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Successful Strategies and Best Practices for Dealing with Energy-Related Legal Issues

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Executing Energy Finance Transactions

Mark Zvonkovic

Partner

Akin Gump Strauss Hauer & Feld LLP

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Finding, producing, storing, and transporting energy today often involve complex financial transactions. The participants in these transactions are primarily companies owning and operating energy assets, private equity concerns investing in such companies or assets, institutions providing capital to such companies, and financial services companies underwriting capital markets issuances or providing financial advisory services. Energy companies are generally categorized by the activities in which they engage: upstream activities (e.g., oil and gas exploration and production), midstream activities (e.g., pipeline transportation and storage), downstream activities (e.g., refining, generation, distribution, and marketing), and energy services activities (e.g., drilling, compression, maintenance, and similar support services for companies engaged in upstream, midstream, and downstream activities). The majority of energy financial transactions can be divided into three types of transactions: merger and acquisition transactions (acquisitions and dispositions of companies or assets), capital markets transactions (underwriting and private placement of securities, commercial debt financings, and project financings), and private equity transactions (large investments by private investors or funds in start-up energy companies or existing companies seeking a large amount of additional capital for a particular purpose). A very large energy finance transaction can incorporate two and sometimes all three of these types of transactions into a single transaction.

Industry Background

Transaction lawyers often employ a formulaic approach to representation of a transaction party, relying heavily upon precedent from other recently completed transactions, forms from law practice publications, and, particularly in the case of the large New York-based firms, master forms maintained by practice departments of law firms. Even disclosure is canned from precedent, as review of several risk factor sections from the prospectuses of recent offerings demonstrates. Although every industry has unique factors that good transaction counsel must take into account when employing precedent in the preparation of transaction documents, the complexity and scope of issues that affect the energy business make it impossible for counsel in such a transaction to stay within the comfortable environment often referred to as "legal matters." The energy industry, from its origins in the Pennsylvania and Texas oil fields, has been mired in a murky hybrid environment combining and sometimes confusing contractual, real property, and regulatory principles. Accordingly, relying on precedent in many energy transactions makes as much sense as using a Gulf Coast rig to drill a well in Wyoming.

Although energy transactions involve many of the same issues and structures that are involved in transactions involving other businesses, the energy sector brings into play a number of unique issues that affect these transactions. The upstream energy business, for example, demands a knowledge of complex issues relating to determination and reporting of oil and gas reserves, leasehold ownership, joint venture relationships with other companies, and factors driven by the type of reserves (oil or gas), the type of development (primary, secondary, or tertiary), and geographic areas (offshore, gulf coast, mid-continent, Rocky Mountains, etc.). A large amount of today's exploration and production activity is being conducted around non-conventional oil and gas resources (e.g., coal bed methane, oil shale mining, and heavy oil extraction), which will also involve complex issues in different states regarding rights to mine coal, pipeline gathering, and transportation easements, and issues on federal land regarding access to drilling locations and water usage and disposal rights. Environmental concerns affect this activity across the board. These factors will affect merger and acquisition transactions, specifically in the representations and warranties and covenants dealing with asset ownership and reserves, and with the kinds of contracts a company enters into. For securities transactions, there is special guidance in Regulations S-X and S-K relating to oil and gas reserves and successful efforts or full cost accounting, including the industry guides relating to disclosure of oil and gas operations under Items 801 and 802 of Regulation S-K. For private equity investments, these factors are important to understanding the assets and operations of a company as well as its future prospects as a part of a modeling process aimed at forecasting investment return hurdles that are key to a private equity investor's decision-making. The practitioner must know how these industry-specific factors are assimilated into the deal-making transaction process and where to expect future problems related to need for capital and delays in implementation of capital projects.

The energy business is capital-intensive, and thus returns in the business are extremely sensitive to fluctuations in commodity prices and the availability and cost of capital. In addition, commodity prices over the past three decades, particularly oil prices, have been cyclical and the industry has historically been a story of boom and bust. Domestically, the easy oil and gas reserves were long ago found, and today's business is dependent on advances in technology and operating techniques that can develop difficult-to-extract reserves or secondary and tertiary reserves from older fields from which the readily accessible reserves have already been produced. These new techniques are, of course, more expensive, and often the time between commencement of a project and commencement of production is longer, making the cost of capital and commodity prices that much more critical to projects. All of these factors have such an impact on the economics and strategies underlying an energy transaction that it is essential that a practitioner have a grasp of the issues and the way the industry is dealing with them. Several helpful industry publications for the practitioner are listed in Appendix A.

