PRIVATE EQUITY OIL & GAS TRANSACTIONS:

INSIGHTS FOR BUYERS AND SELLERS

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Sarah E. McLean, Shearman & Sterling LLP

ABOUT THE AUTHOR

Sarah McLean, a partner in Shearman & Sterling's Energy Transactions practice in Texas, has over 20 years of experience as a trusted advisor to private equity funds and management teams focused on the energy sector. She has represented them in connection with portfolio company investments, acquisitions and divestitures of upstream and midstream oil and gas assets and companies, formations of joint ventures, and various private equity transactions, project documents and operating agreements across the entire oil & gas value chain.

After growing up in northwest Oklahoma, she obtained a B.S. in Biochemistry and Molecular Biology, with honors, from Oklahoma State University and a J.D. from the University of Texas School of Law. Sarah and her children are active volunteers with Generation Serve and the recipients of the 2018 Wally Pilcher Family Volunteering Award.

Sarah can be contacted at sarah.mclean@shearman.com.

Preface

Private equity funds have supplied much of the capital injected into the oil and gas exploration and production sector over the last decade. These investors will typically seek to identify, acquire, operate, enhance, and ultimately exit from an investment within a defined investment period. Assembling a strong management team at the front end of an investment and maximizing returns with a clean exit at the back end are two key areas of focus for a typical private equity fund investor, and these points often drive considerations for the counterparties in private equity deals.

The intent of this chapter is to provide an overview of key concepts and provisions likely to be raised (other than with respect to tax provisions) when negotiating purchase and sale agreements (PSAs) with private equity-backed companies. The provisions discussed and solutions suggested in this chapter are not in any way meant to be exhaustive either as to the provisions that impact Buyers and Sellers who do business with PE Sellers or PE Buyers or as to the compromises with respect to such provisions, but are intended to assist counterparties that find themselves buying oil and gas assets from, or selling those assets to, private equity-backed entities.

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Introduction to Private Equity in the Energy Industry[*]

Private equity funds are pools of institutional money (from sources such as endowments, pension plans, foundations, and high net worth individuals) that typically invest in privately owned businesses. Some private equity funds target underperforming businesses and look for turnaround opportunities while others focus on backing top management teams who can build and grow a business from the ground up.

Private equity firms have raised more than $200 billion for energy investments since 2014, including at least $50 billion specifically for investments in shale drillers,[1] leading to a significant presence of private equity-backed companies on the buyer and seller sides of oil and gas transactions. If a counterparty in an acquisition transaction understands the private equity fund structure, business model, and strategic goals, it can more effectively negotiate a transaction that meets the needs of both parties.

The manager of a private equity fund (generally the general partner of the fund) is paid both a management fee from the institutional investors and a carried interest after certain investment returns are met. The investment returns at the private equity fund level generally require a specified internal rate of return to have been generated on the institutional money prior to the carried interest being paid to the general partner.

In the oil and gas industry, the portfolio company structure is a common investment structure for a private equity fund. In this structure, the private equity fund invests equity capital in an entity jointly owned by the private equity fund and a team of experienced industry professionals (the management team). This jointly owned entity is called the portfolio company. The management team usually makes an equity commitment that is personally meaningful to them but a small portion (typically 1% - 10%) of the equity commitment of the private equity fund. The management team is generally compensated by the portfolio company in the form of a modest salary and bonus (modest when compared to the salary, bonus, stock incentive plans, severance arrangements, and other benefits provided to public company executives) and further incentivized by an equity incentive interest known as a "carried interest" or "profits interest." This incentive interest is paid to the management team out of the net proceeds of the portfolio company after the capital members (i.e., the private equity fund and the management team with respect to their capital) earn certain investment returns, called the "waterfall."[2] The investment returns require a certain internal rate of return or a certain return on investment, or a combination of an internal rate of return and a return on investment.

An internal rate of return represents the average annual return generated by an investment. A return on investment is simply a multiple of the invested capital. Time matters when calculating an internal rate of return but not when calculating a

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[*] Sarah E. McLean, "Considerations for Oil and Gas Transactions Involving Private Equity-Backed Buyers and Sellers," 65 *Rocky Mt. Min. L. Inst.* 6-1 (2019).

[1] Collin Eaton, "Private Equity Poised for Oil Growth as Public Companies Pull Back," *Houston Chronicle* (Mar. 30, 2018).

[2] Although certain private equity portfolio company structures do not include the management team paying part of the incentive interest with their equity, in the author's experience that is a less common structure. This can be an important feature, among many other important terms, on which a management team should focus when the team is comparing term sheets and waterfalls from multiple private equity funds. Oftentimes, the comparison is not "apples to apples" because of the various approaches taken by different private equity funds.

return on investment. Both the general partner of the private equity fund and the management team of the private equity portfolio company have to generate sufficient profits over time to reach the target return on investment numbers in order to earn their carried interest or equity incentive interest.

Management teams seek funding from private equity funds for various reasons, including the team's lack of expertise or scale to raise equity funding directly. The capital provided by a private equity fund to a management team comes with certain costs (e.g., the embedded cost of capital, lack of control over funding and other material business decisions, time commitments, and non-compete restrictions); however, management teams perceive the value of their relationship with a private equity fund to outweigh those costs. In addition to the source of capital and the potential monetary benefits to be derived from profits interests, management teams are interested in teaming with private equity funds to assist with deal origination, to take advantage of the private equity fund's relationships with banks and other sources of financing, and to obtain the benefits of the general support provided by representatives of the private equity fund.

Given that background, what factors are important to private equity funds and their portfolio companies when they are buying or selling oil and gas assets (in addition to those things that are important to every buyer and seller of oil and gas assets such as geology, land and operational diligence, and economics)? A few of the key factors are 1) the speed at which the transaction can be consummated, 2) understanding (and limiting) the obligations the portfolio company is assuming or retaining in connection with the transaction, and 3) maintaining legal and contractual separation between the portfolio company involved in the transaction and the private equity fund and its other portfolio companies.

Nomenclature

In this paper,

"Assets" means oil and gas assets that are the subject of a purchase and sale transaction;

"Buyer" means a generic buyer (which could be private equity backed, strategic, or other);

"GP" means the general partner (or manager) of the PE Fund;

"Management Team" means the team of professionals who obtain funding from the PE Fund and are responsible for the day-to-day operations of a Portfolio Company;

"Parent" means, whether one or more, any entity below the PE Fund but above PE Seller or PE Buyer in its structure;

"PE Buyer" means a Buyer that is backed by a PE Fund;

"PE Fund" means a private equity fund;

"PE Seller" means a Seller that is backed by a PE Fund;

"Portfolio Company" means the company formed by the PE Fund and the Management Team;

"PSA" means the acquisition agreement between a PE Seller and Buyer or between a PE Buyer and Seller;

"Seller" means a generic seller (which could be private equity backed, strategic, or other); and

"Subsidiaries" means controlled subsidiaries of a PE Buyer or a PE Seller.

