Current Issues in Oil and Gas Bankruptcies

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Energy Restructuring and Reorganization (Questions Not Asked in the Northeast a Year Ago)

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I. Oil and Gas Interests in Bankruptcy

A. What is an Oil and Gas Lease?

1. Classification of an oil and gas lease depends on the jurisdiction of lease issuance:

a. Many leases are issued pursuant to state law and governed by the law of the state of the situs of the leased oil and gas acreage

b. However, leases on federal lands or the Outer Continental Shelf (the "OCS") are issued pursuant to and governed by federal law

2. Real property or personal property interest?

a. In most instances, an oil and gas lease will be considered an interest in real property, created by a fee simple determinable. A typical lease structure is that a lease conveys a continuing right to extract oil and gas from the leased acreage, subject to some future event that will cut off the right to continue to extract minerals. Such events that would cut off rights to future extraction commonly include the failure to continue to produce oil and gas from the leased acreage or failure to drill a well on the leased acreage

- This is the "majority" approach followed by most states, including Texas[1]

- Federal courts examining federal leases that are ***not*** OCS leases have also held that such leasehold interests are real property interests[2]

b. However, in some instances, the lease may be determined to be a lease of personal property

- This is the "minority" approach. Kansas is an example of a state following this approach[3]

- With respect to federal leases that ***are*** OCS leases, the United States has taken the position that such lease rights are personal property that can be rejected.[4] Though this issue was raised in the *ATP Oil and Gas Corporation* bankruptcy case, the dispute

[1] *Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70 (S.D. Tex. 1996)("A mineral lease in Texas is a determinable fee … .").
[2] *See, e.g., Mafrige v. United States*, 893 F. Supp. 691, 698 (S.D. Tex 1995).
[3] *UTICA Nat'l Bank & Trust Co. v. Marney*, 233 Kan. 432, 435 (1983).
[4] *See NGP Capital Resources Co. v. ATP Oil & Gas Corp.*, Adv. No. 12-03443, Docket No. 13 (Bankr. S.D. Tex. 2012).

was ultimately resolved via an agreed settlement between the parties

B. Are Oil and Gas Leases Subject to § 365?

1. Though question of whether an oil and gas lease is executory is a question of federal law, the question of whether it is a real property interest is (for non-federal leases) a question of state law[5]

2. If applicable law holds that the oil and gas lease is an interest in real property, the oil and gas lease will not be subject to rejection under § 365 – you can't "reject" ownership of real property[6]

3. If applicable law holds that the oil and gas lease is an executory contract or unexpired lease of real property, the oil and gas lease is subject to § 365 and the procedures set forth therein for assuming or rejecting executory contracts and unexpired leases[7]

4. Split of authority regarding treatment of oil and gas leases within Louisiana. Some cases hold that such oil and gas leases are executory agreements,[8] though more recent opinions have held that Louisiana oil and gas leases are not executory contracts subject to § 365[9]

II. Hidden Liens in an Oil and Gas Case

A. M&M Liens

1. M&M liens exist via application of statutes unique to each state

2. Generally, M&M liens protect persons that provide services and materials in the construction and operation of oil and gas wells and other construction projects. However, again, the nature of goods or services subject to the protection of an M&M lien is unique to each state

3. Lien Scope and Priority

a. Extent of assets/collateral subject to M&M liens varies by statute. Certain liens may extend to the leasehold interest for an oil and gas well[10] or the proceeds of production from that well[11]

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[5] *See Terry Oilfield Supply Co.* at 73 (S.D. Tex. 1996).
[6] *See, e.g. id.*; *In re Topco, Inc.*, 894 F.2d 727, n.17 (5th Cir. 1990).
[7] *See, e.g., UTICA Nat'l Bank & Trust Co. v. Marney*, 661 P.2d 1246 (Kan. 1983); *In re J.H. Land & Cattle Co.*, 8 B.R. 237 (W.D. Okla. 1981).
[8] *See, e.g., Texaco, Inc. v. Louisiana Land & Exploration Co.*, 136 B.R. 658 (M.D. La. 1992).
[9] *See, e.g., In re WRT Energy Corp.*, 202 B.R. 579 (W.D. La. 1996).
[10] *See, e.g.*, Texas Prop. Code. Ann. 56.003.
[11] *See, e.g.* Okla. Stat. Ann. 42-144.

b. M&M liens must be perfected in order to prime existing, perfected liens

c. For M&M liens that "relate back" and have the potential to prime existing security interest, the extent of the relation back varies by statute. Some statutes provide for "relation back" to the earliest point when work began on a project, regardless of whether the claimant at hand was performing work at that time[12]

d. The Bankruptcy Code permits M&M liens, in some instances, to become perfected after the commencement of a bankruptcy proceeding. Such perfection may be accomplished after the commencement of a bankruptcy case if the M&M lien law permits perfection of an interest in property to be effective or continued against a lien existing prior to the date of perfection[13]

B. Producer's Liens

1. Provided to sellers (i.e. the oil and gas producers) to secure the purchase price of oil and gas sold to other third parties. Absent such a lien, the proceeds could become inventory of the purchaser, subject to the security interests against the purchaser's assets[14]

2. Lien priority

a. Like M&M liens, ensuring priority of producer's lien requires perfection of the producer's lien

- Certain producer's liens are automatically perfected upon attachment[15]

- Some producers liens may require filing of a UCC financing statement or other documents to ensure perfection[16]

III. The Gathering Agreement/Executory Contract Controversy

A. Controversy regarding ability to reject a gas gathering agreement: is a gathering agreement an executory agreement or a covenant that runs with the land?

B. Executory agreements can be rejected so long as the Debtor can show that rejection is a reasonable exercise of its business judgment[17]

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[12] *See, e.g.*, Cal. Civ. Code. § 8450.
[13] 11 U.S.C. § 546(b).
[14] *See, e.g.*, *In re Semcrude, L.P.*, 407 B.R. 140, 157 (Bankr. D. Del. 2009)(holding that asserted senior interests of lenders to debtor/gas purchaser were superior to any liens in favor of producers under then-existing Oklahoma law (subsequently amended by Oklahoma in response to the *Semcrude* ruling)).
[15] *See, e.g.*, Tex. Bus. & Comm. Code. § 9.343.
[16] *See, e.g.*, N.M. Stat. Ann. § 48-9-5.

