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Preparing a Midstream Company for a Successful Post-Pandemic Exit

AUGUST 11, 2020 | BY KEVIN CREWS AND ABBEY ZUECH

A primary goal for financial sponsors is working with their portfolio company management teams to maximize their financial return on investment through a carefully orchestrated portfolio company exit. Some of the sponsor's most important, and often most difficult, decisions relate to the timing and method of exiting an investment, which can significantly impact portfolio company returns. Planning a successful exit strategy is a complex process that requires careful advance planning as well as the resources and expertise of legal and financial advisors with proven track records.

The recent decline in merger and acquisition activity across the energy value chain and in particular in the previously redhot midstream sector – resulting from several factors, including the COVID-19 pandemic and related shutdowns, depressed commodity prices and election year regulatory uncertainty – has limited the viable exit opportunities for most sponsor-backed midstream oil, gas or water portfolio companies in the near term.

The upshot is that this period of temporarily reduced deal flow creates an ideal environment for sponsors and management to take an introspective look at their portfolio companies and begin preparing for their eventual sale, once the oil and gas industry has recovered and the M&A market has stabilized.

Begin with the Exit in Mind

Because exits are crucial to capturing overall value, exit objectives should inform every decision a sponsor makes throughout the life of an investment starting with formation of the management platform. Such decisions include:

- Early-stage strategic decisions, such as whether to pursue an acquisition of an existing business or to pursue a greenfield development project such as a joint venture with a dedicated producer customer;
- Capital allocation decisions, such as whether to utilize a company-level credit facility and/or whether to bring in growth capital in the form of preferred equity or a line of equity commitment from a third-party investor;
- Commercial decisions, with a view to putting in place long-term, durable contracts with creditworthy counterparties and optimizing the business with respect to run times and volumes;
- Management decisions, such as whether to refresh the management incentive plan or set up a cash bonus plan for purposes of retaining and incentivizing senior management and core employees through preparation for and execution of a sale process; and
- Late-stage strategic decisions, in particular identifying when the company has reached a key inflection point such that the business can be marketed as ready for a transition to a new owner that can predictably support the next development and growth phase of the company.

Each decision should balance short-term demands for growth with long-term strategies for exit. Over the course of the investment, the sponsor should monitor and adjust the exit plan, as appropriate, to ensure the day-to-day business decisions reflect a strategy that will yield an attractive exit.

Once the Exit is in Sight, Get Organized for the Sale Process

The sale process is dynamic and requires coordination among all internal teams and external advisors. Both buyers and sellers should take into account that COVID-19 may cause the provision of key information (such as financial statements, models or projections, etc.), the due diligence process (meetings with management, site visits, etc.), third-party consents and governmental approvals to take longer to finalize. Getting a jump-start on certain initial preparatory and organizational workstreams will help ensure a smooth and fast-moving process, including:

- Maintain a detailed equity capitalization table;
- Update minute books and ensure they contain copies of all current organizational documents;
- Update and stress-test budgets and forecasts;
- Maintain executed copies of all material contracts, including a tracking chart of key terms and provisions, such as minimum volume commitments, acreage dedications, construction obligations, fees, change of control, indemnification, exclusivity or priority rights, renewal or termination rights, most favored nation provisions and other material provisions that require compliance

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monitoring in the ordinary course;

- Maintain executed copies of contracts relating to material business acquisitions or dispositions and keep track of any provisions that would survive an exit transaction (such as purchase price adjustments, earn-outs, escrows, representations and warranties survival and indemnification, restrictive covenants, etc.);

- Understand the terms of the existing management arrangements and any contractual obligations or potential termination costs, and determine whether any changes should be made;

- Maintain and review environmental audits or site assessments for material facilities and properties in order to determine whether to commission updated reports or whether any remediation work should be started or completed before the process is underway;

- Maintain a litigation tracker identifying past and present litigation, audit and governmental inquiry matters, and any potential restrictions on the company's future activities, and determine the estimated dollar amount and likelihood of potential contingent liabilities; and

- Anticipate commercial or operational questions or concerns from prospective buyers.