Private Equity Transactions as Buyer

Introduction

Although selling a package of Assets to a PE Buyer involves risks that can make a Seller apprehensive, there can be benefits. For one, a PE Buyer usually has a small staff and the acquisition transaction is likely the most important project on which the relevant members of the staff are working. PE Buyers also can, and are motivated to, move quickly and they have fewer levels of approval than a larger company—in fact it is often the ultimate decision makers who are leading the negotiations.[3] The benefits can equal or outweigh the risks if a Seller keeps in mind the structure of the PE Buyer and the PE Buyer's thought process and motivation. PE Buyers look at acquisition opportunities through the lens of a three to five year exit, and the knowledge that they will desire to sell the Assets in that time frame guides decisions they make with respect to the acquisition and the PSA. When negotiating a PSA with a PE Buyer, there are a number of issues of which to be mindful.

"PE Buyers look at acquisition opportunities through the lens of a three to five year exit, and the knowledge that they will desire to sell the Assets in that time frame guides the decisions they make with respect to the acquisition and the PSA."

Confidentiality Agreement

When marketing a package of Assets, a Seller will require each potential bidder or Buyer to execute a confidentiality agreement pursuant to which the potential bidder or Buyer agrees to keep all information relating to the Assets confidential, to limit the use of the information, to not circumvent the Seller with respect to the transaction, and in certain circumstances, to not compete with the Seller in and around the Assets (perhaps with a top lease prohibition or an AMI concept) and not solicit the Seller's employees[4]. To fully protect itself and its Assets, a Seller will want such restrictions to apply to the Buyer and its "affiliates."

While a PE Buyer will be able to bind itself and its Subsidiaries and Parent,[5] it will not be willing to bind the PE Fund or other Portfolio Companies of the PE Fund to either the confidentiality provisions or the restrictive covenants contained in a confidentiality agreement. With respect to the confidentiality provisions, many PE Buyers will provide for this explicitly, with language similar to the following:

> **Without any prejudice to any provision herein to the contrary, Disclosing Party expressly acknowledges that (a) PE Fund, a significant owner of Receiving Party, is in the business of organizing and managing venture capital funds for the primary purpose of making equity related investments in the upstream sector of the oil and gas industry in the United States and Canada; (b) PE Fund, in the course of managing its**

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[3] Depending on the PE Fund and the materiality of the transaction, the Buyers (and Sellers) may find that representatives of the PE Fund itself, as opposed to members of the Management Team, serve as lead negotiators.

[4] Employee non-solicitation provisions must fall within the anti-poaching guidelines published by the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission. *See* U.S. Dep't of Justice & Fed. Trade Comm'n, "Antitrust Guidance for Human Resource Professionals." (Oct. 2016).

[5] Whether a party to a contract can, as a matter of law, bind an affiliate of that party that is not a party to such contract is beyond the scope of this paper. Concerns in this regard are similar to the concerns underlying the no-recourse clauses. In any event, the contracting party could be in breach of the contract on account of actions taken by its affiliate that are contrary to the provisions of the contract.

funds business, is presented with and evaluates numerous investment opportunities, including opportunities presented by entities that are or may be deemed competitive with Disclosing Party's business and operations ("*Investment Candidates*"); (c) PE Fund currently has outstanding, and will hereafter make, investments in entities engaged in oil and gas exploration and production activities or in the gathering, processing, and transporting of oil, gas, and other hydrocarbons ("*Portfolio Companies*"), including entities that are or may be deemed competitive with Disclosing Party's business and operations; (d) PE Fund's investment in a Portfolio Company may control such entity; (e) representatives of PE Fund frequently serve on the board of directors (or comparable governing body) of a Portfolio Company; and (f) a Portfolio Company may currently be evaluating or pursuing, or in the future may evaluate or pursue, investment opportunities that Disclosing Party is or may evaluate or pursue. In view of the foregoing, Disclosing Party agrees that: (i) neither Receiving Party nor any representative of Receiving Party has an obligation or duty to disclose to such Disclosing Party whether any Investment Candidate or Portfolio Company that has not received the Confidential Information, is or may pursue an investment opportunity the Disclosing Party is pursuing or otherwise engaging in activities that are or may be deemed competitive with the Disclosing Party's business or the Assets, (ii) provided Receiving Party complies with the terms of this Agreement (and their representatives comply with the applicable terms of use or confidentiality set forth herein), the mere knowledge (without disclosure) of all or any portion of the Confidential Information by Receiving Party or its representatives shall in no way be imputed hereunder to (A) any Investment Candidate, as a result of PE Fund's contact or involvement with such Investment Candidate or (B) any Portfolio Company, as a result of PE Fund's investment in such Portfolio Company or any representative's participation on the board of directors (or comparable governing body) of such Portfolio Company, and (iii) Receiving Party shall have no liability under this Agreement for the actions or activities of any Investment Candidate or Portfolio Company, absent a direct breach by Receiving Party or its representatives of the covenants and agreements contained herein.

"PE Buyers will likely first try to strike (restrictive) covenants in their entirety and second limit such covenants to be covenants of the PE buyer and its Subsidiaries and Parent, specifically excluding the PE Fund and its Portfolio Companies and other affiliates (other than PE Buyer)."

With respect to the restrictive covenants, including any noncompetition and nonsolicitation provisions, PE Buyers will likely first try to strike such covenants in their entirety; if unsuccessful, PE Buyers limit such covenants to be covenants of the PE Buyer and its Subsidiaries and Parent, specifically excluding the PE Fund and its Portfolio Companies and other affiliates (other than PE Buyer). Management Teams are often sensitive to this issue because some PE Funds specifically prohibit them from contractually binding the PE Fund or any of its other Portfolio Companies (and include serious remedies if they do). Some reasons for this prohibition are practical—if a PE Fund has 20 Portfolio Companies, it would be almost impossible for the PE Fund to keep track of, and to keep each of its Portfolio Companies informed of, such restrictions. Also, if a GP has raised multiple PE Funds and has Portfolio Companies sponsored by each of those funds,

the GP could be in violation of its obligations to its investors if it allowed a Portfolio Company in one PE Fund to enter into a contract that is detrimental to a Portfolio Company in a different PE Fund. Other reasons are more strategic— PE Funds view their Portfolio Companies as independently managed entities and do not want the actions of one Portfolio Company to curtail the business activities of another Portfolio Company. And, increasingly, GPs sponsor more than one Portfolio Company with business plans in the same basin.

