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Redetermination, Perfection and Bankruptcy in the Oilfield

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INTRODUCTION[1]

John English

I recently read an article[2] in *Bloomberg Businessweek* that brought back some fond memories. In the spring of 2012, I made several trips to Arkansas to meet with some bankers and their customers who were beginning to see signs of a surprising development in Arkansas - an oil and gas boom. The surprise was not limited to Arkansas. Until then, hydraulic fracturing was best known for boosting U.S. natural gas production. It was just starting to be used to unlock oil trapped in underground layers of rock like the Bakken Shale in North Dakota, the Eagle Ford in Texas, and the Mississippi Lime in Oklahoma. In those meetings we talked about the benefits of tapping shale. We discussed leasing the land; drilling rigs built with hundreds of components; thousands of employees, many of whom would be highly skilled; trucks to deliver drilling rigs, to haul chemicals, and to haul crude oil from the tank batteries; drilling itself; training facilities; teachers; cooks; coordinators; janitors; filled restaurants and motels; welding and machine shops; and so on.

In 2012, the prospect of a bust seemed remote. Oil was trading at $98.00 a barrel. U.S. crude oil production had begun to increase for the first time since the 1980s. During that period, more than one commentator spoke or wrote about how Saudi Arabia no longer had the ability to flood the world market or, alternatively, that it would take a worldwide economic collapse to trigger a lasting decline in in the price of oil.

The next three years seemed to prove them right. Oil averaged $95.00 a barrel. By the end of 2012, U.S. production had increased by a million barrels a day, the biggest gain in history; the performance was repeated in 2013 and 2014. U.S. oil output reached the highest level in more than four decades. Imports of oil, which made up 60 percent of U.S. consumption in 2005, fell to 24 percent.

Then in mid-to-late 2014, demand for crude oil began to decline along the Pacific Rim. Saudi Arabia began to lower its prices with the stated purpose of protecting its market in that area. By October 2014, the price of crude dropped below $85.00 per barrel; however, the belief in the staying power of high crude prices was so strong that in late 2014 and early 2015, a number of producers liquidated their hedging contracts, took their profits and used those funds as operating capital or to "beef up" their balance sheets on the expectation that crude prices were going to recover quickly and drastically. That expectation did not become reality.

In November, 2014, Saudi Arabia declined to curb its output to arrest the worldwide slide in oil prices. As a result, prices collapsed. By January, 2015, oil was trading below $50.00 per barrel, the lowest price since the 2008 financial crisis. Beginning in mid-2015 we began to see enormous layoffs in the oil and gas industry, exploration and production companies missing payments on debt, downgrading of investment grades for exploration and production companies,

[1] The views expressed by the authors are their personal views and opinions; they do not express the views or opinions of their respective firms or their clients.

[2] Asjylyn Loder, "Gone With The Boom", *Bloomberg Businessweek*, pp. 10-11 (March 14-20, 2016). This introduction is a paraphrase of the article; all of the historical and statistical information is taken from the article.

and bankruptcies filed by companies in all facets of the oil business, but especially in the exploration and production arena.

Prices have stayed low. In the middle of March, 2016, oil was trading at $37.00 per barrel and on March 30, 2016, Nymex crude oil futures were trading at $38.28 per barrel based on concerns that there was still a worldwide glut of oil.[3] Commentators who, two years ago, were talking about a downturn analogous to 2008 are now talking about the 1980s.

This is the world in which oilmen and their lawyers now live. In this presentation Zach (who is a both a lawyer and a banker) will give you an elemental understanding of the rules which govern oil and gas reserve-based loans by U.S. banks. I will then discuss the rights and remedies available to all parties under one of the most basic agreements in the oil business - the joint operating agreement. Finally, Eric will discuss the effect U.S. bankruptcy laws may have on operators and non-operators who have perfected those rights, or not.

[3] "Out of Gas" graphic, *The Wall Street Journa*l, p. C1 (March 30, 2016).

