7 Stages of Grief: Impact of Oil Downturn on Energy Attorneys

Beginning in late 2014, the price of oil fell from over $100 per barrel to under $30 per barrel by early 2016. This decline in commodity prices created a toxic cocktail for U.S. producers when added to a significant expansion of drilling in the preceding years and frothy debt and equity capital markets that provided easy access to capital to fuel increased activity. As oil fell, many companies recognized that their capital structures were unsustainable in a lower-price environment. The response to this commodity price crisis has affected energy attorneys throughout the U.S., and has continued to evolve as a lower-price environment appears inevitable for the next year and potentially beyond.

End of 2014 and First Half of 2015 — Shock, Denial and False Hope

In the first seven or eight months of the crisis, many management teams and their advisers maintained that the commodity price decline would result in a "V-shaped recovery" whereby prices would quickly snap back to pre-decline levels. Many producers responded by making contingency plans to temporarily lay down drilling rigs and lower near-term capital expenditure budgets, while also looking for ways to extend their liquidity runway to survive until prices recovered. During this time, merger and acquisition activity began to tail off, and new initial public offerings in the oil and gas sector were curtailed significantly.

Although commercial lenders that provided first-lien facilities to the industry were generally restrained in their assessment of the spring 2015 borrowing base redeterminations, restructuring attorneys began to recognize that there could be significant activity in the sector. At the same time, some energy M&A practices saw an influx of alternative lenders enter the market seeking to structure off balance sheet financings through a "DrillCo" structure.

The first step taken by the restructuring teams was to examine existing indentures and credit facilities for flexibility to allow capital infusions through the issuance of additional indebtedness. This led to an unanticipated boom for energy capital markets attorneys as the borrowing base instruments and unsecured notes indentures — common in many upstream capital structures — often permitted the issuance of junior secured paper. Typically this was either structured as an issuance of secured paper to new holders or as an "up-tier exchange" to existing unsecured holders for an overall reduction in the face amount of outstanding debt. While the paper issued during this phase often achieved the intended result of extending runway, in many circumstances the failure of the "V-shaped recovery" to materialize meant that additional issuances of indebtedness simply delayed a more comprehensive capital structure revision.

Second Half of 2015 — Anger, Bargaining and Depression

In the second half of 2015, the prospects of using additional leverage as a method to extend runway began to taper as market demand for junior secured paper declined. Management teams did however continue

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to pursue exchange solutions to reduce levels of leverage while avoiding formal restructuring proceedings. Many capital markets attorneys remained busy.

In the early phase of the crisis, hope for an immediate term rebound fueled a reluctance to embrace a more holistic restructuring solution. In this later phase, two primary factors dominated management reticence toward a formal restructuring. The first was a general perception that a formal restructuring included a stigma as a "failed operator," and the second was a desire by the existing equity holders to continue to "play the option" in their equity position in anticipation of an increasingly unlikely upturn in commodity prices. Restructuring attorneys became further integrated with their energy teams, but it was clear that "liability management," a euphemism for measures to extend runway, remained the key objective.

Many professionals also assumed that this phase of the cycle would include a significant return of traditional energy M&A activity as distressed sellers sought to realize additional liquidity. The much anticipated M&A boom did not materialize as sellers were reluctant to sell at the perceived low point of the cycle, or simply monetize assets to repay lenders. Private equity investors and energy M&A attorneys remained largely on the sidelines, with only a handful of traditional M&A and joint venture transactions getting accomplished.

First Quarter of 2016 — Testing and Acceptance

As 2016 approached, the market shifted and more U.S. producers began to request advice as to holistic restructuring solutions. Many believe this dynamic resulted from the expiration of short-term liability management solutions, the acceptance of a "lower for longer" price environment, and the fact that borrowing base lenders signaled that spring borrowing base redeterminations would not be as lenient as previous iterations. For the first time in the crisis, restructuring and litigation practices became more important than strong energy capital markets and energy M&A expertise. Four further critical developments arising from this phase of the cycle are worth noting.

The first is the new paradigm for an earlier formal restructuring solution proposed in cases such as Magnum Hunter Resources and Swift Energy. In the Magnum Hunter Resources case, the debtor proposed that the entire capital structure be equitized, including the debtor-in-possession financing, so that the debtor could emerge from a proceeding quickly and consensually as a largely debt-free entity. Swift Energy went one step further by providing that, as part of such a solution, some of the post-emergence equity would be provided to the former equity owners of the business. In the latter example, creditors were protected as the size of the free and clear vested equity stake issued to old equity holders was small. The remainder was issued in the form of deeply out-of-the-money options, which are only likely to deliver if the post-emergence vehicle realizes value maximizing objectives.

