The current oil and gas environment: Navigating restructuring and insolvency

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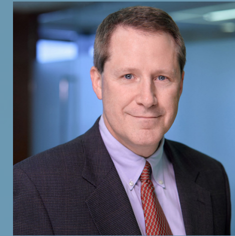

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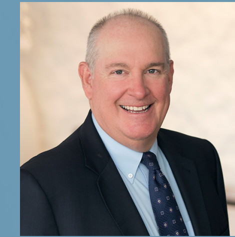

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Can you give us an update on the state of the oil commodity market?

Dan Crowley: We are recording this on April 6th, and the price decline over the past month has been stunning. WTI declined by roughly half in March alone. WTI hit roughly US$20 per barrel last week, and that was the lowest price in over a decade.

The price volatility has also been stunning. WTI increased by more than 30 percent at the end of last week. That increase happened off such a low base that the absolute dollar impact of the change was not significant.

As we try to understand the state of today's oil market, I think it's helpful to briefly recap how we got here.

First, there was a supply issue. OPEC and Russia had been limiting production since September 2016. In early March, OPEC and Russia failed to agree to continued production cuts, and Saudi started a price war by selling its oil at steep discounts and ramping up production and exports.

More important than the supply glut is the demand destruction that's been taking place as a result of COVID-19. There has been an enormous decrease in travel and, therefore, an enormous decrease in demand for gasoline, jet fuel, and other crude oil derivatives. Global oil demand typically had been around a 100 million barrels per day; many estimate that demand is now down to 75 million barrels per day. That's an astonishing decline in such a short period.

There's also been a lot of news recently about the potential for a coordinated global production cut. Any right-sizing of supply would be helpful, but the demand part of the equation is the more problematic one. In the near term, demand destruction will continue to dwarf any production cut that may be implemented.

This supply and demand imbalance has implications that extend well beyond numbers on a screen or futures curve. The glut of oil may test global midstream and storage infrastructure in new, historic ways. For example, certain refineries are out of storage capacity and are not purchasing crude oil. There are also reports of midstream transportation pipelines that are filling up and, as a result, asking upstream producers to stop pushing product into their pipes.

This has resulted in regional pricing that, in some cases, is close to zero. For example, LLS, which is a Gulf of Mexico benchmark, traded at US$6 last week. I spoke with a Canadian E&P company whose realized price was around US$0.73 cents per barrel last Tuesday. There has also been talk of certain oil benchmarks going negative.

In sum, the oil market is extremely difficult, probably more so than most people in the industry have ever seen.

Can you speak to how oil producers are reacting to this crazy environment?

Dan Crowley: E&P companies are doing their best to modify their business plans so they can survive these oil prices. That is a really hard thing to do when realized oil prices are in the teens or worse, and when the environment is shifting so rapidly.

Producers are cutting CAPEX, in many cases by 50 percent or more. They are asking their vendors for price concessions, restructuring their hedge books, and are making very difficult and painful decisions about reducing headcount.

Most importantly, perhaps, they are shutting-in wells. Economically, this makes a lot of sense. If a well has lifting costs of US$10, and realized pricing is below that, it is value destructive to produce the well. But in practice shutting-in a well is not without risk.

First of all, shut-ins can, over time, crystalize and accelerate plugging and abandonment obligations. Second, there is risk shut-in wells may never produce again, either because of reservoir damage or because it would be uneconomical to deploy the capital required to resume production.

Virtually, every company I am working with right now either has shut-in wells or is evaluating shut-ins. Some market analysts are saying that, globally, 5 to 10 million barrels of oil per day could be shut in, and that a meaningful portion of that may never come back online.

Where then do the other markets go from here?

