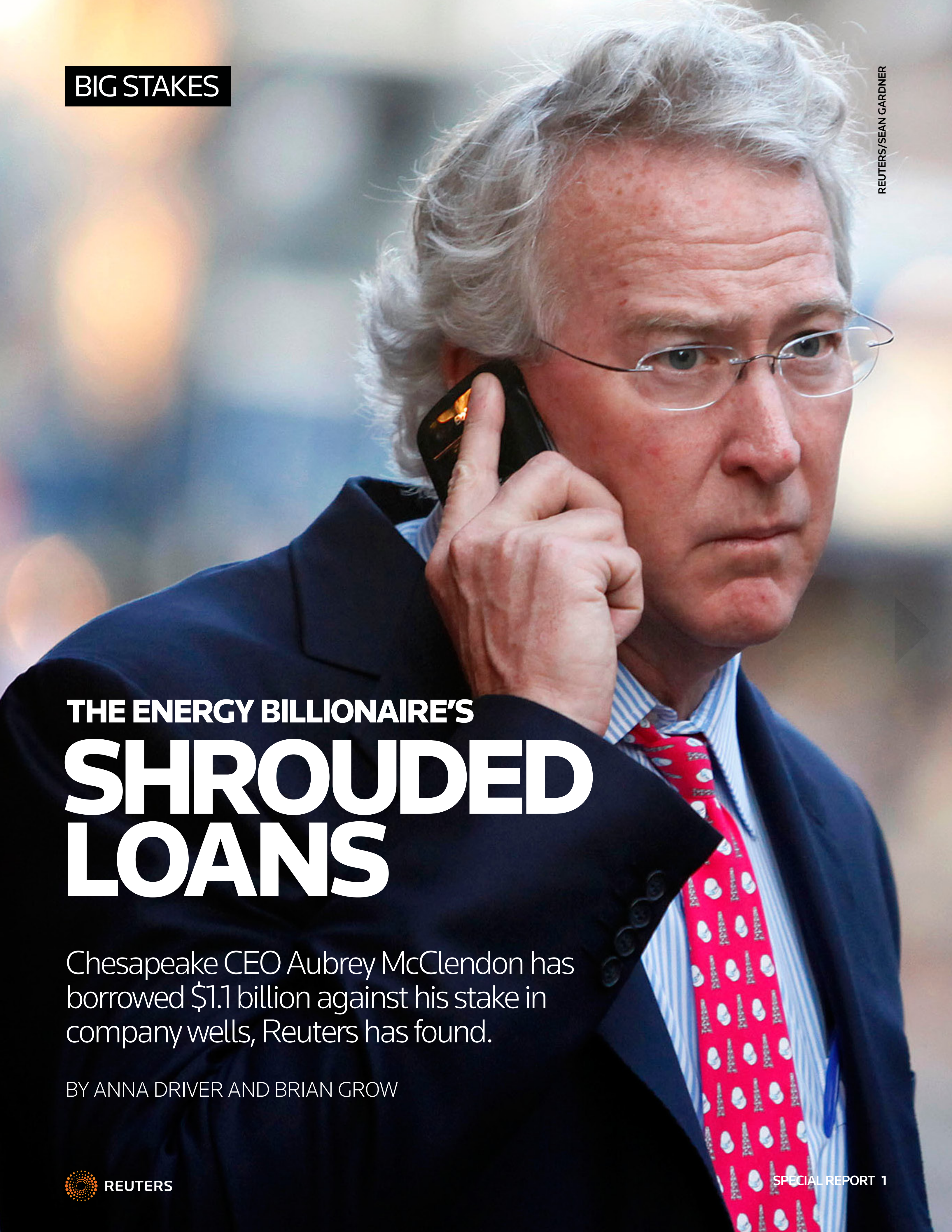


REUTERS/SEAN GARDNER

BIG STAKES

THE ENERGY BILLIONAIRE'S SHROUDED LOANS

Chesapeake CEO Aubrey McClendon has borrowed $1.1 billion against his stake in company wells, Reuters has found.

