Alternatives for Managing Financial Distress in the Oil Patch

Mark L. Burghardt
Dorsey & Whitney LLP
Salt Lake City, UT

H. Joseph Acosta
Dorsey & Whitney LLP
Dallas, TX

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Joseph Acosta
Dorsey & Whitney LLP
Dallas, Texas

Mark Burghardt
Dorsey & Whitney LLP
Salt Lake City, Utah

H. JOSEPH ACOSTA is a partner in the Bankruptcy & Financial Practice Group, in the Dallas office of Dorsey & Whitney LLP. Joseph has a broad base of bankruptcy, corporate restructuring and commercial litigation experience, having worked at national and international law firms for most of his career. During his 22+ years as a lawyer, he has been involved in some of the largest and most complex restructurings and litigation projects in the United States. He has taken lead roles in successfully representing debtors, banks, financing companies, distressed companies, committees, trustees, individuals, landlords, asset purchasers, retailers, and commercial creditors in all types of proceedings, including bankruptcy proceedings, federal and state lawsuits, arbitrations, and appeals.

MARK BURGHARDT, is a partner in the Energy and Natural Resources Practice Group, in the Salt Lake City office of Dorsey & Whitney LLP, where he represents clients in the energy and natural resource industry in litigation, administrative hearings, and transactions. Mark engages with clients to prevent and solve issues with the location and development of their oil, gas, mining, and renewable energy projects. He has worked with companies on projects involving federal, state, private, and Indian lands. Mark has also represented clients in a wide range of transactions and joint ventures. He has litigated energy development and land use disputes in both federal and state court and has routinely appeared before Utah Board of Oil, Gas and Mining and the Utah Division of Environmental Quality.

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Joseph Acosta

Dorsey & Whitney LLP
Dallas, Texas

Mark Burghardt

Dorsey & Whitney LLP
Salt Lake City, Utah

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A. Introduction

According to the U.S. Energy Information Administration (EIA), the United States (U.S.) regular gasoline retail price as of the Monday before Labor Day fell to $2.22 per gallon this year, the lowest level for this time of year since 2004.[1] The EIA concludes that U.S. gasoline prices are relatively low because of continued low demand for gasoline since mid-March, when travel demand fell because of efforts to limit the spread of coronavirus.[2] Indeed, monthly motor gasoline consumption in the U.S., measured as product supplied, reached a low of 5.85 million barrels per day during April 2020, the lowest level since 1974.[3]

There is little question that U.S. oil and gas production is expected to experience a decline in response to the first quarter's supply-and-demand shocks. In addition to reduced production of newly drilled wells corresponding to a reduction in drilling activity, oil and gas production naturally experiences declines in connection with the monetization of existing wells.[4] Specifically, shale wells typically decline 70 to 90 percent relative to their peak production within a three-year period, with the large majority of that production decrease taking place within the first 12 months.[5] Consequently, the absence of current drilling activity can rapidly result in the decrease of U.S. oil production. According to estimates developed by energy news website oilprice.com, the absence of drilling in U.S. shale basins would theoretically cause a decline in production by more than one third to less than 5.0 million barrels per day by the end of 2020.

There is also little surprise that there were almost 50 bankruptcies during the first half of 2020 among (a) 25 exploration and production (E&P) companies, (b) 19 oil field services (OFS) companies, and (c) 3 midstream companies.[6] The numbers are continuing to increase during the second half of 2020, placing (as of August, 2020) a total of $70 billion of debt at risk among E&P and OFS companies. If West Texas Intermediary (WTI) continues to hover around $40/barrel, we could (a) witness another 29 more filings among E&P companies this year, adding another $26 billion of debt at risk, and (b) 150 or so filings during the next 2 years, representing another $128 billion in debt among E&P companies.

According to BDO's 12-Month Energy Investment Outlook, the pandemic has exacerbated these pressures, leading to even lower oil prices, sharp drops in demand, and a widespread economic downturn.[7] Given the COVID-19 resurgences in certain states, and notwithstanding

[1] *See* Kevin Hack, *Today in Energy*, U.S. ENERGY INFORMATION ADMINISTRATION (Sept. 4, 2020), https://www.eia.gov/todayinenergy/detail.php?id=45036.

[2] *See id.*

[3] *See id.*

[4] Mark Winger, *2020 Exploration and Production Industry Outlook*, GORDON BROTHERS (June 12, 2020), https://www.gordonbrothers.com/insights/article/2020/2020-exploration-and-production-industry-outlook.

[5] *Id.*

[6] *See* Artem Abramov and Lefteris Karagiannopoulos, *Even at $40 WTI, about 150 more North American E&Ps will need Chapter 11 protection by end-2022,* RYSTAD ENERGY (Aug. 21, 2020), https://www.rystadenergy.com/newsevents/news/press-releases/even-at-$40wti-about-150-more-north-american-eps-will-need-chapter-11-protection-by-end-2022/.

[7] Clark Sackschewsky and Brian Taggart, *BDO's 12-Month Energy Investment Outlook*, BDO (Sept. 2020), https://www.bdo.com/insights/industries/natural-resources/bdo%E2%80%99s-12-month-energy-investment-outlook.

governmental assistance, the demand for oil will continue to be depressed, thereby leading to more bankruptcies on the horizon.[8]

Because the oil and gas industry is a capital-intensive industry, there are often issues with financing arrangements made with industry participants. In a distress scenario, these issues commonly relate to negotiating with lenders to cure defaults, developing strategies to maximize the value of assets, preserving the rights of secured parties, navigating through disputes amongst different tranches of debt or within a lender group, obtaining new take-out financing and, possibly, operating without no new financing. Addressing these and other financing issues are critical to the viability of an oil and gas company.

B. Industry Participants

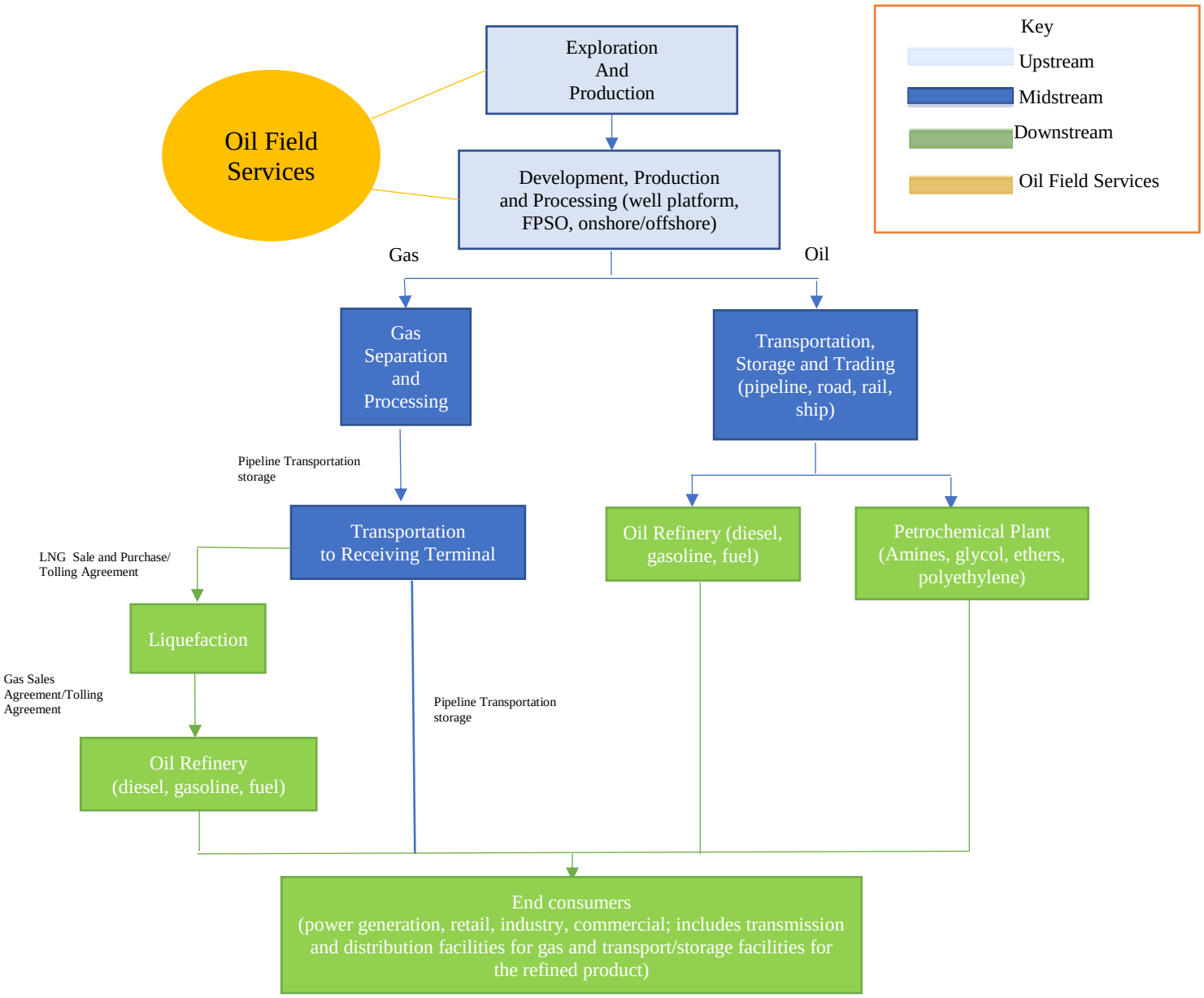
1. Key Players

The four major types of oil and gas companies can be broken down in to 4 groups:

- Upstream companies or E&P companies;
- Midstream companies;
- Downstream companies; and
- OFS companies.

The chart below illustrates how each one operates:

[8] *See id.*



2. E&P Companies

E&P companies participate in the search for and the recovery and production of crude oil and natural gas.[9] Activities within the upstream sector include searching for potential underground or underwater oil and gas fields, drilling exploratory wells, and drilling and operating wells that recover and bring to the surface crude oil, natural gas and related liquids.[10]
E&P companies' primary assets are their oil and gas reserves, which consist of the hydrocarbons below the surface that have not yet been produced and are economically viable to extract.[11]

9 Shishir Khetan and Naveed Yahya, *Valuation Methodologies in the Oil & Gas Industry*, STOUT (March 1, 2016), https://www.stout.com/en/insights/article/valuation-methodologies-oil-gas-industry.
10 *See id.*
11 *See id.*

Reserves can be classified into two main categories: proved and unproved reserves. Proved reserves are quantities (volumes) of oil or natural gas that are recoverable in future years from known reservoirs under existing economic and operating conditions.[12] Within the category of unproved reserves, probable reserves have a 50% probability that reserve quantities will be higher than estimated and a 50% probability that the reserves quantities will be lower than estimated.[13] Possible reserves have a 10% probability that reserves quantities are higher than estimated and a 90% probability that reserves quantities will be lower than estimated.[14]

3. Midstream Companies

The midstream sector of the oil and gas industry comprises the transportation and processing of extracted hydrocarbon products from the upstream directly to the onshore market or to port facilities for storage or onward passage to the relevant domestic or international downstream market (or both). This sector comprises the construction, operation, and maintenance of pipeline projects and vessels, and the building of storage and processing facilities (or any combination of these).

U.S. Midstream companies are frequently incorporated as master limited partnerships ("MLPs"), which are publicly traded on a stock exchange qualifying under Section 7704 of the Internal Revenue Code.[15] The vast majority of MLPs are pipeline businesses, which generally earn stable income from the transport of oil, gasoline, or natural gas. More specifically, energy MLPs are defined as those that own energy infrastructure — including pipelines, storage, terminals, or processing plants for natural gas, gasoline or oil — in the United States. MLPs' access to capital markets and low costs of capital on a pretax basis create a compelling valuation proposition in the transaction markets.

4. Downstream Companies

A downstream operation refers to those projects that process extracted resources to make them into a usable end product or a source of energy supply, including by way of power plants, refineries, LNG liquefaction and regasification facilities and petrochemical plants.

Although lower oil and gas commodity prices adversely impact the valuation of E&P companies, the valuation of downstream companies, such as refiners, often benefits from lower prices of the commodity feedstock.[16] The crude oil of E&P companies is a primary feedstock for downstream companies, and lower feedstock prices may result in higher crack spreads for downstream companies. Crack spread is the differential between the price of crude oil and the price of petroleum products extracted from it — that is, the profit margin a refinery can expect when it "cracks" crude oil. As a result, in a low commodity price environment, downstream companies can be expected to benefit from higher crack spreads in the near term.

12 *See id.*
13 *See id.*
14 *See id.*
15 *See id.*
16 *See id.*

5. Oil Field Services Companies

OFS companies provide the labor and equipment that E&P companies utilize during the various stages of development. There are different types of OFS companies, ranging from diversified companies that provide both oil field services and equipment to less diversified oilfield equipment manufacturers and suppliers to even less diversified companies focusing merely on providing oilfield services or contract drilling.

