The current oil and gas environment:
Buying distressed oil and gas assets

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Where does deal activity go from here?

Dan Crowley: There is no getting around the fact that the market is bleak, but it's for exactly that reason there are and will be generational investments opportunities. Here are some of the deal dynamics that we'll likely see in this upcoming cycle.

First, we'll see quality assets that are available at cheap prices. That will be different than 2016, when the capital markets were still flush and asset values were propped up as a result.

Second, we'll see consolidation increase meaningfully. Investors have been agitating for consolidation for many quarters. Though there's been some increase in merger activity, it hasn't hit the velocity that investors want. Sub thirty dollar WTI will change that; virtually no drilling activity is economic in this price environment, and so the only way E&Ps can control costs is to cut to—but not through—the bone, and then to spread such costs across a larger production base. Companies will have to become more efficient to protect themselves from extremely low prices.

Third, consolidation activity will be fueled primarily by equity mergers, given the lack of investor capital and the fact that virtually any cash sale would be leveraging to a seller instead of deleveraging.

Fourth, "contingent mergers" will be the preferred way to effectuate consolidation in this cycle. In a contingent merger, two companies agree to combine, but only if their stakeholders agree to equitize debt or otherwise right-side their balance sheet as a condition precedent to the M&A transaction. In the last down cycle, the restructuring playbook was typically to go through the restructuring process, then spend six to 12 months optimizing the asset, and then finally explore monetization strategies, which could have included selling takeback debt or equity interests or pursuing a cash sale in the A&D market industry and distributing the proceeds. With a few exceptions, that playbook didn't work well. A contingent merger would address a lot of the shortcomings of the old playbook; it would effectively combine into one efficient step what has historically been a two-step process that was more time consuming and more expensive.

The fifth deal dynamic in this cycle relates to RBL. RBLs will be the fulcrum stakeholder in many restructurings this time around. As a result, they will be the key players in the restructuring processes to a much greater extent than they historically have been. That raises an important question about how RBL lenders will behave.

The first thing to consider is that there is virtually no A&D market for RBLs to sell into. That means that many RBLs will opt for a restructuring solution and will retain a stake in the reorganized company. Basically, they will be betting that over time they can receive a higher recovery than if they were to liquidate the assets immediately. In many cases RBLs will accept takeback term loans, not just takeback RBLs, and they will do so at a discount to their prepetition balance. RBLs will increasingly takeback equity, if only because there will be severe limitations on the amount of debt companies can support in this price environment.

A second consideration is that in most cases RBLs will not need fully built-out management teams to drill wells and explore business development opportunities. Instead they'll need lean management teams that are cost-efficient and very good at producing PDP assets. This will be a boon for PDP-focused contact operators and management teams for hire.

Another thing to keep in mind is there's a practical limitation to how many work outs commercial banks can handle concurrently. Most banks don't have a large enough work-out team to deal with all their non-performing loans, and they have problematic exposure across many industries, not just in old and gas. This will cause them to be very thoughtful and selective in how they reduce E&P loan exposure. From the borrower's perspective, the key to navigating redetermination is to present a clear road map to banks about how they will repay their loan.

The sixth deal dynamic relates to bondholder behavior. The composition of bondholder groups in this down cycle is, so far, very different than in the last cycle. In the last cycle, bondholder groups were largely dominated by hedge funds; so far this cycle bondholder groups are overwhelmingly long-only money managers such as mutual funds and insurance companies. Long-only groups will have a different philosophical approach to restructurings, but, more significant, is their sheer size and the fact that they have material holdings across a larger number of E&Ps. Theoretically, that should be conducive to the industry consolidation.

I'm thinking of buying some assets from a company that may go bankrupt very soon. What might happen if I buy some assets and the company does go bankrupt soon after? What should I be doing to put me in the best position if that happens?

David Simonds: First, a buyer can be subject to some litigation claims; the principal one is fraudulent transfer claims. Fraudulent transfer claims can be brought against a buyer of assets in a subsequent bankruptcy of the seller, or by creditors outside of bankruptcy under state law. Those claims generally arise when the selling company receives less than reasonably equivalent value or less than fair value fer the asset it sold, at a time when it is insolvent or when it is rendered insolvent by the transfer itself. Second, liens and claims may travel with the assets, and the company can pick up potentially unknown liabilities under a successor liability theory or even for unpaid state taxes for which they might not be aware. Third, contract and lease provisions of the selling company may prevent assignment of its key contracts, or it could restrict changes in control, which might affect the purchaser once it takes control of the assets. Lastly, there might

be corporate charter provisions that require certain approvals of shareholders, and potentially all shareholders, in a transaction. There may be further litigation risks, which would need to be analyzed on a case-by-case basis.

Can you go through some of the issues, the ways to deal with those issues?