BY ANNA DRIVER AND BRIAN GROW

APRIL 18, 2012

Aubrey K. McClendon is one of the most successful energy entrepreneurs of recent decades. But he hasn't always proved popular with shareholders of the company he co-founded, Chesapeake Energy Corp., the second-largest natural gas producer in the United States.

McClendon, 52, helped cause Chesapeake shares to plummet amid the financial crisis when he sold hundreds of millions of dollars in stock to raise cash for himself. Later, to settle a lawsuit by shareholders, he agreed to buy back a $12 million map collection that he'd sold to Chesapeake.

His approach to running his company also is renowned: Among other employee perks, on-site Botox treatments are available at its headquarters in Oklahoma City, Oklahoma.

Now, a series of previously undisclosed loans to McClendon could once again put Chesapeake's CEO and shareholders at odds.

McClendon has borrowed as much as $1.1 billion in the last three years by pledging his stake in the company's oil and natural gas wells as collateral, documents reviewed by Reuters show.

The loans were made through three companies controlled by McClendon that list Chesapeake's headquarters as their address. The money is being used to help finance what could be a lucrative perk of his job – the opportunity to buy into the very same well stakes that he is using as collateral for the borrowings.

The size and nature of the loans raise concerns about whether McClendon's personal financial deals could compromise his fiduciary duty to Chesapeake investors, according to more than a dozen academics, analysts and attorneys who reviewed the loan agreements for Reuters.

"If Mr. McClendon has $1 billion in debt through his own companies — companies operating in the same industry as Chesapeake — he has or could have a high degree of risk for conflicts of interest. As in, whose interest will he look out for, his own or Chesapeake's?" said Joshua Fershee, an associate professor of energy and corporate law at the University of North Dakota.

The revelation of McClendon's bout of borrowing comes as he is scrambling to help Chesapeake avert a multi-billion-dollar cash shortfall amid a plunge in natural gas prices.

It also exposes a potentially serious gap in how U.S. regulators scrutinize corporate executives, a decade after those rules were tightened in the wake of major accounting scandals.

The loans portend a number of possible problems, the analysts said. McClendon's biggest lender is simultaneously a major investor in two units of Chesapeake. That connection raises questions about whether Chesapeake's own financing terms could be influenced by its CEO's personal borrowing.

> "The more information the company releases to shareholders the better – particularly when it's such a large amount of money.
>
> **Mike Breard**
> Oil and gas analyst

Another concern: A clause in the deals requires McClendon "to take all commercially reasonable action" to ensure that other owners and operators of the wells – including Chesapeake – "comply with…covenants and agreements" of the loans. Such clauses are common in energy-finance deals. But it is rare for the CEO of a major energy company to be personally subject to one involving the corporation that he runs. That means McClendon could have an incentive to influence Chesapeake to act in the interest of his lenders, rather than of his shareholders.

"Basically what you have here is a private transaction that could potentially impact a public company, depending on the manner in which the clause is interpreted and applied," says Thomas O. Gorman, a partner at law firm Dorsey & Whitney in Washington, D.C., and a former special trial counsel at the Securities and Exchange Commission (SEC). "That may create a conflict of interest."

As a result, the loans should have been fully disclosed to Chesapeake shareholders, the academics, attorneys and analysts said.

NO CONFLICT

Both McClendon and Chesapeake say the loans are purely private transactions that the company has no responsibility to disclose or even to vet. And they disputed the view that the deals could create a conflict of interest.

"I do not believe this is material to Chesapeake," McClendon said in an email response to questions. "There are no covenants or obligations in my loan documents or mortgages that bind Chesapeake in any way."

