Current Issues in the Energy Sector

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AMERICAN BANKRUPTCY INSTITUTE

New York City Bankruptcy Conference: Current Issues in the Energy Sector

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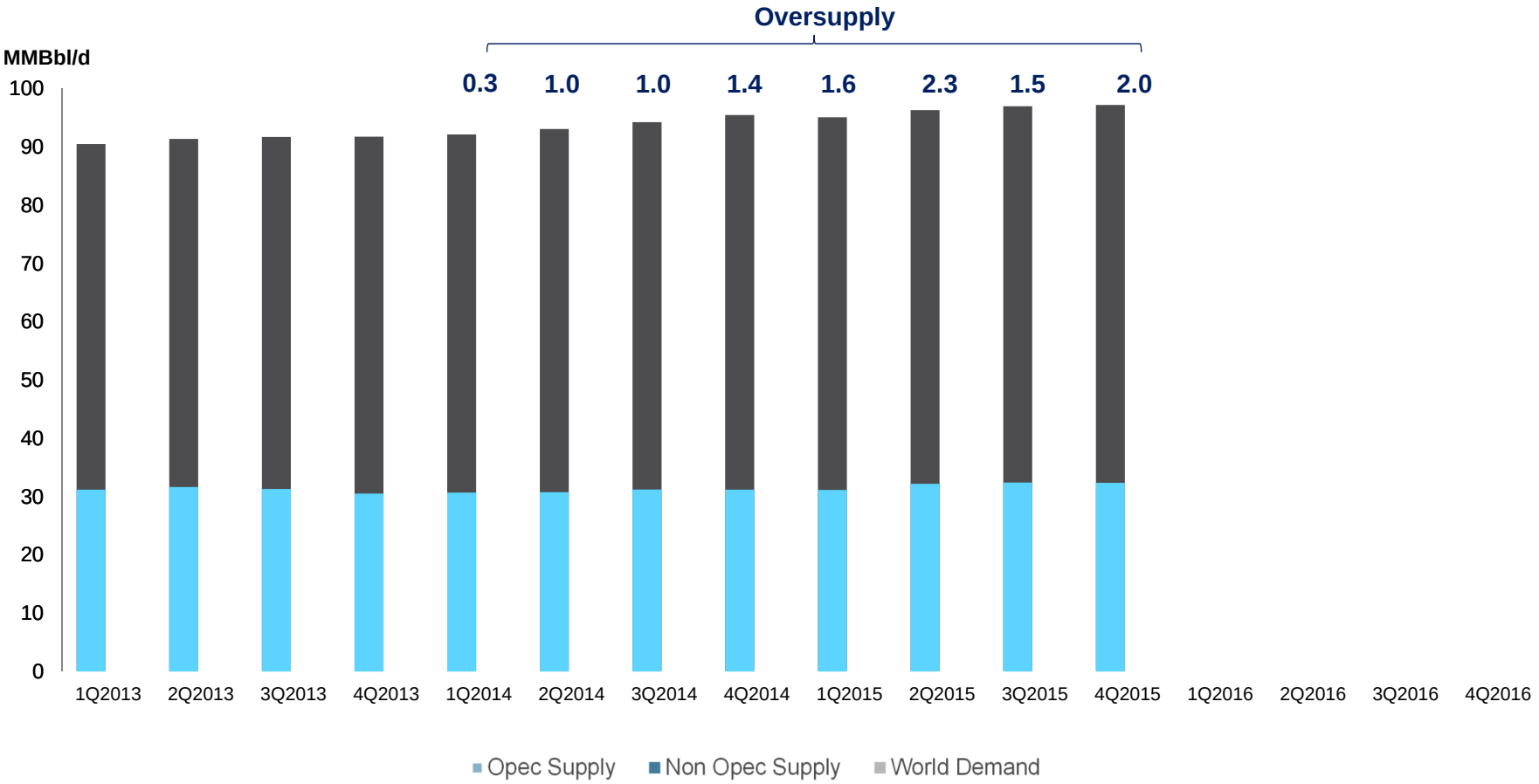
Business Overview

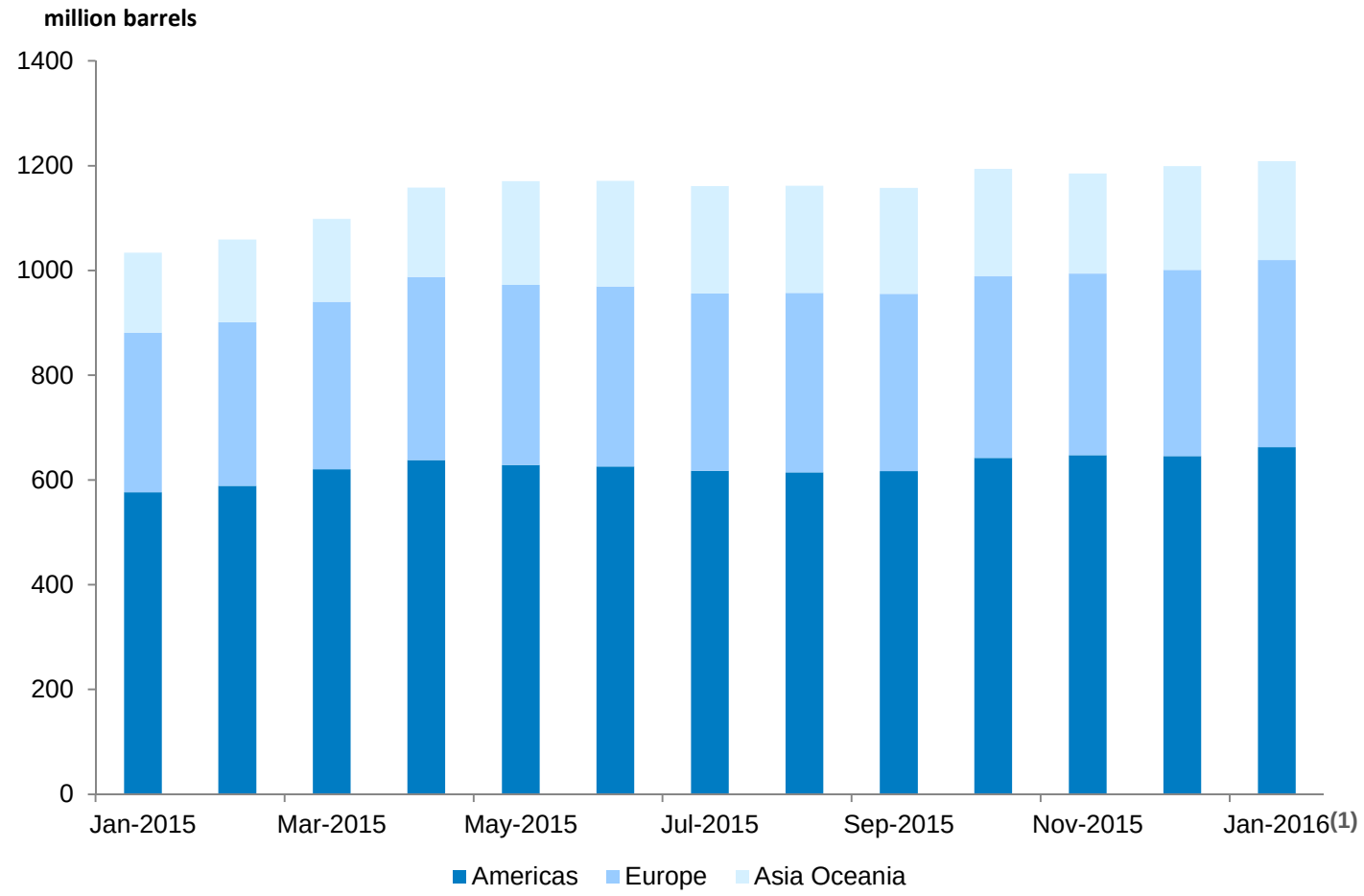
World Oil Supply and Demand



- **Trend shows decelerations in demand growth**
- **Crude prices rose to their highest in three months in early March, with WTI above the $40/bbl level**
- **Opec and Non-Opec Producers meeting on April 17th**

