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Offering Guidance: What to Consider Before Your Next Equity Offering

Most investor-owned utilities and utility holding companies provide annual earnings guidance and quarterly updates to the analyst and investor communities. Guidance is also frequently updated during industry conferences and in non-deal roadshows. A failure to meet the market's earnings expectations can negatively impact management's credibility and, in turn, the price of the company's common stock.

The importance of earnings guidance is heightened during an equity offering when a company is actively soliciting investors. Based on our experiences, decisions with respect to disclosing, updating or discussing earnings guidance are among the most difficult for the bankers, CFOs, lawyers, equity capital markets desks and investor relations departments working on the offering. These decisions are addressed from varying "risk assessment" perspectives and often it can be difficult to arrive at a consensus. Disclosure of earnings guidance in the context of an equity offering goes to the heart of the (sometimes contradictory) sensitivities of the marketing team and the legal team. On the one side is a desire to provide potential investors with the most current information (including management's judgments and expectations, much of which is inherently uncertain) in order to facilitate the selling process and set a good price. On the other side is the need to limit potential liability for the issuer and underwriters.

This article attempts to flag some of the issues involved in dealing with earnings guidance in the context of an equity deal and suggest practical approaches to meeting the parties' goals. As lawyers are fond of saying, dealing with guidance is "a facts and circumstances" exercise. That means there are few easy answers or risk-free solutions. It should be universally agreed, however, that one of the first orders of business when contemplating an equity issuance is for management and underwriters to develop a plan for addressing the issues and questions that will arise relating to guidance.

Liability for Earnings Guidance. Section 11 of the Securities Act of 1933 (the "Securities Act") imposes liability on issuers, their officers and directors and their underwriters for misstatements of material facts in the registration statement or omissions of material facts required in the registration statement or necessary to make the statements included in a registration statement not misleading.

Section 12 of the Securities Act imposes liability on those who offer securities through prospectuses or oral communications which include untrue statements of material facts or omissions of material facts necessary in order to makes the statements, in light of the circumstances under which they were made, not misleading.

Rule 10b-5 under the Securities Exchange Act of 1934 (the "Exchange Act") imposes liability on any person who, in connection with the purchase or sale of a security, makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

If guidance is included (or incorporated by reference) in a prospectus for an equity offering, a plaintiff will generally have three avenues to allege a claim: (i) Section 11, (ii) Section 12 and (iii) Rule 10b-5. If guidance is not included (or incorporated by reference) in a prospectus (or in the roadshow for the deal),[1] a plaintiff normally will only be able to allege a claim for faulty guidance under Rule 10b-5. Being limited to the Rule 10b-5 liability standard is desirable because Rule 10b-5, unlike Sections 11 and 12, requires the plaintiff to prove the additional element of "scienter", which includes an intent to defraud, a reckless disregard for the truth or "an extreme departure from the standard of ordinary care." Depending on the circumstances, it could be substantially more difficult for a plaintiff to succeed on simply a Rule 10b-5 claim, as opposed to a claim under Section 11 or 12.

Guidance is material information, but typically excluded from the prospectus. There is no doubt that earnings guidance is material information to equity investors. Indeed, it is hard to imagine information that equity investors would consider more important than management's expectations of performance. Although the SEC generally encourages issuers to disclose forward looking information, issuers are not required to disclose earnings guidance in the prospectus for an equity deal. This can sometimes be a difficult concept for non-securities lawyers; after all, if guidance is material, doesn't it need to be included in the prospectus? On the contrary, the applicable SEC disclosure rules do not require management to predict earnings, but only to identify known trends as a component of management's discussion and analysis of historical financial results.

Another question that issuers often ask is: if earnings guidance is important to investors, why shouldn't it be disclosed? In the context of an equity offering, the answer requires a weighing of potential benefits and potential liabilities by the company and underwriters. Because of its uncertain nature, guidance is inherently risky from a liability standpoint. Companies and underwriters are reluctant to accept the risk of claims of misleading guidance when earnings projections fail to be realized. This risk is especially prevalent in equity deals because, as opposed to investment grade utility bonds, equity is much more volatile. Losses which are the result of market price fluctuation may lead investors to look for opportunities to claim they were misled.

