



AMERICAN
BANKRUPTCY
INSTITUTE

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Legal and Business Developments in E&P Cases

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INTRODUCTION

Types of Oil and Gas Companies and Assets

- **Upstream / Exploration and Production (“E&P”)** – exploring, recovering and producing crude oil and/or natural gas from underground or underwater fields, including obtaining lease interests, drilling and operating wells.



3

Types of Oil and Gas Companies and Assets

- **Midstream** – transporting and storing crude oil and/or natural gas, including pipelines, trucking, railways and other logistical operations.



ENERGY TRANSFER



- **Downstream** – refining, distribution and marketing of oil and gas products, including refineries, processing plants and other point-of-sale operations, like gas stations



4

Types of Oil and Gas Companies and Assets

- **Oilfield Services** – providing contract services for businesses engaged in the oil and gas industry, including drilling, fracturing, storage, equipment manufacturers, construction, software, testing and transportation and many more.



VANTAGE
DRILLING COMPANY

HERCULES
Offshore

SEVENTY SEVEN
ENERGY

Schlumberger



HALLIBURTON

Key
Energy Services

5

Energy Companies Are Not Fungible

- Oil and Gas is a commodity driven business, but the companies are not commodities.
- Current valuation varies less by the price of oil or gas and more by:
 - production efficiencies
 - acreage
 - costs to drill
 - management's record in reducing costs
 - Relationships
- Value of reserves \neq market value

6

E&P Companies Need to Drill

- By their very nature – assets decrease in value with production
- Potential for assets to become worth less than debt, even before borrowing base redeterminations
- Problem compounded by high production decline rates in non-conventional plays
- Decrease in cash flow from decreased production compounded by lower prices may mean a company can't afford to replace reserves
- Problem compounded by increased pressure on P&A liability

7

Oil and Gas Bankruptcies

- As of December 14, 2016:*
- At least **114** oil and gas producers filed for chapter 11 protection. The combined funded debt on these companies is at least **\$74 billion**.
 - Chapter 11 cases include:
 - Linn Energy (S.D. Tex.) (approx. \$8.3 billion debt)
 - Ultra Petroleum Corp. (S.D. Tex.) (approx. \$3.9 billion debt)
 - Midstates Petroleum Co. (S.D. Tex.) (approx. \$2.1 billion debt)
 - Halcón (Del) (approx. \$2.2 billion debt)
- At least **110** oil and gas service companies filed for chapter 11 protection. The combined funded debt on these companies is at least **\$18 billion**.
 - Chapter 11 cases include:
 - Paragon Offshore Plc (D. Del.) (approx. \$2.4 billion debt)
 - Sanjel Inc. (W.D. Tex.) (approx. \$1.1 billion debt)
- At least 16 midstream companies filed for Chapter 11 protection. The combined funded debt on these companies is at least **\$17 billion**.

*Source: Company filings and Haynes and Boone LLP's December 2016 Oil Patch Bankruptcy Monitor

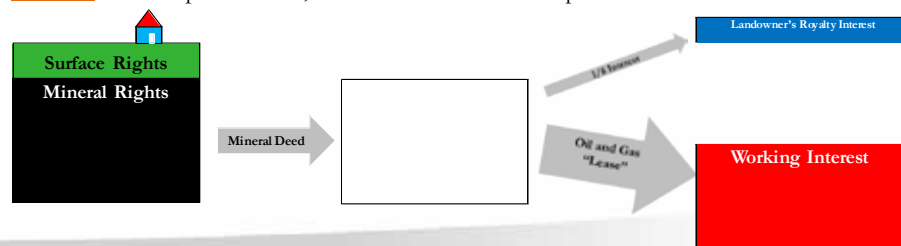
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OVERVIEW OF OIL & GAS INTERESTS

9

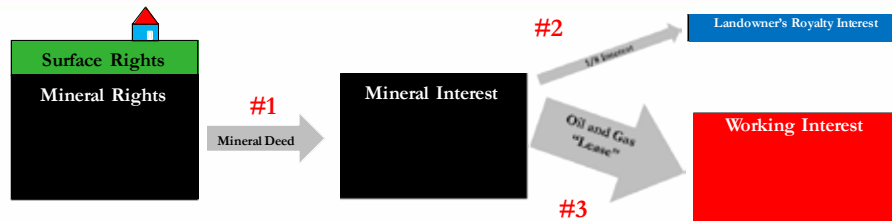
Overview of Common Oil and Gas Interests

