

Oil and Gas Restructurings: The Coming "Global Boom"?

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&
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Sources of Revenue for Oil & Gas Producers and Service Providers

WHERE DO PRODUCERS GET THEIR MONEY?

Cashflow from oil and gas production sales (net of operating expenses)

E&P capital inflows (debt, equity)

WHERE DO OFS COMPANIES GETS THEIR MONEY?

E&P Capital Expenditures (CAPEX)

E&P operating costs

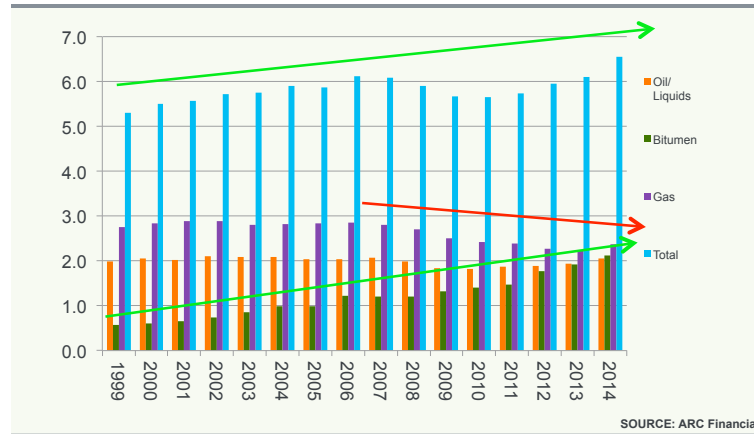
Service sector CAPEX



2015 CROSS-BORDER INSOLVENCY PROGRAM

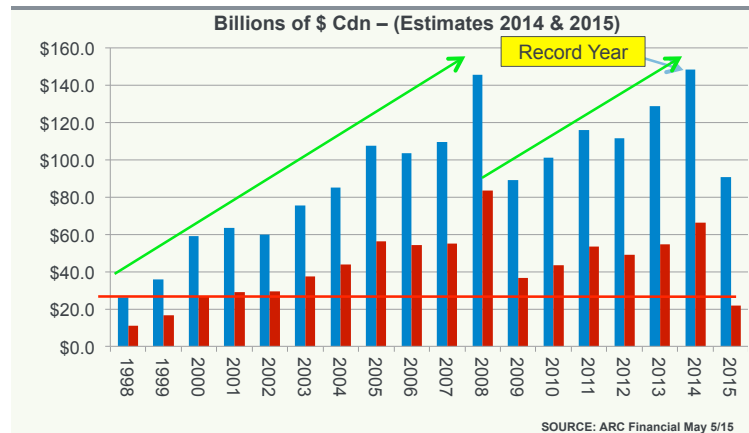
Production Volumes

Millions of Barrels of Oil or Natural Gas Liquids
Millions of Barrels of Oil Equivalent of Gas (@ 6:1) Per
Day



