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Insolvency-Related Implications for the Oil & Gas Industry in the U.S.

Carren B. Shulman
Jeffrey F. Rector

SHEPPARD MULLIN RICHTER & HAMPTON LLP

Carren B. Shulman

Jeffrey F. Rector

Despite the tremendous growth and development of oil and gas resources in recent years, the industry is expected to be a boon for bankruptcy lawyers. This article explores how the current low price environment hurts developers and their lenders, whose past investment premises included a sustained high price environment and provides some insight into what the issues will be in bankruptcy.

Over the past 100 years, politics and periodic limitations on production (often as a result of global affairs) have resulted in price fluctuation and shortages, sometimes significant. In the 1970s, declining domestic production coupled with increased demand left the U.S. vulnerable to fluctuations in the global oil market, and substantial shortages led to the need for rationing and gas lines. In the previous decade, soaring oil prices (up to $145 per barrel of West Texas Intermediate (WTI) in the summer of 2009[1]) sent the airline industry into a tailspin. The U.S. has relatively abundant petroleum resources, but the availability of cheap oil is on the decline, and production is limited in part by state and federal regulation and in part by expectations of the market price for crude.

***Carren B. Shulman** is a partner in the Finance & Bankruptcy practice group in Sheppard Mullin's New York office. She regularly represents creditors in bankruptcy and contract counterparties in protecting their rights. **Jeffrey F. Rector** is a partner in the Real Estate, Land Use and Environmental practice group in the firm's Del Mar office. He is also a member of the Energy industry team.*

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In the last decade, U.S. oil exploration and production has been on an upswing due to improved techniques of horizontal drilling and fracturing tight geological formations to release previously trapped hydrocarbons in new and old fields. The U.S. currently has booming oil and natural gas economies in numerous states based primarily on these technological advancements and increased investment resulting from previously high oil prices. The U.S. has already reemerged as an energy superpower, and with production levels on the rise, some predict that the U.S. could be completely relieved of reliance on foreign oil by 2035. But investment in new U.S. production capacity has been expensive. Hydraulic fracturing and offshore drilling requires an expensive initial investment. A single deepwater well can cost $100 million to test and develop for oil production.[2]

Over the past decade, investors and their lenders made these investments in a high price environment with the expectation that future oil prices would easily support a recovery on investment. However, production increases have outpaced expansion of global demand, and prices in the past 12 months have fallen in half to about $50 per barrel. It's unclear where the bottom will be and how much longer prices will remain at these levels. At $50 per barrel, many of the previous decade's investments cannot make a profit, and new investment is coming to a halt. Politics is also affecting the price of oil, including decisions on how much oil is made available to the market. Many Persian Gulf producers, including Saudi Arabia, can afford to continue current production at these prices or lower, and indeed OPEC has been unable to agree to decrease production,[3] such that unconventional producers are priced out of the market. While consumers want lower prices, lower prices are devastating for oil and gas producers, particularly the smaller companies with tight margins. The detrimental effects are already being felt, with mass layoffs in the industry at oilfield services companies. Accordingly, industry watchers are predicting an increase in filings in the coming years, not just for the U.S. but in the UK and Canada as well.[4]

The current oil and gas bankruptcy cases may be a bit different from the energy bankruptcies of years past, like Enron (the result of massive accounting fraud)[5] and PG&E (precipitated by poorly executed deregulation of the electric power industry in California).[6] Likely issues will include assumption and rejection of leases and lease/land rights, disputes over priority among multiple tranches of debt, joint operating agreements (JOAs) and ownership/rights disputes, among other things.

Please email the authors at cshulman@sheppardmullin.com or jrector@sheppardmullin.com with questions about this article.

A typical oil and gas lease requires the landowner to allow a lessee access to enter lessor's property to explore for oil and gas, drill wells, and transport equipment and product. Oil and gas leases, because they involve the use of real property for a fee (though more like a royalty than rent), may be governed by 11 U.S.C. §365(m).[7] Leases are subject to rejection in bankruptcy under 11 U.S.C. §365(a). However, lessees of non-residential real property are afforded special protection under 11 U.S.C. §365(h), allowing a lessee effectively to ignore rejection and retain its rights under the lease for the balance of the lease term and any extended term. Nonetheless, a debtor has the right to sell assets "free and clear" of any interest in property under 11 U.S.C. §363(f), though not without limitation. The bankruptcy courts are not aligned on the dispute between the application of 11 U.S.C. §§365(h) and 363(f), with only one circuit court weighing in on the issue, though recent decisions appear to turn on the facts.[8] Allowing termination of a profitable oil and gas lease would no doubt have a devastating effect on the industry and, therefore, it is unlikely that a court would allow a debtor-lessor to reject an oil and gas lease in bankruptcy and ignore the protections of §365(h) if the lessee is investing in and operating on the property. Even if a debtor-lessor was authorized to reject a lease, the lessee may be entitled to potentially enormous damages flowing from rejection that will need to be dealt with as part of emergence from bankruptcy. Alternatively, a lease may be viewed as a fee simple interest. For instance, in a state viewing the rights under a lease to constitute "ownership in place," a "lessee" may argue that the estate has no equity interest in the property under 11 U.S.C. §541. Moreover, §541(4) specifically carves out from property of the estate "any interest of the debtor in liquid or gaseous hydrocarbons" transferred pursuant to a farmout or production payment agreement to the extent the recipient "does not participate in the operation of the property from which such production payment is transferred."[9]

Exploration and production require significant capital and the incurrence of debt, often to nontraditional lenders through complicated debt instruments with short horizons and low tolerance for forbearance. For example, the bankruptcies of OGX (filing resulted in $4 billion in defaults) and WBH Energy (filed for bankruptcy protection on January 6, 2015 in Texas to stave off foreclosure sale after defaulting on junior loan facility; on February 12, 2015, lender moved to convert case to Chapter 7 or, for stay relief, to foreclose) illustrate that oil producers with liquidity issues will need to prepare early for a potential restructuring or bankruptcy to maximize their options and preserve value.

