



**Distressed Energy Industry:
Strategies for Lenders and Borrowers
Considerations for Vendors and Customers**

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Snapshot of the Current Energy Market

Snapshot of the Current Energy Market

- Crude prices down more than 60% since January 1, 2020 due to oversupply from the Saudi Arabian and Russian oil price war and demand destruction from Covid-19 pandemic
- OPEC+ production cut agreement of 9.7 million bpd disappoints
 - Demand destruction of almost 30 million bpd
 - Mexico balked and its production cut was reduced to 100,000 bpd instead of the 400,000 bpd OPEC initially requested
 - G20 makes no comments on specific production cuts
- The U.S. rig count was 602 (including 504 crude oil and 98 natural gas) as of April 9, 2020
 - Lowest since 2016
 - Analysts project low 400s by end of 2020 (lowest since 1940)

Snapshot of the Current Energy Market

- Producers are cutting CapEx
 - Exxon cuts 30%
 - Chevron cuts \$4 billion
- Analysts are predicting significant industry-wide declines in CapEx
 - Cowen showing 38% year-over-year decline
 - Rystad predicting \$100 billion in cuts from E&P budgets
- Layoffs and more
 - Anecdotal – Reports that many OFS companies will lay off 30% of their workforce

Snapshot of the Current Energy Market

- Restructuring activity has begun
 - Sheridan Holding Company I, LLC filed for Chapter 11 on March 23
 - Echo Energy Partners I, LLC filed for Chapter 11 on March 24
 - Carbo Ceramics Inc. filed for Chapter 11 on March 29
 - HOS Wellmax Services, LLC filed for Chapter 11 on March 30
 - Whiting Petroleum Corp filed for Chapter 11 on April 1
 - Sklar Exploration Company, LLC filed for Chapter 11 on April 1
 - Others have hired restructuring advisors: Chesapeake Energy Corp., Denbury Resources Inc. and Callon Petroleum Co.
 - Oilfield Services lead bankruptcy filings in Q1 of 2020, including McDermott International, Pioneer Energy Services; many more are expected in Q2 of 2020

Lender Strategies in Distressed Situations

Lender Strategies in Distressed Situations

- Event of Default occurred – what kind?
 - Technical (“soft”) Default – immaterial covenant default or foot fault
 - Financial Covenant Trip – potentially a sign of a larger problem
 - Payment Default/Overadvance – alarm bells – especially if not signaled long in advance. Notice default and reservation of rights letter (or potential amendment/waiver)
- We want to get in front of any significant issues as much as possible – bad situations often get worse if not dealt with

Lender Strategies: What's Next?

- Send a “reservation of rights” letter
 - Alerts the borrower of the occurrence of an Event of Default
 - Tells them loan advances are made at the lender’s discretion
 - Tells them the lenders have all rights and remedies available under the loan documents
 - Does not waive the Event of Default unless the letter says so expressly
 - May tell the borrower what conditions the lender will put on any further relief or lending
 - Reservation of rights rarely terminates lending relationship — goal is for company to survive
- Contrast with acceleration or termination notice
 - Acceleration makes the loans due and payable and is precursor to exercising remedies
 - Reservation of rights rarely terminates lending – goal is for company to survive and grow
- Understand intercreditor agreements; confirm collateral and perfection
- Be mindful of communications – with focus on proper messaging

Borrower Strategies in Distressed Situations

Borrower Strategies in Distressed Situations

- Evaluate and enhance liquidity – Liquidity will determine how much time the company has to address operational issues and business planning
 - Assess access to and sufficiency of existing facilities – Can drawing conditions be met (sufficient borrowing base, no MAE, solvency, bring down of reps and warranties, etc.)?
 - Access to cash – Consider coverage of existing collateral packages and related collateral matters (e.g., deposit account control agreements) – and gaps therein (e.g., unrestricted cash, real estate assets, titled vehicles, overseas assets)
 - Other potential options
 - Incremental/upsized revolving credit facilities
 - Mezzanine or second lien financing
 - Receivables financings (securitizations, factoring facilities, etc.)
 - Other available assets not included in existing collateral package that could be separately financed (including through use of “unrestricted” or “excluded” subsidiaries)?