In an environment of lower commodity prices, E&P companies significantly cut their capital expenditure budgets related to exploring and producing oil and gas. These budget reductions directly impact clients' demand for an oilfield services company's products. Although volatility in commodity prices affects oilfield services companies in general, certain oilfield services companies may suffer more than others due to reductions in E&P capital expenditure budgets. For example, contractors and service providers have diminishing backlogs of work ahead of them and decreasing margins, and therefore there is downward pricing pressure in the contracting market with the result that both rigs and construction equipment are not being fully utilized.

C. Traditional Financing Sources

Because of the capital intensive nature of oil and gas projects and varying degrees of risk (depending on the stage of a project's development and operations), equity investors typically require different sources of financing over the life of a project. Key financing options employed include:

- Equity sources, like IPOs, cash calls (under a joint operating agreement ("JOA"), shareholder loans, and share subscriptions.
- Third-party financing products, including reserve-based lending ("RBL"), corporate loans, acquisition financing, equity bridge loans, project financing, capital markets, hybrid financing, and hedging.
- Other sources of income come from operational or future cash flow and the raising of funds through assets dispositions.

International oil companies will look to their own balance sheets to source funds or alternatively seek corporate loans or high-yield debt. Their proven track record means that they are more likely to be able to raise unsecured corporate debt. However, a smaller to mid-cap player will not have this option and will typically either seek third-party secured financing, additional JV partners, or further equity investments.

1. RBL Loans

A common source of financing in the upstream sector is RBL loans, which are often provided by commercial banks to cover capital and operating expenditures, the development costs of a number of specified assets (in doing so they spread the risk), and for general corporate or working capital purposes.

Drawings under an RBL Loan may cover the refinancing of existing equity/debt (including bridge financing) or the financing of an acquisition. Available loan commitments usually fluctuate on a six monthly basis by reference to the "borrowing base amount," which is calculated using the most recently delivered banking case that covers each of the included oil and gas fields and identifies: (a) the net present value of future cash flows from each field; (b) availability of sponsor collateral; and (c) concentration limits on the borrower.

Other types of financing by upstream companies include corporate debt, project financing, bridge facilities, and project bonds. These types of financings are generally more difficult to obtain in a period of volatile commodities pricing because the lenders generally require that the borrower demonstrate a sufficient production track record.

2. Multi-Source Financing

Midstream, downstream, and integrated LNG projects can be complex with substantial capital costs involved. These kinds of projects typically follow the multi-sourced project financing route during the construction phase. From a transaction-cost perspective, the financing and pricing terms available to midstream and downstream companies may be more competitive than those of commercial banks and typically these sources will be able to finance larger loans than their commercial counterparts.

Multi-sourced project financing may enable sponsors to (a) access a higher debt quantum; (b) leverage equity investment to raise capital on a non-recourse or limited-recourse basis; (c) access large commitments for funding for specified construction projects; (d) access a combination of fixed and floating rate facilities; (e) facilitate the efficient drawing of debt, consistent with the milestones under applicable construction contracts; and (f) access longer term debt, including from capital markets.

Despite this, the project-financing route imposes significant restrictions on the project construction and operations, including in relation to the granting of security and comprehensive representations, warranties, covenants, and events of default. Additionally, there will be substantive and regular ongoing reporting obligations so that the lenders are kept apprised of the project's status, including in respect of delays and cost overruns.

The significant price volatility of oil and gas products has a number of consequences in a project financing context, including in relation to higher debt service coverage ratios and obligations to ensure that any excess cash flow is applied in prepayment of outstanding debt.

3. Equity Capital

The use of shareholder capital as a source of funding is common across the various components of the oil and gas sector where, for example, equity investors might be required to ensure the maintenance of gearing ratios under the terms of a project financing or where they independently fund a project ahead of any third-party financing being put in place. Shareholders may consider extending shareholder loans or subscribing for shares depending on various tax, corporate, and local legal considerations. A shareholder loan can be extended on a commercial, arm's length basis, and may be secured, but generally will be subordinated to that of any third-party financiers.

In recent years, infrastructure and pension funds and private equity investors have all invested in projects across the oil and gas sector. Rights attaching to such shareholder investment will generally be subordinated to those of the third-party financiers of any outstanding senior debt.

Other equity funding sources include capital raised from initial public offerings and private equity investments. Private equity investments can arise either by way of acquisition (perhaps using leveraged financing) during the operational life of an asset or through investment from the outset. However, the relatively short-term exit strategies of private-equity groups are not always commensurate with the more distant development and construction horizons of the upstream sector. Consequently, private-equity investment may be more suitable in a downstream context or for an asset that already has producing operations.

4. Commercial Loans

In a midstream or downstream context, corporate-loan facilities would also typically be available once the project is itself fully operational and has the proven operational and financial track-record required for the commercial banks and/or certain institutional investors such as insurers or infrastructure funds. Mezzanine debt may be used as part of a project financing (or in an upstream RBL context) to optimize the financing plan or fill a funding gap. This can be a secured loan but repayment will generally be subordinated to the senior lenders' rights of repayment (and ahead of the equity distributions).

5. Acquisition Financing

Acquisition debt is often relevant in a midstream or downstream context where, for example, an investor is seeking to purchase an existing gas distribution or transmission asset. Leveraged financing sources through a combination of commercial banks and institutional investors may be used for this purpose.

6. Project Bonds

Project bonds may be used to raise significant capital. In this instance, the issuer is the project company or a specially incorporated entity with bondholder institutional investors. Projects have long accessed the bond market, particularly following the completion of the construction phase where fewer waivers are likely to be sought from the bondholders. The advantage of bonds, as compared to other sources of debt, is that long-term debt can be sourced in large amounts with greater operational flexibility than project finance provided by commercial banks or agency lenders.

7. Expansion Financing

Expansion financing is also not uncommon in an oil and gas context, when a company seek a change in project scope, whether by way of neighboring field development for which the company already has permits and licenses, or whether by constructing a new complementary unit within an existing complex. Production from complex petrochemical plants or refineries can be enhanced through a process known as "debottlenecking," through which existing operating components of the project are modified to enable them to run more efficiently. The loan agreements will often permit a pre-agreed quantum of project revenues to be applied from the

project company's accounts waterfall for debottlenecking but only after first meeting any principal and financing cost payment and prepayment obligations and ahead of the making of any distributions. The lenders may allow the project to incur further secured debt from an existing banking group or, alternatively, the sponsor parties may consider refinancing in full if more favorable or cheaper terms are available in the market.

8. Hedging

The U.S. has active financial markets that allow commodity risk to be mitigated.[17] Typically, minimum and maximum hedging requirements are specified in the terms of the finance documents. The commodity hedging element of this is particularly important in an oil and gas context to the extent that the offtake (and therefore the borrower and its ability to service debt) is exposed to changing commodities prices without any floor. It is critical also in an RBL context that the calculation of the borrowing base amount should be negotiated to take into account any hedging payments or receipts, and that the lenders are protected from the borrower overhedging (that is, hedging an amount greater than the total risk exposure).

D. Liquidity is a Necessity

1. Capital Intensive Industry

Petroleum oil and hydrocarbons are two of the most valuable resources on the planet, used to power everything from cars and planes to factories and industrial plants. But, let there be no mistake, investments in oil and gas projects can be very expensive.

Given the costs involved, there is a "break-even" point where the price of crude oil must be for E&P companies to be profitable. This break-even point depends, in large part, on the difficulty in drilling in certain shale formations. When the break-even point is reached—whether it be $50 or $60 dollar per barrel—cash-strapped E&P companies are compelled to either borrow more money or obtain more investment capital to continue operations. Unfortunately, banks and investors are currently more conservative in their lending and investment practices.

Let's take, for example, the life cycle of an onshore E&P companies. According to a White Paper, prepared by the National Petroleum Council ("NPC"),[18] an onshore drilling and production project can go through several stages until termination, including:

a. Planning Stage, e.g., geological evaluations; exploration wells; leasing; and permitting.

b. Construction, e.g., drilling pads and reserve pits; fuel, road, utility and gasoline construction.

[17] Loretta Cross, *From Boom to Bust: What Happens When the Price of Oil Collapses*, STOUT (March 1, 2015), https://www.stout.com/en/insights/article/boom-bust-what-happens-when-price-oil-collapses.

[18] *Life Cycle of Onshore Oil & Gas Operations*, Paper #2-26, THE NATIONAL PETROLEUM COUNSEL (September 15, 2011), available at https://www.npc.org/Prudent_Development-Topic_Papers/2-26_Life_Cycle_of_Onshore_Operations_Paper.pdf.

c. Drilling, e.g., drilling rigs; horizontal/multilateral/extended reach/complex path drilling; casing and cementing; well testing.

d. Completions and Work Overs, e.g., well perforation and stimulation; hydraulic fracking; workovers and maintenance.

e. Field Production, e.g., installation of wellhead, extraction equipment and field facilities, like flowlines, gathering systems and water separation equipment.

f. Gathering Systems- interconnected flow lines or pipelines that move produced hydrocarbons to storage tanks, a transfer station or other centralized location for transportation and further treatment.

g. Oil Storage and Sales- Based on these stringent regulations, equipment, like custody transfer units, and facilities, like temporary storage tanks, that provide accurate measurement of crude oil volumes are necessary.

h. Transportation, Pipeline and Storage- at field production facilities or gas plants, the oil and gas are metered and sold. Treated oil that leaves the treatment system goes to oil stock tanks (sometimes called tank batteries) and is ready for sale. Treated petrochemicals in stock tanks are transported offsite for further processing or refining via pipeline, tank truck or barge.

- **Pipelines**- More than 190,000 miles of liquid petroleum pipelines traverse the United States,[19] connecting producing areas to end users. Natural gas pipeline makes up the vast majority of the nation's 2.4 million-mile underground pipeline system.[20]

- **Bulk Storage**- Natural gas is most often stored in depleted (empty) natural gas or oil fields or underground salt caverns or similar geological formations.

- **Trucking-** petroleum and petroleum products can be trucked at various stages in the production, processing, and delivery of the products.

i. Abandonment and Final Reclamation-- after all the economically recoverable oil and gas has been produced at a well site, or if a well fails to produce (such as a dry hole), the well is plugged and abandoned and the site is reclaimed.

Each of the above-stages is very expensive. For example, the planning stage involves geological evaluations and drilling exploratory wells, which could cost millions of dollars. The drilling stage entails the use of expensive drilling machinery and a large workforce, also costing millions.

[19] *See Where are the Pipelines?*, AMERICAN PETROLEUM INSTITUTE, https://www.api.org/oil-and-natural-gas/wells-to-consumer/transporting-oil-natural-gas/pipeline/where-are-the-pipelines (last visited September 2020).
[20] *Id*.

Field production is enormously expensive because it generally entails a process of primary, secondary and enhanced recovery.

Working side-by-side with E&P companies are OFS companies that provide most of the technical labor to construct and operate the E&P facility. Indeed, E&P operations, from exploration through transportation, can require a large workforce and 24 hour staffing.[21] OFS companies also provide an E&P operator with expensive equipment and machinery, like drilling rigs, monitoring systems, trucks and pumps, during the various stages of production. All of this expensive machinery and equipment, as well as the workforce and facilities to operate it, require an enormous amount of capital. Over the years, OFS companies have taken out an enormous amount of debt to have the capacity to assist E&P companies with their various needs.

Then, there is the midstream and downstream companies that bring the oil and gas products to the end-users. In April 2017, ICF, a strategic consulting firm, conducted a study (the "**ICF Study**") for the American Petroleum Institute (API), setting forth the expected capital requirements through 2035 for companies to acquire all assets needed to process, refine, store, and transport oil, gas, NGLs, and oil products to end-users.[22]

According to the ICF Study, capital expenditures (CAPEX) from 2012 through 2016 for infrastructure have been averaging about $78 billion per year, with a peak expenditure of over $85 billion in 2013.[23] Spending has been greatest for surface equipment with an average annual CAPEX of roughly $22 billion. New pipelines have accounted for roughly one-third of the capital expenditure, averaging just over $20 billion per year, while onshore gathering and processing expenditures have averaged about $16 billion per year. The remaining categories that include oil and gas storage, refining enhancements and upgrades, products and rail transport, and export facilities collectively add roughly $20 billion per year to the total.

The advent of oil and gas development from shale formations has brought about a renewed focus on North America's oil and gas development. [24] Thus, the ICF study estimates that total CAPEX for oil and gas infrastructure development will range from $1.06 to $1.34 trillion from 2017 through 2035. [25] These levels of investment equate to an average annual CAPEX ranging from $56 to $71billion, including (a) $16.7 to $19.2 billion (30%) annually for surface and lease equipment;[26] (b) $12.3 to $19.0 billion annually (between 22 and 27 percent) for oil, gas and NGL pipelines; (c) $12.4 to $14.8 billion annually (22%) for gathering and processing facilities; (d) $10.3 to $11.4 billion for refineries and oil product pipelines; (e) $2.9 to $4.9 billion for export terminals; and (f) $1.1 to $1.34 billion for oil and gas storage facilities. The ICF Study does not, however, take into consideration operations and maintenance (O&M) costs or distribution infrastructure for which billions of dollars could be added to annual expenditures.[27]

[21] . *See* THE NATIONAL PETROLEUM COUNSEL, *supra* note 18.