Dan Crowley: The WTI forward curve shows oil prices recovering to roughly US$36 per barrel by the end of 2021 fiscal year. But of course no one knows what oil prices will actually be. The shape of the recovery, whether it's a V, a U, or an L, will largely depend on COVID-19 and how long the global economy remains dislocated. It will also depend on so-called "mega-themes" completely unrelated to COVID-19, such as exodus of investor capital from the industry due to ESG-related initiatives and general dissatisfaction with historical capital returns. Regarding an eventual price recovery, it is important to keep in mind the shut-in wells. If a meaningful portion of those are permanently shut-in, then the global oil economy would lose an important portion of its base production, and there may not be enough supply to satisfy demand—whenever demand rebounds—except at relatively high oil prices. Of course, oil inventories will act as a shock absorber to this, but an increasing number of market pundits are talking about the possibility of a sharp rebound in oil prices over the medium term whenever demand improves.

How about gas producers?

Dan Crowley: IIn the public equity markets recently, gas producers have outperformed oil producers. In addition, the long-term outlook for gas is more bullish than it has been in quite some time because of a decrease in associated gas, which is resulting from reduced investment in oil wells, natural declines, and well shut-ins.

What does all of that mean for oil and gas deal activity?

Dan Crowley: TThe E&P capital markets and deal markets are virtually non-existent, and they have been that way for a while. Let's take the markets in turn.

In the public equity market: small and midcap E&Ps are now trading at roughly 2x EBITDA on average, which is a very low figure relative to historical standards. There have not been any material upstream IPOs in at least the past three years. The energy equity index has underperformed the S&P 500 by roughly 75 percent if you go all the way back to 2014. Energy used to comprise around 13 percent of the S&P 500 market cap; it is now below 3 percent.

In the private equity markets: most PE investors are saying that this is the most difficult fundraising environment they have ever experienced. Many have had to reduce upstream allocations to successfully raise funds. Those with dry powder are, in most cases, using that dry powder defensively and to protect their existing portfolio companies.

In the debt markets: the high-yield bond market was open for one week in January of this year, but otherwise has been closed to high-yield issuers for quite some time. The yield of an average non-investment-grade energy bond is almost 25 percent.

Continuing-up the capital structure, to RBLs: in general, you'll find that almost all commercial banks are trying to reduce exposure to E&P. Some banks are trying to exit the industry entirely. As a result, many banks are taking a very firm approach to borrowing-base redeterminations, although there are a lot of nuances to this that we'll discuss later.

Finally, we turn to the A&D market, which has been at or near a 10-year low for quite a few quarters and is nearly non-existent now, except for a few bankruptcy processes. Speaking of those bankruptcy processes, they provide an interesting public way to track failed deals, and there have been quite a few high-profile ones recently, including Approach, EP Energy, and Sanchez, among others.

All of these data points illustrate a single theme, which is that capital has been fleeing the E&P industry for quite some time, and there's very little left of it now.

If I'm a borrower, and I'm trying to get my lender to modify my credit charge to get some relief, can I use the chart of bankruptcy to assist in those negotiations?

Dan Crowley: WWhen a borrower needs relief from its credit terms, the first thing they need to do is explain to their lenders why they need relief as a borrower. They need to explain why that relief will actually maximize value for all parties involved and why their position will not be weakened by the terms that they want to change.

There are a number of things that a borrower can propose to its lenders. They can propose offering additional collateral or additional credit protection, in exchange for relief on other credit terms. The borrower could also propose different pricing or other consideration that can go to the lenders to give them assurance that the risk/reward balance is maintained and that they should enter into agreement for the relief. Sometimes lenders may still be reluctant to provide consent, and the borrower may need to dig deeper into its toolbox in order to convince the lenders that consensual restructuring is the best way to go. In that case it may be that a borrower can explain to the lenders that the law in the United States, including chapter 11 law, permits a borrower, if necessary, to restructure its loans involuntarily over the lender's dissent, although a borrower would always make clear with a lender that that is not the preferred course of action, but that is what the law provides if necessary. It is important that this subject be broached with the right tone and at the right time. But if lenders have experienced counsel and advisors, those advisors will understand what the borrower is saying. It may be that conversations amongst advisors, as opposed to principal to principal, are the right conduit for these messages. And those conversations can be had without causing an unproductive blow up.

