the buyer; and above the higher threshold, the seller must obtain the buyer's consent prior to incurring the expenditure. The same issues arise in the context of the covenant in Clause (f).

The covenant in Clause (e) will not always readily apply as the target may not have the benefit of any rights of first refusal upon a transfer or sale by any of its co-venturers. However, to the extent that there are any such rights (eg, if another co-venturer seeks to sell its interest in the upstream asset during the interim period which triggers a right of first refusal under the JOA), then the buyer will not want the seller to waive such rights without at least some consultation – especially where the buyer is a cash-rich vehicle looking to expand its operations in that particular jurisdiction as the buyer's position will be that it is in the seller's shoes and should have the benefit of any rights to enhance the asset level interest in the joint venture. The seller, however, will not want to be held to ransom by any expression of interest by the buyer to exercise rights of first refusal if there is a high degree of probability that the buyer could be incapable of following through with the acquisition. This would happen, for instance, if the deal between the seller and the buyer is terminated because one of the conditions precedent could not be satisfied or a buyer approval could not be obtained; then the buyer will not have stepped into the shoes of the seller in order to exercise the right of first refusal in any case. Accordingly, the seller's liabilities to its co-venture partners should not be prejudiced by any failure of the buyer after the buyer has indicated that the right of first refusal should not be waived. From a buyer's perspective, the language should be enhanced to refer not only to rights of first refusal but also to pre-emption rights and rights of first offer and other preferential purchase rights.

Clause (g) needs little explanation as it relates directly to the governance and performance of operations of the upstream asset. It would be a big red flag if the seller refused to give this covenant and would suggest some material disharmony between the co-venturers if refused.

Operationally, Clauses (h) and (i) are two sides of the same coin and the buyer will want to know whether the target has gone out on a limb and ostracised itself from the co-venture group by refusing to participate in an approved operation under the JOA (where backing-in subsequently will be at a substantial premium to the initial cost) or proposed an exclusive operation (where it alone or less than all of the co-venture parties are bearing the sole costs of that exclusive operations). These are increased risk exposures to the buyer and can show clearly the synchronicity and working mechanics of the co-venture group. As with Clause (i), however, Clause (h) should also include an information covenant whereby the seller agrees to notify the buyer if any other co-venture partner proposes its own sole risk programme. To the extent that any such sole risk or non-consent scenarios are expected to arise, they should be fully, fairly and accurately disclosed to the buyer as part of the due diligence phase so that the buyer can evaluate the risks associated with such operations.

Clause (j) will likely also be covered in the separate tax covenant and deals specifically with taxation liabilities of the target. The buyer will have valued the tax basis of the target and will not want those bases to have changed during the interim period due to an election made by the seller. The buyer should seek to enhance this by also restricting any "entry into or termination or rescission of any agreement with a taxation authority" and, in the context of a share purchase, any "changes to the tax residence of any target company". The seller, by contrast, will likely want to exclude from the covenant anything that is consistent with past practices or that is otherwise required to comply with applicable laws.

3.3 Exclusions to covenants

Notwithstanding anything to the contrary in this Agreement, Farmor may conduct:

(a) emergency operations related to events endangering lives, property or the environment; provided Farmor shall notify Farmee of such emergency as soon as reasonably practicable;

(b) operations to avoid any penalty under any order of a Government, provided that Farmor shall provide Farmee with written notice of such operations (including AFEs related thereto) as soon as reasonably practicable following the commencement thereof;

(c) operations described in Schedule ___.

As noted above, certain of the specific positive and negative covenants may contain their own individual exclusions which are relevant to the covenant in question. However, it is not uncommon for the seller to insist also on general exclusions to the restrictive covenants. For example, the AIPN Model Form Farmout Agreement permits sellers to carry out:

- emergency operations where lives, the property or the environment would otherwise be at risk; or
- any operation where not to do so would cause a penalty to be payable under the key upstream asset documents.

The buyer will obviously want to limit the exclusions to the restrictive covenants as much as possible and to permit exclusions to apply only in the most extreme of circumstances. However, the seller will typically request more exclusions, such as the performance of any operations:

- pursuant to an approved work programme and budget disclosed to the buyer;
- under a pre-agreed list of specific documents;
- required by law (although the buyer will argue that this will already be a requirement under the positive covenants – see limb (B) of Clause (a) in section 3.1 above);
- with the buyer's reasonable consent; or
- to carry out any required interim period corporate reorganisation or intra-group arrangement.

