Managing the New Reality

Akin Gump
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Managing the New Reality: Opportunities & Landmines for Energy Companies Right Now

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Goodgame: Hi, everyone. Thanks for joining today on such short notice. This is John Goodgame. I'm a corporate partner at Akin Gump and the head of our Houston office. I'm joined today by my partner, Sarah Schultz, who runs our Texas restructuring practice, and Mike Stamer and Ira Dizengoff, the two senior partners of our financial restructuring practice.

Given the state of the markets right now, we put this briefing together to share with you some very practical things that you should all be thinking about right now to manage liability and consider opportunities in this environment. The team on this call has decades of experience in helping some of the world's most prominent energy companies manage liability, deal with challenging times and do deals around the world, and we have played a role in some of the industry's most significant recent restructurings.

So, with that, let me turn to the first thing: director and officer duties.

The business judgement rule will generally protect well-informed and disinterested officers and directors in making decisions that will maximize the value of the company. Transactions that involve an interested party (like a controlling stockholder) will of course be viewed with more scrutiny. Therefore, as always, we encourage officers and directors to continue to approach their roles carefully and thoughtfully, focusing on not only the substance of their decisions but also on the processes involved. Keep in mind that the fiduciary duties of care and loyalty, which run to the corporate entity, do not really change during financial distress. The bottom line in all situations is that corporate directors and officers should act in the best interest of the corporation to maximize its value regardless of the company's solvency. A good shorthand there is that the duty is always to "maximize the pie."

Times like these also lead to consolidation and other change of control transactions, which are contexts where directors' and officers' awareness of and compliance with their fiduciary duties is incredibly important. As we've seen, there is a growing level of shareholder activism in the energy space, and there have also been significant negative shareholder responses to those transactions where an acquirer paid a premium. As a result, we expect that boards will be grappling with, on one hand, the need to rationalize the industry and, on the other hand, the desire to obtain the optimal result for their shareholders. Add to this the fact that the industry as a whole is pretty levered, and you can see that any transactions that get done will have a number of complex considerations and also will require boards to be confident in their process and result. I will also note, as an aside, it is not a bad idea for everyone to review their D&O policies during times like these. Experienced counsel can help with this and it is worth it.

The next topic for me is disclosure issues for upstream and midstream companies. Most E&P companies have already filed their 10Ks, which include 1P and maybe 2P and 3P reserves as of December 31. The undeveloped portion of those reserves, or PUD, were booked based on a number of capex assumptions at that time and an approved development plan. Companies are revisiting their capex plans. I am sure you have seen the press releases that have come out this week, and more are surely coming. Those companies will need to, at the very least, consider that their PUD reserves may significantly decrease of the next measurement time. The SEC has commented recently requesting quantified disclosure around the effect of lower commodity prices on reserves, including on PUDs that no longer are expected to be developed within five years of their initial booking.

In addition, E&P companies are going to need to consider with their accountants whether the current price environment is going to give rise to an impairment of their proved reserves. The SEC has also commented on this recently, requesting that E&P companies quantify any potential future impairment charges, especially those that would reasonably be expected in the next quarter. E&P companies will also need to carefully consider whether their reduced capex plans will affect their ability to maintain any of their material leases, and think about whether any disclosures are necessary around that.

Midstream companies, on the other hand, depend on volumes from upstream companies. Where upstream companies are significantly reducing capex, those volumes are likely not going to increase and in fact, are likely to decrease. Midstream companies are going to need to revisit their volume forecasts, and they are going to need to consider what, if any, disclosure will be appropriate.

In the midstream space there are also a number of other capex related issues that companies will need to consider. Many midstream companies will be under pressure to decrease capex as well, but that is often more complicated than it would be for upstream companies. If you have a commitment to build a pipe, for example, from A to B, you need to be very sure of the repercussions if you slow down or abandon that construction because there are likely contracts that support that pipe, and breaching those contracts will likely have real ramifications.

In addition, even though pressure to decrease midstream capex is real, boards should be very cautious decreasing or delaying maintenance capex because of the serious health, safety and environment risks and liability issues that could arise. If I were on a board that was discussing changes to my company's maintenance capex plans, I would want to make sure I had fully satisfied my duty of care, including fully understanding the potential risks. No director wants to have approved reduced capex that can later be shown to have led to an environmental or safety incident.