Erin Brady: The first mechanism to look at is how to create the evidentiary trail or the facts that a company would want to have if they were stuck in—if they ended up in litigation. A company wants to start to do their due diligence on all of the liability thoroughly. The company must make sure they know what they are buying, make sure they know what the liabilities are. Especially pay attention to unpaid taxes. The best way for a company to protect itself is to really to know what they are getting into. It's generally a good idea, although not a bullet-proof plan, to obtain fairness and insolvency opinions from either a financial advisor or a banker. Those can be used in litigation—they're certainly not dispositive, but they can be helpful as an evidentiary tool. A company may want to get property appraisals, so that there's a clear record of what the value was at the time that the transaction occurred.

They can also create "good facts." Consider having the seller run a marketing process to get a sense of what the market value is. It's similar to what they would do if they were doing a bankruptcy sale—they run a process and an auction so they know what the value is. If there's a documented marketing process where they can see generally what buyers in the market are willing to pay, they can defend the value that they paid for the property.

They can also create a paper trail. When they are having negotiations and discussions with other parties or with their bankers, their financial advisors, they should write down what's going on, create contemporaneous notes. Those may be helpful when they are in litigation—but at the same time don't create an email paper trail that can be subject to discovery. While in these transactions, this could end up in litigation. If it is in litigation, emails and other correspondence could be subject to discovery. Everyone involved should make sure they are not writing anything they don't want to their litigation opponent to see later down the line.

A company can also obtain representations and warranties regarding solvency. The question is just how much those are worth if they are buying a distressed seller, unless they are backed up by a credit-worthy party. They can also obtain an indemnification from the seller—again same issue—or from a third party who actually would have the money to fund an indemnity. They would want indemnification against fraudulent transfer claims, credit liability claims, and the like. The best way to implement that sort of mechanism is to create an escrow that's prefunded that they can then draw on account of indemnification claims.

It is a good idea to limit the time between signing and closing the deal. A buyer wants to decrease the risk that the seller's going to file for bankruptcy between signing and closing, and then seek to reject the agreement so doesn't have to close. It can be important to get the deal done and move on the closing as soon as possible. Finally they are going to want to include language in each of the agreements they sign stating that the agreements are integrated and treated as a single agreement, and that's going to limit the ability of the seller to try to cherry-pick agreements and reject in any subsequent bankruptcy.

I'm thinking about buying some oil and gas assets out of bankruptcy, but they have a lot of existing plugging and abandonment liability related to them. Would I have to take those liabilities if I bought those assets?

Ron Silverman: Plugging and abandonment issues and liabilities in E&P bankruptcies are some of the more unique issues that pertain to E&P bankruptcy and financially distressed matters; they don't come up in other industries the same way they do in E&P cases, so there are special things to watch for and a lot of people don't understand the implications.

P&A (plugging and abandonment) liability refers to federal and state laws that require that oil and gas companies drilling for mineral interests, at the end of a drilling process, at the end of the life of the well, that they take steps to decommission those wells and to return the environment, in a safe way, to the way it was before there was a well that was drilled. Normally, when a company is solvent and healthy, they have the resources to satisfy those liabilities, and those are some of the many liabilities in the ordinary course that E&P companies address. However, when E&P companies are in financial difficulty, oftentimes they don't have the ability to satisfy those liabilities.

There are bonding regimes that state and federal laws provide for, and there may be surety bonds or other coverage that's available to cover off P&A liabilities and fulfill the decommissioning obligations and pay those expenses, but there may not be. In that circumstance, a potential buyer of E&P assets is faced with the prospect of taking over assets, stepping into the chain of title, and becoming liable for those decommissioning liabilities. However, the buyer in a Chapter 11 or a distressed environment does have some flexibility that might not otherwise be apparent.

The buyer of distressed assets in Chapter 11 sale is able to focus on which assets it would like to purchase, which it does not, and how much it's going to pay for those. Taking into account those issues and those purchases decisions, it can decide whether or not it can take on those decommissioning liabilities and whether or not the assets justify that. If they don't, there are some techniques that buyers have used in the past to try and address those.

First, when an entity purchases assets and steps into the chain of title, they're liable for the decommissioning liabilities. They are often liable even if they sell those assets later on, so what may happen is that an operator or an owner of an asset may not have the funds to satisfy the decommissioning liabilities, but predecessors in interests may be healthy and may be able to satisfy those decommissioning liabilities, and by statute may be liable for those. One thing a buyer can do is look back at the chain of title, see who else may be on the hook for those decommissioning liabilities, have the current owner – which is in bankruptcy – abandon an asset with its P&A liability, which is a potential option under Chapter 11 law, knowing that the predecessor in interest will have to satisfy that P&A liability. That's something that not only the potential buyer and the current owner of the asset will look at, but also the government regulator will be focused on: who is going to and how are they going to satisfy P&A liability in those decommissioning activities.

Another focus that the buyer has is whether or not they can work with the regulator in order to come to some sort of agreement, perhaps even in a somewhat bespoke arrangement, to satisfy the decommissioning liabilities that need to be addressed going forward, particularly when they're far in the future. For example, if the well is still productive and it's still operating and it's not actually in the decommissioning phase, but financial assurance needs to be put forward in order to assure the regulator that when that day comes there will be funds to satisfy that decommissioning liability, it's possible that the buyer can work out an arrangement with the regulator that a portion of future production can be set aside or escrowed in order to satisfy P&A liability, as opposed to having the immediate financial wherewithal to bond all that liability up front.

