Client Alert

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What Lenders Should Consider Before Taking Ownership of Oil and Gas Assets

The combination of global oversupply and the demand destruction caused by COVID-19 recently pushed the price of oil to its lowest level in decades. Exploration and Production (E&P) companies of all sizes and from every producing basin are fighting for survival, and lenders are becoming increasingly concerned about their credit exposure to those E&P companies. As E&P production and revenues continue to fall, banks, funds and other lenders are also seeing the value of their reserve-based collateral plummet, and several recent bankruptcies have left senior secured reserve-based lenders with pennies on the dollar. The prospect of taking substantial losses on reserve-based loans is forcing lenders to consider an unconventional approach to protecting their interests: Take ownership of the oil and gas assets that comprise the collateral package.

By taking ownership of oil and gas assets through foreclosure, credit bid or other remedy, lenders can control operations, collect revenue and hold the assets until prices improve and market conditions provide an opportunity to exit. The following are factors for lenders to consider before assuming ownership of distressed oil and gas assets:

Charter, Governance and Regulatory Restrictions

A lender should determine whether owning and operating oil and gas assets is permitted by the lender's charter or formation documents and applicable law. Federal law prohibits national banking associations from holding real property interests for a period of longer than five years, subject to a waiver from the Comptroller of Currency. Lenders should also determine the appropriate ownership and governance structure for the oil and gas assets. A special purpose entity (SPE) is typically formed to hold the assets; however, the lender's existing corporate structure laws applicable to the oil and gas assets should be carefully evaluated before selecting the type and structure of the SPE.

Lien Analysis/Due Diligence

It is imperative for a lender to determine the validity and priority of its liens on the borrower's assets. A lien analysis is an in-depth review of the debtor's assets and the liens that encumber those assets that should be performed at the outset to help determine the best strategy moving forward. The language of the applicable credit facility and loan and security documents must be carefully examined to determine the effectiveness of after-acquired property language and other catchall provisions for assets not expressly described in the mortgages and other security documents. The lien analysis also helps determine a lender's lien priority with respect to other creditors, vendors and materialmen, and it provides the framework for assigning value to the unencumbered assets. The value of unencumbered assets and existence of potentially senior liens could be important in determining strategy and could affect the acquisition cost.

In addition to typical buy-side due diligence, a lender also needs to become familiar with its borrower's operations and understand the contractual relationships that facilitate the flow of hydocarbon molecules from the applicable formation(s) to the final point of sale. Understanding these agreements allows the lender to identify ongoing rights and obligations, and determine which contracts are material to operations on a go-forward basis.

In bankruptcy, contracts are considered “executory contracts” if material obligations of both the debtor and contract counterparty remain unperformed. Typically, when assets are sold in bankruptcy, there is a corresponding process whereby potential buyers, including a lender pursuant to a credit bid, may select executory contracts or unexpired leases to assume as part of the acquisition. In order for a debtor to assume an executory contract or unexpired lease, it must cure all defaults, including monetary defaults through payment of outstanding amounts (commonly referred to as “cure costs”), and provide adequate assurance of future performance. Cure costs can substantially increase the acquisition cost of the assets, and settlement negotiations can provide valuable insight into future relationships with counterparties to such assumed executory contracts or unexpired leases. These considerations are important when the lenders are capitalizing the SPE in which they will hold the oil and gas assets after acquiring the assets.

Any executory contract or unexpired lease not selected for assumption will remain with the debtor, and the assets will be transferred free and clear of any obligations or claims relating to contracts that are not assumed and assigned. It should be noted that assets that are subject to contracts containing real covenants or covenants running with the land, such as certain acreage dedications in midstream gathering and transportation agreements, cannot be transferred free and clear of such real covenants or covenants running with the land.

Funding the Acquisition

First lienholders are generally in an advantageous position to acquire the debtor’s assets due to their ability to use the debt owed to them as credit towards the acquisition cost of the assets, through a process known as a “credit bid.” As previously mentioned, however, the lien analysis could reflect that a lender’s lien may not attach to all of the debtor’s assets, and the liens of competing creditors, vendors and materialmen could prime the lender’s lien. As a result, a lender may be required to include a cash payment in addition to its credit bid to settle and account for cure costs, acquire valuable unmortgaged assets and satisfy liens with higher priority. The lender will also need to ensure that the SPE has sufficient capital to fund operations and comply with regulatory requirements, including ongoing environmental and decommissioning obligations.

Operations

A lender must be prepared to operate the assets or, more likely, cause the assets to be operated on behalf of the lender in a manner that will protect its investment; however, upon closing of the transaction to acquire the assets, the lender may not yet have the financial assurance and regulatory authorizations and qualifications required to own and operate oil and gas assets. Regulatory agencies often take several weeks to approve these items, and prospective bidders generally wait to start the approval process until definitive acquisition agreements have been executed. A Transition Services Agreement (TSA) provides for continued operation of the assets by the seller for the duration of the transition period, which is typically 30 to 120 days after closing. The TSA provides the terms and conditions pursuant to which the seller will continue to operate the assets on behalf of the buyer. The transition services are performed under the seller’s existing permits and authorizations, and the buyer is typically required to indemnify the seller from damages stemming from such operations, subject to traditional carve-outs.

The lender must also make arrangements to operate the assets on a long-term basis after the transition period. Financial institutions and funds are not in the business of operating oil and gas assets on a day-to-day basis, so skilled operating companies are typically engaged to manage operations pursuant to a Contract Operating Agreement (COA). These agreements are heavily negotiated to ensure that the parties are aligned by incentivizing the operator while providing the lender with its desired level of oversight and insulation from operational liability.

This industry downturn has affected both good and bad operators. In situations where a borrower's financial troubles stem purely from external factors rather than operational or management issues, the existing management team may make a good contract operator. If the lender desires to start fresh with a new management team, layoffs from large companies and other restructurings have resulted in the formation of numerous groups of contract operators that are looking for their next opportunity. By negotiating with multiple potential contract operators, a lender may be able to obtain more favorable terms in the COA.

Exit Strategy

Prior to taking initial steps towards acquiring its borrower's assets, a lender should work with financial advisors to estimate the total amount of capital that will be required to acquire and operate the assets, and develop an exit strategy based on projected commodity prices. In the event these estimates and projections present a risk profile that is acceptable to the lender, they will continue to serve as guidelines to keep operations and expenses on track. If the lender or its financial advisors do not have the ability to market the assets, it may also be prudent to engage an investment bank or broker to market the assets and provide advice with respect to potential opportunities and the lender's exit strategy.

Conclusion

This article is based on our experience representing parties to these types of transactions both in and outside of bankruptcy; however, it is not intended to cover the full range of issues that could be applicable to a particular situation. If you have any questions about the process or practical considerations with respect to a lender assuming ownership of oil and gas assets, please do not hesitate to contact us.

Contacts

Timothy A. "Tad" Davidson II
taddavidson@HuntonAK.com

Parker A. Lee
parkerlee@HuntonAK.com

G. Michael O'Leary
moleary@HuntonAK.com

Joseph Rovira
josephrovira@HuntonAK.com

Harve Truskett
harvetruskett@HuntonAK.com

Ian R. Goldberg
igoldberg@HuntonAK.com