3.4 Mutual covenants

From the Effective Date until the Completion Date, the Farmee and Farmor each undertake to the other Party to comply with each of the following undertakings:

(a) each Party, as applicable, agrees to use commercially reasonable efforts to satisfy, in an expeditious manner, the Conditions Precedent.

(b) the Parties shall not take any action nor fail to take any action prior to the Approval Date that would result in a breach of any of its representations and warranties under this Agreement.

As noted previously, the SPA will contain a number of other covenants. Clause (a) is a covenant to ensure that the conditions precedent are satisfied. Depending on the relative negotiating positions and bargaining strength of each party, the buyer or the seller may escalate this standard of performance to be a best endeavours obligation, which, needless to say, requires more effort and expense than the customary reasonable endeavours standard.

Clause (b) is a very buyer-friendly covenant that the seller will typically resist as it is intended to give effect to the seller warranties throughout the interim period (ie, the seller must ensure that those warranties are not breached regardless of whether they are repeated at completion). The seller may be able to advance some technical arguments in order to change the wording of the warranties clause so as to limit the effect of this covenant (eg, the warranties are given only on the dates expressly set forth in the SPA, so despite the wording of the covenant there can be a breach of those warranties only on the dates when they are expressed to be repeated, if they are repeated at all) – although, as stated above, the seller would typically resist this type of covenant in the first place.

4. Oil & Gas UK Model Form Sale and Purchase Agreement

The following is taken from the Oil & Gas UK Model Form Agreement for the Sale and Purchase of Assets in the [•] Field[2]:

9.1 Between the date hereof and Completion, the Seller shall (to the extent it is able so to do having regard to the provisions of the Operating Agreement [Unit Agreement]):

[2] Oil & Gas UK Draft Model Form (reference LEG2520 Final), set forth at www.oilandgasuk.co.uk.

(a) continue to carry on its activities in relation to the Asset in the ordinary and usual course so as to protect and maintain the same [in accordance with good oil field practice] and comply with previously agreed decisions of the Operating Committee in relation to the Assets;

(b) consult with the Purchaser with regard to the Asset and co-operate with the Purchaser so as to ensure an efficient handover of the Asset on Completion and use its reasonable endeavours to protect or procure the protection of the Asset for the benefit of the Purchaser;

(c) insofar as reasonably practicable, keep the Purchaser fully informed in a timely manner on any and all matters (not of a routine nature) relating to the Asset; and

(d) not to do or omit to do anything which would result in a breach of any of the Warranties given by it.

9.2 The Seller shall:

(a) not, except with the prior written approval of the Purchaser (such approval not to be unreasonably withheld or delayed) amend or agree to amend any of the Asset Documents in any respect in so far as such amendment or agreement to amend relates to or affects the Asset or waive or agree to waive any of its rights or remedies thereunder or arising therefrom in so far as such rights and remedies relate to or affect the Asset;

(b) if it considers in good faith that a particular matter or proposal is of a nature which may have an adverse effect on the value of the Asset, notify the Purchaser in writing, consult (to the extent reasonably practicable) with the Purchaser in relation to that matter or proposal, take account of any representation which the Purchaser may make and, provided always that such action shall not be prejudicial to any of the Seller's other business interest and the Seller shall not be in breach of any contractual, legal, statutory or regulatory requirement whatsoever by doing so, carry out the wishes of the Purchaser in so far as it is reasonably practicable to do so following such consultation; and

(c) as soon as reasonably practicable provide the Purchaser (to the extent it is contractually and legally permitted to do so) with details of any matter relating to or affecting the Asset on which the Seller is entitled to vote (a "Voting Matter") and, prior to exercising its vote on a Voting Matter, consult (to the extent reasonably practicable) with the Purchaser in relation to the Voting Matter, take account of any representations which the Purchaser may make and provided always that such action shall not be prejudicial to any of the Seller's other business interests and the Seller shall not be in breach of any contractual, legal, statutory or regulatory requirement whatsoever by doing so, exercise its voting rights in a manner which is not inconsistent with the Purchasers' representations.

The interim period covenants in the Oil & Gas UK model form are broadly similar to the covenants in the AIPN model form and the concepts for which protection is sought are the same. For example:

- Clause 9.1(a) is similar to Clause (a) of the positive covenants in the AIPN model form;
- Clause 9.1(c) is similar to Clause (d) of the negative covenants and Clause (f) of the positive covenants in the AIPN model form; and

- Clause 9.1(d) is identical to Clause (b) of the mutual covenants in the AIPN model form.