Dan Crowley: Investors have become more focused on P&A in recent years, and increasingly they are explicitly quantifying P&A liabilities when they determine their bids for assets. This is true for offshore assets where the P&A obligations often are very large, but it's also true for mature onshore wells. People should keep in mind that a well's economic life is reduced in a low-commodity price environment and that has the effect of accelerating the required P&A spend and therefore increasing the present value of a P&A liability. As a result of all this, investors should remember to due diligence the actual dollar cost of abandoning a well. Remember that the cost of P&A a well at US$50 oil may be quite optimistic compared to the cost to P&A the same well at US$25 oil given that they'll be likely a significant increase in demand for P&A services.

Is there an advantage to trying to structure a transaction pursuant to which the sale would be part of a debtor's bankruptcy? And, if so, how might that be structured?

Ron Silverman: Bankruptcy law and Chapter 11 law provide some significant advantages for buyers of assets through a Chapter 11 process, whether that's purchasing assets through a plan of reorganization or purchasing assets during the case pursuant to what's commonly known as a 363 sale. There are several big-picture reasons why the bankruptcy law provides tremendous opportunities and tremendous advantages to buyers of assets through that process.

First and foremost, bankruptcy law, in order to incentivize the efficient transfer of assets from a distressed owner to a well-capitalized owner, provides that the assets can be sold free and clear of liens and other encumbrances and other liabilities, so that the buyer is obtaining clean title to the asset without also picking up the liabilities. That's something that's not able to be done in the same fashion outside of Chapter 11.

In addition, in Chapter 11 there's a well-developed process for selling assets. There's procedures for marketing the assets, obtaining bids, perhaps having an auction, and then having a closing and transferring the assets. What that does is that fleshes out the market, fleshes out good bids, and it provides a lot of integrity to the process, and that's something that's helpful both for the buyer but also for the seller, who sells its asset in a court-approved environment with the decisions made under a court protection. So there's a comfort in making those decisions and it takes away the fear of future attack on those decisions, which makes the process more efficient, more transparent.

Third is the aspect of finality. Because the court is approving and overseeing asset sales in a Chapter 11, the bankruptcy law provides that the court can do a couple of things. The court can order that the assets have been transferred free and clear. It can order that the buyer has purchased those assets in good faith. It can order that recording government agencies are required to reflect the transfers of the assets in the local record, and that there's protection from a finality basis to the transaction, because bankruptcy law can provide, except in very limited circumstances, that you can't overturn on an appeal a valid transfer under bankruptcy law.

These three things all put together are some of those significant aspects of advantages to buyers in a Chapter 11 case.

David Simonds: Another element of this is that the asset sale is done under court supervision, so in some sense there's confidence that a process has been conducted with the supervision of an official body and also is subject to objections and positions taken by other parties in the case. That does give parties who want to join in the process some level of additional comfort.

Talking about some of the structural issues, Section 363 sales are typically conducted under a set of procedures or auction rules that are approved in advance by a bankruptcy court. Ultimately, after the auction has been conducted, the bankruptcy court holds a hearing, and enters an order approving the sale, which provides some of the benefits previously mentioned. There are generally two approaches. The first involves the debtor signing an asset purchase agreement prior to seeking bankruptcy court approval of the bidding procedures, with a "stalking horse bidder," who has agreed to purchase the assets but subject to higher and better offers that might be submitted in the bankruptcy auction. This, from the debtor's standpoint, sets a floor for the sale price, and also adds some legitimacy to the process for other bidders who may want to jump in and make a bid themselves.

The alternative is a "naked auction." In that case, there's no pre-wired buyer, and it's a bit of a free-for-all. It's not preferred from a debtor's standpoint when seeking to maximize value, but it may be the only option the debtor has at the particular time. Oftentimes, the bidding procedures that are approved by the court allow for the debtor to select a stalking horse during the bidding process.

As a buyer, there are some advantages to serving as a stalking horse bidder under a Section 363 sale. A buyer can negotiate for protections in the asset purchase agreement and approved by a bankruptcy court order providing for an expense reimbursement, and also for break-up fees if the assets are sold to a higher bidder. In addition, throughout the auction process the stalking horse bidder can negotiate an auction timeline and specified auction conditions and procedures. While a bankruptcy court will not approve procedures that chill bidding from other potential purchasers, the bidding procedures and protections can be crafted in a way that gives the stalking horse an edge.

Lastly, an alternative to Section 363 auction process is a sale through a Chapter 11 plan. This process is usually more expensive and the process takes more time, but there are some benefits that can be achieved, such as the ability to keep some of the existing debt in place or restructure that debt, and also potentially to deny existing secured creditors their right to credit bid.

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