

THE NEGOTIATOR



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A photograph of Kevin O'Leary, a middle-aged man with a balding head, wearing a dark suit, white shirt, and patterned tie. He is standing with his arms crossed in a dark, industrial-looking setting with large windows in the background.

KEVIN O'LEARY

CAPL MANAGEMENT NIGHT

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The ROFR Exemptions Under the CAPL Operating Procedure

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The Allocation Dilemma

ROFR Values on Package Sales

THE RECENT ALBERTA COURT OF QUEEN'S BENCH DECISION IN *NAL GP LTD. V. BP CANADA ENERGY COMPANY* (2010 ABQB 626) GOT ME THINKING ABOUT THE AGE OLD "ALLOCATION DILEMMA". This is a term that courts constantly use when anyone (gasp) has the audacity to challenge the reasonableness of the value allocated in a ROFR notice issued as part of a package sale.

We will walk through the *NAL* case later on in this article, but if you don't have the energy to read that far, here's a quick summary, good luck ever getting an injunction if you challenge a ROFR value.

Allocation Dilemma Defined

Through a series of legal articles and a bunch of cases, the Alberta Courts have come to this weird place where it is almost verboten to question ROFR

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values on a package deal. For example, the Court in *NAL* begins its discussion of the challenged ROFR values with the words "... this seemingly unfair allocation of values...". Never a good sign.

The allocation dilemma concept comes with a set of nice fuzzy wobble words that pretty much allow ROFR values to move well beyond a straight up fair market valuation of the ROFR assets (such as a BOE or reserve report allocation based on the total purchase price).

Just in case you need a list, here are some of the concepts:

- in a package sale, there is no clearly defined price for the ROFR assets;
- tradeoffs and synergies in buying a package mean the ROFR assets can be extra special;
- Upside potential of undeveloped property (my favorite); and
- access to processing facilities.

Nothing new here, these concepts have been around for years. A nice summary of the allocation dilemma is quoted in *NAL* from an article written in 1997:

Professor Flannigan points out the same problem when he states:

"The bulk price of the *entire* package would presumably be a fair market value. However, because of tradeoffs and synergies, it will not necessarily represent simply an aggregation of individual fair market values." [paragraph 22]

The Allocation Dilemma Effect (Call of Duty Analogy)

I get it. Its really complicated. But honestly, really, how can it be that in deal after deal, year after year, it always turns out that the very best assets have the ROFRs and hence require a valuation that does not correspond with a straight up BOE or revenue allocation based on the purchase price?

Perhaps I am getting cynical, but I think at least part of the, shall we say, aggressive valuation of ROFRs comes from the entrenchment of the allocation dilemma concept in case after case dealing with ROFRs. By saying things are really complicated and being deferential to what the vendor/purchaser set as the ROFR values, the Courts are pretty much granting vendors (really purchasers) free reign to bump values up on every deal.

It is, I think, pretty much human nature that if you leave the decision as to what is reasonable to the very people who gain a benefit from stretching the limits, you will reap what you sow.

Let's take a real life analogy. My wife is the true moral compass in our family unit, much like a judge. We have a 10 year old who believes he is 15 (youngest child syndrome). Earlier this year my

wife broke the "M for Mature" video game rating rule at our house by allowing the boy to purchase Call of Duty something or other. The boy's argument was that the "Mature" video game rating was very complicated. He explained several factors in such complexity, such as: all his friends had the game, it's only violence not nudity, you only shoot bad guys, only a bit of swearing. Lots of reasons why a video game rating system was very complicated (like ROFR values) and mom should be somewhat deferential to the boys view of what a proper video game for him might be.

Well, Christmas is upon us, and lo and behold, Call of Duty next something or other is the must have game for all the 10 year old boys. Let's just say the same arguments have come up and it is now somewhat difficult for my wife to assert her authority now that she has given into letting the boy make his own rules.

That being said, wives and judges always have the ability to change their minds, especially if the right set of facts come along. If purchasers keep pushing the limits on ROFR values there may come that especially unreasonable set of facts that make the courts decide in favor of the ROFR holder.

Can it be That the Purchase Price Simply Does Not Matter?

My warning is likely misguided, since the leeway on ROFR values seems almost boundless. However, in my simplistic world view I just cannot get around the idea that the allocated ROFR value must bear some relation to the total purchase price for the assets. That is to say, the purchase price for the total package is by definition the fair market value of the assets. This is the pie that you get to divide up between ROFR assets and nonROFR assets. Ergo, the allocated ROFR values must bear some relation to the total pie. If you say allocate 90% of the ROFR value on 30% of the reserve report valuation of the lands, you will have distorted the pie so badly that the ROFR values risk being found to be unreasonable.