A Seller negotiating confidentiality agreements with PE Buyers should endeavor to ensure that the language relating to restrictive covenants binds the PE Buyer, its Subsidiaries, its Parent, and "any other affiliates with whom it shares the information."[6] The addition of this language should be acceptable to a PE Buyer because it likely will not intend to share the information with any other Portfolio Company. Such language will also give the Seller additional comfort that the confidential information will not be shared.

Financing; Deposit

Regardless of whether it has existing assets or is a newly-formed Portfolio Company, a PE Buyer will likely not have existing cash on hand or available borrowing under an established debt facility to fund the purchase price or a performance deposit. Rather, a PE Buyer will either have a documented equity commitment from the PE Fund that is not a firm commitment (that is, the PE Buyer's Management Team cannot draw on the equity commitment without approval by the PE Fund) or will still be negotiating the terms of, and documents relating to, its equity commitment from the PE Fund. This may lead a Seller to be less confident in a PE Buyer's ability to fund the purchase price for the Assets and close the transaction. The Seller may request that the PE Buyer provide a Parent guaranty for the PE Buyer's obligations under the PSA.[7]

It is common for a Seller to request that the PE Buyer deposit a portion of the purchase price for the Assets, either with the Seller or (more typically) in a third-party escrow account. Deposits have been trending upward since 2012[8] and typically range from 5% to 10% of the purchase price, with amounts up to 15% agreed to in select competitive processes. Deposits serve to provide security to the Seller that the PE Buyer is serious about the Assets and intends to close the transaction (absent a breach by the Seller or certain third-party intervention).

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[6] The PE Buyer may also include a provision clarifying that the "dual role" of a representative of the PE Fund who serves as a board member or officer of the PE Buyer and also as a board member or officer of another Portfolio Company does not imply that such Portfolio Company may be deemed to have received confidential information except to the extent such confidential information is actually provided to such Portfolio Company.

[7] Parent guaranties from PE Funds are not common because most PE Funds are either prohibited from guaranteeing the obligations of their Portfolio Companies by their fund documents or they are hesitant to assume liability for obligations for which they otherwise would have no liability. The PE Fund and PE Buyer will argue that the performance deposit provides sufficient exposure for the PE Buyer.

[8] Steven P. Otillar et al., "Private Equity in Upstream Oil & Gas Transactions," 70 *Inst. on Oil & Gas L.* 211, 238 (Ctr. for Am. & Int'l L. 2019).

In a transaction not involving a PE Buyer, the deposit is typically funded contemporaneously with the execution of the PSA. This timing can be problematic for a PE Buyer because, since the internal rate of return starts to accrue on the deposit (both at the PE Fund level and the PE Buyer level) when the funds are called from the PE Fund investors and deposited with the PE Buyer, respectively, the Management Team and the GP are hesitant to call such funds until signing the PSA is a certainty or almost a certainty.[9] Compounding this issue, PE Fund investors typically have at least 10 business days to fund capital calls.

This issue can be addressed by drafting the PSA so that the deposit is not due until a certain number of days after the PSA is signed. If that type of provision is used, then the Seller should consider whether there is an additional incentive to offer the PE Buyer to fund the deposit as quickly as possible and should have a unilateral right to terminate the PSA if the deposit is not funded on or before the negotiated due date. One additional incentive for the PE Buyer to fund the deposit prior to the negotiated due date is a construct that includes a fixed period after signing the PSA for the PE Buyer to perform its title and environmental due diligence (such as 45 or 60 days after signing the PSA) and an acknowledgment from the PE Buyer that it may not access any of the Assets or the Seller's office or files to conduct such due diligence until the deposit has been funded. This incentivizes a PE Buyer to fund the deposit as quickly as possible so that it can begin its due diligence and take advantage of the full diligence period.

[9] In addition, the PE Fund may not want to call capital from investors until PSA execution is a near certainty because the PE Fund, depending on its terms, may not be able to call that capital from its investors again even if it is promptly returned to the investors.

“Thus, a Portfolio Company who is a PE Buyer desires to minimize obligations it assumes with respect to its acquisitions so there are fewer liabilities it has to take into consideration when it is exiting the Assets and winding-down its existence.”

Hedging

In order to make the economics work for a potential acquisition, a PE Buyer may desire to de-risk the transaction by putting commodity price and/or interest rate hedging arrangements in place upon the signing of the PSA. This is problematic for a PE Buyer, however, because it may not have other assets or agreements in place to support such hedging activities. Thus, a PE Buyer may request that Seller put hedges in place and novate them to the PE Buyer at closing. If a Seller agrees to this arrangement, it should ensure that the PE Buyer pays the costs of arranging such hedges (this can be in the form of a purchase price adjustment at closing). If the transaction does not close, and the failure of the transaction to close is not the result of a breach by the Seller of the PSA, then the Seller should be completely reimbursed by the PE Buyer for the costs of arranging and terminating such hedges, with language similar to the following:

> **If (i) this Agreement is terminated for any reason, and (ii) Seller has not willfully failed to perform or observe its material covenants and agreements, Buyer shall pay to Seller an amount equal to the total cost, expense and, if applicable, loss, incurred by Seller to terminate any Seller Hedge within five days after the termination of this Agreement, including both the administrative costs associated with terminating such Seller Hedges and any actual loss incurred by Seller as a result of placing, and then terminating, such Seller Hedges.**

If a Seller is amenable to putting hedges in place upon the signing of the PSA, the Seller should further consider requiring the PE Buyer to deposit additional funds into escrow at the signing of the PSA to support this potential obligation.

Assumption of Obligations

Sellers selling to PE Buyers may be surprised at the hesitancy of PE Buyers to assume pre-effective time obligations, especially given the stance that PE Sellers generally take with respect to retaining obligations when they sell the Assets. However, as previously highlighted, from the time a PE Fund forms a Portfolio Company, both the PE Fund and the Management Team act and make decisions with the ultimate exit from the Portfolio Company’s assets in mind. Thus, a Portfolio Company that is a PE Buyer desires to minimize obligations it assumes with respect to its acquisitions so there are fewer liabilities it has to take into consideration when it is exiting the Assets and winding-down its existence.

While this should not be a point that is a deal driver, and most PE Buyers will not walk away from a good acquisition opportunity over it, there are some compromise constructs both a PE Buyer and a Seller may want to consider.[10] For example, if the PE Buyer has completed its diligence on the Seller and its operations and is comfortable with the level of care and diligence with which the Seller conducts its business, the PE Buyer may assume pre-effective time obligations (subject to customary carveouts) only with respect to the Seller’s period of ownership and operation. The Seller

[10] These compromise constructs are not common.

would remain responsible for any obligations it assumed when it purchased the Assets.