- **Mineral Interest** – The “mineral interest” consists of the ownership of the oil and gas in place under a parcel of property, typically in fee simple, and the “executive rights” to explore, drill, and produce that oil and gas from the land. Mineral interests are conveyed by a “mineral deed.”
- **Working Interest** – The mineral interest owner grants the rights to explore, drill and produce the oil and gas by conveying an “operating interest” or “working interest” to an E&P company in exchange for a bonus payment and an obligation to drill and royalty. The holder of a working interest in the property bears the operating expenses associated with exploration, development and production. The rights conveyed by the working interest typically revert back to the mineral interest owner if certain terms and conditions – including production requirements and royalty payments – are not satisfied.
- As part of the initial conveyance, the mineral interest holder retains a **Landowner's Royalty Interest** = % of production, which is free of costs of production.



10

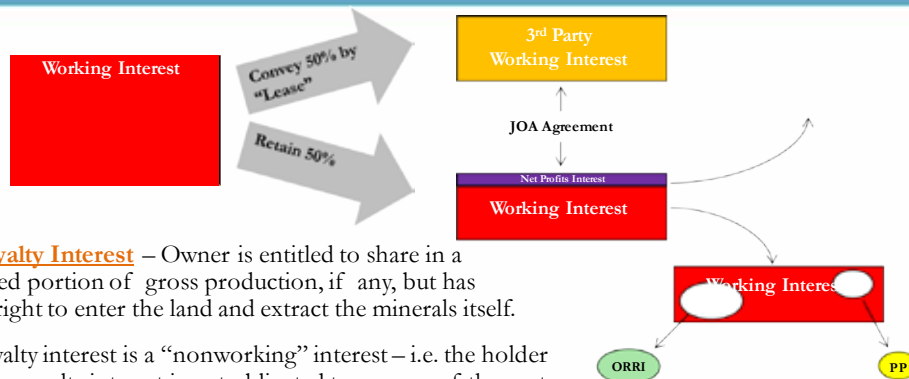
Overview of Common Oil and Gas Interests



1. **Conveyance of Mineral Interest** = Real Property Transfer
2. **Landowner's Royalty Interest** = Retained Real Property Interest
3. **Conveyance of Working Interest** = Review applicable non-bankruptcy law
 - Real Property Conveyance: Texas, Oklahoma, Louisiana, Colorado
 - Personal Property Conveyance: Kansas, Michigan
 - Hybrid: Pennsylvania (personal property license until minerals are extracted, then held in fee)

11

Overview of Common Oil and Gas Interests



- **Royalty Interest** – Owner 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.
 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.
- **Overriding royalty interests** – Carved out of the working interests and last either for the life of the associated working interest (a “perpetual ORRI”) or are limited in duration, typically until a specified volume of production is reached (a “term ORRI”). A Production Payment is a type of term ORRI.
- **Net Profits Interests** – Similar to ORRIs, “net profits interests” or “NPIs,” are carved out of the working interest, but net profits interests are only payable to the NPI holder out of the profits earned from production over the contractually agreed-upon time period.

12

The Oil and Gas Revolution

Old Way of Drilling

Jelly Donut

Conventional Drilling
Basic Vertical Penetration
Limited Formation Contact



Illustration © James Scherrer 2014

New Way of Drilling

Tiramisu

Unconventional Drilling
More Sophisticated Horizontal Penetration
Extensive Formation Contact



Illustration © James Scherrer 2014

13

Drivers into Bankruptcy

- Capital Intensive
- Commodity Prices
- Balance Sheet Rights
- Cash Flow
- Acquisitions with Leveraged Debt

14

Where to Start – E&P

- Are the assets natural gas or oil?
- Is the development conventional, non-conventional, shallow or offshore?
- Categorize and Rank Leases
 - What percentage of acreage is held by production (“HBP”)?
 - What are the drilling obligations under leases not HBP?
- Which Leases produce the most revenue?
- Which Leases will require the most CAPEX?

