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Time to Give Back? Strategies for Oil and Gas Producers Looking to Distribute Free Cash Flow to Stockholders

By Mark L. Jones and Adam W. Park*

Industry commentators have noted a shift in the model for U.S. oil and gas producers from being production growth oriented to focusing on free cash flow. The authors of this article highlight certain considerations that companies should keep in mind when determining how best to deploy free cash flow.

Shale explorers have long felt the pressure from public markets to generate positive free cash flow—net income in excess of capital expenditure.¹ On display at a recent EnerCom Oil & Gas Conference in Denver, Colorado, were oil and gas producers discussing their companies’ plans for generating positive free cash flow, with some also discussing strategies for returning that capital to investors in the form of dividends and stock repurchase plans. Industry commentators have noted a shift in the model for U.S. oil and gas producers from being production growth oriented to focusing on free cash flow.² Returning free cash to investors in the form of dividends can add an element of current income to a producer’s stock where the value of the stock was previously only growth oriented. Stock repurchases can add liquidity to the company’s stock and demonstrate to investors that the company views the stock as undervalued. Companies declaring dividends for the first time or launching stock repurchase plans should consider the legal issues raised in each circum-

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stance to ensure that plans are carried out efficiently. In this article, we highlight certain considerations that companies should keep in mind when determining how best to deploy free cash flow.

DIVIDENDS

The declaration and payment of dividends by a corporation is a function of state law. In general, a corporation's board of directors must determine the amount of the dividend, the stockholders entitled to receive the dividend and the date on which the corporation will pay the dividend. State law varies on limitations imposed on a corporation's ability to pay dividends. For example, Delaware corporations may pay dividends from either of two sources: (1) surplus or (2) in case there shall be no surplus, net profits for the fiscal year in which the dividend is declared and/or for the preceding fiscal year. In connection with each dividend, the board of a Delaware corporation must determine that funds are available for distribution by the corporation and declare a record date for stockholders entitled to receive the dividend. Information sufficient to support the board's determination should be provided in the meeting materials where the dividend is declared or should accompany the form of written consent circulated to the board for adoption.

DIVIDEND REINVESTMENT PLANS

The full amount of a cash dividend need not leave a corporation in cash. A dividend reinvestment plan (“DRIP”) allows investors to elect to automatically have cash dividends reinvested in shares of the corporation’s common stock. Instead of receiving cash dividends, the investors receive either newly issued shares or shares purchased in open market transactions. The source of shares used to fulfill DRIP obligations is determined in accordance with the terms of the plan. Issuing new shares in lieu of cash dividends allows the corporation to retain cash that otherwise would have been distributed. DRIP plans can either allow stockholders to “opt in” to having dividends automatically reinvested or require stockholders to “opt out” to receive their dividends in cash. A corporation may not need to register shares issued through its DRIP, depending on several factors: (i) its level of involvement in marketing the plan; (ii) whether the plan is sponsored by—and offered through—an unaffiliated broker or bank; and (iii) whether the shares used in the DRIP are purchased in the open market. In general, if a corporation’s activities are limited to administrative duties and paying the plan sponsor and the sponsor’s broker commissions, the stock does not need to be registered with the SEC.

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3 Essentially stockholder equity in excess of par value, unless otherwise determined by the corporation’s board of directors.
Stockholders benefit from participation in a DRIP by acquiring additional shares of the corporation, including fractional interests, without incurring additional brokerage fees in the transaction. Unfortunately, participation in a corporation’s DRIP may be difficult for many stockholders. DRIPs are typically administered by the corporation’s transfer agent, and elections for participating in the DRIP are made by registered holders of the corporation’s stock. For many public companies, most of their public float is held in street name through a broker dealer. In order for these stockholders to participate in the corporation’s DRIP, the stockholder would have to request that the shares be recorded in the investors’ name directly, which typically requires additional fees. Broker dealers may operate their own DRIP plans, sometimes referred to as synthetic DRIPs, but these plans do not allow a corporation to issue new shares to satisfy DRIP obligations. The potential benefit of a DRIP will depend on the composition of the corporation’s stockholder base and the nature of beneficial holdings in the corporation’s stock.

DIRECT STOCK PURCHASE PLANS

One potential avenue to increasing the number of direct beneficial holders of the corporation’s stock is to maintain a direct stock purchase plan (“DSPP”). Like a DRIP, a DSPP is typically operated by the corporation’s transfer agent and allows stockholders to acquire additional shares of the corporation’s common stock at regular intervals. However, a DSPP allows an investor to make an initial purchase of the corporation’s common stock directly from the issuer and to make periodic additional investments in amounts in excess of cash received as dividends from the corporation. DSPP participants benefit by not paying broker commissions, and in that way can efficiently increase their position size. However, DSPP participants sacrifice control over the timing of purchases and the ability to dictate the price at which they invest. DSPPs present an opportunity to raise low-cost capital from investors who become stockholders of record—whose identity is known to the corporation.

Whether a corporation is required to register shares issued in a DSPP rests on the same framework underlying registration of DRIP shares. SEC guidance in no-action letters indicates that an issuer may link to the DSPP administrator’s website where plan materials and enrollment documents can be accessed without triggering the need to register the shares being issued. Corporations may find it more effective to file a registration statement or use a portion of shares on a shelf registration statement to fulfill orders through the DSPP to

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allow the corporation greater flexibility in marketing the program. Unregistered shares issued through a DSPP will be freely tradable under most circumstances.  

REPURCHASE PLANS

As a preliminary matter, oil and gas producers may be prohibited from conducting stock repurchase programs under the terms of agreements governing indebtedness. Lenders have an incentive to discourage the use of free cash for purposes other than reducing the company’s indebtedness, and may withhold the consent required to conduct a stock repurchase program. Producers that are not otherwise restricted may find it beneficial to make open-market repurchases at times when their stock is trading at a discount to net asset value.