Engage Professional Advisors and Prepare to Sprint When the Window of Opportunity Opens

When the appropriate time to exit arrives and the sale process is ready begin, the first item on the company's agenda should be to select and retain legal and financial advisors. In light of the short time frame, high stakes nature and complexity of a sell-side process involving a sponsor-backed midstream company, retaining legal and financial advisors that have the requisite oil and gas industry specialization, private equity M&A expertise and depth of team to move in a rapid, yet thoughtful and commercial, manner will likely be the difference between achieving a successful liquidity event or potentially missing the window of opportunity.

When selecting lead legal counsel, sponsors should consider the following, understanding that the right law firm to lead a sell-side process is often not the day-to-day corporate counsel for the company:

- **Private Equity M&A Experience.** It is critical to a successful M&A process that sponsors hire outside counsel with significant experience advising sponsors on M&A transactions. Unlike strategic M&A, private equity M&A poses myriad unique nuances that relatively few legal advisors fully appreciate and understand. For example, the use of representation and warranty insurance, appropriate tax structuring to maximize long-term capital gain treatment, market-based approaches to tax-efficient management rollover structures and other similar private equity-specific issues need to be fully understood and worked through in order to have the most successful exit. In addition to seasoned private equity M&A attorneys, the outside legal team should also include specialists in other practice areas to provide expert advice on particular aspects of the transaction, such as oil and gas, commercial, tax, environmental, regulatory, real estate, executive compensation, employment and benefits issues, all of which should be geared to the unique issues facing a sponsor-backed company in the midstream oil and gas sector.

- **Industry Market Knowledge.** An advisor with in-depth industry knowledge of the energy space, and in particular the midstream industry, can add value by providing market knowledge and expertise on midstream sell-side processes. For example, certain practices have been pioneered recently and are only beginning to make their way more widely into the market, such as upward purchase price adjustments for certain budgeted growth capital expenditures by the company from a pre-closing effective date through closing or, similarly, a separate value adjustment for certain inventory or construction work-in-progress.

The company should select a qualified, capable financial advisor with relevant midstream experience who has knowledge of and access to all potential buyers. When choosing a financial advisor, the advisor's rate of success in selling midstream companies of a similar size, complexity and capital structure should be a primary consideration. In addition, it may be valuable for the financial advisor to be able to offer term loan or similar "staple financing" to potential buyers. Often the financial advisor and legal counsel will be proven partners who have previously worked together successfully on similar sell-side processes.

Maximize After-Tax Recovery

Tax structuring is one of the most critical subject matters where the right legal advisor will provide significant value to a company and its selling sponsor and management team. Consideration should be given to whether or not a sponsor or other sellers (including management equity owners) may want to, or be required to, roll over some existing ownership on a tax-deferred basis. Further consideration should be given to structuring transactions as a sale of assets or as a sale of equity interests, whether or not gain on a sale will be treated as long-term capital gain (and how to maximize for seller's account the amount treated as long-term capital gain, including taking an early position in sales of pass-through entities on allocating value to assets that will generate long-term capital gain) and if there are historic tax liabilities of the company that will need to be addressed prior to or during sale negotiations.

Limit Post-Closing Liability: R&W Insurance; No Fraud Carveout

The right legal advisor is also going to be intimately familiar with how to limit sellers' post-closing liability. Representations and warrantiesinsurance allows a buyer and seller to allocate risk relating to breaches of R&W to an insurer for a fixed premium. R&W insurance offers sponsors a "clean exit" from their investment by limiting or even terminating post-closing indemnification liabilities relating to R&W and allowing the sponsor to return the proceeds from the sale to its investors at closing, while giving the buyer a source of recovery separate from the seller proceeds.

Properly drafted and negotiated provisions often considered to be mere "boilerplate" in the purchase agreement, such as the exclusive remedy, nonreliance and nonrecourse provisions, can provide selling sponsors and management teams with additional post-closing certainty by limiting the buyer's ability to bring extra-contractual fraud claims. An exclusive remedy provision specifies that the indemnification provisions in the agreement constitute the sole and exclusive remedy with respect to claims arising under the agreement.

