

M&A in the commodities sector

Still going strong

Illustration: Getty Images



Hugh Nineham, Prajakt Samant, Scott Megregian, Rashpaul Bahia and David Jacob of McDermott Will & Emery examine some of the practical and legal issues surrounding acquisitions of commodities trading operations.

Mergers and acquisitions (M&A) activity in the commodities trading sector has been buoyant over the past 12 to 18 months, affecting the trading operations of both financial institutions and energy companies. There have been a number of factors at play, including the collapse of significant market players (such as

Lehman Brothers and Bear Stearns), changes of ownership where new owners have a different appetite for the particular market risk, and a desire by some market participants to rebalance asset portfolios (either by upsizing or downsizing) in response to the crisis in the financial markets.

In these circumstances, institutions and companies who take a favourable view of the sector have been able to take advantage of opportunities either to enter the market or to strengthen and diversify existing operations. Examples of transactions over this period are the acquisitions by JPMorgan of the commodity

franchises of Bear Energy and Climate-Care, the sale by UBS AG of its commodities trading business, part of which was sold to Barclays, and the sale of Constellation Energy's coal, freight and international commodities business.

This article considers structuring and other issues which may arise when carrying out M&A in the commodities sector. It concentrates, in particular, on the transfer of risk in the context of transactions involving the sale and purchase of the assets and liabilities of a company conducting a trading business, rather than the shares of the company itself.

COMMODITIES TRADING

The commodities trading markets have seen significant change over the past decade, both in the range of products traded and in the number and character of the market participants. The products traded have evolved from the traditional commodities of coal, petroleum and soft commodities (such as coffee, cocoa and sugar) to natural gas and electricity, while market participants now include financial institutions as well as energy companies.

For many energy companies and financial institutions, at the core of their commodities trading businesses is the trading of derivatives on both a financially and physically-settled basis; that is, transactions where the obligations of the parties are either settled by way of a cash payment or transactions which contemplate the physical delivery of a commodity such as gas. Derivatives are financial instruments that derive their value from an underlying variable, such as a commodity price.

The commodity derivatives markets cover both privately negotiated over-the-counter (OTC) (that is, sold directly by seller to buyer) and exchange-traded transactions. These can include commodity swaps, forwards, spots and options (*for background, see feature article "Derivatives uncovered: swaps, futures and all that jazz", www.practicallaw.com/9-201-2879*). Typically, these transactions will be documented under industry standard master trading agree-

ments that have been developed by industry trade associations, such as the International Swaps and Derivatives Association, Inc. (ISDA), the European Federation of Energy Traders (EFET) and Global Coal. These master trading agreements establish the architecture of the legal and credit relationship between market participants.

Some commodity products will also be subject to more traditional physical trading structures, such as the coal and oil markets, where trading relationships may be documented through the use of bespoke long-term offtake agreements (agreements to buy all or a substantial part of the output or product produced by a project) or long-term supply agreements.

In conjunction with master trading agreements, the terms of derivatives transactions entered into between the parties will be set out in confirmations; which are documents that confirm the economic terms for each individual transaction.

Each trading relationship and individual transaction also may be subject to collateral arrangements where the parties may seek to reduce their credit risk or risk of loss if their counterparties fail to perform their obligations. This may involve the provision of credit support; for example, through the posting of cash collateral or the issue of a parent company guarantee.

STRUCTURING THE TRANSACTION

The first structural decision in M&A transactions in the commodities trading sector, as in any other, is whether the subject of the transaction will be the shares in the company conducting the target business and holding the assets and liabilities (a share purchase), or only some of its assets, liabilities and business activities (an asset purchase). The decision will depend on a number of factors: some fact-based, including how the business for sale is currently constituted in the seller's group and whether the buyer is willing to take on everything comprised within the business; and some related to the possible