Stock repurchase plans have received mixed publicity in recent years. Many investors like stock buybacks, and even insist that corporations do them because the buybacks have the potential to boost the corporation’s net earnings per share and the net asset value per share. Repurchases may also be more tax efficient for investors who benefit from the appreciation in the value of their shares but do not incur a taxable gain until the shares are sold for a profit. Others, including a coalition of Democratic senators, have raised concerns that stock repurchases enrich executives—whose compensation may be tied to metrics like earnings per share—and stockholders at the expense of workers and investments in long-term growth of the corporation. The concern raised by this campaign dovetails with a recent statement released by the Business Roundtable announcing the organization’s position that a corporation’s primary concern should be shared among its customers, employees, community and investors.

Oil and gas producers electing to deploy free cash in repurchase programs may take advantage of safe harbors created by federal securities law to carry out

SEC guidance states that unregistered shares issued from a plan can be resold without any restrictions if three conditions are satisfied: (1) the issuer of the securities is subject to the period reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, (2) the stock being distributed is actively traded in the open market, and (3) the number of shares being distributed is relatively small in relation to the number of shares of that class issued and outstanding. The SEC stated that a number of shares distributed in a fiscal year that is less than one percent of the outstanding securities of the class would be considered a “relatively small amount,” but also indicated that amounts in excess of one percent may still be deemed to involve a relatively small amount. See Securities Release No. 628, Employee Benefit Plans, Jan. 15, 1981.


repurchases effectively and efficiently. These rules provide corporations with the
greatest flexibility to take advantage of ideal pricing conditions for repurchases.

**RULES 10b-18 AND 10b5-1**

The two primary legal considerations in the case of a corporation making
open-market stock repurchases are (1) market manipulation, and (2) trading
while in possession of material nonpublic information. A corporation's partici-
pation in the market for its own stock gives rise to the concern that the
corporation is artificially enhancing the demand for its stock, generating
upward pricing pressure. The corporation is also the ultimate insider—so any
material nonpublic information will give rise to a disclosure requirement before
the corporation can reenter the market. Structuring a repurchase program that
complies with the conditions for safe harbors under Rules 10b-18 and 10b5-1
can enable a corporation to execute trades over a longer time frame and
accumulate substantial repurchases over such period.

Rule 10b-18 under the Securities Exchange Act of 1934 (the “Exchange
Act”) provides a safe harbor from liability for market manipulation. A
repurchase program complying with the conditions of Rule 10b-18 is deemed
to allow the market to establish a trading price independent of influence by the
corporation issuing the stock. Four conditions under Rule 10b-18 relate to:

(1) The number of brokers or dealers completing trades on behalf of the
corporation;
(2) The timing of purchases;
(3) The price of purchases; and
(4) The volume of purchases.

Trades under a Rule 10b-18 repurchase plan must be effected by only one
broker or dealer in any single day. The plan may involve more than one broker
or dealer, but only one firm can make trades on behalf of the corporation on
any given day. The timing of purchases under a Rule 10b-18 program depends
on the public float of the corporation and the average daily trading volume of
its stock, but trades must not be the opening trade or made in the final minutes
of any trading session. Rule 10b-18 does permit some after-market trading
activity but restricts the prices at which after-market trades may be completed.
The price of trades under a Rule 10b-18 program must not exceed the highest
independent bid or the last independent transaction price, whichever is higher.
Finally, the volume of purchases in any single day must not exceed 25 percent
of the average daily trading volume for that security. The volume condition
includes a carve-out for one block purchase per week if no other Rule 10b-18
purchases are effected that day, and the block purchase is not included when calculating the stock’s average trading volume for other purchases made under Rule 10b-18.

Rule 10b-5 under the Exchange Act prohibits corporate insiders from trading while in possession of material nonpublic information. Because there are narrow windows during which the corporation possesses no material nonpublic information, Rule 10b5-1 expands the corporation’s ability to effect stock repurchases without violating Rule 10b-5’s anti-fraud features. A Rule 10b5-1-compliant trading program must satisfy five conditions:

1. It must be a written plan;
2. It must be adopted at a time when the corporation is not in possession of material nonpublic information;
3. It must either use a written formula to derive amounts, prices, and dates or delegate authority to an unaffiliated third party;
4. The plan must include a provision suspending trading in the event of a material transaction or Regulation M distribution; and
5. There should be a delay between adoption of the plan and the first purchase thereunder.

Under a Rule 10b5-1 trading plan, the corporation makes an investment decision at the time it adopts a written plan. The corporation may suspend trading under the program at any time, but any adjustments must occur at a time when the corporation is not in possession of material nonpublic information.

One of the main reasons why corporations adopt a Rule 10b5-1-compliant trading plan is that Rule 10b5-1 allows the corporation to continue repurchasing shares during blackout periods. This expands the period over which the corporation can effect purchases, increasing the odds that shares can be repurchased at favorable prices, particularly during periods of market volatility. However, reliance on Rule 10b5-1 is not required, and corporations may wish to retain control over the price and quantity of purchases.

**PRIVATELY NEGOTIATED REPURCHASES**

Privately negotiated repurchases provide an alternative to plans designed to comply with Rule 10b-18 and Rule 10b5-1. Corporations seeking to repurchase shares in privately negotiated transactions should take care to avoid
inadvertently triggering the tender offer rules or effecting a “going private” transaction.\footnote{8}{Going private transactions are governed by Rule 13e-3 under the Exchange Act. Corporations should take care that repurchases do not cause the corporation to fall out of compliance with exchange listing volume requirements.}