Given this concern, most utilities/holding companies choose not to include guidance in equity offering documentation. Instead, most provide guidance via press releases at regularly scheduled intervals, usually the quarterly "earnings releases" that announce results to the market, or investor slides in connection with industry conferences or non-deal roadshows. These press releases and investor slides are typically "furnished" and not "filed" with the SEC and, as a result, are not incorporated by reference into the prospectus. By excluding guidance from the prospectus, liability surrounding the guidance should be typically limited to claims under Rule 10b-5. As discussed below, the proximity of guidance releases to an offering can create issues for this separation.

Guidance should be current at the time of an offering. As a general matter, under applicable case law, there is no affirmative duty to update earnings guidance in most circumstances. When selling equity, however, if a company chooses not to update/reaffirm guidance at the time of the issuance, management should be comfortable that guidance remains current. In the context of an equity deal, if management knows that guidance will need to be adjusted downward when next addressed, management must consider the consequences of proceeding with an equity deal in the context of such "stale" guidance—namely, that their equity is likely to lose value upon disclosure of the revised guidance. At the very least, that scenario would risk

[1] Note that under Securities Act rules, the roadshow is deemed to be a free writing prospectus, which is not a component of the registration statement. However, if guidance is disclosed in a roadshow, participants may still be subject to liability under Section 12 in addition to Rule 10b-5.

alienating investors who purchased in the context of the old guidance and could lead to claims of disclosure omissions in the actual offering documents. If guidance is not current at the time of an equity offering, management has two options: (i) adjust guidance contemporaneously with the offering or (ii) delay the offering until guidance is updated in the ordinary course.

Press releases that update guidance and are contemporaneous with an equity offering may be deemed offering documents, but Rule 168, if available, provides significant flexibility. If guidance is revised in proximity to an equity offering, there is a risk that it may be deemed to be included in the offering materials, even if it is not included in the prospectus. Any written communication (including, depending on circumstances, certain electronic communications such as webcasts) that "conditions the market" for an offering of securities could be deemed to be a prospectus under the broad definitions of "offer" and "prospectus" in the Securities Act. Even a statement that doesn't mention the offering, such as a description of the company's business, new opportunities, corporate developments or a guidance announcement, may be considered a prospectus if it "conditions the market" for an offering. If deemed a prospectus, the communications will be part of the offering package, for which both the issuer and the underwriters will have liability, which may include Section 12 liability.

These issues are avoided for a communication that can meet the standards of Rule 168, a safe-harbor rule that allows certain issuers to launch an equity deal contemporaneously with a regularly scheduled release of guidance. Specifically, most utilities could utilize the safe harbor of Rule 168 in an equity offering if (i) the company has previously disseminated guidance in the ordinary course of business and (ii) the timing, manner, and form in which the guidance is released is consistent with the past such releases. For the utility industry, Rule 168 is extremely helpful because there are many regularly scheduled industry conferences (e.g., various EEI events) or investment banking events (e.g., Barclays CFO conference) at which utilities regularly present and reaffirm/update earnings guidance. Of course, these events are in addition to the other regularly scheduled occasions—such as quarterly earnings calls—where utilities announce guidance. To the extent an equity deal is launched contemporaneously or soon after one of these events which the issuer has traditionally utilized to present guidance, the guidance should meet the "timing, manner and form" test of Rule 168.

Rule 168 does, however, have some very rigid restrictions. Rule 168 is expressly not available for communications that contain information about the offering or that are disseminated as part of the offering activities. Practitioners should pay special attention to the quarterly earnings releases and webcasts containing or referencing guidance when an offering is to be made contemporaneously or shortly thereafter. Ideally, there should be no references to the offering in either the earnings release or the webcast. If circumstances make that impossible, counsel should be consulted as to what may be said about an offering. Counsel will often give company officers a "script" of exactly what may be said about the offering during these events, and advise the officers to avoid going "off-script." The toughest issues often arise during the part of the event that cannot be scripted: the question-and-answer session with analysts. Analysts will often want to know about plans for equity issuances. A review of historic transcripts from utilities during these events will reveal that the vast majority of CEO/CFO's will respond to questions about a contemporaneous equity deal with a terse suggestion to look at the company's SEC filings or even refuse to answer any such questions due to securities law concerns. Careful lawyers will prepare management regarding what they can and cannot say in response to such questions.