Chesapeake general counsel Henry Hood said in a statement that the clause in the loan agreements questioned by analysts – called "Compliance by Operator" – is "typical boilerplate language" used in oil and gas mortgages. It requires borrowers to exercise their rights with operators of wells, such as Chesapeake, on behalf of the lender.

Neither the existence of McClendon's loans nor their terms create the possibility of a conflict of interest, Hood said, in part because the company has a first lien on McClendon's share of company wells. That would mean Chesapeake gets paid before all other creditors in the event that McClendon defaults on his debt.

"Any loans are Mr. McClendon's personal business and not appropriate for review or monitoring by the company or public comment," Hood said.

The company has many checks to protect against conflicts, Hood said. Among them: Some of the world's largest energy companies own a share of Chesapeake wells and "monitor the actions of the Company" via well audits, government filings and participation in development plans, Hood said.

He added that Chesapeake now employs more than 13,000 people and drills

Beneath the surface

A look at some borrowing by Chesapeake's CEO

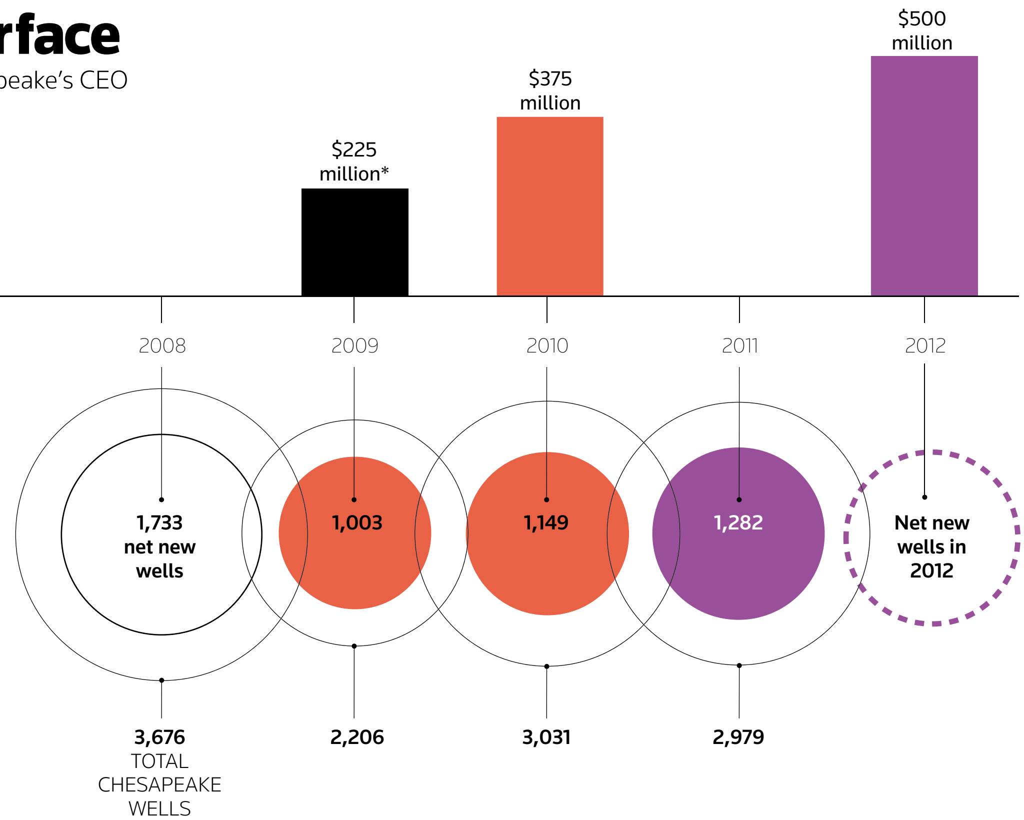
THE LOANS

Loan amounts made to Aubrey McClendon

THE COLLATERAL

McClendon secured the loans with his 2.5 percent working interest in new Chesapeake wells drilled each year

(Color indicates the loan supported)



*Collateral not known

Sources: Financing statements filed in Louisiana and Texas (loans); Securities and Exchange Commission filings (wells)

more than 2,000 wells per year, "all of which minimizes the ability of any one person" – McClendon included – "to influence actions on any single well."