Diligence and Disclosure

Finance lawyers often think of conducting diligence and drafting disclosure as matters of drudgery, a kind of dues one has to pay on the way to managing and negotiating transactions. In fact, many practitioners believe diligence and disclosure are really nothing more than a second line of defense in deal protection mechanisms, assuming that broadly crafted representations and warranties or a lengthy liturgy of risks will cover most ills. Such an assumption can be a detriment to a client's evaluation of a transaction, however, because it potentially obscures information that may have an impact on such evaluation. In the energy business, small nuances in operating fundamentals, property rights, contractual arrangements, and business prospects can have a significant effect on projections of future results. Thus, a client is often better served if diligence and disclosure practices are viewed as value enhancement strategies as opposed to risk mitigation procedures.

Conducting diligence relating to an acquisition, financing, securities offering, or investment involving energy assets or an energy business must go beyond a summary review of entity organization records, governance documents, debt instruments, and material contracts (i.e., those contracts that, for a public company, would be required to be filed as exhibits under Regulation S-K). An energy company can be subject to a wide variety of operating arrangements, property rights, and regulatory requirements that can have a diverse and often material impact on the company's ongoing business and prospects. These arrangements need to be reviewed to determine whether the company is particularly susceptible to future market fluctuations and whether they conflict with strategic plans of the parties to the transaction (e.g., change-of-control triggers in contracts or third-party burdens that may prevent realization of upside potential in future transactions). Even the transaction for which the diligence is being conducted can potentially set in motion consequences the parties need to take into account (e.g., the triggering of preferential rights of purchase in third-party agreements related to property rights and operating contracts). Identifying these matters early in the transaction process provides the parties with the flexibility to adjust both terms and structure to accommodate their impact.

Careful diligence will provide the foundation for good disclosure. In recent years, the Securities and Exchange Commission during the registration process has aimed comments at broad risk factors designed to warn against every single contingency involved in an issuer's business, regardless of the likelihood that any such contingency could arise. Arguably, such a prophylactic approach to risk disclosure, even if permitted by the Securities and Exchange Commission, would not protect an issuer from an omission of a specific contingency to which the issuer was uniquely subject on account of a particular set of operations. In addition, disclosure should go beyond a simple risk analysis and provide a measured view of an issuer's business position, particularly in an industry where an investor is measuring prospects against commodity price volatility and political pressures. Thus, an investor would want to know, and an issuer would want to disclose, that a unique property position or contract rights to certain new energy technologies put it in an advantageous position to capitalize on consensus forecasts by economists and industry commentators regarding market, regulatory, and political environments. Invariably, an energy company's prospects are far more sensitive to a complex mix of property and contract rights that are not made clear by solitary reference to material contracts.

Finally, all transactions will impose future requirements on an energy client—some reporting, some related to financial performance and financial covenant compliance, and some related to impediments to future growth plans. The complexity of the energy business makes it difficult to identify such obligations and foresee their impact on a company's or an investor's evaluation of a transaction. Yet these are certainly matters that must be taken into account in determining whether to proceed with a transaction and in ascertaining what disclosure to investors may be warranted. A good practitioner must utilize diligence and disclosure skills to assist the client in identification and evaluation of these requirements.

A Step-by-Step Process to Energy Transactions

Every energy transaction has unique elements. A practitioner therefore should always be wary about the application of forms or taking a pre-packaged approach to a particular transaction. Nevertheless, one can generally divide the process of initiating, structuring, and executing a transaction into six steps. While these steps are generally taken chronologically in the order presented below, a particular transaction often demands an overlap in timing and, in some cases, rearranging their order. In addition, there may be unique circumstances, such as obtaining third-party approvals (e.g., waivers of preferential purchase rights, consents to assignments, and shareholder approvals) or specific regulatory hurdles and conditions (e.g., Federal Energy Regulatory Commission approvals) that warrant the inclusion of one or more additional steps or sub-steps. Planning the process and mapping out the steps in advance will greatly enhance how effectively and efficiently the transaction is prosecuted.