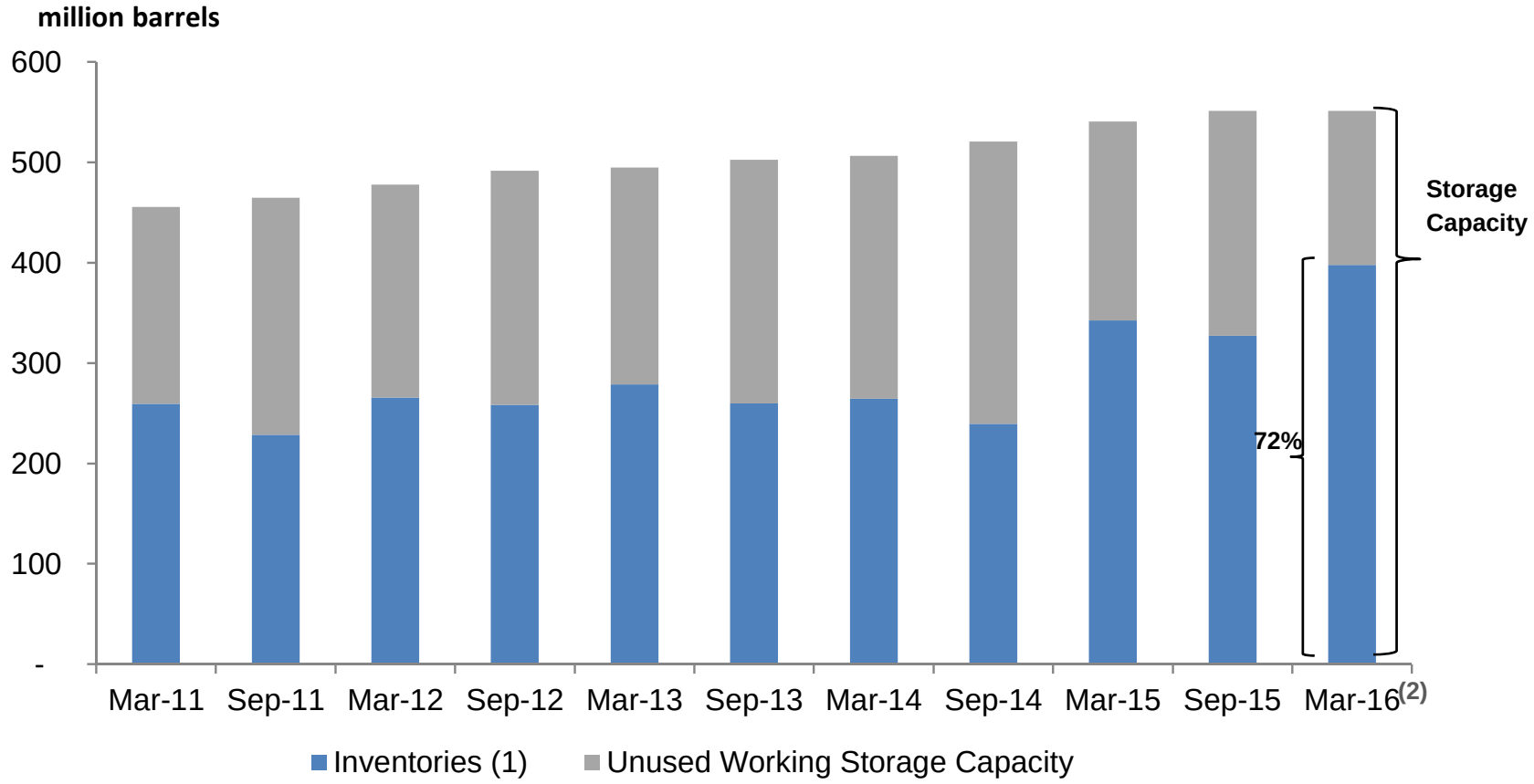
Source: IEA

OECD Crude Oil Industry Stocks



Source: IEA
(1) Estimated

US Commercial Crude Oil Storage Capacity and Utilization

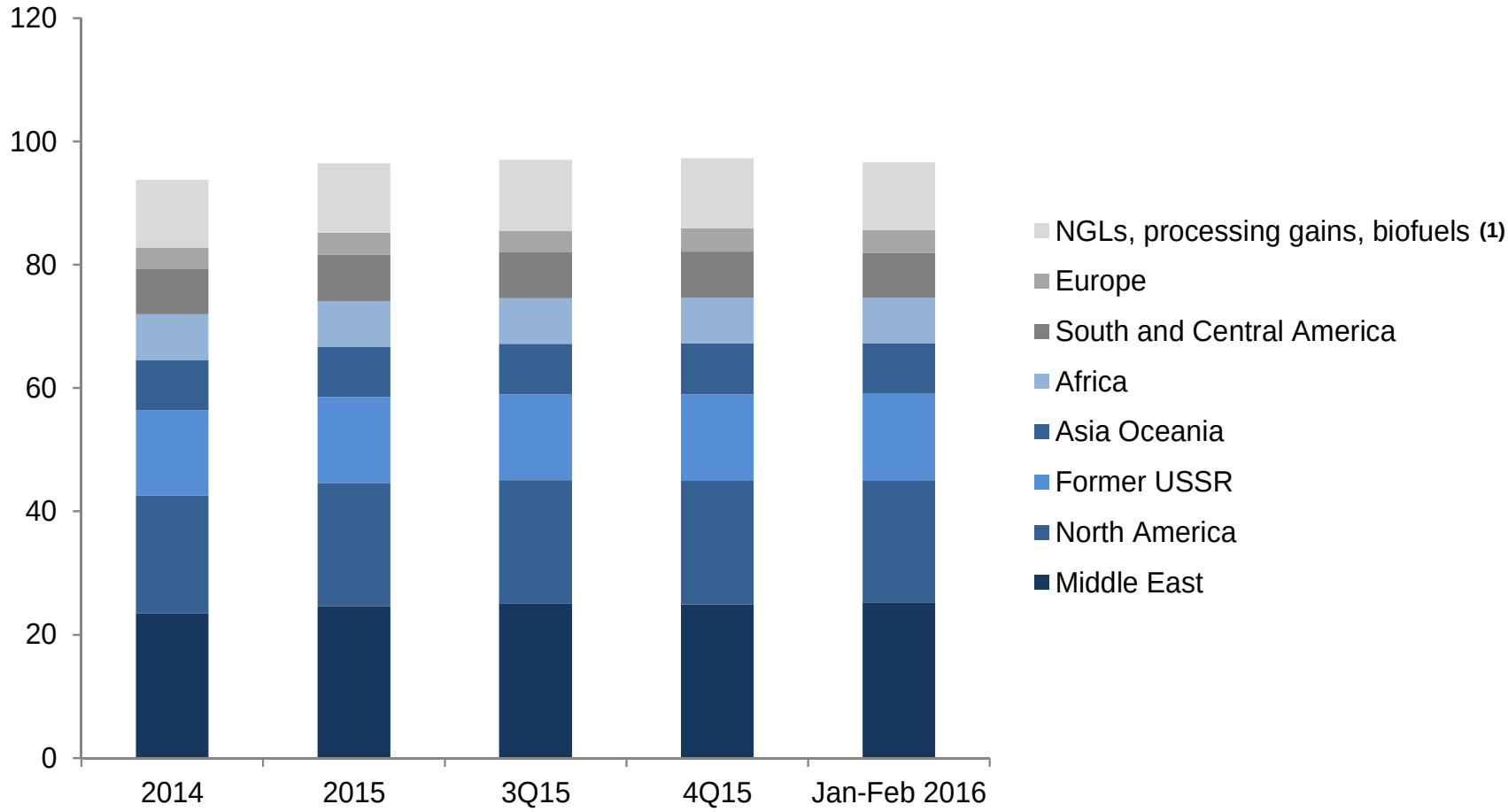


Source: EIA

(1) Inventories shown in the graph do not include pipeline fill, lease stocks, or oil in transit from Alaska

(2) March 2016 shows crude oil inventories as of March 25 2016, adjusted for oil stocks in transit from Alaska, and for estimated lease stocks and pipeline fill. Storage capacity assumed constant to the capacity for September 2015