Borrower Strategies in Distressed Situations

- Assess constraints and limitations in debt documents and contracts
 - Financial covenants, EBITDA, scope of included debt, cash netting – Available EBITDA add-backs? Adjustments to covenant levels? Financial covenant holidays?
 - Limitations on new debt, liens, restricted payments and/or asset dispositions
 - Ability to amend material agreements
 - Equity and other cure rights, grace periods
- Review reporting and notice requirements
- Consider risks associated with continuing to draw on working capital lines

Borrower Strategies in Distressed Situations

- Consider potential liability management transactions
 - Discounted loan buybacks by company and/or sponsor affiliates
 - Amend and extend
 - Refinancing facilities
 - Yank-a-bank rights
- Review available tools to address covenant breaches, including cure periods, equity cures, cash netting, EBITDA/Net Income adjustments

Borrower Strategies in Distressed Situations

- Identify stakeholders in operational and capital structure – Understand their respective motives, rights, and obligations
 - If junior capital exists, consider whether they will push action and how that impacts timing
 - Get organized and begin rallying the various constituent groups (i.e., majority lenders, equity holders, subordinated lenders)
 - Assess ability to block debt transfers (DQ lists, consent rights)
- In advance of waiver/amendment/forbearance discussions, identify needed /desired amendments and waivers; anticipate lender objections and counter-requests

Borrower Strategies in Distressed Situations

- Carefully craft communications strategy (taking into consideration, among other things, securities laws)
 - Consider public disclosure concerns and maintaining confidentiality of any restructuring negotiations
- Involve restructuring counsel and rationally assess and timely prepare for downside scenarios

Commercial Considerations in Distressed Situations

Commercial Considerations in Distressed Situations

- Mitigate possible preference liability
 - The Bankruptcy Code permits a trustee or debtor-in-possession to recover preferential transfers
 - A preferential transfer satisfies each of the following:
 - The debtor transferred an interest in property within the 90 days before the bankruptcy petition date (or one year if the transfer was made to an insider)
 - The debtor transferred the interest to or for the benefit of a creditor
 - The transfer was made on account of an antecedent debt
 - The debtor was insolvent at the time of the transfer
 - The creditor to receive more than it would have if the debtor was liquidated

Commercial Considerations in Distressed Situations

- Transfers made in the ordinary course of business cannot be clawed back
 - Carefully craft communications to avoid "unusual collection activity"
- A transfer that is a contemporaneous exchange for new value cannot be clawed back
- Prepayment strategies – Implementing advanced payment will eliminate the argument that the payment was made on account of an antecedent debt

Out-of-Court Solutions

Out-of-Court Solutions: Waiver or Forbearance

- After lender has done its diligence and borrower has developed a plan for resolving any issues, borrower should request a waiver or a forbearance
 - Waiver: makes the Event of Default go away forever – it no longer exists
 - Forbearance: the lender agrees that it will not exercise remedies during the “forbearance period” (often with additional covenants or lender protections)
 - After the forbearance period expires:
 - New forbearance agreement or forbearance extension
 - Waiver
 - Bankruptcy
 - Remedies
 - Sometimes - nothing

Waiver Basics

- If only waiving EODs, can be short and sweet – a simple statement that the Event of Default is waived and basic boilerplate
- If amending provisions or adding new covenants – can be very long
- Must get cross-defaults waived
- Lender should always ask for a release and reaffirmation of obligations
- Can come with certain conditions required:
 - Fees
 - Equity contribution
 - Updated financials
 - New collateral or tightened package

Forbearance – Basic Concepts and Strategy

- Forbearance Agreements are an important tool when “working out” a troubled credit:
 - They give the borrower time to improve performance without constant fear of lender exercising remedies
 - Guarantees the lender a second seat at the table – unless all defaults are cured, the borrower will need to request another forbearance or a waiver at the end of the forbearance period
 - Provides lender opportunity to impose new covenants, some of them temporary
 - Opportunity for lender to impose forbearance fees

Forbearance Agreement: Typical Features

Forbearance agreements are often accompanied with other amendments to credit documents. Lenders and borrowers should be prepared with “wish lists” of items that would like to revisit during the negotiation of forbearance, including:

- Enhanced Reporting – good information is key
 - 13-week cash flow budgets – tracks the blood that keeps a business alive
 - Variance reporting requires explanation of material deviations for revenues and expenses
 - Who Prepares it? Certified? Reviewed?
 - Regular lender calls and meetings
- Adds a reserve/borrowing base block or otherwise regulates borrower’s access to cash
- Require retention of financial or operational advisor to the company?

Forbearance Agreement: Typical Features

- Require investment banker and sale/refinancing milestones?
- Process improvement plan or business plan?
- Balance above with lender liability concerns: lenders generally do not want to dictate company actions

Out-of-Court Solutions

- Consensual Debt to Equity Exchange – lender receives (some or all) equity in the company in exchange for reducing or cancelling debt claims against the company
 - Reduces balance sheet liabilities
 - Allows lenders to take some of the upside once the company returns to profitability
 - Can keep existing equity and management in place, with lenders holding equity
- UCC Article 9 Sale – foreclosure sale for personal property
 - Expedited and cost-efficient process
 - The sale is not as widely publicized and hence may limit damage to company's reputation
 - Must strictly adhere to the provisions of Article 9
 - Know the collateral – real property interests are not subject to Article 9

Additional Out-of-Court Solutions

- Exchange Offering - company makes an offer to holders of outstanding debt securities to exchange newly issued debt or equity securities for the outstanding debt securities
- Rights Offering - company grants shareholders the right (but not the obligation) to buy additional shares at a discount

Bankruptcy

Bankruptcy – What is It?


