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September 22, 2016

Bankruptcy Update

From the Oil Patch and Beyond

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- Quick Refresher on Oil & Gas Bankruptcy Basics
 - Property of the Estate
 - Lien Perfection Issues
 - Competing Liens
 - Asset Sales
- Of Specific Interest to Energy Companies
- What's Different This Time?
- Other Energy Sectors
- Best Practices

Property of the Estate

- Property of the estate generally consists of all legal and equitable interests of the debtor in property
 - Bankruptcy law defers to state law and other non-bankruptcy law
- Significance: if property of the estate, generally must be marshalled and distributed through claims process
- Relevant exceptions:
 - Equitable title
 - Interest of the debtor in liquid or gaseous hydrocarbons
 - Transferred pursuant to (i) farmout agreement or (ii) written conveyance of production payment

Lien Perfection

- Contractual Liens
 - Somewhat customary in industry not to file memoranda or other recordings necessary for perfection
 - Critical to file (as early as possible) because:
 - Can dictate whether treated as secured or unsecured creditor in bankruptcy
 - Liens created inside of 90 days prior to bankruptcy may be avoided
 - Trustee/DIP given rights that bona fide purchaser would have under state law
 - Priority of many types of liens governed by first-to-file

Lien Perfection

- Contractual Liens (cont.)
 - *E.g.*, under Joint Operating Agreement (JOA), reciprocal security interests, but perfected only upon filing
 - Upon bankruptcy of non-operator, claims for cap ex amounts and unpaid operating expenses would be unsecured if liens not perfected
- Statutory Liens
 - State law provides royalty owners with lien to secure payment of purchase price of production
 - Some may be as PMSI, others automatically perfected
 - Materialmen's and mechanics liens (M&M Liens)
- Note: as with property of estate issues, bankruptcy law will defer to state law on priority among competing liens

Competing Liens

- *SemCrude* saga
 - Bank liens vs. first purchaser liens
 - Always best to file as quickly as possible in every conceivable jurisdiction
- Additional notes re: M&M liens
 - Attaches only to property specifically described in lien statement
 - May be entire leasehold interest, pipeline, well, lease etc.
 - M&M lien cannot attach to working interest if working interest owner paid its Authority for Expenditure
 - Generally cannot attach to surface rights

Executory Contract Issues

- Executory: a contract with material amount of performance still owing on both sides
 - Generally includes JOAs, farmout agreements that have not been fully performed – but usually not leases
- Significance of executory contract: eligible to be assumed or rejected by debtor
 - Assumption: debtor must cure existing defaults and provide adequate assurance of future performance
 - Must assume in order to assign
 - Rejection: treated as equivalent of breach, converting remaining performance obligations into bankruptcy claims
 - Note: contract is not necessarily terminated – sometimes defaults to common law tenants-in-common principles

Asset Sales

- Bankruptcy sales:
 - Can be within chapter 11 plan
 - Part of freestanding sale (a “363 sale”)
- In either case, generally debtor will usually:
 - Establish a stalking horse bidder
 - Get court approval for bidding procedures, including protections for stalking horse
 - Hold private out-of-court auction
 - Get bankruptcy court order approving sale

Asset Sales

- Advantages of bankruptcy sales:
 - Cleanse most forms of successor liability
 - Convey best possible title, and “free and clear” of liens, claims and encumbrances
 - Minimize fraudulent conveyance risk
- Holders of secured claims can credit bid on assets
 - Use of claim to offset purchase price

Safe Harbors

- A series of statutes in Bankruptcy Code give preferred treatment to participants in financial and commodity markets
- To qualify, must establish:
 - Your company qualifies in protected class
 - *E.g.*, “forward contract merchant,” “swap participant,” “master netting agreement participant”
 - Relevant contracts qualify in protected class
 - *E.g.*, “forward contract,” “swap agreement,” “master netting agreement”
- If qualifying, benefits include ability to terminate contracts, exercise setoff; exemption from most avoidance actions

503(b)(9) Claims

- Historically, all claims for pre-petition deliveries would be general unsecured claims (subject to any collateral held)
- In recent years, Congress created a new class of administrative expense claims for value of goods delivered in 20 days prior to bankruptcy
- Because of difference between paying in full and paying pro rata, debtors push back on many aspects
 - Definition of goods (electricity?)
 - When goods are received
 - Value

Mitigating Bankruptcy Risk

- For any creditor or counterparty, collateral/credit support is key – especially if:
 - Long-dated contracts, which heighten risk of rejection
 - FERC approval needed for renegotiation
- Forms of security/credit support
 - Cash/securities
 - Letters of credit
 - Escrow agreements
 - Guarantees
 - Surety bonds
 - Bilateral setoff rights
 - To date, bankruptcy courts have refused to enforce cross-affiliate versions (but may still be better than nothing)

Mitigating Bankruptcy Risk

- Another strategy: acreage dedications where applicable (*e.g.*, in gathering agreements that relate to specific production areas)
 - Concept: create property rights that “run with the land,” conveyed from producer to midstream company
 - If effective, dedication would be immune from rejection because it is property right (recorded in county land records), not executory contract

- But...