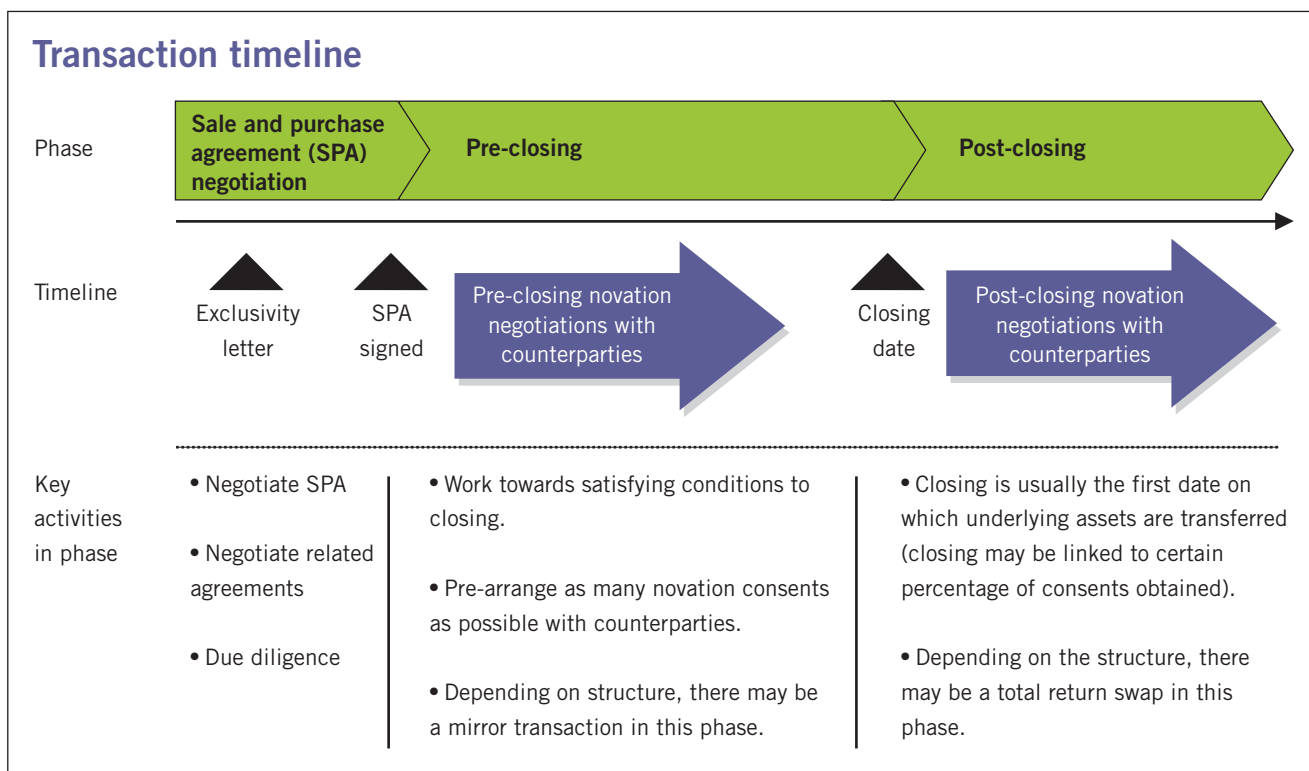
difficulty of transferring the trading contracts (*see "Novation agreement" below*).

Given the nature of the commodities trading markets, with transactions typically priced-out into a future date (for example, on a day-ahead, month-ahead or year-ahead basis), the decision whether to buy the shares or assets is a critical one and will significantly affect the timing and complexity of the sale and purchase.

An asset purchase, particularly in the commodities trading sector, will be more complicated procedurally than a share purchase due to the need to transfer each of the separate assets (transactions or trading relationships) that constitute the business. As a commodities trading portfolio will, by its very nature, involve a multitude of trading relationships with counterparties, more consents and approvals are likely to be required than on a share purchase, in particular in respect of the assignment or novation of trading contracts.

On the other hand, depending on the commercial agreement between the parties, an asset purchase will confer a greater degree of flexibility, particularly in circumstances where the seller has liabilities which cannot be easily quantified or identified, or where it has infrastructure or other assets which the buyer does not want.

There will, however, be some limits on this flexibility; for example, a buyer will need to have regard to possible difficulties in obtaining counterparty consent to the novation or transfer of trading contracts as there may be certain contractual liabilities to counterparties which the buyer has to assume as a price for obtaining the benefit of the contracts. Moreover, the Transfer of Undertaking (Protection of Employment) Regulations 2006 (*SI 2006/246*) (TUPE) may, depending on the facts, apply to transfer employment contracts regardless of the wishes of the parties (*see feature article "Ringling the changes: the new TUPE", www.practicallaw.com/2-203-1131*).



