Lights Out! Hot Topics and Recent Developments in Energy-Related Chapter 11 Cases

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LIGHTS OUT! HOT TOPICS AND RECENT DEVELOPMENTS IN ENERGY-RELATED CHAPTER 11 CASES

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I. FINANCING ISSUES RELATED TO OIL AND GAS CHAPTER 11 CASES

As oil and gas chapter 11 filings have increased, unique issues related to both the use of cash collateral and debtor in possession financing, have come to the forefront. Most oil and gas exploration companies access credit through a combination of a reserve based lending ("RBLs") and public debt. An RBL is typically secured by the proved reserves of a borrower (including producing, non-producing, and undeveloped). It is repaid through proceeds derived from sales of hydrocarbons from such reserves. The facility's borrowing base, limited by its face amount, is "redetermined" by the lenders, typically each spring and in the fall, based on a review of the borrower's reserve report and a valuation of the proved hydrocarbon reserves set forth therein. For example, a lender may advance 50% of the value of proved, developed producing reserves, 30% of the value of proved developed, non-producing reserves and 20% of the value of proved but undeveloped reserves. (Typically, no credit is given for unproved reserves).

In the event a borrowing base is redetermined downward and the amount outstanding under the RBL exceeds the redetermined borrowing base, the borrower will be required to repay the deficiency. With respect to an investment grade borrower, where the borrowing base of an RBL is specifically tied to the borrower's hydrocarbon reserves, the collateral for the RBL will typically be limited to the hydrocarbons contained in the most recent reserve report utilized to

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determine the borrowing base, proceeds of the reserves and assets directly associated with the production of the hydrocarbons.

Most active oil and gas exploration companies typically have additional properties that are classified as probable or possible, i.e., not proved, and may not be included in a reserve report. These unproved assets are not usually encumbered by the borrower's RBL. Additional unencumbered assets exist as a result of the structure of a typical RBL, which only requires perfection of a certain percentage of the value of the proved reserves contained in the applicable reserve report—often between 80% and 85%.

The collateral of secured public debt will often mirror or near mirror that of the RBL. This structure leads to potentially significant pockets of unencumbered assets including: (a) cash drawn under the RBL; (b) assets acquired after the most recent redetermination period; (c) unproved properties; and (d) assets that are unencumbered because the lenders have not perfected their security interest. As oil and gas companies navigate chapter 11, the existence of significant unencumbered assets has awoken previously "settled" or "accepted" issues and created significant litigation.

A. Cash, Cash, and More Cash

Cash drawn under an RBL is not traditionally part of the RBL collateral package for an investment grade borrower. (Many lenders therefore require borrowers to pledge cash drawn under RBLs as collateral in connection with forbearance or loan modification requests.) As a result, it is not unusual for a borrower to fully draw down on its RBL and deposit funds in a non-lender account immediately prior to a chapter 11 filing. The debtors in *Quicksilver Resources, Inc., et al.*, Case No. 15–10585 (CSS) (Bankr. D. Del.), *Samson Resource Corporation, et al.*, Case No. 15–11934 (CSS) (Bankr. D. Del.), and *Endeavour Operating Corporation, et al.*, Case No. 14-12308 (KJC) (Bankr. D. Del.), each did just that. The action may alleviate the need for post-petition financing and, arguably, the need for a cash collateral order: in effect, the draw down acts as debtor in possession financing (and potentially also exit financing).

While borrowers may find it attractive to enter chapter 11 with significant unencumbered cash, this comes with some unique issues. Drawing down on an RBL may also create increased liability for a borrower's officers, directors, and managers. Most facilities require a borrower to provide a solvency certificate in connection with a borrowing. To the extent that a party submits a patently false solvency certificate that causes a borrower to plunge deeper into insolvency, the act may not be excused as ordinary negligence of inattention, but may constitute gross negligence. *See, e.g.*, *In re Greater Se. Cmty. Hosp. Corp. I*, 353 B.R. 324, 343 (Bankr. D.D.C. 2006), *as amended* (Sept. 26, 2006).

B. Adequate Protection

The Bankruptcy Code requires a debtor to provide a secured creditor with adequate protection against the diminution in value of the creditor's interest in collateral resulting from: (a) the imposition of the automatic stay under § 362; (b) the use, sale, or lease of the property under § 363; and (c) the granting of a lien under § 364. 11 U.S.C. §§ 361–64. This adequate protection should maintain the status quo: "the code specifically ensures the protection of a secured creditor's assets against any decrease in value from the beginning of the automatic stay, and, because the stay is instituted the moment the petition is filed, the protection from depreciation and also begins at the moment." *Chase Manhattan Bank USA NA v. Stembridge (In re Stembridge)*, 394 F.3d 383, 387 (5th Cir. 2004). But for an oil and gas exploration company, many customary forms of adequate protection, including granting of liens on unencumbered assets and waiver of §§ 502(c) and 552, often induce objections from a debtor's stakeholders.

1. Granting of liens on unencumbered assets and superpriority claims

Most chapter 11 cases do not involve significant unencumbered assets. However, the structure of an RBL lends itself to a case with a potentially large number of unencumbered assets. When presented with this, unsecured creditors are resistant to provide prepetition lenders with liens on all unencumbered assets or superpriority claims that will allow the lenders to recover against unencumbered assets. This is particularly true where a lender does not provide additional funding for the case, but rather seeks adequate protection solely in connection with the use of collateral or cash collateral. Creditors will commonly assert that secured lenders should not be allowed to swoop in and bolster their secured position to the detriment of unsecured creditors, but rather, that they should be required to "pay to play"—particularly if the lender seeks to use the chapter 11 process to liquidate its collateral.

2. Waiver of §§ 502(c) and 552

It is common for a lender to require a borrower to waive both the right to surcharge the lender's collateral pursuant to § 506(c) and the equities of the case remedy of § 552(b). Debtors are often willing to waive these provisions because most debtors have little to no unencumbered assets and, therefore, secured lenders are already likely bearing the cost of the case. This is particularly true where a lender has agreed to a "carve out" of their collateral to provide for the payment of certain estate administrative costs. However, in a case where substantial unencumbered assets exist to fund administrative expenses, creditors have asserted that it is inappropriate to both encumber all previously unencumbered collateral and at the same time require a debtor to provide §§ 502(c) and 552(b) waivers. One potential practical solution to address this concern is to limit §§ 502(c) and 552(b) claims to any cash adequate protection payments made to a lender during the chapter 11 case.

C. Accounting for and Segregating Cash Collateral

Section 363 provides that "[e]xcept as provided in paragraph (2) of this subsection, the trustee *shall* segregate and account for any cash collateral in the trustee's possession, custody, or control." 11 U.S.C. §363(c)(4) (emphasis added). While this may seem innocuous, for an oil and gas operator, it is near impossible to segregate cash collateral upon receipt. First, it takes a typical oil and gas operator thirty to sixty days to determine what portion of monthly production revenue belongs to the operator. (See Appendix A for an illustrative example of one oil and gas company's revenue timeline.) Second, revenue payments, when received, include the revenue of both the operating debtor and its non-operating partners. Finally, because many wells produce hydrocarbons from both encumbered and unencumbered leases, to properly segregate and account for cash collateral, a debtor must devise an appropriate methodology for determining what portion of each well's production was derived from encumbered leases and what portion was derived from unencumbered leases.