1. thus, for gathering agreements, rejection usually requires showing that the gathering agreement burdensome to Debtors

2. this business judgment standard is generally easy for the Debtor to satisfy and difficult to challenge

C. Covenants that run with the land cannot be rejected

1. Whether covenant runs with the law is determined by state law

2. Main focus is on "privity" and whether the covenant "touches and concerns" the land

a. Is right to production a personal property interest or real property interest; personal property interest does not touch and concern land

b. Traditional definition of royalty, generally considered a real property interest, is oil and gas "produced and saved"; many gas gathering agreements use same language

c. Rejection may turn on whether dedication of oil and gas is determined to be of oil and gas produced (personal property) or oil and gas in the ground (real property interest)

D. Analysis of this issue in New York: the *Sabine Oil and Gas* Case:[18]

1. Court ultimately held that (i) rejection of gas gathering agreements was permissible and a valid exercise of the debtor's judgment; and (ii) gas gathering agreements were not covenants running with the land under Texas law

2. Key aspect of this holding is that gas gathering agreements were not covenants running with the land (there was little dispute that Sabine had a plausible reason for rejecting the gathering agreements in order to negotiate a more favorable replacement agreement)

a. Agreements did not create horizontal privity between Sabine and the gas gatherer because there was no conveyance of the Sabine mineral estate – the right to transport or gather gas was not part of the mineral estate

b. Agreements did not touch or concern the land because they were focused on transportation of "products" extracted from the ground – oil and gas extracted from the ground is personal property, not real property. Moreover, agreements were triggered by delivery of

[17] *See, e.g., In re Sabine Oil & Gas Corporation*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016)
[18] *Id.*; *In re Sabine Oil & Gas Corporation*, 2016 WL 2603203 (Bankr. S.D.N.Y. 2016).

gas to "receipt points" or "central delivery points" which allowed for intervening steps between extraction of minerals from the ground and delivery of those minerals in a manner consistent with the gathering agreement

E. The *Sabine Oil and Gas* ruling has provided bankruptcy debtors with greater leverage in negotiating with counterparties to modify or propose more beneficial terms to a gas gathering agreement as part of a bankruptcy proceeding

1. In addition to *Sabine Oil and Gas*, there were two other notable oil and gas cases pending in Delaware, *Quicksilver Resources*[19] and *Magnum Hunter Resources*,[20] which proposed to reject significant oil and gas gathering agreements. In the wake of the *Sabine Oil and Gas* ruling, the disputes in both *Quicksilver Resources* and *Magnum Hunter Resources* were ultimately consensually resolved

IV. "Farmouts" and Similar Agreements

A. What is a "farmout"?

1. Generally, a "farmout" involves the transfer by an oil and gas lease owner (the "Farmor") to a third party (the "Farmee") of some portion of the Farmor's lease rights, in exchange for an agreement by the Farmee (i.e. the transferee) to drill one or more wells on the subject lease area

2. Drilling by the Farmee is a prerequisite to the transfer of "farmout" rights

B. The farmout safe harbor of § 541(b)(4)

1. The Bankruptcy Code contains a safe harbor that helps protect Farmees that have fulfilled the conditions of the farmout but have not yet received their assignment of lease interests[21]

2. The "safe harbor" provides that certain oil and gas lease interests subject to farmout agreements are not property of the bankruptcy estate (and thus, cannot have the Farmee's rights to such interests modified as part of the bankruptcy process)

3. Though the section is most commonly associated with situations where the Debtor is the Farmor, it applies both in situations where the Debtor is the Farmor and situations where the Debtor is the Farmee

a. The Debtor as Farmee. Where a debtor/Farmee has undertaken all actions necessary to receive its assignment, but the assignment has

[19] *In re Quicksilver Resources Inc.*, Case No. 15-10585 (Bankr. D. Del. 2015).
[20] *In re Magnum Hunter Resources Corporation*, Case No. 15-12533 (Bankr. D. Del. 2015).
[21] 11 U.S.C. § 541(b)(4).

not yet been completed, the debtor/Farmee should have equitable title to the assigned interest, which vests in the debtor/Farmee's bankruptcy estate. If debtor/Farmee has agreed to separately convey parts of the assigned lease interest to others, the agreement to assign the lease interest may also be subject to the farmout safe harbor

b. The Debtor as Farmor. This is the more classic application of the bankruptcy code safe harbor

- If the Farmee has taken all necessary steps to receive the assignment, but the assignment has not happened yet, then the assigned interest is excluded from the Debtor's bankruptcy estate

- Question is tougher if the Farmee still has ongoing tasks to complete under the farmout before it is entitled to an assignment under the farmout agreement

V. Plugging and Abandonment Obligations

A. Oil and gas regulations require a well that is no longer producing or otherwise to be shut down must be "plugged" to prevent harm to the environment before the well can be abandoned. "Plugging" generally requires mixtures of mud, cement, and other additives into the well hole in order to prevent discharge of potential pollutants

B. Ability of Estate to Abandon Property vs. Statutory Obligation of Well Operator to Properly Plug Shut-in Wells

1. Because "plugging" a well can be expensive, debtors frequently try to abandon non-productive wells before plugging, in order to spare the estates the potentially significant costs of plugging activities

2. Imminent Harm to Public vs. Violation of Environmental Law

a. Some courts hold that an environmental law violation along cannot prevent a debtor/trustee from abandoning a well, so long as the property to be abandoned is not likely to cause imminent harm to the public[22]

b. Other opinions suggest that a debtor/trustee may not abandon a well in violation of applicable environmental law (including without complying with plugging and abandonment regulations), based on the presumption that all environmental regulations are

[22] *See, e.g.*, *In re Guterl Special Steel Corp.*, 316 B.R. 843, 858-59 (Bankr. W.D. Pa. 2004)

important to public safety, and it not the bankruptcy court's job to determine which violations are truly dangerous[23]

C. Nature of the Remediation Claim

1. Administrative vs. Unsecured Claim – for remediation/plugging and abandonment claims, question is whether claim arose postpetition (making it eligible for an administrative claim) or prepetition (making it ineligible for administrative claim treatment)

a. Some courts have examined the outside deadline for completing the remediation/plugging and abandonment liability, so that as long as the outside deadline occurs after the petition date, the claim will be a postpetition claim[24]

b. Other courts have taken a more expansive view, holding that remediation obligations are continuing, with new obligations arising each day, making all remediation/plugging and abandonment obligations eligible for consideration as postpetition administrative claims[25]

[23] *See, e.g., In re American Coastal Energy Inc.*, 399 B.R. 805, 813 (Bankr. S.D. Tex. 2009).
[24] *See In re H.L.S. Energy Co.*, 151 F.3d 434, 438 (5th Cir. 1998).
[25] *In re American Coastal Energy*, 399 B.R. at 814-16.