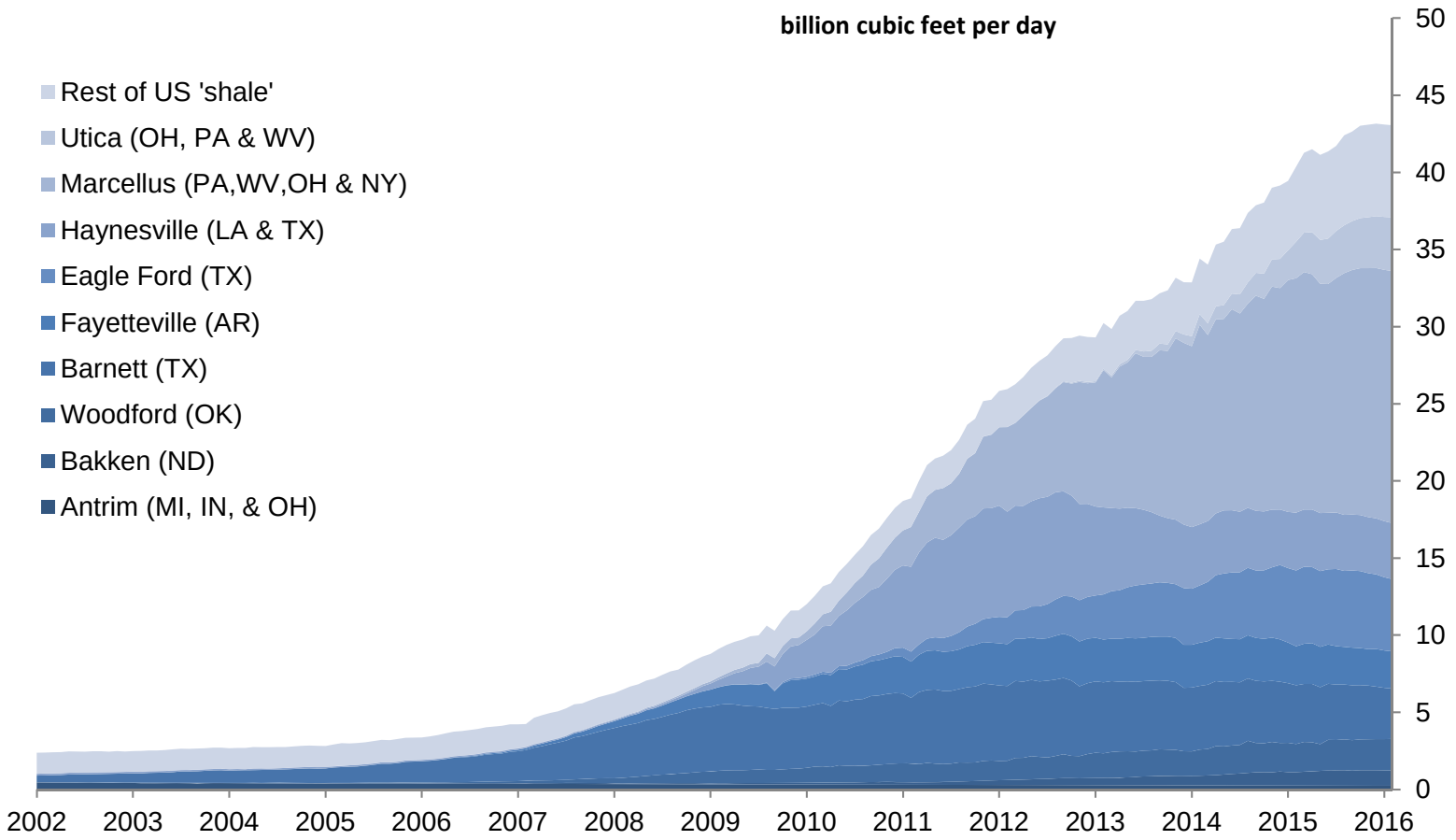
Global Oil Production by Region



(1) NGLs Include condensates and oil from non-conventional sources reported by OPEC countries, e.g. Venezuelan Orimulsion (but not Orinoco extra-heavy oil), and non-oil inputs to Saudi Arabian MTBE. Processing gains include net volumetric gains and losses in refining and marine transportation losses

