ABI/UMKC Midwestern Bankruptcy Institute

Commercial: Oil and Gas Tools in the Toolbox

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CONCURRENT SESSION

2022

ABI PANEL
Oil & Gas Tools in the Toolbox

The Honorable Janice Loyd
WDOK Bankruptcy Court

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Traditional Restructuring Tools in the Toolbox

- Secured Creditor Protections
- Sale of Assets Free and Clear
- Assumption, Assignment and Rejection of Contracts

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But . . . Oil and Gas is Special No, Really, It Is

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SECURED CREDITORS

11's are All the Same.

Or is it?

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Nature of Lease as Collateral

- Nature of interest dependent on governing state or federal law
- Many states treat oil and gas leases as real property; not an actual lease
- Type of property interest will govern type of security interest and perfection
- Distinguish between leases "held by production" and leases of undeveloped reserves

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Foreclosure and Sale Issues

- Plugging and abandonment (P&A) obligations do not go away
- Bonding requirements
- Transfer of federal leases requires government consent
  - *Find out which AUSA handles bankruptcy matters in your court, and call them*

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Do You Really Want the Collateral?

- Producing oil and gas properties must have an approved operator
- Some leases may have negative value due to future P&A costs
- All owners in chain of title can be liable for P&A — if you ever owned it, the government can look to you!

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Competing Lien Issues

- Contractor and vendor liens governed by state law
  - *Some states have specific laws for liens on oil and gas properties*
- Perfection of such liens can relate back to when work was first performed
- May take priority over secured lender
- Detailed factual and legal analysis — may not be controlling law

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State Law Liens

- Real estate taxes, severance taxes, etc.
- Governed by state law
- May take priority over all other liens

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Other Interests Burdening Leases

- Interests in leases may be transferred to others (royalties, overrides, etc.)
- May be unrecorded
- If state treats lease as real property, these interest are also real normally real property interests
  - *Royalties are not a claim — they are property of the royalty owner*
- May not be able to transfer free and clear

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Cash Collateral Issues

- Ongoing sale of oil and gas will be proceeds of collateral, but…
- Other interests (royalties, etc.) may have priority
- Operating costs and health and safety costs must be paid

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Surcharge Issues

- Preserving lease/collateral requires payment of operating costs
- Cost of maintaining operating lease may come out of cash collateral
- May even include P&A obligations

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Section 363 of the Bankruptcy Code

- Overview of key provisions of Sections 363 of the Bankruptcy Code affecting E&P Companies
  - *363(a): Use of Proceeds, Products and Offspring (From Reserves)*
  - *363(e): Adequate Protection (For a Depleting Asset)*
  - *363(f): "Free & Clear" Sale of Property*
    - *(f)(2): Price > Liens on Property or Secured Lienholder Consent*
  - *363(h): Co-Owned Property Sale*
  - *363(k): Lienholder Credit Bid Rights*

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Section 363 of the Bankruptcy Code

- Business Considerations: Use of Cash Collateral From Reserve Production and Adequate Protection [363(a) and 363(e) Interplay]
  - *"Let's Make a Deal" – Can a Debtor Really Prove Adequate Protection for Use of Proceeds From PDP Reserve Production?*
    - *Reserve Report Evaluation: PV 10% v. Market (ROR Value)*
    - *The Reserve Waterfall and Adequate Protection*

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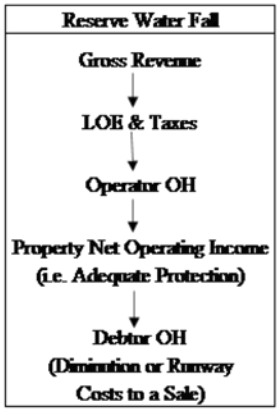
Section 363 of the Bankruptcy Code



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Section 363 of the Bankruptcy Code

- *What Expenditures Provide Adequate Protection?*
  - *LOE – Yes*
  - *Operator OH – Yes*
  - *Operator General OH – The "Elephant" That Drives the Sale Process*
- *Does Every Dollar of General Overhead Diminish Reserve Collateral?*
- *Utilizing Variable Adequate Protection Payment Tied to Production Quantities*
  - *Dollars of Decline in Collateral Value Per BOE/MCFE*
  - *Most Fairly Protects the Lienholder*

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Section 363 of the Bankruptcy Code