Economic Challenges Facing The Oil & Gas Industry

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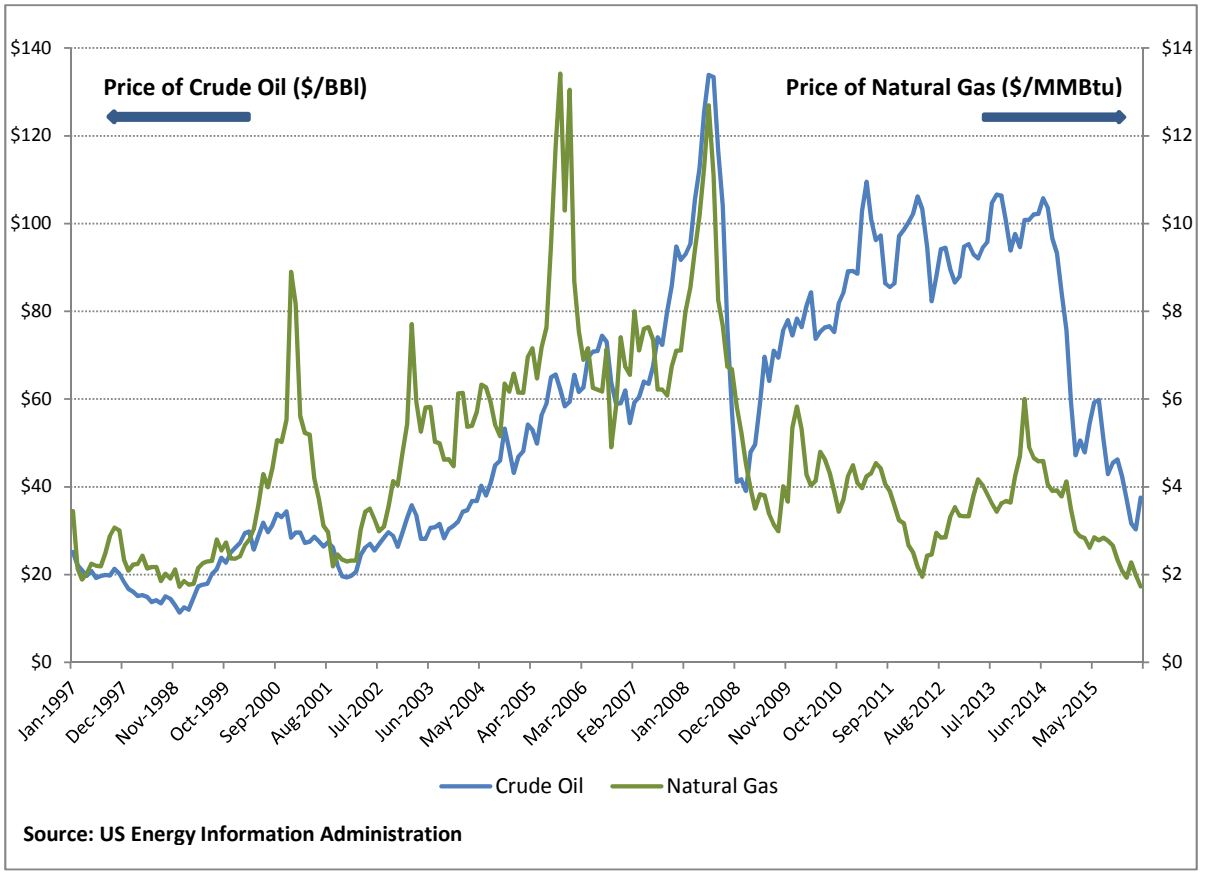
ECONOMIC CHALLENGES FACING THE OIL & GAS INDUSTRY

I. SUMMARY: WHERE WE ARE TODAY

The energy market finds itself operating in a world where (nominal) prices for crude oil reside at or near levels not seen in the last ten years; where current prices reflect approximately 30 percent of their pre-financial crisis peak of nearly $135 per barrel. The purpose of this paper is to present an overview as to the causes of this seeming "new-old" price environment and what that portends for US energy companies facing the test of operating in this environment.

Figure 1. Historical Spot Price of Natural Gas and Crude Oil



The challenges imposed by this pricing environment cannot be underestimated. Energy Futures Holdings, a large Texas generation and distribution company, went from the largest leverage buy-out in 2007 to one of the largest bankruptcies in 2014 on the basis of what may fairly be called a bet on natural gas prices gone bad. CNN recently reported that no less than 67 oil and natural gas companies filed for bankruptcy in 2015, a more than five-fold increase over the number of bankruptcies in 2014. And it hasn't stopped. Fortune recently estimated that 175 US oil and gas exploration and production companies were at risk of default or bankruptcy. Those servicing producers are also feeling the effects. Sabine Oil & Gas Corp was recently awarded permission by New York's bankruptcy court to shed the costs associated with certain pipeline transportation agreements. It was reported that shares of major pipeline operators fell with the news, while the Dow Jones index of pipeline operators declined by more than 5 percent. Halliburton, the large oil field services firm, has laid off more than 20,000 positions, representing about 25% of its work force, since the collapse of oil and gas prices. And even the strong have taken a hit: Standard & Poor's downgraded ExxonMobil's credit rating to AA+ from AAA – one of only three US companies to hold that rating – on the expectations of continuing low oil prices.