D. What to do with diminution in value claims

After the entry of a cash collateral or debtor in possession financing order, the very nature of the oil and gas industry creates additional disputes about the valuation of diminution in value claims. To the extent the liens granted to an undersecured creditor under § 361 of the Bankruptcy Code are insufficient to provide adequate protection for a creditor's interest in its collateral, the secured creditor is entitled to a superpriority claim under § 507(b) of the Bankruptcy Code, which entitles such creditor to recovery ahead of every unsecured and regular administrative creditor. *See*, *e.g.*, *LNC Investments, Inc. v. First Fidelity Bank*, 247 B.R. 38, 41 (S.D.N.Y. 2000) (stating that "in the privileged world of administrative claims, the § 507(b)-anointed claim is *primus inter pares*."). Section 361 of the Bankruptcy Code, which generally provides for a secured creditor's entitlement to adequate protection, provides no guidance with respect to determining the quantum of the adequate protection to which such creditors may be entitled (whether on secured or superpriority basis). The Supreme Court has explained, however, that valuation in the adequate protection context is the same as the valuation for establishing the amount of a secured claim under § 506(a) of the Bankruptcy Code. *See United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988); *see also In re Winthrop Old Farms Nurseries, Inc.*, 50 F.3d 72, 74 (1st Cir. 1995) (stating that "a valuation for § 361 purposes necessarily looks to § 506(a) for a determination of the amount of secured claim"). Section 506(a) of the Bankruptcy Code provides that "value shall be determined in light of the purpose of the valuation and of the proposed distribution or use of [collateral], and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a)(1) (emphasis added).

In the face of this, parties may assert that the calculation of a diminution in value claim simply requires the court to look to the proved value of a debtor's assets as of the petition date verses the proved value of a debtor's assets as of the calculation date. If this simplistic approach were accepted, the lender's superpriority administrative claim would likely swamp all other claims, resulting in an administrative insolvent estate. Parties who stand to fund the diminution in value claims from their recovery will likely assert that a secured lender's diminution in value claim must be adjusted to reflect the cost to the secured lender to liquidate or otherwise take control of the collateral. Given the cost attendant to litigating such an issue, it is likely that such disputes will, as they have to date, settle prior to trial.

II. ENVIRONMENTAL CONSIDERATIONS

A. The Role and Importance of Surety Bonds as Security for Environmental Obligations in Coal, Oil, and Gas Bankruptcies

"A bedrock principle of environmental law and regulation" holds that "pollution costs should be borne by their creators." James Boyd, *Financial Responsibility for Environmental Obligations: An Analysis of Environmental Bonding and Assurance Rules* (Aug. 2001), *available at* http://www.ucl.ac.uk/cserge/Boyd.pdf (last accessed May 27, 2016) [hereinafter "*Financial Responsibility*"]. To effect this goal, state and federal laws impose bonding requirements on potentially polluting activities. Mining and oil and gas extraction have environmental consequences, so often catch lawmakers' eyes. For example, the Surface Mining Control and Reclamation Act ("SMCRA" or the "Act") mandates that a mining permit applicant submit a performance bond that covers reclamation obligations. 30 U.S.C. § 1259..

Bonding requirements ensure that states have sufficient funds to reclaim mined land if the operator cannot. *See, e.g.*, Gregory E. Conrad, *Mine Reclamation Bonding—From Dilemma to Crisis to Reinvention: What's a State Regulator to Do?* at 3 (Feb. 11, 2014), *available at* http://www.imcc.isa.us/EMLF%20Bonding%20Presentation%20Final.pdf (last accessed May 27, 2016). They thus force an operator to account for environmental risks on its balance sheets. *Financial Responsibility* at 7. Further, bonding "can also foster timely, relatively low-cost public access to compensation." *Id.* at 8.

Different types of bond are available: "surety, collateral (such as cash, securities, letters of credit and CDs), self-bonds and corporate (or third party) guarantees." *Id.*; *see also* W. Va. Code Ann. 22–3–11(c)(1) (approving of "surety bonding, collateral binding . . . establishment of an escrow account, self bonding, or a combination of these methods."). Operators that self-bond must demonstrate independent wealth; those that use surety bonds must persuade an independent, self-interested arbiter of their capacity for reclamation. *Id.*

Self-bonds are popular among mining companies: an aggregate $3.6 billion of self-bonds have been posted for SMCRA permits. They are also controversial. On March 8, 2016, Senators Cantwell (D-WA) and Durbin (D-IL) penned a letter to the Comptroller General of the United States requesting that he investigate self-bonding authorizations and performance. Letter from Senators Maria Cantwell and Richard J. Durbin to the Honorable Gene L. Dodaro, Comptroller General of the United States (Mar. 8, 2016), *available at* http://www.energy.senate.gov/public/index.cfm/files/serve?File_id=47C14E0B-8A9D-457F-A1DE-0B7135144E1B (last accessed June 7, 2016). Senators Cantwell and Durbin believe that SMCRA's self-bonding authorization should be revisited: they write that self-bonds rely on the applicant's financial status. But energy companies who self-bond lack a diversified business and participate in a rapidly changing commodity market; they are therefore at a higher risk of default than self-bonds pledged by companies in other industries. Further, self-bonding places an inappropriate obligation of regulators, the Senators write. Regulators are not trained financial analysts, but must perform that task when evaluating a self-bonded permit application. The Senators next describe previous investigations into self-bonding across a number of industries by the Government Accountability Office, which generally concluded that the practice is often inadequate protection and frequently leaves taxpayers footing large bills.

Regardless of form, though, the supporting bond must cover the entire area permitted (and incremental increases) for the length of the permit. 30 U.S.C. § 1259; W. Va. Code Ann. § 22–3–11(a). On this point, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, the Supreme Court reaffirmed that an operator's bankruptcy does not empower its circumvention of otherwise applicable health and safety laws. 474 U.S. 494, 502, 505–07 (1986). The Court found that Congress did not intend for the abandonment power, 11 U.S.C. § 554, to preempt laws "reasonably designed to protect the public health or safety from identified hazards." *Id.* at 507. Put another way, "[t]he principle underlying *Midlantic* is that a bankruptcy court should not allow abandonment where it would be in derogation of laws reasonably designed to protect the public's health and safety." *In re ATP Oil & Gas Corp.*, No. 12–36187, 2013 WL 3157567, at *3 (Bankr. S.D. Tex. June 19, 2013).

A bankruptcy filing forces parties to make hard choices: debts are plentiful, but funds are not. In most cases, not every creditor recovers. So too for reclamation obligations: some may remain uncompleted. *Midlantic* prohibits a debtor from abandoning burdensome property if health and safety law would not allow it. Yet, notably, *Midlantic* refrained from addressing "the question whether certain state laws imposing conditions on abandonment may be so onerous as to interfere with the bankruptcy adjudication itself[.]" 474 U.S. at 507. Thus, one must wonder whether a federal or state regulatory body could *waive* certain bonding requirements to maximize the allocation of funds to certain projects. Put another way, could a regulatory body allow the abandonment of one piece of property to ensure that another is fully remediated?