[22] Petak, Kevin, et al., *U.S. Oil and Gas Infrastructure Investment Through 2035*, at 9, ICF (April 2017), https://www.api.org/~/media/Files/Policy/Infrastructure/API-Infrastructure-Study-2017.pdf.

[23] *Id.* at 6.

[24] *Id.*

[25] *Id.* at 1.

[26] *Id.* at 3.

[27] *Id.* at 9.

In short, the oil and gas industry is an extremely capital-intensive business. As Peter Trelenberg, a Manager of Environmental Policy and Planning at Exxon, predicted in 2019, trillions of dollars of investment will be needed to generate sufficient supplies of this type of energy to meet demand.[28] Energy consumption will remain highest in countries, like the United States, where energy is more heavily relied on for human development.[29] Indeed, the U.S. Energy Information Administration (EIA) forecasts U.S. energy demand will grow by 12 percent between 2012 and 2040, with more than 60 percent of the energy demand expected to be met by oil and natural gas.[30]

2. Liquidity Shortfall During Commodities Volatility

As has been seen in the recent past with WTI descending from a high of $142.03 per barrel in July 2008 to a 12 year low of $21.44 per barrel in April 2020, market prices can be highly volatile, creating difficulties in assessing the ability to forecast and service debt (or provide a sustainable return on an equity investment). Indeed, E&P companies have been contending with low oil prices, mounting debt obligations and decreasing capital access since well before COVID-19.[31] During times of low commodities pricing, drilling activity amongst the E&P companies reduces, which means projects are halted or abandoned and production decreases. [32] But, E&P companies have experience – developed over the last 40 years – with downsizing and quickly reducing capital spending and headcount. [33]

The reduction in drilling activity has a direct impact on the OFS industry for several reasons, including a reduction in the workforce and utilization of expensive equipment. For example, when state and federal governments began reacting to the coronavirus pandemic, the U.S. rig count began a rapid decrease from 792 for the week ended March 13 to 284 for the week ended June 5—a reduction of 64.1 percent.[34] In the COVID-19 environment, with drilling activity being substantially reduced and an over-abundance of machinery and equipment being side-lined, the value of assets maintained by OFS companies has suffered. [35] Indeed, a leading appraisal firm expects that secondary market demand for machinery and equipment will be weak in the short term and weaker in the medium term due to an anticipated future reduction in natural gas production volume.[36] The secondary market demand for anything other than ongoing well servicing equipment such as lift equipment or other niche sectors will go to very low levels for as long as this price environment lasts.[37]

[28] Joseph H. Acosta, *Southwest Chapter, Eighth Annual Energy Summit*, THE SECURED LENDER (Secured Finance Network), November 2019, at 72.
[29] *Id.*
[30] *Energy Primers*, AMERICAN PETROLEUM INSTITUTE, https://www.api.org/oil-and-natural-gas/energy-primers (last visited Sept. 2020).
[31] *See* Clark Sackschewsky and Brian Taggart, *supra* note 7.
[32] *Id.* at 23.
[33] *See* Loretta Cross, *supra* note 17.
[34] Mark Winger, *supra* note 4.
[35] *See id.*
[36] *See* Mark Winger, *supra* note 4.
[37] *See id.*

This dynamic further results in uncertainty in the investment community,[38] where sentiment towards the oil and gas industry will likely remain lukewarm for the foreseeable future.[39] Commercial banks also face new financing constraints, which result in shorter tenors and higher pricing to reflect higher capital and regulatory costs. Structured financings are increasingly "club deals" rather than underwritten/syndicated as the commercial bank market becomes tighter and less liquid. Across the banking sector, there is lower appetite for longer maturities. Hence borrowers have to maximize the use of alternative funding sources, if available.

Ultimately, the accumulation of one or more of the above factors leads to a reduction in midstream and downstream infrastructure projects.[40]

E. Prioritizing Obligations and Assets

In this environment, outside or inside of bankruptcy, E&P companies have been forced to downscale operations significantly just to survive. Companies must triage their assets to make sure that they are prioritizing the assets with the most value. Here is a brief discussion of the ways in which E&P companies can maintain assets in times of financial distress.

1. Maintaining Leases

Most of the value in an oil and gas asset comes from the leases. It is essential that an E&P company maintain its leases, with priority being given to the leases with the most value. The typical oil and gas lease is issued for a primary term (usually for three, five, or ten years) after which the lease can only be held through continuous operations, production, or the payment of shut-in royalties.

The activities that constitute "continuous operations" are determined by the language of the lease and governing law. A discussion of the types of operations required to maintain a lease beyond its primary term is beyond the scope of this paper. Suffice it to say that continuous operations is one strategy that could be used to extend the primary term of a non-producing lease during periods of financial distress. However, engaging in continuous operations to hold a non-producing lease is, at best, a short-term solution.

Leases that are beyond their primary terms are usually extended through production in paying quantities. This production can either be direct production (i.e., where the well is producing from the leasehold) or associated production (i.e., where the production is allocated to the lease through pooling). As with continuous operations, what constitutes "production in paying quantities" is a question of fact that must be determined using the terms of the lease and governing law and is beyond the scope of this paper. Nevertheless, it may be possible to shut-in production on leaseholds that are held by multiple wells without losing the lease.[41] A careful

38 *Id.* at 23.

39 *See* Clark Sackschewsky and Brian Taggart, *supra* note 7.

40 *Id.* at 23.

41 This assumes that the lease does not contain a "Pugh Clause." A vertical Pugh clause provides that the lease will terminate as to any lands outside of a certain geographical size on which there is not a producing well. A horizontal Pugh clause has the same effect but provides that a lease will terminate as to the depths below which there is a producing well. Keep in mind that Pugh clauses often only take effect at the end of the primary term and may not be relevant to leases that have already been extended beyond their primary terms.

review of the lease terms and the direct and associated production is required to ensure that wells not required to hold a lease can be shut-in.

In addition to continuous operations and production, it is also possible that a lease could be maintained through payment of shut-in royalties. A significant portion of leases covering private lands contain provisions allowing for the payment of a specific sum of money to maintain the lease when a well capable of producing in paying quantities is shut-in. Keep in mind that the shut-in provision usually only applies to gas wells and is often allowed only when there is a lack of a market for the sale of natural gas.

The failure to maintain a lease covered by a credit facility could result in violation of the terms of that credit facility. In deciding whether to take actions that could result in termination of the leases, the E&P company should have a clear understanding of its obligations under the credit facility to ensure that it does not unwittingly violate its terms.

2. Contractual Obligations

There are a variety of contractual obligations that are likely tied to the oil and gas asset. For less mature fields, the majority of the obligations may be found in the terms of the leases. For those fields with established production, the contractual obligations will likely include JOAs, gathering and other transportation agreements, communitization agreements, unit agreement, and marketing agreements. It should be understood what the risks and penalties are under these agreements for reducing or shutting-in production or from failing to participate in drilling operations proposed by another operator under a JOA. The failure to comply with contractual obligations or pay to participate in operations could result in penalties that significantly devalue the asset.

As with any contract, the agreement can most likely be amended to obtain relief of forbearance from the obligations that cannot be met. The ability of willingness of the other side to enter into an amendment will depend on the nature of the contract and will likely require significant concessions. Companies will need to evaluate the value of these agreements in the greater context of the asset and the possible penalties for violating their terms.

The contractual obligations tied to the oil and gas assets should help inform the decision of how and where to allocate limited capital.

F. Financing Issues in Bankruptcy

1. Working with Lenders/Avoiding Foreclosure

As commodity prices fluctuate, so too does the available loan commitment. If key ratios are breached, the borrower must prepay a corresponding proportion of its loan under RBL loans. RBL lenders consider only proven, and proven and probable reserves (not possible and contingent reserves) and the extent to which projected production figures enable debt service.[42]

[42] "Proven reserves" means those with a 90% (known as a P90) chance of recovery and "proven and probable reserves" constitute those with a 50% (known as a P50) chance of recovery.

With an RBL loan, once a bi-annual redetermination is performed by a lender (using the lender's price deck), E&P companies often find themselves noncompliant because values are depressed. Similarly, a regular commercial loan to OFS companies would be noncompliant because of depressed values for idle equipment and machinery. Quarterly financial covenants would also likely be breached due to multiple factors, including reduced income and operations.

Lenders have several options upon a default of an RBL facility. They can restructure the loan terms or enter into a forbearance agreement in hopes that prices may increase. They could also take other steps outside of court (short of exercising remedies) to push through profitability. Of course, they also have the option of foreclosing or pursue a reorganization or an orderly liquidation of assets in a bankruptcy proceeding.

To stave off lenders, borrowers in these circumstances often request financial covenant relief. They may also be charged with the task of cutting operational costs (G&A) and raising income outside of operations, which may entail liquidating favorable hedges or selling select assets to raise quick capital, to pay the lenders.

In certain cases, RBL lenders have the ability to stretch the borrowing base, by redetermining the borrowing base at a higher number than prices would otherwise have dictated. This may entail using higher advance rates, less conservative risk factors or increasing value attributed to nonproducing properties (PDNP, PUPs). Lenders could also seek to restructure a nonconforming borrowing base loan to a term loan or implement automatic borrowing base reductions upon repayment.

A forbearance agreement additionally enables the lender to maintain to maintain existing defaults while refraining from exercising remedies. The goal of forbearance is to enable the debtor to pursue a quick strategy to pay off the secured debt, like seeking the sale of properties, refinancing the RBL facility, selling the company, raising second lien debt, or raising equity investment or effectuate a debt for equity exchange. Forbearance agreements generally do not last very long (e.g., a couple of months) and typically come with strings attached, like increased interest rates, recovery efforts milestones, retention of restructuring professionals, enhanced financial and operations reporting, approved budget, and/or release of claims.

2. Fulcrum Debt Strategies

Unlike the environment in the 1980s, where single lenders provided funding to O&G companies, today's environment is marked by many new players in the industry. Oil and gas companies today have access to larger capital markets. There has been a significant rise in private equity groups and hedge funds investing in oil and gas companies. With the advent of new players in the industry, it is not uncommon to find middle market E&P or OFS companies layered with several tranches of debt. This creates certain restructuring opportunities, because of the rigid priority system under the Bankruptcy Code.

Pursuant to section 506(a) of the Bankruptcy Code, a secured lender holds a secured claim up to the value of the collateral that was pledged to such lender and an unsecured claim for any deficiency between the outstanding debt owed by the debtor and the value of the encumbered property. 11 U.S.C. § 506(a). Pursuant to section 1129(b)(2) of the Code, only secured debt is

entitled to 100% recovery in a reorganization where not all impaired classes vote in favor of a chapter 11 plan. 11 U.S.C. § 1129(b)(2)(A).

In a restructuring scenario involving several tranches of debt, where not all the debt will be treated as secured under section 506(a), the least senior debt that is at least partially entitled to a recovery is generally considered the fulcrum debt. Another way of looking at it is that the fulcrum debt is the tranche of debt found at the threshold of where a borrower's assets exceed its liabilities.

Identifying the fulcrum debt can provide a debtor with several restructuring options, especially in an environment where capital seems to have swollen. For example, in the chapter 11 bankruptcy of Samson Resources Corporation, Samson was able to use the fulcrum debt to negotiate effectively with both senior classes of debt, which mostly were entitled to full recovery, and junior classes, which were entitled to receive no recovery.[43] The senior class consisted of two tranches of secured debt, $950 million owed under a first priority, revolving credit facility and $1 billion owed under a second priority, secured term loan facility (the fulcrum debt). The junior class consisted of $2.25 billion of outstanding senior unsecured notes.

The fulcrum debt proposed a plan that would eliminate approximately $3 billion in long-term debt of Samson through (a) converting most of the fulcrum debt into equity, (b) reinstating the senior secured debt, (c) a rights offering of debt and equity securities up to $450 million backstopped by the fulcrum lender and (d) eliminating all junior classes of debt.

The senior unsecured notes, who stood to lose all of their investment, proposed an alternative restructuring plan that provided for an out-of-court exchange offer converting the junior unsecured notes to senior secured notes (with priority over the fulcrum debt) and a new secured money investment of $650 million by the unsecured noteholders (also with priority over the fulcrum debt).

Samson ultimately elected to pursue the in-court restructuring proposed by the fulcrum, because it provided the Company with a substantially deleveraged balance sheet, sufficient new capital and less contingencies. Nonetheless, the early identification and utilization of the fulcrum debt allowed Samson with two alternatives for fresh capital that otherwise likely would not have been available. This strategy could be utilized by other debtors facing similar levels of stacked debt.