If earnings guidance is included in the prospectus, take steps to limit liability. Some transactions will inevitably occur when the Rule 168 safe harbor is not available and guidance must be updated because management's expectations are materially different than previously-announced guidance. Under these circumstances, companies may have little choice but to include (or incorporate by reference) guidance in the prospectus. In such situations, companies should seek to comply with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). The PSLRA provides a safe harbor from liability under the Securities Act and the Exchange Act for guidance which is identified as a "forward looking statement" and is accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statements." By accompanying the guidance with meaningful cautionary statements, both companies and underwriters can limit their liability under the securities laws. Most prospectuses or underlying Exchange Act documents contain disclosure designed to be responsive to the PSLRA and provide generic coverage for forward looking statements contained in the entire disclosure package. However, the company should also include key assumptions and factors specifically underlying the guidance. The courts and SEC have stressed that only meaningful and focused cautionary statements can be relied on to make the safe harbor available.

Regularly released guidance should be provided in a manner which minimizes pressure to update at the time of the transaction. Accompanying earnings guidance with key drivers that are assumed in formulating such guidance can minimize or avoid the need for unscheduled updates. Disclosure of these assumptions and qualifications emphasizes the uncertain nature of the projection, and, along with certain other cautionary statements, can entitle the company to statutory defenses from liability claims (as discussed above). In the utility space, several "drivers" would appear to be universally applicable, including normal weather and reasonable outcomes to rate and regulatory proceedings. A sensitive driver that would need to be addressed would be number of shares outstanding. Certainly, by assuming a level of outstanding shares that contemplates additional equity as a "driver" of the guidance, the pressure to update for the issuance would be minimized. Disclosure of future equity issuances, however, is highly sensitive, as such statements may have a dilutive "overhang" effect on stock price and are subject to many uncertainties. Management and underwriters would be wise to discuss this issue early in the transaction process.

Any decision to include (or incorporate by reference) guidance in the prospectus must be made in consultation with underwriters and underwriters will need to diligence such guidance. Management and the underwriters should have an understanding of what diligence the underwriters would expect to do with regard to guidance included in the prospectus. Guidance is typically not addressed by the accountants in the comfort letter. Although comfort alone would not suffice as "reasonable due diligence", the absence of comfort on guidance enhances the need for the underwriters to diligence the projections themselves, with assistance from counsel. Reasonable diligence could include discussions with management as to the assumptions made in formulating guidance, a management representation letter or certificate, a review of reconciliations to historical numbers or other actions to evidence the reasonableness of the projections. Understanding what will be required in regard to diligence and completing the process as early as possible will minimize the possibility of delay or disruption.

Is Everybody Going Dutch? The Modified Dutch Auction Debt Tender

With interest rates near historic lows, many issuers with which we work are seeking ways to refinance high-cost debt. Unfortunately, in the current low interest rate environment, standard make-whole redemption provisions result in high premiums, eroding or eliminating the economic benefit. An alternative approach is for an issuer to tender for outstanding debt, and a way to minimize the cost of a tender is to introduce the element of competition through a modified Dutch auction. In fact, at Hunton & Williams, we have noticed an uptick in the number of modified Dutch auction debt tenders in the market. We thought it might be helpful to our readers to discuss the basic framework for the modified Dutch auction debt tender.

In the modified Dutch auction, the issuer sets a range of acceptable prices within which a holder may tender its debt securities. The offer is for a specified portion, but not all, of an outstanding series of debt. The issuer ultimately pays the single lowest price (the "clearing price") within the range that will enable the issuer to purchase the amount of securities sought in the tender offer (the "tender cap") to each holder that has tendered their securities at or below such clearing price. The Dutch auction creates an incentive for the tendering holder to offer at a lower price. This is because the holder will want to minimize the risk that if the holder's offer price is not low enough some or all of the holder's securities may not be purchased.

A Dutch auction is "modified" because a range is provided for acceptable tenders. Because the price to be paid is the lowest price at which the issuer can buy all of the securities for which it has solicited a tender, an "any and all" tender offer cannot be conducted on a Dutch auction basis. If the issuer were to tender for all of the debt securities of a series on a Dutch auction basis, at least one holder would certainly tender its securities at the highest price, and therefore the clearing price for an "any and all" tender would always be the highest price in the suggested range.

