KING & SPALDING

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In this January edition, we are delighted to present legal and industry updates from the firm's global network of offices. The selection is based upon our experience of the wide variety of issues faced by our clients in their business operations and investments around the world.

We hope that you enjoy the edition, and would welcome the opportunity to discuss further any matters which impact your business today.

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Chambers Global

In This Issue:

Managing Risks in Acquisitions from Financially Challenged Sellers in the Resources & Energy Sector

Low Commodity Prices

After a decade long boom in the resources and energy sector, prices across almost all commodities declined from 2012, with particularly sharp declines during 2015 and into 2016, as supply grew in excess of demand, largely as a result of the slowing growth of the Chinese economy.

Coal prices were among the first to suffer a significant correction, with prices having dropped by about 60 percent over the last 5 years, resulting in over 20 major bankruptcies among US-based coal producers, including the bankruptcy of Peabody Energy, the world's largest private sector coal producer. Similarly, iron ore producers have had to adjust to a price crash from over US$190 per tonne in 2011 to US$38.50 per tonne in December 2015, as the market struggled to absorb the additional production of approximately 400 million tonnes per annum.

Meanwhile, copper and other base metals such as nickel, zinc and aluminium sustained significant price corrections as a result of increasing supply/demand imbalances. The oil sector has also seen a dramatic price decrease from over US$100 per barrel in June 2014 to a January 2016 low of below US$30 per barrel.

Impact on Companies' Operations

Many companies which were highly geared and operating with high production costs have not been able to survive. Meanwhile, others have been able to survive by cutting costs, reducing capital expenditure and spinning off non-core assets. Some have also been able to restructure their debts with longer maturities or have issued high yield bonds or have managed to raise funds by way of heavily discounted share placements and rights issues. For many companies in the energy and resources sector, these opportunities have become increasingly limited.

Additionally, although in 2016 there has been some recovery and stability in the prices of a number of commodities, many producers are encountering increased pressure due to the expiry of favourable commodity hedges, which has resulted in them now being more exposed to relatively unhedged commodity prices, which are insufficient to cover their costs of production and debt service obligations.

Many companies may have little alternative to filing for bankruptcy. Others may seek to sell some of their better assets or to seek joint venture partners as a way to raise additional funds, which may mean that their price expectations will now be more closely matching those of the potential buyers and investors. While this can produce opportunities to acquire assets at attractive prices, which may generate attractive longer term returns for those buyers with available funds and patience, it is important for those buyers to be mindful of the associated risks and to seek ways to best manage those risks.

Due Diligence

Perhaps the most important factor that determines whether an acquisition from a financially challenged seller is a success or failure is the quality of the due diligence which is undertaken. The purpose of any due diligence process is to identify any issues and risks that could, in the future, prevent the buyer from attaining the value that it hopes to capture through the acquisition. Identifying any issues and risks as early as possible is essential for being able to properly price any assets, as well as for identifying any additional protections the buyer ought to incorporate in its sale and purchase agreement.

In a distressed vendor environment, reliable warranty or indemnity cover is either unlikely to be available or will be of limited value because a distressed vendor may not have the financial resources to honour a warranty or indemnity claim. This exposure should be reflected in an appropriately discounted purchase price. Even where such a claim is honoured, there is a risk that if the seller later goes into bankruptcy the payments under any warranty or indemnity obligations may be challenged as 'unfair preferences'.

It is also worth noting that once a potential sale of distressed assets becomes known, some third parties may seek to exploit any leverage which might be available to them in pursuing their claims, such as employee claims, environmental claims and claims to any royalties.

Areas of Risk

This means that due diligence is the key line of defence for the buyer. Particular areas of risk to address in the conduct of due diligence when buying from a distressed or financially constrained seller include:

- **Assets**: identifying the key assets, title to the assets and security over the assets - gaining good title to distressed assets can be difficult and buyers may find themselves competing against secured lenders, holders of retention of title claims, holders of liens arising by operation of law or other parties claiming to have acquired the assets;
- **Obligations**: verifying whether the seller has failed to meet its obligations:
  - at a project level - where the seller is the sole owner or perhaps the operator and majority joint venture participant: e.g. whether there are any unfulfilled drilling commitments, or expired leases due to a lack of production or lapsed contracts; or
  - at a joint venture participant level - where the seller is a minority joint venture participant: e.g. whether the seller may have: (i) failed to pay any cash calls or otherwise failed to meet its obligations under the applicable joint operating agreement or joint venture agreement (even though the joint venture as a whole may have met its obligations to third parties); or (ii) elected to be a non-consenting party in respect of any operations under the applicable joint operating agreement or joint venture agreement;
- **Contracts**: ascertaining the rights and obligations under key contracts held by the target company in the case of a corporate acquisition or to be assigned or novated to the buyer in an asset acquisition and ensuring that they are still in force and are not in default (as this would be likely to allow the counterparties to terminate those contracts);
- **Transfer**: identifying whether any of the assets might not be transferable because they are regarded as being “personal” to the seller, eg technology or processing licences, in which case the buyer might need to assume performance of the obligation eg payment of licence fees until they can be formally transferred – this is a risk to the buyer if in the interim the seller might become insolvent, especially if this would give rise to termination rights under the applicable contracts;