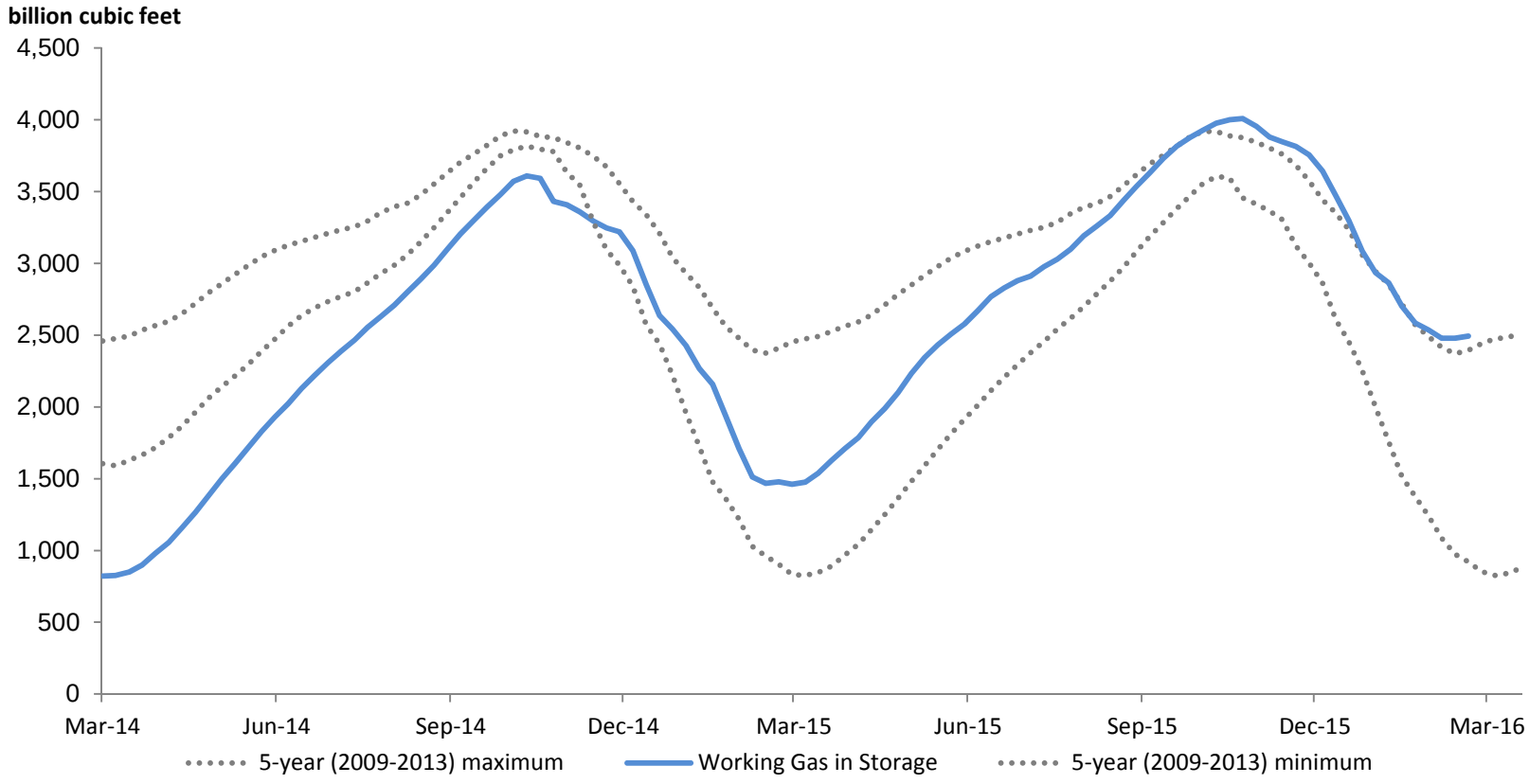
Source: IEA

US Natural Gas by Region



Source: IEA

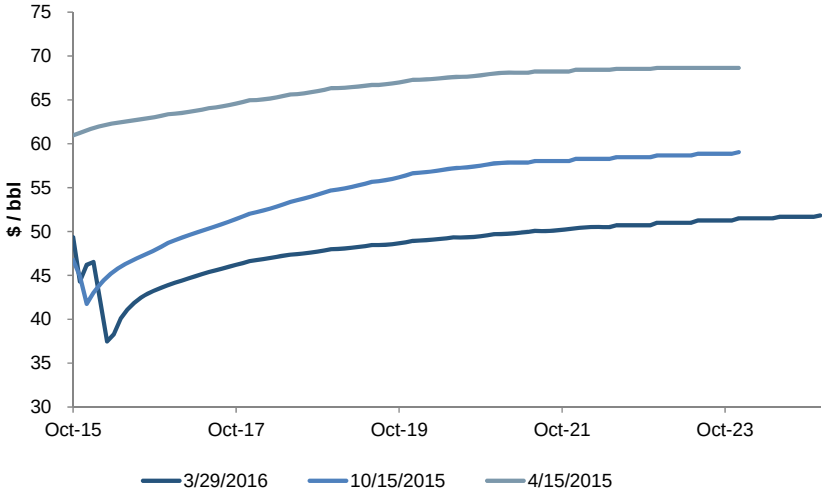
US Natural Gas Storage



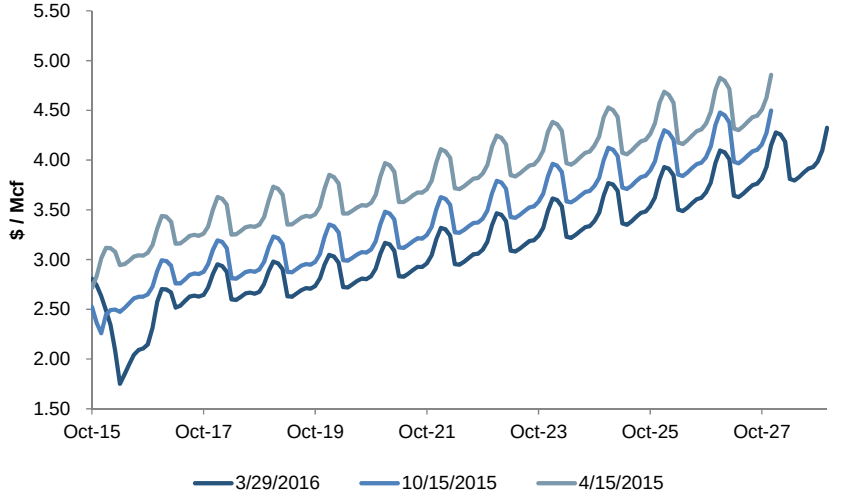
Source: IEA

Market Update

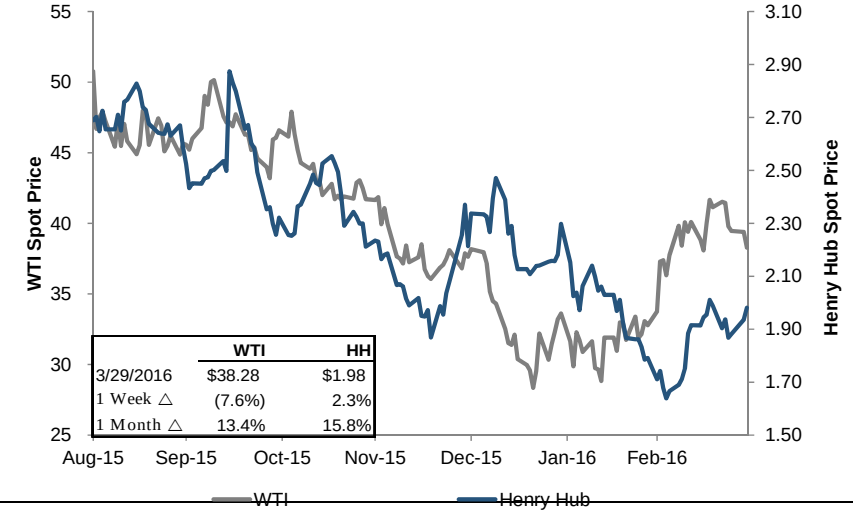
WTI Strip Comparison



Nat Gas Strip Comparison



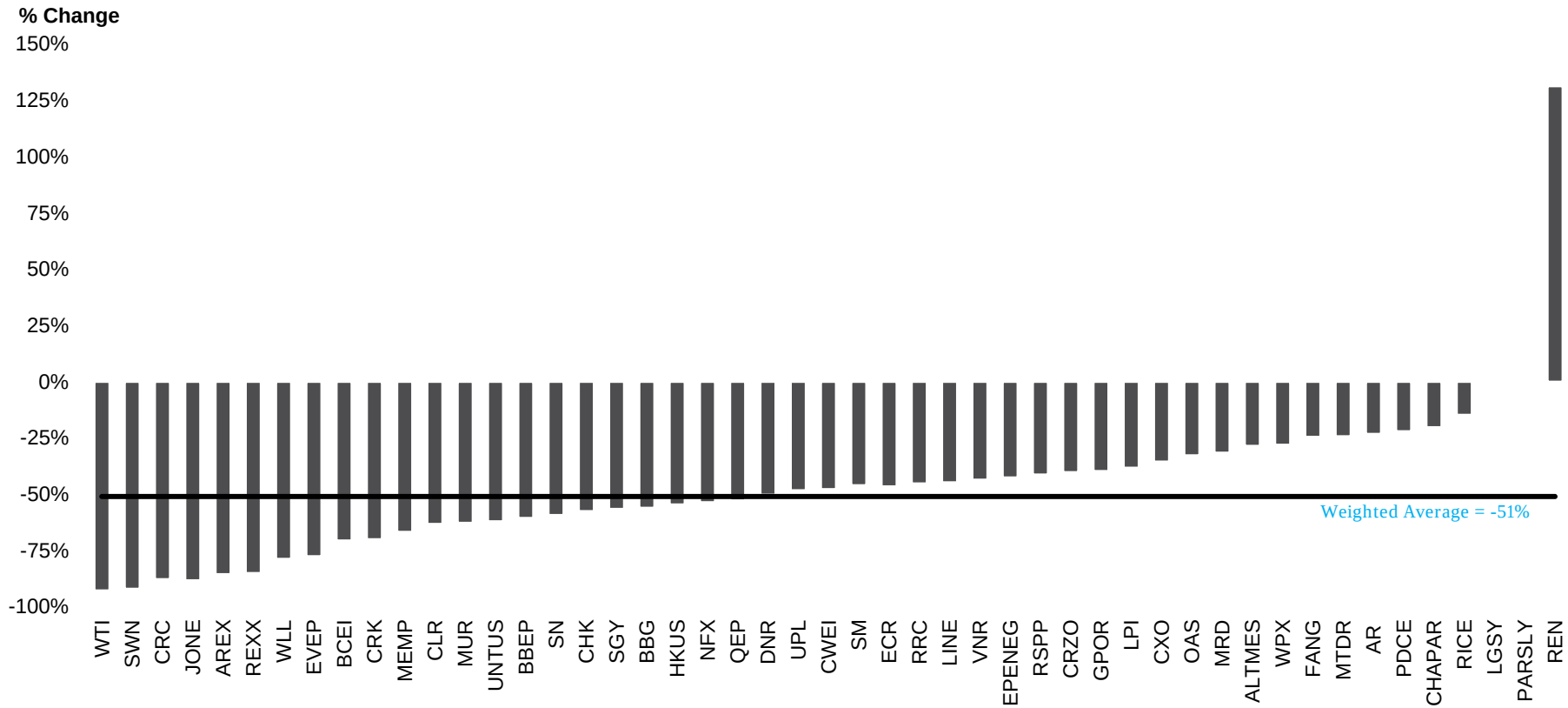
Historical Spot Prices



	WTI	HH
3/29/2016	$38.28	$1.98
1 Week △	(7.6%)	2.3%
1 Month △	13.4%	15.8%

Source: Cap IQ

2016E YoY Capex % Change



Source: Company reports

Key E&P Restructuring Players and Issues

Key Players in E&P Restructurings

- Company / Debtor
- Secured (first and second lien) creditors
- Noteholders
- M&M lien claimants
- Service providers
- Derivative counterparties
- Regulatory agencies
- Royalty owners
- Working interest owners
- Farmers / farmees / production payment parties
- Executory contract parties (JOAs, gathering systems, etc.)
- Equity
- DIP Lender

Source: IEA

Key E&P Restructuring Issues

- Value of reserves at current strip pricing
- Value of other assets
- Collateral - encumbered vs. unencumbered Assets
- Cash burn / liquidity runway
- Midstream contracts
- Post-reorganization capital structure
- Ability / attractiveness of selling asset in current environment
- Preserving joint operating agreements
- P&A Liabilities
- Exit financing
- Development plans in a depressed commodity price environment
- Quality of management
- Cost reductions: LOEs and G&A

Source: IEA

Oil & Gas Concepts

Oil & Gas Concepts

> *"In attempting to convert dreams of black gold to hard cash, aspiring capitalists split the property interest in oil into more fragments than the atom or the rainbow." Jones v. Salem Nat'l Bank (In re Fallop)*, 6 F.3d 422, 424 (7th Cir. 1993).