Prior to presenting to a client a step-by-step process based on the criteria below, a practitioner would be well served to meet with the client and solicit the client's broad expectations regarding principal transaction terms and other matters that are of strategic importance. Asking a client to insert business considerations into process steps often obscures matters of strategic importance to a client, particularly when such matters don't neatly fit within a legal framework presented by counsel. The practitioner's job is to ensure that the framework ultimately proposed does not conflict with or prevent the accomplishment of a client's strategic goals. A second benefit of this early meeting with a client is the insight a practitioner will obtain regarding a client's transaction execution expectations. Clients generally assess transaction execution by a focus on three elements: preservation of the perceived bargain, length of time to consummation, and cost. How a client may prioritize these three elements is sometimes difficult to ascertain but invaluable to a practitioner's development of an execution process. For example, the better the bargain a client perceives he or she has made, the more likely speed of implementation will be a high priority and, perhaps, the less likely the client will be concerned with the costs of implementation. When the client believes he or she has made a very good deal that fits well in their company's strategy, common sense will dictate that the diligence process and the scope of risk allocation covered by the documentation should be tuned to allow quicker execution. Perfect agreement provisions and exhaustive diligence are not very appealing to a client after the other party walks away from the deal on account of difficulty in its execution. Said another way, a practitioner may miss the forest for the trees by striving to achieve legal documentation that is textbook perfect.

Here are the six steps:

Write a Term Sheet

The principal terms of a transaction are straightforward and easily committed to memory. One does not need a term sheet for these. The more difficult terms to a transaction are the ones the principals did not talk about in their preliminary meetings, either because they assumed there would be no arguments about them or because they simply did not think of them. This phenomenon is particularly acute in an energy transaction, because energy businesses and assets involve such broad and complex areas that deal-makers often do not have a sufficient background to take a whole range of contingencies into account. The job of the energy practitioner is to apply experience and expertise to the identification of secondary, and sometimes tertiary, terms and how their resolution will impact the client's perception of the transaction. The term sheet in that sense is a checklist for the client and should be written in much the same way a chef writes a recipe. Development of the term sheet demonstrates for the client how the use of different ingredients can produce a widely different result. The term sheet allows the deal-maker to reexamine priorities and compromises relative to the principal terms of the transaction, and it gives the deal-maker support for complicated issues with which he or she is unfamiliar, such as those relating to Employee Retirement Income Security Act, tax, and intellectual property matters. The term sheet also provides context for all of the integrated parts of the transaction, which will prove invaluable to the practitioner and the deal-maker during the negotiation of the definitive transaction agreements. A sample term sheet appears as Appendix B.

Prepare a Structured Diagram

Achieving an agreement between parties can be as much about education as it is about negotiation. A simple diagram can present a visual image of a transaction around which the parties can deliberate on common ground. In fact, the very act of creating the diagram can often sharpen a practitioner's recognition of contingencies and hurdles the parties will face in transaction implementation. A structure diagram often proves useful throughout an entire transaction, sometimes ending up in a prominent position on the closing table as a check on fulfillment of all a transaction's parts. Finally, the diagram is an excellent tool for quickly introducing the transaction to other professionals within the client organization, such as human resources and investor relations personnel, from whom input on key terms may be required and who often play substantial roles in later stages of a transaction's execution. A sample structure appears as Appendix C.

Prepare a Time and Responsibility List

A time and responsibility list is perhaps more organization than it is substantive, but the list can help a client and the counterparty put transaction terms and implementation into context. On its face, the list delineates what it will take to get the transaction over the finish line, specifically in terms of length of time needed to process pieces of the transaction and the human resources that will need to come to bear. More importantly, however, the list illustrates for the deal-maker where it might be appropriate to compromise transaction terms or structure alternatives to increase speed of implementation of the transaction, or vice versa. Finally, the list will manage the expectations of all participants regarding execution of the transaction. A sample checklist appears as Appendix D.

Prepare Diligence List and Conduct Diligence

As discussed earlier, careful diligence lays the foundation for a successful transaction. The diligence may be conducted in stages, particularly in a complex transaction where there are gating issues, the resolution of which are critical to proceeding, or it may be conducted from the time of preliminary agreement on principal terms through the execution of definitive agreements. As detailed knowledge about an energy company's business or assets is critical to whether a transaction agreement reflects a complete understanding of the parties, conducting extensive diligence before critical negotiations involving the agreement (even, if possible, before a draft of the agreement is exchanged) is crucial. Conducting diligence after an agreement is executed, but before closing, relegates the diligence only to confirmation of a condition (e.g., that nothing bad exists) and is therefore only a technique for mitigating risk.