15

CAPEX Evaluation

- What is the drilling schedule?
- What is the projected increase in value?
 - Are reserves gained?
 - Is acreage earned?
 - Is acreage lost?
- What are the consequences of NOT spending the CAPEX?
 - How long can cash flow be maintained?
 - Will lessors renegotiate?
 - Will a Joint Exploration Agreement be breached?

16

Unique Oil & Gas Bankruptcy Issues

- What is the “breakeven” price?
- Are wells being drilled economic at current prices?
- What is the management’s “record” of AFEs vs. Actual Costs?
- What is the management’s record of drilling costs vs. industry competitors in the same field?
- Are there any truly critical vendors/service companies?
 - If so, what is the relationship with those vendors?

17

Pricing Pressures

- DUC - fracquake
 - Drilled but uncompleted
 - Completing a well means taking the final step of fracking the well and hooking it up to production
 - Estimated at over 3600 wells in the United States alone
 - One recent estimate was at \$60.00/bbl – “there won’t be any deferrals”
- Young Wells
 - Nearly half of the oil pumped in the lower 48 was from wells drilled after the start of 2014
 - Longer production
 - Decline curves on the near horizon

18

TOP ISSUES

19

Issue #1 Classification of Property Interests in Bankruptcy

20

Classification of Property Interests in Bankruptcy

- Generally, property interests are defined by applicable non-bankruptcy law; for oil and gas interests, this is typically the law of the state where the property interest is located
- Production payments and term overriding royalty interests that have been carved out of the working interests are not “property of the estate”
 - **11 U.S.C. § 101(42A)** – “The term ‘production payment’ means a term overriding royalty satisfiable in cash or in kind—(A) contingent on the production of a liquid or gaseous hydrocarbon from particular real property; and (B) from a specified volume, or a specified value, from the liquid or gaseous hydrocarbon produced from such property, and determined without regard to production costs.”
 - **11 U.S.C. § 541(b)(4)(B)** – The Bankruptcy Code carves out from the definition of property of the estate a debtor’s interest in hydrocarbons that have been transferred pursuant to the “written conveyance of a production payment to an entity that does not participate in the operation of the property”

Unlike ORRIs – a net profits interest may be deemed transfers of personal property and potentially impacted by a Chapter 11 case

21

Issue #2

Redeterminations of Reserve Based Loans

22

RBL Borrowing Base Considerations

- E&P companies frequently have a secured, revolving reserve-based lending (“RBL”) facility with a borrowing base that adjusts based on the Bank determined value of company’s reserves
- How a borrowing base is calculated:
 - Typically calculated at the lenders’ sole discretion, “in accordance with the lenders’ customary practices and standards for oil and gas lending as they exist at the particular time,” which provides lenders flexibility in turbulent markets
 - Value attributed to reserves based on lenders’ current oil and gas pricing policy (the “price deck”)
 - Formula is calculated as a percentage of a producer’s proved developed producing reserves (“PDP”) plus a percentage of proved developed non-producing reserves (“PDNP”), plus a percentage of proved undeveloped reserves (“PUD”)
 - *Calculations are based on value of proved (“1P”) reserves and generally not on the probable (“2P”) or possible (“3P”) reserves*
- Borrowing base redeterminations are based on an independent petroleum engineer’s “Reserve Report,” created annually, and an unaudited mid-year Reserve Report
 - Redetermination occurs at least twice per year, plus RBL agreements frequently allow borrower and/or lenders one or more additional redeterminations per year
- Market value does not equal reserve value

23

RBL Borrowing Base Considerations

- Commodity price shifts can create situations where borrowing base is upside down (i.e., outstanding amount is greater than borrowing base amount)
- If not corrected, generally by paying down outstanding amount, Borrower is in default
- Result: At a time of lower cashflow due to lowered commodity price, Borrower is expected to pay down substantial amount of loan

24

Issue #3

Extent and Validity of Liens

25

What is Leased? Where are the Liens?

- What is covered by the lease?
 - Is it all minerals?
 - Is it minerals to a certain depth?
 - Is it minerals to certain formation?
 - Is it minerals in a certain formation?
- What acreage is HBP?
- Are there any farmout agreements?