These facts, however, represent the effects of this new pricing environment. The questions for those working with energy companies more appropriately concern the causes. That is, how did this new operating environment come about and what does it portend for the foreseeable future?

II. HOW DID WE GET HERE

Here is the popular answer: What is referred to as the shale revolution took off at a time when oil prices were in the $90-$100 per barrel range and natural gas prices in the range of $10-$12 per MMBtu. Companies took on significant leverage to fund exploration and drilling operations with the then seemingly reasonable expectation of receiving higher prices. The dramatic increase in bankruptcy filings now corresponds with the plunge in oil prices from well over $100 a barrel in mid-2014 to approximately $40 today, and a corresponding change in natural gas prices that reside near 14-year lows. The drop in revenues choked off cash flows, presenting a challenge to companies seeking to make payments on all that debt.

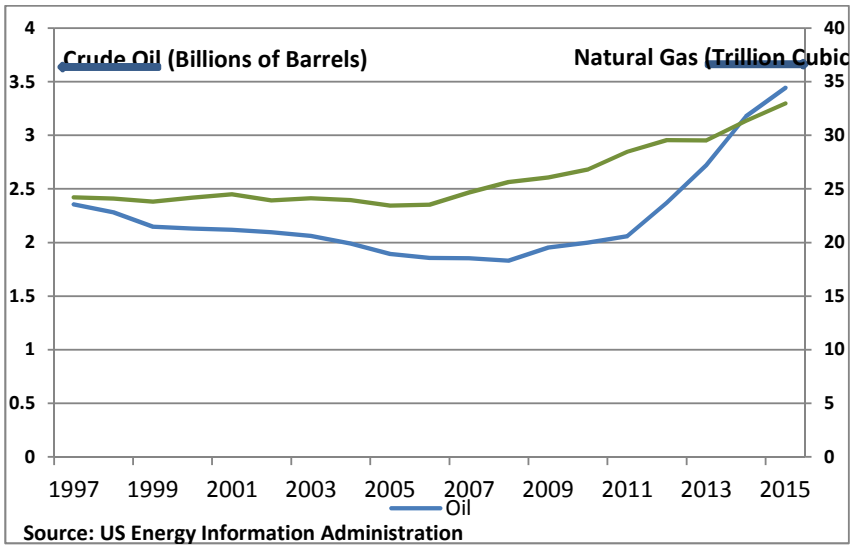
The facts, however, are more nuanced than that, however. A confluence of separate but related factors has had a profound impact on the value of oil and gas assets. First, the energy market realized massive new supplies from the United States. Second, the world encountered an OPEC that was incapable of stabilizing prices. Third, the global economy experienced a decline in the demand for energy, particularly in the OECD but developing countries, as well. In sum, the energy marketplace saw an increase in supply of oil and natural gas at a time when demand for those fuel supplies was declining, which in turn upset the traditional economic paradigm.

A. Shale Revolution

Most individuals are now familiar with what is often referred to as the "shale revolution": major technological advances in the application of horizontal drilling and hydraulic fracturing in the United States dramatically expanded domestic oil and natural gas production. Neither the existence of the hydrocarbons nor the

techniques used to produce what appeared to be newfound supplies were new to the industry. Rather, it was the combination of the two techniques as applied to known reservoirs of natural gas that has been heretofore uneconomic to produce which fundamentally altered the US energy marketplace. Figure 2 shows the increases in domestic production, driven largely by the successful application of these technologies to shale and other tight formations. Since 2006, the US has realized a 40 percent increase in natural gas production. The impacts on domestic oil production were, perhaps, more surprising. After nearly thirty years of decreasing domestic production, the US saw production reach levels not seen since the early 1970's. Since 2006, production increased from 1.86 billion barrels annually to over 3.44 billion barrels annually – an increase of 85%.

Figure 2. US Production of Natural Gas and Crude Oil



Yet, while natural gas prices never seemingly "recovered" after their decline with the economic crisis of 2008, the global price of oil quickly climbed from $40 dollars in early 2009 to over a $80 per barrel by early 2010, and reaching nearly

$110 by early 2011. Prices for the US benchmark crude, West Texas Intermediated, remained between $80 and $110 per barrel from October 2010 until late November 2014, despite nearly 9% growth in global supplies. Significant new supplies of U.S. crude being introduced into the seemingly had little effect on abating global prices This raises an interesting question as to why the market did not respond sooner with, for example, gradual declines in prices as supplies steadily grew.