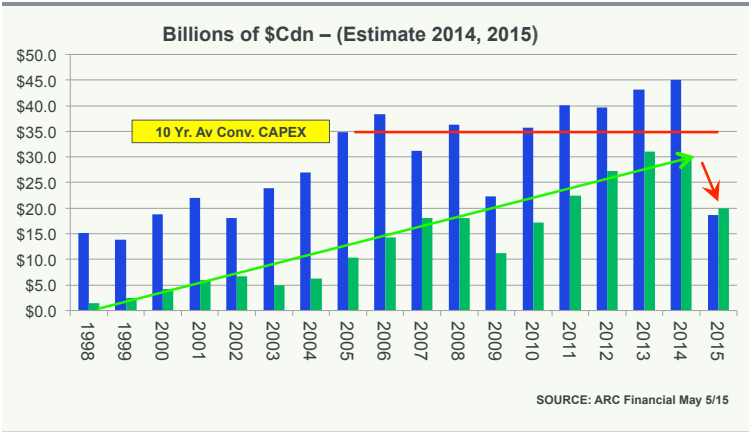
2

Revenue/Cashflow 1998 - 2015



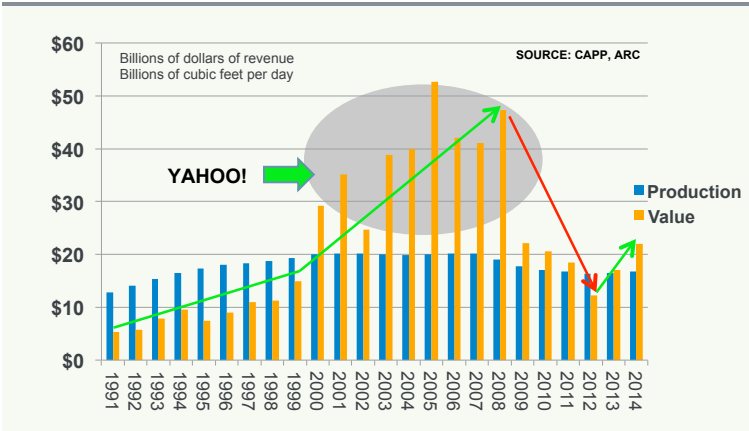
3

CAPEX Conventional/Oilsands 1998 - 2015



4

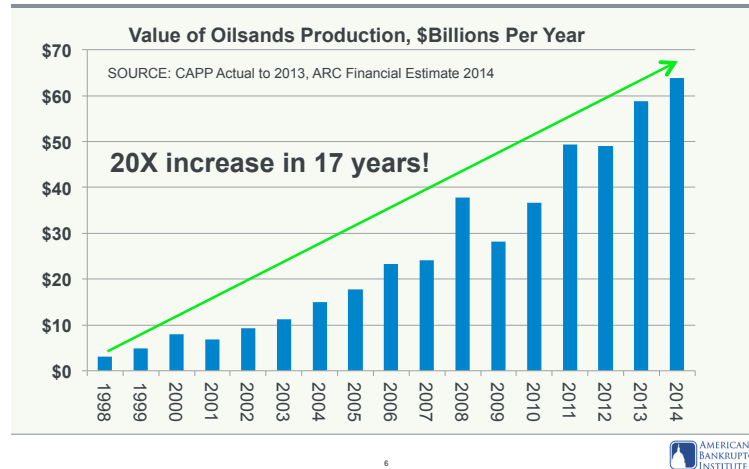
The Gas Boom – 2000 to 2008



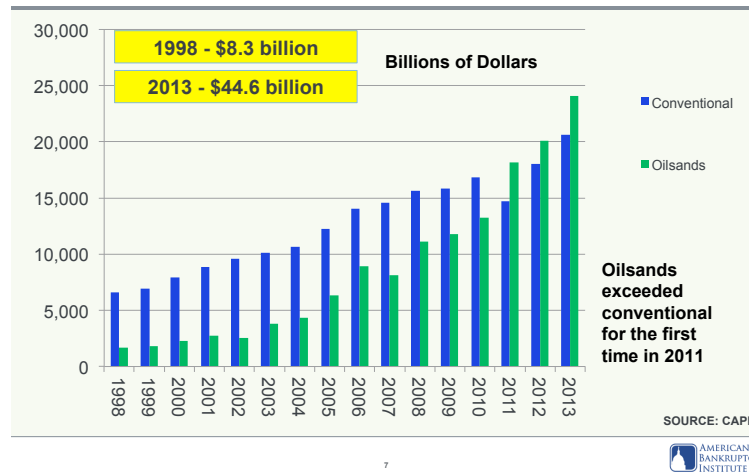
5

2015 CROSS-BORDER INSOLVENCY PROGRAM

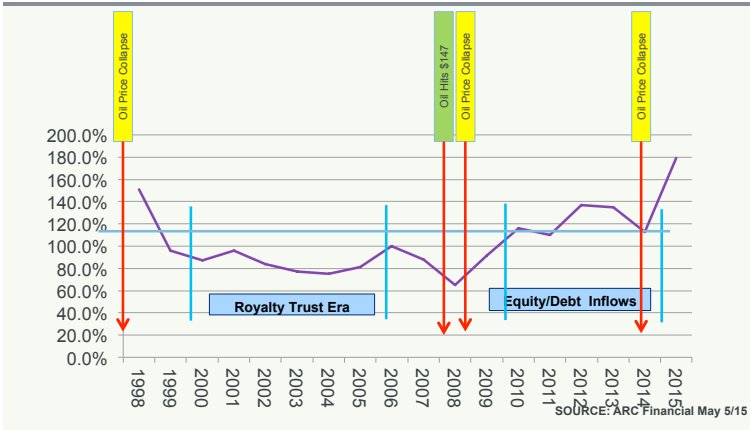
The Oilsands Boom – 1998 to 2014



Production Operating Costs

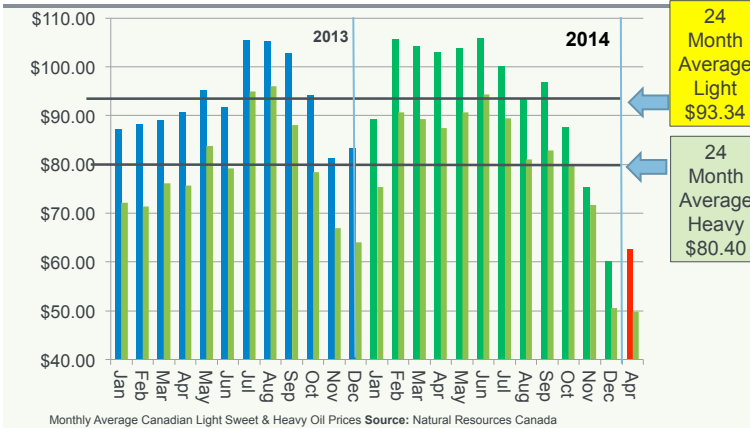


Reinvestment Ratio: CAPEX/After-Tax Cashflow
(Estimates 2014, 2015)



8