- In general, the oil and gas industry uses a number of unique arrangements to govern the relationships among the multitude of parties involved in the exploration, production, transportation and delivery of oil and gas.
  - Rights and functions may be allocated among parties under various types of agreements, which can vary depending on the facts and circumstances involved, including the location of the oil and gas assets.
  - The entitlements of these parties in the context of a producer's bankruptcy may raise issues of law that have not been fully addressed (or resolved) by courts, and which could turn on the presence of one or more industry and jurisdiction-specific factors.

Oil & Gas Concepts

Oil & Gas Leases

- An oil & gas lease typically is an agreement between a property owner, as lessor, and an oil and gas company, as lessee, describing the parties' rights and obligations with respect to the exploitation of oil and gas reserves located below the surface of the owner's property.

- Typically, an oil and gas lease conveys to the oil company the mineral owner's rights to explore, develop and produce oil and gas. In return, the producer pays the lessor a monetary share of the value of the oil and gas produced. The lessor's economic benefits include may include a rental, a royalty based on the value of the oil and gas produced, and a bonus.

  - In most states with a history of oil and gas production (including Texas), ownership of the mineral estate may be "severed" and conveyed separately from the "surface" estate.

  - In other states, fee simple ownership of a tract of land necessarily includes the minerals below.

  - In addition, other fractionalized interests and rights of varying scope and duration may exist.

Oil & Gas Concepts (cont'd)

- Despite its name, an oil and gas "lease" allows the producer to develop and extract sub-surface minerals and gives the producer ownership of the oil and gas that is extracted from the property, subject to satisfaction of certain contractual conditions.
  - For example, the lease will typically require payment of royalties based on a percentage of production, and may contain "continuous drilling" or similar provisions that require payments or result in termination if the producer ceases production.
  - In many states (including Texas), the producer's rights under the lease are treated as a *real property* interests in the subsurface minerals, provided that the producer continues to exploit such interests and/or make royalty payments in accordance with the terms of the lease; in other states, such rights are treated as *personal property* interests.

Oil & Gas Concepts (cont'd)

Working Interest

- By virtue of its execution of an oil and gas lease, the E&P company becomes the 100% "working interest" owner and also obtains a royalty interest in the amount conveyed by the mineral interest owner under the oil and gas lease.
- In contrast to the mineral owner's royalty interest, a "working interest" holder will have the right to explore and develop the minerals along with the obligation to pay the costs associated with exploration and development.
- A working interest in a property does not exist in perpetuity, but is governed by the terms of the oil and gas lease. Termination may be conditioned on a number of circumstances, including: (a) the failure to meet specified minimum production requirements, (b) the end of the productive life of a well, and (c) a date agreed upon by the parties.
- The working interest holder may use portions of its interest to finance production, either by selling part of its working interest to third parties, using a fractional part of its net revenue as collateral for a loan or by selling a portion of the income to be generated by production in connection with the working interest.

Oil & Gas Concepts (cont'd)

Royalty Interests

- The owner of a "royalty interest" is entitled to share in a stated portion of gross production, if any, but has no right to enter the land and extract the minerals itself .
- As such, the royalty interest is a "nonworking" interest – *i.e.* the holder of a royalty interest is not obligated to pay any of the costs associated with exploration or production.
- A "landowner's royalty interest" is, as discussed above, a type of interest commonly dealt with by bankruptcy courts, as it is the interest retained when a mineral owner grants a working interest .

Oil & Gas Concepts (cont'd)

Overriding Royalty Interests ("ORRIs")"

- Unlike a landowner's royalty interest, an "overriding royalty interest" typically is carved out of a working interest

- As a general matter, there are two types of ORRIs–

  - "Perpetual ORRIs" last for the life of the lease between the working interest holder and the mineral rights holder

  - "Term ORRIs" are limited in duration until a specified volume of production or stated value of production is reached

Oil & Gas Concepts (cont'd)

Net Profits Interests

- Similar to ORRIs, "net profits interests" or "NPIs," are carved out of a working interest, but net profits interests are only payable to the NPI holder out of the profits earned from production over a contractually agreed-upon time period.

- State law is less clear whether NPI's are considered to be a personal contractual right as opposed to a real property interest, even in jurisdictions where royalty interests are considered to be interests in real property.

Oil & Gas Concepts (cont'd)

Production Payments

- Production payments, like ORRIs, refer to an interest created out of the lessee's estate, which is a share of the minerals produced from described premises, free of the costs of production at the surface.
- Production payments, in contrast, terminate either
  - Upon the expiration of the lease, or
  - When the owner of the production payments has received the agreed quantum of production or dollar amount from the sale of production.
- Production payments sometimes are called "term ORRIs" because they operate like an overriding royalty interest with a specified term.

Oil & Gas Concepts (cont'd)

Joint Operating Agreements

- If there are other parties with an interest in oil and gas leases in the area that the producer wishes to exploit, the producer may enter into a "joint operating agreement" or "JOA" with such interest holders.
  - JOAs are typically based on a standard form by the American Association of Professional Landmen.
- JOAs are treated as executory contracts under the Bankruptcy Code, but are not typically "rejected", as in the absence of a JOA, the parties' relationship would merely be one of co-tenants under state law 365 . (*E.g.*, *Wilson v. TXO Prod. Corp. (In re Wilson)*, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987).)
  - Absent a JOA setting forth explicit rules for the division of costs and benefits of a well, the default rules under state tenancy law would apply and could impose fiduciary duties or other obligations on the parties that are inconsistent with their intent or expectations.

Oil & Gas Concepts (cont'd)

- JOAs appoint one party as the "operator," who is responsible for conducting operations with respect to a given well or area, and who contracts with third-party service providers as necessary to carry out such operations.
  - Operator and non-operator(s) bear risks of non-performance of the other
  - Lien rights, non-consent penalties
  - Are they of record/perfected?
- Although the risk of JOA rejection cannot be entirely eliminated, a party may mitigate that risk by (1) including a standard provision ensuring that the joint operating agreement is construed as an executory contract and providing for adequate assurance of performance; (2) filing a memorandum of the operating agreement of record to protect any contractual lien rights; (3) negotiating for and preserving offset and recoupment rights; and (4) drafting the operating agreement to protect certain rights as covenants running with the land, which are not subject to rejection in bankruptcy.

Oil & Gas Concepts (cont'd)

Gathering Agreements

- In addition to a JOA, the operator may enter into a gathering and processing agreement (a "Gathering Agreement") with a midstream service provider, which typically:
  - Provides for transportation from the well-head through a "gathering system" to a major transport pipeline, hub or refinery, and/or as processing that may be required before delivery "downstream"
  - Has a duration of several years (20-year terms are not uncommon)
  - Is priced on a per unit basis (*i.e.*, cost determined by volume of hydrocarbons going through system)
- Gathering Agreements may contain minimum volume commitments that result in penalty payments if unmet, regardless of whether oil or gas is being transported through the system:
  - If such minimum requirements are present, a producer may to continue to operate an under-producing or unprofitable well, simply to absorb a portion of the payments

Oil & Gas Concepts (cont'd)

- Absent minimum volume commitments, the producer might simply shut-in the well (*i.e.*, cease to produce oil or gas) or use the threat of doing so to negotiate for more favorable rates from the midstream service provider

- Gathering Agreements may contain "dedication" language whereby the producer agrees to send *all* oil or *all* gas produced from the well through the system (particularly if the gatherer has built out portions of the system for the producer).
  - *Key Point*: Dedication language can be important factor in whether a midstream agreement is an executory contract or a "covenant that runs with land" for purposes of the Bankruptcy Code—an executory contract can be rejected under section 365 of the Bankruptcy Code, while a covenant running with the land likely cannot be rejected.

Rejection of Oil & Gas Agreements: *Sabine and Quicksilver*

Rejection of Oil & Gas Agreements

Subject to Section 365 or Not?

- Many long-term oil & gas-related agreements have, with the downturn in the oil and gas markets, become economically burdensome for their E&P signatories.
- Gathering agreements entered into before the downturn, for example, may now be "above market" and contain minimum volume commitments and prohibitions on a producer's ability to transport and/or process oil or gas with another provider.
- A distressed producer may wish to rid itself of burdensome midstream agreements (or increase leverage to renegotiate such agreements) through a chapter 11 filing, but questions may exist as to whether such agreements are (a) "executory contracts" under Section 365 of the Bankruptcy Code that may be rejected; or (b) alternatively, whether they contain "covenants that run with the land" that may not be rejected by a debtor (and which would survive as ongoing obligations of the debtor).