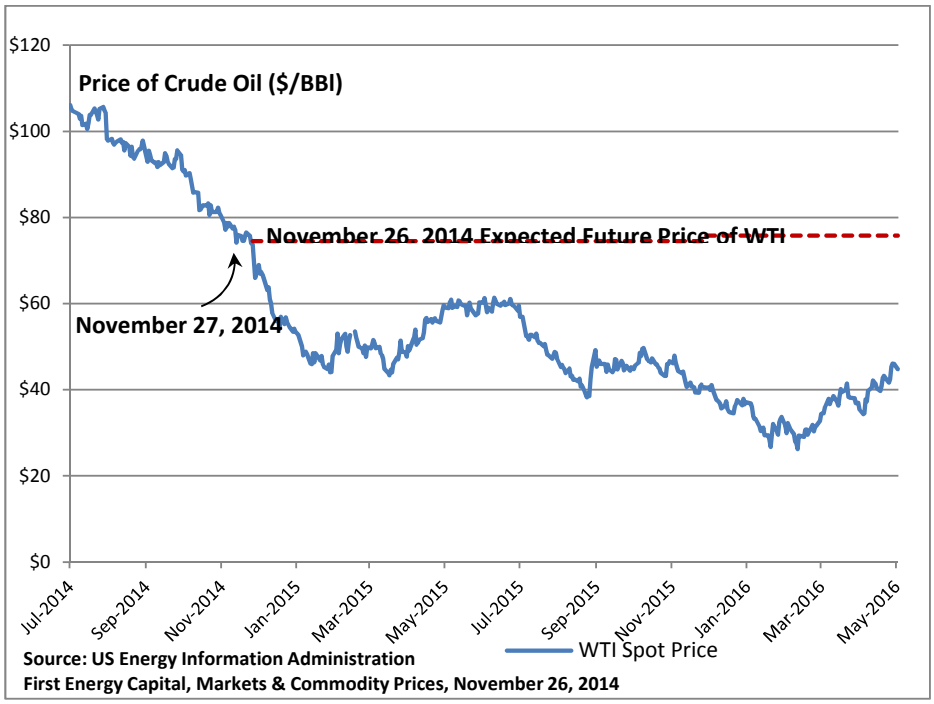
B. Breakdown of OPEC

The difficulties associated with the estimation of future crude and gas prices are a well-trod area academic and professional research. A recent paper in the Journal of Economic Perspectives titled "Forty Years of Oil Price Fluctuations: Why the Price of Oil May Still Surprise Us" highlights the challenges with predicting changes in energy-related commodity prices.[1] Within this framework, we may reasonably ask: What surprised us about the global oil market in November 2014? As noted above, oil prices had remained relatively high, even the face of increasing supplies. While prices began softening in the summer of 2014, even as late as November 2014 the price of WTI was still approximately $75 per barrel. On November 27, however, the market realized a one-day 10% drop in the price of crude oil, starting a period of rapid decline in oil prices that did not abate until late January 2015. It was on that November day that Saudi Arabia announced that it would not cut production in response to softening oil prices. Figure 3 shows the results of this announcement. In particular, it compares the realized daily spot

[1] See, for example, Baumeister, Christiane and Lutz Kilian. 2016. "Forty Years of Oil Price Fluctuations: Why the Price of Oil May Still Surprise Us." Journal of Economic Perspectives, 30(1):139-60. ("Baumeister and Kilian")

price of WTI crude oil over the July 2014 – April 2016 time period to the expected price of crude oil as of November 26, 2014.[2]

Figure 3. Actual Spot Price of WTI Crude Oil v "Expected Price"



I would argue that prior to the Saudi's actions, the market's *expectation*s – even as new supplies were coming on line – were such that oil would continue to remain relatively scarce. There were, for example, geopolitical conflicts flaring up in key oil-producing regions around the world, including a war in Libya, Iraq facing threats from ISIS, and new US sanctions on Iran with their consequences for Iranian oil production. In addition, African producing regions suffered supply disruptions, while Russian actions around Crimea and Ukraine increased tensions in Europe. But perhaps most importantly, market participants expected OPEC, as

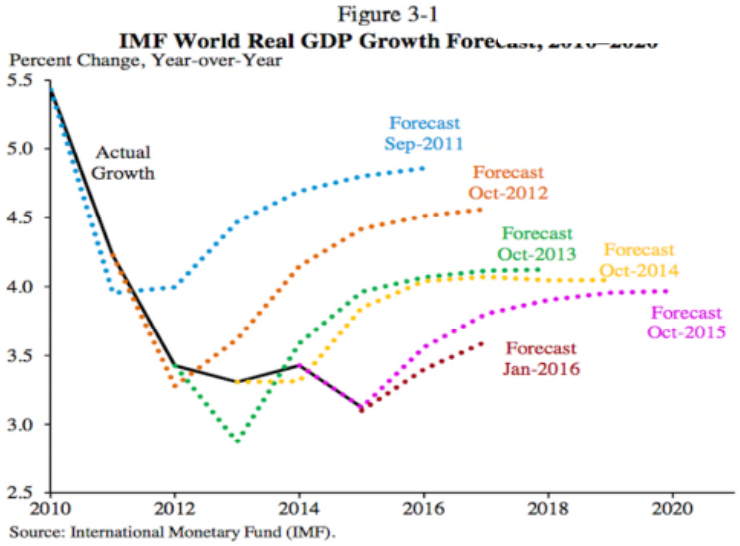
[2] The line combines the 12 month strip and 2016 strip as reported by First Energy Capital, Markets & Commodity Prices, November 26, 2014. It is used for illustrative purposes only.

it had in the past, to apply "market discipline" to any significant changes in the overall supply-demand balance and, thereby, stand ready to support relatively high crude oil prices. The market, however, was surprised by the Saudis' announcement – and the sell-off began in earnest.

C. Unanticipated Slowdown in Global Economic Growth

Figure 4, taken from the 2016 Economic Report of the President, compares realized global economic growth against forecasted growth over the September 2011 – January 2016 time period. As shown by the figure, the world has transitioned from one of 5% expected annual growth to 3.5% - a loss of 150 basis points. The change in expectations stem largely from slowing growth in emerging-market economies, including large economies like India and China, as well as continued disappointing growth in Europe. The connection to oil prices is quite straight forward: declining economic growth contributes to the relative decline in demand for oil and, thus, results in downward pricing pressure.

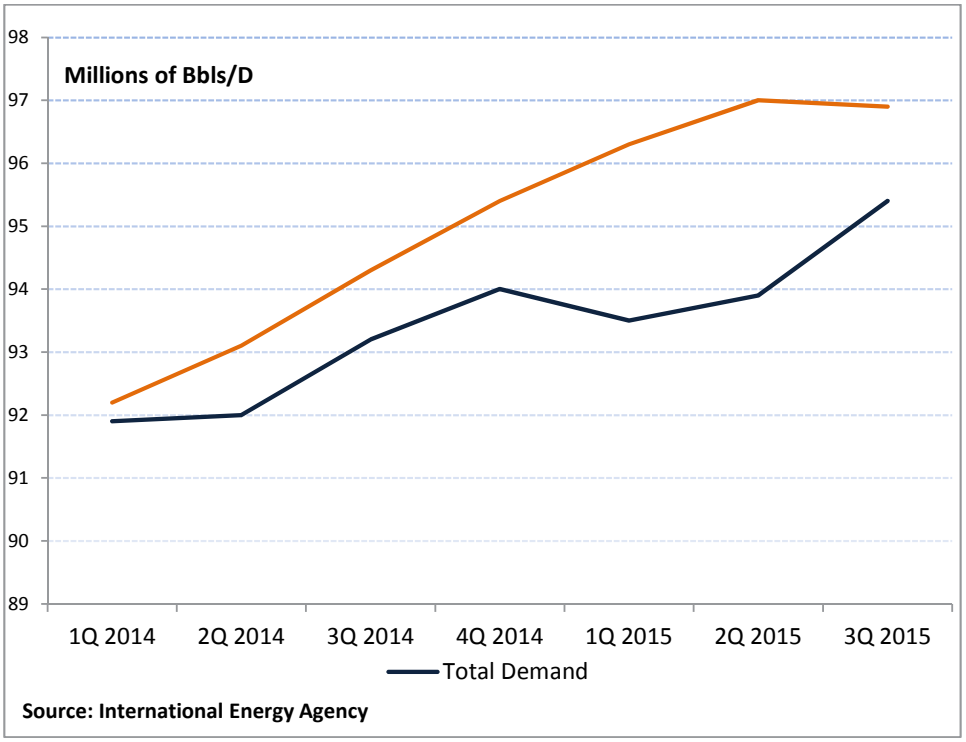
Figure 4. Changing Expectations of Global Economic Growth