3. Post-Bankruptcy Financing

Where reserve values and the values of machinery and equipment are expected to be depressed for the foreseeable future, obtaining new financing in bankruptcy could be challenging, especially considering many middle market or lower middle market E&P and OFS companies are already over-leveraged and experiencing substantially reduced income. The problem is two-fold. First, in addition to the swelling of investor appetite, these oil and companies do not have many unencumbered assets that can be used to pledge for a new loan. Second, even if these companies could obtain a new loan, they are not producing enough revenue to meet new debt

[43] *See* Declaration of Philip Cook In Support of Chapter 11 Petitions and First Day Motions (Docket No. 2), *In re Samson Resources Corp.*, Case No. 15-11934 (Bankr. D. Del. Sept. 17, 2015).

servicing obligations, on top of their existing debt obligations, which are already likely to be in default.

A traditional debtor-in-possession (DIP) secured lender will likely require unencumbered collateral for a new loan and/or a priming lien. For E&P companies, the collateral base primarily consists of the oil and gas reserves. For OFS companies, the collateral base generally consists of machinery and equipment, technology intellectual property, and sometimes real estate. All such collateral is likely to be fully-encumbered by first lien debt, leaving no assets to secure a new loan.

With respect to priming liens, pursuant to 364(d)(1) of the Bankruptcy Code, the bankruptcy court is authorized to allow a debtor to obtain new secured loans with priority senior or equal to that of existing secured debt provided that, among other things, there is adequate protection of the interests of the existing secured debt that is being primed. *See* 11 U.S.C. § 364(d)(1). This generally requires a showing that there is a percentage of equity in the mutual collateral in which the DIP lender is obtaining priming liens. The existence of an equity cushion seems to be "the preferred test in determining whether priming of a senior lien is appropriate under section 364."[44] However, some courts apply a "holistic" approach that looks not just to whether there is an equity cushion, but the likelihood that the collateral will depreciate or appreciate in value as a result of the proposed financing, and the overall prospects of for a successful reorganization.[45]

In this environment, it will be difficult to demonstrate that there is an equity cushion in reserves or equipment to provide adequate protection to pre-bankruptcy secured lenders. The authors also have discovered no bankruptcy opinion that has utilized the holistic approach to grant priming liens in a volatile pricing environment.

Setting aside a little thing like collateral, a debtor must also demonstrate that it can afford DIP financing. For E&P and OFS companies, this will be difficult to show because their income has dropped dramatically during the volatile market. Even if they had extra income, they would still have a difficult time demonstrating that they could afford new financing, if pre-bankruptcy financing is not being paid, because secured parties are entitled to adequate protection for the reduced value of their collateral during the bankruptcy. *See, e.g.*, 11 U.S.C §§ 361, 362(d)(1) and 363(e).

[44] *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 442 (Bankr. S.D.N.Y. 2010); *see also In re Packard Square LLC*, 574 B.R. 107, 123-24 (Bankr. E.D. Mich. 2017) (highlighting inherent uncertainty and speculative nature of projections of future value of construction project and slim equity cushion of less than 6% assuming those projections were accurate in concluding senior secured creditor not adequately protected); *Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 701 (E.D.N.C. 2009) (finding that equity cushion of 11%, plus improvement in collateral and monthly interest payments did not provide adequate protection); *In re Strug-Division LLC*, 380 B.R. 505, 515 (Bankr. N.D. Ill. 2008) (finding future improvement in value of property did not provide sufficient adequate protection to existing lender).

[45] *See In re Aqua Assocs.*, 123 B.R. 192, 196-99 (Bankr. E.D. Pa. 1991) (adopting holistic approach and concluding that while there was sufficient equity cushion and the proposed financing would significantly increase the value of the subject collateral and increase the likelihood of a successful reorganization, debtor needed to first negotiate with its present first mortgagee to obtain the requested financing); *see also In re Campbell Sod, Inc.*, 378 B.R. 647, 654-55 (Bankr. D. Kan. 2007) (adopting holistic approach and concluding that permitting priming lien was likely to ultimately increase the value of the senior secured creditor's collateral and allow the debtor to succeed).

In few cases, an E&P and OFS company might be able to obtain a defensive DIP loan from a pre-bankruptcy secured lender that might be looking to protect (or improve) its priority position in the capital stack. This type of DIP is often met with resistance by other secured parties claiming priority, including materialsmen lienholders, taxing authorities, or other secured lenders with priority over distinct collateral. The challenge continues.

A strategy for attracting a post-bankruptcy DIP loan that has proven successful as of lately is the recapitalization of the debtor with junior secured debt, resulting in a substantially deleveraged balance sheet for the borrower. In the recent case of Denbury Resources Inc. (filed on July 30, 2020), the debtors had approximately $2.4 billion in long-term obligations, including $230 million owed under a first-priority prepetition RBL loan and $2.1 billion owed to secured and unsecured bondholders.[46] By an agreement to equitize all of its bond debt, Denbury was able to propose a chapter 11 plan that deleveraged its balance sheet by $2.1 billion and refinance and extend the maturity of its RBL loan, increasing the availability by over $375 million (up to $615 million).[47] The debtors also were able to exit bankruptcy within approximately 2 months.[48]

The Denbury case was followed by the pre-packaged filing of Oasis Petroleum Inc., on September 30, 2020, where debtors currently propose a plan to convert $1.8 billion in outstanding bond debt to equity and refinance and extend their RBL loan, with $150 million in new post-bankruptcy funding and an additional $125 million in new exit facility loans.[49] Thus far, the vast majority of the post-petition financing has been approved, [50] and plan confirmation is scheduled for November 10, 2020 (approximately 40 days after the filing).[51]

4. Syndicated Loans

Secured lenders, including participants in syndicated loans, are not always in alignment on the approach to take during difficult times. For example, in *In re Alta Mesa Resources, Inc.*, No. 19-35133 (Bankr. S.D. Tex. Sept. 11, 2019), certain minority lenders under the debtor's syndicated

[46] *See* Declaration of Christian S. Kendall, Chief Executive Officer of Denbury Resources Inc., In Support of Chapter 11 Petitions and First Day Motions at 17 (Dkt. No. 3), *In re Denbury Resources Inc., et al.*, Case No. 20-33801 (Bankr. S.D. Tex. July 30, 2020).

[47] *See id.* at 34.

[48] *See* Order Approving the Debtors' Disclosure Statement, and Confirming, the Debtors' Joint Chapter 11 Plan of Reorganization of Denbury Resources Inc. and Its Debtor Affiliates (Dkt. No. 273), *In re Denbury Resources Inc., et al.*, No. 20-33801 (Bankr. S.D. Tex. Sept. 2, 2020).

[49] Declaration of Michael Lou, Chief Financial Officer of Oasis Petroleum, Inc., In Support of Chapter 11 Petitions at 6 (Dkt. No. 26.), *In re Oasis Petroleum Inc., et al.*, No. 20-34771 (MI) (Bankr. S.D. Tex. Sept. 30, 2020).

[50] Interim Order (a) Authorizing the Debtors to Obtain Postpetition Financing (b) Authorizing the Debtors to Use Cash Collateral, (c) Granting Liens and Providing Claims with Superpriority Administrative Expense Status , (d) Granting Adequate Protection to the Secured Parties, (e) Modifying the Automatic Stay, (f) Scheduling Final Hearing, and (g) Granting Related Relief, at 15 (Dkt. No. 73.), *In re Oasis Petroleum Inc., et al.*, No. 20-34771 (MI) (Bankr. S.D. Tex. Sept. 30, 2020).

[51] Order (i) Scheduling a Combined Disclosure Statement Approval and Plan Confirmation Hearing, (ii) Conditionally Approving the Disclosure Statement, (iii) Establishing Plan and Disclosure Statement Objection and Related procedures, (iv) Approving the Solicitation Procedures, (v) Approving the Combined Notice and (vi) Conditionally Waiving the requirements that the U.S. Trustee Convene a Meeting of Creditors and the Debtors File Schedules, SOFAs, and Rule 2015.3 Financial reports at 2 (Dkt. No. 51), *In re Oasis Petroleum Inc., et al.*, No. 20-34771 (MI) (Bankr. S.D. Tex. Sept. 30, 2020).

secured credit facility objected to the sale of the debtors' asset, asserting that the debtors could not satisfy the requirements under section 363(f) to sell the assets free and clear of the lenders' liens, because section 363(f)(2) requires each holder of a lien to consent to a sale and the dissenting lenders did not consent.

In support, the dissenting lenders argued that (a) the governing credit agreements did not expressly delegate the authority of each lender to consent to a sale under section 363(f) to the administrative agent and (b) in any instance, they were parties in interest under section 1109(b).[52]

The agent and debtors countered that if the agent was delegated the power to sell the collateral on each lenders' behalf, the agent must also have ben delegated the lesser power to consent to a sale, irrespective of the absence of an express grant of authority to consent under section 363(f)(2).[53] The agent and debtors also pointed to the collective action provisions of the credit agreement, which prohibited individual lenders from enforcing rights and remedies under the loan documents.[54] Finally, the agent and debtors countered that while the dissenting lenders fall within the definition of a "party-in-interest" under section 1109, they lacked standing to challenge the binding effect of the agent's and requisite lenders' consent in breach of the credit documents.[55]

The bankruptcy court ultimately held that the credit documents authorized the agent "to take all the necessary actions" to "maximize their recovery of their secured claim" and therefore only the agent had authority to raise issues regarding the sale of the assets free and clear.[56] The court further explained that although individual lenders "have standing in one narrow sense to raise objections that [do not] deal with collateral," pursuing such objections would frustrate the agents exercise of its exclusive authority in violation of the contracts' collective-action provisions.[57] Thus, the court found that it could exercise its equitable authority "to enforce [the credit documents] and to prohibit the dissenting lenders from making any argument[s] . . . that would upset what the administrative agent has consented to."[58]

The *Alta Mesa* opinion is consistent with well-established case law.[59] For example, in *In re Chrysler*, a minority lender holding less than one percent of the first-lien debt objected to a sale,

[52] *See* Br. by Bank of Texas Regarding Standing and Consent, ¶¶ 15-21 (Dkt. No. 920), *In re Alta Mesa Resources, Inc.*, No. 19-35133 (Bankr. S.D. Tex. Jan. 17, 2020).

[53] *See* Administrative Agent's Response to the Brief by Bank of Texas Regarding Standing and Consnt (Dkt. No. 943), *In re Alta Mesa Resources, Inc.*, No. 19-35133 (S.D. Tex. Jan. 20, 2020) ("AMH Agent Br."); Brief of Wells Fargo Bank N.A. as Agent (KFM Debtors) in Response to Lender Seeking Standing to Object to Sale of KFM Debtors' Assets (Dkt. No. 946), *In re Alta Mesa Resources, Inc.*, No. 19-35133 (Bankr. S.D. Tex. Jan. 20, 2020) ("KFM Agent Br."); Debtor's Reply to (i) Objection of Bank of Texas to the Debtors' Motion to Sell Substantially All of Their Assets and (ii) Brief by Bank of Texas Regarding Standing and Consent (Dkt. No. 947), *In re Alta Mesa Resources, Inc.*, No. 19-35133 (Bankr. S.D. Tex. Jan. 20, 2020) ("AMH Debtor Br."); KFM Debtors' Omnibus Reply Brief on Standing (Dkt. No. 945), *In re Alta Mesa Resources, Inc.*, No. 19-35133 (S.D. Tex. Jan. 20, 2020) ("KFM Debtor Br.").

[54] *See* KFM Agent Br. ¶¶ 10-12; AMH Debtor Br. ¶ 10.

[55] *See* KFM Agent Br. ¶ 2; AMH Debt Br. ¶ 27.

[56] Hr'g Tr. at 71; *In re Alta Mesa Res. Inc.*, No. 19-35133 (Bankr. S.D. Tex. Jan. 21, 2020).

[57] *Id.* at 73.

