

Lower for longer – Boards will be challenged in 2016

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Canada's Energy sector has produced hydrocarbons for more than 150 years, and the growth of that sector has occurred through entrepreneurship, innovation and successful management of costs and commodity prices. The profound decline in crude prices since late 2014 has renewed challenges, carrying with it significant implications for the boards that supervise these enterprises.

Throughout 2015, as the depth and duration of the energy downturn played out, companies responded in meaningful ways. Many adopted plans that included reduced capital and administrative spending, layoffs, renegotiated service contracts, and sales of non-core assets to access capital. Business combinations occurred in the service sector where companies combined to strengthen balance sheets and lower operating costs. These strategies permitted companies to tread water while waiting for price recovery.

"Lower for longer" is now expected to characterize much of 2016, and many market observers believe that Canada's oil and gas industry will face significant headwinds in addition to low commodity prices. These challenges include continuing market access constraints, federal and provincial tax increases, loss of hedges, uncertainty over the impact of Alberta's royalty review and cost of climate change initiatives, opposition by well-funded environmentalists and some governments, creditworthiness of partners and suppliers, and deeper borrowing base re-determinations. As such, a strategy that permits an enterprise to hang on while awaiting better days may not be sufficient.

We expect that reduced spending and headcount reductions will continue in 2016 and that companies will allocate available capital to select projects offering the best returns. However, boards will increasingly have to consider whether more aggressive strategies should be pursued including:

- selling core assets or the enterprise as whole
- shutting-in uneconomic production
- challenging for operatorship, taking possession of defaulting party's production, enforcing contractual liens, security rights and rights of set off against late or non-paying counterparties
- strategic use of the *Companies' Creditors Arrangement Act* and the *Bankruptcy and Insolvency Act* to defend claims of creditors or petition counterparties into insolvency
- recapitalization/restructuring the balance sheet, including extending maturity dates, reducing interest rates or swapping debt for equity as an alternative to foreclosure and liquidation proceedings. Companies that have debt maturing or expect to experience covenant defaults in the coming months should have a plan to deal with such events, or

risk losing control of the process as creditors exercise their available remedies, including overcoming the reluctance to own or manage distressed assets.

Boards of financially distressed companies are encouraged to understand their personal exposure for the debts of the companies they supervise. Certain obligations, including to employees, to CRA for source deductions, and in respect of environmental liabilities, can become personal obligations of the directors. Indemnification agreements supported by D&O policies are important protections against such personal liability as are policies to segregate corporate funds to pay premiums, deductibles and other liabilities.

We anticipate that a substantial rebalancing of the Canadian oil & gas sector will occur, but that the entrepreneurialism and solutions-oriented approach which has characterized its growth will also result in a stronger and more capital efficient industry, guided by strategic decision-making of experienced executives and directors.

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