Rejection of Oil & Gas Agreements (cont'd)

Covenants Running with Land

- Under Texas state law, in order to determine whether a covenant "runs with the land," the following requirements must be satisfied:

  (i) there must be "horizontal" privity and "vertical" privity of estate

  (ii) covenant must "touch and concern" the land

  (iii) covenant must relate to a thing in existence or specifically bind the parties and their assigns

  (iv) covenant must be intended by the original parties to run with the land; and

  (v) the successor to the burden must have adequate notice.

- Most states employ similar common law factors, although some do not require a showing of "horizontal" privity for a covenant to run with the land.

Rejection of Oil & Gas Agreements (cont'd)

Sabine

- Many of the foregoing issues were addressed by Judge Chapman in a recent decision in the chapter 11 cases of Sabine Oil & Gas Corporation and its affiliates ("Sabine"), pending before the U.S. Bankruptcy Court for the Southern District of New York
  - In *Sabine*, the debtors sought to reject (a) certain gathering agreements with Nordheim Eagle Ford Gathering, LLC ("Nordheim") that contained minimum volume commitments and required "deficiency payments" in the event such commitments were not fulfilled, as well as (b) certain agreements with midstream provider HPIP.
  - Nordheim objected to the debtors' motion to reject, arguing that under applicable Texas law, the gathering agreements at issue satisfied the requirements to be considered covenants that run with the land because, among other things, (a) the "dedication" language in the agreements conveyed a real property interest in the hydrocarbons subject to the debtors' lease; and (b) the debtors' promise to pay certain transportation fees under the gathering agreement was the type of agreement that could constitute a covenant running under the land.

Rejection of Oil & Gas Agreements (cont'd)

- For the latter proposition, Nordheim cited a decision by the Fifth Circuit in *Energytec*, in which the court ruled that a promise by the owner of a pipeline running *through* a parcel of property to make certain ongoing payments to the landowner could constitute a covenant running with the land.
- The *Sabine* debtors argued that the gatherers were unable to satisfy the Texas state law test to demonstrate a covenant running with the land, including the elements of privity and "touch and concern."
- The objectors also argued that the Second Circuit's decision in *In re Orion Pictures* precluded Judge Chapman from ruling on whether the agreements contained covenants running with the land under Texas law in the context of the debtors' rejection motion.
- On March 8, 2016, Judge Chapman issued a bench decision (i) ruling that the *Sabine* debtors had met their burden under section 365(a) of the Bankruptcy Code for rejection of the Nordheim and HPIP agreements; and (ii) determining on a "non-binding" basis that the agreements were not covenants running with the land under Texas law, but ruling that the Second Circuit's decision in *Orion* precluded her from making a final ruling on the issue in the context of the rejection motion.

Rejection of Oil & Gas Agreements (cont'd)

- With respect to the Sabine debtors' decision to reject the agreements, the court noted that it only needed to assess the reasonableness of the decision from the perspective of the debtor – i.e., it did not need to consider the adverse impact on Nordheim and HPIP.
  - Given that the debtors were unable to meet their ongoing obligations under the agreements, the court found they had satisfied their burden for rejection.
- Judge Chapman also analyzed the agreements under the multi-factor test used by Texas courts for determining whether an agreement is a "covenant running with the land" and concluded that the agreements only granted interests in (and impacted the value of) oil and gas extracted from the land, which she found to constitute personal – not real – property under Texas law.
  - As such, the court determined the objectors could not establish "horizontal privity" or that the agreements "touched and concerned" any *real* property.
- Although Judge Chapman cast her decision as a "non-binding" ruling, she made it clear that she did not expect to re-litigate these issues in the context of the yet-to-come Orion-compliant proceedings.

Rejection of Oil & Gas Agreements (cont'd)

- On March 18, 2016, the *Sabine* debtors commenced adversary proceedings against each of Nordheim and HPIP, seeking declaratory judgment that the covenants at issue in the relevant agreements did not run with the land.
- On May 3, 2016, Judge Chapman issued a Memorandum Decision which largely echoed the rulings that had previously been made, holding that the covenants at issue do not run with the land under Texas law either as real covenants or equitable servitudes.

Rejection of Oil & Gas Agreements (cont'd)

Quicksilver

- These issues are also the subject of a dispute in the chapter 11 cases of Quicksilver Resources and its affiliates ("Quicksilver"), pending before Judge Silverstein in the U.S. Bankruptcy Court for the District of Delaware
  - In *Quicksilver*, the debtors sought to reject certain gathering agreements with Crestwood Midstream Partners, LP ("Crestwood"), and to sell the underlying oil and gas leases to BlueStone Natural Resources II, LLC ("Bluestone") in a sale "free and clear" of any asserted real property interests under section 363(f).
  - Crestwood objected to the debtors' motion to reject, arguing that under applicable Texas law, the gathering agreements at issue granted certain rights to Crestwood that satisfied the requirements to be considered (i) covenants that run with the land, or, alternatively, (ii) equitable servitudes.
  - The *Quicksilver* debtors argued that the Crestwood was unable to satisfy the Texas state law test to demonstrate that Crestwood's interests constituted either covenants running with the land or equitable servitudes, and argued that even if Crestwood could do so, the debtors would still be able to sell their assets "free and clear" of any such property interest under section 363(f).

Rejection of Oil & Gas Agreements (cont'd)

- Crestwood also argued that the debtors were required to initiate an adversary proceeding to determine the extent of Crestwood's real property interests, or, alternatively, to obtain a declaratory judgment that Crestwood's interests are not real property interests running with the land.
- This issue was fully briefed, and oral argument was heard on March 4, 2016. However, the issue was resolved consensually, as the *Quicksilver* debtors withdrew their motion to reject the Crestwood gathering agreements, and Crestwood signed new gathering agreements with Bluestone. As such, no ruling was issued.

Plugging and Abandonment Liability

Plugging and Abandonment Liability

- Under state and federal law, E&P companies generally are obligated to plug and abandon a well after drilling or production ceases.
  - Conflicts arise between federal and state statutes and regulations imposing operational and financial obligations on operators that seek to "plug and abandon" or "decommission" wells and the broad power granted by the Bankruptcy Code to abandon property, reject contracts, and subordinate claims.
  - Under federal law, oil and gas companies operating offshore on the Outer Continental Shelf, or OCS, are obligated to plug and remove all structures on a lease within one year of the end of production.
    - The federal agency responsible for all Outer Continental Shelf oil and gas leasing, the Bureau of Ocean Energy Management (or BOEM), requires companies that do not meet certain financial thresholds to provide a surety bond that ensures funds are available for plugging and abandoning (P&A) wells and removal operations at the end of the lease in the event of bankruptcy.

Plugging and Abandonment Liability (cont'd)

- Working interest owners not deemed financially capable to acquire surety bonds may set up escrow accounts or acquire U.S. Treasury bonds to meet their decommissioning liabilities. The BOEM determines the amount of that estimated P&A liability, and therefore the size of the bond required, in accordance with federal regulation.
- During periods of financial stress in the upstream sector, operators and working interest owners may be required to provide supplemental bonding, which at times can be quite significant.

➢ Accordingly, one of the major issues that often arises in bankruptcies involving E&P companies with offshore oil and gas leases is whether a P&A claim is entitled to administrative priority.

- A Fifth Circuit decision held that a P&A claim arising postpetition is entitled to administrative priority if the P&A liability accrued under state law, and interpreted the law of Texas in that regard. State v. Lowe (In re H.L.S. Energy Co., Inc.), 151 F.3d 434 (5th Cir. 1998).

Plugging and Abandonment Liability (cont'd)

- Nevertheless, debate remains over whether the court's reasoning in the H.L.S. Energy case was influenced by the Texas Railroad Commission's finding that the wells created an imminent danger to the groundwater. Moreover, the decision did not reach the more nettlesome question of whether P&A liability arising prepetition should be treated as an administrative claim. At least one court has held that a claim for reimbursement of P&A expenses incurred postpetition was entitled to administrative expense status where the debtor's P&A obligations arose prepetition.

➢ Another layer of complexity arises in connection with the obligations of bonding companies who issue bonds to secure an E&P company's P&A obligations. Some courts have held that, where a surety company makes payments to satisfy a debtor's P&A obligations, the surety may be subrogated to the original obligor's claim and priority for the amount funded.

