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ARTICLE

Pandemic Considerations for Distressed Energy Businesses

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Covid-19 effects have been felt worldwide, and consumers have been forced to stay home while factories remain shuttered. As a result, demand for oil and gas is forecasted to decline as economic growth slows and international travel is severely limited. However, there is a great deal of uncertainty about the duration and severity of the coronavirus pandemic. The decline in energy demand could be severe if Covid-19 has long-lasting effects—or more limited if there is a quick recovery and economic activity resumes. How should distressed energy businesses respond to this crisis?

Improving financial health

Recent changes in the market have affected financing, and both borrowers and lenders should adjust their approaches and positions in the new economic environment. Companies in any industry should evaluate their own financial health in the coming months, especially with respect to long-term obligations and credit facilities. They should weigh whether they can service their current debt obligations and other payments and whether any notice provisions have already been triggered. Cash is king in the current market, including in the energy sector; companies should focus on maintaining liquidity, even at the expense of capital expenditures (CAPEX) or bringing additional energy production online.

Borrowers should evaluate whether counterparties are at risk of not being able to honor their agreements and what the impact would be if a counterparty does fail to do so. Borrowers should be proactive and determine if they will need waivers to shut-in the wells in order to not bring new production online. They should also communicate frequently with their lenders to demonstrate that they are on top of any potential problems and to build goodwill.

Lenders should evaluate their existing rights under agreements with borrowers and create plans to take into consideration the default processes built into credit facilities. Lenders should take advantage of requests for waivers or forbearances to tighten up loan covenants that were drafted in covenant-light period of time (e.g., when secured debt was not as important a priority and there were stronger guarantees of repayment) and to gather additional information on where and how secured goods may be retrieved in the event of default.

They should also consider their collateral position (e.g. their priority on any items that could be liquidated to satisfy the debts owed by a borrower to its creditors), including that the collateral package has been properly updated as development has occurred. Collateral can take many forms, including real property, tools, goods, contracts, potential suits, and other items and rights that have any value.

Fluctuations in the marketplace also present new opportunities for companies, especially with private equity, alternative financing, consolidation and acquisitions, and going private. Private equity firms that raised capital prior to the downturn will have capital to deploy, so long as the bid and ask price gap narrows, which can be expected in the near-term. Alternative financings like volumetric production payments (VPPs), farmouts, and DrillCo funding will also likely become more prevalent as companies have difficulty tapping existing capital markets.

Finally, with equity prices low, it may be difficult for companies to consolidate, but financial sponsors will be likely to pick up distressed assets in the next few months. With anticipated prices for assets lower than in the previous several quarters, private equity sponsors with cash or commitments at the ready ("dry powder") will be in a position to buy high-quality assets at deep discounts. We can expect investors to take advantage of historically low prices in anticipation of a future expansion.

Exchange Requirements

As public energy companies face falling demand and increasing supply, they may run afoul of exchange requirements. See NYSE Rule 802.01 and NASDAQ Rule 5450(a)-(b). Public companies are required to keep a minimum $1.00 per share value closing price on major exchanges, and if they fail to do so for a 30-day period, they will receive a notice of non-compliance from the New York Stock Exchange or NASDAQ. If that occurs, companies will be subject to new exchange requirements, as well as Securities and Exchange Commission disclosure rules. See NYSE Rule 802.03 and NASDAQ Rule 5810(b).

As a solution, companies can engage in reverse stock splits to reduce the outstanding number of shares while maintaining current market capitalization levels. In a reverse stock split, a company converts each existing share into a fraction of a share. For example, if a company announces a one for ten reverse stock split, every ten shares owned would be converted into one share, thereby preserving the overall value of the shares owned but increasing the value of each individual share.

Employment Law Issues

The oil and gas price war and Covid-19 present new challenges to companies' workforces, but recent legislation and existing regulatory frameworks may provide some relief. Companies are subject to Occupational Safety and Health Administration requirements to maintain workplaces that are free from recognized hazards, like workplace violence, ergonomics, and many more. See §5(a)(1) of the Occupational Health and Safety Act.