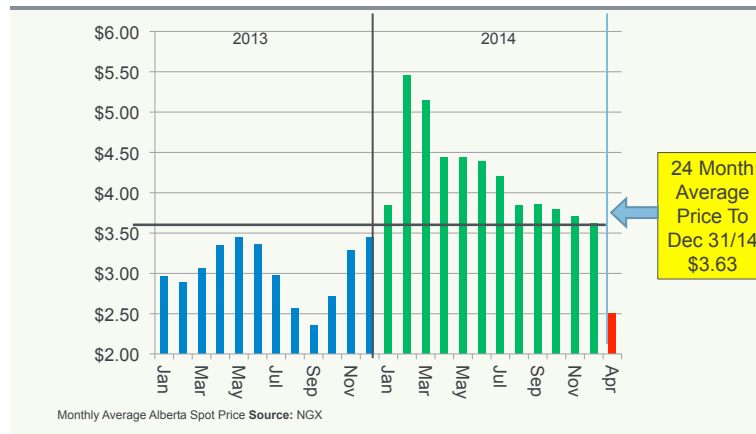
Oil Prices 24 Months to December 2014 – Canadian Light
(Edmonton) Heavy (Hardisty)



9

2015 CROSS-BORDER INSOLVENCY PROGRAM

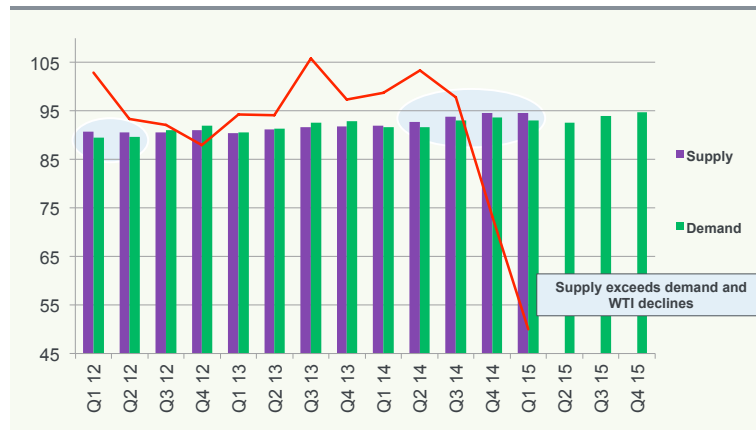
Natural Gas Prices (AECO) 24 Months to December 2014



10



World Oil Supply & Demand vs. WTI 2012 – 2015 IEA, EIA Millions of Barrels Per Day, US\$ Per Barrel



Funds Available to OFS 2014, MNP Model

Source	Value, Billions
E&P Capex (CAPP)	\$69
E&P Operating Costs (1/3, CAPP)	\$15
OFS CAPEX (MNP)	\$10
Less – land sales, licenses, permits	(\$5)
Total	\$89



