Lawyers McCullough Robertson

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Energy and Resources M&A Transaction Guide

Managing potential deal killers – liabilities, risks and the impact of the chain of responsibility

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ABOUT THE GUIDE

This is series 4 of McCullough Robertson's six part *Energy and Resources M&A Transaction Guide* developed for the resources sector.

ABOUT THIS ARTICLE

We look at ways that liabilities and risks can be appropriately managed and allocated between parties and through the appropriate structuring of an M&A transaction involving natural resources.

MASTERCLASSES

We'll wrap up the series with a Masterclass where you can ask our expert panel any questions related to undertaking a transaction. To register for the **Brisbane (27 September)**, **Sydney (6 October)** or **Melbourne (11 October)** breakfast events please contact Amanda Mason on 07 3233 8504 or amason@mccullough.com.au.

Risk allocation between transacting parties, deal completion risk and basic risk management plays a significant role in any M&A transaction. The ownership structure, demand for capital and unique operational requirements such as rehabilitation and environmental obligations of resource projects elevates the need to deal with risk to a level far higher than is the case for transactions in most other industry sectors.

Structuring to manage legal risk

The joint participation in resource projects and investments and the efficiencies of direct asset ownership have led to unincorporated joint venture structures becoming the ownership standard of the industry.

While they have their advantages, for example, tax depreciation rights and the ability for participants to access those rights given the rather recent advent of tax consolidations, unincorporated joint ventures carry with them a high degree of risk.

Perhaps the greatest issue is the joint liability of participants. Joint liability means that a single owner could be liable for the entirety of a claim made against all project owners even though it has a small percentage interest in the joint venture. Joint venturers go to great lengths to limit their liability on a several basis (i.e. so they are only liable for their proportion of any claim reflecting their interest in the joint venture) by, for example, having counterparties to material contracts accept that the joint venturers are only severally (and not jointly and severally) liable under the contract. However, there are many instances where joint venturers are both jointly and severally liable for loss or damage. Liabilities for breaches of conditions under mining leases or environmental authorities are prime examples of where all owners are jointly liable.

Buyers considering acquiring an interest in an existing project should therefore look to ring fence this risk by using a special purpose vehicle and avoid, where possible, providing parent guarantees and indemnities.

A buyer should also test the adequacy of the cross security held by each of the joint venturers as this security will provide priority to assets of the other joint venturers to fund any reimbursement where the buyer has to meet another non-performing joint venturer's share of a third party liability.

A special purpose vehicle will protect a buyer's other assets and investments in most cases but it is not a fool proof solution. The new chain of responsibility laws in Queensland extend liability for environmental damage to a participant's holding companies as well as others who gain financial benefit from the project which caused the environmental damage. Other strategies are required to manage this potential exposure.

Due diligence

Beyond careful deal structuring, the most effective way to manage risk in any transaction is to undertake a thorough due diligence process prior to committing to that transaction. In-depth due diligence will assist with establishing the value of assets and identify any material issues that may have an effect on the future performance of the business. In a resources context, a legal due diligence process should ordinarily assess possible risks associated with corporate status, title to assets, native title and land access rights, material contracts including access rights to transport infrastructure and their associated take or pay obligations, tenements, licences or permits required to operate the project, marketing and offtake arrangements, employment, safety and environmental compliance and bonding requirements.

Matters uncovered during the due diligence process, which are adverse to the project's value or its future performance, may cause the buyer to retreat entirely from investing in the project. In most cases buyers will, however, engage with the sellers for the purpose of negotiating an allocation of the risks associated with what has been uncovered. At the very least, negotiations between the parties are likely to affect the transaction price and the extent and nature of the warranties and indemnities to be provided by the sellers.

Warranties and indemnities

Claims for breach of warranties should always be considered as actions of last resort.

Sellers go to great lengths to limit their exposure to warranty claims. Time restraints on when a claim may be made, monetary limitations on how much a buyer can recover under a claim and carve outs for pre- agreement disclosures made to the buyer and information not actually known by the seller's management team all place significant inhibitors on a buyer's ability to be compensated for a loss based on a breach of warranty claim.

This is not to say that a buyer will never succeed in such a claim. Sellers therefore wanting a clean exit with effect from completion might take advantage of warranty and indemnity insurance. The premiums for that style of insurance range from 1% to 1.5% and provide sellers with the comfort that it will be protected against any post closing exposure. Buyers on the other hand might also encourage this insurance to be taken out as a form of security for its rights to make a warranty claim, particularly where the seller is not financially secure or is likely to leave the jurisdiction once the transaction is completed.

Beyond warranties, a seller might be asked to assume or remain liable for a particular risk relating to the sale project. In that case, the seller will be asked to indemnify the buyer against any loss relating to that liability or risk. Areas which the parties may agree should be the subject of a specific indemnity in resource industry transactions include tax claims, claims that relate to the period prior to completion, matters subject to ongoing litigation and liability for environmental contamination or disturbance. Conversely, the recent introduction in Queensland of the chain of responsibility legislation, which makes sellers just as liable as the buyer for environmental damage for at least two years following completion of a sale, has seen the introduction of reverse indemnities in that the buyer is the provider of the indemnity in favour of the seller for that exposure.

Security for claims against the seller

The overall liability of a seller under a sale agreement needs to be considered in the context of its financial strength, particularly where the sale of assets will leave the seller with limited capacity to fund warranty or indemnity claims. In these circumstances it may be appropriate for the buyer to seek a parent company or personal guarantee from the seller.

Retention amounts and escrow accounts also remain popular forms of security for warranty and indemnity claims although a seller will resist any mechanism that limits the receipt of immediately available funds on completion. Again, the level of security required by a buyer will depend on the covenant strength of the seller and whether a parent company guarantee, bank guarantee, charge over assets or some other form of security can be negotiated by the parties. Buyers should be particularly cautious of sellers who are potential flight risks in that they might be able to leave the jurisdiction shortly after completion. Seller warranties and indemnities that are not secured might prove to be of little value in those circumstances.

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