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## E&P Restructurings: Focus on Uptiering Transactions

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Times are tough, very tough, for many mid-cap and small-cap exploration and production (“E&P”) companies. Crude oil prices have fallen from more than \$100/barrel in July 2014 to a twelve-year low of less than \$30/barrel in January 2016. Natural gas prices are at a three-year low. The growing consensus is that depressed prices will experience a slow recovery that may continue into the 2020s. In response, a number of overleveraged E&P companies have completed significant out-of-court restructurings since 2015, while others have filed for bankruptcy protection. Even those companies that have deleveraged their balance sheet and reduced their overall interest expense may face a liquidity crisis if commodity prices remain depressed through 2016 and beyond.

The significant, prolonged decline in commodity prices hurts E&P companies in two significant ways—first, by forcing a reduction in development activities that are unprofitable in low price environments, and second, by limiting access to capital through traditional reserve-based lending (“RBL”) financing. Overleveraged companies, especially those with significant senior unsecured debt, feel these effects more acutely. One telling sign is the disclosure by certain E&P companies in periodic filings with the Securities and Exchange Commission (the “SEC”) that they would not be able to pay contractual obligations as they became due in 2015 unless the company could complete a restructuring transaction.

The key question that these companies face is—what are the best strategic options to survive the depressed price market? While a restructuring often involves many elements, the most notable development in 2015 in out-of-court restructurings has been the use of junior lien financings and “uptiering” transactions in which companies offered a new security, often a second- or third-lien debt security or term loan, in exchange for cash or for existing senior unsecured debt.

### Basics of an Uptiering Transaction

In 2015, a few companies repurchased existing senior notes with available cash. Others exchanged existing senior unsecured notes for newly issued common stock. However, the growing trend in debt restructurings for E&P companies is to exchange existing senior unsecured debt for new junior lien notes or term loans which may provide all parties with an improved position.

An uptiering transaction may be accomplished through various methods, including:

- privately negotiated transactions where the company offers new junior lien debt in exchange for existing debt held by institutional holders;
- a publicly-announced exchange offer for the exchange of new junior lien debt for existing debt held by eligible holders; or
- an SEC-registered exchange offer to issue a new security or instrument in exchange for existing notes.

In addition, a consent solicitation of noteholders may be required to amend the terms of an existing series of notes, either to increase flexibility or to strip most of the covenants in an “exit consent” to incentivize noteholders to participate.

The following companies successfully completed an uptiering transaction in 2015/early 2016 (information based on SEC filings):

<b>Date</b>	<b>Company</b>	<b>Uptiering/Exchange Transaction</b>
May and June 2015	Midstates Petroleum Company, Inc.	Private exchanges of \$504 million principal amount of 12.0% third-lien senior secured notes due 2020 for existing senior unsecured notes (exchange rate 80.0%).  Private exchanges of \$20 million principal amount of third-lien senior secured notes due 2020 for existing senior unsecured notes (exchange rate 70.0%).
September 2015	Goodrich Petroleum Corporation	Private exchanges of \$75 million units consisting of 8.875% second-lien senior secured notes due 2018 and warrant for existing senior unsecured notes.
September 2015	Halcón Resources, Inc.	Private exchanges of \$1 billion principal amount of 13.0% third-lien senior secured notes due 2022 for \$1.5 billion existing senior unsecured notes.
October 2015	EXCO Resources, Inc.	\$700 million principal amount of 12.5% senior secured second-lien term loans, of which \$300 million was used to pay down credit facility debt and \$400 million was used in private exchanges for existing 7½% senior unsecured notes due 2018 and 8½% unsecured notes due 2022.
November 2015	Linn Energy LLC	Private exchanges of \$1 billion principal amount of 12.0% senior secured second-lien notes due 2020 for \$2 billion senior unsecured notes (exchange rate 50%).
December 2015	Halcón Resources, Inc.	Exchange offer to issue \$150 million principal amount of 12.0% second-lien senior secured notes due 2022 for existing notes to all eligible holders (exchange rate 39%). Following expiration, issued \$112.8 million principal amount of new second-lien notes.

Date	Company	Uptiering/Exchange Transaction
December 2015	Chesapeake Energy Corporation	Exchange offer of up to \$3 billion principal amount of 8.00% senior secured second-lien notes due 2022 in exchange for several series of senior unsecured notes to all eligible holders (exchange rate ranged from 56% to 100% depending on series of notes). Approximately 41% of existing notes tendered.
January 2016	Eclipse Resources Corporation	Private exchange offer of 9% senior secured second-lien notes due 2023 in exchange for 8.875% senior unsecured notes due 2023.

**Advantages of Uptiering Transactions.** Given today’s turmoil in the oil and natural gas industry, E&P companies must focus on liability management and reconsider their debt structure and their ability to deleverage and manage cash flow. An uptiering transaction may benefit the company by reducing its overall leverage through the repurchase of existing debt at a significant discount, increasing the ability to access secured debt financing beyond traditional RBLs, reducing overall interest expense and extending overall debt maturities. As opposed to traditional credit facility debt, junior lien debt also typically provides greater flexibility on covenant ratios and does not have periodic redeterminations on borrowing availability.