A nonreliance provision stipulates that the buyer is solely relying on representations contained in the agreement and not on information obtained during due diligence or negotiations. A nonrecourse provision provides that the sponsor and other nonparty affiliates of the company are not subject to any contractual liability under the purchase agreement. Working together in the intended way, such provisions effectively bar a buyer from bringing a claim against the sponsor and otherwise from claiming fraud in order to defeat the negotiated protections sellers negotiated in the purchase agreement.

Prepare Marketing Materials

A sponsor and the company management team, in particular, will also coordinate with its advisors to prepare marketing materials. If a sponsor elects to sell via an auction process, the marketing materials will include a teaser, confidential information memorandum and management presentation. The teaser is a marketing document which gives a brief description of the company, often without identifying it, and highlights a few facts that make it an attractive business to be acquired. The CIM is one of the most important marketing documents prepared in the sale process, and unlike the shorter and more generic teaser, the CIM contains a detailed description of the company's history, operations, finances, sales, marketing efforts, customer background, employees and management team, and facilities.

Because the financial advisor needs to understand all aspects of the business in order to prepare a CIM that will capture buyer interest and address any potential concerns or uncertainty regarding the company's business, gathering the information needed to prepare these materials can be an extremely time-consuming process. The CIM should be reviewed by the legal advisor to avoid making any problematic disclosures from a regulatory or antitrust perspective and for purposes of thinking through the appropriate R&W and covenant package to be offered to any buyer.

A more streamlined set of marketing materials can be prepared if it is contemplated the exit will arise from direct negotiations with just one or two counterparties that are already familiar with the company.

Because the CIM contains highly sensitive and confidential information relating to the company, all interested bidders must first sign a confidentiality agreement before receiving a copy of the CIM. A well-drafted confidentiality agreement is an essential launching pad for the due diligence process and is typically drafted by the seller's legal counsel.

Prepare Data Room and Facilitate Buyer Due Diligence

As noted, a seller can begin preparing to populate a data room and proactively planning for buyer due diligence well before the sale process begins. With the assistance of its financial advisor and legal counsel, the seller will typically assemble an online data room using a third-party vendor. The scope of due diligence varies from transaction to transaction and may be impacted by the size and timing of the deal, the buyer's familiarity with the business and the buyer's risk tolerance. Particularly in the midstream space, it is critical to identify any potential issues and quantify the associated risks that will need to be addressed in the deal structure and definitive documentation early on in the deal process. Such issues include the location of the pipeline system, whether there are processing or treatment facilities involved and whether the system is an inter- or intrastate pipeline system.

A key component of the legal and commercial due diligence process for midstream deals is reviewing key customer and commercial agreements (gathering, processing, transportation and capacity agreements, among others). When reviewing midstream contracts during the due diligence phase, buyers often focus on the following:

- **Dedications/Commitments.** Often midstream contracts will contain a dedication or commitment, whereby the producer counterparty promises to deliver to the midstream company all produced volumes from a specified geographic area, oil and gas leases, and/or wells. In many cases, these midstream contracts also contain a MVC, which obligates the producer counterparty to deliver a minimum volume of oil, gas or water to the midstream company over a specified time period. A shortfall payment will typically be owed if the volumes provided to the service provider are below the applicable MVC.

- **Fees and Other Economics.** Buyers will be focused on the economics, including rate tiers, fee escalators, floors and chargebacks.

- **Covenant Running with the Land.** A specific area of legal and commercial diligence in all midstream deals relates to potential challenges to midstream contracts by producers in light of the Sabine line of cases, including an evaluation of whether the commercial contracts and associated dedications contain covenant "running with the land" language and the latest market technology to mitigate and defend against any potential argument from the producer counterparty that such contract is rejectable. From a commercial perspective, and as part of the marketing effort in a sell-side process, it should be determined whether the midstream company's key upstream customers have alternative transportation other than through the midstream company's system; if not, even if there is a legal risk, there is less practical risk of a challenge to the midstream contracts by producers.

Conclusion

Starting the exit preparation process now, during a period of headwinds for the energy industry and M&A generally, will position all stakeholders in the business, including sponsor and management, for a smooth and successful sale process at the optimal time when competitive dynamics return and willingness to pay for growth is high.

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