Just to give some examples of the ways in which chapter 11 law can involuntarily restructure lenders' obligations or borrowers' obligations to their lenders, and, therefore, convince lenders to consent to such modifications, we can look at a couple examples to start with. For example, unsecured lenders may end up consenting to relief on credit terms if a borrower with additional debt, such as secured debt, may not be able to satisfy its obligations as they come through, and will have to end up resorting to a chapter 11 bankruptcy. In that case, because of fallout with the business and disruption, and even perhaps a lack of immediate value, the secured lenders will end up with a recovery, leaving unsecured lenders with little. In that circumstance, unsecured lenders may understand that it is better to negotiate a restructuring outside of court on a consensual basis. Alternatively, in the context of discussions with secured lenders, you may be able to make the case that, in bankruptcy, you will be able to stretch out the lender's term, stretch out the length of their obligations, and even possibly modify economic terms of their loan, such as their interest rate, and lower the interest rate. All of which may be less attractive than what is being discussed

with the lenders outside of court. Those are just a couple of initial examples of how bankruptcy leverage can be used to get to a consensual deal with lenders outside of court on a consensual basis.

David Simonds: Here are some of the ways that bankruptcy may be a useful threat to lenders. First, there are potentially lower voting thresholds in bankruptcy than out of bankruptcy. Specifically, in order to modify so-called "sacred rights" in most corporate loans and bonds (for example, extending maturity, changing interest payments, or haircutting principal), 100 percent lender consent is required. In contrast, a chapter 11 plan requires votes of 66.67 percent by dollar amount and a majority number of claims in each class of creditors.

Second, even if you do not get the necessary consent from a class of lenders, the bankruptcy code may permit a debtor to cram down a chapter 11 plan on the lenders if the bankruptcy court determines that the terms of the proposed plan, in essence, are going to provide the lenders with full value for their collateral. Third, in a bankruptcy case, there is some threat that a committee representing unsecured creditors or some other party seeking to obtain value for unsecured creditors will investigate perfection of liens, fraudulent conveyance claims, and other potential challenges and affirmative claims against the lenders. A bankruptcy case opens lenders to often unwanted scrutiny, which may also put pressure on them.

Finally, upon filing for bankruptcy, as long as a bankruptcy court determines that the lenders are adequately protected, either through a sufficient cushion of collateral value or otherwise, the debtor may be able to obtain non-consensual use of the lender's cash collateral, or prime their prepetition liens in order to obtain so-called "DIP financing" or "debtor-in-possession financing." While attempts to obtain DIP financing or cash collateral usage on a non-consensual basis are usually difficult, having a legitimate threat might help persuade lenders to play ball and provide financing needed for the bankruptcy case.

If I'm a borrower having those negotiations with my lender, do I need to engage a financial advisor experienced in such transactions to have success at those?

David Simonds: It is important to engage a financial advisor who is experienced in both in-court and out-of-court restructurings early in the process. First, it suggests a heightened level of seriousness and muscle in the lending negotiations. Second, a high-quality financial advisor will have seen the playbook and deal dynamics multiple times from different perspectives and will be able to help guide a borrower through the restructuring process from a financial standpoint. Third, most counterparties in a restructuring will usually expect the debtor to engage advisors and expect that the advisors will have diligenced the debtor's business plan before engaging with the counterparty's own advisors. Finally, in a bankruptcy case, testimony from an outside financial advisor, either in the form of a written declaration under penalty of perjury or live testimony subject to cross-examination will be required. In a contested case, having someone very experienced on your side will be critical. There may be exceptions if the company knows the lender well and the loan is still held with the relationship bank, but getting a financial adviser onboard is a good idea anyway, for backup purposes and to be prepared for the unexpected.

