LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Preserving The Business Deal In The Final Hours

By **Justin Stolte**

Law360, New York (September 1, 2017, 9:38 AM EDT) --
While not matching the peaks of prior years, transactional activity in the oil and gas sector (upstream, midstream and downstream) remains fairly robust, with new transactions being announced on an almost daily basis. As we head into the final stretch of 2017, tight capital markets, cash flow "neutrality" goals and the need to fund capital plans, among other factors, will likely result in industry players continuing to monetize assets, commonly utilizing some form of a competitive bid process in order to obtain the very best deal possible.

Justin Stolte

In these situations, transactional professionals (business development, legal, technical and C-suite) on the buy side (the "deal team") are often faced with a daunting task.

After spending weeks — and, in many cases, months — sourcing, evaluating and chasing an opportunity, a call is received from the seller (or, more likely, its investment banker) relaying some variation of the following: (i) the bidder has made it into the final phase of the bid process; (ii) the bidder needs to "sharpen its pencil" on the bid amount (code for "increase your bid") and provide additional information on its financing sources; and/or (iii) the bidder needs a "markup" of the purchase and sale agreement (the PSA) for the prize.

And, oh, by the way, the seller needs all of those items in the next 48 to 72 hours (typically, over the weekend), with the goal of having the PSA executed shortly thereafter.

Oftentimes, the initial excitement of having the prize within the bidder's grasp is quickly tempered by the frightening reality of having to deliver all of the above-mentioned items in a condensed time period — along with having to call your spouse to cancel those weekend dinner plans — and in a manner that allows the prize to ultimately be won.

Although not an exhaustive discussion of the pitfalls sometimes faced experienced by deal teams, this article provides those facing this common situation an overview of certain matters that, as a consequence of the rushed pace, are often inadequately addressed or, in some cases, forgotten altogether, by deal teams. Missteps similar to those described below may result in a material diminution of value to the bidder's business deal, impairing the transaction's economics from the outset of the acquisition.

Valuation

A transaction’s economics are based on a myriad of factors — including commodity pricing and/or production forecasts; costs, expenses and liabilities; and the bidder’s cost of capital — which the deal team should take into account when reviewing, revising and negotiating the PSA.

A transaction’s presumed value can quickly be whittled away through thresholds, deductibles and/or liability caps in the PSA that are inharmonious with certain assumptions made in the bidder’s economic model. Further, a PSA that does not adequately reflect the means by which value was allocated among the assets to be acquired (e.g., producing wells vs. undeveloped acreage vs. midstream systems) could lead to disastrous commercial outcomes following signing of the PSA.

We have seen post-PSA signing situations where deal teams had allocated substantial value in their economic models to portions of the acquired assets for which, due to oversight, there were limited remedies in the PSA in respect of title defects, environmental contamination and/or other bases for diminution of value.

Other matters of similar importance include consideration of whether production hedges are desired (in which event, the bidder may need seller’s assistance with pre-closing hedging) and understanding onerous overhead arrangements (e.g., under joint venture arrangements) to which the bidder will be subject following the closing of the transaction. Each of these items can have material impacts on transaction economics.

Seller Creditworthiness

As mentioned above, the seller will typically request additional information, or evidence, with respect to bidder’s ability to fund the purchase price for the acquired assets. This may come in the form of a commitment letter from the bidder’s lender or private equity sponsor or through comfort received from a review of the bidder’s financial statements.

Often overlooked, though, is the bidder’s need to perform a similar due diligence undertaking in respect of the seller’s ability to fulfill its obligations under the PSA. This is especially pertinent in instances in which the seller is divesting most, or all, of its assets as part of the proposed transaction, as is often the case with private equity portfolio companies and, more recently, companies exiting bankruptcy and winding up their businesses.

In these situations, bidders should consider including special mechanisms in the PSA (e.g., a post-closing escrow of a portion of the purchase price) so that, to the extent possible, the seller’s post-closing obligations will be fulfilled. Hard-fought protections in the PSA may not be worth much if the seller cannot stand behind them following the transaction’s closing.