However, in a number respects the Oil & Gas UK model form is substantially more buyer-friendly than the AIPN model form as:

- Clause 9.1(a) elevates the standard to that of 'good oilfield practice'; and
- Clause 9.1(b) is a new covenant requiring the seller to ensure an efficient handover of the target to the buyer and to cooperate with the buyer to ensure that this is the case.

Furthermore, Clause 9.1(c) is a more fulsome information-sharing covenant than the AIPN model form in that it is not qualified by materiality or a threshold amount, and applies wholesale to any matters to do with the target assets (other than those matters of a routine nature).

Clause 9.2(a) is reflective of Clauses (a) and (c) of the negative covenants in the AIPN model form (although the waiver in Clause 9.2(a) is not limited by materiality and is, therefore, again more favourable to the buyer).

However, Clauses 9.2(b) and (c) provide perhaps the biggest difference between the Oil & Gas UK model form and the AIPN model form as these covenants pass voting control at the asset level from the seller onto the buyer. Obviously, there are caveats to the extent to which the buyer can assume total voting control, but the principle of these clauses is that the seller must vote in accordance with the buyer's instructions (unless that would be prejudicial to the seller's other business interests or cause the seller to be in breach of law or any of the upstream asset documents). These covenants open the door to a significant level of buyer control and any prudent buyer would request some form of voting influence, although sellers will inevitably fight to limit the scope of any such voting covenant.

5. Other typical interim period covenants

Supplementary to the covenant slate in the AIPN model form and the Oil & Gas UK model form, the following are examples of other types of interim period covenant which buyers may request.

5.1 Positive covenants

The following are examples of other positive covenants which buyers may seek during the interim period.

Adhering to the previously agreed decisions of the target's operating committees:

comply with previously agreed decisions of the operating committees (including with respect to any work programme and budget) in relation to the Assets;

Obviously, to the extent that the seller has exercised any non-consent rights in relation to any such decisions, then the seller may seek to exclude those decisions. The seller would need to justify any refusal to include such a covenant or exclusion to such a covenant because non-compliance with operating committee decisions will be a material issue for any buyer.

Allowing a representative of the buyer to attend meetings of the target's operating committees:

allow a representative of the Purchaser, or an Affiliate of the Purchaser, to attend meetings of the operating committee, and any subcommittee that the operating committee may establish, under the Joint Operating;

The buyer may also seek to push for voting rights (as per the Oil & Gas UK model form), but at the very least a buyer will expect to have observer status at operating committee meetings so that it can be suitably informed and forewarned about the status of operations.

Paying any and all accounts payable in accordance with their terms:

pay all of its accounts payable, invoices and third party receivables in accordance with their terms;

The buyer will want to ensure that ongoing dealings with third parties (on which the buyer will also be reliant after completion) are also dealt with and handled in the ordinary course (eg, the buyer will not want the seller to interact differently with third parties and jeopardise relationships with third-party suppliers and contractors). The seller will not, however, want this covenant to fetter its right to dispute, in good faith, any amounts in respect of such invoices and receivables. This type of covenant is likely to be even more important where the target being acquired serves as the operator under the JOA of the upstream asset.

Providing the buyer with copies of all reports and minutes of operating committee meetings:

provide the Purchaser with copies of all management committee minutes, operating committee minutes, board minutes and minutes of any similar meeting or proceeding in connection with the Company or the Asset, together with any supporting documentation relating thereto;

This covenant dovetails with the other operating committee covenants and further enhances the principle of transparent information flow during the interim period, which will be a key issue for any buyer. The seller will, however, expect that such a covenant is qualified by any applicable confidentiality restrictions.

Notifying the buyer of any breaches of the upstream asset documents by any of the co-venture partners:

notify the Purchaser of any claim, action, legal proceeding, expert determination reference or arbitration of which written notice has been received by, or which is threatened against, any member of the Seller's Group relating to the Company, the Assets or the Shares;

notify the Purchaser in a timely manner of any facts or circumstances of which it is aware which indicate that there has been a breach by another party of any Upstream Asset Document, any authorisation from any Governmental Authority or any other instrument, document or agreement relating to the Asset.