Termination Remedies

In order to place a cap on its exposure in the event that a PE Buyer is obligated to close a purchase of Assets under a PSA but fails to do so, the PE Buyer will often insist that the performance deposit is the Seller's sole and exclusive remedy (as liquidated damages) on account of that breach. Accordingly, the PE Buyer will resist specific performance remedies or exposure to damages over and above the amount of the performance deposit. A Seller may argue that this converts the Asset purchase from a firm obligation to an "option"; however, the size of the performance deposit should serve as a significant deterrent for PE Buyer to fail to close in this context, particularly when considered in light of the internal rates of return required to be earned on funding provided by PE Fund investors and the fact that the loss of the performance deposit will have to be made up from other investments by the PE Buyer.

No-Recourse Clauses

PE Funds have grown increasingly concerned about extra-contractual liability arising from "equitable and tort-based theories asserted by a disappointed counterparty seeking recourse from persons with whom it did not contract."[11] As a result, in PSAs involving PE Buyers (and PE Sellers), the "no recourse clause" has become a common request by PE Buyers (or PE Sellers) and expected by, and acceptable to, most Sellers (and Buyers). The purpose of the "no recourse clause" is to "expressly limit the [S]eller's recourse for any breach of the [PSA] to the named [PE Buyer] and to constrain the [S]eller contractually from seeking to otherwise avoid the statutory liability shield and seek recourse directly against any affiliate of the [PE Buyer] (i.e., the [PE Fund])."[12] An example of a no recourse provision is as follows:

***No Recourse Against Nonparty Affiliates*. All claims, obligations, liabilities, or causes of action (whether in contract or in tort, in law or in equity, or granted by statute) that may be based upon, in respect of, arise under, out or by reason of, be connected with, or relate in any manner to this Agreement, or the negotiation, execution, or performance of this Agreement (including any representation or warranty made in, in connection with, or as an inducement to, this Agreement), may be made only against (and are those solely of) the entities that are parties to this Agreement ("*Contracting Parties*"). No Person who is not a Contracting Party, including without limitation any director, officer, employee, incorporator, member, partner, manager, stockholder, affiliate, agent, attorney, or representative of, and any financial advisor or lender to, any Contracting Party, or any director, officer, employee, incorporator, member, partner, manager, stockholder, affiliate, agent, attorney, or representative of, and any financial advisor or lender to, any of the foregoing ("*Nonparty Affiliates*"), shall have any liability (whether in contract or in tort, in law or in equity, or granted by statute) for any claims, causes of action,**

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11 Glenn D. and West & Natalie A. Smeltzer, "Protecting the Integrity of the Entity-Specific Contract: The 'No Recourse Against Others' Clause—Missing or Ineffective Boilerplate?" 67(1) *Bus. Law.* 39, 39 (2011).

12 *Id.* at 66.

obligations, or liabilities arising under, out of, in connection with, or related in any manner to this Agreement or based on, in respect of, or by reason of this Agreement or its negotiation, execution, performance, or breach; and, to the maximum extent permitted by law, each Contracting Party hereby waives and releases all such liabilities, claims, causes of action, and obligations against any such Nonparty Affiliates. Without limiting the foregoing, to the maximum extent permitted by law, (a) each Contracting Party hereby waives and releases any and all rights, claims, demands, or causes of action that may otherwise be available at law or in equity, or granted by statute, to avoid or disregard the entity form of a Contracting Party or otherwise impose liability of a Contracting Party on any Nonparty Affiliate, whether granted by statute or based on theories of equity, agency, control, instrumentality, alter ego, domination, sham, single business enterprise, piercing the veil, unfairness, undercapitalization, or otherwise; and (b) each Contracting Party disclaims any reliance upon any Nonparty Affiliates with respect to the performance of this Agreement or any representation or warranty made in, in connection with, or as an inducement to this Agreement.[13]

Transition Services

If a newly formed Portfolio Company is a PE Buyer, it likely will not have a full staff ready to take over operations of the Assets upon the closing of the PSA, including both oil and gas operations and accounting and back-office functions. Thus, during the negotiation of the PSA, the Seller in such a transaction should expect the PE Buyer to request that the Seller perform a menu of transition services for a period of time after the closing. The fees paid by the PE Buyer for such transition services typically only cover the Seller's costs (and thus are not a source of income for the Seller). Therefore, the Seller should consider whether its post-closing plans require its immediate attention or whether it would have the capacity to perform such transition services for the PE Buyer.

13 *Id.* at 71-72.

Private Equity Transactions as Seller

Introduction

The ultimate goal of a GP is to maximize the PE Fund's return on its investors' money and thus maximize the carried interest earned by the GP. And with the waterfall structure typical of a Portfolio Company, the ultimate goal of a Management Team is to maximize the return on the PE Fund's investment in the Portfolio Company and thus maximize the carried interest received by the Management Team. While critical factors for achieving such investment returns, such as land expertise and operational execution, are not related to the sale documentation or negotiations, when a PE Seller is in a position to sell its Assets, it can solidify such investment returns during the sale documentation and negotiation phase by ensuring that the PSA is executed and closed quickly, that there is certainty of closing, and that potential clawbacks to the negotiated consideration are limited. When negotiating a PSA with a PE Seller, there are a number of issues of which to be mindful, including those discussed in this section.

"While critical factors for achieving such investment returns, such as land expertise and operational execution, are not related to the sale documentation or negotiations, when a PE Seller is in a position to sell its Assets, it can solidify such investment returns during the sale documentation and negotiation phase by ensuring that the PSA is executed and closed quickly, that there is certainty of closing, and that potential clawbacks to the negotiated consideration are limited"

Representations and Warranties

PE Sellers are generally willing to give a Buyer a comprehensive set of representations and warranties (probably a more comprehensive set than a Buyer would get from a major or large independent), but there are some that can be troubling, not because of hidden disclosure issues, but because the Seller is a PE Seller. For example, a Buyer may request a representation with respect to financial statements. This can be problematic for a number of reasons, including that the PE Seller's financial statements are consolidated with other entities or assets, or the PE Seller is a newly-formed entity and has not been in existence for a full audit cycle. Another example is the corporate records representation. Portfolio Companies typically operate relatively informally and may not have robust corporate records and minute books. These representation issues do not usually require lengthy negotiations or significant concessions from either side.

More troubling from a PE Seller's perspective are representations that could cause an erosion of value after the closing and that the PE Seller views as a due diligence issue that should be determined prior to closing. Thus, PE Sellers are usually not willing to give title representations (and may argue that consent and preferential right to purchase representations are title matters that the Buyer should get comfortable with based on its own due diligence) and, if willing to give at all, are generally only willing to give limited environmental representations with heavy qualifications that require knowledge and materiality to constitute a breach. PE Sellers otherwise believe that title matters and environmental matters should be handled through the diligence process.