Less than four years ago, a personal transaction by McClendon did negatively influence the company.

To buy more Chesapeake stock, McClendon borrowed money from his brokers - what's called "buying on margin." In October 2008, just after the financial crisis erupted with the bankruptcy of Lehman Brothers, he was forced to sell more than 31 million Chesapeake shares for $569 million to cover margin calls from those brokers. The company's stock fell nearly 40 percent the week of McClendon's share sales. McClendon issued an apology but the company's credibility with many shareholders suffered significantly.

Chesapeake's board of directors is aware that McClendon has borrowed against his share of company wells, Hood said, but "the board did not review or approve the transactions." Nor did the company vet the loan terms for possible conflicts. "If there were any conflicts of interest," Hood said, "they would have surfaced by now."

Chesapeake board members contacted declined to comment. Marc Rome, Chesapeake's vice president for corporate governance, did not respond to requests for comment.

The loans reveal how McClendon is using an unusual corporate incentive as collateral. The perk, known as the Founder Well Participation Plan, grants Chesapeake's billionaire co-founder a 2.5 percent stake in the profits – and makes him pay 2.5 percent of the costs – of every well drilled during each year he decides to participate.

Today, Chesapeake is the only large publicly traded energy company to grant its CEO the opportunity to take a direct stake in wells it drills. Chesapeake says the well plan is a uniquely powerful incentive because it aligns McClendon's personal interests with those of the company.

The well plan does not allow McClendon to select the wells in which to invest; Chesapeake says the program is an all-or-nothing proposition so that McClendon can't cherry-pick only the most profitable wells.

"He has to eat his own cooking here," said company spokesman Michael Kehs.

But because McClendon is using the loans to finance his participation in the well plan, he defrays his risks. Two of McClendon's lenders, both private equity firms, in turn spread the loan risks to other investors by raising money from state pension funds and other investors to fund them. Those insights emerge from a February 2011 document detailing a meeting between McClendon's largest personal lender and a prospective investor.

AT WORK: Chesapeake's 50-acre campus in Oklahoma City, Oklahoma, boasts a state-of-the-art gym and offers employees Botox and teeth whitening treatments. **REUTERS/STEVE SISNEY**

"If he hasn't had to put up any of his own money, how is that alignment" of McClendon and Chesapeake's interests, asked Mark Hanson, an analyst with Morningstar in Chicago.

Chesapeake says McClendon's loans are "well disclosed" to company shareholders. General Counsel Hood cited two references in the company's 2011 proxy. In them, the firm refers to McClendon's personal "financing transactions," including one in a section entitled "Engineering Support" that discusses McClendon's use of Chesapeake engineers to assess well reserves.

Nowhere in Chesapeake proxy statements or SEC filings does the company disclose the number, amounts, or terms of McClendon's loans. Veteran analysts of the company said they were never aware of the loans until contacted for this article.

"We believe the disclosures made by the company have been appropriate under the circumstances, particularly since the disclosure of the loans is not required in any event," Hood said in a statement.

> "If Mr. McClendon has $1 billion in debt through his own companies — companies operating in the same industry as Chesapeake — he has or could have a high degree of risk for conflicts of interest.
>
> **Joshua Fershee**
> Associate professor of energy and corporate law

Legal experts say the size and terms of McClendon's borrowing are unusual – and highlight a gap in regulatory scrutiny of American corporate executives.

In the past, major Wall Street banks formed separate companies – or special purpose vehicles, just as McClendon has – to allow select employees to borrow from the employer and make investments. The WorldCom accounting scandal was, in part, fueled by more than $1 billion in loans taken out by former chief executive Bernard Ebbers that were secured by his shares of company stock. And energy giant Enron used off-balance-sheet entities to hide debt from investors. New accounting and corporate governance laws and regulations banned such transactions or required their disclosure.