Ron Silverman: There are many things that the financial advisor can do in this context such as provide strategy and/or financial modeling calculations. They can provide needed information in a way that is useful in a court proceeding to the borrower's counsel, but the context of the dynamics is also important. It is often the case that the financial advisor can be a bit of a go-between between the borrower and the lenders. While the borrower works to keep their business afloat, a financial advisor can be part of the interface with the lenders. This is useful not only to permit the borrower an opportunity to run their business, but, also, it can be very important in preserving the right relationship between the company and its lenders. That way, if the financial advisor needs to give a hard answer to the lenders or at least to have a hard negotiation, its financial advisors on the front line for that, and they can do that in a way that's tried and true and that lenders expect and understand, while removing some of the personal adversarial environment that's not as helpful when the company itself is on the other side. Financial restructuring is something that most companies do not hope to engage in more than once. A lot of the issues that come up, whether they are legal or financial or intermixed, are things the companies have not dealt with before. So, as smart and as good as the company is at managing its business and managing its finances, this is uncharted territory. Bringing in a financial advisor who is used to those rules and is used to that dynamic can add a lot of value.

I'm a borrower, and I'm now considering a chapter 11 filing, what are the pros and cons I should be considering, and how can I maximize the likelihood of success?

David Simonds: When looking at a restructuring, always look at what would happen inside a bankruptcy case, as a yardstick. You have a number of tools in bankruptcy that can help coerce consent and bring parties together, but the idea is to try to get something done outside of bankruptcy. Even if it is a financial restructuring that involves just a balance sheet change, there are some tools that, if necessary, can be used in bankruptcy, such as the rejection of contracts and leases and other minor tools to help with an operational restructuring. Often, with an oil and

gas restructuring, there is not a need for that, and the borrower can pursue just the balance sheet restructuring.

In preparing for a chapter 11 case, there are three things that are critical: liquidity, consensus, and planning. First, on liquidity, chapter 11 cases are very expensive, and that is part of the reason why a company would try to avoid one by doing an out of court restructuring. If the company does go into a bankruptcy case, it needs to be well financed, either through debtor-in-possession financing or cash on the balance sheet that it can use. Very often, the borrower will seek to get a lender's consent to use its cash collateral, but, if necessary, it can try to get approval to use its cash collateral non-consensually, assuming it can demonstrate to the court that the lenders are adequately protected. At the bottom, the borrower really does want to get its prepetition lenders and secured creditors on board or be prepared to move forward on a contested basis.

Second, getting consensus regarding the plan. If the company's problems are financially oriented and the restructuring only requires a balance sheet adjustment, the debtor should try to effectuate an out-of-court restructuring or a so called "pre-packaged" bankruptcy case that requires only minimal bankruptcy court involvement. In that transaction, because affected parties are consenting, and the trade creditors are going through unaffected, the company might be able to negotiate a plan that preserves some shareholder value. In any case, the greater level of consensus the company has, the less costly and disruptive a restructuring will be.

Third, a company needs planning to ensure that, if it does go into bankruptcy, there is minimal disruption to the company's business. The company will need to go into the bankruptcy court on the first day and obtain approval for the continuance of ordinary business operations as unaffected as possible by the bankruptcy filing. There are a number of typical first-day motions that it would file with the bankruptcy court to get that approval. In addition, it wants to make sure that it has established effective and well-planned communications that sends the proper message to suppliers, customers, employees, current creditors, and potentially future investors and creditors.

Most chapter 11 cases, even reorganizations, do not typically lead to a meaningful recovery for shareholders. If there is an operational restructuring that impacts trade creditors and other commercial counterparties, it will be significantly more difficult for shareholders to retain any material value, because of the absolute priority rule, which requires senior parties in the capital structure to be paid first. It may be possible for equity holders to reorganize through a new value chapter 11 plan. In that type of plan, equity holders can invest new capital and buy back their equity interests, even though junior creditors are not being paid in full. In most cases involving insider purchases of equity through a restructuring, the company will need to engage in significant marketing process to test the proposed purchase price. However, old equity holders typically have an edge through their intimate knowledge of the business and the parties involved, but this requires time and planning.