B. The Division of Good Assets from Bad in § 363 Sales—With Particular Consideration to Parties Willing to Purchase Bad Assets

After notice and a hearing, § 363 of the Bankruptcy Code authorizes a debtor to sell its assets outside the normal course of business. Under certain conditions, the debtor can sell the assets free and clear of any party's interest in them. In the energy sector, a "free and clear" sale can be lucrative: the avoidance of contractual covenants and non-assignability clauses and minimization of successor liability entices buyers.

Not all encumbrances can be avoided, though. Some environmental and tort injuries do not appear during the bankruptcy proceeding, but take years to manifest. Some environmental laws impose strict liability. *See, e.g.*, 42 U.S.C. § 9607(a). So some assets acquire a taint for which § 363 is no solvent.

Few purchasers want such assets—from which extensive litigation or reclamation and significant judgments or fines can materialize. To entice prospective purchasers, a debtor naturally prefers to offer liability-free assets. In recent proceedings, some coal companies have done just that. Specifically, companies have offered productive, profitable assets in one package and encumbered, burdensome assets in another. *See, e.g.*, *In re Patriot Coal Corp.*, No. 15–32450 (KLP), Notice of Filing of Debtors' Fourth Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code, [Docket No. 1332] at 31–33 (Bankr. E.D. Va. Sept. 18, 2015) (outlining two asset purchase agreements). Most prospective purchasers are interested only in "good assets." Yet, some do want "bad assets."

Virginia Conservation Legacy Fund (and its sibling ERP Compliant Fuels LLC (collectively, "VCLF")) is one organization eager to purchase bad assets. *See, e.g.*, Dylan Brown, *Environmentalist's Foray Into Mining Gets Bolder*, GREENWIRE, *available at* http://www.eenews.net/stories/1060037949 (May 26, 2016) (last accessed May 26, 2016). VCLF purchases distressed assets sullied by environmental liabilities. It continues to operate the mines. But it does so to generate revenue for reclamation. VCLF also aims to reforest mined land and then sell coal in carbon-neutral bundles. *See, e.g.*, *id.* and Scott Tong, *Here's a Plan: Plant Trees, Mine Coal*, Marketplace (Oct. 7, 2015). VCLF thus offers something for everyone: miners get jobs, environmentalists get trees, and debtors' estates get a fillip.

So far, VCLF has succeeded in two endeavors and failed in another. In *Patriot Coal*, VCLF took on "more than $400 million in [] reclamation and miner health care liabilities in exchange for more than 150 mining permits in six Appalachian states, [as well as] mines and equipment." *Environmentalist's Foray Into Mining Gets Bolder*, *supra*. The purchase complemented the debtors' sale of good assets to an entity formed by a number of lenders. *See also, generally*, *Patriot Coal*, Confirmation Order [Docket No. 1615] (Bankr. E.D. Va. Oct. 9, 2015) (approving, *inter alia*, the sales of assets to VCLF and Blackhawk Mining LLC). And in *Walter Energy*, a division of VCLF purchased coal and coke assets for $1 and assumption of liabilities related to the properties. *See, e.g.*, Daniel Tyson, *Walter Energy Assets Sold to Seminole Coal Resources*, Beckley Register-Herald, (Feb. 18, 2016). But in *Alpha Natural Resources*, VCLF lost out on its bid for assets despite offering the embattled companies $3 billion. *Environmentalist's Foray Into Mining Gets Bolder*, *supra*.

C. Permit Blocking

As described above, a company that seeks to operate a mine must obtain state and federal permits. The permits typically include reclamation obligations. *See, e.g.*, 30 U.S.C. § 1258. One method by which reclamation obligations are enforced is through "permit blocking." In essence, an operator that fails to comply with its reclamation obligations for one permit is prohibited from obtaining another.

Specifically, SMCRA established an "Applicant Violator System" through which regulatory bodies monitor permit condition violations. New applicants pass through the system; a negative hit mandates denial. *Id.* § 1260(c); *see also* Office of Surface Mining, Reclamation, & Enforcement, Applicant/Violator System, *available at* http://www.osmre.gov/programs/avs.shtm (last accessed May 27, 2016). At the state level, regulators must verify that an applicant does not have an outstanding permit violation before a new permit can issue. *See* Maureen D. Carmen & Richard Warne, *SMCRA Enforcement in Bankruptcy: Regulatory Powers Revisited*, 25 Energy & Min. L. Inst. 185, 193–94 (2005).

Thus, an owner or operator of a mine that fails to comply with SMCRA is effectively precluded from mining; the Applicant Violator System is an effective "blacklist." *See* Douglas E. Deutsch, *Emerging Issues in Coal Industry Bankruptcy Cases*, LAW 360, *available at* http://www.law360.com/articles/676448/emerging-issues-in-coal-industry-bankruptcy-cases (last accessed May 27, 2016). Bankrupt coal companies therefore often try to reach an agreement with state and federal regulators on permit blocking issues—as happened in *Patriot Coal* and *Arch Coal*. *See, e.g.*, *In re Arch Coal, Inc.*, No. 16–40120 Notice [Concerning Reclamation Bonding of their Surface Coal Mining Operations in Wyoming], [Docket No. 289] (Bankr. E.D. Mo. Feb. 9, 2016) and West Virginia Department of Environmental Protection, *WVDEP, Patriot Coal Reach Agreement* (last accessed May 30, 2016); *see also Patriot Coal*, Notice of Filing of Supplemental Exhibit [Docket No. 385] at § 3.07 (Bankr. E.D. Va. June 23, 2015) ("No Seller or any Affiliate of such seller is permit blocked on the Applicant Violator System by any Governmental Authority or similar state regulatory program.").

D. The Standing of Environmental Groups to Participate in Bankruptcy Proceedings

"Article III of the Constitution grants the federal courts the power to decide legal questions only in the presence of an actual 'Cas[e]' or 'Controvers[y].'" *Wittman v. Personhuballah*, 578 U.S. __, No. 14–1504, slip op. at 3–4 (May 23, 2016) (alteration in original). The corollary of this restriction is that a litigant who seeks to invoke the authority of the federal judiciary must possess Article III standing. *Arizonans for Official English v. Arizona*, 520 U.S. 43, 65 (1997). He does so by showing "that he has suffered an 'injury in fact,' that the injury is 'fairly traceable' to the conduct being challenged, and that the injury will likely be 'redressed' by a favorable decision." *Wittman*, slip op. at 4 (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560–61 (1992)).

The Supreme Court has defined an "injury in fact" as "an invasion of a legally protected interest which is (a) concrete and particularized . . . and (b) actual or imminent, not conjectural or hypothetical[.]" *Lujan*, 504 U.S. at 560 (internal citations and quotation marks omitted). Because some harms are tough to identify, or intangible, "Congress has the power to define injuries and articulate chains of causation that will give rise to a case or controversy where none existed before." *Id.* at 580 (Kennedy, J., concurring in part and concurring in judgment).

In the bankruptcy context, Congress supplied litigants with § 1109 of the Bankruptcy Code. That authority provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109(b). The Bankruptcy Code does not define "party in interest." Nor is Congress's list of examples exhaustive. But it is indicative: courts consider a party in interest to be one with a financial stake in the debtor's assets. *See, e.g.*, *In re C.P. Hall Co.*, 750 F.3d 659, 660–61 (7th Cir. 2014).

Mining and oil and gas extraction have environmental consequences. A company engaged in these activities that seeks bankruptcy protection generally wants to reduce or shed its environmental liabilities. Environmental advocacy groups therefore often try to participate in the bankruptcy proceeding. But—in contrast to federal or state regulatory bodies and bond counterparties—they frequently struggle to do so because of standing issues.

