Oil and Gas Companies Utilize Restructuring Strategies to Navigate Industry in Flux

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Precipitous commodity price declines that began in mid-2014 continued to disrupt the oil and gas industry in 2015, outlasting the expectations of many analysts. By the end of 2015, prices for both Brent and WTI crude were fluctuating in the mid- to high $30s per barrel, down from highs of over $100 a barrel in mid-2014.

Exploration and production (E&P) companies, which face high operating costs for drilling, production and transportation — particularly in those basins with limited access to transportation and processing infrastructure — have been most impacted by falling prices, with some experiencing revenues below the break-even point. Compounding the issue is the fact that E&P companies, which have in large part funded their substantial capital budgets with borrowed money, also are burdened by material financial debt and liquidity constraints.

While some E&P companies have relied on various restructuring techniques to weather these challenges, not all have successfully navigated those options, seeking bankruptcy protection instead. If commodity prices remain low, E&P companies will have to continue to work through these financing constraints or seek to restructure through the bankruptcy process.

Banks Feel Pressure to Limit Exposure to Oil and Gas Producers

Generally, E&P companies rely on a combination of reserve-based revolving loan (RBL) financing facilities and unsecured bonds to fund their capital programs. RBL facilities typically provide for semiannual redeterminations of their borrowing base and a yearly discretionary redetermination at the election of the borrower or lenders. While RBL lenders and their agents have significant discretion to set borrowing bases, lower reserve values and the ongoing roll-off of favorable hedges will likely translate into lower revolver availability for many companies, further reducing the liquidity available to already stressed companies.

As the financial crisis for exploration and production companies has continued, the restructuring strategies available to such companies have become more limited.

Increasing regulatory pressure on U.S. banks engaged in oil and gas lending also is causing certain RBL lenders to reduce their exposure to the sector. This may be a pivotal driver in borrowing base redeterminations during the spring of 2016. Federal regulatory agencies, including the Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corp., have warned banks to limit their exposure to increasingly risky oil and gas producers, thereby pressuring banks to tighten and increase the frequency of oil and gas loan reviews. Bank regulators have advised that a significant number of outstanding loans to E&P companies should be classified as "substandard" (meaning there is uncertainty as to underlying collateral value and/or borrower ability to repay the loans). Bank regulatory agency actions appear to be causing banks to take steps to limit loans in the oil and gas sector. The fall 2015 redetermination season resulted in borrowing base reductions for certain E&P companies — although to a lesser extent than many analysts had predicted — averaging approximately 9 percent overall, as reported by *The Wall Street Journal* on December 3, 2015.

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Restructuring Strategies for E&P Companies

Given these challenges, during the past year many E&P companies have taken steps beyond cost cutting to improve their liquidity and reduce their leverage. Strategies include taking on first-, second- or third-lien secured debt; issuing unsecured notes; exchanging unsecured notes for new secured debt at a discount; buying back notes at a discount; issuing equity; selling noncore assets; and entering into joint venture or similar agreements to share costs of developing mineral interests. However, as the financial crisis for E&P companies has continued, the options available to such companies have become more limited.

One frequently used E&P company financial restructuring strategy has been the nonratable debt exchange, whereby a group of unsecured noteholders is given the opportunity to exchange their unsecured notes for secured debt (plus, in some cases, cash and/or equity). In such a transaction, the E&P company's overall indebtedness is reduced because a lower principal amount of secured debt is issued in exchange for unsecured notes at a discount to par value (but at a premium to current trading levels). These exchanges offer certain advantages. In many cases, the agreement governing the relevant unsecured notes permits new secured debt to be incurred without the consent of the noteholders. In addition, because these exchanges are negotiated with a small number of individual noteholders, they typically are not subject to tender offer rules and can be accomplished quickly and privately. However, because all holders of unsecured notes do not have the opportunity to participate in such exchanges, nonparticipating noteholders may raise issues or consider litigation strategies.

Another exchange structure that companies may find useful in the current climate, depending on their timing and goals, is a reverse Dutch auction, which allows a company to buy back (including by exchange) its debt at the lowest market-clearing price. A reverse Dutch auction process may be more time-consuming and complicated than other strategies (including a private exchange transaction) because it must comply with the debt tender offer rules. However, it offers the advantage of potentially identifying the lowest market-clearing price and may be structured to give a greater number of noteholders an opportunity to participate in the transaction. If a company has the goal of ensuring that all noteholders have a chance to participate, it may want to consider conducting an SEC-registered exchange offer.

Debt exchanges and debt issuance transactions generally require the consent of the E&P company's RBL lenders because RBL financing facilities generally provide little leeway for companies to incur material amounts of additional debt or liens. In contrast, indentures governing E&P company bonds typically provide more flexibility for additional debt and lien incurrence. It follows that E&P companies will look to accomplish financial restructuring transactions that comply with existing indenture baskets and then negotiate the requisite consent from their RBL lenders. In some cases, obtaining such consent may necessitate offering protective accommodations to RBL lenders, including a borrowing base reduction.

Despite possible capital-raising and debt-reduction strategies, in 2015, more than three dozen oil and gas companies filed for bankruptcy. If commodity prices remain low or continue to decline, we expect additional distressed or highly leveraged E&P companies to seek bankruptcy protection to effectuate restructurings.