In addition, many midstream companies are constructing projects through joint ventures where they are depending on other companies to share part of the financing burden. Many of those joint venture partners are upstream companies or other midstream companies, and though the joint venture arrangements typically allow for a defaulting partner to be diluted, an insolvent or non-contributing partner still means that the other partner or partners have to come up with the additional capital to do the project. Therefore, those midstream companies should make sure to review their joint venture documents and any debt agreements at the joint venture level for any potential alternate financing restrictions or other issues, and they should also assess the creditworthiness of their joint venture partners and be ready to address financing shortfalls if necessary.

In summary, from a corporate perspective, during times like these, boards need to keep their duties at the front of their minds and make sure they are well counseled in that regard. Communication with the market and proper disclosure is paramount. Keep in mind both the equal disclosure rules of Regulation FD as well as the SEC's MD&A disclosure requirements around known trends and uncertainties. Also, be ready to be nimble. Times like these bring opportunities as well as risks and distress.

I would like to now turn it over to my partner Mike Stamer to address some key liability management issues and options that companies and their investors have. Mike has more than 30 years of experience as a financial restructuring attorney. He has played a leading role in many high profile recent restructurings in the energy and oil field services and power industries, including Weatherford, PG&E, Stone Energy, Rex Energy, Parker Drilling, PetroQuest, Cobalt, Endeavor and Hercules Offshore, among many others. Mike?

Stamer: John, thank you very much and good afternoon everyone, and thanks again for coming out on this pretty incredibly volatile Thursday afternoon. I am going to talk a little bit about liability management. Energy companies will need to be creative in their approach to the capital markets to survive the current downturn in commodity prices as well as to create more runway for themselves while awaiting a recovery in prices. Many energy companies have a mix of bank debt and bonds on their balance sheet, and this presents numerous opportunities for companies able to move quickly and decisively. Most of the bonds and bank debt issued by these energy companies are trading at significant discounts, which may create an opportunity to de-lever at significantly below par prices.

When dealing with liability management strategies, there are a few ground rules that people have to abide by. Any attempts to interact with the capital markets or creditors or shareholders generally are subject to a few ground rules. Number one: there cannot be any material non-public information shared without your counterparty or the recipient of that information signing a non-disclosure agreement. By the way, instituting a buyback plan of any kind is likely material non-public information. Number two: the board should seriously consider whether a buyback is a good use of corporate cash. As you all know, cash is king in an environment like this. Three: the company should confirm that any transaction is permitted by its debt instruments, including whether they could be held up by challenging stakeholders, even if, ultimately, they are in compliance with the debt covenants.

In addition, when it comes to repurchasing debt, since most of the debt of E&P companies is trading well below par, rather than paying back the debt at par maturity, E&P companies selectively can repurchase their debt. Debt can also be exchanged for longer dated debt instruments, debt with greater collateral, or for equity. Debt-for-debt exchanges are often done at a significant discount, as we already discussed, for the face amount of the debt. In addition, debt that is being exchanged for equity is often very dilutive to existing shareholders. Just above the trading value of your debt is a good target price. At least that is where discussions should start if you are in fact going to pursue some type of debt buyout or debt exchange.

Debt can obviously be repurchased for cash. However, for many companies, this is not an attractive alternative because of liquidity considerations and constraints. With respect to high-yield debt issuances, while the traditional equity markets are closed to almost all E&P companies, a number of issuers have been able to tap the high-yield bond markets. These deals have typically involved longer dated bonds to repay upcoming maturities. Interest rates on these bonds have also been higher than the debt that is being refinanced, and these bonds typically also have tighter covenants that restrict the types of secured transactions the issuer will be able to do in the future. Even with these disadvantages, assuming the high-yield markets are, or will in the near term, be open, many issuers that have this option available may find it helpful in managing the liabilities to push out maturities on their bonds. Another alternative is issuing secured debt. Most existing high-yield indentures allow E&P companies to incur significant amounts of secured debt. While a number of these issuances occurred during the last oil price downturn, in many cases, they were largely unsuccessful in ultimately staving off bankruptcy filings. It remains to be seen how accepting the market will be of secured debt financing in the current downturn.

Reducing capital expenditures: the focus here is on first reducing capital expenditures for projects with lower rates of return until prices have recovered. While reducing capital expenditures also reduces the amount of cash an E&P company spends, it also has the effect of reducing the amount of cash the E&P company generates.

Also, cost reduction: reducing operating expenses. Many of these expenses are fixed. However, midstream, gathering, processing and transportation fees may be negotiated downward on the basis that neither the producer nor the midstream company will benefit if the producer becomes distressed and contracted volumes become at risk.

Finally, reducing G&A costs, reducing staff, and/or freezing salaries or benefits for remaining employees. This is always a difficult step, but under extreme circumstances, these actually should be considered, if the market shows no signs of recovering any time in the near term.