Most Dutch auction tenders are executed with a small premium that is offered only to holders who tender during the first ten business days or "early period" of the offer. Therefore, under normal circumstances, most if not all of the tenders will be made by the tenth business day of the offer. The issuer, on day ten, is thereby made aware of what is likely to be the final participation levels at various prices.

Legal Framework and Documentation—the Base Case

The legal framework regulating cash debt tender offers is straightforward. The rules for equity tender offers, such as the requirement that all holders receive the same consideration, are not applicable. Since no new security is offered, a registration statement and prospectus are not used. Instead an "offer to purchase" is provided to holders which sets forth the terms of the tender. Disclosure with respect to the issuer is provided by incorporating the issuer's filings under the Securities Exchange Act of 1934, as amended (the "1934 Act"). Basic antifraud provisions such as Rule 10b-5 under the 1934 Act still apply. Regulation 14E under the 1934 Act, which is applicable to any foreign or domestic tender offer, does require that an offer be kept open for a minimum of 20 business days. One or more dealer managers are engaged by the issuer to solicit tenders into the offer. An information agent is responsible for providing the offer documentation, accepting tenders and ultimately calculating the payment due to holders.

Pricing the Offer

If the issuer is unsuccessful in achieving participation in the offer which meets or exceeds the tender cap, then the clearing price of the offer will be the highest price of all of the tenders which are made within the acceptable range. As an example, if the issuer launches a tender offer for $100 million of a $300 million series, but only succeeds in getting $50 million of participation in the offer, then the "clearing price" will be the highest price of all of the tenders in the acceptable range—and will very likely be the absolutely highest price in the range (as long as at least one holder tendered at such price). Given this scenario, an issuer should be certain that even the highest price in the range set for the tender is an acceptable price to the issuer. Further, the issuer and counsel should consider including a "minimum condition" in the offering document. This condition would describe to holders a participation level below which the issuer would abandon the tender.

The Oversubscribed Tender

Various options are presented to the issuer when, at the expiration of the early period, the principal amount of securities tendered by holders exceeds the tender cap. In such a scenario, the issuer has the opportunity to increase the tender cap of the offer. The issuer will review the amount of debt tendered above the original cap in order to identify how upsizing the tender cap would affect the clearing price to be paid to holders.

We will use a tender offer with a tender cap of $100 million (for a series with $300 million outstanding) as a hypothetical. If, at the end of day ten of the offer, $200 million of securities have been tendered, the issuer may upsize the tender cap to $120 million at the associated clearing price of X+1 or upsize even further to $150 million at the associated clearing price of X+2, and so on. Because there is little chance that additional tenders will come in after the early period, the issuer can identify the size of tender it would like to do based on the corresponding clearing price. This allows the issuer to pick a "sweet spot"—the size of deal at a corresponding clearing price. Even if additional tenders are made after the early period, the effect of the additional tenders can only be to further reduce the clearing price.

Increasing the size of the tender cap implicates Rule 14e-1(b) of the 1934 Act, which requires that upon an increase or decrease of the percentage of the class of securities being sought, the tender must remain open for at least 10 business beginning with the date that notice of such increase or decrease is first given to security holders.[2] However, because the decision to upsize can be made immediately after the expiration of the "early period", there are 10 business days left on the back end of the tender. This allows the issuer to increase the tender cap, without also increasing the overall duration of the tender. Barring some other concurrent change to the terms of the offer, this increase of the tender cap of the offer can be made without any extension of holders' withdrawal rights (which typically expire at the end of the 10-day early period).

One Wrinkle—Pro-rating The Debt

If the purchase of all the securities validly tendered in the tender offer on or prior to the expiration with a price that is lower than or equal to the clearing price would cause the issuer to accept an aggregate principal amount of securities in excess of the tender cap, then the offer is "oversubscribed." In that case, the securities which are tendered at the clearing price will be prorated. None of the other securities accepted by the issuer, which were tendered below the clearing price, will be prorated.