Title and Environmental Matters

The remedies in a PSA for title and environmental defects typically include 1) disputing the existence of the defect, 2) reducing the purchase price by the defect value, 3) curing the defect, and 4) removing the defective property from the Assets, and the Buyer and Seller often negotiate which party has the right to elect the remedy. With respect to title defects, Sellers believe that the ability to choose a remedy keeps Buyers from asserting fringe defects that may not be clear defects in title because the Buyer will

run the risk that the Seller removes the property from the sale transaction. Conversely, Buyers want the ability to choose a remedy so that the purchase price they pay matches the value of the Assets determined by their diligence.

PE Sellers, who are typically exiting their entire position in an area, may feel more strongly about negotiating for the ability to choose a remedy than other Sellers. PE Sellers do not want a Buyer to be able to pick and choose properties to exclude from the sale because after the sale, the PE Seller likely will not have the staff to manage any remaining properties. Thus, a PE Seller will often compromise in other provisions relating to title defects so that it can retain the ability to choose the remedy for defects. Some common compromises include that a PE Seller cannot exclude a property unless the defect value exceeds a certain percentage of the allocated value of that property. This protects the Buyer from the PE Seller excluding properties with minor defects that the Buyer needs for its business plan after the closing. It is also acceptable to a PE Seller because the PE Seller does not want to exclude properties other than in extreme circumstances. Another compromise gives the PE Seller some period of time after closing to cure an asserted defect and if the asserted defect cannot be cured, the purchase price is reduced by the value of the defect (which is generally the Buyer's preferred remedy in almost all circumstances).

"PE Sellers, who are typically exiting their entire position in an area, may feel more strongly about negotiating for the ability to choose a remedy than other Sellers."

Both Buyers and Sellers view environmental defects differently from title defects. Buyers do not want to be in the chain of title of properties with significant environmental issues, especially if that property is not vital to the Buyer's business plan after the closing. PE Sellers do not want to be stuck with properties at all, but they especially do not want to be stuck with properties with environmental issues that they have no staff, experience or resources to address. This issue is compounded by the fact that the cost of remediating an environmental defect can greatly exceed the value allocated to the defective property in the PSA.

As with title defects, PE Sellers remain determined to be the party that chooses the remedy to address the environmental defect. The choices are typically the same choices for remedying title defects, but there are sometimes thresholds that must be met (or not be met) before a certain remedy can be chosen. Similar to title defects, it might be that the PE Seller cannot exclude a property from the transaction unless the defect value exceeds a certain percentage of the allocated value of that property.

Given that the cost of remediating an environmental defect can far exceed the allocated value of the affected property, and the fact that when asserting defects, Buyers typically overestimate remediation costs, a PE Seller is hesitant to agree to a purchase price reduction for environmental defects. Moreover, since a Buyer does not want to acquire a defective property and a PE Seller does not want a defective property excluded, a typical outcome for environmental defects is that the PE Seller remedies the defect prior to it being conveyed to the Buyer (or, if the defect is a permit or more technical defect, after it is conveyed).

Certainty of Closing

As noted, PE Sellers are motivated to execute on a sale transaction quickly. And, because of the small size of the staff at most Portfolio Companies, the process of negotiating a PSA, working with the Buyer on diligence and

operational issues, and generally working the transaction, takes most of the time of a significant number of team members. Thus, when a PE Seller signs a PSA, it wants closing to be a near certainty, only subject to a significant material issue with respect to the PE Seller or the Assets.

Conditions to the Buyer's obligations to close are typically drafted such that the only ways the Buyer is not obligated to close is if 1) the Seller has materially breached a material representation or warranty, 2) the Seller has materially breached an interim covenant, 3) a third party has filed an action to stop the transaction, or 4) there are unresolved title issues, environmental issues, exercised preferential rights to purchase and casualty losses between signing the PSA and closing the PSA in excess of a percentage of the purchase price (typically 10%-20%).

"Thus, when a PE Seller signs a PSA, it wants closing to be a near certainty, only subject to a significant material issue with respect to the PE Seller or the Assets."

With respect to the closing condition relating to a PE Seller's representations and warranties, a PE Seller may take the position that the typical language "**the representations and warranties of the Seller contained in this Agreement shall be true and correct in all material respects on and as of the Closing Date (other than any such representation or warranty that is made as of a specified date, which shall be true and correct as of such specified date),**" does not give it sufficient deal certainty because, pursuant to such language, a material breach of an immaterial representation would give the Buyer a right to terminate the PSA. Alternatively, a PE Seller may propose language such as the following, and draft the PSA so that if the Buyer is required to close over a breach of a representation, the Buyer would still be entitled to post-closing indemnity with respect to the breach:

> **The representations and warranties of the Seller contained in this Agreement shall be true and correct on and as of the Closing Date as if made on and as of such date (other than any such representation or warranty that is made as of a specified date, which shall be true and correct as of such specified date), except (i) for such breaches, if any, of representations and warranties (without regard to any Material Adverse Effect (which will instead be read as any adverse effect or change), "materiality," "material," or similar qualifier) as would not individually or in the aggregate reasonably be expected to have a Seller Material Adverse Effect or a Material Adverse Effect on the Assets, taken as a whole, and (ii) as affected by actions specifically permitted by this Agreement.**

Sometimes a PSA will include a closing condition that third party consents have been received. A PE Seller may push back on the inclusion of this condition because 1) it views consents as a representation issue or a title issue that is already addressed by those provisions, and 2) it wants closing to be an almost certainty and does not want a minor consent to provide a contractual reason for the Buyer to not close the transaction. Additionally, if a counterparty whose consent must be obtained becomes aware that obtaining its consent is a condition to closing, such counterparty may use the granting of the consent as a way to gain leverage and obtain a concession or payment from the PE Seller. If there are significant "hard" consents that impact the Assets and the Buyer does not want to close without obtaining such consents, a PE Seller may be amenable to a closing condition that those specified hard consents have been obtained.

The other closing condition that is typically negotiated deals with the proper threshold and metrics for the aggregate unresolved title defects, title and environmental issues, exercised preferential rights to purchase, and casualty losses. A PE Seller generally will want to include this closing condition as a bilateral closing condition (especially if it knows that the Buyer is motivated to purchase the Assets) because the possibility that the PE Seller would terminate the PSA will keep the Buyer from asserting fringe or gray defects.

A PE Seller will want to exclude from this closing condition calculation any title and environmental defects it is disputing and, if one of the remedies for title and environmental defects includes curing such defects post-closing, any defects for which it has elected to cure post-closing. The Buyer will want to include all asserted defects that have not been cured prior to closing because there is no certainty that the defects will be cured post-closing. Having all such defects included also motivates the Seller to cure as many defects as it can prior to closing. There is not a common compromise on this point and the outcome of such negotiations depends on the nature of the Assets and the relative negotiating leverage of the PE Seller and the Buyer.

"PE Funds and Portfolio Companies are sensitive to contractual provisions that could bind their affiliates, because under the common definition of "affiliate," the PE Fund, all other PE Funds managed by the GP, and all Portfolio Companies of each such PE Fund would be considered "affiliates" of each other."