In September 2006, the SEC revised its related-party transaction rules to require companies to disclose when executives pledged corporate stock as collateral for loans. "These circumstances have the potential to influence management's performance and decisions," the SEC wrote.

McClendon's loans - backed not by stock but by stakes in company wells - aren't covered by the SEC rule. "Because they have decided to compensate him with a business interest, it kind of falls through the cracks," says Francine McKenna, an accounting expert and author of the accounting-related blog re: The Auditors.

As a result, no SEC regulation precludes McClendon from using his well plan stake as loan collateral. The SEC declined to comment on the McClendon loans.

TEETH WHITENING

Tall and thin, McClendon is a tireless booster for the oil and gas industry - and of his company. At an energy conference in November in Houston, he sported a tie printed with tiny drilling rigs. His daring deals and stirring speeches to investors have attracted some adoring followers.

During one speech last September, McClendon said opponents of a controversial drilling technique called hydraulic fracturing were interested in "turning the clock back to the Dark Ages."

"What a great vision of the future!" he said sarcastically. "We're cold, it's dark, and we're hungry!"

McClendon's investor presentations are standing-room-only. But he often bristles when his business model is questioned by analysts, frequently arguing that Wall Street does not understand the company.

That tension has intensified as Chesapeake scrambles to shed more than $10 billion in debt through the rapid-fire sale of assets amid the lowest natural gas prices in a decade.

McClendon continues to treat his employees well. In recent years, he built a 50-acre red-brick campus in Oklahoma City as Chesapeake headquarters. It boasts a 72,000 square-foot state-of-the art gym, visiting doctors who provide lunchtime Botox treatments for employees, and dentists who whiten teeth.

A part owner of the NBA's Oklahoma City Thunder and supporter of charitable causes in the state capital, McClendon holds considerable sway in Oklahoma. Former U.S. Senator Don Nickles and former Oklahoma Governor Frank Keating, both Republicans, are members of the Chesapeake board.

McClendon's close relationship with the board hasn't left him immune to tensions with stockholders.

After Chesapeake's board agreed to buy McClendon's map collection in 2008 for $12.1 million, shareholders sued. The lawsuit was settled in November 2011, when McClendon agreed to refund the $12.1 million, plus interest, and hold stock worth 500 percent of his annual salary and bonus. Chesapeake also agreed to hire Rome, the vice president of corporate governance, and an executive compensation consultant to evaluate corporate pay packages.

The well participation plan, which was approved by shareholders in 2005 and cannot be discontinued until 2015, has remained unaffected.

Disgruntled investors continue to launch challenges. On March 13, New York Comptroller John C. Liu and the $113 billion New York Pension Funds called on Chesapeake to let large long-term shareholders put up their own nominees for the board of directors.

Key aspects of McClendon's loans remain hidden from shareholders. Because promissory notes underpinning the loan agreements are private, the interest rate, the exact amount borrowed and other terms of the transactions are not publicly known.

But the loan agreements demonstrate the extent to which McClendon has leveraged his interests: He has pledged as collateral almost every asset associated with his share of Chesapeake wells. Oil, gas and land interests, platforms, wells and pipelines, hedging contracts, geological and business data, and intellectual property are among scores of well-related assets that can be seized should McClendon default.

Chesapeake said it would be "unaffected by any dispute" between McClendon and a lender in the event of a default because of its first lien on oil and gas production, equipment and land leases.

> "We believe the disclosures made by the company have been appropriate under the circumstances, particularly since the disclosure of the loans is not required in any event.
>
> **Henry Hood**
> Chesapeake general counsel

The company also says that McClendon's share of "related assets" pledged as collateral - such as business data and hedging contracts associated with wells - is completely separate from similar assets owned by Chesapeake. That means Chesapeake would not become entangled should McClendon default, the company said.