[58] *Id.*

[59] *See In re Chrysler LLC, 405 B.R. 84, 95 (Bankr. S.D.N.Y. 2009), aff'd, 576 F.3d 108 (2d Cir. 2009), vacated as moot*, 558 U.S. 1087, 130 S. Ct. 1015 (2009); *see also In re Metaldyne Corp*., 409 B.R. 671, 677 (Bankr.

despite the administrative agent's consent to the sale with overwhelming lender support.[60] The bankruptcy court overruled the objection, explaining that, upon a default, the collateral trustee, at the direction of the administrative agent, had the power to take enforcement actions against the collateral and any actions it "deems necessary to protect and preserve the Collateral and to realize upon the Collateral," including selling the collateral.[61]

The *Chrysler* court reasoned further that "[t]he right to consent to the sale of the [d]ebtors' assets that constitute Collateral" is a collateral-enforcement action within the administrative agent's authority, and that the junior lenders had agreed to not object to the agent's exercise of such authority.[62] Arguments similar to those asserted by the dissenting lenders in *Alta Mesa* have also been rejected by other courts.[63]

Although *Alta Mesa* was consistent with *Chrysler*, it went a step further, as *Chrysler* permitted the dissenting lender to argue its objections to the sale,[64] but *Alta Mesa* prohibited the dissenting lender from participating at the sale hearing in support of its objection or any other objection.[65] Consistent with *Chrysler*, the court in *Boston Generating* held that second-lien lenders had standing to object to a sale, despite the fact that the first-lien agent had consented to the sale and the second-lien lenders' rights were subordinated under an intercreditor agreement.[66] The *Boston Generating* court found that, in the absence of an express provision in the intercreditor agreement waiving the second-lien lenders' right to appear, the language granting the second-lien lenders the rights of an unsecured creditor was sufficient to establish standing.[67]

Thus, there is some lack of clarity about the consequences of a dissenting minority lender taking action to obstruct the administrative agent's chosen course. The *Alta Mesa* decision appears to go a step further than previous decisions, and if followed in other cases, could significantly limit the ability of individual lenders in a club loan to capture holdup value in the context of a section 363 sale.[68]

S.D.N.Y. 2009); *Beal Sav. Bank v. Sommer*, 8 N.Y.3d 318, 332 (2007) ("Here, the supermajority vote is meant to protect all Lenders in the consortium from a disaffected Lender seeking financial benefits perhaps at the expenses of other debtholders."); *In re Inn Keepers U.S.A. Trust*, 448 B.R. 131 (Bankr. S.D.N.Y. 2011) (securitization trust certificate-holder was contractually bound by no-action clause and could not assert individual objections to bidding procedures).

60 *See Chrysler*, 405 B.R. at 101-03.

61 *Id.* at 101.

62 *Id.* at 102.

63 *See Beal Sav. Bank v. Sommer*, 8 N.Y.3d 318, 320 (2007) ("The agent was authorized to act on behalf of the lenders collectively by its own initiative or at the direction of a majority of lenders."); *In re Metaldyne Corp.*, 409 B.R. 671, 676 (Bankr. S.D.N.Y. 2009) (holding that "the Credit Agreement and Security Agreement [are] correct and hold [ing] that the Agent may credit bid under § 363 (k) up to the full amount of the debt and may release the lien on any collateral").

64 *Chrysler*, 405 B.R. at 109, n.26 (explaining that dissenting lender is party-in-interest under § 1109 with right to be heard in contested matter and that lender was granted "a full and lengthy opportunity to cross-examine all the witnesses").

65 *See* Hr'g Tr. at 73, *In re Alta Mesa Res. Inc*., No. 19-35133 (Bankr. S.D. Tex. Jan. 21, 2020).

66 *In re Boston Generating LLC*, 440 B.R. 302, 320 (Bankr. S.D.N.Y. 2010).

67 *Id.*

68 George Davis, *et al*., *Agents Consent to Sale Bars Objections from Dissenting Lenders*, XXXVIX ABI Journal 18.

5. No Postpetition Financing

In many of these latest oil and gas bankruptcies, there is no post-petition funding available, in large part because (a) there is insufficient unencumbered collateral, (b) existing lenders do not want to provide more funding or (c) there is diminished appetite amongst new funding sources. This leaves the debtor with only one option to fund its restructuring, the use of the debtor's cash flow from operations. An immediate question arises: if this cash flow was generally insufficient to keep the debtor out of bankruptcy, how can this cash flow be used to reorganize the company with significant restructuring expenses being tacked on to working capital needs?

Part of the answer is that debt service is suspended during a bankruptcy, as prebankruptcy creditors generally cannot be paid on their prebankruptcy debts until a plan of reorganization is confirmed.[69] But still, if the cash flow being used to fund a bankruptcy constitutes the cash collateral of a secured lender—which it often does—that secured lender is entitled to adequate protection under section 363(e) of the Bankruptcy Code.[70] Yet many secured lenders appear to consent to, or not seriously oppose, the cash collateral usage, because apparently there are no other attractive solutions for the lender.

This appears to be the case even though the reserves that produce the cash collateral funding a case are diminishing, meaning that, in certain cases, the prepetition lenders may not be adequately protected from the diminished value of their collateral.

Certain OFS companies, with different tranches of debt secured, also may face challenges in in-court restructurings, when there is no liquidity or outside funding sources. Take for example the recent bankruptcy of *BJ Services, LLC*, a leading provider of pressure pumping and oilfield services for the petroleum industry. In that case, the debtors have several tranches of secured debt, including those belonging to (a) an asset-based lender (ABL Lender) that is secured by accounts, inventory and cash and (b) a separate lender (M&E Lender) that is secured by 11,500 pieces of machinery and equipment dispersed throughout North America. The ABL Lender's collateral is readily converted to cash collateral and is used to maintain cash flow to fund operations and conduct post-bankruptcy sales of several businesses and certain assets. Meanwhile the M&E Lender does not want to use its cash collateral to assist the debtors' liquidation efforts and claims that its collateral has already been used to generate more collateral

[69] *See, e.g.*, *Chiasson v. J. Louis Matherne & Assoc. (In re Oxford Mgmt.)*, 4 F.3d 1329 (5th Cir. 1993) (holding that the payment of a prepetition claim prior to confirmation of a chapter 11 plan was contrary to the provisions of the Code).

[70] In bankruptcies of E&P companies, there is little debate that the post-bankruptcy proceeds from the production of oil and gas minerals constitute the cash collateral of a secured lender with pre-bankruptcy liens on the borrower's post-bankruptcy production. *See, e.g.*, *Matter of Fullop*, 6 F.3d 422, 429 (7th Cir. 1993) ("Under the exception contained in § 552(b), however, even if the extracted oil and resulting accounts constituted after-acquired property, they remained subject to the pre-petition lien as the product or profits of the working interest."); *American National Bank v. United States (In re Hawn)*, 149 B.R. 450 (Bankr. S.D. Tex. 1993) ("Under Texas law where a creditor has a security interest which is perfected both as a deed of trust on the minerals in the ground and perfected under Article 9 after extraction, as here, the resulting interest is a single continuous security interest that attaches while the minerals are in the ground and continues after extraction."); *In re Hess*, 61 B.R. 977, 979-80 (Bankr. N.D. Tex. 1986) (Bank's prepetition lien on minerals and production extended to post-petition production).

for the ABL Lender, *i.e.*, accounts receivable from previously unfinished client projects.[71] The M&E Lender even filed a motion for relief from the automatic stay to recover a good portion of its collateral to avoid further liquidation by the debtors.[72]

As a result, the debtors in *BJ Services* filed a motion to surcharge the M&E Lender, pursuant to sections 506(c) and 552(b) of the Code, on the basis that "the [M&E Lender] ha[s] been unwilling to pay a mutually agreeable share of the costs of these chapter 11 cases."[73] The debtors contend that surcharge "is appropriate here given that the [d]ebtors have incurred reasonable and necessary administrative expenses that ultimately benefitted the [M&E Lender] and led to the preservation and value maximizing sale of certain of their Collateral."[74] Such expenses, amounting to approximately $22.7 million, include the costs associated with the sale of the debtors' cementing and fracturing businesses, conducting separate auctions for certain collateral, maintaining and storing the collateral, retaining employees and professional and other costs associated with the preservation of the collateral.[75]

The *BJ Services* debtors and M&E Lender ultimately agreed to lift the automatic stay as to the remaining machinery and equipment that has not been sold.[76] However, the M&E Lender has not agreed with the debtors and ABL Lender about the proposed $22.7 million surcharge.[77] According to the M&E Lenders, "[t]he relief requested by the Debtors, if granted, would turn the narrow, equitable defensive remedies of sections 506(c) and 552(b) of the Bankruptcy Code into far-reaching, offensive weapons to be used by debtors to force secured creditors to pay for any and all administrative expenses that a debtor incurs in a Chapter 11 case, while ignoring the rest of the architecture of the Bankruptcy Code, steamrolling secured creditor rights under the Bankruptcy Code and other applicable law."[78] The bankruptcy court is currently scheduled to decide this dispute in October 2020.

As a further indicator of the financing challenges in this industry, at the Ninth Annual Energy Summit, held on September 16, 2020, in Dallas, Texas, and hosted by the Secured Finance Network, Turnaround Management Group and Association of Insolvency Professionals, Greg White, a Director of Arena Investors L.P., a leading provider of capital to small and middle market oil and gas companies, announced that financing in the oil and gas space has virtually dried up and finance companies, like Arena, are currently being selective on the oil and gas projects that they elect to pursue. With no financing available, O&G debtors are under infinitely

[71] M&E Lender's Preliminary Objection to Debtor's Motion Surcharge Certain Collateral ¶¶ 2, 13 (Dkt. No. 686), *In re BJ Services, Inc.*, Case No. 20-33627 (Bankr. S.D. Tex. Sept. 18, 2020).

[72] M&E Lender's Motion for Relief from Stay by GACP Finance Co., LLC ¶6 (Dkt. No. 290), *In re BJ Services, Inc.*, Case No. 20-33627 (Bankr. S.D. Tex. August 6, 2020).

[73] Motion to Surcharge Certain Collateral ¶ 3 (Dkt. No. 589), *In re BJ Services, Inc.*, Case No. 20-33627 (Bankr. S.D. Tex. Sept. 4, 2020); ABL Lenders' Statement in Support of Motion to Surcharge Certain Collateral ¶¶ 1-3 (Dkt. No. 668), *In re BJ Services, Inc.*, Case No. 20-33627 (Bankr. S.D. Tex. Sept. 16, 2020).

[74] *Id.* at ¶ 4.

[75] *Id.* at ¶¶ 4, 21.

[76] Agreed Order Lifting the Automatic Stay (Dkt. No. 553.), *In re BJ Services, Inc.*, Case No. 20-33627 (Bankr. S.D. Tex. Sept. 2, 2020).

[77] M&E Lender's Preliminary Objection to Debtor's Motion Surcharge Certain Collateral (Dkt. No. 686), *In re BJ Services, Inc.*, Case No. 20-33627 (Bankr. S.D. Tex. Sept. 18, 2020).

[78] *Id.* at ¶7.

more pressure to pursue innovative strategies to fund their bankruptcy cases, including relying entirely on the collateral of secured lenders.

G. Conclusion

Over the last 40 years, O&G industry have become very adept at dealing with downturns in commodities pricing, learning to downsize quickly, utilizing financial safety nets, like hedges, and developing new technologies that reduce the cost of production.[79] As the ICF study concludes, with untapped North American shale plays remaining, technological advances, and emerging markets for natural gas, there is good reason to be optimistic about the industry in the long-term.[80]

In the short term, however, as Rystad Energy predicts, the U.S. may see some bumpy roads in the industry due to volatile markets, lower production, and investor appetite. As Charles Darwin foresaw over a hundred years ago, some of the least fit players in the industry may not survive.

[79] *See* Loretta Cross, *supra* note 17.
[80] Kevin Petak, *supra* note 22, at 9.