Defining "Affiliate"

As noted above, PE Funds and Portfolio Companies are sensitive to contractual provisions that could bind their affiliates, because under the common definition of "affiliate," the PE Fund, all other PE Funds managed by the GP, and all Portfolio Companies of each such PE Fund would be considered "affiliates" of each other. PE Sellers and Buyers may address this issue in many ways, and common language to address this issue is to define "affiliate" as follows:

> **Affiliate means when used with respect to any person, any other person directly or indirectly controlling, controlled by or under common control with such person; provided, that, notwithstanding the foregoing, in no event shall PE Fund, GP, any PE Fund managed by GP, or any Portfolio Company of PE Fund or any such other PE Fund (other than Portfolio Company, Portfolio Company's Parent, and Portfolio Company's Subsidiaries), be deemed an Affiliate of PE Seller.**

If the Buyer does not want to exclude all such persons as "affiliates" of the PE Seller for all purposes, the provision can be written such that the PE Fund is, for example, considered an "affiliate" for certain purposes. However, language that does not exclude the PE Fund and its related PE Funds and Portfolio Companies (other than the PE Seller, its Parent, and its Subsidiaries) from the definition of "affiliate" can be an issue for a PE Seller for several reasons. First, as discussed above, a PE Seller should not contractually bind the PE Fund or other Portfolio Companies to contractual obligations, such as post-closing AMI provisions or other restrictive covenants. Second, many PSAs require that the Seller terminate all "affiliate" contracts prior to the closing of the PSA. Sometimes, the PE Seller may have arm's-length, commercial contracts with a different Portfolio Company backed by the same PE Fund that the Buyer will want to keep in place after the closing under the PSA.

Multiple Seller Issues

A Buyer may find itself in a situation in which it is acquiring Assets pursuant to a single PSA from more than one PE Seller. Unless the two or more PE Sellers are very closely affiliated (for example, one is the subsidiary of the other or they are both subsidiaries of the same Parent), PE Sellers and the PE Funds who own them will write the PSA so that all of the representations, warranties, covenants, and indemnities being made or given by each PE Seller are several, and not joint and several, especially if different PE Funds own the two or more PE Sellers.

The drafting of this concept can be pure joint and several, pure several, or a compromise that is closer to one extreme or another. For example, the representations and covenants may be viewed from a joint and several basis for purposes of the closing conditions, but on a several basis for purposes of the Buyer's right to indemnification. And with respect to indemnification, it can be several with respect to breaches and with respect to damages (so each PE Seller is responsible for its own breaches and thus its own damages) or joint and several with respect to breaches but several with respect to damages (so each PE Seller is responsible for all breaches but only to the extent of its pro rata share of the purchase price or its share of the Assets for which the breach relates). There are almost limitless ways to write these provisions. In a transaction with more than one PE Seller, if any part of the post-closing obligations will be joint and several, PE Sellers should execute an agreement among themselves that further allocates responsibility among the PE Sellers.

In a transaction with more than one PE Seller, a Buyer may be concerned about post-closing decision-making by the PE Seller group. It is often cumbersome to require more than one PE Seller to execute post-closing documents, negotiate post-closing issues with the Buyer (such as the cure of post-closing defects, the post-closing settlement statement, the release of funds from escrow, etc.), and otherwise make post-closing decisions. Without something specifically addressing this in the PSA, a Buyer cannot rely on the actions of one PE Seller being enforceable against another PE Seller. Thus, it is common for the PE Sellers to appoint a Sellers' Representative and to include a provision in the PSA granting the Sellers' Representative certain authority and giving the Buyer the right to rely on that grant of authority. These provisions are typically lengthy, but the additional detail included in them inures to the benefit of both PE Sellers and Buyer. An example of such a provision is as follows:

> **Sellers' Representative.**
> **(a) By execution of this Agreement and subject to the terms of this Section, each Seller hereby irrevocably appoints Party A, as such Seller's representative, attorney-in-fact and agent with full power and substitution to act in the name, place and stead of such Seller (the "Sellers' Representative") with respect to all matters arising under this Agreement, including the right to act for and on behalf of such Seller and to take any and all actions and make any and all decisions with respect to such Seller in connection with this Agreement and the transactions and documents contemplated hereby. Each Seller acknowledges that such appointment hereunder is coupled with an interest. Each Seller fully and completely, without restriction, authorizes the Sellers' Representative to,**

in its sole discretion (i) prepare, finalize, approve and authorize all documents contemplated hereby, (ii) deliver on its behalf to Buyer as provided in this Agreement all assignments related to its respective interests duly endorsed by it and otherwise as provided in this Agreement and all materials to be delivered in connection with such interests, (iii) execute, deliver and accept on its behalf the documents contemplated hereby, and (iv) execute and deliver, and to accept delivery, on its behalf such amendments to this Agreement or the documents contemplated hereby as may be deemed by Sellers' Representative to be appropriate, other than any amendment decreasing the amount or changing the form of the Unadjusted Purchase Price, and to execute and deliver and to accept delivery, on its behalf, such agreements, instruments and other documents (including all notices and consents contemplated hereby) as may be deemed by Sellers' Representative to be appropriate under this Agreement or the documents contemplated hereby. Each Seller shall be bound by all of the actions taken by Sellers' Representative whether or not authorized if Sellers' Representative had apparent authority to take such action. The authorizations of Sellers' Representative shall be irrevocable and effective until its rights and obligations under this Agreement terminate by virtue of the termination of any and all of the obligations of Seller to Buyer under this Agreement or the documents contemplated hereby. Purchaser is hereby expressly authorized to rely on the genuineness of the signature of Sellers' Representative and, upon receipt of any writing that reasonably appears to have been signed by Sellers' Representative, Buyer may act upon the same without any further duty of inquiry as to the genuineness of the writing, or any duty of inquiry as to the authority of Sellers' Representative. For the avoidance of doubt, Buyer shall be entitled to rely upon (x) any notice from Sellers' Representative as constituting valid notice from each Seller and (y) any consent or waiver of Sellers' Representative as constituting the valid consent or waiver of all Sellers. Where this Agreement obligates Buyer to consult or cooperate with Seller (or take any similar action), Buyer may consult or cooperate with Sellers' Representative and, except as expressly notified by Sellers' Representative or any Seller that additional consultation, cooperation or similar action is required with respect to another Seller, Buyer shall be deemed to have complied with the applicable obligation. Sellers may appoint a substitute person to act as the Sellers' Representative at any time by giving written notice of such substitution to Buyer in a writing signed by each Seller.

