Oil Price Rebound Could Create Headaches for Bankrupt Drillers

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Most oil producers would welcome higher crude prices, after a two-year downturn has pushed more than 100 U.S. energy companies into bankruptcy. But for some distressed drillers, a rebound could actually make things worse.

Throughout the rout in oil prices, senior lenders have largely been able to dictate the terms of energy bankruptcy proceedings as drillers' assets have fallen in value. But when oil prices rise, so does the value of a company's reserves. That can in turn can prompt so-called junior creditors to challenge restructuring plans in a bid to get a bigger piece of what's left of the pie.

Those junior classes include holders of the company's stock, who may see the value of their shares go to zero, and unsecured creditors, lenders or vendors the debtor owes money, but whose loans are not backed by collateral. In a bankruptcy, senior lenders have a legal claim to recover their investment before other more junior classes of debtholders.

High oil prices "embolden junior classes to fight harder, meaning possibly fewer agreements, and hence more need for a court process to resolve the issues," said Patrick Hughes, a Denver-based bankruptcy lawyer at Haynes and Boone.

Creditors at all levels have a lot to lose in the current bankruptcy cycle.

Last year, creditors recovered just 21 percent of the capital they lent to 15 bankrupt oil and gas exploration and production companies with at least $100 million in debt, Moody's Investors Service reported this month. That compares with a historical average recovery rate of nearly 59 percent.

There is nothing abnormal about shareholders and unsecured creditors challenging restructuring plans in order to seek a better deal from the indebted company. Stock owners and junior creditors are first in line to take losses when drillers buckle under debt, so it makes sense that they would try to claw back what they can.

Oil workers make a pipe connection on a drilling rig near Encinal, Texas.

Right now, it's unlikely that there will be a large number of contentious court battles over bankruptcies because oil prices have stagnated in the $40 to $50 range after rebounding from the winter low near $26 a barrel, Hughes said.

But a few recent energy bankruptcies have shown that junior creditors and shareholders are willing to put up a fight in bankruptcy proceedings, rather than take just any deal they're offered.

Shareholders who stood to be wiped out in SandRidge Energy's bankruptcy proceeding tried to argue that the company had misrepresented its value, though SandRidge's restructuring plan was ultimately approved.

In the ongoing bankruptcy proceedings for Houston-based Energy XXI, unsecured creditors have sought to submit their own restructuring proposals. Unsecured creditors in legal filings claim the company has materially understated its value, and the methodologies and assumptions that underlie its valuations are flawed.

Energy XXI declined to comment for this story.

Debtors will often set aside some value for unsecured creditors — known as a tip — in order to head off a possible fight over asset values.

Bankruptcy costs are substantial, so it is crucial to get all parties on board, especially when the debtor is seeking a judge to sign off on a restructuring plan reached with creditors, said Kim Brady, a restructuring specialist and partner at financial advisory firm SOLIC Capital.

"Obviously everyone is not going to feel like they're getting enough, so nobody is going to be happy," he said. "It's a matter of *how* unhappy they're going to be."

Bill Rhea of J.W. Rhea & Associates, head of the independent restructuring committee in Saratoga Resources' bankruptcy, said challenges from a shareholder committee had stretched out court proceedings, leading to higher administrative costs that he believes contributed to the company's equity getting wiped out.

"Against the backdrop of some buoyancy in prices, people tend to forget about how the administrative cost of bankruptcy is just accumulating, month in and month out," he said. "We went from having something that could have been negotiated, to there being nothing there at the end."

Saratoga Resources did not return a request for comment.

If oil prices begin to rise substantially, the tip that's offered to junior creditors at the start of bankruptcy proceedings might not look so good in light of the cost of crude.

Oil prices have fallen so low that the value of reserves has cratered to levels few anticipated. When the market recovers, asset values will presumably head significantly higher.

"There will be a point where we will bottom out," Hughes said. "I have to believe that just as the loss of value was exponentially impacted by the drop in commodity prices, the increase in value should also presumably exponentially rise as well" as crude prices recover.

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