Options for risk transfer

If the parties decide to proceed by way of a share purchase, all the benefits and risk associated with the business will effectively transfer at closing. There may be a need for closing to be deferred depending, among other matters, on the regulatory position (for example, whether there will be a need to obtain merger control clearances). If there is a gap between signing and closing, there will need to be a purchase price adjustment mechanism for any value changes occurring during this period (see box “*Transaction timeline*”).

In the case of asset purchases, the position may be more complex and the following structures may be used to deal with the transfer of benefit and risk:

Structure 1. An asset purchase of the relevant commodities transactions for a fixed purchase price set at the signing of the sale and purchase agreement (SPA) and paid at closing. The closing date will be the date on which the transfer of the portfolio is effective. There will be a purchase price adjustment mechanism for changes in asset value between signing and the closing date, and all assets will be transferred on the closing date.

Structure 2. An asset purchase of the relevant commodities transactions for a fixed price paid at signing, with a total return swap (TRS) being effective on signing to transfer specified risks of transactions from the seller to the buyer (see box “*TRS transactions: an example*”). Alternatively, the TRS may be effective on the closing date rather than at signing. There will be no price adjustment mechanism because the TRS will transfer the economic and other risks to the buyer and, once all underlying trades are transferred to the buyer, the TRS will terminate.

Structure 3. An asset purchase of the relevant commodities transactions for a fixed price paid at signing, with mirror transactions between the seller and buyer that transfer price (market) risk between signing and the closing date, and a TRS effective at the closing date (see box “*Mirror transactions: an example*”). No price adjustment mechanism is needed because mirror transactions (followed by the TRS) transfer the price risk to the buyer at signing. Once the underlying assets are transferred to the buyer, the TRS terminates.

KEY DOCUMENTS

There are a number of issues that may arise in the context of negotiating the

key documents relevant to the structures outlined above.

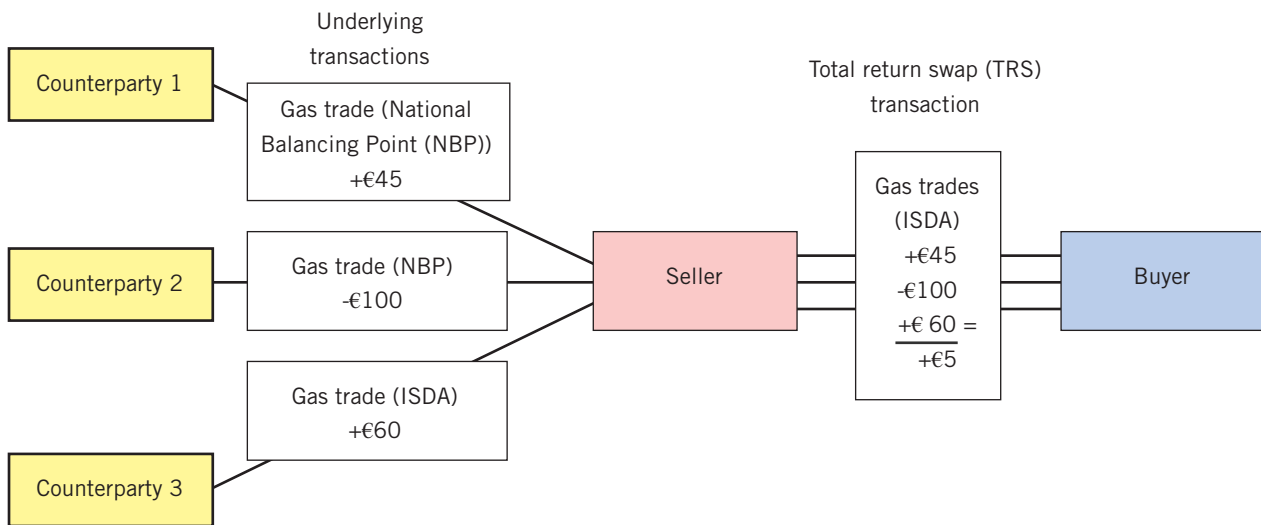
Sale and purchase agreement

In the context of a share purchase, the main negotiation points on the SPA will be relatively consistent with transactions in other sectors, although the price adjustment mechanism, if there is one, will be very specific to valuation methods relating to the underlying assets. The representations and warranties will also be tailored to the particular characteristics of the market.