**Impact of Charter and Contractual Provisions.** Prior to engaging in an uptiering transaction, the company must review any applicable contractual or charter restrictions relating to, among others, the incurrence of debt, the incurrence of liens, and the ability to repurchase debt prior to maturity. Often, a restructuring transaction will require a waiver, consent or amendment from the lenders under the credit facility or under other outstanding debt agreements. If a consent, waiver or amendment is required with respect to outstanding senior unsecured notes, the company may be required to engage in a consent solicitation.

Uptiering transactions have been successful, in part, because many senior unsecured note indentures permit the incurrence of additional debt and liens under “credit facilities” as an exception to the general limitations on incurring debt and liens. The definition of “credit facilities” in these indentures may permit debt facilities beyond the typical RBL loan, including term loans with parties other than banks or capital markets notes transactions. As a result, companies with outstanding senior unsecured notes may be able to incur secured debt under the “credit facility” carveout at a time when the company cannot incur additional senior unsecured debt. The credit facility carveout in many E&P companies’ indentures provide for a dollar limit of additional debt based on the greater of a fixed dollar amount and a percentage of the companies’ adjusted consolidated net tangible assets (“ACNTA”). When commodity prices are high, the cap on credit facility debt permitted may rise above the fixed dollar amount. Conversely, when prices are low, the ACNTA will be lower and the cap may be the fixed dollar amount.

In connection with an uptiering transaction, a company may solicit consents to amend one or more provisions in its indentures to provide or increase the flexibility for repurchase or exchange transactions or, if the solicitation occurs in the context of a tender or exchange offer, as an “exit consent” to strip covenants from the indenture and incentivize noteholders to participate in the exchange offer. Determining the timing of the solicitation can be important in terms of incentivizing the noteholders of outstanding notes to consent to an amendment if the company is not simultaneously repurchasing all of their notes.

**Noteholder Incentives.** One of the biggest difficulties a company must consider in these transactions is determining what the existing noteholders might accept in the exchange in order to limit the ability of “holdouts” who will attempt to extract more consideration to participate. With an uptiering transaction, the main incentive for noteholders to participate is the receipt of secured debt in exchange for unsecured debt. Subject to the intercreditor agreement among the secured creditors and depending on whether the value of the collateral exceeds the amount owed to the first lien creditors, the transaction may put the noteholder in a better position in the event of a company bankruptcy. Completing a repurchase or exchange through separate privately negotiated transactions can minimize noteholder collusion.

**Tax and Accounting Implications.** Prior to executing an uptiering transaction, the company should review the tax and accounting implications, including the regulations on cancellation of indebtedness income and original issue discount.

### Securities Law Considerations for Uptiering Transactions

Before going forward with an uptiering transaction, the company and its legal counsel must consider the applicable securities laws, including the following:

**Tender Offer Issues.** If the repurchases or exchanges of notes are considered to be a “tender offer,” the company must comply with the applicable tender offer rules in Regulation 14E, Regulation 14D and/or the regulations in Section 13e-4 promulgated pursuant to the Securities Exchange Act of 1934, as amended. The term “tender offer” is not defined in the federal securities laws, but case law, especially in the context of equity tender offers, provides some guidance. The repurchase or exchange of notes in separate privately negotiated transactions can present a risk that the transactions may be viewed as a “creeping tender offer,” and, as a result, subject to the tender offer rules.

A tender or exchange offer for non-convertible notes that is subject to the tender offer rules is generally subject only to Regulation 14E, which includes the requirement to hold the offer open for 20 business days, among others. If the notes are convertible into common stock or another equity securities, additional rules may apply under Section 13e-4 or Regulation 14D, including filing requirements with the SEC and compliance with the all holders and best price rules.

**Securities Act Compliance for New Securities.** If the company is issuing a new security in exchange for the notes, the company must consider whether the issuance of the new security must be registered with the SEC or whether it can be issued in a private placement or in an exempt exchange pursuant to Section 3(a)(9) of the Securities Act of 1933, as amended.

**Disclosure Issues.** During any restructuring transaction, the company will face numerous disclosure issues under the securities laws. For example, the company must consider whether it has material nonpublic information that should be disclosed publicly prior to engaging in a transaction or making an offer. If the company will make selective disclosures to noteholders, is the information required to be disclosed under Regulation FD or subject to a non-disclosure agreement? It may be helpful for the company to have generic disclosure regarding possible restructuring transactions in its periodic SEC filings.

### What's Next?

In 2015, many E&P companies completed debt restructurings that included the exchange, at a significant discount, of existing unsecured debt for senior secured second-lien term loan or senior secured second-lien

notes. Some of these companies have made significant improvements to their balance sheets and made substantial reductions in interest and other operating expenses.

Going into 2016, with the expectation that commodity prices will not increase in the near future, E&P companies will have to manage the effects of lower ACNTA valuations and reductions in borrowing capacity, capital expenditure budgets and overall development efforts. In an effort to further reduce costs, E&P companies will continue to engage in restructuring transactions to the extent that the terms are acceptable. The goal of an uptiering transaction, and other restructuring efforts, is to manage liabilities in a manner that provides sufficient liquidity to pay debts as they come due and operate until commodity prices improve.

If you have any questions, please contact one of the lawyers listed below.

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