Chesapeake "does not have an interest in the (McClendon's) related assets … and Mr. McClendon does not have an interest in the company's related assets," general counsel Hood said in a statement.

In explaining why Chesapeake's board isn't obligated to monitor McClendon's personal loans, Hood cited a September 2003 decision by a Delaware Chancery Court. The ruling in Beam v. Stewart found the board of Martha Stewart Living Omnimedia did not breach its fiduciary duty to shareholders by failing to monitor her personal investments. (Stewart served five months in prison in 2004 following her conviction for obstruction of justice in an unrelated insider-trading case.)

Given the size, scope and complicated

ENJOYING THE GAME: Actor Rob Lowe (L) and Chesapeake CEO Aubrey McClendon watch the Oklahoma City Thunder play the Los Angeles Lakers in February . **REUTERS/STEVE SISNEY** terms of the loans, their particulars constitute important stockholder information and therefore should be more fully disclosed, said David F. Larcker, a professor of accounting at Stanford University's Graduate School of Business.

Some shareholders agree. "While recognizing (McClendon's) right to privacy, the more information the company releases to shareholders the better – particularly when it's such a large amount of money and related to the oil and gas business," said Mike Breard, oil and gas research analyst at Hodges Capital Management in Dallas, which owns Chesapeake shares.

As with a mortgage on a residential home, state law requires ownership rights to physical property be recorded with county clerks.

Reuters found McClendon's loan agreements by following the trail of well and land lease transfers from Chesapeake to three companies that list McClendon as their corporate representative, according to state deed records.

In county courts in Louisiana, Texas, Arkansas, Pennsylvania and Oklahoma, where Chesapeake operates thousands of wells, the company regularly files a form called a conveyance. In keeping with the corporation's well participation program, the conveyance grants McClendon a 2.5 percent share of each well and of the leased land on which it is drilled.

For years, Chesapeake has distributed 2.5 percent shares in wells and land to three McClendon-controlled companies – Chesapeake Investments LP, Larchmont Resources LLC and Jamestown Resources LLC.

Since he co-founded Chesapeake in 1989, McClendon has frequently borrowed money on a smaller scale by pledging his share of company wells as collateral. Records filed in Oklahoma in 1992 show a $2.9 million loan taken out by Chesapeake Investments, a company that McClendon runs. And in a statement, Chesapeake said McClendon's securing of such loans has been "commonplace" during the past 20 years.

But in the last three years, the terms and size of the loans have changed substantially. During that period, he has borrowed as much as $1.1 billion – an amount that coincidentally matches Forbes magazine's estimate of McClendon's net worth.

The $1.1 billion in loans during the past three years breaks down this way:

In June 2009, McClendon agreed to borrow up to $225 million from Union Bank, a California lender, pledging his share of wells as collateral.

In December 2010, he borrowed $375 million from TCW Asset Management, a private equity firm.

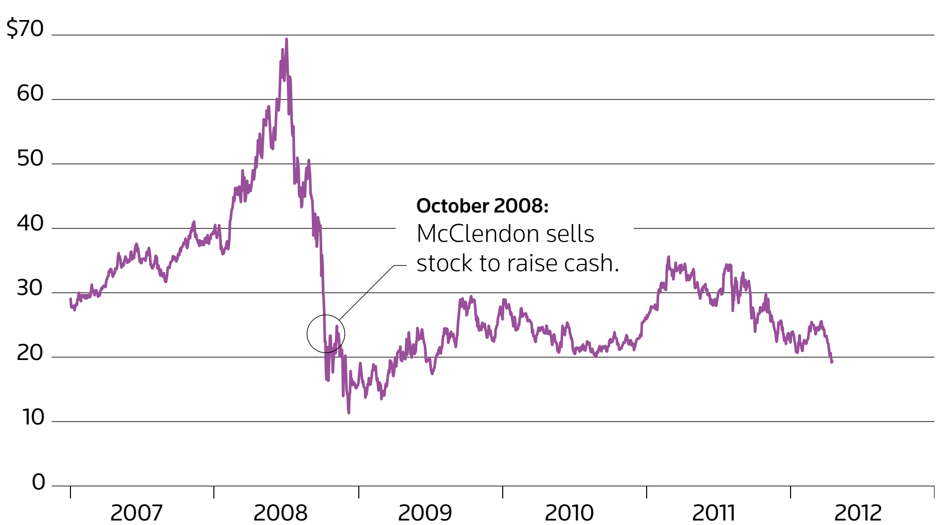
And in January 2012, McClendon borrowed $500 million from a unit of EIG Global Energy Partners, a private equity firm formed by former TCW executives.

