DISTRESSED FINANCE

With E&Ps facing a three-headed dragon of low commodity prices, closed financial markets and lender redeterminations, five industry experts suggest ways to get over the hump.

ARTICLE BY
JEANNIE STELL

LLUSTRATION BY
DAVID TILLINGHAST

Excerpted from

Oil and Gas Investor

March 2009
Copyright© Hart Energy Publishing
1616 S. Voss Rd.
Suite 1000
Houston, TX 77057
(713) 993-9320

Some oil and gas producers are being caught off guard by falling oil and gas prices and reserve values as they head into borrowing-base redetermination season this spring. In fact, almost any producer that made a large acquisition with debt within the past 30 months with an expectation of higher commodity prices, but didn't hedge against price risk, is likely facing some form of financial distress.

So are producers that entered large drilling commitments or farm-outs and now find it hard to keep up, or those that unexpectedly suffered an abrupt decline in production due to a well blowout, hurricane or pipeline damage or other unforeseen event.

While negative price-based reserve revisions are not expected to affect the liquidity of most investment-grade issuers, E&Ps with reserve-based revolvers could experience reduced borrowing capacity, thus a limited ability to fund operations.

At press time, Standard & Poor's had red flags on about 25% of the oil and gas debt issuers it covers, and that percentage is expected to increase through this half, especially for high-yield issuers. The common concerns are liquidity, borrowing-base resets, capital-spending constraints, counterparty risk, refinancing risk and the expectation that oil and gas prices will remain at or near current levels in the near term.

At the first sign of financial distress, management should proactively approach its lender with a solid business plan for solvency and access to supporting data, advises Clark. Preserving the lender's long-term confidence is key. The lender may then offer a waiver to forgive a default, a forbearance or amendment to loosen up financial covenants, or some other workout program to "get over the hump" of low oil and gas prices.

This strategy is easier when working with one banker as opposed to a syndicate. In a large group, one of the lenders might resist a workout program. In the past, that bank could be replaced or other lenders in the group might increase their commitments, through a "yank a bank" provision, but current debt capital constraints have made that option problematic.

"Also, companies with credit-facility problems should be mindful that opportunistic non-commercial lenders may be looking to buy debt at a discount, accelerate the default process and cause a liquidation to get a better return on their investment," Clark says.

If nothing can be worked out, it's time to negotiate with critical vendors and determine ways to raise additional cash, including approaching equity owners and industry partners. A couple of Clark's E&P clients have found that larger oilfield-service providers, such as Halliburton and Schlumberger, are willing to work on terms to assist valued customers because they have a vested interest in their cus-

While a hedge might not enhance the value of the collateral, it mitigates the risk of further commodity-price-driven cash-flow decline.

tomer's survival.

Meanwhile, E&Ps should be aware that, in most states, unpaid vendors have 180 days after invoicing to file a lien under the mechanic's and materialman's lien law, gaining a protected and secured position. If these liens are unresolved, they can trigger a cross-default with the company's lender facilities. Other secured creditors will be forced to accelerate notes and even post properties for foreclosure.

"The last resort, once a company reaches the zone of insolvency, is to file bankruptcy," Clark says. "It's very expensive, inefficient and time consuming, but it does allow a company to reorganize rationally."

In the past, bankruptcy allowed a company to get debtor-in-possession, bridge or exit financing, but that may not be possible now, given the stress in current capital markets. Nevertheless, seeking refuge under the automatic stay of bankruptcy may be the best hedge against low commodity prices, assuming the cycle turns before it's time to emerge from the protective shield of the bankruptcy court, he says.

At the first sign of financial distress, management should proactively approach its lender with a solid business plan for solvency and access to supporting data, advises Buddy Clark, partner with Haynes and Boone LLP.

SIGNS, REMEDIES

There are signals that a joint operating agreement (JOA) partner may be in financial distress.

- Late payment on disbursements.
- Pressure on joint-interest obligations and acceleration of billing cycles including the pre-billing of authority-for-expenditure contracts.
- Delay or refusal to undertake needed capex, repairs and maintenance.
- Disconcerting press releases, financials, form 8-Ks, status of operations and bank-loan issues.
- Indications from vendors and other partners that payments are late.
- Lawsuits by vendors for collection, or lien filings.
- Derogatory reports from royalty owners or media sources.

Remedies can be proactive or reactive.

Proactive remedies include:

- Ensuring the title is properly filed in the county in which a property is located.
- If the JOA provides for cross-lien rights, a memorandum of these rights should be filed. If a memorandum is not on file, the American Association of Professional Landmen has a recording-supplement form that should be circulated, executed and recorded, including proper descriptions of the contract area.
- Ensuring the operator's insurance is current for coverage against property and casualty loss.
- Demanding a meeting of all owners to discuss well status and be included in planning and resolution discussions.
- Organizing an ad-hoc owners' group to spread the time commitment and costs to retain counsel to assist in restructuring issues.
- Demanding payments directly to vendors or causing joint-interest billing payments to be maintained in a separate account. (An operator may "rob Peter to pay Paul" and use funds to pay costs for other wells while stockpiling unpaid bills. If third-party funds held by an operator are commingled with the operator's general funds, they can be difficult to identify and recover.)
- Demanding adequate protection via guarantees, letters of credit or other documentation.

Reactive remedies include:

- Acting quickly to preserve and protect lien rights and, if enforceable, actimg early to ensure adequate protection of lien rights. In addition to contractual lien rights under a JOA in Texas and a handful of other states, a producer may be entitled to assert a statutory producer's lien for production proceeds. (A producer lien is not the same as the oilfield mechanics and materialman lien, which working-interest owners are typically not entitled to assert.)
- Seeking to separate production revenues to ensure payment and that royalties are paid and conditions of oil and gas leases are met that could otherwise void leases.
- Offsetting and recovering any amounts due and owed by defaulting party.
- Monitoring bankruptcy filings and reviewing monthly operating reports to determine if revenues and expenses are reasonable.
- Taking action in the bankruptcy case to assert rights and interests.
- Requesting information from the creditors committee (if unsecured) on the debtor, its operations and the steps the committee is taking to protect the unsecured interests.

—Buddy Clark, Haynes and Boone LLP