26

Terminable Events – Is a Lease Still Covered by the Liens?

- Generally determined by the lease
- As to Undeveloped Acreage:
 - failure to pay delay rentals
 - failure to continuously drill may cause release of undeveloped portions of lease
- As to the Entire Lease
 - in some cases, the failure to pay royalties
 - failure to drill within primary term
 - the lack of production in paying quantities

27

Issue #4 After-Acquired Property Clauses

28

After Acquired Property

- What, if anything, is covered by an “after acquired property clause”?
- Does applicable state law require description of a lease with specificity
- Does the language in the mortgage or deed of trust cover all property in a county?
- Does the language in the mortgage or deed of trust only cover property “earned” in a specific lease?
- After Acquired Property Clauses
 - Are they drafted to cover all acreage or just acreage within a lease or prospect?

29

Issue #5

Strategy on Oil and Gas Unencumbered Assets

30

Unencumbered Assets

Collateral Coverage Issues

- E&P companies typically pledge all of their “Oil and Gas Properties” to obtain secured lending
 - Pledge of all Oil and Gas Properties typical for both secured term loans and RBL facilities
 - Unlike borrowing base calculations, the standard formulation of security interests granted includes a pledge of “Probable” (2P) and “Possible” (3P) oil and gas reserves in addition to the more valuable “Proved” (1P) reserves
- “Oil and Gas Properties” are generally real property interests – liens on such interests must be perfected through mortgages
 - Mortgages are filed at the county level in the jurisdiction of the Oil and Gas Property
 - Mortgages can be expensive to file and maintain
 - Procedures for filing mortgages vary from state-to-state and even county-to-county
 - Process typically takes longer than UCC-1 filings
 - Company cooperation required to accomplish filings

31

Unencumbered Assets

Collateral Coverage Issues

- Due to difficulties in keeping mortgages current for all Oil and Gas Properties, credit agreements require delivery of mortgages at a percentage of 1P value
 - Facility size typically based on value of proved reserves, often sized at ~60% of PV-9 or PV-10 value of proved reserves
 - Required collateral coverage percentages often between 75-90% of total value of borrower's proved (1P) reserves
 - From lenders' perspective, value of mortgaged assets held as collateral only needs to be high enough to maintain cushion
- E&P Lenders often do not lend based on value of probable (2P) or possible reserves (3P), so no credit is given for mortgages delivered on those properties
- Thus, E&P companies typically do not deliver mortgages for their 2P and 3P properties, so liens on those properties are unperfected when companies enter chapter 11

Result: E&P companies often have unencumbered assets

Typical Formulation:

“Maintenance of Liens on Properties. The Borrower shall cause the Mortgaged Properties to constitute at least eighty-five percent (85%) of the total value of the Proved Reserves of the Borrower and its Subsidiaries and at least eighty-five percent (85%) of the total value of the PDP Reserves of the Borrower and its Subsidiaries (the “Required Percentages”).

Within thirty (30) days following each determination or redetermination of the Borrowing Base, the Borrower will execute and deliver documentation in form and substance satisfactory to the Administrative Agent, granting to the Administrative Agent first perfected Liens on Oil and Gas properties that are not then part of the Mortgaged Properties, sufficient to cause the Mortgaged Properties to include the Required Percentages.”

32

Are Prior Liens Perfected?

- Did a lease expire as to certain acreage not HBP?
- Did lease expire as to certain acreage pursuant to a continuous development clause (“CDC”)?
- Are any leases unitized or pooled? If so, to what depths?
- Are UCC financing statements correctly and timely filed?

33

What is the History of the Leases?

- In the ordinary course of business, rights to wells or leases can be gained, reduced, increased or lost
- Generally, record title remains with the farmor until the earning event
 - Farm-outs (requiring the assignment of part of a lease in exchange for drilling)
 - Farm-ins (earning all or part of a lease by undertaking the costs of drilling)
 - “farmout safe harbor” in § 541(b)(4)
- Was a lease renewed or extended?
- Is it a “new” lease not covered by a prior mortgage?
- Does lender have right to an override?

34

What are the Drilling Obligations?