The bottom line: it is clearly going to be bumpy in the short term, but these liability management alternatives could help stabilize things and could potentially create opportunities to de-lever at discount prices. John?

Goodgame: Thanks, Mike. Next, I would like to introduce my partner Ira Dizengoff to discuss RBL issues as well as transactional alternatives. With nearly 30 years of experience, Ira has advised numerous companies in restructurings and recapitalizations in- and out-of-court, including energy and power companies, such as Sanchez Energy, BreitBurn, First Energy Solutions and Seadrill among others. Ira?

Dizengoff: Thanks a lot, John. There are a number of RBL and corporate transactional alternatives that are available to companies as they navigate these turbulent times. First and foremost among every company and board is how to manage liquidity. Drawing down the full availability under an RBL, especially if the borrower expects the borrowing base to be cut in the next redetermination, can be a useful source of liquidity, including if the borrower anticipates ultimately needing to file for bankruptcy. In the last price downturn in the commodity space, borrowers used this tactic and as a result, banks tightened some of their requirements for drawing down the full availability under an RBL by including anti-hoarding provisions. However, the market loosened up and many RBLs do not have that same provision. So, you need to carefully examine your RBL structure and whether that is available to you. Drawing down on the RBL also may provide borrowers that ultimately need to file for bankruptcy with an alternative to get financing, and that needs to be explored.

I referenced earlier the redetermination. So, availability under an RBL is limited by a borrowing base. That amount is set by the lenders, and it is based on the value of the borrower’s proved reserves. Lenders typically reset those borrowing bases semi-annually. The next one, typically, is coming up on April 1; they do it in the spring and the fall. Lenders are typically allowed a floating redetermination, a special redetermination between the scheduled ones. Companies need to be prepared for those RBL redeterminations, which could, in some cases, reduce the borrowing base below the current amount that is available and that will require the borrower to pay down the deficiency or add additional collateral in a specified period of time.

In addition, while banks have been lenient in the past during the last commodity downturn, it remains to be seen whether they would be willing to play ball with borrowers, or whether the regulators will permit them. My guess is that they will not. There are transactional alternatives available to companies. Upstream companies that are facing liquidity issues can also consider various non-financing transaction alternatives. These can include asset sales. The asset sales may allow for redirecting capital towards higher return projects, or for de-levering one's balance sheet.

In addition to the sales of oil and gas assets, other asset monetization strategies could include sales of the midstream assets, which, while important to the business, are a non-core asset that could provide cash in the short term. Asset sales, however, also need to be taken into account because they could reduce the availability under the RBL if they are pledged to secure the RBL.

Other types of asset level sales could include production payments, which is a present payment for reserves. It could include the monetization of commodity hedges. If hedges are in the money, which they might be at current commodity prices, some or all those hedges could be unwound for current cash payments. Unwinding of the hedges has to be done in conformity with the RBL, and it might result in a reduction of the borrowing base under the RBL.

Another useful strategy is joint ventures. They are useful companies that do not have the capital expenditures to fund projects for themselves. We sometimes see structures set up as AcquisitionCos or DrillCos, and this allows companies to deploy capital elsewhere if they are capacity constrained on their availability of capital. Another asset that companies can look at is to merge with other upstream companies. Depending on how the asset profiles of the two merged companies sync up, the merged company may be able to realize tremendous synergies through a larger production profile or the elimination of redundant expenses. This might trigger change in control issues for bonds that are outstanding, so these transactions have to be carefully considered. And then finally, the alternative is financial restructuring itself, in-court or out-of-court. With that, I will pass it back to you, John.

Goodgame: Thanks, Ira. Finally, I am going to turn it over to my partner Sarah Schultz to share her insights on a very specific topic: counterparty risk. Sarah has nearly 20 years of experience advising on large, complex cases and out-of-court restructurings. She works across a broad range of industries including oil and gas, and has recently advised on the restructurings of

Elk Petroleum, Emerald Oil, Goodrich Petroleum, Quicksilver Resources, and Swift Energy Company. Sarah?

Schultz: Thank you, John, and thank you everyone for being here with us this afternoon on such short notice.

As John indicated, I am going to speak to a very specific issue, which relates to counterparty risk in this challenging environment. I am going to start by talking about contracts. As we noted, many parties are going to be seeking to limit or otherwise slow their entry into new contracts. Despite this, companies still have to operate, which means there are going to be new contracts. As companies start to evaluate entering into new contracts, there are a couple of things that they need to carefully consider when they are transacting with a potentially distressed contract counterparty.

