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Some Cash-Strapped US Oil Companies Can't Even Afford Chapter 11 Bankruptcies. That Means They Have to Wait Things Out or Liquidate
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Benji Jones and Casey Sullivan
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Oil markets made history once again in May, with US crude posting its sharpest monthly gains on record. The price per barrel surged by almost 90% for the month to settle at about $35 last Friday.

But the worst is still to come for many upstream producers and oilfield-service companies loaded with debt, according to Ken Coleman of the law firm Allen and Overy, who heads up the firm's US restructuring group and banking practice.

In fact, some smaller companies may be in such poor shape that they won't even be able to afford the Chapter 11 bankruptcy process, he said. They may also struggle to find lenders to provide funding during a restructuring — especially given the questions around long-term valuations for oil and gas assets.

"Chapter 11 bankruptcy is expensive," Coleman said. "I just don't know that there's the funding."

Some companies that can't afford Chapter 11 may simply inform creditors of their position and try to wait until the price of oil recovers, at which point they may file, says Bill Brandt, founder of the restructuring consulting and advisory firm Development Specialists Inc.

Others in a more dire position may be forced to file for another form of bankruptcy known as Chapter 7, Coleman said. In that situation, the companies essentially get liquidated.

No matter the path they take, the idea that Chapter 11 could prove too costly puts a fine point on why this downturn for the energy sector is worse than the last one, which started in 2014, Coleman said.

"It's going to be a very different wave of bankruptcies for the industry this time around," he said. "Obviously it's going to be bigger. But importantly, they're going to be harder cases to launch."

The cost of bankruptcy

When you hear that a company is going bankrupt, you may assume that it's essentially dead, never to return again.

In reality, Chapter 11 bankruptcy is more like a reset button. Through restructuring, the company is relieved of debt and typically exchanges the money it owes to creditors with equity.

While it can be helpful, filing for bankruptcy protection under Chapter 11 isn't cheap, Coleman said.

Restructuring and selling off assets requires droves of lawyers, financial advisors, and consultants — "high-price, professional talent, and that needs to get paid," he said.

"In most cases, this doesn't mean that they don't have the funds necessary to pay the minimal filing fees, but rather that they don't have the liquidity necessary to pay the sometimes-hefty retainers that could likely be required to retain professionals in advance of filing a case," Brandt said.

During a bankruptcy case, companies also need to keep their operations running. To do so, they seek what's known as debtor-in-possession loans, or DIP financing, which offers special protection to creditors under the bankruptcy code.

"The problem the oil and gas industry is going to have is whether there's enough DIP financing to run the case," Coleman said.

Even with special protection that comes with DIP financing, lenders may be "more reluctant than previously because valuation is much more uncertain now," Coleman said. While oil prices have bounced back in recent weeks, the pandemic may cause longterm changes to energy demand that could depress prices for years to come, he said.

"Even if there is some comfort on the bases to forecast demand, the fallout in the industry is likely to be so widespread that there is a question whether there will be enough funding available to meet the need," he said.

When Chapter 11 isn't an option

For some companies that can't afford to run a Chapter 11 case, they'll simply do nothing, Brandt said.

"Most creditors are cognizant of the commonsensical position that says if the business isn't doing well enough to file a bankruptcy, pushing it into one isn't going to increase your prospective return as a creditor," he said.

Creditors have the option to put a company into involuntary bankruptcy, he said. But one fact he says most people overlook is that doing so requires that the creditors commit "to at least a modest and reasonable outlay of further funds in order to retain counsel to file."

Brandt added that most creditors are "astute enough" to realize that "any further funding they put out to file a bankruptcy for one of these companies will essentially be good money after bad."
In some more dire situations, however, companies may file for another form of bankruptcy known as Chapter 7.

In a Chapter 11 filing, the company maintains its management team and continues to try and maximize value through production, whereas in a Chapter 7 the company cedes business control to a trustee who quickly begins selling off assets, according to John Sparacino, a principal at the

trial firm McKool Smith. In this case, the goal is not to try and revive the business but to liquidate it as quickly as possible and pay back creditors.

"Think of a firesale, basically," Coleman said.

To be clear, most creditors don't want companies to file for Chapter 7. They want to maximize value, said Patrick Hughes, a partner at the law firm Haynes and Boone, which typically involves converting debt to equity in lieu of a fire sale.

So in most cases, Chapter 7 is the last resort, reserved for cases where companies have little value in the assets they own — and little prospect of strong revenue, even as the price of oil recovers.
More generally, some lenders and investors have already been bracing for situations where they might wind up actually owning assets.

In March, a JPMorgan exec reminded investors in the private-debt space — especially less experienced ones that haven't ridden through an economic downturn yet — that they should be prepared to take possession of assets companies have borrowed against.

In April, Reuters reported that major US lenders were gearing up to become operators of oil and gas fields across the country for the first time in a generation.

Small oilfield service companies are most at risk

Coleman expects to see more Chapter 7s in this downturn, due in part to the price of oil. Most analysts say it won't return to pre-pandemic levels until late 2021 at the earliest.

To be sure, Hughes says that some companies seeking lenders are in a better position today than during the downturn of the 1980s, when interest rates were much higher. As part of its response to the coronavirus pandemic, the Federal Reserve slashed benchmark interest rates that were already low, historically speaking, to near-zero.

But he said that Chapter 7 cases could still very well mount, especially among small oilfield service companies.

For the most part, downstream companies involved in oil refining are safe, as are large-cap upstream companies, he said. When you get into the small shale firms focused on oilfield services, such as water transportation and drilling, that's where the risk of Chapter 7 filings increases, Hughes said.

"You're probably looking at the smaller outfits quite well going to a 7," he said. "They don't have the asset base to sustain in this environment [or] the cash flow necessary to keep their equipment financers satisfied."

It's hard to say how many companies will meet this fate, but it's clear that hundreds of companies are struggling today.

Of the 500 or so private-equity-backed shale companies in North America, as many as 80% of them are unable to find buyers, according to Adam Waterous, the former head of investment banking and North American energy and power at Scotiabank.

"What you're seeing is the rapid shrinkage of the industry," he told Business Insider in early May. "A lot of companies are going to cease to exist."