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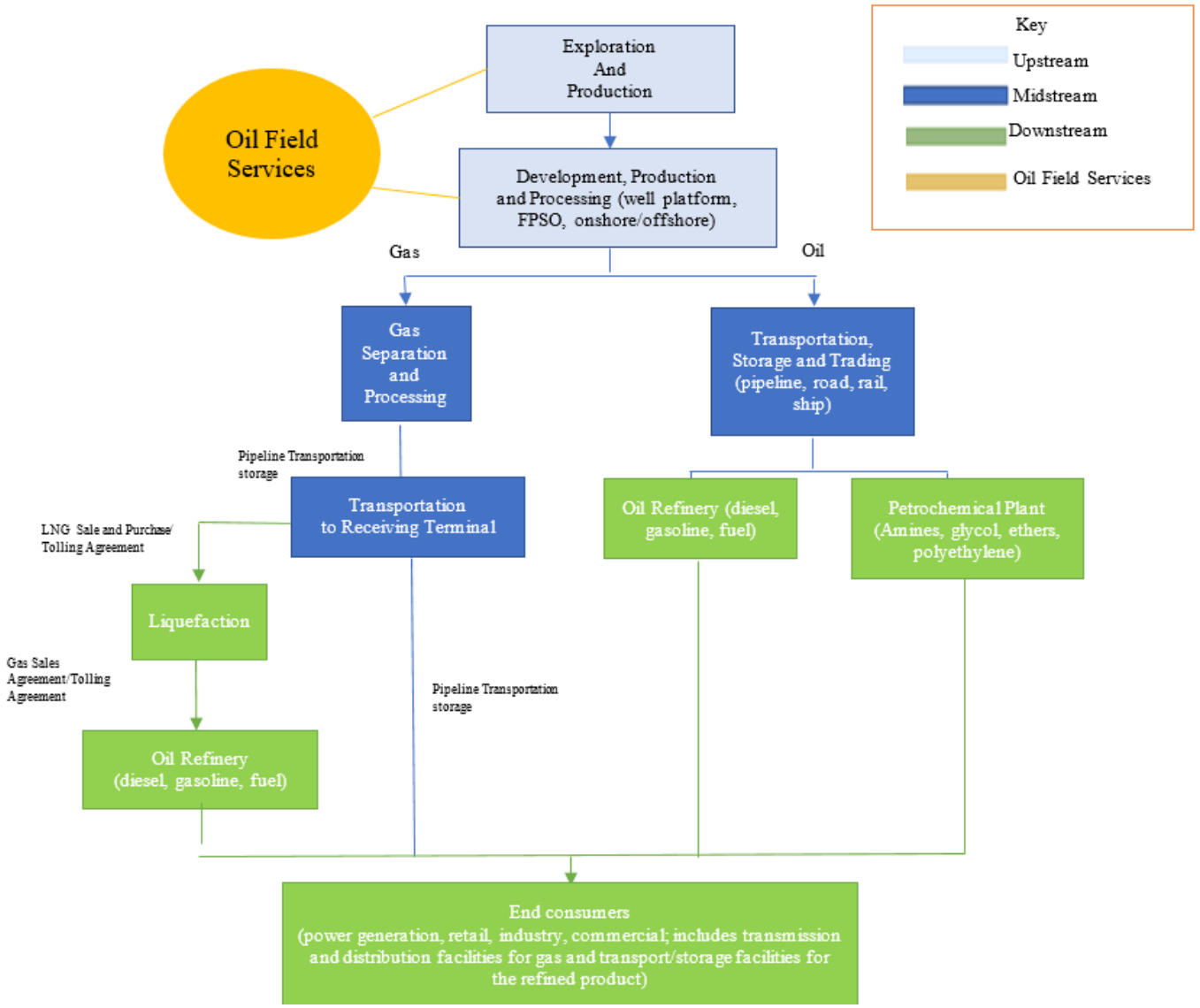
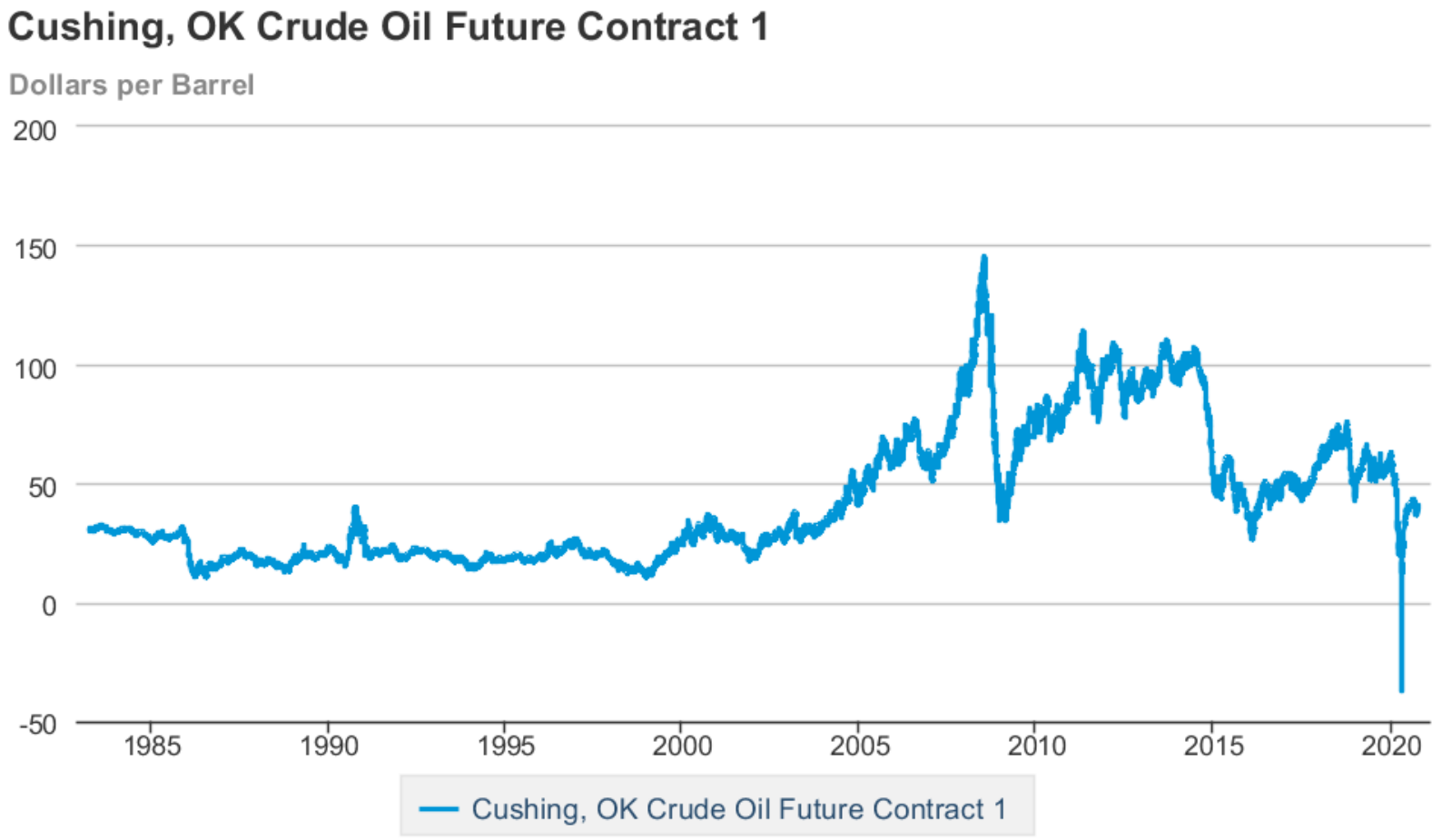
INDUSTRY PARTICIPANTS

- **Quick background on key players**
  - **Upstream companies**
    - **Exploration & Production or E&P (drillers and operators)**
  - **Midstream companies**
    - **Transportation (pipelines, storage, processing facilities, terminals)**
  - **Downstream companies**
    - **Refineries, manufacturing petrochemicals, and marketing and distributing refined products and natural gas**
  - **Oil field services companies**
    - **Provide the labor and equipment for E&P Companies for drilling and operation of oil and natural gas wells**

INDUSTRY PARTICIPANTS



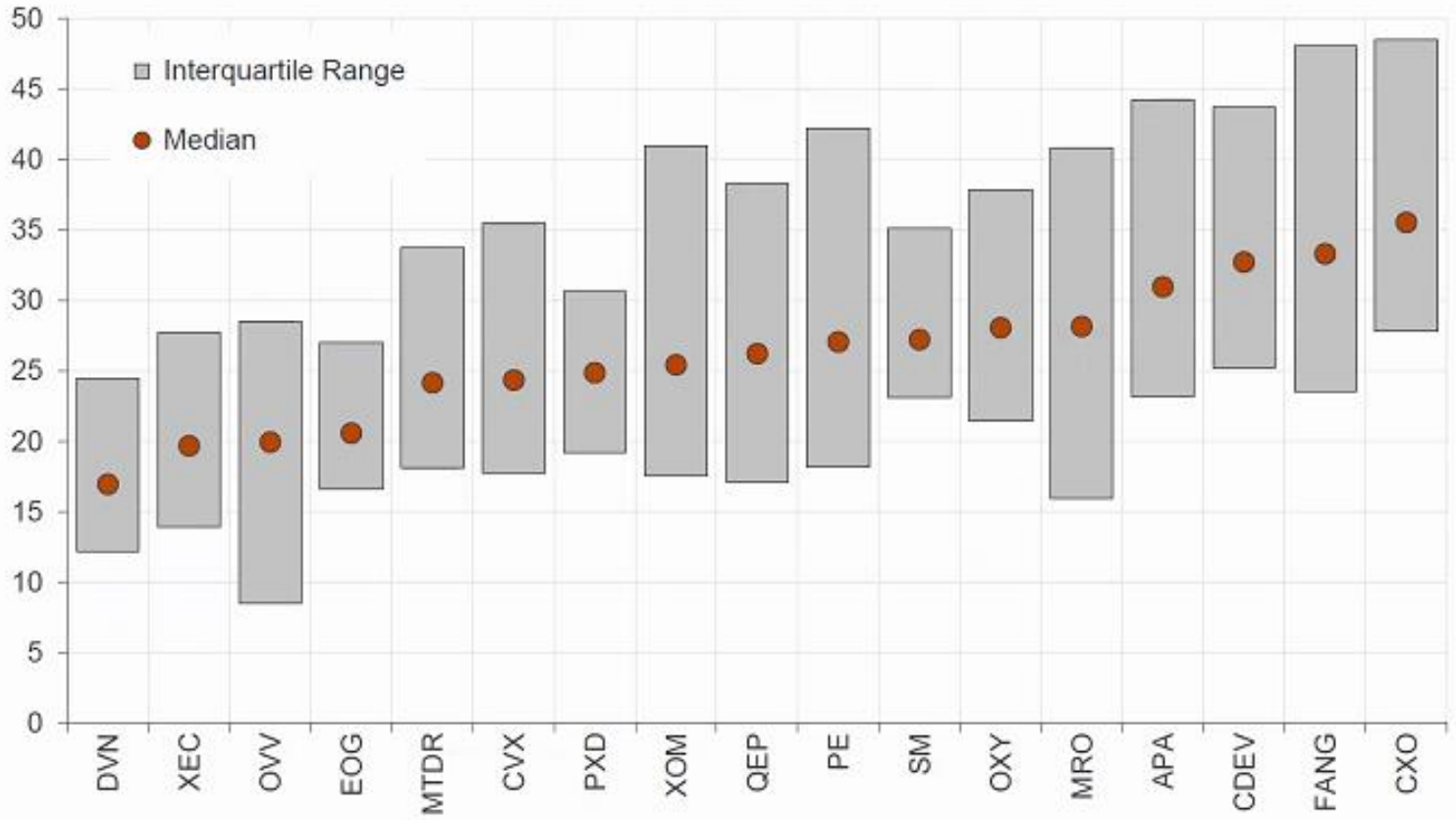
Volatile Market



Source: U.S. Energy Information Administration

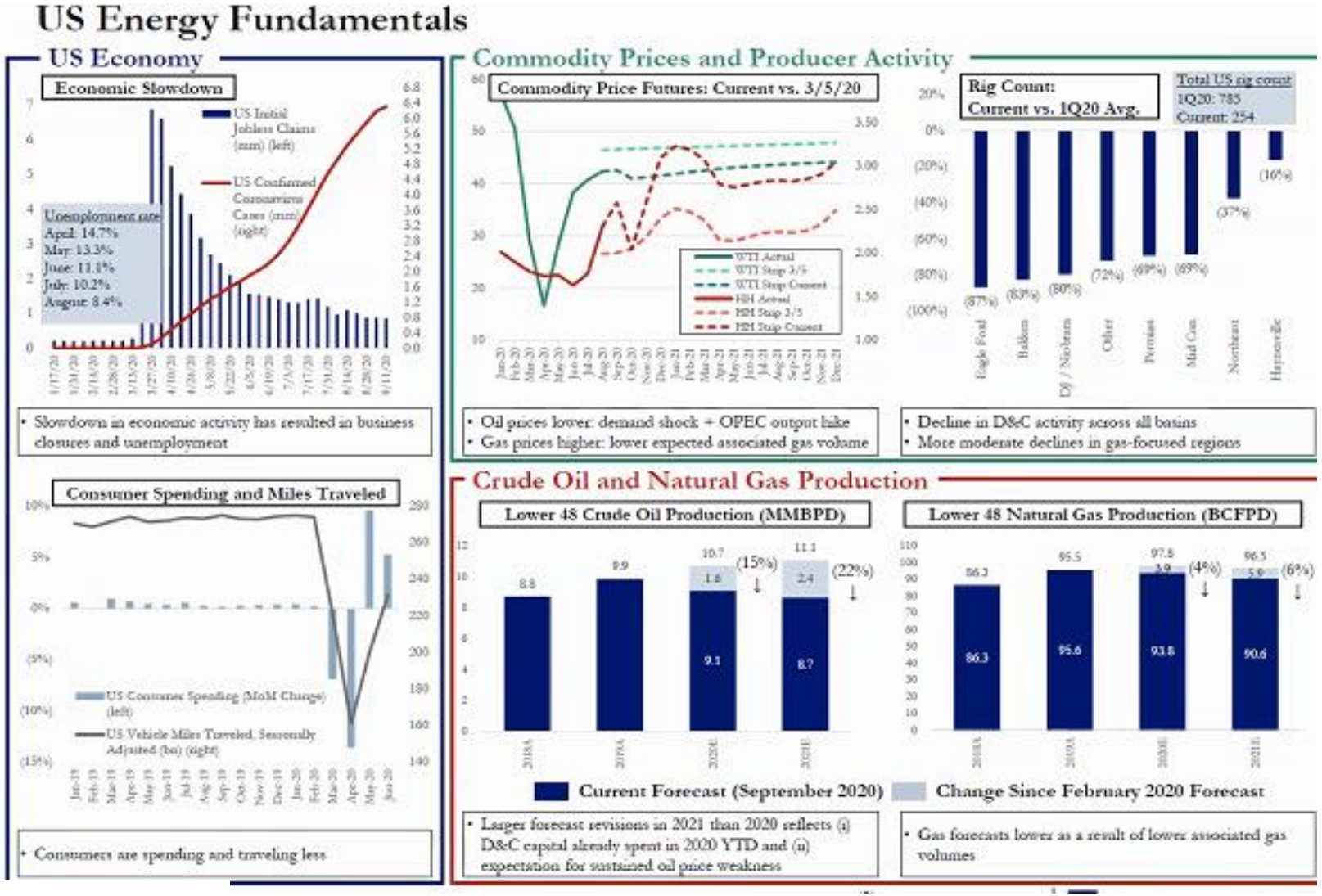
Breakeven

Permian portfolio wellhead* breakeven prices for oil wells in 2019-2020 YTD**
Dollars per barrel