The first question is, can the contract potentially be avoided as a fraudulent transfer? While every transaction is different, parties should expect that in a case of Chapter 11, significant contracts entered into prior to the filing that had the result of transferring value from the debtor party to the non-debtor party will be reviewed carefully. To the extent that the contract is viewed as not beneficial, third parties might seek to avoid that contract as a fraudulent transfer. In addition to thinking about fraudulent transfer risks, contract counterparties should think about if proper protections are embedded in the contract to protect the non-debtor entity in the event of a Chapter 11 filing. Depending upon the structure of the contract, you may be able to embed protections into the contract that will enhance your credit protection in the event of a Chapter 11 case. These protections may include letters of credit, upstream and/or true third party guarantees, and setoff rights. The specifics surrounding which of these enhancements may be applicable for your contract will need to be reviewed on a transaction-by-transaction basis.

Next, I want to talk a little bit about the automatic stay. We have all heard about the automatic stay and probably generally understand that it is going to prohibit you from taking certain actions against the estate. In the context of our current market, we want to think about this prohibiting you from doing things like debt collection, terminating contracts, modifying management rights of the debtor, or otherwise enforcing contractual rights. Because we know that so many parties that we are transacting with may be at risk in this market, parties might want to seek to exercise rights under contracts as soon as possible and reserve the right to revert to status quo or otherwise unwind such actions if a consensual business resolution can be reached. This is a little different than what we would typically see, where we might want to negotiate nicely with a party for a little bit and then call an event of default. What we are saying here, is that it may make more sense to exercise your contractual rights and then unwind them if necessary.

As was mentioned earlier, as a result of this challenging market, we expect there might be more assets on the market from distressed companies. This may include disposition of assets; it may present healthy purchasers with an opportunity to purchase assets at a depressed value. Like contracts, transactions occurring prior to a Chapter 11 filing will be examined closely. If it appears that the asset was transferred for less than reasonably equivalent value, the stakeholders of the debtor may seek to avoid the transaction as a fraudulent transfer. A successful fraudulent transfer action must establish both that the debtor was insolvent at the time of the transaction and/or was left with unreasonably equivalent value as a result of the transaction, and that they received less than unreasonably equivalent value as part of the transaction.

With respect to solvency, unfortunately solvency is always valued with the benefit of hindsight and perfect information. As such, a good adversary can almost always create an argument that a party was insolvent either under the balance sheet test or because it was not paying its debts when they became due and owing. To protect against this, a buyer may require a solvency opinion and/or solvency representation from the seller or require the seller to provide financial information that will allow the buyer to independently assess the seller's financial status. Each of these protective measures has its own positives and negatives, and accordingly each transaction needs to be reviewed to determine what is appropriate for that transaction.

Like solvency, reasonably equivalent value is a subjective question that will always be analyzed with the benefit of hindsight. At the end of the day, reasonably equivalent value is equal to the price where a reasonable buyer and seller are prepared to transact. As such, the best protection for an asset sale is a market test. Understanding it might not always be practical or desirable to perform a full market test, purchasers may also opt to preserve all information relating to the value of the asset at the time of the transaction that led to the underlying transaction price. Depending upon the value of the transaction, the purchaser may also explore purchasing fraudulent transfer insurance.

The final topic that I am going to touch on is midstream contracts. Everyone in this industry certainly understands that midstream contracts and their treatment in Chapter 11 cases are a very trendy topic. We could spend all day talking about the intricacies of a midstream contract, but we have promised to restrict ourselves, so let's have some key points. Until a couple of months ago, all signs from the courts pointed to midstream contracts being subject to rejection by a debtor. Recently, in the Badlands case, and then again in Alta Mesa, courts found that midstream contracts with certain characteristics contained covenants running with the land and were therefore real property interests that could not be rejected and instead, required consent to be transferred. While the latest cases on this topic certainly levelled the playing field between producers and midstream providers, at the end of the day, the question of whether a midstream contract qualifies as a covenant running with the land remains a factual analysis that must be performed with respect to each contract, and perhaps, equally if not more important, the relationship between the midstream provider and the producer remains a symbiotic one that will almost certainly result in, as we have seen in the past, a business resolution.

Goodgame: Right. Thank you, Sarah, and thank you to the audience for tuning in. We will make a recording available after the call and will plan to do more of these short briefings in the coming weeks. If you have any topics you would like us to address, please be in touch. Have a great rest of the day and good luck in this challenging market. This concludes our call.

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