OFS CAPEX Includes: third party operated pipelines, processing plants & production storage facilities: drilling rigs, well servicing equipment, rental equipment

12



Funds Available to OFS 2015, MNP Model

Source	Value, Billions
E&P Capex (CAPP)	\$46
E&P Operating Costs (1/3, CAPP)	\$16
OFS CAPEX (MNP)	\$3
Less – land sales, licenses, permits	(\$1)
Total	\$64

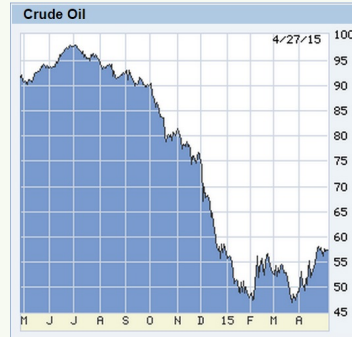


This would equate to a \$25 billion reduction in total funds available in 2015 from 2014 or 28%

13



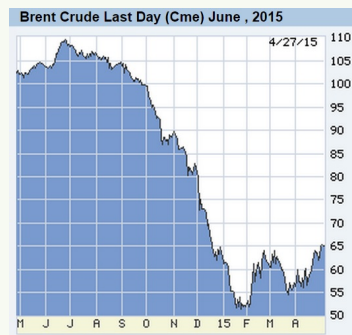
Price of West Texas Intermediate – 1 year