- **Services**: ascertaining the extent to which any services are provided centrally by the seller group and how readily any reliance may be placed on the ongoing provision of those services until the target business achieves operational independence;
- **Litigation**: identifying any litigation, pending litigation or arbitration proceedings or outstanding judgments or arbitration awards which might imperil the assets being acquired or otherwise give rise to a liability which the buyer may be called on to bear;
- **Environmental**: verifying that there have been no breaches of applicable environmental laws and regulations and that any proposed development will be in conformity with applicable legislation, regulations and approvals;
- **Remediation**: determining the rehabilitation and remediation obligations under the applicable legislation and regulations - eg, it is important to ascertain whether there may be any plugging and abandonment liabilities in respect of previous drilling activities or any remediation obligations in relation to the previous operation of a refinery or processing plant that might have to be assumed (the buyer will also need to understand the extent which in the applicable jurisdiction an occupier may be required to take clean-up measures regardless of whether the occupier is actually responsible for the pollution in question); and
- **Insolvency**: understanding how the insolvency laws of any relevant jurisdiction might affect the outcome of the transaction in the event that the seller goes into a bankruptcy or liquidation – eg whether off-balance sheet instruments and liabilities, environmental claims, employee benefit claims, priorities assigned to certain tax liabilities, or other potential claims might take priority over any claims that the buyer might have under the sale and purchase agreement for breach of warranties or under any indemnities provided by the seller and whether the transaction could constitute a "fraudulent transfer" or be challenged because the seller did not receive reasonable value for the assets.

Asset Sale rather than Share Sale

In a share sale, the sale and purchase agreement effects an indirect transfer of assets through the sale of the share capital of the target company which holds the relevant oil and gas or mining interest. The buyer therefore acquires all of the rights and liabilities of the target company, known and unknown, including those arising prior to the acquisition. In the case of an acquisition of a distressed company, the risk of assuming unexpected liabilities becomes an especially important concern.

In asset sale, the buyer will acquire only those assets, rights and liabilities expressly transferred to the buyer in the sale and purchase agreement. There are limited exceptions to this principle: in certain jurisdictions, regulatory requirements impose additional liabilities on the holder of an asset. For example, in the UK, liability for the decommissioning of an installation can be imposed on any party entitled to derive a financial or other benefit from that installation. Notwithstanding this type of exception, asset sales offer the buyer the advantage of being able to cherry-pick assets that have the greatest financial or strategic value to it.

Even more important, in the case of a distressed seller, structuring the sale as an asset sale rather than as a company share sale enables the buyer to insulate itself from most of the unwanted liabilities that may be associated with those assets or which are more generally affecting the seller.

Closing and Pre-closing Covenants and Conditions

It is preferable to seek as short a period as possible between the signing and the closing of an acquisition transaction, so as to reduce the risk during a pre-closing period of any deterioration in the condition of the assets being acquired and in the financial position of the seller (or in the case of a share acquisition, of the target company). However, this may be difficult to achieve if shareholder/joint venture consent, third party consent (eg from a licensor of any intellectual property) or regulatory approval is required. In such a case, it is especially important to have thorough and substantial pre-closing covenants and conditions (and extensive rights of access and control up to the closing) which allow the buyer to terminate the transaction.

When the seller is in a precarious condition, even if other pre-closing covenants and conditions are satisfied, it is important that the buyer also reserves the right to terminate the transaction if there is a change in circumstances which has a material adverse effect on the assets, business, properties, operations, prospects or

financial condition of the seller or its business taken as a whole. However, it should be noted that, at least in the UK, if a party was aware of a particular state of affairs (or was aware that something was likely to occur), it might not be able to rely on the pre-existing circumstances which it knew about as a material adverse change trigger for terminating the agreement – a relevant consideration when contracting with a seller which is known or suspected to be in some financial difficulty.