(b) Each Seller hereby expressly acknowledges and agrees that Buyer shall be entitled to rely upon any and all actions taken by Sellers' Representative and deal with Sellers' Representative, both before, from and after Closing, as the sole and exclusive spokesperson and agent of such Seller with respect to any matter arising under this Agreement without any liability to, or obligation to inquire of, such Seller, including the receipt and distribution to Seller of any

payments made by Buyer under this Agreement, and may rely upon and act pursuant to any agreement, direction, notice, election or other communication given by Sellers' Representative purportedly on behalf of Seller, either before, at or after the Closing, without ever having to inquire as to the authority of Sellers' Representative to so act.

(c) EACH SELLER INTENDS FOR THE AUTHORIZATIONS AND AGREEMENTS IN THE FOREGOING SUBSECTIONS OF THIS SECTION TO REMAIN IN FORCE, DOES HEREBY AUTHORIZE SUCH RECORDINGS AND FILINGS HEREOF AS SELLERS' REPRESENTATIVE MAY DEEM APPROPRIATE AND DOES HEREBY DIRECT THAT NO FILING OF ACCOUNTS OR INVENTORIES OR POSTING OF A SURETY BOND SHALL BE REQUIRED.

Retention of Obligations

Because PE Funds desire to wind down Portfolio Companies whose assets have been sold as quickly as practical, they do not want to retain significant obligations in connection with the sale. Although a "my watch-your watch" construct may be acceptable (and even typical) for a strategic Seller, such construct will be met with resistance by a PE Seller. A PE Seller taking a position that the Buyer must assume all obligations, regardless of when arising, will likewise be met with great resistance by most Buyers (regardless of whether the Buyer is a PE Buyer).

"Because PE Funds desire to wind-down Portfolio Companies whose assets have been sold as quickly as practical, they do not want to retain significant obligations in connection with the sale."

A middle ground that has been successful and generally accepted by PE Sellers and Buyers is a construct that provides that the Buyer assumes all pre- and post-effective time obligations, but that the PE Seller will indemnify the Buyer for certain pre-effective time or pre-closing items. Such pre-effective time items generally include items that are difficult for the Buyer to diligence or for which PE Seller should have insurance coverage and almost always include 1) offsite disposal, 2) payment of royalties, 3) personal injury, 4) certain employee matters, and 5) civil or criminal fines or penalties. In a document in which the Buyer assumes all pre- and post-effective time obligations relating to the Assets, an example of such a provision would contain a covenant such as the following and an indemnity by the PE Seller with respect to such covenant:

Notwithstanding anything herein to the contrary, Seller hereby agrees to fulfill, perform, pay and discharge (or cause to be timely fulfilled, performed, paid, or discharged) all Damages caused by or arising out of or resulting from (i) any injury or death occurring on or attributable to the Assets prior to the Closing Date for a period of 12 months from the Closing Date, (ii) any civil fines or penalties or criminal sanctions imposed on Seller to the extent resulting from any pre-Closing violation of Law, including Environmental Law, for a period of 12 months from the Closing Date, (iii) any Environmental Liability that is the result of any off-site disposal or transport for disposal, or arrangement for off-site disposal or transport for disposal, of any Hazardous Substances from any Assets, in each case prior to Closing for a period of 12 months from the Closing Date, or (iv) the accounting for, failure to pay, or the incorrect payment to any royalty owner, overriding royalty

owner, working interest owner or other interest holder under the Leases and escheat obligations insofar as the same are attributable to periods and Hydrocarbons produced and marketed with respect to the Properties prior to the Effective Date for a period of 12 months from the Closing Date.

Indemnities and Post-Closing Security

Any Buyer will want assurance that a Seller can perform its post-closing obligations, including the ability to perform with respect to its retained obligations and post-closing covenants and to satisfy its post-closing indemnity obligations. While a conventional Seller will typically have additional assets and capital that were not part of the sale remaining in the Seller entity after the sale, a PE Seller will likely not have any assets or capital remaining other than the consideration received in the sale that, because of the internal rate of return calculation at both the Portfolio Company level and the GP level, it has an incentive to distribute to its owners as quickly as possible. As a result, the Buyer and the PE Seller must agree on a form of post-closing security that is not overly burdensome on the PE Seller's rate of return for its investors and adequately protects the Buyer.

"The Buyer and the PE Seller must agree on a form of post-closing security that is not overly burdensome on the PE Seller's rate of return for its investors and adequately protects the Buyer."

The manners in which this issue can be handled include: 1) a covenant of the PE Seller to retain a certain amount of funds and not distribute them to its owners, 2) a guaranty from the PE Fund that owns the PE Seller, 3) an escrow holdback, and 4) representations and warranties insurance. Of these four alternatives, the escrow holdback has been utilized in a significant majority of PE Seller transactions, but the trend is expected to move toward representations and warranties insurance.

The first type of post-closing security, a covenant of the PE Seller to retain funds, is not common. It is typically used in smaller transactions, in transactions where the PE Seller is not selling all of its assets in the transaction or is planning to sell all of its assets in a series of transactions over a period that corresponds somewhat to the indemnity period (6 to 18 months), or in instances where the Buyer and the PE Seller have a preexisting relationship. The language essentially tracks the Delaware Limited Liability Company Act[14] or the Delaware Revised Uniform Limited Partnership Act[15] requirements and often includes a reporting obligation. A sample provision reads as follows:

(a) From and after Closing, Seller agrees that it shall (i) not distribute to its members and will retain available cash or cash equivalent funds, or (ii) cause its members to keep available and promptly provide, upon request of Buyer, such available cash or cash equivalent funds, in either case as would be sufficient for Seller to timely and properly discharge and make reasonable provision for all of the liabilities and obligations of Seller, including those arising under this Agreement (including all Retained Liabilities and obligations of indemnity and defense) or any document delivered pursuant to this Agreement. Seller shall not make any

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14 Del. Code Ann. tit. 6, §§ 18-101 to -1208.

15 *Id.* §§ 17-101 to -1111.

distribution to its members, including of any portion of the adjusted Purchase Price or Closing Amount, except to the extent it is made in a manner and amount that does not violate (A) Seller's obligations in the immediately preceding sentence, and (B) any provision of Subchapter VIII of the Delaware Limited Liability Company Act.

(b) Buyer and Seller acknowledge and agree that, on an interim basis that is no more than quarterly, upon delivery of a written request by Buyer, Buyer shall have the right to require that Seller prepare and deliver to Buyer, within five (5) business days of such request, a written certificate executed by a senior officer (Chief Executive Officer, Chief Financial Officer or Chief Operating Officer) or manager of Seller certifying that Seller is then in compliance with its covenants and obligations set forth in this Section.

