Oil and Gas Creditors Play the Waiting Game

While there is empirical evidence that Section 363 sales in bankruptcy can sometimes ensure a higher price tag for assets, the majority of bankrupt oil and gas producers over the past 18 to 24 months have opted to wait until after emerging to put assets on the block.

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Over the past 18 to 24 months, more than a handful of sizable U.S. oil and natural gas exploration and production companies have made their way through bankruptcy, swapped huge chunks of equity to eliminate massive debt loads and emerged from Chapter 11 protection with a tidy balance sheet, only to hire an investment bank, launch a formal review and sell assets months later.

With an uncertain commodity price environment over the coming years and the need to satisfy creditors that may ultimately press for a sale, the question becomes: Why have more U.S. oil and gas companies not opted to sell assets through Section 363 sales in Chapter 11 rather than launching reviews after emerging?

Raoul Nowitz, a managing director with investment bank SOLIC Capital Advisors LLC, said in his experience bankruptcy dealmaking comes with a distressed discount.

"I think trying to get a sale in bankruptcy may weigh negatively on the ability to get an optimal price," Nowitz said. "Versus waiting until you've emerged and you are rated as a cleaner business."

Indeed, a number of U.S. oil and gas exploration and production companies have seemingly shared the same sentiment.

Samson Resources II LLC said March 29 it had tapped Jefferies LLC as lead adviser and Houlihan Lokey Inc. as co-adviser for a strategic review, which subsequently led to a number of asset sales. Also in March, Energy XXI Gulf Coast Inc. (EXXI) said it had hired Morgan Stanley to advise management on business options and strategic planning.

In late February, Jefferies launched a review for Linn Energy Inc., the reorganized successor to Linn Energy LLC that has been working to sell various noncore assets to focus on its core Oklahoma holdings. The company subsequently announced its Oklahoma assets would be committed to Roan Resources LLC, a new joint venture with Citizen Energy II LLC, while Jefferies continued to assist various other advisers in selling off the remainder of its U.S. asset base.

If activist hedge fund Fir Tree Partners gets its way, Houston natural gas producer Ultra Petroleum Corp. (UPL), which emerged from bankruptcy in April after swapping $1.3 billion in senior notes for equity, will soon join that list.

As The Deal reported Tuesday, Sept. 26, Midstates Petroleum Co. (MPO), another formerly bankrupt oil and gas producer, has tapped SunTrust Robinson Humphrey Inc. to market its Anadarko Basin assets. Notably, Fir Tree also holds a 25% stake in Midstates Petroleum, which it picked up in October in exchange for $166 million of the company's 10% second-lien senior notes due 2020.

Titan Energy LLC, the reorganized successor of Atlas Resource Partners LP, is still working its way through various asset sales, including the disposal of its Raton Basin assets in New Mexico. Another Chapter 11 survivor, Chaparral Energy Inc., announced Monday the formation of a drilling joint venture with Bayou City Energy LP.

And still others, such as BreitBurn Energy Partners LP, are working their way through the final innings of bankruptcy proceedings, with industry followers expecting more asset sales to come as a result.

According to Haynes and Boone LLP restructuring partner Keith Sambur, this trend likely has sprouted from creditors hoping for a rebound in the commodity market and may be somewhat unique to the upstream oil and gas industry, where a company's operations can be dormant for months at a time without necessarily losing any value.

"Oftentimes you see 363 sales when the value of the company is best realized by selling it as a going concern, or a fully operational business," Sambur said. "When businesses are operating at losses and bankruptcy may not provide an opportunity to address those losses, creditors often balk at financing the company going-forward, but are willing to provide incremental capital to allow for a going-concern sale of the company. In that instance, a 363 sale is the best way to maximize value and for the creditors to exit that position.

"Creditors will say, 'Hey, I know I'm going to take a loss, but the best way to exit is sell assets as a going concern.'"

For upstream oil and gas companies, however, creditors don't necessarily have to pump a lot of cash into the business during or after restructuring to keep it going, Sambur added.

Instead, these companies can stop drilling and completing wells and effectively mothball operations, without the resources in the ground below becoming any less valuable. By comparison, it would foolish for a retail store outlet to simply shut its doors and not sell its inventory throughout a bankruptcy process.

