In The News

2020 Oil & Gas Bankruptcy Trends: Midyear Report

06.23.20

Law360

Law360 (June 23, 2020, 8:20 PM EDT) -- The story of 2020 so far for the oil and gas industry: The financial reckoning is here.

The industry was girding for a flood of Chapter 11 filings even before the COVID-19 pandemic, with approximately $200 billion in oil and gas debt coming due within the next few years and virtually no help coming from investors. Then the pandemic led to a historic crash in energy demand.

Federal coronavirus aid provided a temporary stay of execution for some companies, but experts say that impact has already started to wear off.

The road through bankruptcy is proving to be bumpier compared to the previous bankruptcy wave of 2016-17, experts say. While some companies are still able to convince some of their major creditors to swap their debt for equity in a reorganized company, it's a tougher and more expensive process as talk of banks riding to the rescue fizzles out.

The alternative of selling off a bankrupt company's assets hasn't been a cakewalk either, as oil prices still waffle and the pandemic clouds the industry's near-term future. Meanwhile, experts say fights are already erupting over attempts by drillers to reject service and midstream contracts in bankruptcy.

Here, attorneys explain five significant oil and gas bankruptcy trends that emerged in the first half of the year.

Coronavirus Aid Is a Temporary Reprieve

The year didn't start with a bonanza of new bankruptcy cases. Of the 35 bankruptcies for drillers, oil field services and midstream companies filed through the first five months of the year, 12 were filed in May, according to figures compiled by Haynes and Boone LLP.

Porter Hedges LLP restructuring and bankruptcy partner Eric English said the shock of free-falling oil prices earlier in the year, including a first-ever trip to negative territory, may have played a role in the initial slow pace of filings.

"To a certain extent, people didn't know whether there was going to be anything to reorganize," English said. "Now that we see a little more stability in the oil prices and hopefully some kind of recovery in the economy, people are a little more confident to do more restructurings and go through the process of a Chapter 11 to accomplish it."

But experts also point to the loan program under the Coronavirus Aid, Relief and Economic Security Act — including the federal government's expansion of eligibility requirements and allowing companies to carry five years' worth of net operating losses to offset taxable income — as giving some oil and gas companies temporary breathing room.

"These companies have been able to broaden their runway and ... navigate the pandemic by resorting to these provisions and the relief they provide under the CARES Act," said Jay Ong, a shareholder in Munsch Hardt Kopf & Harr PC's bankruptcy practice.

But any additional runway is starting to run out. Chapter 11 filings this month include drillers Templar Energy, Extraction Oil & Gas Inc. and Chisholm Oil and Gas Operating LLC and fracking sand firm Vista Proppants and Logistics LLC.

"There's only so much that a stimulus program can do and how far it can reach," Ong said.

Debt-to-Equity Swaps Are a Tougher Sell

While oil and gas companies are still able to convince lenders to swap their debt for equity in a restructured company just as they were in the previous bankruptcy wave, it's been harder this time around, experts say.

For example, a Texas bankruptcy judge in March scuttled EP Energy Corp.'s $3.3 billion Chapter 11 plan just two weeks after confirming it, after the company and its creditors agreed that the debt-for-equity swap underpinning the deal was no longer financially viable as oil prices plunged to new lows.

Jackson Walker LLP bankruptcy partner Liz Freeman said that secured lenders are having to raise significant amounts of additional cash to pull off debt-to-equity swaps. That isn't easy in what's been a chilly environment for new oil and gas investment, she said.

"I think it was easier to raise financing during the previous bankruptcy wave," Freeman said. "It's been more difficult for the new equity holders to obtain new financing or new capital commitments. There's been less money available, the money has largely dried up."

Experts say an even bigger hurdle for debt-to-equity swaps is that in many cases, the key creditors aren't junior secured lenders or unsecured bondholders. Instead, they're first-lien lenders like banks who hold reserve-based loans and are facing losses after getting through the previous bankruptcy wave relatively unscathed.

"They're not going to have the same appetite as bondholders to roll the dice and take the equity and see if this turns around in the next six to 18 months," said Buddy Clark, who co-chairs Haynes and Boone's energy practice group and primarily represents oil and gas lenders. "The proposals from existing management and existing equity to the banks was, 'Why don't you take a discount on your notes and we'll go forward together?' The banks' attitude is, 'No, we don't want to join hands with the management of these failed companies.'"