In an asset purchase, the SPA may look more different from the norm, principally because of the procedural aspects of the transfer of the underlying assets and liabilities, and the time that the process is likely to take, which is often considerably longer than in other types of transaction. The following points may give rise to particular difficulty:

- Conditions precedent to closing. Apart from any required regulatory conditions, there may be tension between buyer and seller as to the required level of counterparty novations that are to be achieved before the transaction may be closed.

TRS transactions: an example



In contrast to the mirror transaction (see box “Mirror transactions: an example”), if Counterparty 3 fails to pay, as the TRS transfers credit, legal and other risks to the buyer in addition to market risk, the seller is not obligated to pay €60 to the buyer when the counterparty defaults.

- Novation process. There will need to be clear agreement over the conduct of the novation process (see “Novation agreement” below).
- Conduct of the business between signing and closing. In view of the estimated time that the novation process is likely to take, there will be more than the usual focus on the provisions relating to the conduct of the target business between signing and closing.
- Termination rights. A combination of all these factors is likely to lead to close discussion about the rights of either party to terminate before closing (including on the basis of material adverse change), particularly if the novation process is not proceeding as envisaged (for background, see feature article “Untying the knot: material adverse change clauses”, www.practicallaw.com/6-101-6634).

TRS/mirror transactions

Structures 2 and 3 (see “Options for risk transfer” above) contemplate the use of a TRS. Pending required consents or approvals to the transfer of the portfolio, the parties can use a TRS to transfer the benefits and burdens of trades from the seller to the buyer before the trades

are legally transferred by novation. Risks that may be transferred include market, credit, legal and operational risk, and the buyer may agree to assume all or some of these risks. For example, in terms of credit risk, a TRS allows flexibility as to who is going to take the risk if a counterparty to a particular trade does not pay.

Characteristics of a TRS include the following:

- Physical delivery requirements are usually financially-settled or booked out; that is, either a party may close out its physical delivery obligations by way of a cash payment, or the party will enter into a back-to-back physical contract thereby on-selling the physical delivery obligation.
- A TRS fee is likely to be payable covering, for example, credit and funding charges.
- A TRS may be structured as an option; that is, the buyer may have the right but not the obligation to buy the underlying asset.
- Collateral obligations of the parties will be set out in a credit support document.

- Trades will continue to be novated post-TRS.

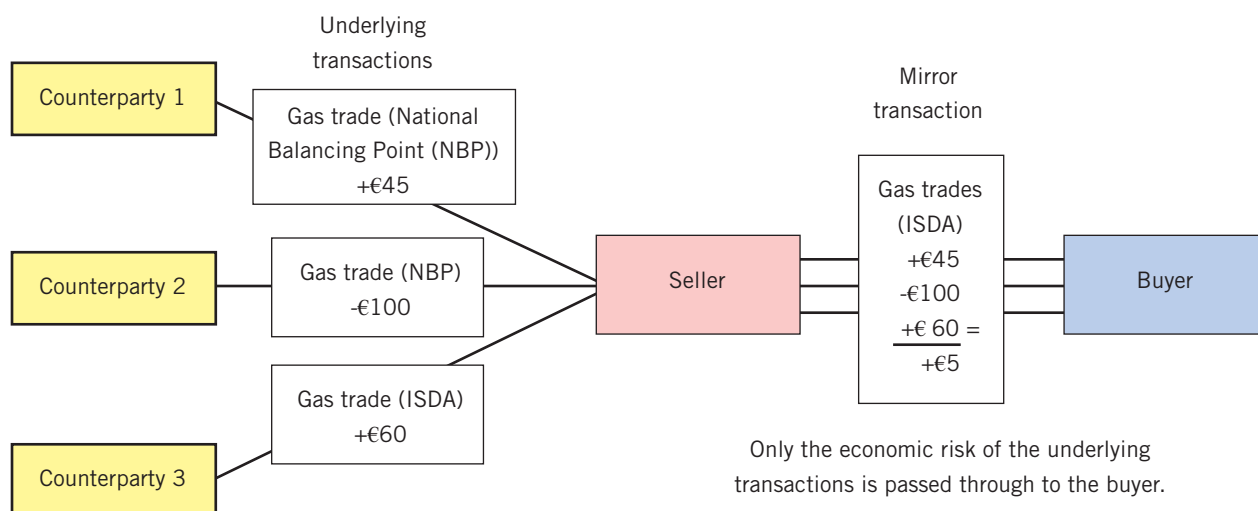
The documentation of a TRS will typically comprise an ISDA master agreement, other master trading agreement or bespoke agreement containing the general terms and conditions of the TRS, and a confirmation containing the specific economic terms, usually in a spreadsheet, of each trade in the portfolio.