Although this is similar to the notification covenant in limbs (A) and (B) of Clause (a) of the positive covenants in the AIPN model form, the first paragraph above is further reaching and beneficial to the buyer as it includes threatened proceedings, as well as actual notified proceedings. The second paragraph relates to breaches by co-venturers; this will be important from a buyer's perspective as any such breach could require the buyer post-completion to fund a share of the breaching party's project costs up to the amount of their default. Any such breach could also threaten the sanctity of the upstream asset if, for example, the party in breach is the operator and the other co-venturers cannot step up and fund the operator's share of defaulted costs.

5.2 Negative covenants

The following are examples of other negative covenants which buyers may seek during the interim period.

Prohibiting the seller from carrying out corporate activities in relation to the special purpose vehicle being acquired in cases of share purchase:

make any adjustments in respect of the share capital of the Company, including issuing any new equity;

acquire or agree to acquire any share, shares or other interest in any company, partnership or other venture;

incur any additional financial indebtedness or prepay or cancel any existing financial indebtedness;

create, allot or issue, or grant an option to subscribe for, any share capital of any Group Company;

repay, redeem or repurchase any share capital of the Company;

make any loan or cancel any loan or other debt (other than in respect of any trade credit in the ordinary course of business) to any person;

enter into any guarantee, indemnity or other agreement to secure any obligation of a third party or create any Encumbrance over any of its material assets or undertaking;

make any change to its accounting practices or policies or amend its constitutional documents;

pass any resolution of its shareholders or any class of shareholders, whether in general meeting or otherwise;

enter into any commitment or take any action with respect to or in contemplation of any liquidation, dissolution or other winding up of any Group Company;

These covenants are typical corporate controls (no share increase or issue, no redemption of capital, no declaration or payment of dividends, etc) that a buyer would expect to see and prohibit corporate actions from being undertaken which directly affect the target company being acquired. They are effectively the corporate equivalent of asset level covenants not to alter the upstream project documents and not declare sole risk operations; they are therefore fundamental to protect the buyer from value erosion of the target. To the extent that a corporate reorganisation is required during the interim period, the seller will likely require an exclusion permitting the seller's group to carry out the necessary corporate actions required for the reorganisation.

Prohibiting the seller from voting in favour of any changes to agreed work programmes and budgets:

> *vote in favour of changes, revisions or amendments to any approved work programmes or budgets relating to the Asset;*

The seller will likely include a *de minimis* exclusion to this covenant as it will not want to be unduly burdened and prohibited from agreeing to routine and non-material changes to agreed work programmes and budgets.

Prohibiting the seller from agreeing to any other work programmes and budgets:

> *approve any work programme and budget under the Joint Operating Agreement, or enter into any material expenditure with respect to the Asset;*

The buyer will want to control future capital expenditures and not be forced into a costly work programme and budget which it would not otherwise have elected to approve as this will drastically affect project economics. The longer the interim period, the more likely it is that another work programme and budget vote will be required for a subsequent year; the seller will seek appropriate caveats dealing with this (which will emphasise the importance of satisfying all of the conditions precedent as soon as practicable so that the interim period is shortened). Also, as with Clause (b) of the covenant of the AIPN model form discussed in section 3.2 above, the seller will likely include a *de minimis* exclusion to this covenant.

Prohibiting the seller from amending the terms of any employment contracts with key employees:

> *make any amendment to the terms and conditions of employment (including remuneration, pension entitlements and other benefits) of any senior employee;*

The seller will want to add a materiality qualifier to this covenant so that the restriction does not capture minor *de minimis* amendments of an administrative nature. The seller will also want to narrow the scope of which individuals constitute key employees so that covenant compliance is more manageable.

Prohibiting the seller from dismissing any key employees or engaging any new key employees:

> *dismiss any senior employee other than for cause or engage or appoint any additional senior employee;*

As with the foregoing covenant, the seller will want to narrow the scope of which individuals constitute key employees and may also include an ordinary course exclusion permitting the buyer to engage new senior employees where required.

Prohibiting the seller from amending any existing or adopting any new employee ancillary benefit programme:

> *discontinue or amend any benefit arrangements to any material extent or commence to wind them up or terminate them;*

The foregoing proposed employee covenants will be a key issue where the buyer expects to be reliant on certain key individuals post-completion and needs their participation and historic knowledge in order to operate the upstream assets. For example, an entry into a new country by a buyer will likely require management retention.

