Energy Sector Alert Series: Risks and Opportunities in Distressed Oil and Gas

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Recent volatility in the energy markets has put increasing stress on the capital structures of companies operating in those markets. When commodity prices were higher between 2010 and 2014, many of those companies took on significant amounts of debt to pursue new opportunities.[1] Starting in 2014, oil prices dropped precipitously, and since then have remained at record lows.

This unique economic environment presents companies operating in this space (and their directors and officers) with numerous challenges involving complicated business and legal issues. This article focuses on three scenarios that an energy company may face depending on its particular financial situation—over-leverage, risk isolation, and strategic opportunities—and discusses some of the legal considerations with respect to each. Indeed, many of these scenarios have played out in one form or another across a variety of companies over the past 18 months.

The range of issues a company may confront depends to some extent on its overall financial position. At one end of the spectrum, highly-levered companies with significant debt loads may have difficulty complying with their current obligations (or may expect those difficulties on the horizon), but they may also be able to mitigate their financial situation by seeking to refinance or restructure a portion of their existing debt. Companies that are financially healthy, at least on an overall basis, often face different issues. Those companies may want to isolate or divest potential sources of financial stress to stem losses or to minimize the risk that they could adversely affect the enterprise as a whole. Finally, at the other end of the spectrum are companies that, given their relatively strong current financial condition, may in a position to take advantage of current market opportunities presented by the abundance of businesses that are not as healthy. Companies in these situations should focus on the risks attendant to taking such opportunities.

Highly-Levered Companies May Face Obstacles and Opportunities

As noted above, many energy companies took on substantial amounts of debt during a period of higher commodity prices and more generous credit availability. By way of background, it is helpful to consider an example of a typical capital structure of an energy company, for example an oil or gas exploration and production (E&P) company. The top level of the capital structure of many energy companies consists of first lien secured debt, often in the form of a revolving asset-based loan facility. Lower levels of the capital structure may consist of secured or unsecured notes issued pursuant to an indenture.

The typical E&P company's debt capacity is linked to the value of its oil and gas reserves, a critical element of its revolving credit facility borrowing base and its high-yield indenture covenant measure of adjusted consolidated net tangible assets.[2] Lower commodity prices and declining investments in new reserves have combined to reduce the value of reserves precipitously, thus restricting borrowing ability. With limited borrowing capacity and no viable refinancing options, E&P companies have been seeking other ways to increase liquidity, including the reduction or elimination of dividends, asset sales, and cost-cutting measures. With their remaining projected liquidity, E&P companies must weigh the risks and benefits of reinvestment, deleveraging through market debt purchases of their own debt now trading well below par, and a host of other in- and out-of-court restructuring options.

Out-of-court options may include, among other things, consent solicitations, private exchanges, tender offers, and negotiating waivers or modified terms with credit facility lenders. Each of these options raises numerous complex business and legal issues that are beyond the scope of this article. In the context of private exchanges, one critical issue is that it is often difficult or impossible to get all noteholders to agree to any proposed restructuring. Recent litigation involving noteholder invocation of the Trust Indenture Act (TIA), which requires unanimous consent before an issuer can alter the basic payment terms of notes outside of bankruptcy,[3] has brought into focus some potential limits of out-of-court note restructurings. Even when an overwhelming majority of (but not all) noteholders are in favor of an exchange, it may be difficult to consummate certain types of restructurings without the compulsive features of chapter 11.[4]

When out-of-court options are not viable or sufficient, chapter 11 bankruptcy restructuring, of course, is also one such option, and it carries with it both advantages and disadvantages that should be thoroughly considered. In the energy company context, certain bankruptcy rules may apply differently, and in ways that a borrower thinking about chapter 11 should fully consider in advance. For example, the general rules regarding the treatment of contracts apply in unique ways to contractual arrangements like joint operating agreements and oil and gas leases, which can be essential to an energy company's ability to continue operations. The presence of significant regulatory obligations, which are often treated differently in bankruptcy than run-of-the-mill creditor claims, should also be considered. And of course, even when chapter 11 might be a suitable solution from a legal perspective, its financial and other costs may weigh against pursuing bankruptcy.

Financially Sound Companies May Nevertheless Seek to Isolate Risks

A company that is financially sound may nevertheless have subsidiaries or divisions under financial stress, or that are likely to come under financial stress, and it may want to make sure that stress is isolated.

In many situations, a company may make a strategic commitment to maintain its existing business, including underperforming divisions, during a period of depressed commodity prices, so that it can take advantage of any future rebound. This approach may carry with it an increased business cost, but may also present fewer legal risks than its alternatives.