14



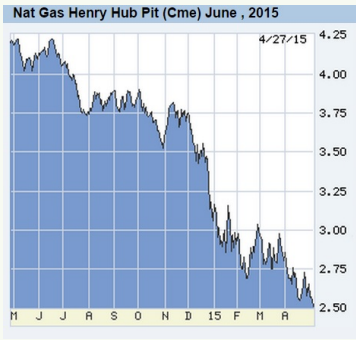
Price of Brent Crude – 1 year



15



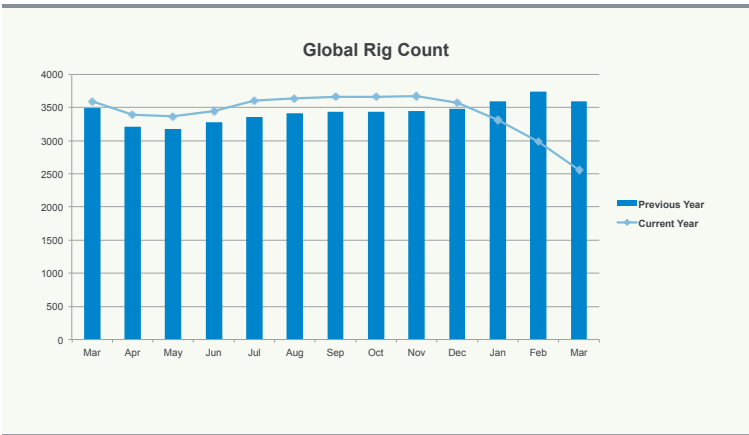
Price of Natural Gas – 1 year



16



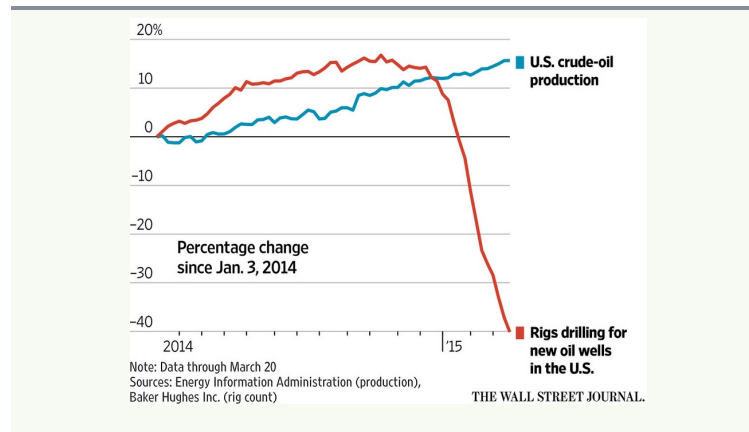
Rig Count – Global



17



Production Continues to Rise



18



Options for Distressed Companies

- A distressed company may look to extend its debt maturity profile, reduce interest expense and obtain flexibility regarding interest payment schedules by offering debt investors security or better terms
- Overview of options:
 - Amendments to current debt agreements
 - **Amendments to credit facilities** to extend maturity or modify interest rate. Amendments of this type generally require 100% consent of lenders. Such amendments/waivers will likely require fees to be paid to lenders, and may be unavailable for distressed companies. Possible that lenders will agree to such amendments in return for collateral (or higher priority collateral), if available to pledge, and/or a reduction in their commitments
 - **Amendments to note indentures** generally require 100% consent of noteholders to extend maturity or change interest rate, making them impractical for distressed debt restructuring purposes given large numbers of holders. Such amendments may also "substantially modify" terms of security and therefore SEC rules deem it to be a new security (requiring additional disclosure and burdensome execution process)

19



Options for Distressed Companies (cont.)

- One-step exchange of outstanding debt securities (avoids 100% consent requirement but effective only with respect to debt exchanged)
 - **Exchange offer:** A public offer to holders of its outstanding debt securities, agreeing to exchange newly issued debt or equity securities (or possibly bank loans) for the outstanding debt securities, perhaps with a fair value at a significant discount to the face amount of the old securities
 - **Private note exchange:** Similar to above, but involves a private offer to limited number of holders of outstanding debt securities. Care needs to be taken to avoid characterization as a "tender offer" under U.S. securities laws

20



Options for Distressed Companies (cont.)

- Two-step debt refinance
 - **Step 1:** Issue/incur new debt (in the form of new debt securities or bank debt)
 - **Features of new debt** may include (1) extended maturity, reduced interest expense or "PIK" interest flexibility, in order to aid the company, and/or (2) collateral (or higher priority collateral), increased interest expense or interest expense contingent on financial metrics, in order to entice investors to purchase new debt
 - **Creative structures** may be necessary in order to structure around existing covenants
 - **Step 2:** Use net proceeds to concurrently repurchase/redeem outstanding debt securities or repay bank debt
 - **Cash redemption:** should the terms of the debt permit optional redemption at the proposed time of the transaction. Redemption may be an unattractive option as the redemption price generally is the face amount or, in many cases, is at a premium to the face amount (which in the current environment may likely significantly exceed the market value)
 - **Cash tender offer:** In a cash tender offer, the company makes a public offer to purchase some or all of its outstanding debt securities, perhaps at a significant discount to the face amount. Often combined with a consent solicitation to obtain exit consents to amend terms of debt securities remaining outstanding
 - **Cash purchases:** The company may be able to acquire its outstanding debt securities through open market purchases or in privately negotiated transactions, often at a significant discount to the face amount. Care needs to be taken to avoid characterization as a "tender offer" under U.S. securities laws. Often impractical to accomplish in connection with a debt refinance, as limited ability to impose timing constraints, new financing often contingent on retiring old debt and New York law suggests exit consents are only valid so long as all holders are given same opportunity to consent (so would require a stand-alone consent solicitation to all holders)
 - **Loan buybacks:** Few reserve-based credit facilities clearly permit non-pro-rata prepayments or buybacks at market prices. Most require pro-rata prepayment (or some type of amendment to permit such non-pro rata prepayment)
 - **Bank debt prepayment/termination:** Bank debt agreements generally permit prepayment of outstanding amounts and/or termination of commitments at any time, although may require a prepayment/termination fee

21



Creative Structures

- Creative structures may be necessary in order to structure around existing debt covenants
- Examples include:
 - **Second lien debt layering.** Remaining Debt and Lien covenant capacity, and/or credit facility refinancing capacity, could be used to incur second lien debt. Proceeds could be used to repay existing credit facility debt (to the extent credit facility amendments may be needed for the transaction) or unsecured debt
 - **Drop-down financings.** Using any available Restricted Payment covenant capacity to transfer assets or cash to unrestricted subsidiaries, such unrestricted subsidiaries could incur debt secured by such assets/cash. Proceeds of the new debt could be used to repay unsecured debt, in return for an intercompany loan from the unrestricted subsidiaries to the company which provides interest payment cash flow on the new secured debt (provided such intercompany loan could be incurred as "refinancing debt" upon the unsecured debt being repaid)
 - **Unrestricted subsidiary debt capacity.** Credit facilities are often guaranteed by only U.S. subsidiaries. Foreign non-guarantor subsidiaries with their own cash flow could incur secured debt (subject to Debt incurrence/maintenance covenant capacity and/or Restricted Payment capacity through declaring foreign subs unrestricted) and use proceeds to repay unsecured debt

22



Creative Structures (cont.)