The Bankruptcy Court for the Eastern District of Virginia recently addressed this subject in *Alpha Natural Resources*. 544 B.R. 848 (Bankr. E.D. Va. 2016). There, the debtors operated a vast complex of mines in West Virginia (among other places). To obtain permits, they had to comply with environmental bonding obligations that totaled over $317 million—which they did in part through self-bonds. The debtors' financial difficulties threw their ability to satisfy the self-bonds into doubt. For that reason, they struck a compromise with the West Virginia Department of Environmental Protection (the "WVDEP"): the agency would reduce bonding requirements in return for a superpriority claim. Three environmental advocacy groups objected, though. In short, they believed that the settlement violated state and federal mining laws.

After finding that the objectors lacked standing to do so and that the compromise was in the best interests of the debtors' estate, the court approved the settlement. *Id.* at 856, 859. On the former point, the court found that the objectors lacked Article III and statutory standing. First, it wrote that the objectors failed to identify a concrete and particularized injury that would result from approval of the compromise. *Id.* at 856. Notably, they did not plead that members would be harmed by approval of the compromise. *Id.* They only alleged that the settlement violated state and federal law. *Id.* However, the court wrote, vindication of the rule of law does not suffice as an injury sufficient to confer standing. *Id*. Second, the court also found that the objectors lacked statutory standing. The objectors did not fall into any of the categories listed by Congress. Nor did they have a pecuniary interest at stake in the bankruptcy proceeding. Thus, the court determined they were not parties in interest under § 1109. 544 B.R. at 856.

Whether the *Alpha Natural Resources* decision may have turned out differently had the environmental advocacy groups alleged particularized injuries is an interesting question. Outside of bankruptcy proceedings, advocacy groups have satisfied Article III standing by alleging that members lived near polluted sites, enjoyed recreational activities in threatened areas, refrained from recreational activities because of contamination, or suffered diminished home values because of pollution. *See, e.g.*, *Friends of the Earth, Inc. v. Laidlow Envt'l Servs. (TOC), Inc.*, 528 U.S. 167, 181–83 (2000). *Cf. Sierra Club v. Morton*, 405 U.S. 727, 735 (1972). Yet, such injuries would probably struggle on Article III's redressability hurdle in the context of a Rule 9019 motion: a tenuous chain connects approval of a bonding settlement to pollution that ruins a weekend kayak trip. *See, e.g.*, *Steel Co.*, 525 U.S. at 107.

Another potential stumbling block exists, insofar as courts have required a litigant to possess a *financial* stake in a debtor's estate to qualify as a party in interest under § 1109. *See, e.g.*, *C.P. Hall*, 750 F.3d at 660–61 and *Alpha Natural Res.*, 544 B.R. at 855. Impaired recreational, conservational, and aesthetic interests are cognizable injuries in fact. *See, e.g.*, *Friends of the Earth*, 528 U.S. at 183–84, and *Sierra Club*, 405 U.S. at 738. But financial stakes they are not. Whether that distinction is meaningful for purposes of § 1109 remains to be seen.

III. THE WHITE- HOT ISSUE IN OIL AND GAS RESTRUCTURING: THE DISPOSITION OF MIDSTREAM SERVICE AGREEMENTS IN CHAPTER 11

Generally, midstream services providers supply gathering, transportation, treating, processing, and compression services to the exploration and production ("E&P") sector of the oil and gas industry. Gas flows from a reservoir through wells owned by the E&P company. In technical terms, the E&P company "severs" the minerals from the ground at the wellhead. The gas is then delivered directly from the wellhead into a network of pipelines owned by the midstream service provider. The gas is then processed by the midstream provider by separating dry gas from liquids. Next the gas is transported into larger pipeline systems for delivery to customers.

Historically, the oil and gas industry has operated under the assumption that, under Texas state law, agreements to provide such services include covenants running with the land, creating a real property interest and constituting an equitable servitude subject to and as specified in such agreements. Specifically, standard midstream agreements "dedicate"—or promise—the total volume of gas owned or controlled by an E&P company in a particular area to the midstream provider's gathering systems. Further, midstream agreements may provide that any transfer of the applicable property be made subject to the agreement.

Prolonged pressure on commodity prices has resulted in a downward shift on the market for midstream services. This turmoil has incentivized E&P companies to negotiate more favorable pricing on contracts for midstream services and, in the chapter 11 context, to seek to reject these burdensome, legacy agreements in favor of negotiating new agreements on better terms using market leverage. Motions to reject midstream contracts have upset the apple cart, because the industry expectations and behavior hinges on the belief that midstream contracts create real property interests with the benefits attendant thereto. Most recently, debtors in *In re Quicksilver Resources Inc.*, *supra*, and *In re Sabine Oil & Gas Corporation*, Case No. 15–11835 (Bankr. S.D.N.Y.), have sought to reject such agreements. Their midstream counterparties asserted that the contracts created real property interests not subject to rejection.

A. The Creation of Real Property Interests: A Question of State Law

To determine the nature of an interest in property, bankruptcy courts must look to the applicable state law. *See Butner v. United States*, 440 U.S. 48, 55 (1979) ("[p]roperty interests are created and defined by state law."). For a covenant to "run with the land" under Texas law, a party must establish the following five[2] elements:

i. Privity of estate between the parties to the agreement at the time the covenant was made;

ii. The covenant "touches and concerns the land;"

[2] Some Texas courts have required "horizontal privity" by mandating that the covenant be contained in a grant of land or property interest in land. Others have acknowledged ambiguity in state law on this point. *See Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. 2013) and *Wayne Harwell Props. v. Pan Am Logistics Ctr.*, 945 S.W.2d 216, 218 (Tex. App. 1997).

iii. The covenant is intended by the original parties to run with the land;

iv. The covenant relates to something in existence or specifically binds the parties and their assigns; and

v. The successor to property burdened by the covenant has notice of the covenant.

Inwood N. Homeowner's Ass'n, Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987); *Wayne Harwell*, 945 S.W.2d at 218; *Clear Lake Apts., Inc. v. Clear Lake Utils. Co*., 537 S.W.2d 48, 51 (Tex. Civ. App. 1976).

When a debtor seeks to reject a midstream agreement, its contract counterparty bears the burden of establishing each of these five elements because it is seeking to enforce a restrictive covenant. *Webb v. Voga*, 316 S.W.3d 809, 813 (Tex. App. 2010) ("In every case where parties seek to enforce a restrictive covenant, the burden of proof is upon them to establish that the covenant was imposed on defendant's land for the benefit of land owned by them.") (quoting *Reagan Nat'l Adver. of Austin, Inc. v. Capital Outdoors, Inc*., 96 S.W.3d 490, 495 (Tex. App. 2002)). Of the elements, the first three are particularly important to gas gathering agreements.

First, under Texas law, a covenant running with the land "must be made between parties who are in privity of estate at the time the covenant is made, and must be contained in a grant of land or in a grant of some property interest in land." *Wasson*, 405 S.W.3d at 973; *Wayne Harwell*, 945 S.W.2d at 218; *Clear Lake Apts*., 537 S.W.2d at 51. Privity of estate means a "mutual or successive relationship exists to the same rights in property." *Wasson*, 405 S.W.3d at 973. In other words, there must be "simultaneous or successive interests in the land." *Wayne Harwell*, 945 S.W.2d at 218.