Some cases will require a quick sale of assets,[10] and others may require a new substantial infusion of cash, often through complicated lending vehicles (e.g. REITs, multiple indentures) to maximize investments and loans while staggering the obligations. Where there is real value in the assets, existing lenders likely will seek to infuse new capital and convert debt to equity. For instance, Energy Future Holdings filed its long-awaited bankruptcy in 2014 after extensive negotiations with its many bondholders and lenders through its various related entities. The debtor recently obtained another extension on exclusivity to continue negotiating a settlement with certain lenders that should pave the way to reorganizing into multiple companies with new opportunities for investment through complicated debt vehicles.[11]

JOAs may also be prevalent in upcoming energy bankruptcies. These agreements pool investments to better manage the costs and risks associated with research and production and therefore necessarily include non-debtor third parties. While the right to terminate upon a bankruptcy filing typically is viewed as an unlawful ipso facto clause and disregarded in the U.S., such rights may be an issue in bankruptcy, particularly among foreign entities; accordingly, debtors may need to meet certain payment obligations during bankruptcy. For instance, Endeavour International filed in October 2014 with a proposed debt-for-equity swap with its multiple bondholders and the need to restructure foreign debt. The debtor in the Endeavour bankruptcy has rights and obligations under JOAs with unrelated non-debtor entities that it sought and obtained approval to meet during bankruptcy.[12]

In short, the U.S. is becoming less dependent on foreign oil as new and existing companies are harnessing our resources through improved technologies. However, low prices caused by oversupply and the high expense of technology, among other things, make those exploration companies that cannot implement economies of scale or have less negotiating power with service companies to lower costs more vulnerable. Thus, bankruptcies of oil and gas companies are likely to be on the rise with complicated contract and debt issues to grapple with in bankruptcy.

1. Cushing, OK WTI Spot Price FOB (Dollars per Barrel) U.S. Energy Information Administration.

2. "Exxon's Offshore Discoveries Fuel Deepwater Profits," *Energy & Capital*, by Keith Kohl, 6/10/11, http://www.energyandcapital.com/articles/exxons-offshore-discoveries-fuel-deepwater-profits/1559.

3. John Defterios and Anna Stewart, *OPEC: No cut in oil production and prices keep falling*, CNN Money (November 27, 2014), available at http://money.cnn.com/2014/11/27/news/opec-oil-prices/.

4. Andrew Critchlow, "Third of listed UK oil and gas drillers face bankruptcy," *The Telegraph* (December 19, 2014), available at http://www.telegraph.co.uk/finance/newsbysector/energy/11315956/Third-of-listed-UK-oil-and-gas-drillers-face-bankruptcy.html.

5. Notably, OW Bunker filed for bankruptcy in November 2014 due to fraud and bad hedging bets and Young Oil Company's filing in 2009 stemmed from the appointment of a receiver by a Kentucky court following a complaint for fraud and securities law violations.

6. ATP Oil & Gas Corp. filed its bankruptcy in 2012 following the explosion of the deepwater horizon and the resulting liability and losses that followed from the explosion.

7. *See In re Aurora Oil & Gas Corp.*, 439 B.R. 674 (Bankr. W.D. Mich. 2010) (holding that an oil and gas lease qualified as a lease under section 365(m); *In re Powell*, 482 B.R. 873 (Bankr. M.D. Pa. 2012) (holding that an oil and gas lease qualifies as an unexpired lease under section 365(m)).

8. *See Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 540 (7th Cir. 2003) (albeit not in the oil and gas context, finding that while 11 U.S.C. §365(h) protects the rights of a lessee, possessory interests are extinguished after a §363(f) sale); and *see In re J. H. Land & Cattle Co., Inc.*, 8 B.R. 237, 238 (Bankr. W.D. Okla. 1981), (oil and gas lease may be rejected by the debtor under §365), *cf In re Clark Res., Inc.*, 68 B.R. 358, 358 (Bankr. N.D. Okla. 1986), (under Oklahoma law, an oil and gas lease was not an unexpired lease or executory contract subject to assumption or rejection).

9. Rhett G. Campbell, *Significant Issues in Oil and Gas Bankruptcy Cases* (1999).

10. On January 15, 2014, GASFRAC Energy Services, Inc. filed a Chapter 15 bankruptcy after filing a foreign main proceeding in Canada under the Companies' Creditors Arrangement Act and sought to quickly sell all or substantially all assets immediately. Additionally, Buccaneer Resources, LLC moved for a quick sale after its bankruptcy filing to sell all assets and distribute cash from its exploration operations.

11. Second Order Extending the Debtors' Exclusive Periods to File a Chapter 11 Plan and Solicit Acceptances Thereof Pursuant to Section 1121 of the Bankruptcy Code, *In re Energy Future Holdings Corp, et al.*, No. 14-10979-CSS (Bankr. D. Del. 2014) (DN 3507).

12. Interim Order (I) Authorizing Payment of (A) Joint Interest Billings and (B) Lien Claimants in the Ordinary Course of Business and (II) Directing Financial Institutions to Honor and Process Checks and Transfers Related to Such Obligations Pursuant to Sections 105(A) And 363(b) Of the Bankruptcy Code, *In re Endeavor Operating Corporation, et al.*, No 14-12308 (KJC) (Bankr. D. Del. 2014) (DN59).