- Examples include (cont.):
 - **Asset Sale covenant.** While it may not be the ideal time to sell oil and gas assets, a company could sell assets and use the proceeds to pay down secured debt. Should the Asset Sale covenants not require a corresponding permanent retirement of commitments upon such repayment, this could free up secured debt basket capacity to refinance unsecured debt
 - **Lien covenant holes.** We have seen that certain indenture covenants in the oil and gas space have a hole in the Liens covenant that allows unlimited liens securing any credit facilities (rather than the dollar-capped credit facility permitted debt basket, or otherwise capped by a secured leverage ratio). As "credit facility" is often defined broadly, this effectively allows any available permitted debt to be secured, and accordingly can be used to replace unsecured debt with secured debt. In addition, subordinated liens may also be available
 - **Production payments.** Indentures for oil and gas companies often allow unlimited incurrences of production payment obligations (and liens to secure such payments)
 - **Prepack stapled exchange offer.** A company's exchange offer solicitation document could simultaneously serve as a chapter 11 disclosure statement and be accompanied by a proposed chapter 11 prepack plan. The combination might be used to threaten to bind holdouts

23



Oil & Gas Restructurings: Select Key Legal Issues

There are a number of unique statutory and other issues that a debtor energy company faces in addition to liquidity concerns

- Contractual and Finance Issues
 - Nature of oil and gas leases
 - Select lien issues
 - Farmout and royalty agreements
 - Forward contracts and swaps
 - Gathering contracts
- Environmental/Regulatory Issues
 - Plugging and abandonment claims
- Labor-related Issues
 - WARN Act

24



Nature of an Oil & Gas Lease

- The law is unsettled as to whether oil and gas leases are true leases or executory contracts under the Bankruptcy Code
 - Variations depend on state law property rights and on what interest is being conveyed by virtue of a typical oil and gas lease; applying bankruptcy law yields different results
 - Some courts applying state law have held that oil and gas leases are executory contracts subject to section 365
 - Other courts applying state law have found that a mineral interest "lease" is neither a lease nor an executory contract, but rather a conveyance of real property rights
 - Where courts have found that an oil and gas lease conveys real property rights, the applicability of section 365 is unclear; the outcome may depend on whether, under state law, the property interest has vested in the lessee
- Classification of an oil and gas lease as an executory contract or an unexpired lease affects whether the lease may be assumed or rejected
 - 210-day maximum time limit to decide whether to assume or reject real property leases

25



Select Lien Issues

- Conflict can occur over priority between producers' liens arising under state law and the liens of funded debt creditors
 - Analysis and outcome depends on state law governing classification and perfection of security interests, so the outcome is uncertain. See, e.g., *Arrow Oil & Gas, Inc. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 127 (Bankr. D. Del. 2009) (applying Delaware law to determine producers' lien on hydrocarbons sold to a first purchaser was non-statutory and unperfected, thereby granting priority to inventory financiers and subordinating producers' lien)
 - Contractors, mechanics and materialmen may have state-law priming liens on real property, mineral rights or leasehold interests to secure payment of their services
- Oil and gas leases may have anti-assignment provisions, which may prohibit assigning and/or pledging a lease as collateral without the consent of the lessor
 - However, in chapter 11 case of an oil or gas company, potential lenders may look to the leases as collateral for any debtor-in-possession and exit financing