Plugging and Abandonment Liability (cont'd)

- Finally, the question arises at whether such obligations can be rejected under section 365, any related property can be abandoned under section 554, and any related claims can be subordinated under various provisions, including section 364 and 510.
  - However, based upon 28 U.S.C. 959(b) (requiring debtors to "manage and operate property in its possession . . . according to the requirements of the valid laws of the State in which such property is situated") and the Supreme Court's decision in Midatlantic Bank v. New Jersey Department of Environmental Protection, 474 U.S. 494 (1986), courts have generally required debtors to honor prepetition "plugging and abandonment claims" on public health and safety policy concerns. See, e.g., In re H.L.S. Energy, Inc., 151 F.3d 434, 438 (5th Cir. 1998) (declining to permit abandonment of well because "a combination of Texas and federal law places on the trustee an inescapable obligation to plug unproductive wells.")

Energy Sector Valuation Issues

Energy Sector Valuation Issues

- Valuation of assets in all sectors of the energy market involves unique criteria and the application of specialized expertise.
  - ➢ Oil & Gas Valuation
    - Petroleum Engineering Expertise: Need to evaluate geologic data and draw inferences regarding future production.
    - Reserves: Different values assigned to proven, probable, and possible reserves; values may differ in financing and acquisition contexts.
    - Risk Analysis: Critical to factor in both reserve and market risks: (i) reserve risk, to the extent that projected reserves can never be economically developed; and (ii) market risk, to extent that developed reserves may be sold into a glutted market.
    - Rolling Basis; Aggregated for Fair Value: Because the amount of reserves in producing wells is constantly declining, reserve reports must be updated on periodic basis. Reserve reports produced on well-by-well basis; corporate fair value analysis requires consideration of other assets, liabilities and risks at the corporate level.

Energy Sector Valuation Issues

- Power Asset Valuation
  - Discounted Cash Flow: Key input is price for product sold, but where multiple products sold (e.g., electricity, capacity, supporting services), calculation is complex.
  - Option Valuation: Key input is term structure of volatility, but again, given multiple factors affecting market volatility, option analysis is not straightforward.
  - Monte Carlo DCF: Set up distributions for each input assumption and then randomly simulate thousands of outcomes to generate anticipated equity returns.
- Application to Secured Creditors
  - Dual Tracks: Different assumptions and discounting metrics applicable when valuation is performed for financing rather than acquisition purposes.

Environmental Issues

Environmental Issues

Unique and Unprecedented

- Ever more stringent environmental regulations impose on energy sector participants unique and unprecedented capital costs, with cascading effects throughout the sector.

Applicable Regulation

- The Clean Air Act is the primary source of federal environmental law governing such matters. The Act establishes a dual-responsibility regime under which the federal EPA sets air quality standards that the states enforce under State Implementation Plans. The federal regime, however, is not the sole source of environmental regulation. States can—and often do—issue rules that are stricter than federal requirements.

End-Users

- The impact of such regulation is most acute on the end-users of coal, oil, gas and other fuels, including, primarily electric generating facilities.
  - ➢ Edison Mission Energy: Edison Mission, which was saddled with many coal-burning plants, is the most recent example of an end-user contending it was

Environmental Issues

- crippled by increased environmental capital costs. Under the combined EPA/Illinois regime, EME projected spending in excess of $3.5 billion on a three phase program to reduce emissions. These requirements undermined attempts to restructure or operate company as going concern, as they imposed significant costs on future operation of the facilities.

Coal and Oil Suppliers

- The second-level impact of such regulation on suppliers of fuel to generating facilities has been equally catastrophic. Coal miners, and to lesser extent oil refiners, have been adversely affected by shutdown of coal and oil-burning facilities in favor of less expensive, and environmentally more friendly, gas-fired generating plants.
  - Patriot Coal: In justifying its chapter 11 filing, Patriot Coal contended that "the regulation of electricity generators has made it increasingly difficult for companies to use coal as an energy source and may lead to a further reduction in the amount of coal consumed by the electricity generation.

Environmental Issues

- ATP Oil & Gas Corp.: ATP, in turn, blamed its downfall on an "increasingly uncertain regulatory environment" that "adversely affected [its] operations and planned development that was necessary to service its additional debt." (Affidavit of Albert L. Reese, Jr. ¶ 22.)

Environmental Issues

Mining-Specific Environmental Issues

- Mining is regulated by a number of statutes, including the Surface Mining Control and Reclamation Act or "SMCRA," the Clean Air and Clean Water Acts, the Resource Conservation and Recovery Act and the Comprehensive Environmental Response, Compensation and Liability Act also known as Superfund.
- SMCRA requires environmental protection and reclamation standards to be satisfied during mining activities
- SMCRA, among other things, requires a coal mine operator to provide a performance bond to the appropriate regulatory authority (either an office within the US Department of the Interior or, where so assumed by a state, a similar state entity) to ensure performance of all permit and regulatory requirements
- Mining companies are allowed to self-bond their liabilities in a number of states. But self-bonding may create additional problems for coal companies in financial distress if they are unable to maintain financial benchmarks required to qualify for self-bonding.
  - For example, the primary reason that Alpha Natural Resources was compelled to file for bankruptcy in August 2015 was its failure to satisfy

Environmental Issues

- Wyoming's self-bonding requirements, which imposed a new potential $400 million bonding obligation on Alpha when it could least afford it.

- SMCRA also requires coal operators to pay reclamation fees into trust funds for unfunded remediation costs. These fees are due quarterly and are based on the number of tons of coal mined. In chapter 11 cases, courts have found that fees payable under SMCRA are "excise taxes" that cannot be discharged.

- Coal regulators may also seek to impose liability if an individual (as an agent) fails to operate the mine in an appropriate fashion. For example, failure to remediate property as promised has led to financial liability for the individual agent who acknowledged representing a company, including with respect to promises to remediate.

- Nothing in the US bankruptcy code abrogates an owner or operator's obligation to continue operating the property while the company is in bankruptcy in compliance with environmental laws. Environmental obligations that arise after the bankruptcy filing must be paid as "administrative expenses" ahead of payments to creditors.

Environmental Issues

- The US Supreme Court has made clear that bankrupt companies cannot simply abandon their hazardous properties in a bankruptcy case in contravention of statutes designed to protect public health or safety.

Pension and Benefit Issues

Pension and Benefit Issues

Union Role

- Coal miners have traditionally enjoyed strong protection as a result of collective bargaining agreements.
- Mining companies in bankruptcy have attempted to use the bankruptcy process as a means of stripping themselves of certain obligations to employees and retirees obtained as a result of these collective bargaining agreements.
- In recent years the United Mine Workers of America has lost significant bargaining leverage, as it represents a mere fraction of active miners, partially due to the opening of non-union mines.
- Patriot Coal is a recent example of a mining company that entered chapter 11 seeking to to significantly decrease its obligations to current and former employees.

Pension and Benefit Issues

Pension and Benefit Issues

- Often retiree pensions are in a multiemployer plan, funded in part by contributions from other coal operators:
  - If any one of the companies ceases contributions, other companies may be forced to contribute more to make up the difference
  - Pension Benefit Guaranty Corporation will not intervene to protect pensions unless plan is determined to be distressed.

Pension and Benefit Issues

Pension Obligations

Section 1113 of the Bankruptcy Code addresses pension liabilities under collective bargaining agreements.

- Section 1113 provides, in relevant part, that a debtor in possession may assume or reject a collective bargaining agreement if:

  - subsequent to filing a petition and prior to filing an application seeking rejection of a collective bargaining agreement, the debtor in possession ... shall –

    - (A) make a proposal to the authorized representative of the employees covered by such agreement, based on the most complete and reliable information available at the time of such proposal, which provides for those necessary modifications in the employees benefits and protections that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably; and

    - (B) provide, subject to subsection (d)(3), the representative of the employees with such relevant information as is necessary to evaluate the proposal.

  11 U.S.C. § 1113(a), (b)(1).

Pension and Benefit Issues

- The Bankruptcy Code further requires that the debtor "meet, at reasonable times, with the authorized representative to confer in good faith in attempting to reach mutually satisfactory modifications of such agreement." 11 U.S.C. § 1113(b)(2) (2012). Section 1113(c) provides that:
  - [t]he court shall approve an application for rejection of a collective bargaining agreement only if the court finds that--
    - (1) the trustee has, prior to the hearing, made a proposal that fulfills the requirements of subsection (b)(1);
    - (2) the authorized representative of the employees has refused to accept such proposal without good cause; and
    - (3) the balance of the equities clearly favors rejection of such agreement.