Prohibiting the seller from relinquishing or surrendering any part of the upstream assets:

> *relinquish or surrender or withdraw from any part of the Asset, or agree or approve or vote in favour of any proposal to do so;*

This is a fundamental covenant and is particularly important during the initial exploration phase of an upstream asset when progressing through each exploration stage and into the development phase requires relinquishment of a certain proportion of the upstream asset. Accordingly, any refusal by the seller to give this covenant should be a red flag to a buyer as the buyer must know the exact acreage that it is acquiring at completion.

Prohibiting the seller from doing or omitting to do anything that could cause any of the upstream asset documents to be terminated or revoked:

> *do or omit to do anything which could result in the termination, revocation, suspension, modification or non-renewal of any Asset Document, authorisation from any Governmental Authority or any other instrument, document or agreement creating or evidencing the Asset;*

This is also another fundamental covenant which cuts to the heart of the transaction; it is a red flag as any potential termination or revocation of an upstream title document would be catastrophic for the buyer as there would no longer be any upstream asset to acquire. The seller, however:

- is likely to require that the covenant apply only to acts or omissions which are reasonably likely to cause such termination or revocation; and
- will also narrow the scope of the documents to which this covenant applies (although at the very least the buyer will need this to apply to the upstream title documents).

Prohibiting the seller from commencing any unitisation negotiations:

> *enter negotiations in respect of the unitisation of any part of the Asset or sign any unitisation agreement relating to any part of the Asset;*

This is another key covenant as unitisation increases the scope of the joint venture group as the target's field will be contiguous with the field of another co-venture group operating a different upstream asset. Unitisation will have a profound effect on reserves figures as they will be allocated between each separate co-venture group and will affect voting mechanics for operational activities in the unitised area. Accordingly, the seller should have no problem giving such a covenant and the buyer should be fully informed of any unitisation discussions.

Prohibiting the seller from incurring expenditure for any purpose in excess of a pre-agreed maximum figure:

> *enter into any agreement or incur any expenditure or commitment involving any capital expenditure in excess of US$[•] per item and US$[•] in the aggregate;*

As with Clauses (b), (c) and (d) of the negative covenants of the AIPN model form discussed in section 3.2 above, this is a deal economics issue and the buyer will need to know what financial commitments it is stepping into. The amount agreed will depend on the risk appetite of the buyer and the seller.

Prohibiting the seller from entering into unduly onerous contracts with respect to the target or which are outside the normal course of business of the target:

> *enter into any contracts which are subject to unduly onerous terms, or which are outside the normal course of business of the Company concerned, or which are not at arms' length, nor terminate any material business relationship (other than expiry in accordance with its terms);*

This is a deliberately broad covenant designed to capture any other matters which could be problematic from a buyer's perspective and which are unexpected and not customary. Sellers are, therefore, likely to reject this broad covenant and require buyers to identify the specific classes of issue for which they are seeking protection through the other covenants. Sellers will also undoubtedly challenge the ambiguity of the covenant and argue that referring to unexpected issues (ie, unknown unknowns) is subjective and open the door for the buyer to shoe-horn multiple claims for breach.

There are no hard and fast rules as to which interim period covenants must be provided and this will depend very much on the relative bargaining strength of the parties (although the continued operation of the target in accordance with law and in the ordinary course is clearly a fundamental principle and the most basic of interim period covenants which any buyer should ask for).

The need for interim period covenants will also be very much dictated by the transaction structure. For example, where the deal is an asset farmout and the buyer is already a co-venturer in the upstream asset being acquired, then the buyer is likely to be already extremely well informed about the asset and will already have a vote at the relevant operating committee level and may, therefore, be able to a take a more relaxed approach to interim period covenant protection.

However, some combination of the above covenants should be requested by the buyer to protect the target being acquired from losing value in the interim period or from being further encumbered and subjected to other third-party interests. To the extent that the seller is resistant to providing interim covenants, then the buyer should insist that more warranties be repeated at completion.

6. Post-completion covenants

While the bulk of protections that a buyer will need relate to the interim period prior to which the buyer owns and has control over the target, a number of other covenants are also typically included in SPAs.

In the context of a share purchase, where the buyer acquires the special purpose vehicle, the seller will want to know that post-completion the buyer is disassociating itself and the target from the seller's corporate group as the seller will not want an external unrelated party (the buyer and, post-completion, the target) from holding itself out as part of the seller's group. Accordingly, the buyer will normally provide a covenant to ensure that names changes are made and signage removed within a certain period of time after completion (this can range from 30 days to 180 days, depending on the complexity of the jurisdiction).