Second, for a covenant to "touch and concern" the land, the covenant must affect the nature, quality, or value of the land burdened by the covenant or affect the enjoyment of the land. *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982). The *Westland Oil* opinion goes on to explain, "[i]f the promisor's legal relations in respect to the land in question are lessened—his legal interest as owner rendered less valuable by the promise—the burden of the covenant touches or concerns that land." *Id.* A personal covenant, in contrast, does not touch and concern the land because such a covenant affects the grantor personally and is unrelated to the use of the real property. *In re El Paso Refinery, LP*, 302 F.3d 343, 356 (5th Cir. 2002); *see also Martindale v. Gulf Oil Corp*., 345 S.W.2d 810, 813 (Tex. Civ. App. 1961) (holding agreement to purchase all petroleum requirements was personal contract and not a covenant).

Third, the counterparty must show that the original parties intended for the agreement to constitute a covenant running with the land. Without an express statement within the agreement to that effect, the counterparty is forced to seek to rely on parole evidence. "[W]hen construing [an unambiguous] deed, the intent of the parties is to be determined from the express language found within the four corners of the document. All parts of the deed are to be harmonized, construing the instrument to give effect to all provisions." *Montfort v. Trek Res., Inc*., 198 S.W.3d 344, 355 (Tex. App. 2006).

B. *In re Quicksilver Resources Inc.*

In February 2016, the *Quicksilver* debtors sought to reject certain gas gathering and related contracts in satisfaction of a condition precedent to closing the pending sale of substantially all of their U.S. assets for $245 million. After extensive and expedited discovery, the issues discussed herein—among others—were fully briefed in early March. For example, one of the gathering agreements at issue in *Quicksilver* included the following provision:

> Producer dedicates and agrees to deliver or cause to be delivered to Gatherer . . . the total volume of Gas owned or controlled by Producer lawfully produced from wells now or hereafter drilled on the lands within the Contract Area (or lands pooled therewith) . . . . Any transfer by Producer of its right, title, or interest in the Gas, or in an oil and gas lease, fee mineral interest or other agreement, interest or right which creates or gives rise to Producer's interest in the Gas, to a third party, whether by farmout, contract, or otherwise, shall be made specifically subject to

> this Agreement. Producer will notify any person to whom Producer transfers all or a portion of its right, title, or interest in the Gas, or in such lease, interest, agreement or right, that such Gas is dedicated pursuant to the terms of this Agreement to be gathered by Gatherer, and Producer shall obtain such third party's agreement to continue delivering such Gas to Gatherer during the term of and in accordance with this Agreement.

The midstream provider argued that rejection would be improper because the covenants are property interests that would continue to burden the subject property even after rejection. *See In re Energytec, Inc*., 739 F.3d 215, 225 (5th Cir. 2013) (holding that bankruptcy sale was not free and clear of covenants running with the land); *Gouveia v. Tazbir*, 37 F.3d 295, 298-99 (7th Cir. 1994) (finding § 365 inapplicable to covenants running with the land, which are property interests); *In re Beeter,* 173 B.R. 108, 114 (Bankr. W.D. Tex. 1994); *In re Banning Lewis Ranch Co*., 532 B.R. 335, 345–46 (Bankr. D. Colo. 2015). Therefore, non-executory (i.e., performed) portions of the gathering agreements would remain unaffected by rejection. The debtors countered, however, that the agreements did not constitute property interests and, in any event, that a covenant running with the land would not preclude them from rejecting it under § 365.

In sum, taking each of the applicable elements of a real property interest in turn, the parties argued as follows:

i. <u>Privity of estate</u>: The debtors argued that the gas becomes personal property at the moment the minerals are severed from the ground at the wellhead. Therefore, their dedication to deliver this personal property to the midstream provider did not convey any real property interest in the land itself. As a result, there is not simultaneous or successive interest in land, because no real property is involved or conveyed. *See Wayne Harwell*, 945 S.W.2d at 218 and *Clear Lake*, 537 S.W.2d at 50–51.

   The midstream provider countered that Texas courts no longer require horizontal privity as an element of the applicable legal test, noting that the Fifth Circuit has questioned whether horizontal privity is a requirement in Texas by observing that the Restatement (Third) of Servitudes "explicitly rejected" horizontal privity and that the Texas Supreme Court has not expressly required horizontal privity. *See Energytec*, 739 F.3d at 222 (citing RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 2.4 (2000)).

ii. Touch and concern: The debtors pointed out that, as a matter of law, a covenant to pay an encumbrance on land (such as a mortgage) is not a covenant that runs with the land. *Talley v. Howsley*, 170 S.W.2d 240, 243 (Tex. Civ. App. 1943). Such a covenant does not "touch and concern" the land, because it does not affect the "nature and quality" of the land itself. *Westland Oil*, 637 S.W.2d at 911. Although the covenant to pay an encumbrance may increase a person's legal interest or value in the land, such a fact is not sufficient by itself to qualify as "touching or concerning" the land. *See id*.; *Talley*, 170 S.W.2d at 243; *El Paso Refinery*, 302 F.3d at 356-57. Because, the debtors argued, the gathering agreements concern personal property and not real property, any rights created under the agreements more closely resemble personal covenants. Stated differently, the debtors' legal relations with respect to the land and its mineral leases are not lessened or rendered less valuable by the gathering agreements.

The midstream provider asserted that the plain language of the agreements satisfied the touch and concern element in that gas in the ground, and gas when produced, are both under the ownership and control of producer. Accordingly, when the producer agreed to limit its use of the land by dedicating the delivery of owned and controlled gas to the midstream provider's network, and by agreeing to subject a transfer of the land to the obligations of the agreement, the use and enjoyment of the land were impacted. *See Am. Ref. Co. v. Tidal W. Oil Corp*., 264 S.W. 335, 336–38 (Tex. App. 1924) (holding that gas sales contract providing that "gas coming from the oil wells" was as a covenant running with the land). *Wimberley v. Lone Star Gas Co.*, 818 S.W.2d 868, 870 (Tex. App. 1991).

iii. Intent: The debtors argued that the parole evidence rule applied to the court's analysis of the gathering agreements, and pointed out that the sophisticated parties could have easily included language indicating a clear intent to create a covenant running with the land, but failed to do so. *See Perry Homes v. Cull*, 258 S.W.3d 580, 606 (Tex. 2008) ("The language used in the agreement is the primary evidence of [the true intent of the parties to the agreement].").

The midstream provider urged the court to look beyond the four corners of the agreements due to ambiguity, noting that the agreements were filed in real property records as strong evidence of intent. *Harris Cnty. Flood Control Dist. v. Glenbrook Patiohome Owners Ass'n*, 933 S.W.2d 570, 575 (Tex. App. 1996). The provider also pointed out a number of SEC filings and other statements issued by the E&P company indicated, among other things, that the agreements would be filed in applicable counties and would survive any direct or indirect transfer of the company's right, title, or interest associated with its natural gas production.

Following a contested hearing on these issues, among others, the court took the matter under advisement. In the meantime, the midstream services provider and the purchaser engaged in negotiations that resulted in a settlement of contested matters. In accordance with that agreement, the debtors withdrew the rejection motion in April 2016, obviating the need for a final decision on the issues.