Holdbacks and Escrow Arrangements

To the extent that a financially constrained seller provides any covenants or representations and warranties or assumes any indemnification obligations under the sale and purchase agreement, the buyer may need to consider one or more of the following risk mitigants:

- **Security**: obtaining security or a guarantee from a third party whose credit worthiness is not in doubt;
- **Escrow**: structuring the transaction so that an escrow arrangement is established as to at least part of the purchase price or that there is a holdback as to part of the purchase price to support those covenants and obligations, including obligations with respect to retained liabilities such as pre-closing environmental or tax obligations or retained litigation, provided that the purchaser does not have notice of, or suspicion, that the vendor was insolvent;
- **Pricing**: applying conservative pricing assumptions in relation to the completion accounts and the apportionment of creditors and debtors so that it is more likely that the buyer will be required to make any adjustment payment given that the seller might not have the financial capacity to honour any downward adjustments or if it does, the amount paid may be later challenged as an 'unfair preference; and
- **Insurance**: obtaining buy-side warranty and indemnity insurance against insurable warranties (although such insurance will often not be available or not at an acceptable cost).

Meanwhile, the buyer should avoid paying a deposit to a financially constrained seller or it should insist that any deposit is paid into a third party escrow account.

Seller bankruptcy/insolvency risk

Any buyer from a financially distressed seller must be mindful of the risk that the seller may become bankrupt or commence insolvency proceedings and that there may then be an attempt to overturn a transaction which is considered to be at undervalue and the seller was insolvent at the time of the transaction (ie if it was an "uncommercial transaction" or is considered to be a "fraudulent transfer").

To address this sort of risk, the buyer should require the seller's directors to:

- **Valuation**: document steps taken to satisfy themselves that they got the best deal possible (eg by third party valuation); and
- **Best Price**: record in minutes of the board meeting approving the transaction the basis on which they consider the price to be the best that could reasonably be achieved in the circumstances.

In a jurisdiction such as the USA, if a seller is suspected to be about to file for bankruptcy it may be preferable to wait until the transaction can be included in any reorganisation package which might be filed by the seller so that the deal gets protection under the applicable bankruptcy regime.

About the Author

Rupert Lewi is a founding partner of King & Spalding's Tokyo office, and is a core member of the Global Energy Practice.

The Global Energy Practice is comprised of an award winning and internationally ranked team of 250 energy lawyers who serve clients out of major world energy centres – including Abu Dhabi, Dubai, Houston, London, Moscow, New York, Paris, Riyadh, San Francisco, Singapore and Tokyo. Our deep and diverse bench and years of experience allow us to support our clients along the entire commercial value chain, from investment financing, joint venture interest acquisition, regulatory filing and proprietary know-how protection to disputes in local courts or international arbitration.

Chambers Global 2016 ranks King & Spalding among the top firms for energy and projects globally. In addition, Legal 500 named King & Spalding as a Client Champion for the Global Energy Sector in 2016.

Resources & Links

The following links provide access to further King & Spalding Dispute Resolution and Crisis Management publications.

Legal Updates

International Arbitration: Second Circuit Addresses Expropriation and Imputation Issues under FSIA

Sanctions: Extension of Iran Sanctions Act: For Now, A Symbolic Act

Middle East: An Overview on Directors' Duties and Liabilities in Saudi Arabia

Russia: LinkedIn Blocked in Russia: Privacy and Trade Law Aspects

Employment: New Obama Administration Employment-based Visa Rule and Trump's Plan to Target Visa Abuse Create Uncertainty For Employers

Trade: TPP and Other Trade and Manufacturing Issues Front and Center After Election

Trade: President-Elect Trump Announces Creation of White House National Trade Council

Trade: Commerce Department Investigates Evasion of Steel Duties

Privacy: EU-U.S. Privacy Shield: Assessing The New Regime

Cybersecurity: The Convergence of Trade Secret Theft and Cybersecurity: An In-House Counsel's Primer on Mitigating Risks

King & Spalding News

Recognition: King & Spalding Recognized as a Top Firm in Asia in the Chambers 2017 Guide

Recognition: Legal 500 Recognizes King & Spalding as an Energy Client Champion

Recognition: London Arbitration Partner John Savage Appointed Queen's Counsel

Result: King & Spalding Client Prevails In Swedish Appeal of $500 Million Arbitration Award Against Kazakhstan

Recognition: Law360 Names King & Spalding "Firm of the Year" for Winning in Six "Practice Group of the Year" Categories

Publication: Ronni Solomon, Rose Jones, Jennifer Mencken, Ed Logan Author Chapter in ABA Book on Advanced E-Discovery Techniques

Lateral Hire: King & Spalding Boosts Appellate Practice With Addition of Anne Voigts

Result: King & Spalding Obtains Appellate Win in the Seventh Circuit for Wind Farm Client

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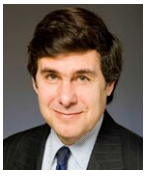

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