Economic Report of the President, 2016, Figure 3-1.

Figure 5 shows the confluence of the aforementioned factors. The world is coming off an extended period where the relative availability of crude oil outpaced the ability to consume those supplies – with the attendant effect on global oil prices.

Figure 5. Global Crude Oil Demand – Supply Balance

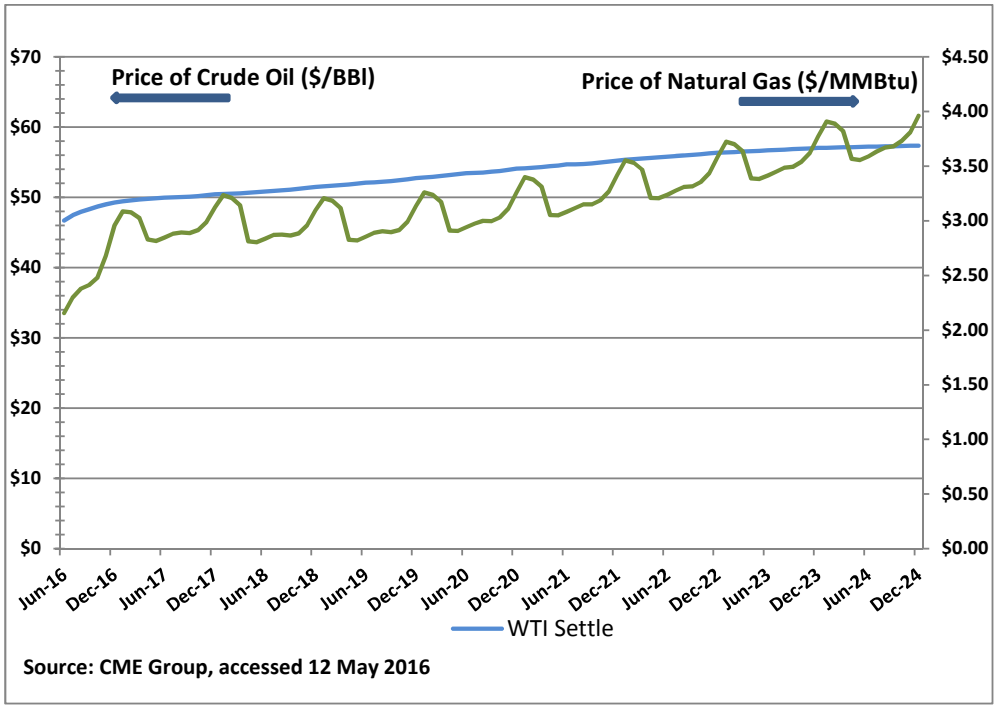


III. WHERE WE ARE GOING

The International Energy Administration aptly states the precariousness in trying to forecast the oil market: "Attempting to understand how the oil market will look during the next five years is today a task of enormous complexity. Some certainties that have guided our past outlooks are now not so certain at all: that oil prices falling to twelve-year lows will lead to a strong demand growth spurt; that oil prices falling to twelve-year lows

will lead to a mass shut-in of so-called high cost oil production; and not least that oil prices falling to twelve-year lows will force the largest group of producing countries to cut output to stabilise oil prices."[3]

Figure 6. Future Expected Price of Crude Oil and Natural Gas



Accepting the IEA's warnings, Figure 6 presents the market's estimate of the conditions confronting companies operating in the energy space futures prices for oil and natural gas. Specifically, it maps the market's expectation as to the future value of natural gas and oil and, as such, it offers some insight into the exploration and production companies' expected return on energy-related assets.

To move away from this future, one must ask what will change relative to the market's current set of expectations. In this sense, the question becomes where are the surprises?

[3] International Energy Agency Medium Term Oil Market Report 2016, accessed at https://www.iea.org/Textbase/npsum/MTOMR2016sum.pdf.

Demand: It is evident that energy prices influence consumers' behavior. In periods of high prices, energy consumers seek ways to purchase less, be it greater preference for more fuel efficient cars or developing energy substitutes, such as renewables. The inverse is also true. Low prices diminish those incentives. Over the near term, however, such changes tend to occur slowly. Certainly, demand could exceed forecasts. It becomes a bit more challenging, however, to identify where those surprises will come from. Will European malaise suddenly dissipate? Will the Chinese economy return to pre-2011 rate of growth? As summarized by the IMF, "[r]isks to the global outlook remain tilted to the downside and relate to ongoing adjustments in the global economy.[4]

Over the longer term, surprises become more plausible – although not perhaps to the advantage of producers. The world is in the midst of a re-thinking as to how energy is going to be produced, distributed, and consumed. This is not to argue that oil and gas (or coal or nuclear) are in eminent threat of being displaced by solar or wind. I do not believe that to be the case. But rather, it becomes harder to discount the impact of, for example, energy storage, and the implications it can have on oil and gas prices, when modeling over a longer time horizon.