C. *In re Sabine Oil & Gas Corporation*

In early 2016, the *Sabine* debtors sought to reject midstream contracts. Although the agreements differ slightly from those in *Quicksilver*—most notably, they contained express acknowledgements of the parties' intent to create a covenant running with the land—the arguments made in *Sabine* were substantially similar to those made in *Quicksilver*.

In March 2016, the *Sabine* court entered an order that authorized rejection of the midstream agreements. However, the court declined to opine as to whether the agreements created a covenant running with the land, noting that applicable Second Circuit law required an adversary proceeding for such declaratory relief. This left the debtor in a quagmire regarding future production—with the current midstream contracts rejected but no ruling on whether the dedications contained in the agreements continue or were terminated along with the rejection, it was impossible to enter into new midstream contracts with a third part.

Recognizing this difficulty, the court provided a preliminary opinion indicating that the debtors were not in horizontal privity with the midstream companies. The court also found that, because the agreements provided that the midstream companies would receive the gas at certain points away from the wells and that their fees would be triggered at the receipt points, the subject of the agreements were minerals already severed from the ground (i.e., personal property). As a result, it wrote that the agreements neither touched and concerned the land nor created real property interests. In May 2016, the court issued a consistent final, binding ruling..

The midstream providers appealed the *Sabine* court's final ruling and sought to stay the order, arguing that these are unsettled issues of state law with the potential for significant repercussions in the oil and gas industry. Both the Debtors and the midstream providers seek direct appeal to the Second Circuit, and the midstream providers have requested certification of state law issues to the Texas Supreme Court. These requests remain pending as of this writing.

IV. EMPLOYMENT ISSUES

The bankruptcy of a mining, oil, or gas company presents two sides of the employment coin. On one, a company needs strong and nimble leadership to guide it through bankruptcy. On the other, a company's reorganization (let alone liquidation) frequently aims to close locations, shed liabilities, and possibly even cut its workforce. Each side presents unique difficulties.

A. The Role a Management Team Plays in Energy Bankruptcies, How Its Actions Determine Success, and How It Can be Rewarded.

Tales of woe that relate the difficulties facing coal, oil, and gas producers are legion. Already, "69 oil and gas producers with $34.4 billion in cumulative secured and unsecured debt have gone under. Since share prices peaked in 2014, the oil bust has wiped out about $1 trillion in equity[.]" Christopher Helman, *The 15 Biggest Oil Bankruptcies (So Far)*, Forbes, (May 9, 2016). A tough environment demands strong leadership. A bankrupt energy company must satisfy (or silence) competing creditor constituencies, comply with environmental and employee responsibilities, and maximize the value of its estate. And it must do so in a terrible market. Management's ability to do navigate these obstacles determines a company's success or failure.

To incentivize and reward employees, debtors employ two tools: Key Employee Retention Plans ("KERPS") and Key Employee Incentive Plans ("KEIPS"). The former pays employees bonuses for remaining with the company. The latter provides bonuses for hitting performance metrics. *See, e.g.*, *In re Alpha Natural Res., Inc.*, 546 B.R. 348, 351–54 (Bankr. E.D. Va. 2016). Two sections of the Bankruptcy Code govern such plans: §§ 363 and 503. *In re Residential Capital, LLC*, 491 B.R. 73, 82 (Bankr. S.D.N.Y. 2013). "Transfers made in the ordinary course of business are evaluated under section 363(c). Transfers to insiders, or transfers made outside the ordinary course of business, are subject to the requirements of section 503(c)." *Id.*

In 2005, Congress added § 503(c) to the Bankruptcy Code in reaction to excessive KERPS. In short, outside of extraordinary circumstances, § 503(c) prohibits KERPS for insiders of a company. 11 U.S.C. §503(c)(1); 11 U.S.C. § 101(31)(B) (defining insider). Section 503(c) also prohibits other payments made to an insider outside of the ordinary course of business, *unless the facts and circumstances of the case* justify them. *Id.* § 503(c)(3). Thus, a debtor can offer KERPS only to non-management employees. *See, e.g.*, *Residential Capital*, 491 B.R. at 85–86. And though KEIPS can be offered to insiders if approved by the court, they cannot be mere masquerades of KERPS. *Id.* at 82–84; *see also Alpha Natural Res.*, 546 B.R. at 357–58.

Section 503(c)(3) requires they be justified by the facts and circumstances of the case. What does that mean? Some courts believe that the KEIP must satisfy the business judgment test—similar to the § 363(b) standard. *Alpha Natural Res.*, 546 B.R. at 356–57 (collecting cases). Others believe that § 503(c)(3) imposes a higher standard. *In re Pilgrim's Pride Corp.*, 401 B.R. 229, 236–37 (Bankr. N.D. Tex. 2009). Under the latter test, "even if the [c]ourt finds the debtor has demonstrated a sound business reason for the incentive proposal, [it] must undertake its own independent analysis to determine if the particular proposal will serve the best interests of creditors and the debtor's estate. *Alpha Natural Res.*, 546 B.R. at 357. Under the former, courts analyze six factors:

> (1) Is there a reasonable relationship between the plan proposed and the results to be obtained; i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, *is the plan calculated to achieve the desired performance*?; (2) Is the cost of the plan reasonable in the context of the debtor's assets , liabilities, and earning potential?; (3) Is the plan consistent with industry standards?; (4) Is the plan proposal

> consistent with industry standards?; (5) What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry? and (6) Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?

In re Dana Corp., 358 B.R. 567, 571 (Bankr. S.D.N.Y. 2006) (emphasis in original); *see also Alpha Natural Res.*, 546 B.R. at 356 and *Residential Capital*, 491 B.R. at 84.

In *Alpha Natural Resources*, for example, the court authorized a KEIP for fifteen members of the management team. It first distinguished the plan from an impermissible KERP: the proposal established "aggressive" performance goals "that the Debtors [would] struggle to achieve[,]" which "encourage[d] the Debtors to minimize their cash bleed while simultaneously cutting expenses and maintaining their safety and environmental standards." 546 B.R. at 358. It then found the KEIP to be justified: the employees to whom it would be offered were "necessary for the development and implementation of the Debtors' business plan and for the Debtors' reorganization." *Id.* at 360. And the metrics on which the KEIP would evaluate those employees had been used throughout the industry. *Id.* at 361–62. *See also Patriot Coal*, Order [Approving Retention Plans], [Docket No. 672] (Bankr. E.D. Va. July 29, 2015).

B. Under What Circumstances Can a Coal, Oil, or Gas Company Reject or Modify Collective Bargaining Agreements to which it is a Party?

Sections 1113 and 1114 of the Bankruptcy Code allow debtors to reject and modify collective bargaining agreements to which they are a party. Because legacy liabilities under collective bargaining agreements can be costly, §§ 1113 and 1114 are powerful tools. Indeed, "[o]ne of the main reasons that Patriot [Coal Corporation initially] filed for bankruptcy in 2012 was to address its employee and retiree obligations." *Emerging Issues*, *supra*. Thus, a debtor's request to reject collective bargaining agreements frequently encourages negotiations and a consensual resolution of labor disputes. *See, e.g. Patriot Coal*, [Docket Nos. 1018, 1321, 1734].

Section 1113 requires that a debtor:

> 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 provide . . . the representative of the employees with such relevant information as is necessary to evaluate the proposal.