In re Sabine Oil & Gas Corp.

- Applying Texas law, NY bankruptcy court found that acreage dedication in 4 agreements were not effective to “run with the land” and the underlying agreements could be rejected
- Holding is unique to:
 - Texas law because of case law applied to determine whether “run with the land”
 - Specific contractual language
- Therefore, should not be taken as a universal rule
- Still, some reason for concern for midstream companies:
 - Incentive for producers to try rejection
 - Increased incentive for producers to file bankruptcy

In re Sabine Oil & Gas Corp.

- Post-Sabine, similar issues teed up in other cases
 - *Quicksilver Resources*
 - Purchaser of assets required rejection of gathering agreements as condition to closing sale
 - Contractual language was less favorable for rejection than in *Sabine*
 - Parties settled
 - *Magnum Hunter*
 - Similar factual background to *Sabine*, but counterparty
 - Was also in bankruptcy
 - Raised sticky jurisdictional issues
 - Parties settled
 - Same issue approaching in *Emerald Oil*

Where We Are and How We Got Here

- Thanksgiving 2014, OPEC/Saudi Arabia signals unwillingness to curb production
 - Price of WTI crude: \$107 (6/14) to \$29 (1/16)
 - Baker Hughes N.A. rig count: 1,931 (10/14) to 404 (5/16)
- Beginning 2015, 90 bankruptcy cases involving North American oil and gas producers
 - 48 filings in 2016, representing \$49.3B in cumulative debt
 - (*Haynes and Boone Oil Patch Monitor*, 8/1/16)

- Compared to recent downturns, the present E&P crash features
 - Generally smaller debtors
 - Less focus on derivatives
 - Less accompanying litigation
 - More likely to have quick 363 sales or prepacks
 - Usually, less recovery for unsecured creditors
- Major issues:
 - Rejection of midstream contracts
 - Statutory oil & gas liens
 - M&M Liens
 - Treatment of JOAs
 - Plugging and Abandonment (P&A) Issues

Statutory Oil & Gas Liens

- Generally provide for lien on proceeds received by and obligations owed to lessee related to hydrocarbons
- Different treatment in different jurisdictions
 - Louisiana Oil Well Lien Act
 - Texas Property Code
 - Outer Continental Shelf Lands Act: generally look to law of adjacent state
- If lien applies, lienholder may be entitled to adequate protection payments in bankruptcy

Treatment of JOAs

- Generally accepted as executory contracts
 - In older busts, “twilight zone” was frequent concern
- Modern statutes expanded lien rights; non-operator often has lien on operator’s interest
 - As a result, debtors may pay non-operators early in case
 - Still subject to later assumption/rejection, but prepetition amounts may not be at stake
- Setoff and recoupment issues related to JIBs
 - Setoff: nets prepetition costs against prepetition production proceeds – need relief from automatic stay
 - Recoupment: allows netting of prepetition costs against postpetition proceeds *if* part of same transaction

P&A Issues

- Relevant only when wells are being abandoned – usually only in liquidation scenarios
- Regulatory regimes vary, but almost all require some provisions for P&A before allowing abandonment
 - Mechanics: generally a slurry of water, cement and drilling mud
 - Primary question: who pays if debtor cannot?
- *ATP Oil & Gas Corp.*: bonding, exemptions, predecessor liability, decommissioning trust for certain properties
- *Black Elk Energy Offshore Operations, LLC*: bonds secured by cash collateral, government bonds/private bonds, P&A escrows in favor of predecessors

Distress in Coal and Renewables

■ Coal

- Since 2010, 232 U.S. coal plants (1/3 of fleet) shuttered or retired
- Nearly all leading coal companies encountering bankruptcy
- Results: mix of reorganizations and liquidations (or with *Patriot Coal*, one of each)
- Like P&A, issues if liquidating debtor cannot cover envt'l liabilities

■ Renewables

- Earlier batch, headlined by *Solyndra, Inc.*
 - Product of crashing prices of PV solar panels
- Today, *SunEdison, Inc.*
 - More a sign of rapid debt-fueled expansion – though ironically, SUNE received more in federal grants than Solyndra

- Take steps to perfect security interests as early as possible, and analyze competing liens
- Prior to bankruptcy, analyze contractual rights, status of credit support, MTM position
- Immediately upon bankruptcy, analyze status of perfection, setoff/recoupment rights, deliveries, payables/receivables
- Monitor docket activity for orders that may affect interests (*e.g.*, utility orders, claims bar date orders), especially early in case
- Respect the automatic stay, but consider relevant exceptions and possible strategic violations (rare)

- File proof of claim in gross amount, with documentary support and broad descriptions of bases for claim
 - If hard-copy filing required, leave an extra day for courier mishaps
 - Selling a claim is usually a bad deal, but consider whether circumstances warrant it
- If any claims qualify for administrative expenses, file a motion
 - Usually including 503(b)(9) claims
- Consider whether asset acquisition might be attractive, particularly if credit bidding is available
- Review any proposed Plan of Reorganization carefully, and consider filing protective objections

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