By contrast, in a mirror transaction, the buyer and the seller enter into trades that mirror the seller’s underlying trades with counterparties so that the seller’s position with the buyer is opposite to the seller’s position with the counterparty. In addition, market risk is transferred from the seller to the buyer so that the seller’s market position becomes flat (that is, the transaction becomes a back-to-back arrangement).

Services agreement

The seller and the buyer may enter into a services agreement under which the buyer provides specified services to the seller for the portfolio pre-transfer, because often the seller will not retain the relevant staff to perform certain services. The seller may also provide similar services to the buyer where the buyer

Mirror transactions: an example



In contrast to the total return swap transaction (see box "TRS transactions: an example"), if Counterparty 3 fails to pay, the seller must still pay the buyer under the mirror transaction, even though it has not received the €60, because the buyer is not taking counterparty credit risk on the underlying transactions.

does not have the relevant personnel or operational assets.

These services may include: acting as a scheduling agent with a transmission provider; acting as nomination agent with commodity transporters and storage operators; margining payments and settlements; ensuring compliance with the terms and conditions of transactions; and managing and resolving disputes with counterparties.

A services fee may be separate or combined with the SPA or TRS. When transaction risks have been transferred under a TRS, the indemnities in the services agreement must be drafted carefully. The seller will appoint the buyer as its exclusive agent for the purposes of performing the services, and the seller will execute forms of power of attorney so that the services agreement does not need to be sent to all counterparties to the portfolio transactions.

Novation agreement

One of the critical components of a portfolio purchase will be the need to novate the transactions comprising the portfolio. Therefore, the parties may include in the SPA the process for transferring the underlying trades and the SPA

will need to cover issues such as the seller using commercially reasonable efforts to obtain counterparty consents to the novation of transactions and to agree a form of novation agreement.

Another option will be to have a separate transfer process agreement establishing the terms and conditions for transferring the trades to the buyer. In this case, the parties will also need to agree to a form of novation agreement.

The following considerations will need to be borne in mind when negotiating the novation process:

- The extent to which the parties endeavour to obtain counterparties' consents to novate should be specified or limited. It is important to avoid allowing a counterparty to leverage its position with the buyer or the seller as a result of the novation.
- The buyer may charge the seller a fee for preparing novation agreements and trade schedules.
- The parties may require novations before or after the closing date, depending on the structure of the transaction.

- The novation agreement will include standard representations and warranties.
- There should be an option to terminate if a related agreement terminates, such as a TRS or services agreement.
- Where a contract is novated, a new contract effectively replaces the old one, and the buyer will assume the responsibilities of the seller, with the counterparty releasing the seller from its obligations under the original contract.
- The counterparty will need to be a party to the novation as it will be entering into a new contract with the buyer.
- If contracts are to be novated, the buyer may wish to take an indemnity from the seller for any pre-novation breaches of contract by the seller.

THE REGULATORY ENVIRONMENT

As with any M&A transaction, the impact of competition law will need to be considered. Generally speaking, trading activity in the commodities markets is considered by competition authori-

ties to be sufficiently fragmented that substantive competition issues are unlikely to arise, although the markets in each of the commodities which are the subject of an M&A transaction must be considered separately and levels of competition differ in each of them. Therefore, it should not be taken for granted that no substantive issues will arise.

The first question is whether the transaction satisfies the relevant tests that might bring it within the scope of merger control regulations, either on a national or supra-national level. In the case of jurisdictions such as the EU where the relevant tests are based on turnover of the acquirer and the target, the character of the parties and the nature of the target business make it more likely than in many other types of transactions that the tests will be met.

In this context, it should be noted that, in relation to physical trades, the relevant turnover of the target is computed on a gross basis, although for financial derivatives the test is applied on a net basis (*Article 5(3)(a)(iv), EC Merger Regulation (139/2004/EC)*) (ECMR). A further element of the analysis, at any rate for EU purposes, is whether, in the case of an asset purchase, the portfolio of contracts (along with any ancillary assets or personnel) together comprises an “undertaking”. If it does not, the transaction will fall outside the ECMR. Relevant considerations include whether employees transfer under TUPE, whether customer relationships transfer and the length, nature and value of the trading contracts.