To be sure, for a distressed exploration and production company there may be certain benefits to a 363 sale, Sambur said. For one, buyers are sometimes willing to pay more for an asset in a 363 sale than directly from a distressed seller before Chapter 11, as bankruptcy protection eliminates the risk of the buyer being caught up in a fraudulent transfer lawsuit if the seller is alleged to have been insolvent and to have parted ways with the asset for less than reasonably equivalent value.

Furthermore, through 363 sales, third parties can buy assets free and clear of any claims and liabilities. For these reasons and more, buyers may actually insist a distressed company go through Chapter 11 proceedings before buying an asset, and given that bankruptcy is such an expensive process, it's reasonable to assume sellers would then demand a higher price tag.

However, neither Sambur nor Nowitz said these advantages are necessarily enough to move the needle for the bulk of oil and gas companies and their creditors.

"The thing about an asset sale is it forces the company and its creditors to effectively crystallize losses," Sambur explained. "Early on the thought was oil in the $30s and $40s [per barrel] was a temporary glitch. [The Organization of the Petroleum Exporting Countries] was going to tighten the screws and cut production, and we were going to see rebounds."

Of course, as management teams and bondholders alike now know, that wasn't the case. But at a time when dozens of U.S. oil and gas companies were entering Chapter 11, such thinking is likely what drove companies to try to get in and out of bankruptcy quickly, then consider a sale afterward. It also is what may have propelled their creditors to accept such a proposal.

"If you're a creditor in what was perceived to be a temporarily low commodity environment, the last thing you may have wanted to do is sell assets," Sambur said. "Because if you loaned a company money at $100 per barrel and oil is selling between $30 and $40 per barrel [when the debtor enters bankruptcy], you effectively crystallize your losses at let's say 65 cents on the dollar."

Not to mention, third-party buyers were going to have a tough time finding a bank willing to fund acquisitions of those assets in that type of commodity environment.

So the majority of public E&Ps made deals with their creditors, handed over equity to debtholders and pushed off deciding how to prune the hedges until later.

Yet certain companies, including Ultra Petroleum, have yet to formally disclose any type of post-bankruptcy strategic review process.

That may be why some debtholders now have seemingly turned to activism. Case in point: Fir Tree Partners. The firm is no stranger to distressed energy investment, having stakes in Linn Energy, Ultra Petroleum, Midstates Petroleum, Halcón Resources Inc. (HK), Sandridge Energy Inc. (SD) and Stone Energy Corp. (SGY), all of which dropped into Chapter 11 between 2015 and 2016.

As Nowitz and Sambur both pointed out, there are investors who buy up swaths of distressed debt like this on the cheap with the sole purpose of taking control of the company after Chapter 11.

Witness Elliott Management Corp.'s run at Energy Future Holdings Corp., the bankrupt parent of Texas utility Oncor Electric Delivery Co. LLC. Elliott became Energy Future's largest debtholder with the hope of reenacting a play it made in 2009 with auto parts maker Delphi Corp.

But that's not typically Fir Tree's ball game.

Nor does the firm frequently launch public activist campaigns. Until Sept. 18, Fir Tree had publicly disclosed just two letters to management teams and hasn't launched a single proxy fight.

Now, though, the company is agitating alongside Q Investments at Jones Energy Inc. (JONE) and told Ultra Petroleum it has hired an investment bank to review strategic alternatives for the company.

According to Sambur, investors may now be getting used to the so-called new normal in terms of pricing and subsequently considering how to best position themselves.

"If you're a distressed-control investor, you may have effectively loaned money at $30 per barrel based upon when you bought these bonds," Sambur said. "When you look at forward strips, it doesn't look like commodity prices will hit 2014 highs anytime soon, and the underlying assets are not producing a whole lot of income for you, so you have to think, How do you start to maximize your return? How do you exit from that $30 per barrel position so you can achieve targeted investment returns?"

So are there more bankruptcies to be filed, and if so, will the majority play out the same way? Sambur said it's hard to say. But if more E&Ps do file, as some expect, and $50 oil is the truly the new normal, it's reasonable to assume fewer creditors will be as patient to wait through bankruptcy for the upside play.

Still, Nowitz isn't convinced there aren't still investors with a little faith, especially given OPEC's recent comments on global supply and demand returning to balance.

"I'm not as much of a skeptic as I was a year ago," he said. "I'm encouraged by what I'm seeing out of OPEC. And I feel a lot of guys who have done this long enough have seen their fortunes change. So I'm not so sure most people believe there is as much downside now as there is upside."

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