New Department of Labor guidance from March 2020 notes that employers must take action with respect to infection control, hygiene, and safe work practices. In addition, OSHA provides employees with a mechanism under Regulation 1977.12(b)(2) to refuse to work in unsafe conditions and grants potential claims to employees subjected to such conditions.

If a company is expecting to reduce the size of its workforce, it will be subject to additional requirements. Federal, state, and local governments have notice requirements before companies can lay off employees, with exceptions for unforeseen business conditions and natural disasters.

In response to Covid-19, Congress implemented new legislation, including the Families First Coronavirus Response Act (which provides paid sick leave for employees missing work due to Covid-19). See Families First Coronavirus Response Act, Pub. L. No. 116-127 §§5101-5111.

In addition, the CARES Act requires that any company accepting federal funds to not abrogate existing collective bargaining agreements for the term of the loan and two years after, as well as an agreement to remain neutral in any union organizing efforts during the term of the loan). See Coronavirus Aid, Relief, and Economic Security Act (CARES), Pub. L. No. 116-136 §4025.

Options for Distressed Energy Companies

Companies facing difficulties in the energy sector have several options available to them, including out-of-court restructurings and bankruptcy.

Out-of-Court Restructurings

Lenders and borrowers can oftentimes come to a solution on defaults with out-of-court restructurings. After a lender has completed its diligence and a borrower has crafted a plan for resolving its debt issues, the borrower should request a waiver or forbearance. A waiver from a lender would nullify the event of default, while a forbearance would indicate that a lender is agreeing to not exercise any of the remedies provided under a contract to seek payment of the debt (often for a period of time). After the forbearance period is expired, lenders and borrowers can renegotiate if the debt is not satisfied or enter into the formal bankruptcy process.

Lenders and borrowers can also enter into consensual debt to equity exchange offerings. In exchange offers, existing notes are exchange for equity or new notes with longer-terms maturities or a lower principal, which relieves total leverage or impending maturities. These agreements lower balance sheet liabilities while allowing lenders to participate in the increase in equity value once the borrower returns to profitability.

Lenders and borrowers can also enter into a rights offering, by which a group of current equity holders agree to backstop a raise of equity offered to all current equity holders. In this scenario, a company gives the lender the right, but not the obligation, to buy additional shares at a discount. There are also distressed merger and acquisition transactions, which may involve ceding board control to the debtholders to control the process.

Bankruptcy

Bankruptcy is a process by which a debtor can reorganize, sell its assets, or liquidate. There are several forms of bankruptcy, including:

- **Chapter 7, Liquidation**: Debtor has no hope for reorganization or a going-concern sale
- **Chapter 11, Reorganization**: Debtor files as a going-concern and will either reorganize itself or sell it assets
- **Chapter 9, Municipalities**: Only permitted for cities and towns authorized by state law
- **Chapter 15**, **Cross-Border**: If proceedings are commenced in multiple countries, including the U.S., Chapter 15 is available to organize the proceedings

There are advantages to bankruptcy, including the automatic stay. An automatic stay halts all enforcement actions absent the bankruptcy court's consent. A debtor company that enters bankruptcy should decide whether its goal is to reorganize, sell its assets, or liquidate in order to satisfy its debts. In bankruptcy cases, there are several key players, including the debtor in possession (which is the borrower), the U.S. Trustee who serves as the "watchdog" for the proceedings, secured lenders who wish to be repaid, and potentially other parties like landlords, plaintiffs, lessors, and many more.

Chapter 11 is the most common form of bankruptcy for companies, and in this structure, companies reorganize their balance sheets. Debt can be treated differently with new terms, exchanged for equity, or satisfied at a lower rate (a partial payment that satisfies the debt, sometimes referred to as "pennies on the dollar"). Any reorganization plan under Chapter 11 needs to secure the support of the classes of creditors that are involved, unless the plan is "crammed down", and while Chapter 11 can be expensive, it has advantages that are unavailable in other forms of bankruptcy or out-of-court restructurings.