- Need to balance contractual obligations to drill (as often as every 90 days) against the costs of drilling and the value (if any) gained from production
- What are the specific obligations?
- Can you drill but not complete a well and still satisfy the drilling obligations?
 - Over 1,000 wells in North Dakota
 - Over 1,400 wells in Texas
- Given the current pricing by servicers, is drilling but not completing the best of both worlds?
- Are the Lessors willing to modify the drilling obligations?

35

Issue #6 Subordination of Liens

36

Service Companies and Sub-Contractor Liens

- If the Debtor/Service Company does not pay its subcontractors,
 - Most state law permits subcontractor to file liens against the property where the work was performed
 - The Operators (owner of such property) will exercise their rights of recoupment and/or setoff
 - Significant impact on cash flow projections

37

Mineral Liens

- Lease-specific and arguably well-specific in certain instances
- Relate back to the date of the first work on the property
- Typically have six months from the date of last work to file the lien affidavits
- Whether proceeds of production are covered varies by state
- Valuation of the property may be critical
 - What was the purpose of the reserve report?
- Are Mineral Liens included in the collateral?
 - What notice is required to be given to service company lenders regarding the filing of mineral liens?

38

Liens Against the First Purchaser



In re SemCrude [Case No. 09-3009 (3d Cir 2009)]

- Superpriority security interest to secure payment of the purchase price of oil and gas will automatically arise and be perfected in favor of an owner
- The security interest will only attach to the oil and gas (and any proceeds thereof) of the first person that purchases the oil and gas from the interest owner
- Any subsequent buyer in the ordinary course will take the oil and gas free and clear of the security interest
- Exists in Texas and a few other states pursuant non-uniform provisions of the UCC or by other statute [Texas UCC § 9-343]

39

Subordination Considerations Specific to Oil & Gas

- Lenders in the oil and gas industry should be aware of certain subordination risks, including broad state-created statutory liens in favor of trade creditors
 - **Texas** – Tex. Prop. Code Ann. § 56.002 (2014)
 - Grants a “mineral contractor” or “mineral subcontractor” a lien to secure payment for labor or services related to “mineral activities”; “mineral contractor” and “mineral subcontractor” are broadly defined to include persons performing labor or furnishing or hauling material, machinery or supplies; “mineral activities” is also broadly defined and includes “digging, drilling, torpedoing, operating, completing, maintaining, or repairing” an oil and gas well or pipeline
 - **New Mexico** – N.M. Stat. Ann. § 70-4-1 (2015)
 - “Every person who shall, by contract, express or implied” who performs labor, furnishes or hauls materials, equipment, tools, or machinery that can be used or employed in digging, drilling, maintaining, operating or repairing any oil or gas well is permitted to file a lien upon the land, leasehold, pipeline, right-of-way or other real property interest
 - **Colorado** – Colo. Rev. Stat. § 38-24-101 (2014)
 - “Every person, firm, or corporation” that works as a contractor, subcontractor, laborer or supplier to any owner or lessee of an oil and gas lease is entitled to a lien upon the well itself or even the working interest to secure payment
 - **Louisiana** – La. Rev. Stat. Ann. § 9:4862 (2015)
 - Grants liens to secure “obligations incurred in operations,” plus Louisiana state courts have held the state’s lien law is “stricti juris,” meaning the lien can attach to any of the gas proceeds, property interests, or other property described in the state’s lien statute—including third-party working interests

40

Issue #7

Debt Layering

41

Debt Layering

- High yield indentures often allow for the incurrence of new debt
 - Analysis of high yield indentures in the oil and gas space reveal that many of these indentures have highly permissive definitions of “Permitted Liens”
 - So long as the indebtedness incurred qualifies as “Permitted Indebtedness,” these highly permissive “Permitted Liens” provisions allow significant, and in some cases virtually unlimited, secured debt to be layered on top of the unsecured notes, often as part of the “Credit Facilities basket”
 - The “Credit Facilities basket” permits a borrower to incur a specified amount of debt under “Credit Facilities,” a broad term customarily defined to include both bank debt and capital markets debt in the form of debt facilities, indentures, or commercial paper facilities