The second option, a guaranty from the PE Fund that owns the PE Seller, is also not commonly used because most PE Funds are either prohibited from guaranteeing the obligations of their Portfolio Companies by their fund documents or they are hesitant to assume liability for obligations for which they otherwise would have no liability.[16] If there is a fund guaranty, the guarantor's obligations are primary obligations and not merely a surety. Fund guaranty language might read as follows: "**Guarantor hereby irrevocably, absolutely and unconditionally guarantees to the Company the prompt, complete and full payment, when due, of Seller's obligations under the Purchase Agreement.**"

The third type of post-closing security, and most common in the upstream acquisition market, is an escrow holdback. This is similar to a covenant to retain funds, except that the PE Seller deposits the funds with a third-party escrow agent. The amount of funds deposited with the escrow agent typically serves as a cap on the PE Seller's liability (subject, oftentimes, to certain carveouts for breaches of fundamental representations, certain tax matters, and retained obligations, or matters that are assumed obligations but difficult for the Buyer to diligence, such as off-site disposal and royalties). Funds withheld and placed in escrow make up between 5% and 20% of the purchase price, depending on many factors including deal size, and the escrow period is typically between 6 months and 18 months (matching the survival period for the representations and warranties). In some deals, the escrow amount steps down over time, such as with half of the withheld amount being distributed to the PE Seller on the date that is six months after the closing and the remainder on the first anniversary of the closing.

The fourth type of post-closing security and an emerging product in the upstream oil and gas acquisitions space, is representations and warranties insurance (RWI). RWI emerged in the 1990s as a way to shift indemnification risk from the Seller to an insurer. The number of midstream oil and gas deals utilizing RWI has grown exponentially over the last five years. Most significant midstream deals over the last 18 months have used

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16 In transactions involving midstream assets, fund guaranties are more common especially with respect to breakup or termination fees to which PE Sellers sometime agree in such deals. Breakup or termination fees are rarely used in transactions involving upstream assets.

a RWI product. And as of 2018, both Aon plc and Marsh LLC, the two largest insurance brokers, have been placing RWI policies on upstream transactions, including covering special warranty of title claims.

Typically, a RWI policy is purchased by the Buyer and the Buyer is the insured party. The premium for the RWI policy varies, and is higher if a special warranty of title is covered, but is generally 2%–3% of the coverage limit. Thus, if you have a transaction with a purchase price of $100 million and the Buyer purchases a RWI policy in place of a 10% holdback, the premium should be between $200,000 and $300,000. There is an underwriting or due diligence fee of up to $50,000 and there also may be a broker fee in certain instances.

The RWI policy will include a deductible (retention) which is typically 1% of the purchase price for the transaction (so $1 million in the example above). In the past, the retention was almost always split between the Buyer and Seller, with the Seller's 0.5% of the retention being held in an escrow account and released 12 months after the closing. The RWI product has changed in the last year or two, and it has become common for the Seller to not be responsible for any part of the retention. The policy term is typically three to six years, covering operational representations for three years and fundamental representations for six years. The underwriters of the RWI policy rely on the diligence completed by the Buyer.

A RWI policy as post-closing security for a PE Seller's obligations benefits both the PE Seller and the Buyer in certain ways. For the PE Seller, it reduces or eliminates the indemnity holdback and allows the PE Seller to distribute sales proceeds to its owners sooner, thus improving the internal rate of return on the capital of the PE Seller. It also gives the PE Fund backing the PE Seller an exit with fewer contingent obligations to keep in mind post-closing. Furthermore, the PE Seller and its PE Fund may feel comfortable making more extensive representations and warranties without qualifications as to materiality and knowledge, which benefits both the PE Seller and the Buyer and makes negotiation of the PSA smoother and quicker. For the Buyer, since a RWI policy term is significantly longer than the typical 12 month escrow holdback, Buyer will have more time to discover breaches of representations and warranties.

"Typically, an RWI policy is purchased by the Buyer and the Buyer is the insured party. The premium for the RWI policy varies, and is higher if a special warranty of title is covered, but is generally between two percent to three percent of the coverage limit."

Transition Services

Despite the desire to wind down a Portfolio Company whose assets have been sold as quickly as practical, PE Sellers oftentimes do not balk at providing transition services post-closing. Even if revenue neutral, transition service arrangements provide a PE Seller the ability to cover a portion or all of its overhead during the wind-down phase.

Post-Closing Restrictive Covenants

A Buyer will often want a Seller to agree to not compete with the Buyer with respect to the lands covered by the Assets. When the Seller is a PE Seller, the question becomes who should, and who is willing to, agree to not compete. For the Buyer, an ideal post-closing covenant not to compete would come from the PE Seller, the PE Fund itself, the Management Team, and affiliates of each of the above.

Since the PE Seller will likely be winding down after the sale and will not be acquiring additional assets or businesses in the PE Seller entity after the sale, and since the PE Seller will not be able to bind its affiliates, obtaining a covenant not to compete solely from the PE Seller will not adequately protect the Buyer. The PE Fund will be hesitant to agree to a covenant not to compete that binds its other Portfolio Companies and affiliates (some of whom may already be competing in the area) or that prohibits the PE Fund from engaging in new business in the area with another Management Team.

Oftentimes, when a post-closing covenant not to compete is signed in connection with the sale by a PE Seller, the parties agree that the covenants will be agreed to by the PE Seller and key individuals on the Management Team.[17] This result should give the Buyer some comfort that the individuals who sourced and developed the Assets the Buyer is acquiring will not compete after the sale and prevents the PE Fund from funding the same individuals in a new entity that would compete with the Buyer. If there will be a post-closing covenant not to compete executed by individuals, it should be structured so that it is executed at the signing of the PSA and effective upon the closing, so that there is not closing execution risk relating to the actions of the individuals.

Conclusion

The market for oil and gas assets and the sandbox in which PE Funds and their Portfolio Companies play has shifted: the shale oil and gas industry is entering a new stage in its evolution that is forcing PE Funds to rethink their investment model. The old model of originating or acquiring a leasehold, drilling a few wells and quickly flipping the asset is not working because public energy companies, which have historically been the traditional purchasers of their private equity-backed peers, are much more selective with the assets they buy. These Buyers are demanding that assets come with cash flow (many producing wells). To drill more wells and have larger operations, Portfolio Companies must employ larger staffs and precisely execute on their drilling and development plan—this is a change to how they have operated in the past. As a result, the way PE Funds and their Portfolio Companies think about acquisition and divestiture documents will have to evolve to address new market realities.

Shearman & Sterling's Oil and Gas Team

Shearman & Sterling's oil & gas team represents private equity and other investment funds, private and independent oil and gas companies, MLPs, and alternative asset investors in a variety of transactions in the oil & gas sector, including mergers, acquisitions, dispositions, joint ventures, project development, finance and restructuring in the upstream, midstream, and downstream sectors. Contact Andressa Lessa to be added to our mailing list for future oil & gas reports, updates and seminars.

[17] These arrangements may or may not require the payment of additional consideration to the individuals to be bound.

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