Environmental, Social and Governance Dimensions

ESG considerations will likely remain paramount in the future. Following the economic downturn of 2008-9, many stakeholders focused more intensely on environmental, social, and governance (ESG) issues in the companies they were invested in. Companies began taking on new roles in areas like climate change mitigation, workplace diversity, and more open disclosures in order to meet the more robust expectations of investors who wished the companies they invested in to reflect their values.

In the near- and long-terms, we can expect that as workplaces are disrupted by both Covid-19 and the oil and gas price war, companies will be expected to take on additional social responsibilities to limit the impact on their workforces and to support workers as they respond to the crisis in their own communities.

Additionally, as Covid-19 has demonstrated, supply chains are increasingly vulnerable to disruption, and companies will need to consider additional diversity in its suppliers in order to properly factor in the risk from a globalized world. We can expect that as the world moves past Covid-19 and the oil and gas price war that companies will continue to play larger roles in new ESG areas.

Oil & Gas Price War

The Saudi-Russian oil and gas price war has rapidly increased the supply of energy in the markets, and the U.S. has limited options to bring an end to the conflict. Lower energy prices are typically a positive for energy consumers, because companies would be able to purchase additional supplies for new economic activity at a lower rate and individuals would enjoy lower prices at the pump and cheaper airfares from lower jet fuel prices. However, given the current restrictions on travel and production due to the coronavirus, energy consumers are unable to take advantage of the prices and drive up demand. At the time same, lower energy prices make the market conditions uneconomical for American suppliers who are competing in a global market comprised of often hostile nation-states.

The U.S. has an interest in both keeping energy prices low to enough to ensure its industries and consumers are able to engage in their activities at a reasonable rate and high enough where its suppliers can continue producing enough energy supplies to meet American demand and continue investing in domestic production.

However, the U.S. has limited leverage to counter the current conflict between Saudi Arabia and Russia, because the U.S. is not a member state in the Organization of the Petroleum Exporting Countries (OPEC) and prohibits its producers from behaving in an anti-competitive manner (thereby preventing its producers from forming a cartel to counteract OPEC+, described below). In addition, the U.S. has already implemented severe sanctions on Russia, and any additional economic measures would likely have little effect.

As a result, we can expect a rising inventory and limited capital investments by energy companies in the future. OPEC+ is determined to bring Russia back into the fold by oversupplying the international market with oil and gas, causing prices to plummet. Prices for West Texas Intermediate (WTI), the oil benchmark for North America and primarily sourced in the Permian Basin, have declined from highs around $66 in April 2019 to, for the first time ever, sub-zero prices (as low as -$37.63 on April 20) because of the negative demand shock coupled with a supply glut and diminishing storage capacity.

The U.S. has responded by purchasing additional supplies for the strategic oil reserve and launching negotiations with Russia and Saudi Arabia, but with limited leverage, it may be difficult to conclude any deal. Texas oil and gas producers do have the option to limit production within the state through the Texas Railroad Commission (the primary regulator for oil and gas producers within the state). In the past, the Texas Railroad Commission has ordered producers to limit extraction in order to stabilize prices, but it is uncertain whether any similar action in the future would have an effect on prices.

Conclusion

Oil and gas companies can take several actions now to mitigate the negative effects of Covid-19 and the oil and gas price war, and take advantage of opportunities in the market. Energy businesses should evaluate their financial health in light of near-term fluctuations, and be ready to respond to potential defaults by counterparties. Market conditions may push oil and gas companies into non-compliance with national exchange requirements for minimum share price and market capitalization, but there are several options available, including reverse stock splits, that can be used to regain compliance.

If oil and gas companies do run into severe financial distress, they have options, including: out-of-court restructurings or bankruptcy, both of which can be opportunities for companies to realign their goals for the future. In addition, investors and marketplaces have ESG expectations for companies for which oil and gas companies will need to focus on in order to access capital. The oil and gas price war has caused unpredictable changes to the price of energy products and its effects have rippled through the global economy, however, the energy industry has weathered disruption before and emerged stronger for it. If companies take the right steps now, they can be well-positioned when the next growth period hits.

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