- Business Considerations: Free and Clear Sale Procedures – Structuring a Highest and Best Process [363(f), 363(h) and 363(k)]
  - *Bulk Sale versus Lot Sale bidding process*
    - *Operated, Non-Ops, Mineral, Wellbore Interests, Undeveloped LHI, Seismic/Geological, Surface Land, SWD's Marginal(s), P&A's*
      - » *Should Courts require more evidence of Business Judgment regarding Bulk v. Lot Process before approving a Sale Procedures Motion?*
  - *Use of Call for Offers Process*
    - *Occurs before Selecting a Stalking Horse Bidder(s)*
    - *Provides a pricing pre-view*

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Section 363 of the Bankruptcy Code

- *Debtor and Secured Creditor interplay in Call for Offers and Release of Section 363(k) Credit Bid Rights*
  - *Competitive interplay to obtain optimum Stalking Horse Price*
  - *Credit Bidding Non-Op Properties is Credible to Bidders; Operated Properties Not so Credible*
- *Use of Purchase Price Allocation to Individual Properties in Lot Bidding*
  - *Include in Bid Procedures Motion*
  - *Creating Price Uplift*
  - *Allocate liability or negative pricing to P&A and Surface Restoration Obligations*

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Section 363 of the Bankruptcy Code

- *Carve-Out Properties without sufficient Bid Price*
- *Can potentially avoid Section 506(a) secured claim determination appraisal adversary proceedings*
  - *Example DUC's with M&M Liens*
- *Don't Overlook the value of Bid Day Rules for Calling the Auction*
  - *Bid Increments*
  - *Sequence of Calling Lot*
  - *Pre-Qualification and Value of Assumption of Cure Costs*

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Section 363 of the Bankruptcy Code

- Pre-Pooling Letter Agreement Rights – The Wild West of Contracts
  - *Forfeiture*
  - *Lien Foreclosure*
- Marketing Operated Properties when Operator Rights and Gas Sales Contract Rights are held by Affiliate through MAS/SSA
- Unfunded Interest Owner Obligations and Transfer of Operated Properties and Operating Rights
  - Revenue Suspense Quantifications

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Section 365 of the Bankruptcy Code

- Sections 365 of the Bankruptcy Code contains one of the most powerful tools in a debtor's toolbox – the ability to assume, assume and assign, or reject an execution contract or unexpired lease, without regard to the terms of the underlying contract.
- This allows a debtor to shed unwanted contracts while keeping those that are beneficial to its reorganization.
- At first blush, this would seem to have to potential for profound impact in an oil and gas bankruptcy.
- But, like most things in chapter 11, it is not that easy.
- The oil and gas world embraces a language that is all its own. It is filled with unique terms of art, acronyms and, at least one misnomer.
- The industry's unconventional language, coupled with inconsistent state law, gives rise to one of the most confusing issues in oil and gas bankruptcies – whether or not section 365 of the Bankruptcy Code is applicable to oil and gas conveyances.

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OIL AND GAS LEASES

- The transfer of oil and gas interests is typically effected through a "lease". Most use the terms lessor and lessee and they contain a reversionary interest in favor of the grantor.
- Is this a "lease"?
  - *Maybe?*
  - *Maybe not?*
  - *The answer lies in state law.*
- Despite the fact that oil and gas leases contain many of the characteristics of a traditional lease, the majority of bankruptcy courts, including Texas, Oklahoma, North Dakota and Colorado, that have addressed this question have determined that oil and gas leases constitute a transfer of real property and therefore are not within the definition of a lease.
- Kansas, however, considers an oil and case leases a conveyance of a license to enter the land and explore for minerals, which is a personal property right. Therefore, in Kansas an oil and gas lease may be subject to assumption or rejection.

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OIL AND GAS LEASES (con't)

- Alternatively, one may argue that an oil and gas leases is an executory contract and, therefore, subject to section 365.
- Although the Bankruptcy Code does not define the term executory contract, most courts have adopted the *Countryman* definition or some variation thereof which requires that both parties have unfulfilled obligations under the contract that, if not fulfilled, would constitute a material breach.
- Using this test, most courts have determined that because the lessor has nothing to do but sit back and collect royalty payments or wait for the property to revert, oil and gas leases are not executory in nature.