The seller will also want to ensure that it is not prejudiced should the tax authorities conduct an audit of its activities and tax filings post-completion. Accordingly, the seller may require the buyer to covenant that tax and financial records will be maintained by the buyer for a sufficient period of time after completion to satisfy tax legislation and to grant the seller reasonable access to those records in the event that an audit is conducted.

In smaller transactions, the handover of books and records during the early exploration phase is frequently dealt with as a completion deliverable. But where the transaction involves a long-term producing asset, the seller may simply be unable to handover all the books and records relating to the upstream asset at completion. In this case, the buyer will require a covenant from the seller that those books and records are handed over within a certain period of time after completion. This period of time will be subject to negotiation between the parties and depend on how much unbundling is required by the seller to separate the necessary books and records from the other books and records in the seller's group. From the buyer's perspective, though, following completion (unless there is a deferred component to the purchase price) the buyer will have no financial leverage over the seller to incentivise the seller to provide these documents quickly; there is effectively no penalty if the seller breaches this covenant other than a damages claim (for which losses to any accurate degree will likely be difficult to quantify). It is, therefore, in the buyer's best interest to ensure that all of the material books and records are handed over at completion (with the less important ones to follow pursuant to the covenant).

To the extent that the transaction requires a release of liability of any member of the seller's group, the SPA will most likely also include a covenant by the buyer to indemnify the seller post-completion where the seller's group incurs losses as a consequence of the liability not being released by the buyer.

As with any other sale and purchase transaction, the seller may try and include customary post-completion restrictive covenants on non-solicitation of employees of the seller's group (although this is relatively uncommon in upstream transaction, unless the seller is a private equity-backed entity – in which case a full suite of seller protections is customarily proposed). However, unlike sale and purchase transactions in other sectors any such post-completion restrictive covenants do not typically include non-solicitation of customers and non-compete clauses as the very nature of the upstream industry necessitates that sellers and buyers will likely be dealing with the same contractors and offtakers. In any case, the same principles that apply to other restrictive covenants will be applicable. Accordingly, any such covenants will need to be reasonable, proportionate and justifiable to protect the sellers' legitimate business interests – consequently, covenants for more than 12 months are fairly uncommon.

Additionally, SPAs will include typical covenants to comply with completion obligations, such as entering the buyer into the corporate shareholder books, removing and appointing new directors and officers and passing the necessary corporate resolutions (especially where the transaction is a share purchase deal and the buyer is acquiring a special purpose corporate vehicle).

7. Conclusion

Interim period covenants in SPAs are extremely important and are the only way that a buyer can influence and exercise any element of control over the target assets that it is acquiring before completing the actual acquisition. Without any interim period covenants, a buyer would essentially be at the behest of the seller and reliant entirely on warranties (many of which may not be repeated at completion, thereby leaving the buyer exposed). They are, therefore, a fundamentally important component of any transaction with a non-simultaneous signing and completion (although in a seller's initial bid draft in an auction process it is frequent that either very few or no interim period covenants are included in the draft SPA).

The recent trend, particularly in a low oil price environment where sellers are looking to exit from non-core assets, is for deal certainty. Sellers are now, therefore, more willing than has previously been the case to trade recourse and post-completion liability for less transaction conditionality, as a certain exit is frequently the main priority with sellers looking to de-risk their asset portfolio.

This means that sellers are becoming fairly pragmatic when it comes to buyers' requests for interim period control. Greater deal certainty means a larger chance that completion will occur, and that the buyer will assume the target and the upstream assets; consequently, the buyer will require influence and control over how those assets are to be operated pending completion. This does not mean that sellers write blank cheques and grant buyers whatever interim period covenants they ask for; it does mean, though, that buyers can get a robust slate of controls during the interim period.

In the context of a low oil price, interim period covenants unquestionably take on greater significance as part of any transaction, as the reins are tightened across the sector on project expenditure and capital commitments. Therefore, any incurrence of further costs and expenses or any agreement for extensive further work operations by a seller during the interim period will be key issues for any incoming buyer and will need to be controlled and influenced to some degree.

This chapter 'Covenants in upstream acquisitions and divestitures' by Kevin Atkins is from the title Oil and Gas Sale and Purchase Agreements: SPAs for International Oil and Gas Acquisitions and Divestitures*, published by Globe Law and Business.*