These structures are important. They have led more producers to consider a formal restructuring process earlier in the fight for survival as the management team perceives a path to lead a debt-free post-emergence company and old equity perceives that they could retain some portion of their equity "option" through a formal proceeding.

The second significant development is the dislocation caused by lending draws from the secured revolving borrowing base credit facilities put in place for most producers. In many cases, well-advised borrowers recognized that the ability to draw down on their facility is an asset of the borrower, and as such should be utilized if it is in the best interests of maximizing value of the enterprise for stakeholders. The side effect of drawing from these facilities is that it has also strained relations between producers and the commercial lenders who have little interest in funding incremental amounts into a distressed situation. This dynamic has led to increased negotiation between borrowers and lenders pursuant to which lenders may be willing to offer covenant relief or desired amendments in exchange for an agreement by the borrower to provide additional protections for the banks, including anti-hoarding provisions, increased collateral requirements and a restriction on future draws unless specified conditions are met. To date, almost all legitimate borrowing base draws made by producers have ultimately been satisfied, but it remains to be seen whether this funding track record will continue. Finance attorneys and restructuring attorneys have been particularly active during this phase of the crisis.

The third significant development relates to challenges to midstream contracts by producers. In the Sabine Oil & Gas Chapter 11 proceeding, an international law firm with a large Houston office argued successfully in New York bankruptcy court that Sabine should be permitted to reject its midstream contracts. The rejection was permitted despite the assertions by counsel for the midstream entities that such contracts were, on their face, expressly written to include covenants that "run with the land," and as such were not contracts that could be rejected (at least in their entirety). The successful rejection argument was quickly adopted in multiple, similar upstream restructurings, and may be the first step toward causing the commodity price distress to fully pollute the midstream sector.

Despite the fact that some lawyers and law firms that were not involved in the Sabine case have now, in hindsight, characterized the arguments made as "low-hanging fruit," it is fairly clear that the midstream industry at large had not fully anticipated that such arguments could be made successfully. The reaction to the case by the legal community has varied, however, the most sound advice, pending new developments, is to recognize that the Sabine case should be considered in the context in which it was made.

On the one hand, the judgment is highly caveated by the legal limitation that it may not be followed in all jurisdictions, and the practical limitation that it is of limited use to an upstream

provider that has no alternative to transport hydrocarbons than the apparatus of the relevant midstream entity. On the other hand, the judgment is a carefully considered analysis by a highly respected federal judge, and it would be foolhardy for midstream companies to heed advice that purports to completely dismiss the decision on the basis that it will not stand due to the disturbance it may cause generally to the oil and gas industry. The only certainty arising from the decision is that it will result in rational economic negotiations among producers and midstream companies in the coming months as each side grapples with the uncertainty created by the decision.

The final significant development highlighted here is the recognition of the pitfalls relating to the master limited partnership structure in the event of a formal proceeding creating significant cancellation of indebtedness income for public unitholders. The complexities associated with this topic are too expansive to cover here; however, in short, the industry has realized that the incurrence of significant CODI at a pass-through vehicle may result in public unitholders receiving less than zero for their investment in the event of a restructuring. This realization has reportedly impacted the trading price of MLPs and may contribute to a decline in the use of MLPs as a structure used to invest in upstream assets.

In the early phase of the crisis, some tax advisers indicated to clients that the only solution to this issue was to “check the box” and change the tax status of the pass-through vehicle to a corporation. Beginning in the fall of 2015, other law firms with large restructuring practices, and the largest four accounting firms, formed informal working groups to brainstorm more nuanced solutions to the problem, which have now, thankfully, begun to take hold. This aspect of the crisis will continue to evolve.

Future Developments — Resurrection?

Predicting the future evolution of the crisis is difficult; however, certain projections can probably be made. In the absence of a serious macro-geopolitical event, it seems unlikely that oil will return to precrisis levels in the immediate future. In the event that pricing does not recover in 2016, it is likely that there will be further large Chapter 11 filings by upstream producers and midstream providers. Full equitization of capital structures, possibly with a related “tip” for old equity, may encourage earlier filings, and the stigma for management of entering a formal proceeding has either been eradicated, or is outweighed by the possibility of emerging as a debt-free enterprise. As more participants file for bankruptcy, two buckets of entities are likely to emerge — those that successfully come through a formal proceeding quickly with dry powder to take advantage of distressed asset sales, and entities that are broken up and sold as part of a formal proceeding. Commodity prices will return at some point, as they always have, and private equity will re-enter the sector in a meaningful way as funds with large committed war chests seek to deploy capital. Finally, it is clear that the legal industry will be busy in 2016, and beyond, as the fallout from the commodity price decline reaches its apex.

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