Banks Are No White Knight

During the worst of the pandemic-fueled oil price slump, there was talk in industry circles that large banks would assume control of and operate oil and gas companies through special purpose entities or other structures, something they've historically been reluctant to do.

But experts say that simply hasn't materialized. Not only are banks resisting swapping their debt for equity, they're preparing to take losses on their existing loans as part of winding down their oil and gas lending activities. That includes banks pushing their reserve-based loans into a workout to avoid foreclosure, or simply pushing a company to sell its asset under Section 363 of the federal Bankruptcy Code.

"There are some lenders that have flat out told us, 'We are getting out of this space,'" Porter Hedges' English said.

Clark said that in 2015, just before the previous oil and gas bankruptcy wave, there were at least 30 major lenders actively sinking cash into the oil and gas industry. That number may be down by as much as one-third today, he said.

"And they're just actively managing their current portfolios, they're not actively making new loans," Clark said. "That will be an interesting thing to keep an eye on in the future: Who are going to be the players in the energy lending field going forward?"

Asset Sales Face a Tight Market

Banks and other lenders may be pushing for Section 363 asset sales to salvage what they can from a bankrupt oil and gas company, but that doesn't mean they've been easy to pull off, experts say.

For example, driller Alta Mesa Resources Inc. had to renegotiate a deal to sell assets as part of its Chapter 11 liquidation after its original deal fell through, though the sale price didn't drop much.

English, who represented Alta Mesa in its Chapter 11 case, said he's seeing fewer stalking horse bids for oil and gas assets, as well as potential buyers simply abandoning a Section 363 sales process.

"We've been contacted by buyers in a couple of these 363 processes that do some diligence, look at it and then just drop out and say it's not worth it," English said. "I just haven't seen a lot of 363 processes that have had robust auctions where the price goes way up. It seems to be pretty weak still."

Munsch Hardt's Ong said that with oil and gas asset values still largely depressed, there's even been some hesitation on the part of debtors to move forward with Section 363 sales. To the extent they can pause a bankruptcy — or delay or extend the Section 363 process — they're doing so in the hopes the market will improve, Ong said.

"It's a dicey game to play, to try and press pause," Ong said. "A lot of that comes down to what type of cooperation a debtor is able to manage with its major creditors ... and its ability to get the court to encourage that type of cooperation."

But while buyers and sellers may be more cautious, it doesn't mean that Section 363 sales won't happen, said Haynes and Boone bankruptcy partner Charlie Beckham. The financial pressures facing companies and lenders are simply too great, and dragging out a bankruptcy only makes it more expensive, he said.

"I think we're going to see it because people have lost their patience," Beckham said.

Resurgence in Contract Rejection Fights

The previous bankruptcy wave was punctuated by a 2016 court decision that Sabine Oil and Gas Corp. could reject gas-gathering contracts in bankruptcy because they didn't contain covenants that tied the contracts to Sabine's drilling properties — a concept known as "running with the land" — as interpreted by Texas law. The ruling, affirmed by the Second Circuit in 2018, sent ripples throughout the midstream industry as other drillers looked to shed their own midstream contracts or renegotiate them.

Experts say contract rejection fights are resurfacing in the current spate of bankruptcies, and the Sabine decision looms large.

"That's the hot issue that people are thinking about now," K&L Gates LLP restructuring and insolvency of counsel Robert Honeywell said. "Which contracts run with the land and which ones don't?"

While decisions like Sabine have helped establish a basic framework for contract rejection, Jackson Walker's Freeman said the variation between contracts means there has to be a fact-intensive analysis to determine if an agreement can be rejected.

It technically didn't happen this year, but the judge handling Alta Mesa's bankruptcy in December rejected its bid to ditch a contract to sell oil and gas to a pipeline company because it was related to Alta Mesa's land and mineral interests and therefore "ran with the land."

Freeman said that further complicating the contract rejection question is the issue of "integrated agreements" such as agreements for gathering, transportation and off-take that drillers have inked with a single midstream company that contain clauses integrating the deals into an overarching contract.

"You have to determine which of the related agreements are integrated and would be rejected," Freeman said. "You have two different baskets of litigation."

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