26



Farmout & Royalty Agreements

- Farmout agreements and production payments (as defined in section 101(21A) and (42A)) receive special treatment in bankruptcy under section 541(b)(4)
 - Farmouts are contractual arrangements by which one party (the farmee) earns interest in a property owned by another (the farmor) in exchange for the performance of certain tasks (e.g., drilling wells)
 - Section 541(b)(4) carves out from a debtor's estate a debtor's interest in liquid or gaseous hydrocarbons that have been conveyed pursuant to a farmout agreement, even if the farmout agreement might otherwise constitute an executory contract
 - Debtor as farmor: section 541(b)(4) prevents the debtor's windfall; debtor-farmor cannot reject the agreement and effectively reclaim the property, even if rejection would create more value for the estate than recognition of the farmee's interest. The Bankruptcy Code prohibits the debtor-farmor from claiming that proceeds from a farmout agreement are property of the estate so long as the farmee complies with the agreement
 - Debtor as farmee: if contract is executory, debtor-farmee cannot assume without curing prior defaults and providing adequate assurance for future performance
 - Section 541(b)(4) likewise carves out from a debtor's estate a debtor's interest in liquid or gaseous hydrocarbons that have been conveyed as a production payment to a non-operator
 - Asset purchases from distressed sellers, whether or not characterized as a farmout or production payment, are likely to be investigated as potential fraudulent transfers if seller files for bankruptcy

27



Farmout & Royalty Agreements (cont.)

- Royalty agreements may receive special treatment in bankruptcy, depending on state law treatment of royalty interests
 - Landowner may hold a royalty interest when it conveys a working interest to an E&P entity; the holder of a working interest may convey an overriding royalty interest ("ORRI") to a third party in exchange for financing capital expenditures or providing goods/services
 - Holders of either kind of royalty interest are generally not obligated to pay E&P costs but do not receive payment for their interests until production has begun
 - Generally, unpaid prepetition royalty interests constitute unsecured claims
 - In some states, royalty interest holders may have a statutory lien
 - Some debtors have sought court permission to pay prepetition royalty payments, reasoning that loss of a valuable lease due to non-payment would harm the estate
 - Holders may also argue that unpaid royalty is not "property of the estate," either under state law or as a production payment
 - Debtors may seek a bankruptcy court's recharacterization of term ORRIs, arguing that they are not real property rights carved out of the estate, but actually debt financings within the estate
 - Finally, certain royalty interests may "run with the land" and be non-dischargeable in bankruptcy

28



Forward Contracts & Swaps; Gathering Contracts

- Forward contracts and swaps have special protection in bankruptcy
 - Counterparty to an agreement may argue that the contract is a "forward contract" or "swap" that qualifies as a "protected contract" under the Bankruptcy Code, permitting the party to terminate an "in the money" contract upon a bankruptcy filing without any liability to the debtor
 - Some agreements expressly state that they are "forward contracts" and each of the parties is a "forward contract merchant," but that contractual language does not bind the court
 - A debtor could argue that the counterparty is not a protected entity (i.e., not a "forward contract merchant," "financial participant" or "commodity broker"), and the contract is not a swap agreement (which allows any counterparty to terminate)
 - A debtor could also argue that even if termination is permitted, the counterparty must make a termination settlement payment
 - The law in this area is not settled, creating litigation risk; issues likely would be subject to significant factual dispute, and expert investigation and testimony would be required
- Gathering agreements may create covenants running with the land
 - Contracts that obligate producer to deliver and pay processing fee to gatherer who must collect, treat and process and deliver gas may commit oil or gas to a certain gathering system

29



Environmental/Regulatory Issues

- Plugging and abandonment (“P&A”) claims are common in oil and gas bankruptcies
 - Who is proper claimant: operator, co-owners, predecessor owners may all be obligated to pay; they may be able to seek indemnity or contribution from others who are/were owners of undivided interests
 - Whether claim is entitled to administrative priority: may depend on state law determination of when liability arose
- Most environmental liabilities and certain other governmental liabilities probably not subject to the automatic stay and probably not dischargeable in chapter 11
 - A non-governmental party may exercise police and regulatory powers notwithstanding the automatic stay in certain circumstances
- Ongoing compliance with environmental regulations during bankruptcy
 - A debtor must continue to comply with its environmental obligations under applicable federal, state and local laws, regulations and permits, as well as any obligations under court orders and settlements with regulators or non-governmental organizations
 - In the event a debtor fails to comply with its environmental obligations, penalties assessed will be granted administrative expense status, which must be paid in full in connection with a reorganization

30



Labor-Related Issues: WARN Act

The Worker Adjustment and Retraining Notification Act of 1988 (“WARN”) and the related Department of Labor WARN Regulations generally require that covered employers give affected employees 60 days’ notice in writing before undertaking a plant closing or a mass layoff at a single site of employment.

