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The Top 5 Traps in Energy M&A Transactions
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Energy M&A transactions require counsel with specialized knowledge of the energy business, project or portfolio of projects being acquired or sold. Such knowledge requires deep understanding of the energy industry across many legal disciplines, including general corporate, tax, energy regulatory, environmental, health and safety, employee benefits, real estate and often international. Without this understanding, parties to energy M&A transactions may find themselves hindered by the following common problems.

1. Lack of a Broad Knowledge Base

The energy industry is highly complex, with varying market structures and regulations throughout the world. As a result of this complexity—particularly the energy, environmental, health and safety, and other regulations affecting the industry—energy M&A transactions are rife with risk that is difficult to identify, navigate and understand. Failure to adequately identify and understand the level of risk involved in a transaction may result in dire consequences, including overvaluation of the business or assets being acquired, limitations on the intended use of the assets after closing, fines, penalties and other unforeseen liabilities.

While some issues may be common to the energy industry or a specific segment thereof, issues and risks more often than not vary across the industry, or even a segment of the industry, based on location and the type of business or asset. For example, the power generation business is subject to completely different regulations and market structures depending on the state and region where a power plant is located. Some parts of the United States have regulated markets, and others have deregulated markets. The nature of these markets may differ substantially depending on the structure, rules and regulations established by the relevant Independent System Operator or Regional Transmission Organization, the applicable state's public utility commission (PUC) and the Federal Energy Regulatory Commission (FERC).

Further, natural gas fired, coal fired, wind, solar and biomass power projects each have their own unusual issues, risks and concerns. The power generation business is but one example. The energy industry as a whole is exceptionally complex, and each business, asset and jurisdiction—regardless of the energy industry segment—will often have unique regulations, rules and market structures.

The energy industry is further complicated by the commercial arrangements in which energy businesses are involved. The large capital outlays involved in these transactions warrant a detailed due diligence review that complements the business team's evaluation of the business being purchased, including complex project finance documents; performance and efficiency guarantees (*e.g.*, heat rates, availability guarantees and other performance metrics); tying input and output risks; hazardous substance arrangements; gathering, processing and refinement of hydrocarbons; transportation agreements; and interconnection and transmission rights and agreements. To ensure a successful M&A transaction, the person performing this review should have the knowledge necessary to identify the pertinent information, issues and risks associated with these industry-specific complex commercial arrangements.

2. Misunderstanding Risks Involved with Project Based Assets

Many energy industry M&A transactions involve projects, portfolios of projects or development assets. The value of each individual project is driven by the cost of its operation, including fuel supply, and the revenue generated by its assets. The due diligence process should evaluate each side of this equation in order to provide a clear picture of the legal, regulatory and economic health of the project. In addition, projects often have their own financing, interconnection rights, permits and real property rights, each of which may have a material impact on the operation or performance of the project. Finally, development assets present their own risks and vary depending upon the relevant assets' development stage. Special care should be given to identifying and analyzing the risk associated with the completion, construction, commissioning and operation of such assets.

Fuel supply, warranty agreements, operation and maintenance, and other material agreements affecting the cost of performance should be reviewed and evaluated to determine the legal, regulatory and commercial risk involved in such agreements, including potential increases in the cost of the performance of the project over time, anticipated deterioration in performance, and the adequacy of fuel supply, replacement parts and other inputs. This analysis should include the identification of material exposure or weakness in these commercial arrangements, including issues in availability guarantees, response times, fuel delivery, minimum commitments for parts or fuel, and other hidden costs.

A project's revenue contracts are crucial to the value being assigned to a project. Performance guarantees, credit support requirements and credit exposure, off-takers' rights to refuse performance, early termination rights and the allocation of risk between the parties for *force majeure*, curtailments and other uncontrollable risks must be indentified and understood in order for the business team to evaluate the project's revenue stream.

Project companies are often subject to other legal or commercial arrangements that affect their operation and performance, including project financings, transmission or transportation agreements, interconnection agreements, permits and real property rights. The covenants in these various agreements can influence the project company's ability to operate its assets and perform its obligations under its fuel supply and revenue contracts. Therefore, material issues within such arrangements should be identified and analyzed when assessing the overall value and risk associated with the project.

Finally, energy M&A transactions often involve the acquisition of development assets. In these situations, the purchaser often assumes the additional risk that the project will be capable of being completed. The due diligence process is critical in evaluating the level of development and other work that must be completed before the project can be constructed, commissioned and placed into service. This includes evaluating the risk of delay in obtaining permits and other governmental authorizations; completion of the project interconnection; and obtaining adequate transmission, transportation or other rights necessary to timely complete the project.

3. Difficulty Identifying Energy Regulatory Issues

The energy industry is highly regulated and requires numerous local, state and federal licenses, permits and approvals in order to operate. A business may be the subject of enforcement or other proceedings in front of FERC, a state PUC or another regulatory commission. Regulatory issues and material proceedings affecting a business or transaction should be identified in the due diligence process and adequately addressed and understood by the parties prior to entering into the purchase and sale agreement.