  11 U.S.C. § 1113(c).

Pension and Benefit Issues

Retiree Benefits

- Section 1114 of the Bankruptcy Code addresses "retiree benefits" provided to union employees
- Section 1114(e) of the Bankruptcy Code provides in relevant part that:
  - notwithstanding any other provision of this title, the [debtor] shall timely pay and shall not modify any retiree benefits" unless the court, on the motion of the [debtor] or authorized representative of the retirees, orders, or the debtor and the authorized representative agree to, the modification of such benefits. 11 U.S.C. § 1114(e) (2012).
- Section 1114(b) defines the "authorized representative" as the person designated by a labor organization as the authorized representative of persons "receiving any retiree benefits covered by a collective bargaining agreement." 11 U.S.C. § 1114(b) (2012).

Pension and Benefit Issues

- Section 1114 defines "retiree benefits" as follows:
  - payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title.

  11 U.S.C. § 1114(a) (2012).

Pension and Benefit Issues

- Section 1114(f)(1) provides that a debtor, after filing the bankruptcy petition but prior to filing a motion to modify retiree benefits, shall:
  - (A) make a proposal to the authorized representative of the retirees, based on the most complete and reliable information available at the time of such proposal, which provides for those necessary modifications in the retiree benefits that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably; and
  - •(B) provide, subject to subsection (k)(3), the representative of the retirees with such relevant information as is necessary to evaluate the proposal.

  11 U.S.C. § 1114(f)(1).
- The debtor is also required to meet with the authorized representative of the union at reasonable times to confer in good faith in an attempt to "reach mutually satisfactory modifications to such retiree benefits." 11 U.S.C. § 1114(f)(2).

Pension and Benefit Issues

Order Modifying Retiree Benefits

- Pursuant to Section 1114(g), a court shall enter an order that permits the modification of retiree benefits if the court finds that:
  - (1) the [debtor] has, prior to the hearing, made a proposal that fulfills the requirements of subsection (f);
  - (2) the authorized representative of the retirees has refused to accept such proposal without good cause; and
  - •(3) such modification is necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities.

11 U.S.C. § 1114(g).

Pension and Benefit Issues

Criteria for Modification of Retiree Benefits

- For court approval of a motion to reject and modify a CBA under Section 1113 or to modify retiree benefits under Section 1114, the debtor must meet the following requirements:
  - The debtor in possession must make a proposal to the Union to modify the collective bargaining agreement.
  - The proposal must be based on the most complete and reliable information available at the time of the proposal.
  - The proposed modifications must be necessary to permit the reorganization of the debtor.
  - The proposed modifications must assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably.
  - The debtor must provide to the Union such relevant information as is necessary to evaluate the proposal.

Pension and Benefit Issues

- Between the time of the making of the proposal and the time of the hearing on approval of the rejection of the existing collective bargaining agreement, the debtor must meet at reasonable times with the Union.
- At the meetings the debtor must confer in good faith in attempting to reach mutually satisfactory modifications of the collective bargaining agreement.
- The Union must have refused to accept the proposal without good cause.
- The balance of the equities must clearly favor rejection of the collective bargaining agreement.

Pension and Benefit Issues

CASE STUDY: Peabody Coal/Patriot Coal:

- Patriot Coal – Bankr. E.D. Missouri (Judge Surratt-States)
- Peabody Coal – S.D. West Virginia (Judge Goodwin)

Factual Background

- Prior to October 31, 2007, Patriot Coal Corporation and a number of its subsidiaries (collectively, "Patriot") were wholly-owned subsidiaries of Peabody, the world's largest private-sector coal company.
- On October 31, 2007, Patriot was spun-off from Peabody through a dividend of all of its outstanding shares.
- In exchange for stock in Patriot, Peabody contributed subsidiary companies (assets and liabilities) to Patriot, together with the retiree health care liabilities associated with those operations.

Pension and Benefit Issues

- As a result of the spin-off, Patriot became a separate, public company and the independent parent of 64 subsidiaries.
- Peabody agreed to pay liabilities that Patriot incurred for the provision of health care benefits for 3,100 retired miners (hereinafter the "Peabody-Assumed Group").

Patriot 2008 Acquisition Of Magnum

- In 2005, Arch Coal sold 100% of the stock of three Arch subsidiaries to Magnum Coal Company (hereinafter "Magnum"). This transaction allowed Arch to assign to Magnum less than 15% of its assets but more than 90% of Arch's retiree health care liabilities.
- In 2008, Patriot announced that it signed an agreement to purchase Magnum. At the time of its acquisition by Patriot, Magnum was one of the largest coal producers in Appalachia. A substantial portion of those mining operations were operated by UMWA-represented labor.
- The acquisition of Magnum caused Patriot Coal to assume Magnum's liabilities for health care benefits to current and former employees of Magnum and other entities associated with Arch.

Pension and Benefit Issues

- Following the Magnum acquisition, over 90% of the health care beneficiaries who received post-retirement benefits from Patriot were former employees or dependents of former employees of Peabody, Arch or their subsidiaries that were acquired by Patriot.
- As of February 2013, Patriot paid for or administered retiree health care benefits to approximately 21,000 individuals.
- In 2012, Patriot spent approximately $83 million dollars on retiree health and financed benefits administered pursuant to the Coal Act for more than 2,300 retirees and dependents, and other benefits for approximately 1,200 non-union retirees and dependents.
- Patriot spent approximately $20.8 million dollars in 2012 on contributions to the 1974 Pension Plan.

Pension and Benefit Issues

Patriot Coal 1113/1114 Motion

- Patriot filed a motion in its chapter 11 cases proposing to make various modifications to the CBAs to divest itself of the responsibility to provide retiree benefits and pensions.

Patriot Coal Opinion (May 29, 2013):

- The Bankruptcy Court found:
  - There was no dispute that, for Debtors to survive, concessions were necessary.
  - Patriot's obligations for retiree benefits consumed double its revenue in relation to competitors.
  - Patriot also faced considerable expense and impediments to productivity if the current CBAs remained in place, with the result that Patriot would not be competitive in the coal market.
- The Bankruptcy Court:
  - granted the Motion to Reject Collective Bargaining Agreements and to Modify Retiree Benefits;

Pension and Benefit Issues

- authorized Patriot to terminate retiree benefits for certain of its current retirees pursuant to Section 1114 of the Bankruptcy Code; and
- transition the retiree health care to the UMWA Retiree Healthcare Trust, to be structured as a Voluntary Employee Beneficiary Association (VEBA)

Pension and Benefit Issues

Peabody Coal (District Court Action)

- A lawsuit was filed on behalf of more than 10,000 retirees and active workers whose health care and pension benefits were transferred to Patriot Coal by Peabody Energy and Arch Coal. Pursuant to the lawsuit, the two spinoffs then merged, resulting into a Patriot Coal that had large legacy obligations and below-market coal contracts.
- The miners and UMWA sued Peabody and Arch for violating ERISA, saying the companies should be held accountable for the retirement obligations to 10,000 retired miners following Patriot's July 2012 bankruptcy filing.
- Patriot cited dropping prices and demand for coal, as well as “unsustainable labor-related legacy liabilities,” among its reasons for declaring bankruptcy.
- The Complaint by the miners and the UMWA, had claimed Peabody and Arch spun off some of their subsidiaries, which eventually combined into Patriot, specifically to shed their burdensome retirement liabilities. “In view of the realities of the transaction and the cyclical nature of the price of coal, it was inevitable that Patriot would eventually fail under the weight of its retiree health care and other legacy obligations.”

Pension and Benefit Issues

- Peabody and Arch asserted the miners' eligibility for benefits remained the same before and after the spinoffs under ERISA

Peabody Coal (District Court Holding)

- Agreeing with Peabody and Arch, Judge Goodwin reflected that the miners remained eligible to qualify for and collect benefits for several years after the spinoff:
  - "The change in sponsorship of the fund does not interfere with the employees' ability to attain Benefits."
  - The "employees were still entitled to the same welfare benefits after the transactions as before."
  - "ERISA only guards the individual rights of employees to obtain benefits, not the financial security of a pension plan as a whole."
  - "Rather than being a decision made by an employer that impacts the employee in the immediate future, Peabody and Arch made decisions as shareholders of the companies employing the plaintiffs, and these decisions did not impact the employees' access to their benefits until many years later."

Pension and Benefit Issues

- Eventually Peabody and Patriot entered into a settlement with the UMW by agreeing to fund $310 million into a VEBA (health care trust fund) to pay future retiree benefits.
- The ongoing funding for this trust was cast into doubt when Patriot filed for chapter 11 protection for the second time in 2015 and may again be placed into jeopardy as Peabody teeters on the edge of its own chapter 11 filing.