- Federal judicial process where a debtor can reorganize, sell its assets or liquidate

Voluntary

- Chapter 7 – liquidation – no hope for reorganization or going concern sale
- Chapter 11 – reorganization – company files as a going concern and will either reorganize or sell its assets
- Chapter 9 – municipalities – only cities or towns authorized by state law
- Chapter 15 – cross border – if proceedings are commenced in multiple countries, including U.S., Chapter 15 can become relevant
- No insolvency requirement to file, but probably some requirement for bona fide financial distress

Involuntary

- Involuntary case commenced against an insolvent entity (not paying its debts as they come due) by three unsecured creditors with bona fide claims at least \$15,775 in aggregate



Bankruptcy – Now what?

- Automatic Stay: all enforcement actions cease absent court's permission
- What is the goal of filing – reorganize? Sell?
- Main Players:
 - Debtor in Possession – the borrower
 - United States Trustee – the watchdog
 - Official Committee of Unsecured Creditors
 - Secured Lenders
 - Others: plaintiffs, lessors, landlords, PBGC
- Note - no “bankruptcy trustee” unless chapter 11 trustee is appointed (or case converts to Chapter 7)

Paying the Bills: DIP Loan or Cash on Hand

- Financing – new loan (“DIP”) or use of cash collateral
 - DIP Financing
 - Priming – new debt can come before existing
 - Roll Up – new debt can “roll up” or refinance existing, turning prepetition secured debt into post-petition secured debt
 - Defensive DIP – often our strategy is to provide financing to protect your collateral and control of the case – keep you in the driver’s seat rather than on the sidelines
 - Protections included in DIP order include Adequate Protection and reporting (budget compliance and reporting)
 - DIP or cash collateral budget should be pre-negotiated with secured lenders

Bankruptcy Code Option – Sale Process

- Section 363 sale allows for sale of debtors' assets and gives buyer protection of a federal court order that it purchased assets free and clear of claims and interests
- Best case: file case with a “stalking horse” bidder in place to set a floor bid
 - Stalking horse receives bid protections, which can include 1-3% break-up and expense reimbursement
- Court approves marketing process and the protections provided to stalking horse bidder in the “bid procedures” order
- Assume 60+ day process (courts won't approve less and schedule always lengthens)
- Sale culminates in live auction amongst qualified bidders

Bankruptcy Code Option – Chapter 11 Plan

- Chapter 11 Plan “reorganizes” debtor’s balance sheet – debt can receive new treatment – equitized, new terms or paid out pennies on dollar (usually for unsecured debt)
- Plan needs support of all “classes” of creditors (or classes are unimpaired) unless it is a “cram-down” plan
 - Plan is confirmed with support of two thirds in amount, 50+% in number
 - Cram-down plan can be confirmed even if not all classes vote in favor of the plan so long as at least one consenting, impaired class, supports
- Plan process often is expensive but has advantages not otherwise available

Bankruptcy Code Option – Plan Strategy

- Prepacked, prearranged, or pre-negotiated Chapter 11 plans can expedite the chapter 11 process
 - Prior to filing, a company negotiates the Chapter 11 plan with key creditors so they walk into court in lockstep with the plan in place – sometimes with all needed votes in place
 - Good candidates: consolidated creditor pools with strong creditors actually willing to swap debt for equity and inject new capital, good management
 - Bad candidates: warring creditors, bad (non-producing) collateral, bad managers
- Pre-negotiated cases are less than perfect alternative – lock up some creditors and file, keep negotiating with others
- Last round of oil & gas bankruptcies saw a number of prepacked and pre-arranged filings.
 - This time could be more difficult – is there anything worth saving?

Bankruptcy Code: Oil and Gas Contracts

- Bankruptcy Code allows for the assumption and assignment of executory contracts
- It is unclear if JOAs are considered executory contracts
 - Does the non-operator have continuing obligations under a JOA?
- Whether an oil and gas lease constitutes an executory contract is contingent on how applicable state law classifies the type of interest created by an O&G lease
 - Texas, Oklahoma, New Mexico – Not an executory contract
 - Louisiana – Unclear
 - Kansas and Ohio – Executory contract

Bankruptcy Code: Oil and Gas Contracts

- Setoff Rights in JIBs
 - The Bankruptcy Code preserves the right to setoff that exists under “applicable non-bankruptcy law”
 - Only offset pre-petition debts
 - Upon the filing of the bankruptcy petition, creditor’s right to setoff is automatically stayed
- Recoupment Rights in JIBs
 - A creditor may recover a pre-bankruptcy debt out of post-bankruptcy payments owed to the debtor
 - A properly exercised recoupment will not violate the automatic stay

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