The regulatory knowledge required for an energy M&A transaction will depend on the business or assets being purchased and acquired, and the jurisdiction in which they are located. For example, M&A transactions involving interstate natural gas pipeline projects will require FERC experience that differs from the FERC experience required for M&A transactions involving power generation and transmission assets. Additionally, each state adds its own regulations through legislation, PUCs, railroad commissions or other authorities. Accordingly, the regulatory advice needed for a transaction will depend upon the nature of the business being purchased and sold, and the location of its assets.

Finally, regulatory approvals and notices may be required for certain types of M&A transactions. For example, Section 203 of the Federal Power Act requires FERC authorization for mergers, dispositions and acquisitions involving electric generation and transmission companies. Section 1289 of the Energy Policy Act amended section 203 of the Federal Power Act and expanded FERC's authorities and requirements. The right regulatory advice can be critical to navigating these and other approvals and authorizations.

4. Missing the Full Legal Picture

The laws and regulations affecting the energy industry go beyond the energy regulatory regime and include environmental, health and safety, tax, employee benefits and real property issues. Therefore, energy infrastructure M&A transactions often require the support of skilled professionals in environmental, health and safety, tax, employee benefits and real estate law in order to provide a complete picture of the risks to a business or project.

Coal, natural gas and nuclear power plants, as well as upstream, midstream and downstream oil and gas assets, all are faced with their own unique environmental challenges, including emission permits, potential carbon and frac fluid regulation, and pre-existing conditions and liabilities associated with releases of mercury, petroleum, radiation and other potentially environmentally hazardous substances. Even renewable energy projects face stringent environmental regulations related to preserving wetlands and mitigating the impact a project may have on animal and plant life. Equally important is the identification and analysis of issues relating to the health and safety of workers; the tax structure of the transaction; depreciation rights; and, in the context of renewable or nuclear energy projects, qualification for tax credits and treasury grant programs, ERISA, employee benefit liabilities and real property rights. Accordingly, knowledge covering a wide range of the law is necessary for a complete picture of the risks and liabilities involved in an energy M&A transaction.

5. Inadequate Identification of International Exposure

Oil and natural gas are global commodities, and energy companies frequently do business around the world. Accordingly, energy M&A transactions often involve projects, assets or businesses located in foreign jurisdictions. The rules and regulations affecting the energy business vary widely around the globe, and local professionals should be engaged to assist with M&A transactions involving foreign operations in order to properly understand these differences. Similarly, international transactions may involve additional U.S. legal issues that should not be overlooked, such as compliance with the Foreign Corrupt Practices Act.

Conclusion

The market structure, regulations and commercial arrangements associated with the energy industry are complex and varied. The right skill and understanding of the business involved is crucial to successfully identifying, navigating and addressing the risks associated with energy M&A transactions.

The Top 5 Traps in Distressed M&A Transactions

by Nathan Coco

"The Chinese use two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger—but recognize the opportunity." John F. Kennedy, speech in Indianapolis, Indiana, April 12, 1959.

As a result of the contraction of the capital markets, it has become increasingly difficult for distressed corporate borrowers to refinance their existing debt facilities, recapitalize their businesses or even obtain the debtor-in-possession financing necessary to reorganize through bankruptcy. As a result, distressed sales—both inside and outside of bankruptcy—have become commonplace. Most distressed M&A transactions are structured as asset sales, rather than corporate mergers. By purchasing the assets of a distressed business, the purchaser is able to extricate and unburden the operating assets from the debts and liabilities of the distressed seller. The exigent circumstances surrounding distressed sales, the often-precarious relationship between the seller and its lenders, and the lack of meaningful strategic alternatives available to the seller place downward pressure on the purchase price and create the opportunity for value.

Commensurate with the opportunity for greater value, distressed M&A transactions also present greater risk, particularly execution risk. In many instances, the purchaser is dealing not with a willing seller, but with a coerced seller that is being forced to liquidate by its senior lenders. The purchaser may find the seller's principals to be recalcitrant, making it more difficult to get the deal done. Moreover, the distressed seller's creditors (most particularly, junior lien holders) may attempt to interfere with or scuttle the sale in order to gain leverage in their negotiations with senior lenders. Each of these risks can, of course, be managed, but any purchaser evaluating a distressed acquisition should be mindful of the following five traps.

1. Selecting the Right Process for the Acquisition

One of the most important decisions that a purchaser must make in connection with a distressed M&A transaction is how to implement the sale. Because every transaction is unique, a purchaser should give careful thought to the proper procedural approach. The decision may be driven by a myriad of factors, including (i) the nature and complexity of the business and its assets, (ii) the seller's need for and access to operating capital in the interim period prior to a closing, (iii) the extent and priority of the existing liens, (iv) the level of acrimony among creditor constituencies and (v) the time available to complete the transaction. Choosing the wrong approach may jeopardize or complicate the execution of the transaction.