The Latest Development—The Corporate Dutch Auction Debt-for-debt Exchange

Although commonly used for tender offers, the Dutch auction format had not in recent memory been used by a corporate issuer to effect a debt-for-debt exchange. As described in the Hunton & Williams October 22, 2012 news release, our group of attorneys at Hunton & Williams recently represented the dealer manager on a groundbreaking debt-for-debt exchange conducted on a Dutch auction basis. The transaction received Deal Maker of the Year 2012 recognition by *Finance Monthly*.

Similar to any fixed-spread Dutch auction tender, the total exchange consideration offered for each old note equaled the discounted value of the remaining payments of principal and interest (excluding accrued interest) using a yield of (i) a

[2] There is a *de minimus* exception not to exceed two percent of the class of securities that is the subject of the tender.

reference yield plus (ii) the clearing spread, *as such clearing spread was determined by the Dutch auction*.

The offer was not registered but instead was structured as a private placement under Section 4(2) of the Securities Act of 1933, as amended (the "1933 Act"). The offer was made only to holders which were "qualified institutional buyers", as defined in Rule 144A of the 1933 Act and outside the U.S. to persons other than "U.S. persons" as that term is defined in Rule 902 under the 1933 Act. The dealer manager was responsible for soliciting tenders from existing holders. Similar to the Dutch auction tender, an information agent was also engaged. An additional obligation of the information agent was to verify that holders submitted a representation letter as to their status as a qualified institutional buyer or non-U.S. person. Only then did the information agent provide the holder information with respect to the offering. Although structured as a private transaction, holders of the new notes were granted registration rights.

If the modified Dutch auction debt tender remains a popular liability management tool in the near future, we expect that the Dutch auction debt-for-debt exchange should be equally popular for similar reasons.

Conflict Minerals: A Brief Update for Utility Issuers

In August 2012, the SEC finalized its "Conflict Minerals" rule, as required by the Dodd-Frank Act. The final rule requires reporting issuers for whom conflict minerals are "necessary to the functionality or production of a product" manufactured or contracted to be manufactured by that issuer, to make certain disclosures regarding the source of those minerals and the due diligence that the issuer has performed on those minerals. Conflict minerals include cassiterite, columbite-tantalite, gold, wolframite, and their derivatives (including tin, tantalum and tungsten); and the rule requires diligence to determine whether such minerals originated in the Democratic Republic of Congo or adjoining countries.

Interpretive questions remain regarding what it means to "manufacture" or "contract to manufacture" a product under the rule. What is clear is that the generation, transmission and distribution of electric energy does not trigger the rule — and thus most electric utilities will not have to comply with the rule. However, issuers should perform a comprehensive review of their lines of business to identify any products they may "manufacture" or "contract to manufacture," including any products ancillary to their main business. There is no de minimis exception to the rule; any product (no matter how insignificant to a company's bottom line) that contains ANY amount of a conflict mineral can trip the rule. Utility companies with which we work have reviewed, and are continuing to review, their business lines to determine whether any activities trigger the rule. The prevailing sense, however, is that most utilities will not trip up the rule, absent the sale of some unique product outside of the core business of generation, transmission and distribution of electricity.

Companies that are affected by the rule must file their first required report by May 31, 2014, covering the calendar year 2013. Therefore, issuers who are subject to the rule must have a proper monitoring and compliance program in place beginning January 1, 2013.

Steven R. Loeshelle, Editor
212.309.1028
sloeshelle@hunton.com

Steven C. Friend, Editor
212.309.1065
sfriend@hunton.com

If you have questions related to any of the articles in this issue, please contact any of the below members of the Capital Markets Group of the Energy and Infrastucture practice at Hunton & Williams LLP:

Dee Ann Dorsey
212.309.1174
ddorsey@hunton.com

Bud Ellis
212.309.1064
ellisb@hunton.com

Kevin C. Felz
212.309.1053
kfelz@hunton.com

Michael F. Fitzpatrick, Jr.
212.309.1071
mfitzpatrick@hunton.com

Steven C. Friend
212.309.1065
sfriend@hunton.com

Steven R. Loeshelle
212.309.1028
sloeshelle@hunton.com

Peter K. O'Brien
212.309.1024
pobrien@hunton.com

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