Disclosure Schedules

The importance of reviewing the seller’s disclosure schedules to the PSA cannot be overstated. These schedules disclose certain items for which, in most cases, the seller will not have any liability under the PSA (e.g., serving as carve-outs to the seller’s representations and warranties) or otherwise to the bidder.

It is important that the deal team receive the seller's disclosure schedules early in the process and, prior to PSA execution, fully understand the items being disclosed therein, including the terms and conditions of material contracts that will be binding on the acquired assets and/or the bidder following the closing of the transaction. Unfortunately, this type of review often does not occur, as most sellers typically provide disclosure schedules as one of the last steps prior to executing the PSA (sometimes only hours beforehand), leaving the deal team with potentially an inadequate amount of time to review them.

Moreover, even if the disclosure schedules are received in a timely manner, in many cases, junior members of the deal team are delegated the responsibility of reviewing them, even though they do not have the experience or background to fully understand what is being disclosed in the context of the PSA. Failure to adequately review the disclosure schedules should be avoided, given that it may result in the bidder being responsible for substantial liabilities not factored into its valuation.

Due Diligence

The time period between the signing and closing of the PSA (often referred to as the interim period) is intended to provide, among other things, a buyer with the opportunity to perform due diligence on the to-be-acquired assets.

This interim period might be the only opportunity that the bidder will have to perform any meaningful diligence prior to the closing of the transaction. The PSA must, therefore, be structured in a manner that provides the bidder not only with the access necessary to perform the due diligence, but also with adequate time periods in order to perform it.

For example, an often-overlooked item in PSAs relates to the bidder's environmental diligence team having adequate time to perform its environmental due diligence during the interim period. The 30-to-45 day interim period included for most transactions is inadequate — in most, if not all, cases — to perform a phase II environmental site assessment (which often requires sampling and/or laboratory analysis taking several weeks to months to complete) deemed necessary.

The bidder's ability to perform due diligence prior to closing is often an absolute necessity for it being able to enforce certain remedies under the PSA, including those with respect to title matters, environmental matters and breaches of the seller's representations and warranties.

Allocation of Liability

One of the most heavily negotiated items in a PSA is the allocation of post-closing liability between the parties with respect to the acquired assets. Often, the seller will push for the bidder to assume all liabilities with respect to the assets, irrespective of when arising, while the bidder will likely request some form of a "my watch, your watch" allocation, where the seller remains liable for some portion of, or all, pre-effective time liabilities.

While this topic is typically left to the respective legal teams for each side to negotiate — as the allocation of liability is often addressed as part of increasingly complicated indemnity provisions — it is imperative that the entire deal team participate in, or have input on, these negotiations. The liabilities that end up being allocated to the bidder can be significant and, similar to the others items noted above, may materially impair transaction economics if not properly assessed prior to signing of the PSA.

The final bid amount is typically the deciding factor in a competitive bid process, but the PSA markup

can be, and often is, used to select the winning bidder for the prize, especially in situations in which competing bid amounts are close. As such, when working on the PSA markup, it is important that the deal team differentiate between the “must-have” and the “nice-to-have” changes, all in the context of what is “market” for similar transactions.

Simultaneously, the deal team must not lose sight of certain other items that, while not necessarily of a contentious nature, need to be addressed in the PSA, or prior to it being signed, in order to protect the transaction’s economics.

We hope that this article alerts the reader of a handful of those items and, more broadly, serves as a reminder of the importance of constant communication within deal teams to avoid pitfalls similar to those described above. And, perhaps of greatest importance, we hope that you do not forget to reschedule that cancelled dinner with your spouse.

Justin T. Stolte is a corporate partner in the Houston office of Gibson, Dunn & Crutcher LLP, and a member of the firm's mergers and acquisitions, energy and infrastructure, and oil and gas practice groups.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2017, Portfolio Media, Inc.