It is unclear how much, if any, of those loans have been repaid.

Randall Osterberg, a senior vice president at Union Bank who signed the loan agreement, declined to comment. TCW and EIG also declined to respond to questions.

Margin fall

Chesapeake Energy's daily share price



Source: Reuters

REAL LOSS?

At first blush, what the company tells shareholders suggests the well plan is a money-loser for McClendon.

In its proxy statements, Chesapeake says McClendon lost $116 million in 2009, and $141.9 million in 2010.

It's unclear whether McClendon has suffered any real losses, however. Asked about the calculations, Hood said McClendon's net loss is a byproduct of his drilling costs being "front end loaded," while his revenues accrue over many years.

"If they are showing that kind of negative cash flow, the wells don't have value," said Phil Weiss, oil analyst at Argus Research who has a sell rating on the company's shares. But given that McClendon has borrowed more than $1 billion based on the value of his well stakes, "I really don't think (the company's disclosures) tell me much," Weiss said.

Chesapeake has resisted attempts by regulators to get more information on McClendon's well-participation plan before. In 2008, the SEC requested more information about McClendon's benefits from the well plan as part of a review of the company's 2007 annual report.

From May to October that year, Chesapeake and SEC officials exchanged at least eight letters and held negotiations on the issue. After first refusing to provide more information, Chesapeake ultimately agreed to provide shareholders a chart detailing well plan revenues and costs, a review of the letters shows.

Chesapeake's Hood said in a statement that the company's disclosures are "fully compliant with all legal and regulatory requirements." The chart and other SEC filings contain "all material facts that Chesapeake was required to disclose," he said.

A spokesman for the SEC declined to comment.

McClendon's biggest personal lender, EIG, has been a big financer for Chesapeake, too.

In November, Chesapeake raised $1.25 billion from a group of investors including EIG through the sale of "perpetual preferred shares" in a newly formed entity, Chesapeake Utica LLC, which controls about 800,000 acres of oil and gas-rich land in Ohio. The sale offers lucrative terms to EIG investors, paying an annual dividend of 7 percent and royalty interests from oil and gas wells, according to analysts.

On April 9, the company announced a nearly identical deal to raise another $1.25 billion from EIG and other investors, in another new subsidiary called CHK Cleveland Tonkawa.

Dividends on preferred shares are controversial because they are paid before regular dividends owed to common shareholders. "Basically it's a form of more expensive debt," Morningstar's Hanson said. "It makes it appear that it's not debt, but it sits on top of obligations to the common shareholder."

The fact that McClendon's largest personal lender received favorable terms on its Chesapeake investments caused some Wall Street analysts to call for more information about McClendon's loans.

"I think the company should disclose this information. One reason is that the

DRILLING DOWN: A worker at a Chesapeake rig site in South Texas walks past stacks of drill pipe used to tap oil and gas. **REUTERS/ANNA DRIVER**

A lucrative deal for the CEO's financier

The lender behind $500 million worth of Aubrey McClendon's personal loans is a private equity firm with headquarters across the street from the White House and the Chinese government as a minority owner.