11 U.S.C. § 1113(b)(1)(A)–(B). The debtor must also "meet, at reasonable times, with the authorized representative to confer in good faith in attempting to reach mutually satisfactory modifications of such agreement." *Id.* § 1113(b)(2). Section 1114 imposes substantially similar requirements. *See In re Walter Energy, Inc.*, 542 B.R. 859, 878 (Bankr. N.D. Ala. 2015); *see also United Mine Workers of Am. 1974 Pension Plan & Trust v. Walter Energy, Inc.*, No, 2:16–cv–00057–RDP, 2016 WL 2894091, at *8–13 (N.D. Ala. May 18, 2016) (discussing § 1114).

In 1984, the Bankruptcy Court for the District of Minnesota restated § 1113 as a nine-part test. *In re Am. Provision Co.*, 44 B.R. 907, 909 (Bankr. D. Minn. 1984). It wrote that:

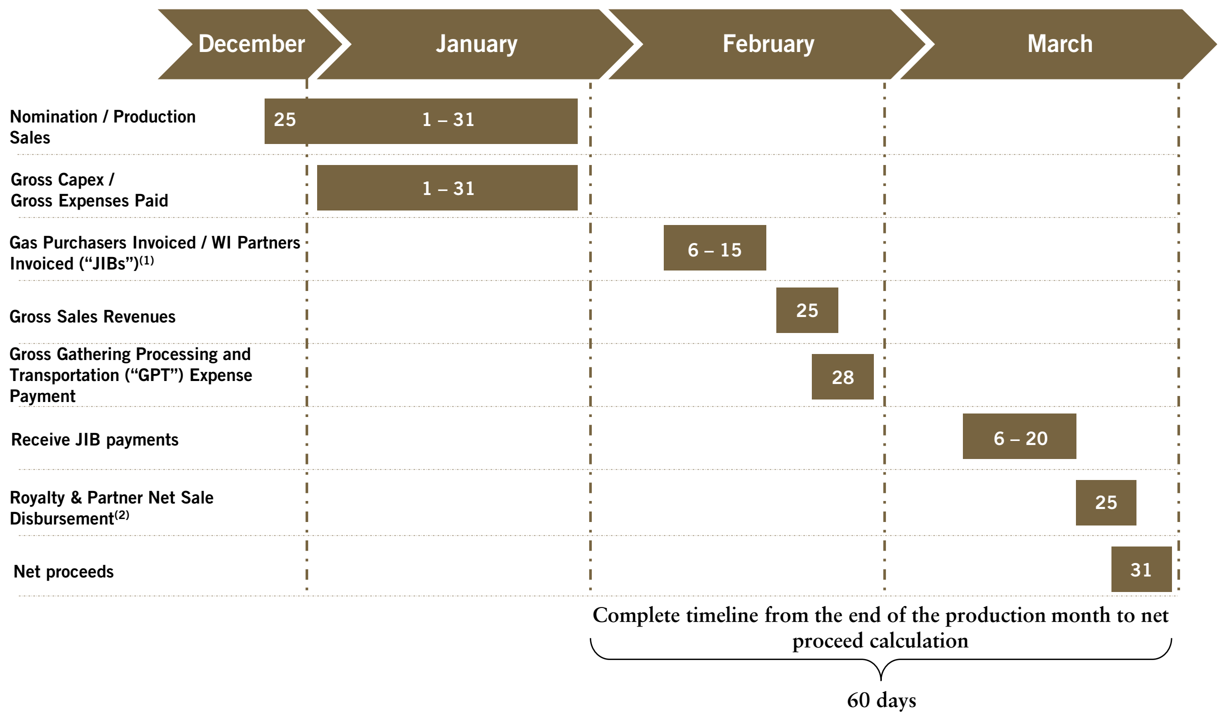
> (1) The debtor-in-possession make a proposal to the Union to modify the collective bargaining agreement, 11 U.S.C. § 1113(b)(1)(A); (2) The proposal must be based on the most complete and reliable information available at the time of the proposal, *id.*; (3) The proposed modifications must be necessary to permit the reorganization of the debtor, *id.*; (4) The proposed modifications must assure that all creditors, the debtor, and all of the affected parties are treated fairly and equitably, *id.*; (5) The debtor must provide to the Union such relevant information as is necessary to evaluate the proposal, *id.* § 1113(b)(1)(B); (6) 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, 11 U.S.C. § 1113(b)(2); (7) At the meetings the debtor must confer in good faith in attempting to reach the mutually satisfactory modifications of the collective bargaining agreement, *id.*; (8) The Union must have refused to accept the proposal without good cause, *id.* § 1113(c)(2); and (9) The balance of the equities must clearly favor rejection of the collective bargaining agreement, *id.*§ 1113(c)(3).

Id. Courts in both the Fourth and Fifth Circuits have applied this formulation. *See, e.g.*, *In re Lady H Coal Co.*, 193 B.R. 233, 241 (Bankr. S.D.W. Va. 1996) (collecting cases); *In re*

Appletree Markets, Inc., 155 B.R. 431, 437–38 (S.D. Tex. 1993); *In re Tex. Sheet Metals, Inc.*, 90 B.R. 260, 263 (Bankr. S.D. Tex. 1988). Most recently, so did the bankruptcy court in *Walter Energy*. 542 B.R. at 878–79.

Quicksilver Resources, Inc.

Operational Cash Flow: Sample Month – January Sales



(1) WI partners are invoiced their proportionate share of capital and operating expenses. These expenses are not netted against sale disbursements as this is only contractually allowed at the point of delinquency as applicable.

(2) Royalty and WI partners receive disbursements net of expenses to deliver gas to sales points, which includes production taxes and GPT, as applicable. Not every royalty owner bears GPT expenses per the terms of the individual leases.

United States Senate
WASHINGTON, DC 20510

March 8, 2016

The Honorable Gene L. Dodaro
Comptroller General of the United States
U.S. Government Accountability Office
Washington, D.C. 20548

Dear Comptroller Dodaro:

Under Section 509 of the Surface Mining Control and Reclamation Act (SMCRA), the Secretary of the Interior ("the Secretary") and States with approved regulatory programs under Section 503 of SMCRA may accept reclamation performance bonds from coal mining companies, subject to a financial test detailed in regulation (30 CFR 800.23), without separate surety.

SMCRA does not require the acceptance of these bonds, known as self-bonds, and some states do not allow their use. Nevertheless, our understanding is that companies currently operating coal mines under SMCRA permits have posted an aggregate of $3.6 billion of self-bonds across multiple states to cover their performance bond obligations. Several of these companies, including Alpha Natural Resources and Arch Coal, have recently entered bankruptcy under chapter 11 of the Bankruptcy Code.

Wyoming actions

In the case of both companies, the State of Wyoming, under what it claims is exclusive authority[1] under SMCRA, has entered into agreements to categorize a small portion of the outstanding self-bonds (15 percent and 19 percent, respectively) as "superpriority" claims against the companies' collateral in federal bankruptcy proceedings. In exchange, despite the clear failure of both companies to meet the financial test for self-bonding established by the Department, the State has agreed to allow the companies to continue operating mines under their existing SMCRA permits. These agreements leave $743 million in outstanding self-bonds unsecured.