- **Plant Closing** – closure of an entire site or a discrete organizational unit, building or department within a single site
 - Occurs when an employer closes an entire single site of employment or a building or an operationally distinct product, operation or work function at a single site and this shutdown results in an employment loss of 50 or more full-time employees at that site within any 30-day period
- **Mass Layoff** – large scale workforce reductions at a single site, irrespective of whether an entire department or unit is closed
 - Occurs when (i) 50 or more and at least 33% of “active” full-time employees or (ii) 500 or more full-time employees (not clear if it includes “active” employees) at a single site of employment suffer an employment loss within any 30-day period

Most states have statutes that supplement WARN and, in some cases, have more strict requirements.

- It is important to understand the state law in each affected state

31



WARN Act – Faltering Company Exception

The exception applies only to plant closings

- The exception is narrowly construed
- Notice is not required when the employer is taking specific steps to obtain new capital or business to keep the company running
- The employer must believe in good faith that giving notice would preclude it from obtaining the capital or business, and must be able to objectively demonstrate this fact
- Capital includes financing or refinancing through the arrangement of loans or the issuance of stocks or bonds
- There must have been a realistic opportunity to obtain the financing or business sought and the financing or business sought must have been sufficient, if obtained, to have enabled the employer to postpone or avoid the plant closings

If the Company, at any point in time, ceases to satisfy any of the faltering company exception requirements, and WARN Act notice is triggered thereby, the Company must promptly provide such notice (or be prepared to make payments in lieu of notice)

Proper substantiation and continued monitoring of the faltering company exception is essential to ensure that the Company remains in compliance with WARN

32



October 2014

Endeavour Files for Bankruptcy in Debt Swap With Bondholders

December 2014

Chevron Suspends Arctic Offshore Drilling Program in Canada ‘Indefinitely’

Company Cites Uncertainty Over Crude Prices

January 2015

Schlumberger Cuts 9,000 Jobs as Oil-Price Ax Falls

Oil-Field Services Company Takes More Than \$1 Billion In Charges

Shell to Cut Spending Amid Lower Oil Prices

Dividends to Be Frozen, Shale Investments to Be Reduced

33



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February 2015	Weatherford International Laying Off 8,000 Employees Cuts Would Bring Total Headcount to Under 50,000 by the End of the Year
	Halliburton to Cut 8% of Workforce Oil-Field Services Company Says Layoffs Aren't Related to Pending Baker Hughes Acquisition
March 2015	Cal Dive Files for Chapter 11 Oil-and-gas contractor hurt by project suspensions and plummeting oil prices
	Exxon Mobil to Reduce Capital Spending 12% in 2015 Company becomes the latest oil producer to trim its budget
	Dune Energy Files for Chapter 11 Bankruptcy Protection Latest company to seek bankruptcy protection due to falling oil prices
	BPZ Resources Files for Bankruptcy Protection Amid Oil-Price Drop Move follows Dune Energy's Sunday filing

34



March 2015	Sabine Oil & Gas Announces Delayed Filing Of Form 10-K Hires Advisors To Explore Strategic Alternatives
	Quicksilver Resources Files for Chapter 11 Bankruptcy Protection Oil-and-gas exploration company failed to find a buyer to improve its finances
April 2015	Oil Layoffs Hit 100,000 and Counting Roughnecks feel brunt of cuts as tumble in price of crude ripples through energy industry
	Schlumberger Profit Falls 39%; 11,000 More Jobs Cut Oil-services company says workforce down 15% from peak levels
	Halliburton Feels Impact from Low Oil Prices Oil-field service firm posts loss and plans more layoffs; customers seek price concessions
	Baker Hughes Cuts 17% of Staff, Closes Facilities Amid Oil's Fall Oil-field-services company's quarterly results fall well short of expectations
	PetroChina Net Profit Down 82% Chinese oil giant says it reduced costs during the first quarter

35



Where is the floor?

WTI hit a six-year low of \$42.28 a barrel on March 18, 2015

Factors suggesting further downward trajectory

- Stored oil nearing record highs
- Mixed economic forces in US, Europe, and Asia
- OPEC output remains high
- US production continues to rise despite drop in rig count

Factors suggesting stability

- Shale producers can react more quickly by slowing down drilling and completion, rather than shutting in wells
- Gasoline consumption typically increases in spring and summer, driving prices up (although heating oil use decreases)

36