I understand you get some wiggle room, but in an increasing number of transactions over the last few years senior lawyers working for purchasers have argued that the purchase price for the package is simply irrelevant in determining ROFR values. Don't get it. Can't understand it. However, this is a real viewpoint and the ROFR allocation cases don't do anything to temper this ROFR value enthusiasm.

Purchaser's Indemnity (Don't Worry Be Happy)

The final nail in the "let's be reasonable on ROFR values" coffin often comes from the purchaser's indemnity for ROFR values which appears in almost all sale agreements. The idea is that the

vendor essentially defaults to the purchaser to set ROFR values. In exchange, the purchaser agrees to be responsible for all damages and costs the vendor might incur should a third party ROFR party challenge the ROFR value allocation.

As a vendor you need the indemnity, however I do not think this should be equated to a carte blanche acceptance of whatever values the purchaser provides. The duty under your prior agreement with the third parties holding the ROFR was to provide them with a meaningful preferential right of purchase. Again, I know I might be preaching to the choir here, but there it is.

Duty of Good Faith (Wink, Wink, Nudge, Nudge)

All the ROFR cases acknowledge that the vendor has a “duty of good faith” to the third party ROFR holder in issuing the ROFR notice. Seems like a tough standard and it pulls at my puritan sense of duty to imagine that all vendors would honor this duty to the highest standard.

In the good old US of A, these kinds of duties are strictly construed by the Courts and should you as a vendor be found in breach of such a duty, the Court will beat you with a punitive damages stick so hard you would never risk being clever again. But alas, we do not live in the USA, we live here, and our Courts almost never issue significant punitive damages awards. In fact, we almost never get court decisions which find the ROFR value to be improper. So it becomes somewhat difficult to preach about the duty of good faith, without having purchasers (and often vendors) smirk a little bit.

The Court in *NAL* may have moved this standard even further. The Court states:

I conclude, as did Justice LoVecchio, that there simply is no evidence to establish that the price being allocated by BP Canada and Apache was done in bad faith. The onus is on the Applicant to provide some evidence which would indicate bad faith. It has failed to do so. *I am satisfied that there is no serious issue to be tried with respect to the allegations of what amounts to fraud.* [paragraph 24] [emphasis mine]

I believe *NAL* is on appeal, and the above text deals with issues outside of the injunction application, however the text implies that proving a breach of the duty of good faith may mean essentially proving fraud. Proving fraud is extremely difficult at law and if we move the bar this high it may mean you can never successfully challenging a ROFR value.

A Few Words on *NAL* and Injunctions

The *NAL* action was commenced as an interlocutory injunction application to prevent the sale of the ROFR assets from occurring until a court determined whether the ROFR values were reasonable. If such an injunction were granted it would mean that the

sale of the ROFR assets could not occur until final resolution of the action. This could be years in the future.

Very scary, but not really. Injunction applications have a standard three part test:

- serious issue to be tried;
- irreparable harm to plaintiff (ROFR holder) if sale allowed to proceed; and
- balance of convenience favors injunction.

In this case, the Court found that *NAL* did not even meet the first part of the test. This is quite rare and may have had something to do with *NAL* not providing enough evidence that the ROFR values were out of whack. Don't know. Doesn't really matter. What really matters is that several cases in a row have killed ROFR allocation injunction applications based upon the second part of the test, irreparable harm. In *NAL* the Court quotes another case which found that:

This loss of opportunity is simply that, a loss of opportunity. The Assets are not unique nor do they possess any inherent value exclusive to Constellation ...[the plaintiff ROFR holder] [paragraph 25]

This comes back to a very specific legal issue as to whether a plaintiff would be granted the remedy of specific performance (i.e. sell me the ROFR lands at a fair price) or merely damages. In almost all cases, except for some reason the purchase and sale of homes, courts only grant damages. If your remedy is damages, you almost never get an injunction.

Injunction applications cost lots of money in legal fees and you spend it all very fast. Bottom line is that you may not want to waste money on injunction applications.

So What is a Fellow To Do?

So what do I tell landmen who call and are outraged by the values provided in ROFR notices:

- don't bother with an injunction;
- if you are serious, you must start a Court action before the ROFR period expires (i.e. don't call your litigation lawyer on day 29 of 30);
- if you are really serious, you need to exercise the ROFR, pay, and then sue on the ROFR value;
- get solid evidence of the ROFR value being out of whack and keep it organized; and
- be ready to lose on the ROFR value challenge and be ready for the court case to take years.

Tough situation, but there it is. 📖