Supply: Headlines from the industry are news of exploration and production companies deferring production. One has to be careful, however, in considering how such deferment will impact future operating environment. Deferring of production historically referred to large scale projects took years of planning to bring to fruition. Consequently, a delay implicitly meant foregone supply for an extended period of time. In contrast, shale production—a major factor in driving downturn in oil and natural prices—is very easy to

[4] "Subdued Demand, Diminished Prospects", International Monetary Fund, World Economic Outlook Update, January 2016. http://www.imf.org/external/pubs/ft/weo/2016/update/01/

dial up or down. Spudding a shale well can take just a few weeks; ramping down operations can be done in a matter of days. And many companies have continued to drill wells without actually "completing" those wells – i.e., bringing them to production – to conserve funds in the near term. In effect, the marketplace is simply using the ground as a form of storage. When prices move up, each of those producers will have the incentive to bring those wells back on line.

As a consequence, when one thinks of changes in supply, one is implicitly making assumptions as to the continuing success (or not) of the shale technology. The reality is that this type of production is still quite young. As a consequence, there remain questions related to, for example, the long-term well performance of currently producing reservoirs and, hence, the long-production forecasting; the rate at which efficiencies gains and technological advancements will further reduce costs; and the extent to which current technology (or near-like technology) is applicable to non-producing shale and other tight-formation reservoirs.

OPEC: The recent Doha talks lay bare the near-term economics confronting OPEC. Simply put, Saudi Arabia recognizes that it is not in its economic interest to cut back on production as any increase in prices would largely be to the benefit of others – many of whom are not likely to share Saudi Arabia's geo-political interests. Any quota, were one able to be agreed upon, would only serve to offer greater incentives on the part of cartel members to cheat on that quota, while induce non-OPEC members to bring deferred production back on line.

This is not to say that geo-political events aren't relevant. Rather, this seems to me to be the most likely surprise, as there remains an extensive list of threats to major oil

producing regions. The reality is that most oil is produced from a region that is involved in a significant number of conflagrations, any of which can have a significant and sudden impact on the supply of crude oil. As noted by Killian and Baumeister, "most oil price predictions simply ignore the possibility of future political or economic crises, except to the extent that they are already priced in at the time the prediction is made. Because crises are rare, this strategy usually works, but occasionally it may result in spectacular predictive failures."[5] In sum, it is here where our propensity to consider the "past as future" is likely to surprise us.

[5] Baumeister and Kilian at 157.

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CME Group

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Illustrative Recent Oil and Gas Filings and Distressed Situation

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I. Midstates Petroleum Company, Inc. – A Pre-Negotiated Plan

A. Midstates Petroleum Company, Inc. ("Midstates") is an independent exploration and production company with operations focused in the Mississippian Lime in Oklahoma and Anadarko Basin in Texas and Oklahoma. Midstates filed bankruptcy petitions on May 1, 2016 in the Bankruptcy Court for the Southern District of Texas, reporting $679.2 million in assets and roughly $2 billion in liabilities. The debtors entered the case with a plan support agreement ("PSA") in place.

B. Midstates Background

Like many other E&P companies, Midstates faced challenges on account of declining commodity prices. It sought to address those by cutting costs and increasing efficiency. Further, Midstates restructured their balance sheet by (i) issuing second lien notes and third lien notes and (ii) "uptiering" (i.e., exchanging unsecured notes for second or third lien notes).

In early April 2016, Midstates entered into discussions with its lenders under the reserve based loan facility ("RBL") and several ad hoc groups of the second and third lien note holders. The discussions accelerated after the reserve based loan administrative agent notified Midstates that the borrowing base under the RBL facility would be $170 million, resulting in an $82 million deficiency, and after Midstates then failed to make an interest payment on its notes.

The negotiations focused on:

i. Equitizing all the debtor's second lien, third lien, and unsecured notes, to equity in the reorganized company, subject to dilution from equity issued in a management incentive plan – a key aspect being the allocation of reorganized equity between the second and third lien noteholders as well as the unsecured noteholders and other unsecured creditors;

ii. Terms for use of cash collateral and the conversion of the RBL facility to post-emergence facility.

C. Midstates Plan Support Agreement

Pursuant to the PSA, Midstates filed a plan as on May 18, 2016 a that would:

i. Pay priority claims in full, in cash;

ii. Pay the existing reserve-based loan down by $82 million and the remaining claim reinstated as a first lien exit facility.

iii. Distribute equity to the second and third lien noteholders, as well as the unsecured noteholders and GUCs, as follows, 96% of equity going to the

second liens, 2.5% to the third lien and 1.2% to unsecured claimants, (in each case subject to dilution from a management incentive plan).

iv. In addition, the second lien noteholders would receive up to $60 million in cash.

v. The third lien noteholder consideration includes warrants to purchase an additional 15% of equity, that strike at a price translating to a $600 million of reorganized Midstates equity valuation.

II. Chaparral Energy LLC – PSA negotiated but not finalized

A. Chaparral Energy LLC ("Chaparral") filed for chapter 11 protection on May 9, 2016 in the Bankruptcy Court for the District of Delaware. The Oklahoma City-based E&P company reported $50 million to $100 million in assets and $1 billion to $10 billion in liabilities.

B. Unlike Midstates, Chaparral did not enter Chapter 11 with a plan support agreement in place, because it had not yet reached a definite agreement on the material terms of a restructuring. Under the draft term sheet that was circulated prepetition, the unsecured noteholders were to receive 100% of reorganized equity subject to dilution by warrants, a management incentive plan and a value creation plan.

C. Pre-Petition, Chaparral had entered into a forbearance agreement through April 15 after it triggered a 30-day grace period due to a missed $16.5 million interest payment that was due on March 1 on its 2021 senior notes. The announcement on the missed interest payment came after the company stated that it had fully drawn on the commitments under its revolving credit facility.

D. As part of its first day filings Chaparral filed a non-consensual cash collateral motion. A primary issue was whether $152.6 million in cash at Arvest Bank, were subject to the RBL lender's lien. Ultimately, the parties agreed during the first day hearings to a consensual use of cash collateral on an interim basis.

III. Chesapeake Energy Corp. – Not yet in bankruptcy

A. Chesapeake Energy Corp. ("Chesapeake"), according to its annual report, is the second-largest producer of natural gas and 11th-largest producer of oil and natural gas liquids in the U.S. The operator has crude oil and NGL positions in the Eagle Ford Shale, Utica Shale, Anadarko Basin and Powder River Basin, while the Haynesville/Bossier, Marcellus and Barnett shales are mainly natural gas.