42

Issue #8

Asset Sales

43

Asset Sales

- Interest varies significantly by Field
- Permian is “hot” – some producers breaking even at \$37
- In Samson
 - No overbids for four asset packages in Williston (North Dakota and Montana); Oklahoma and San Juan (New Mexico and Colorado)
 - Permian – four bidders with 37 rounds of overbids
- Assets have been sold at depressed prices averaging about \$.15 on the dollar of total debt when sold to third parties:
 - **American Eagle Energy Corp.** owed \$215 million. Its properties sold for \$45 million.
 - **BPZ Resources Inc.** owed \$275.2 million. Its assets sold for about \$9 million.
 - **Dune Energy** owed \$144.2 million. Its assets sold for \$20 million. Two fields sold for \$1.00 plus assumption of tax P&A obligations.

44

Asset Sales cont'd

- **Emerald Oil Inc.** – auction cancelled, pre-petition lender only bidder with a \$110 million credit bid. \$312 million in total debt, \$112 million secured.
- **Endeavor International Corp.** owed \$1.63 billion. Some assets sold for \$9.65 million and the rest were handed over to lenders.
- **ERG Resources LLC** opened an auction with a minimum bid of \$250 million. No takers.
- **Intervention** – no purchasers.
- **Osage** owed \$42 million. Its assets sold for \$8.4 million (3 bidders).
- **Quicksilver** owed \$2.35 billion. Its assets sold for \$235 million.
- **RAMM Global Energy Company.** No qualifying bids.
- **Samson** owed \$4.3 billion. Its assets sold for \$660 million.
- **WBH Energy.** No qualifying cash bids.

45

Issue #9

Momentive Cram Down Considerations

46

Background

- Momentive Performance Materials produces silicones, silicone derivatives, and products derived from quartz and specialty ceramics
- Formerly a division of General Electric Company, it was acquired by investment funds affiliated with Apollo Global Management, LLC in 2006 and filed a Chapter 11 case on April 13, 2014
- Apollo as prepetition equity holder exerted its influence to obtain a restructuring support agreement with Momentive and its Ad Hoc Committee of Second Lien Noteholders that would propose a prearranged plan that effectively eliminated senior noteholder claims for make-whole premiums and postpetition interest through a “death trap” mechanism, by agreeing to provide \$600m in equity for the reorganized business

47

Restructuring Support Agreement and Plan

- Death trap:
 - If senior noteholder classes accept: Paid in full in cash, but agree to take no make-whole or post-petition interest
 - ✓ If class rejects: Receive secured cramdown note, including make-whole claim, if allowed
 - Principal = equal to allowed secured claims
 - Interest rate = amount sufficient to give present value

Note: A cramdown is the involuntary imposition by a bankruptcy court of a plan of reorganization on a class of creditors following a vote to reject a proposed plan or reorganization by that class

48

Momentive Tools: Cramdown Interest Rates

- The Court held that the debtors can “pay” senior noteholders with a cramdown note at interest rates approximating seven-year treasury note rate plus a premium for risk, with no make-whole or postpetition interest
- Proposed plan treatment vs. Judge Drain’s ruling vs. creditor proposed treatment:

Creditor	Plan Proposed Treatment	Court Proposed Treatment	Creditor Proposed Treatment
\$1.0 billion first lien notes	Seven-year Treasury note rate plus 1.5 percent, <u>3.60%</u> as of August 26, 2014	Seven-year Treasury note rate plus 2.0 percent, <u>4.1%</u> as of August 26, 2014	Market-rate, as evidenced by seven-year exit term loan, LIBOR plus 4.0% (1% floor), <u>5.0%</u> as of August 26, 2014
\$250 million 1.5 lien notes	Imputed 7.5 year Treasury note rate (based on weighted averaging of the rates for seven-year and ten-year Treasury notes) plus 2%, <u>4.09%</u> as of August 26, 2014	Imputed 7.5 year Treasury note rate (based on weighted averaging of the rates for seven-year and ten-year Treasury notes) plus 2.75%, <u>4.85%</u> as of August 26, 2014	Market-rate, as evidenced by exit bridge facility, LIBOR plus 6.0% (1% floor), <u>7.0%</u> as of August 26, 2014, subject to 0.5% step-ups every 3 months up to cap