Meanwhile, Alpha Natural Resources succeeded in obtaining approval from the Bankruptcy Court for the Eastern District of Virginia to pay 15 executives $12 million in bonuses this year. The company is separately seeking to reduce medical, life insurance, and retirement benefits for its workers.

At a recent hearing before the Senate Committee on Energy and Natural Resources, the Secretary said that she thinks "there's a very significant problem and risk to the taxpayer with the high-profile bankruptcies that have taken place recently with coal companies." The Department recently issued "ten-day notices" to the State of Wyoming with respect to both companies and filed concerns and reservations of rights in both bankruptcy proceedings.

[1] See, for example, the State of Wyo. and the Wyo. Dep't of Env't Quality's Reply to the W. Org. of Res. Councils' Combined Ltd. Objection at 3, In re: Arch Coal, Inc., No. 16-40120 (Bankr. E.D. Mo., Feb. 22, 2016).

These recent developments and the scale of other companies' self-bonding, including $1.47 billion posted by Peabody Energy (another potentially financially challenged company), have led us to conclude that the Department and Congress should revisit SMCRA's self-bonding authorization. As previous reports by your agency and others have detailed, there are numerous reasons why reclamation self-bonding is inherently problematic.

Inherent problems with self-bonding

In principle, there may be private sector activity for which self-bonds or self-insurance are appropriate policies, such as mitigating risk for poorly understood or catastrophic events that the private surety market won't otherwise cover. But coal mining is not subject to such risks.

Instead of collateral or a third-party surety, the integrity of a self-bond relies solely on the value of the firm's underlying financial status. Many firms that specialize in natural resource extraction lack diversified lines of business that can dilute the risk of market downturns. Self-bonds issued by these firms may carry a higher risk of default. Because the current eligibility test for self-bonding evaluates a firm's historic and current financial condition, it also fails to account for rapidly changing market conditions—a common feature of commodity markets.

Beyond the heightened risk of allowing self-bonds in an extractive industry, the policy also places an inappropriate obligation on natural resource regulators. The core competency of federal and state regulators is generally not financial analysis. Yet accepting self-bonds places the burden of evaluating private companies' financial health on the government.

Furthermore, once market conditions do decline, self-bonding has the perverse outcome of discouraging a shift to a stronger form of financial assurance because the shift would occur at the weakest financial moment for the firm. This precise dynamic is occurring today with coal mining companies.

Previous GAO investigations

As you know, the Government Accountability Office (GAO) has a long record of examining financial assurance requirements and practices in many industries, including the fate of financial assurance under the Bankruptcy Code. In 1988, GAO interviewed coal mining regulators in four Appalachian states and found that the states discouraged the use of self-bonding because of the need to closely monitor companies to assure they continued to meet a financial eligibility test.[2]

In a 2005 report that several of our colleagues and Senator Cantwell requested about financial assurance required by the Environmental Protection Agency (EPA) under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and Resource Conservation and Recovery Act, GAO stated:

> The mechanisms that pose the greatest financial risk to the government— the corporate financial test, the corporate guarantee, and some insurance products—also require specialized expertise to oversee. Concerns have been raised, both within EPA and by others, that the corporate financial test and the corporate guarantee offer EPA minimal

[2] GAO, *Surface Mining: Cost and Availability of Reclamation Bonds*, GAO/PEMD-88-17 (Washington, D.C., Apr. 8, 1988).

long-term assurance that the company with environmental liability will be able to fulfill its financial obligations.[3]

In a 2006 letter to EPA, its own Environmental Financial Advisory Board echoed GAO's views.[4]

In 2001, in what should be an instructive example for the Office of Surface Mining Reclamation and Enforcement (OSMRE), BLM finally prohibited the use of corporate guarantees for hardrock mining in the wake of bankruptcies such as Galactic Resources in Colorado and Arimetco in Nevada. Even after this prohibition, GAO has repeatedly found that financial assurances for hardrock mines on federal lands are inadequate.

For example, in a 2005 report, GAO found that corporate guarantees that had been grandfathered in after BLM's 2001 prohibition totaled $204 million, nearly all in the State of Nevada. The Nevada BLM state office at the time rated corporate guarantees as "not effective" for minimizing losses to the federal government.[5] In follow-up testimony three years later, GAO found that BLM's financial assurances were still $61 million short.[6]

In 2011, GAO declared enhancing financial assurances and bonding one of seven key management challenges for the Department.[7] GAO underscored this point in testimony the same year, pointing out that between 1997 and 2008, four key reclamation and cleanup agencies (BLM, the Forest Service, EPA, and OSMRE) had spent at least a total of $2.6 billion to reclaim abandoned hardrock mines on federal, state, private, and Indian lands.[8] Taxpayers may face even larger liability for coal mines.

The GAO again investigated the topic of inadequate financial assurance in 2012, finding that millions of dollars in CERCLA financial assurances for phosphate mines in Idaho was in the form of potentially risky corporate guarantees.[9]

Most recently, in December 2015, GAO issued a report describing problematic bonding waivers issued by the Bureau of Ocean Energy Management for the decommissioning costs of offshore oil and gas infrastructure.[10]

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[3] GAO, *Environmental Liabilities: EPA Should Do More to Ensure That Liable Parties Meet Their Cleanup Obligations,* GAO-05-658 (Washington, D.C.: Aug. 17, 2005).
[4] EPA Environmental Financial Advisory Board, Letter to EPA Administrator Stephen Johnson, "Re: EFAB initial findings concerning use of the financial test and corporate guarantees to meet financial assurance requirements under RCRA programs" (Jan. 11, 2006).
[5] GAO, *Hardrock Mining: BLM Needs to Better Manage Financial Assurances to Guarantee Coverage of Reclamation Costs,* GAO-05-377 (Washington, D.C.: Jun. 20, 2005).
[6] GAO, *Hardrock Mining: Information on Abandoned Mines and Value and Coverage of Financial Assurances on BLM Land,* GAO-08-774T (Washington, D.C.: Mar. 12, 2008).
[7] GAO, *Department of the Interior: Major Management Challenges*, GAO-11-424T (Washington, D.C.: Mar. 1, 2011).
[8] GAO, *Abandoned Mines: Information on the Number of Hardrock Mines, Cost of Cleanup, and Value of Financial Assurances*, GAO-11-834T (Washington, D.C.: Jul. 14, 2011).
[9] GAO, *Phosphate Mining: Oversight Has Strengthened, but Financial Assurances and Coordination Still Need Improvement,* GAO-12-505 (Washington, D.C.: May 4, 2012).
[10] GAO, *Offshore Oil and Gas Resources: Actions Needed to Better Protect Against Billions of Dollars in Federal Exposure to Decommissioning Liabilities,* GAO-16-40 (Washington, D.C.: Dec. 18, 2015).

Request
Given this recent and extensive body of work, we request that you initiate two new investigations: (1) a comparison of authorizations to self-bond (and related practices, including self-insurance, that rely on corporate guarantees) across federal programs that govern resource extraction; and (2) a performance audit of self-bonding under SMCRA, including an examination of the practice under States with programs approved under section 503 of SMCRA and the status of the market for conventional reclamation bonds such as surety bonds.

The results of these investigations will help policymakers evaluate the future of financial assurances for coal and other resources.

Thank you for your consideration.

Sincerely,

Maria Cantwell
United States Senator

Richard J. Durbin
United States Senator