Diligence is the most effective if it is carefully orchestrated. To that end, the practitioner should prepare a diligence request list that sets out for the opposing party all of the items they and their client expect to review as a part of the diligence process. These lists are usually fairly extensive and broad, which normally results in some negotiation between the parties over what information will be produced. The list itself, however, does not produce good diligence. The execution of the review and the organization of the reviewers are the keys to good results. Thus, a practitioner is often well served to accompany younger lawyers and consultants to the first diligence meeting and to conduct interviews with those responsible for providing the material responsive to the diligence request. Also, the more organization in the review and the clearer the instructions for a reviewer, the better the end product of the diligence will be. Reviewers work well when broken up into teams, provided with training and background on the types of materials they will review and instructed to complete review forms tailored to the material reviewed. For complex contractual reviews, such as matters relating to rights of way, oil and gas leases, and transportation and sales contracts, a good practice is to provide supervision of the reviewers by one who is experienced in the area. For this reason, practitioners should consider hiring an independent contractor to assist in the process, such as a land-man. A sample of diligence list items appears as Appendix E.

Conduct an "All Hands" Meeting

As a general rule, the parties to a transaction will always benefit from an "all hands" or organizational meeting to kick off the transaction. The right time for this gathering often depends upon the dynamics of the relationship between the parties, but a practitioner should resist meetings that are premature (i.e., before there is a clear indication of interest from both sides). The ideal all hands meeting occurs contemporaneously with an exchange of one or more of the term sheet, the structure diagram, the time and responsibility list, and the diligence request. Either a term sheet or a structure diagram should be a prerequisite.

The first meeting of the principals and their advisors is an extraordinary opportunity for a practitioner to create a positive agreement-oriented process rather than an adversarial one. The meeting provides an easy environment for the first success of the parties by an agreement upon the process under which they will move forward. Thus, although the parties may not reach agreement on all of the terms in a term sheet or the scope of diligence information to be produced, they will come together on a process that will become the roadmap for the legal documentation and the other items that need to be accomplished to complete the transaction. An agenda for an organizational meeting appears as Appendix F.

Draft and Negotiate the Definitive Agreements

The culmination of the discussions on terms, the development of the structure, and the diligence review is one or more definitive agreements covering the transaction. Invariably, controversy will spring up after the first distribution of these drafts, no matter how complete and negotiated the term sheet. For that reason, many seasoned practitioners will insist that the first meeting on the drafts be among counsel only and that counsel develop an issues list at that meeting that will go back to the principals. Limiting the session to counsel prevents the principals from becoming entrenched in their positions, and it avoids overreactions to the unexpected but inevitable issues that were not covered by the term sheet. The meeting among counsel also affords each counsel an opportunity to submit a prioritized issues list to a client, together with proposed resolutions, all in a controlled environment. The deal-maker is then given the luxury to review the sum of the issues at one time, after which he or she can craft a formulation of responses to those issues in a careful and measured fashion. The goal of this "shuttle diplomacy" is to promote compromise on all of the less important issues and reserve the in-person meeting of the principals to what are truly "deal points." Of course, sifting through the issues list for the deal points demands a command of the fundamentals applicable to the client's energy business—meaning, equally, fundamentals applicable generally in the energy industry and those particular items that were uncovered in the diligence review. The accomplished energy practitioner will in these instances be guided by experience and will reap the rewards of the first five steps in the process.

Conclusion

A successful energy concern is always composed of a group of team-oriented individuals who focus diverse expertise on the common enterprise goal. An energy law practitioner is well advised to emulate this model. The material above suggests several techniques for the practitioner to consider in the representation of a transaction party. The materials also emphasize how important it is for the energy practitioner to know the energy industry. Each of these items is important to a practitioner's success. No technique, process, or command of industry know-how, however, will compensate for a practitioner's failure to recognize the importance of team-based values to the success of transaction execution. Lawyers are sometimes notorious for zealously guarding expertise and knowledge, as if they were trade secrets. The combining of information and knowledge that is brought to bear on an energy transaction demands the energetic cooperation of team members that arises from the sharing of experience and knowledge. There are many examples of fundamental terms in an energy transaction that were only inserted as a result of the diligence work of a first-year lawyer. Good deals are made not by well-crafted words, but by well-managed deal teams.

Mark Zvonkovic is a partner of Akin Gump Strauss Hauer & Feld LLP. He received his B.A. in 1972 from Boston University and his J.D. in 1977 from Southern Methodist University, where he was the editor in chief of the Southwestern Law Review.

Mr. Zvonkovic represents companies engaged in the energy and specialty chemical sectors, private investment funds investing in those sectors, and investment banks and financial advisors performing services for companies operating in those sectors. As part of his practice in the energy sector, he has engaged in numerous transactions involving partnerships and limited liability companies, and he has advised clients with respect to the structuring of specialty financial instruments involved in complicated acquisition, joint venture, and reorganization transactions.

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