B. Liquidity and Maturity Management through Amendments and Exchanges.

Chesapeake has not, yet, filed for bankruptcy and is currently taking various steps to manage liquidity and push-out maturities on its debt obligations.

1. Chesapeake amended its revolving credit facility to convert it from an unsecured revolving credit facility to a secured credit facility with a $4 billion borrowing base. This amendment included the introduction of two new financial covenants: a senior secured leverage ratio of 3.5x through 2017 and 3x thereafter, and an interest coverage ratio of 1.1x through the first quarter of 2017, increasing to 1.25x by the end of 2017.

2. The second amendment increased the company's permitted junior lien debt basket from $2 billion to $4 billion *plus* Additional Permitted Junior Lien Debt.

3. On Dec. 2, Chesapeake announced a private exchange offer of up to $1.5 billion aggregate principal amount of its new 8.00% Senior Secured Second Lien Notes due 2022, in exchange for certain senior unsecured notes. The exchange targeted Notes with near term maturities.

4. On May 12, 2016, Chesapeake entered a private exchange of its senior notes for 28.1 million shares of Common Stock, representing approximately 4.1% of the Company's outstanding Common Stock

C. Market observers expect Chesapeake to use additional debt exchanges, along with equity and cash from asset sales, to continue addressing its capital structure. Operationally, Chesapeake will likely also pursue additional renegotiations of gathering and processing and volumetric production payment agreements to cut operational costs.

IV. Sabine Oil & Gas Corp. – Rejection of gathering contracts

A. Sabine Oil & Gas Corp. ("Sabine") commenced its chapter 11 bankruptcy on July 15, 2015 in the Southern District of New York.

B. Gathering Contracts

i. Shortly after filing, Sabine filed a motion to reject certain gathering agreements that the debtors deem "no longer necessary or desirable."

ii. The gathering agreements obligated Sabine to "deliver certain minimum amounts of gas and condensate to the contracts' counterparties on an annual basis, pay annual gathering fees to the contracts' counterparties for the services provided thereunder, and, to the extent that Sabine does not deliver certain minimum amounts of gas or condensate each year, make deficiency payments to the contracts' counterparties on an annual basis."

iii. Sabine stated that they would "likely be unable" to deliver the minimum amounts of gas and condensate required under the agreements and, absent rejection of the agreements, would be obligated to make certain deficiency payments. The debtors estimated that rejection would save the debtors

about $35 million in deficiency payments over the course of the gathering agreements.

iv. On May 3, 2016, after issuing a non-binding ruling on the rejection motions, in separate adversary proceeding Judge Shelley Chapman issued a subsequent ruling in the Sabine bankruptcy cases that the debtors can reject certain gathering agreements and that "the covenants at issue do not run with the land either as real covenants or as equitable servitudes, and therefore it denies the Defendant Motions and grants the SJ Motion."

v. This issue is currently on appeal and could involve questions of Texas law certified to the Texas Supreme Court by the Second Circuit.

Additional Oil and Gas Background and Research Sources

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In re Energytec, Inc., 739 F.3d 215 (5th Cir. 2013) (discussing covenants that run with the land, specifically rights associated with a gas pipeline, such as the right to receive a transportation fee based on gas volume moving through the pipe)

Matter of H.L.S. Energy Co., Inc., 151 F.3d 434 (5th Cir. 1998) (discussing priority to be afforded to state's claim on a bankrupt estate, specifically finding that costs incurred by state in plugging debtor's unproductive oil wells in accordance with state law during course of Chapter 11 proceeding was an "actual, necessary cost" and therefore, state's claim was entitled to administrative expense priority)

In re Topco, Inc., 894 F.2d 727 (5th Cir. 1990) (holding that an oil and gas lease is not an executory contract because the rights conveyed are an interest in real estate and not truly a lease)

QEP Energy Co. v. Sullivan, 444 Fed. Appx. 284 (10th Cir. 2011) (discussing assignment of oil and gas lease with regard to production payments, specifically find that a production payment terminates when the lease expires, or sooner if the owner of the interest has received the agreed quantum of production or dollar amount from the sale of production)

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Barnsdall v. Bradford Gas Co., 225 Pa. 338, 74 A. 207 (1909) (describing interests created by oil and gas licenses and leases and holding that an instrument granting, demising, and leasing land for the sole purpose of mining and operating for oil and gas is a lease conveying an interest in the land, and not a license to enter and operate for oil or gas)

In re Quicksilver Res. Inc., 544 B.R. 781 (Bankr. D. Del. 2016) (discussing the perfection of lien on oil and gas interests and finding that subsection of mortgages granting blanket lien on all real property

interests located in Texas owned by debtor and "all other" property owned by debtor included disputed real property interests)

In re Sabine Oil & Gas Corp., No. 15-11835 (SCC), 2016 WL 890299 (Bankr. S.D.N.Y. Mar. 8, 2016) (discussing covenants that run with land and finding that a bankrupt oil and gas producer could reject its executory contracts with gatherers that processed gas from its wells because the covenants related to products that had become personal property once they were extracted from the land)

In re ATP Oil & Gas Corp., 497 B.R. 238 (Bankr. S.D. Tex. 2013) (ruling on motion for summary judgment in oil and gas company's bankruptcy case for recharacterization; finding genuine issue of material fact as to economic substance of transactions whereby parties were granted overriding royalty interest in production from oil and gas wells, whether as conveyances of real property interests or disguised financing transactions, precluded entry of summary judgment)

In re Aurora Oil & Gas Corp., 439 B.R. 674 (Bankr. W.D. Mich. 2010) (concerning dispute about royalty payments under oil and gas contracts; court holding that oil and gas lease is a lease or executory contract, the bankrupt lessee must assume the lease in order to continue to exploit the value of the oil and gas, but if the oil and gas lease affects a transfer of property rights in the minerals themselves, then the bankrupt retains the property transferred and the lessor is left with a secured or unsecured claim for unpaid royalties)

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