As an alternative to maintaining distressed divisions through a downcycle, there may be instances where a company needs to wind-down or divest assets that it has determined are not worth its continuing investment. Implementing such divestitures can involve unexpected complications and risks.

Three primary considerations come to mind. First, certain intercompany arrangements like guaranties or co-liability on contracts can result in the continuing enterprise remaining liable as a contractual matter for the divested entity's debts. A company considering such a transaction should fully analyze which liabilities can be minimized or eliminated, and which may remain. Second, a buyer of a distressed business segment may insist on obtaining contractual indemnities from the seller as a condition to consummating the sale. From a seller's perspective, such provisions should be thoughtfully tailored to mitigate and contain the risk of continuing liability. Third, even putting aside intercompany and contractual liabilities, there may be extra-contractual liabilities that will remain with the seller following a divestiture. In particular, environmental regulations, which often impose strict liability, pose a risk of trailing a sale or wind-down.

Thriving Companies May Seek to Take Advantage of Market Opportunities

A company that is in a strong financial position may seek to capitalize on opportunities presented by companies that are not as financially healthy by acquiring those companies or their assets. But the acquirer needs to approach such transactions with its eyes wide open.

The general rule is that a buyer does not take on liability for claims against a seller. However, the doctrine of successor liability can operate as an “exception” to that rule. Under the doctrine of successor liability, a creditor may be permitted to assert against a purchaser a claim based on the seller's pre-sale actions. It is important to diligence these potential liabilities, but in a distressed scenario, it is often difficult to obtain a full picture of the potential liabilities. In some circumstances, bankruptcy can help. The Bankruptcy Code allows, under certain circumstances, a sale “free and clear” of certain liabilities. But there are exceptions. As one example (and there are more), environmental liability cannot always be cleansed entirely in bankruptcy, and buyers can often be held strictly liable for clean-up obligations.

Even in situations where successor liability and debt concerns are contained, there are additional risks to consider. Where a transaction leaves creditors of the acquired entity with insufficient recoveries, they may seek to challenge the transaction. For example, in 2014, Sabine Oil & Gas LLC combined with and then merged into a publicly traded oil and exploration and production company, Forest Oil Corporation. Ultimately, the combined enterprise filed for chapter 11 bankruptcy.[5] The Official Committee of Unsecured Creditors is seeking to assert a myriad of claims stemming from the business combination. The claims include fraudulent transfer claims against the company's lenders, as well as breach of duty claims against the directors and officers, and claims against the private equity owner of Sabine. This highlights the risk that a transaction will be put under a microscope in a distressed context, and emphasizes the care that must go into diligence and structure for these types of transactions.

Conclusion

Each of the scenarios discussed above (which are only some of the scenarios that companies in the current market may be facing) raises varied and complex issues (only some of which are previewed above). In addressing these scenarios, directors and officers often must consider the interests of various stakeholders, including shareholders, creditors, and other constituencies. Accordingly, it is important to involve legal counsel early in the process to strategize about ways to approach these and other scenarios to mitigate risk and maximize benefits while balancing the interests of various stakeholders.

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[1] http://www.oilgasmonitor.com/the-domestic-oil-gas-industrys-current-debt-problem-a-new-chapter-of-an-old-book/9009

[2] The SEC requires public companies to use a discounted cash-flow analysis, called the “PV-10,” to value their oil and gas assets. The PV-10 includes only “economically producible” reserves, which, under SEC rules, are measured by the average price during the 12-month period prior to the reporting date. 17 CFR 210.4-10(a)(22)(v). The backward-looking nature of the PV-10 calculation means that (a) in some scenarios, companies still have not felt the full effect of a downward adjustment of their reserve values on their borrowing ability, though they can see that effect on the horizon, and (b) even if oil and gas prices rebound, it will take some time for the increased value of a company's reserves to be reflected in its borrowing ability and ability to meet financial covenants.

[3] Section 316(b) of the Trust Indenture Act provides that “the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security . . . shall not be impaired or affected without the consent of such holder . . .” Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b).

[4] *Marblegate Asset Mgt. et al. v. Education Management Corp., et al.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015); *Marblegate Asset Mgt. et al. v. Education Management Corp., et al.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014); *MeehanCombs Global Opportunities Funds, L.P., et al. v. Caesars Entm't Corp., et al.*, 80 F. Supp. 3d 507 (S.D.N.Y. 2015); *BOKF, N.A. v. Caesars Entm't Corp.*, Nos. 15–cv–1561 (SAS), 15–cv–4634 (SAS), 2015 WL 5076785 (S.D.N.Y. Aug. 27, 2015).

[5] *In re Sabine Oil & Gas Corporation, et. al.*, Case No. 15-11835 (SCC) (Bankr. D. Del.).

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