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JOINT OPERATING AGREEMENTS

The Joint Operating Agreements ("JOA") is a contractual agreement between two or more parties with shared interests in a tract or leasehold that outlines coordinated exploration, development and production activities in a designated contract area.

Under a JOA:

- One entity is classified as the operator. The operator has a working investment in the lease and bears the most impact by the terms and conditions of the JOA. The operator is responsible for all E&P activities on the lease.

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JOINT OPERATING AGREEMENTS (con't)

- All other entities in the agreement are classified as non-operators. They are not responsible for E&P activities but are still associated with the operator. Non-operators include investors, financial institutions, or other entities.
- There are several common joint operating agreements available from various organizations, such as the American Association of Petroleum Landmen 610 (AAPL) and the Association of International Petroleum Negotiators 2002 (AIPN).
- There are many common terms between JOAs that provide guidance in the various business activities and interests of those brought together by the agreement. Terms include "duration of the agreement," "parties participating interest," "scope of work," "designated operator," and "dispute resolution."

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JOINT OPERATING AGREEMENTS (con't)

- The operator has control of all operations as established by the JOA. The non-operators retain only indirect control of operations. They may vote on future operations, elect whether or not to consent to an operation, and have some inspection rights.
- JOAs have been universally held to be executory contracts that can be assumed, assigned or rejected under section 365.

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JOINT OPERATING AGREEMENTS (con't)

- Although it is often threatened, it is rare to see a JOA rejected in a chapter 11 proceeding.

Risks associated with rejection of a JOA include:

- Practical Considerations
  - *Who will operate the leases on a go forward basis?*
  - *Will the parties now be joint tenants in common, without the benefits of a governing contract?*
- Contractual Lien Rights
  - *A JOA may create a contractual lien right in favor of the operator*
  - *These rights, if properly perfected, will survive the rejection of a JOA*
- Setoff and Recoupment Rights
  - *Operators may exercise setoff and recoupment rights against a non-operator's estate if such rights exist under the JOA*
  - *The recoupment rights of the operator may be superior to a mortgage lien encumbering the estate's interest in the property*

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MIDSTREAM AGREEMENTS

- Simply stated, a midstream contract is a long-term contract to transport oil and gas from the wellhead to central facilities by pipeline.
- These pipelines are typically very expensive to construct and, as a result, midstream companies sought to incorporate various protections in the underlying contracts including covenants running with the land that purport to create a real property right which in turn insulates against, among other things, rejection in a chapter 11 case.
- Beginning in 2015 and continuing through last year, the bankruptcy world saw a spate of decisions around the question – can a midstream agreement with a covenant running with the land be rejected?
- The very unsatisfying answer seems to be maybe, but maybe not?

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MIDSTREAM AGREEMENTS (con't)

As the case law has unfolded around this question over the last 10 years, two pivotal questions have arisen:

1. Do the dedication clauses create actual enforceable covenants that run with the land under applicable state law?
2. If so, does the running covenant preclude rejection or just create an in rem interest that survives it?

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MIDSTREAM AGREEMENTS (con't)

A threshold question is whether dedication clauses are what they purport to be: real covenants or equitable servitudes that "run with the land."

A running covenant is an agreement among real property owners that is deemed to attach to, and "run" with, the land, binding later owners, even if contractual privity is lost. Such covenants originate in contract but acquire in rem character only if they satisfy certain requirements prescribed by state law. These vary from state to state, but at common law there are two fundamental elements: The covenant (1) is an element of a contemporaneous real property conveyance between the covenanting parties (denoted "horizontal privity"); and (2) "touches and concerns" the land, meaning, roughly, that it benefits or burdens it.

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MIDSTREAM AGREEMENTS (con't)

In late 2019, courts and practitioners alike seemed to take the view that the existence of a valid covenant running with the land embedded in a gathering agreement rendered the agreement beyond the powers of section 365.

Recent cases, however, have sought to addressed not just the state law nature of the dedications, but the scope of the rejection power in bankruptcy.

Some of these courts have questioned the premise (assumed, but not discussed, in early decisions) that a valid running covenant precludes rejection. They emphasize that the dedication clause is but one provision of a larger contract; that the dedication clause runs with the land does not necessarily mean all of the debtor's obligations do. On this view, the question is not whether the debtor can reject its gathering agreement, but whether the contract encompasses any in rem interests that survive rejection. On this basis, a bankruptcy court in the Southern District of Texas recently authorized a debtor to reject midstream agreements despite concluding that its dedication clauses ran with the land under state law and thus would survive rejection.