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BASICS: Redeterminations, Perfection, and Bankruptcy in the Oilfield

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I. INTRODUCTION

When commodity prices are low, the relationship between an oil and gas company and the banks that provide loans to them is impacted. Most economic downturns and periods of low commodity prices are weathered by both parties with little incident. However 2016 is shaping up to be a much different year. The purpose of this paper is to describe the historical relationship between an E&P company and a bank, and to pull back the curtain some of the reasons why the relationship between these two long-time partners may be evolving in an unprecedented way.

Energy banks play an integral role in the exploration and production of oil and gas. Many E&P companies have had long-standing relationships with their bank or banker for decades. For the E&P company their banker is a friend, a confidant, even a partner in their pursuits to expand and grow their business. Most E&P companies probably chose a bank or banker in part because they felt they understand the cyclical nature of the oil and gas business. Historically oil and gas banks have demonstrated a willingness to work and be flexible with their E&P company clients who are seeking additional working capital to fulfill drilling commitments in a down market.

In 2016 the relationship between bank and E&P company is changing – in some cases drastically and E&P companies' need to wake up to this new reality. Almost every day there is another story in the newspaper or the nightly news – or both – about the global "glut" of oil and how it is wreaking havoc on energy markets. In 2016 an E&P company has probably started to notice their banker is not as quick to return their phone calls. A phone conversation with your banker today might not contain as much small talk and the tone is certainly less friendly than in years past. A request to borrow additional capital in order to fund a drilling commitment – a request that has been routine and simple in years past, and one that has been granted time and time again throughout the relationship with its bank – is met with resistance, even hostility, in

2016. Is there a reason that the bank or banker appears to have become Mr. Hyde? The short answer to that question is no. However, in 2016 – and for the foreseeable future – E&P companies do not need to start treating their bank as the enemy but rather be awakened to a reality facing oil and gas lenders – bank regulators.

II. RELATIONSHIP BETWEEN BANK AND E&P COMPANY

It is no secret that E&P companies need access to a large amount of working capital to explore for, drill, and produce hydrocarbons. The traditional role of bank credit in the oil and gas industry has been to finance exploration and production activities, including equipment needs, and to provide working capital to service companies.[1] Most – if not all – E&P companies look to banks to extend working capital – typically in the form of revolving credit lines – in order to finance their operations. Most often in a down market, E&P companies utilize revolving credit lines in order to cover short-term funding gaps. The repayment of these credit lines ultimately depends on the successful gathering and marketing of a commodity, and on the value of the collateral taken for the loan.

By now, we have all heard the phrase "global supply glut" so many times we have lost count. The excess supply of oil and natural gas, coupled with a weakened global demand for such commodities, has sent the prices of oil and natural gas tumbling since June 2014.[2] The increased supply of oil and natural gas is a direct result of a revolution in drilling technology which unlocked bountiful supplies of oil and natural gas from layers of shale rock in the United States.[3] What you might not know is this boom in production – which has exacerbated the glut of

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[1] Dai, Shasha, *Borrowing Base Redetermination 101*, WALL ST. J., Sept. 29, 2015, *available at* http://blogs.wsj.com/privateequity/2015/09/29/borrowing-base-redetermination-101/ .

[2] Friedman, Nicole, *Oil Prices Tumble Amid Global Supply Glut*, WALL ST. J., Dec. 10, 2014, *available at http://www.wsj.com/articles/crude-oil-prices-continue-to-fall-on-tepid-demand-ample-supply-1418209538.*

[3] Mufson, Steven, *The new boom: Shale gas fueling an American industrial revival*, WASH. POST, Nov. 14, 2012, *available at https://www.washingtonpost.com/business/economy/the-new-boom-shale-gas-fueling-an-american-industrial-revival/2012/11/14/73e5bb8e-fcf9-11e1-b153-218509a954e1_story.html.*

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