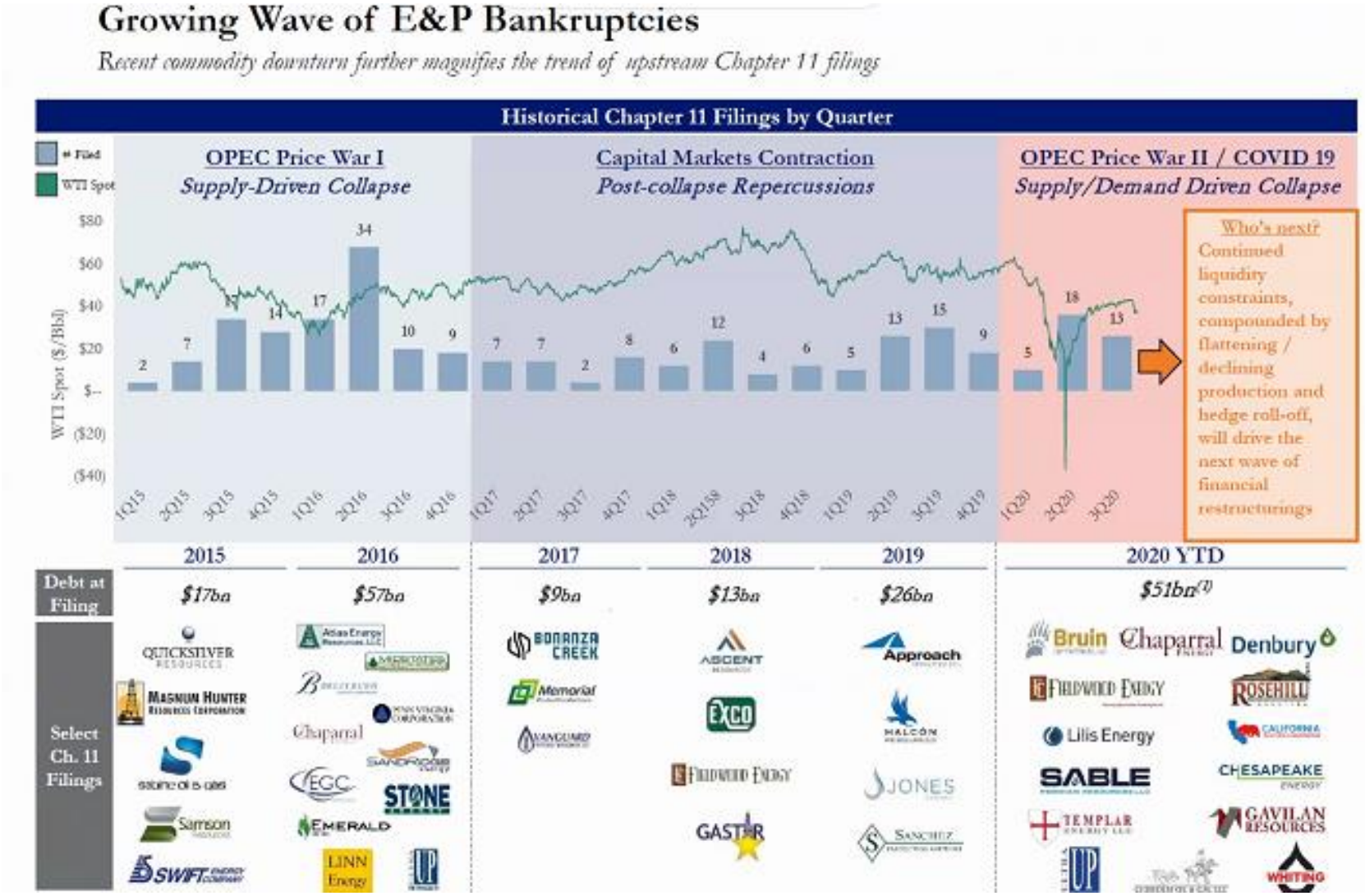


*Median breakeven of horizontal wells with at least three months of production
**Oil wells are defined as any well with cumulative light oil content > 40%
Source: Rystad Energy ShaleWellCube

How it All Fits Together



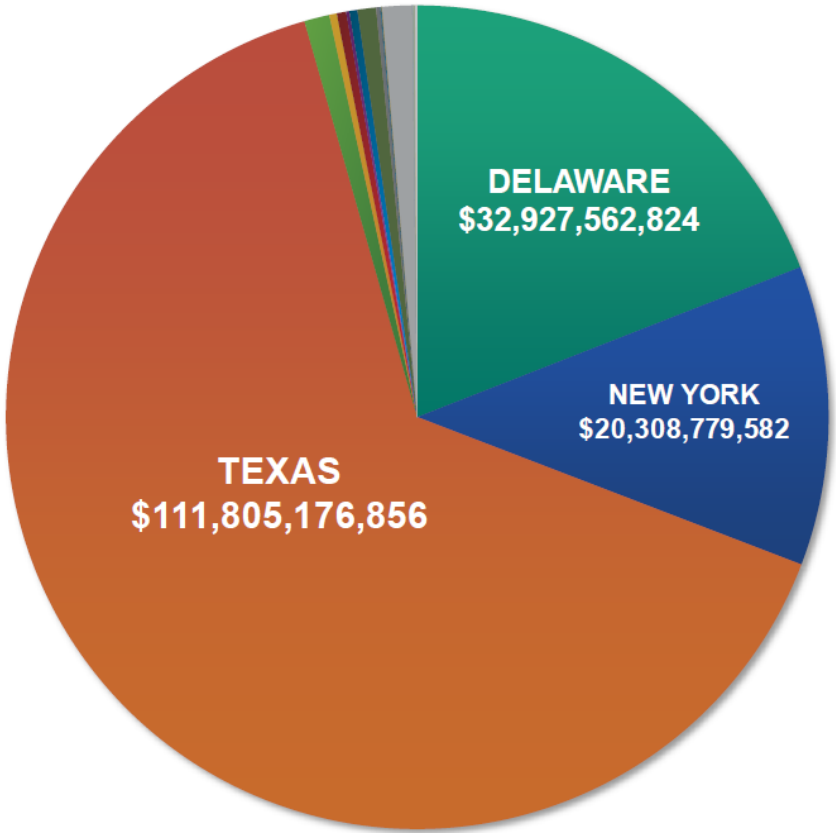
Bankruptcies



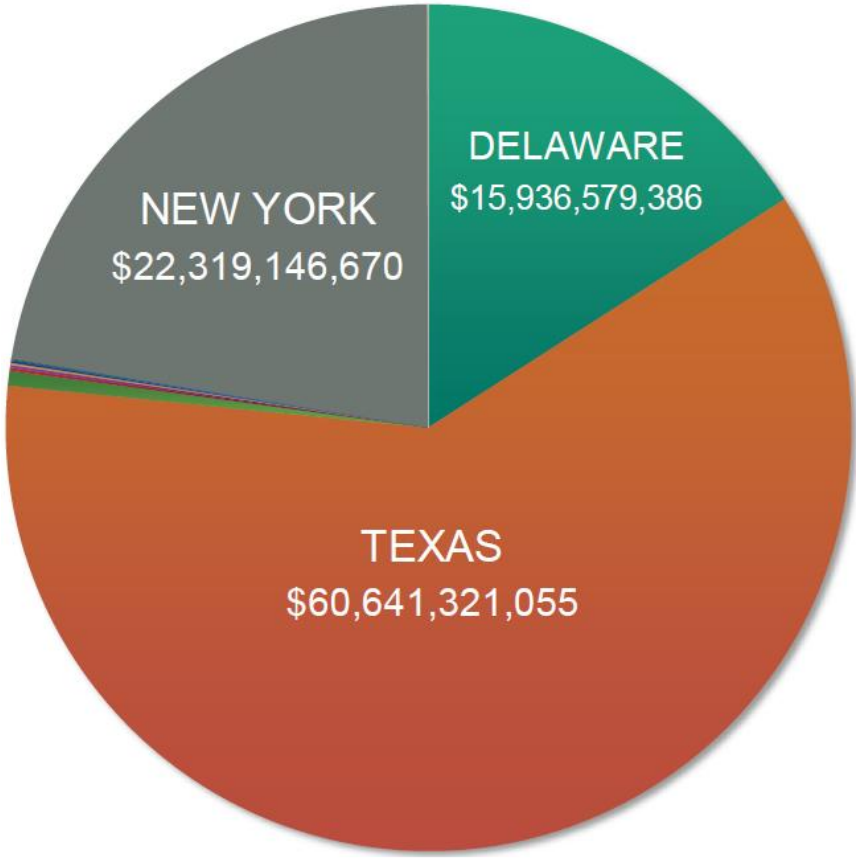
[1]YTD as of 9/17/20

Aggregate Debt 2015 - 2020

E&P



OFS



Source: Haynes & Boone. Through 8/31/20

Lender Options

- **Hang On:** Restructure the loan terms or enter into a forbearance agreement in the hopes that prices increase, or take some other steps outside of court (short of exercising remedies) to push through to profitability
  - Recapitalize
  - Exchange Offers
- **Go to Court:** Reorganize or liquidate in a proceeding controlled by a court through a voluntary or involuntary bankruptcy
  - chapter 7 or chapter 11
  - voluntary or involuntary
  - State law remedies (litigation, receivers, injunctions, etc.)
- **Take the Keys:** Become the owner and operator of the borrower's properties either through foreclosure or by accepting the properties in satisfaction of some or all of the debt

Reserve Base Loan Facility Primer

- Limited by borrowing base that is redetermined twice per year based on reserve reports provided by the company
  - Lenders apply their own price deck to determine value
  - Multiple factors are considered and an advance rate applied in order to set the borrowing base
- Secured by a first lien on oil and gas reserves in the ground covered by mortgages
- Quarterly financial covenants
- Hedges are required on a minimum and maximum amount of oil and gas production
- Sales of a percentage of properties typically permitted without a required prepayment of the line

Restructuring the Facility

- Stretching the borrowing base:
  - Redetermining the borrowing base at a higher number than prices would otherwise have dictated
  - OCC: Stretching should not be used to avoid borrowing base deficiencies
  - Document mitigating factors
  - Stretching Methods
    - Higher advance rates
    - Less conservative risk factors
    - Increasing value attributable to nonproducing properties (PDNP, PUDs)
  - Implement automatic borrowing base reductions upon repayment
- Create conforming and non-conforming borrowing bases or restructure the deficiency as a term loan
- Permit hedge liquidation for pay down of the debt
- Financial covenant relief

Forbearance

- Forbearance agreement – maintain existing defaults but agree not to exercise remedies for some period of time
  - **Goal**: sale of properties, refinance the RBL facility, sell the company, raise second lien debt, equity investments, debt for equity exchange
  - **Length**: results of collateral review may require 90 days to pass the preference period
  - **Typical**:
    - Increased interest rates
    - Recovery efforts milestones
    - Borrower required to hire FA, CRO
    - Enhanced financial and operations reporting, approved budget
    - Release of claims against the lenders
- If no success: negotiate a pre-packaged bankruptcy or exercise remedies