The firm, EIG Global Energy Partners, is run by R. Blair Thomas, an attorney and veteran energy investor. Formerly the Energy & Infrastructure Group of Trust Company of the West, EIG spun out of TCW in January 2011. It had $9.5 billion under management at the end of last year.

Those deep pockets – along with special ties to McClendon - have enabled it to bankroll his share of Chesapeake wells, according to minutes of a February 2011 meeting between EIG and the New Mexico State Investment Council, the state's public investment fund.

At the meeting, EIG chief operating officer Randall Wade sought a $50 million investment from New Mexico. Asked about a prior EIG investment in McClendon's well interests, Wade boasted EIG had known Chesapeake for more than 25 years and "provided pre-IPO financing for them in the late 1980s."

Those tight bonds, Wade said, have created other unique opportunities for EIG.

"In fall 2008, Mr. McClendon didn't have liquidity to participate in the (well) program in 2009, at which point EIG entered into discussions with him and ultimately" formed a special purpose vehicle called Larchmont Resources, Wade said.

Through Larchmont, EIG acquired the rights to all of McClendon's well stakes for 2009 and 2010. EIG then set up a new special purpose vehicle – Jamestown Resources – to control McClendon's well shares in 2011, with rights to 2012, Wade said.

EIG's investments have been extremely profitable. "EIG sweeps 100 percent of the cash flow generated by those projects until EIG has gotten all of its money back plus a 13 percent realized return," Wade told New Mexico investors. EIG also gets a 42 percent cut of McClendon's share of the well profits "in perpetuity," he said.

EIG declined comment.

In February, EIG announced that China Investment Corp.(CIC), China's sovereign wealth fund, had acquired a minority stake for an undisclosed amount. CIC declined comment.

Reporting By Brian Grow and Anna Driver; editing by Blake Morrison and Michael Williams

CEO is taking out loans from at least one entity, EIG, which recently provided financing to Chesapeake," said Joseph Allman, oil and gas industry analyst at JPMorgan in New York, who reviewed the loan agreements. "In the same way that investors want to know the counterparty to significant Chesapeake transactions, they would want to know if one of those firms has significant private dealings with the CEO."

Chesapeake's Hood acknowledged there could be "some theoretical possibility of a conflict of interest" with the company and its CEO borrowing from the same lender. But because Chesapeake does not believe there is "an actual conflict of interest," more disclosure is not required, Hood said.

CLOSING A GAP

McClendon's personal loans highlight a gap in current SEC rules governing disclosures of related-party transactions, say accounting experts. The SEC requires disclosure of any transaction over $120,000 involving a company and a related party, such as the CEO, directors and certain family members, "with direct or indirect material interest."

Chesapeake said the SEC's related-party rule doesn't apply to McClendon's loans - only to his participation in the well plan. That's because Chesapeake believes the loans "do not constitute a material transaction with Chesapeake or even involve Chesapeake," Hood said.

That disclosure gap may be closing. A proposed new standard, released for public comment by the Public Company Accounting Oversight Board on Feb. 28, would require auditors to identify and evaluate "significant unusual transactions" with executives connected to publicly traded firms. The board defined such transactions as those "outside the normal course of business or that otherwise appear to be unusual due to their timing, size or nature."

Board chairman James R. Doty described the proposal as a way to scrutinize transactions that have played "a recurring role in financial failures." The oversight board declined to comment on McClendon's loans.

For now, said analyst Weiss, Chesapeake and McClendon are pushing the limits. "If Chesapeake were trying to make things muddy and unclear without breaking the law, this would be a good way to do it."

Reporting by Anna Driver in Houston and Brian Grow in Atlanta; additional reporting by Joshua Schneyer in New York; editing by Blake Morrison and Michael Williams

INVESTED IN COMPANY: Chesapeake CEO and co-founder Aubrey McClendon has taken out personal loans to invest in the company's oil and gas drilling efforts. **REUTERS/SEAN GARDNER**

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