Erin Brady: Even where a company has achieved consensus on plan strategy before going into bankruptcy, we all know that the best-laid plans can go sideways. In recent years there have been pretty significant fluctuations and volatility in pricing and on the forward curve, and, if there's a significant downward trend while a company is waiting to confirm their plan of reorganization, frankly, the deal may just blow up, leaving them back at the drawing board but already in a chapter 11, which is a costly and difficult process for a company. At that point, the best thing that a company can have is a well-thought out backup plan or a series of backup plans they can quickly pivot toward and avoid a liquidation scenario. The best practice would be that, were it at all possible, as they work through the deal they want, they should also model out the various contingencies and plan how they would address those if they came up. That preplanning, which is something a financial advisor can help with, can really be the difference between a successful restructuring and a liquidation, especially where things turn south on a dime, and there's just really not a lot of opportunity to react.

Over the last couple of years, we've seen more and more oil and gas debtors file their chapter 11 proceedings in a federal court in Texas versus some of the more traditional venues like Delaware and New York. Are there reasons or advantages to doing that?

Rick Wynne: Venue is something that the company has first choice of, but there are other interested parties, such as, the lenders that may dictate or push for a certain venue. Sometimes bondholders or creditors that are in pre-bankruptcy negotiations will push for a venue. A pretty unique set of circumstances have resulted in many of the oil and gas companies filing in the Southern District of Texas in Houston, as opposed to some of the other venues that have been very popular for chapter 11 cases, such as Delaware or New York. When looking at venue companies look at a variety of factors. First is a "comfort level" issue with the board or management with where they would prefer to have the case.

Then the lawyers will analyze a whole range of legal issues to determine the available options across various possible venues. Access to courts, convenience, and cost are all other factors that go into the mix. A lot of oil and gas cases in the 2014 - 2016 time period were actually filed in either New York or Delaware. One of the big factors pushing cases after that to Houston was Judge Chapman of the Southern District of New York's decision in the Sabine oil and gas case. Judge Chapman allowed Sabine to reject three gas gathering and handling agreements, which really set off alarm bells throughout the oil and gas industry. That helped push different players to be looking more at the Houston courts. In addition, Houston adopted a local rule where two

bankruptcy judges, effectively, would handle all of the large chapter 11 cases, providing a degree of certainty that people had in terms of filing. Sabine was a very shocking decision to people, particularly in the Texas and Oklahoma oil and gas bar. Those Lawyers thought that all of these contracts would always be considered as real estate, as covenants running with the land, and thus could not be rejected during a Chapter 11 case. Now, it is understandable why Sabine wanted to reject the contracts. They saved US$30 or US$40 million a year on deficiency payments that they had to make up on their excess production. On the other hand, one of the gathering and processing companies spent some US$80 million constructing a purpose-built pipeline just for Sabine. That's why this case has had such a dramatic impact. There's been lots of lobbying work by the Gas Processing Association; the Texas Pipeline Association has appeared as amicus in different bankruptcy cases. This created a big industry issue. A variety of those factors have helped pushed cases to Houston.

Ron Silverman: Borrowers, lenders, and other parties interested in restructuring can, particularly when it's an oil and gas restructuring, can view Texas as a desirable venue. Not only will there at times be the situation where many of the players are located near Texas, but when so many of the issues related to oil and gas are related to state law issues or other local law issues that are not purely bankruptcy, the local bankruptcy courts have extensive experience in looking at those issues over a period of time. They may also be familiar with the way that the state, Texas, and federal non-bankruptcy courts are looking at those issues. Whether there are issues involving liens, whether those are issues involving purely oil and gas unique financing and property instruments like overriding loyalties, looking at royalty lease issues -- these things have a long history of being addressed in Texas and other surrounding regions. Texas courts and judges there may have more experience and more facility dealing with these than courts outside Texas. When parties come to realize this, that often impacts the desirable aspect of seeking relief in a Texas bankruptcy court.

Rick Wynne: There is a comfort level for oil and gas companies filing in Houston, even though the Sabine ruling by Judge Chapman was actually more pro-debtor in terms of giving the debtor optionality to reject the agreement. Judge Jones, in the Sandridge Energy case, on the record, said that he was looking for an opportunity to "correct" the New York ruling in Sabine. Judge Jones has also made other decisions that could be perceived as pro-debtor. Overall this falls into the comfort factor zone that oil and gas companies and oil and gas lenders have that comfort that Texas courts understand the business and have a lot of familiarity with it.

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