Potential implementation options include (i) a bankruptcy sale pursuant to Section 363 of the U.S. Bankruptcy Code, (ii) a secured creditor disposition pursuant to Article 9 of the Uniform Commercial Code (UCC), and (iii) a receivership or assignment for the benefit of creditors (ABC). Each option has relative benefits and detriments. Although it is beyond the scope of this article to address the intricacies of each approach in detail, a broad overview the three basic approaches is helpful.

- **Bankruptcy Sale.** Bankruptcy sales provide a number of benefits that cannot be obtained outside of bankruptcy. The most significant benefit is that the assets are generally transferred to the purchaser free of all claims, liens and encumbrances, pursuant to Bankruptcy Code Section 363(f). The purchaser is given clean title and the benefit of a federal court order insulating the purchaser from successor liabilities and other claims and liens previously associated with the assets. In addition, the court is generally authorized under Section 365 of the Bankruptcy Code to effect an assignment of the debtor's executory contracts and unexpired leases to the purchaser even if they contain provisions purporting to prohibit assignment. However, compared to the alternative approaches discussed below, a bankruptcy sale can be tremendously expensive, somewhat unwieldy and relatively slow to implement.

- **UCC Article 9 Disposition.** A distressed asset sale can also be implemented through a secured creditor disposition under Article 9 of the UCC. The UCC authorizes a secured creditor to dispose of personal property by public or private sale. This is a non-judicial method of foreclosure and generally has the effect of discharging any junior liens and security interests on the assets, but it does not provide the breadth of protection conferred by a bankruptcy court "free and clear" order. An Article 9 disposition can be implemented relatively quickly (in a matter of weeks) and is cost effective in comparison to a Section 363 sale in bankruptcy. However, in some instances, going concern value may diminish during the foreclosure process based upon the reaction of the seller's employees, vendors and customers.
- **Receivership or Assignment for Benefit of Creditors.** A receivership generally involves a judicial proceeding whereby the receiver is placed in control of the seller and its assets. An ABC is a non-judicial proceeding whereby the debtor assigns all legal and equitable title to its assets to a trust for the benefit of its creditors. The "assignee" (or trustee) is empowered to administer the trust estate for the benefit of the debtor's creditors. In each case, the receiver or assignee collects and liquidates the assets of the estate and distributes the proceeds to the appropriate creditors in accordance with their priorities. Generally speaking, neither a receivership sale nor an assignment discharges liens or security interests, but they can be used to sell assets under circumstances where a secured creditor consents to such sale, and the sale must be accomplished in a relatively short time period.

2. Multi-Party Negotiations

Unlike a "healthy" M&A transaction, a distressed asset sale is not a transaction between the seller and the purchaser alone. This is especially true of a sale in bankruptcy. A purchaser in a distressed sale is often required to negotiate with and/or placate multiple constituencies, including (i) senior and junior lien holders, (ii) trade creditors, (iii) an unsecured creditors' committee, and (iv) a bankruptcy judge. Each of the seller's various creditor constituencies may have its own agenda, which may or may not be consistent with the purchaser's objectives in the transaction. Dealing with intransigent creditors requires both flexibility and resiliency on the part of the purchaser.

3. Rights of Senior Lien Holders; Credit Bidding

Of all the creditor constituents involved in or affected by a distressed sale, the most important from the standpoint of the purchaser is the seller's senior lien holders. It is critical that the purchaser reach an agreement with the senior lenders regarding the sale terms, and involve them in the process. Absent the consent and support of the senior lenders, the transaction is unlikely to succeed. In many instances, the seller cannot continue to operate pending a sale without the interim financing provided by the senior lenders. Furthermore, with respect to an Article 9 disposition, it is the senior lien holders who initiate the process. Even in the context of a bankruptcy sale, the Bankruptcy Code recognizes the right of a secured creditor to "credit bid" its debt at the auction.

4. Stalking Horse Protections

In most instances, distressed sales—both inside and outside of bankruptcy—are market tested and subject to higher and better bids. Accordingly, it is tremendously advantageous for a purchaser to act quickly at the outset and negotiate to become the stalking horse. Serving as the stalking horse gives a purchaser the inside track. The purchaser will generally be able to shape the auction procedures governing the sale. Those procedures not only protect the stalking horse's interests in the event it loses the transaction to another bidder (by providing a break-up fee and/or expense reimbursement, for example), the procedures can also provide the stalking horse with a strategic advantage.

5. Limited Due Diligence; Fewer Contractual Protections

In contrast to a "healthy" M&A transaction, a purchaser in a distressed sale is often given very little time to conduct due diligence and has substantially fewer contractual protections. Due diligence must be executed efficiently and expediently, focusing primarily on the mission critical aspects of the transaction. Also, under the typical distressed asset purchase agreement, the purchaser is not given meaningful rights of indemnification. The representations and warranties made by the seller are fewer and more narrowly tailored than in a healthy M&A transaction. Moreover, there is often no hold-back or escrow provided to the purchaser to protect against a subsequently revealed breach. In some cases, distressed asset sales are conducted on an express "as is, where is" basis with no representations at all.

For all of these reasons, it is incumbent upon the purchaser to factor the additional transaction risk into the purchase price offered to the seller, thereby striking the proper balance between "danger" and "opportunity."