49

Momentive Tools: Cramdown Interest Rates

- Judge Drain’s analysis of the appropriate method of calculating a cramdown interest rate focused on two significant Chapter 13 cases, the Supreme Court’s plurality opinion in *Till v. SCS Credit Corp.*, and the Second Circuit’s decision in *In re Valenti*.
 - *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004)
 - *In re. Valenti*, 105 F.3d 55 (2d Cir. 1997)

50

Issue #10

RBL Prepetition Draw Downs

51

Revolver Draw Downs Prior to a Chapter 11 Filing

- As capital markets remain tight in the oil and gas industry, many distressed oil and gas companies are fully drawing revolver availability
- Many RBLs have very few limitations on a distressed company's ability to draw on remaining revolver availability
 - RBLs generally require a representation that a company is solvent for the initial revolver draw/initial entry into the agreements
 - A solvency representation is often not required for subsequent draws
- Many RBLs also do not require that a company deposit drawn funds with a lender bank
 - Many RBLs do not require control agreements with RBL banks
 - Therefore, many distressed oil & gas companies have tapped remaining revolver availability and then deposited the funds in a bank outside the potential reach of RBL lenders
- Unencumbered funds may be used to fund a Chapter 11 bankruptcy
 - Avoids expensive DIP financing

52

Recent Revolver Draw Considerations

Below are examples of distressed E&P borrowers that full drew on revolving credit facilities in an effort to maximize liquidity prior to anticipated Chapter 11 filings

COMPANY	DRAW DATE	ANNOUNCED	AMOUNT DRAWN (millions)
 Alpha Energy Services	Jun. 2015	July 7, 2015 (8-K)	\$445
 VANTAGE ENERGY	Sept. 2015	Nov. 9, 2015 (10-Q)	\$150
 PARAGON ENERGY	Sept. 2015	Sept. 3, 2015 (8-K)	\$332
 SANDRIDGE ENERGY	Jan. 2016	Mar. 3, 2016 (PR)	\$233
 LINN ENERGY	Jan. 2016	Jan. 25, 2016 (8-K)	\$488.9
 MIDSTATES ENERGY	Feb. 2016	Feb. 4, 2016 (8-K)	\$919
 Chaparral Energy	Feb. 2016	Feb. 9, 2016 (8-K)	\$249.2
 Peabody Energy	Feb. 2016	Feb. 12, 2016 (8-K)	\$141
 UP ENERGY	Feb. 2016	Feb. 18, 2016 (8-K)	\$120
 UP ENERGY	Feb. 2016	Feb. 18, 2016 (8-K)	\$266

Source: Company filings.

53

Impact on Fulcrum Security

- Fulcrum is a lever
- A partially-in-the-money group of claims has leverage over a bankruptcy plan because they are often the only class of claims that has a vote that matters
- The existence of a fulcrum security usually means that a senior class of debt is being paid in full

54

Comptroller Guidelines for Examiners

- ***Safety and Soundness – Oil and Gas Exploration and Production Lending***
issued by the Comptroller focused on upstream lending
 - March 2016
 - 84 pages
 - Addresses
 - Capital Adequacy
 - Asset Quality
 - Management
 - Earnings
 - Liquidity
 - Sensitivity to Market Risk
 - Other Activities

55

Issue #11 Gas Gathering Contract Rejections

56

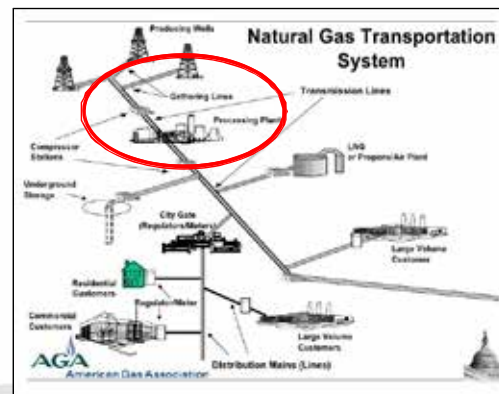
Executory Contracts Recap

- A debtor has the ability to assume, assign, or reject executory contracts and unexpired leases pursuant to section 365 of the Bankruptcy Code. Rejection of an executory contract constitutes a **breach** of that contract [§ 365(g)]
- Importantly, a debtor's rejection of an executory contract or unexpired lease does not affect covenants to non-debtors parties that “**run with the land.**” This is because while rejection is a breach, it does not terminate separately granted property rights, which are frequently subject to recording requirements and are intended to burden real property