Other regulations must be considered on a jurisdiction-by-jurisdiction basis. As a general rule, there is no single regulatory regime that will apply to these types of transaction. However, in the US, for example, energy sector regulatory approvals may need to be considered, such as approvals under the Hart-Scott-Rodino Antitrust Improvements Act 1976 and, in the UK, it is highly likely that certain activities undertaken by the target will be covered by financial services regulations.

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TAX

There is no material difference in tax treatment between a sale and purchase of shares in the commodities trading sector and such a transaction in any other sector. In the case of asset purchases, however, different issues will arise. The following is a brief outline of the relevant UK tax issues to consider when undertaking an asset purchase.

Corporation tax

With the possible exception of precious metals, physical commodities are most often traded rather than held as investments. Therefore, a UK corporation tax paying commodities trader should be subject to corporation tax on income on any profit on the sale of physi-

cal commodities in accordance with the trading income rules in Part 3 of the Corporation Tax Act 2009 (CTA 2009). Similarly, a trading buyer of these commodities should be entitled to a deduction for the cost of purchase in accordance with the same trading income rules. This treatment should apply equally to one-off trading transactions as to sales and purchases of trading portfolios.

Profits, losses and gains on derivatives trading should be brought into account for corporation tax purposes in accordance with their accounting treatment as receipts or expenses of the trade under the corporation tax derivatives rules in Part 7 of the CTA 2009.

VAT

The value added tax (VAT) treatment of the contracts in the portfolio will depend on various factors, including:

- The subject matter or reference point of the contract (such as gas, electricity, freight).
- Whether the supply is treated as one of goods or services (electricity and gas are treated as supplies of goods).
- Whether delivery occurs (this will depend, among other things, on whether the contracts are physical, or financial or cash-settled) and, if so, where.

Physical commodity derivatives generally follow the VAT treatment of the underlying commodity, while financial or cash-settled commodity derivatives should be VAT-exempt as financial transactions within item 1, Group 5 of Schedule 9 to the Value Added Tax Act 1994. Where the portfolio consists of a mixture of such contracts, determining the VAT treatment of each item can be complicated.

However, it should not be forgotten that the sale of no more than a portfolio could qualify as a transfer of (part of) a business as a going concern for VAT purposes if the relevant conditions in Article 5 of the Value Added Tax (Special

Provisions) Order 1995 (*SI 1995/1268*) (1995 Order) are satisfied. If they are, Article 5(1) of the 1995 Order treats the sale as neither a supply of goods nor a supply of services, so the sale is not subject to VAT. The fact that part of a business can only run if integrated into another business which has the facilities to support it does not necessarily mean that it is incapable of separate operation.

In any case, the consideration for the portfolio should be expressed as VAT-exclusive so that the buyer pays any VAT due in addition to the consideration and the seller is not left out of pocket.

Climate change levy

The climate change levy (CCL) is chargeable on, broadly, the industrial and commercial supply (the taxable supply) of taxable commodities for lighting, heating and power by consumers in, among other sectors of business, industry, commerce, agriculture and public administration (www.practicallaw.com/2-101-4095). Taxable commodities include electricity, natural gas as supplied by a gas utility, liquid petroleum and coal.

Although the CCL should not apply to the sale of the portfolio itself, the portfolio may consist of contracts under which there are taxable supplies of taxable commodities. In this case, it is important to know what those taxable commodi-

ties are so that the correct rates of CCL are applied to them and to ensure that the consideration for those commodities is exclusive of CCL so that the buyer pays the CCL in addition to the consideration and the seller itself does not have to fund the CCL.

Stamp taxes

The sale of the portfolio should not attract stamp duty on the basis that the contracts should be neither stock nor marketable securities for stamp duty purposes.

Similarly, an agreement to transfer the portfolio should not be subject to stamp duty reserve tax (SDRT) on the basis that the contracts in the portfolio are not chargeable securities for SDRT purposes.

Non-UK taxes

Non-UK taxes may also be relevant, so the implications of such taxes for the sale and purchase of the portfolio should also be considered. In the US, for example, an inventory of commodities stored in the US could create a nexus for corporate income tax, franchise tax, and sales and use tax purposes.

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