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MIDSTREAM AGREEMENTS (con't)

- Two recent decisions of bankruptcy judges in the District of Delaware go further, concluding not only that a gathering contract containing a valid running covenant is susceptible to rejection, but that the running covenant itself can be rejected.
- These decisions reason that, because running covenants arise by contract and are reducible to claims for money damages, they merit no different treatment in bankruptcy than other contractual obligations.

Faculty

Timothy A. (Tad) Davidson, II is a partner with Hunton Andrews Kurth LLP in Houston and co-leads the firm's Bankruptcy/Restructuring practice group. His practice includes representing parties in out-of-court and bankruptcy court financial restructurings. These clients include private-equity firms, hedge funds, secured lenders, investors, debtors, unsecured creditors, boards of directors, and various official and ad hoc committees in matters across the country. Mr. Davidson's practice also includes structuring distressed acquisition, financing and real estate transactions, as well as advising clients on insolvency and counterparty risks related to mergers, acquisitions and general corporate transactions. He is listed as Recommended for Restructuring (including Bankruptcy): Corporate in *Legal 500 United States* for 2020-22, selected for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law in Texas in *The Best Lawyers in America* for 2020, and recognized as a Leader in Bankruptcy/Restructuring in Texas by *Chambers USA* for 2016-22. Mr. Davidson received his B.A. *cum laude* in 1994 from the University of South Carolina and his J.D. in 1999 from Emory University School of Law.

Hon. Janice D. Loyd is a U.S. Bankruptcy Judge for the Western District of Oklahoma in Oklahoma City, sworn in on Dec. 12, 2014. Prior to her swearing in, she was an officer, director and shareholder with the Oklahoma City law firm of Bellingham & Loyd, P.C. Prior to taking the bench, Judge Loyd's practice emphasized the areas of bankruptcy, reorganization and commercial litigation. She also was a member of the Chapter 7 Trustee Panel for the U.S. Bankruptcy Court for the Western District of Oklahoma for 22 years, handling over 20,000 cases. Judge Loyd is a member of the Oklahoma County Bar Association, the Oklahoma Bar Association, the Federal Bar Association, ABI and the National Conference of Bankruptcy Judges. She has chaired both the Bankruptcy Section of the Oklahoma County Bar Association and the board of directors for the Bankruptcy and Reorganization Section of the Oklahoma Bar Association. She also has served on the Mediation Advisory Board Committee and is a Permanent Member of the Standing Local Rules Committee for the U.S. Bankruptcy Court for the Western District of Oklahoma. In 2019, Judge Loyd was appointed to the Tenth Circuit Bankruptcy Appellate Panel. In 2006, she received the Oklahoma Bar Association Award for Outstanding Pro Bono Service, and she is a two-time recipient of the Mona Salyer Lambird Service to Children Award for services provided as a volunteer for Lawyers for Children. Judge Loyd received her B.A. in political science in 1983 from the University of Oklahoma and her J.D. in 1986 from the University of Oklahoma College of Law.

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Sarah L. Schultz is a partner in Akin Gump Strauss Hauer & Feld LLP's Financial Restructuring group in Dallas and handles large, complex restructuring cases and out-of-court corporate reorganizations for public and private companies, as well as for alternative investment funds. She routinely handles representations for debtors, official and unofficial committees of creditors, secured lender groups, debtor-in-possession lenders and acquirers of assets. Ms. Schultz focuses on the energy market, particularly oil and gas, with substantial work across a broad range of industries, including shipping, retail and health care. Her energy representations include the restructurings of Tapstone Energy, Elevation Midstream, SAExploration, PetroQuest Energy, EMAS CHIYODA Subsea Limited, Quicksilver Resources, Brazos Electric Power Cooperative and Just Energy, among others. Ms. Schultz was recently included in *The American Lawyer*'s Trailblazers: South list and named one of the "Best Lawyers in Dallas" by *D Magazine*. She received her B.A. *summa cum laude* in 1998 from the University of North Dakota and her J.D. *cum laude* in 2001 from the University of Minnesota Law School, where she was a member of the *Minnesota Law Review* in 2000 and 2001.