Bankruptcy Remedies

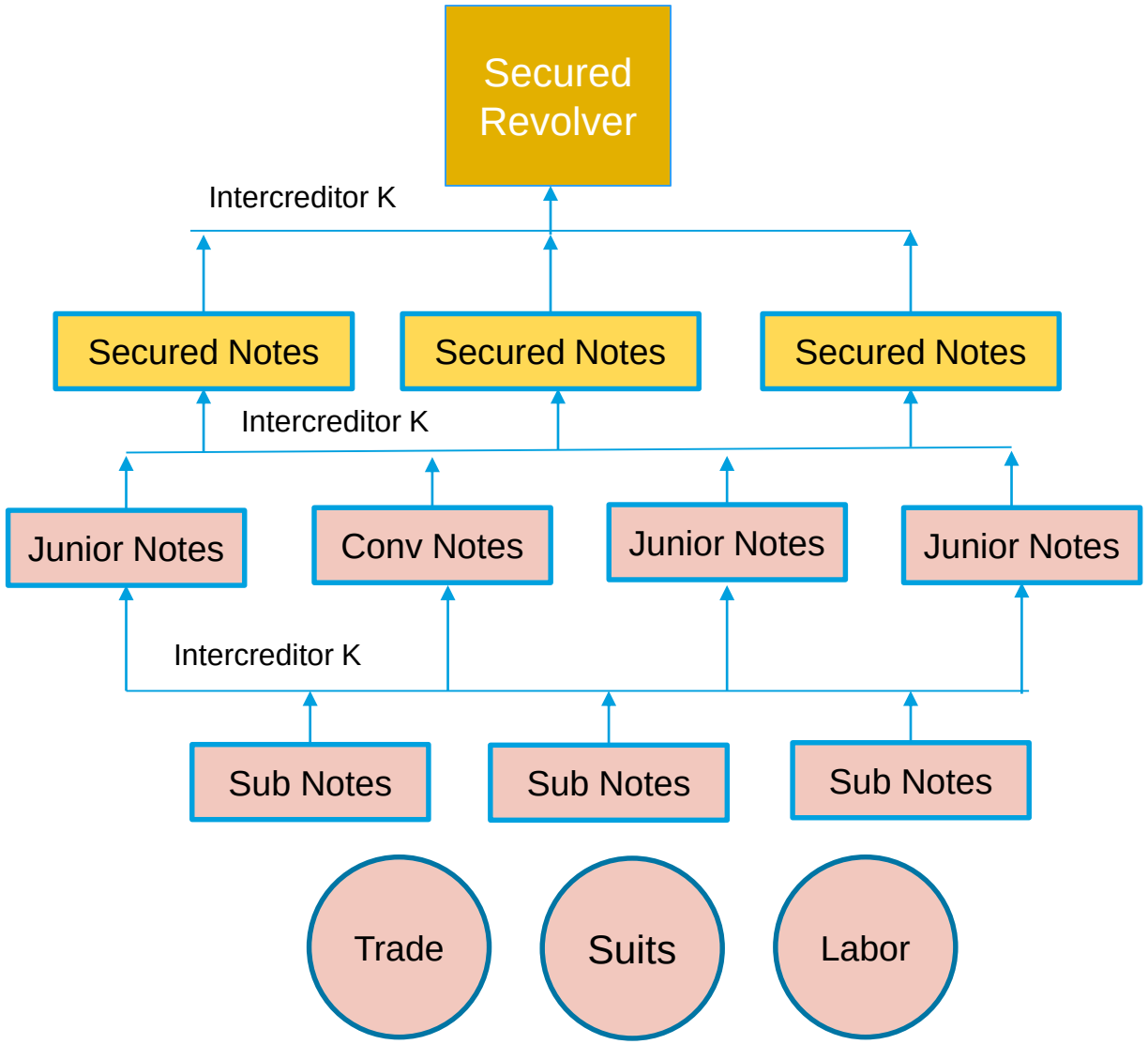
- Cash collateral / budgets
- Credit bidding
- Priming protection
- Subordination agreement
- Adequate protection / relief from automatic stay

- Reimbursement of interest / attorneys' fees
- Prepetition receivership
- Conversion / dismissal
- Trustee / examiner
- Plan treatment – 100% recovery
- Section 1111 election
- State law remedies: guarantees, non-debtors

Prepackaged E&P Bankruptcies

- **Restructuring Support Agreement ("RSA") with sufficient key constituents that form the basis for a chapter 11 plan.**
- **Recapitalization with secured debt – achieves substantial deleveraging**
- **Obtain new DIP financing from RBL Facility**
- **Creditor voting occurs before the filing**
- **Trade debt receives 100% recovery**
- **Equity or junior L/T debt gets warrants or wiped out**
- **Quick Exit**

Fulcrum


Secured Revolver
Intercreditor K
Secured Notes
Secured Notes
Secured Notes
Intercreditor K
Junior Notes
Conv Notes
Junior Notes
Junior Notes
Intercreditor K
Sub Notes
Sub Notes
Sub Notes
Trade
Suits
Labor

Adequate Protection for Existing Lenders

- **DIP Financing – section 364(d) requires an equity cushion**
  - **Valuation**
- **Cash Collateral – section 363(e) requires adequate protection**
  - **cash, replacement liens or indubitable equivalent value**

Collective Action

- **Increasing club loans in Oil & Gas Industry**
- **Tension in terms of credit documents:**
  a. **Certain terms treat all lenders as single group represented by an agent – agent enforces remedies upon default *versus***
  b. **Certain terms provide each lender be treated independently (e.g., 100% approval for amendments or waivers that forgive principal, extend maturity or release collateral)**
- **Consent to 363 Sale--**
  - ***Alta Mesa Resources, Inc.* (Bankr. S.D. Tex. 2020) – minority can't object and frustrate agent's choice to consent to sale**
  - ***In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009) – consent to sale is collective action but minority can object**
- **Credit bidding under 363(k) – commit all lenders. *In re GWS Holdings*, 2009 WL 453110 (Bankr. D. Del. 2009)**


LIQUIDITY

LIQUIDITY: A CAPITAL INTENSIVE INDUSTRY

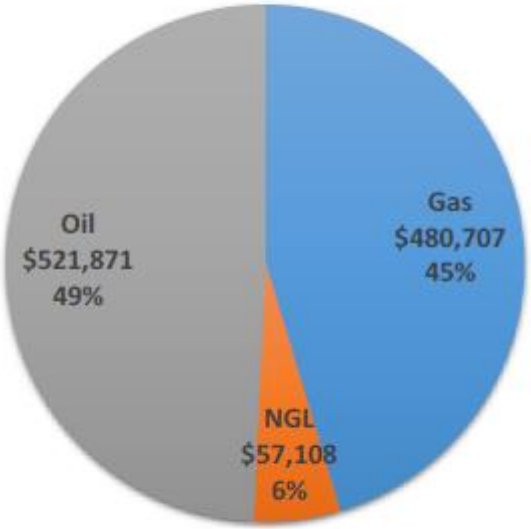
- **Lifecycle of an oil and gas project**
  - **Planning stage**
    - **Geological evaluations, exploration wells, leasing and permitting**
  - **Construction**
    - **Drilling pads, reserve pits, and other necessary infrastructure**
  - **Drilling**
    - **Drilling rigs, well testing, casing and cementing**
  - **Completions and work overs**
    - **Hydraulic fracking, well perforations and stimulation, workover and maintenance**
  - **Field production**
    - **Installation of wellhead, extraction equipment, field facilities (flowlines, gathering systems and water separation systems)**
    - **Secondary and enhanced recovery**
  - **Oil storage and sales**
  - **Abandonment and final reclamation**

LIQUIDITY: CAPEX

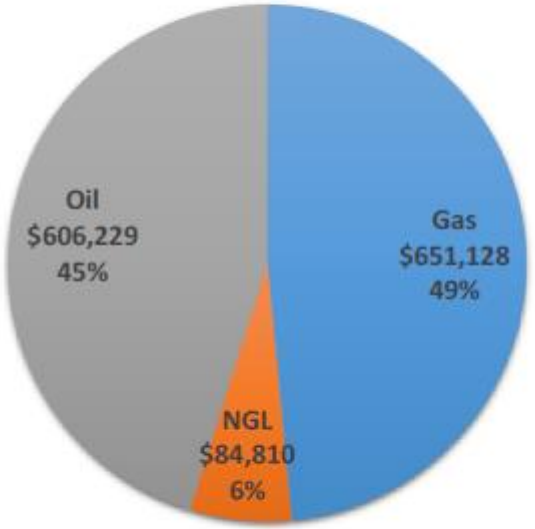
- **American Petroleum Institute Study**
  - **From 2012 to 2016 capital expenditures (CAPEX) averages $78 billion a year**
    - **Surface facilities (including pipelines) accounted for $22 billion of that cost**
  - **Forecast that annual CAPEX will be $56 to $71 billion a year through 2035**
    - **$16.7 to $19.2 billion for surface and lease equipment**
    - **$12.3 to $19 billion for gathering and processing facilities**
    - **$10.3 to $11.4 billion for refineries and oil product pipelines**
  - **This does not take into account costs for operations and maintenance**
  - **Although these are strange times, the US. Energy Information Administration (EIA) forecasts U.S. energy demand to grow by 12% by 2040**
    - **60% of increased energy demand will be met by oil and gas**
    - **That's a 7.2% increase in oil and gas demand**

CAPEX FORECAST

Base Case
Total Investment = $1,059,686



High Case
Total Investment = $1,342,167



EXPENDITURE BREAKDOWN

Exhibit 23: Oil and Gas Infrastructure CAPEX from 2017-2035 by Category (Million 2015$)

	2012-16		Base Case, 2017-35		High Case, 2017-35	
	CAPEX	% of Total	CAPEX	% of Total	CAPEX	% of Total
Surface and Lease Equipment	$111,375	28.6%	$318,010	30.0%	$364,997	27.2%
Gathering and Processing	$78,524	20.2%	$235,621	22.2%	$280,418	20.9%
Oil, Gas, and NGL Pipelines	$101,670	26.1%	$234,072	22.1%	$361,579	26.9%
Oil and Gas Storage	$10,242	2.6%	$20,977	2.0%	$25,456	1.9%
Refining and Oil Products Transport	$79,081	20.3%	$195,722	18.5%	$216,829	16.2%
Export Terminals	$8,742	2.2%	$55,284	5.2%	$92,887	6.9%
Total Expenditures	$389,633	100.0%	$1,059,686	100.0%	$1,342,167	100.0%

SO WHAT DOES THIS MEAN RIGHT NOW?

LIQUIDITY: MANAGING SHORTFALLS

- **Market price is highly volatile**
  - **$21.44 per barrel in April 2020**
  - **Current price around $40 currently**
- **There has been a historic drop in demand and revenues have fallen**
  - **Demand will likely increase slowly**
- **Managing liquidity could determine which companies survive!**
- **After several years of volatility, companies should be familiar with the tools to manage liquidity**
  - **Cut CAPEX**
  - **Cut operating costs**
  - **Shutting in production**
  - **Cutting or eliminating dividends**
  - **Reduce general and administrative costs (G&A)**

PRIORITIZING OBLIGATIONS AND ASSETS

PRIORITIZING OBLIGATIONS AND ASSETS

- **Types of assets**
  - **Oil and Gas leases**
    - **Federal, state, Indian, fee**
  - **Surface authorizations**
    - **Rights-of-way, easements, surface use agreements**
      - **Be aware of any rentals or reporting obligations**
  - **Other agreements**
    - **Unit agreements**
    - **JOAs**
    - **Farmout agreements**
    - **Gathering agreements**
    - **Marketing agreements**
    - **Service agreements**

PRIORITIZING OBLIGATIONS AND ASSETS

- **Strategies for maintaining value during financial crisis**
  - **Maintaining leases**
    - **Priority should be given to maintaining leasehold position**
    - **Evaluate status of your lease**
      - **Within primary term?**
      - **Held by actual or associated production?**
        - » **Pugh clause? Active after primary term?**
        - » **Can you shut in some wells without affecting lease validity?**
        - » **Do you have BLM leases? Have you received a 60-day notice?**
        - » **Do you have a shut-in clause**
          - **Usually only applies to gas wells and sometimes only if lack of market**
      - **Questions of paying in producing quantities are a question of fact**
        - » **Latent defects**
        - » **Could affect ability to sell asset**
      - **Does losing your lease violate your credit facility?**

PRIORITIZING OBLIGATIONS AND ASSETS

- **Satisfying contractual obligations**
  - **Do you have development obligations?**
    - **Farmout agreements or other JV**
    - **Express/implied covenant to develop**
  - **JOA obligations**
    - **Do you have a drilling obligation under your JOA?**
    - **For non-operators, understand the consequences of going non-consent**
    - **Cash call?**
  - **Obligations under a unit agreement**
    - **Can you seek a stay**
  - **Marketing and other supply contracts**
    - **Do you have minimum volume commitment?**
    - **What is the penalty for failing to meet this obligations?**
  - **Other contractual obligations?**
- **Understand what bankruptcy means for you and your partners**
  - **Automatic stay**
    - **Can’t force pool**
    - **All administrative hearings/litigation/proceedings suspended?**

PRIORITIZING OBLIGATIONS AND ASSETS

- **Unique solutions**
  - **Enter into contractual arrangements with private owners**
    - **Ratifications or shut-in, minimum royalty arrangements**
  - **Work with states to obtain relief from leasehold obligations**
  - **Request a suspension from federal government**
- **Latent defects**
  - **Often not obvious**
  - **May only be discovered in a sale**
  - **Can significantly affect value**

Thank you!

Mark Burghardt
Dorsey & Whitney LLP
Salt Lake City, Utah
burghardt.mark@dorsey.com

Joseph Acosta
Dorsey & Whitney LLP
Dallas, Texas
acosta.joseph@dorsey.com