57

Gas Gathering Systems

- A “**Gas Gathering System**” is a network of pipelines directly connected to wells producing natural gas. The purpose of a gas gathering system is to collect gas from various wells and bring it by smaller, individual lines to a central point
- Once gathered, the natural gas is processed by separating dry gas from natural gas liquids: both are then streamed for further delivery
- The **Gas Gathering System** is usually constructed by a company granted a dedication of the hydrocarbons produced in the designated area
- Various obligations are brought under one **Gas Gathering Agreement**, which typically purports to “**run with the land**”



58

Case Study: *Sabine Oil and Gas*



- In *In re Sabine Oil & Gas Corp.* [Bankr. S.D.N.Y. Case No. 15-11835], the debtors sought to reject two Gas Gathering Agreements as executory contracts pursuant to section 365 of the Bankruptcy Code
- **Facts:** While the Gas Gathering Agreements were filed under seal, we do know certain facts from the pleadings
 - Both Gas Gathering Agreements were governed by Texas law
 - Both non-debtor counterparties agreed to construct and operate the gas gathering systems at their own expense.
 - Both Gas Gathering Agreements included dedications of all gas produced from a designated area and agreed to deliver that gas to the contract counterparties. At least one of the Gas Gathering Agreements required Sabine to deliver a minimum amount of gas or make a deficiency payment (a “**take or pay**” provision)
 - Both Gas Gathering Agreements contained specific language stating that the agreement was a **covenant running with the land** within the designated areas
 - Both counterparties had properly filed local recordings with the appropriate authorities in connection with the Gas Gathering Agreements

59

Case Study: *Sabine Oil and Gas*



- **Official Ruling:**
 - The Debtors satisfied the standard for the rejection of the executory contracts, showing the rejection was a “**reasonable exercise of their business judgment.**” Neither counterparty had shown the rejection was the product of “**bad faith, whim, or caprice.**” [Opinion at 6]
 - The Second Circuit’s ruling in *Orion* [4 F.3d 1095 (2d Cir. 1993)] acted as a legal limitation on the Court’s authority in the context of a motion to reject, and thus it could not decide the substantive legal issue of whether the contract “ran with the land”
- **Non-Binding “Advisory” Ruling:**
 - The covenants did not run with the land under Texas law as either a real covenant or an equitable servitude, holding, “[t]he covenants at issue are properly viewed as **identifying and delineating the contractual rights and obligations with respect to services to be provided, and not as reserving an interest in the subject real property.**” [Opinion at 13]
 - The Court also held that the Agreements did not grant the counterparties a real property interest in the Debtors’ mineral estate, because the Agreements did not provide for (1) a right to develop, (2) a right to lease; (3) a right to bonus payments, (4) a right to delay rentals, or (5) a right to royalty payments. [Opinion at 13]

60

Impact on Upstream and Midstream Companies

- On May 3, 2016, the *Sabine* court issued its final opinion and held that dedications in the midstream agreements were not conveyances of real property:
 - Court noted that the agreements did not contain typical grantor/grantee, sell/transfer/convey language, the producer retained title to the produced gas, and the dedication was for performance under the agreement and not for the benefit of a grantee
 - E&P companies can threaten rejection of Gas Gathering Agreements to force midstream companies to the bargaining table
 - Both groups must review their existing Gas Gathering Agreements and consider how to protect their rights, either immediately or in the next round of negotiations with one another
- This is not the last we have heard of this issue, and clients in both the upstream and midstream space are already asking questions and trying to act proactively to ensure their rights remain intact
- Covenants running with the land will also arise in the context of sale of oil/gas assets
 - Can a debtor sell assets free and clear of a covenant running with the land?

61

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62

“How did you go bankrupt?”
“Two ways. Gradually, then suddenly.”
— Ernest Hemingway, *The Sun Also Rises*