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Common Issues in the Troubled Energy and Production (Oil and Gas) Sector[1]

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The oil and gas exploration sector in North America has been crushed by high debt, globally low oil prices, and regional overcapacity. The result: Over one hundred oil and gas exploration and production companies have filed bankruptcy over the past 18 months, and dozens more are expected to follow. The stress on the producers is threatening a secondary wave of bankruptcies among the downstream counterparties to the producers – in particular, the so-called "midstream" entities that move the oil and gas produced into the broader system who are tied to the producers through gathering and similar agreements.

The vast majority of recent oil and gas filings have occurred solely in the United States, with filings in Texas leading the way. A few filings have occurred solely in Canada under its insolvency regime. A very small subset of those have filed in both jurisdictions.

Of the fifteen largest oil and gas filings over the past 18 months, two involved filings for corporate families (*Quicksilver Resources, Inc.* and *Pacific Resources*) in both the U.S. and Canada, and of those two, only *Pacific Resources* involved a cross-border proceeding, defined as a proceeding in which the orders pursued and obtained in one proceeding are intended to be recognized and have effect in the other proceeding. *Quicksilver* filed separate proceedings in the U.S. and Canada one year apart, with neither proceeding referencing the other.

This article will provide a general overview of common issues faced by debtors in the energy and production (oil and gas) sector, and brief observations about an approach to cross-border insolvency for those oil and gas sector companies that can exercise the option to file in both the United States and Canada.

Characterization of Oil and Gas Leases as Real or Personal Property

An oil and gas lease conveys a right to extract oil and gas for a period of time, usually terminable by an event that cuts off the lease rights, such as the failure to continue to produce oil or gas from the well site. Leases can be obtained under state law or, in the case of leases on federal lands, federal law, the jurisdiction determined by the operating site of the lease. The majority rule (in states such as Texas) is that an oil and gas lease is a fee simple interest in property. That is also the rule for federal leases, other than federal leases on the Outer Continental Shelf. The United States takes the position that shelf leases are personal property but the question remains open in the courts. In a minority of states, oil and gas leases are personal property. To the extent that an oil and gas lease is considered to be personal property, it may be subject to rejection under Section 365 of

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the Bankruptcy Code if the debtor, exercising its business judgment, determines that it is better off terminating the lease, shedding its obligations and converting any claims of the counterparty (e.g., breach of contract) into a general unsecured claim.

Abandonment Obligations

The oil and gas sector is heavily regulated. One area of regulation involves the abandonment of wells that have produced out or were drilled and never produced. Such wells must be plugged before they can be abandoned. The process for plugging is itself highly regulated, and the cost can be significant, up to $17 per linear foot of well depth per well, according to 2015 estimates compiled by the Texas Railroad Commission.

To avoid the cost of plugging, a debtor in bankruptcy may seek to use the power to abandon property in bankruptcy (where such property provides no value to the estate) and avoid both the obligation and cost of plugging. While the case law in this is mixed, oil and gas producers faced with restructuring and considering bankruptcy should be aware that bankruptcy will not necessarily allow them to avoid well-plugging costs. While some courts have concluded that a debtor may abandon a well without fulfilling its plugging obligations if the well does not present an "imminent danger" to the public, the majority have hewed to the approach that a debtor (or bankruptcy trustee) cannot avoid environmental remediation obligations because such obligations are, by their nature, necessary to prevent harm to the public. Furthermore, where the debtor does have plugging obligations, a court may determine such obligations may give rise to an administrative priority claim, even if the plugging costs were incurred prepetition.

Gathering Agreements

Oil and gas producers rely on downstream parties to move their product to refining facilities and ultimately to market. The agreements that paper these transactions are known as midstream agreements, of which gathering agreements are a subset. A gathering agreement documents the terms between a producer and a midstream company by which the midstream company collects and moves the oil and gas from the production site to a pipeline in the commodity's primary transmission system. These midstream companies agree to build out the gathering system – at substantial cost – in exchange for a royalty or similar long-term payout of a percentage of the proceeds of production for as long as the well remains operational. Key components of a typical gathering agreement are (a) the dedication of real estate to the gathering infrastructure, and (b) a minimum volume commitment – a floor that the producer agrees to pay on a periodic basis regardless of the amount of production.

The seismic systemic economic shifts that have crushed the exploration and production companies are having a secondary, but equally harsh effect, on the midstream companies that help the oil and gas entities move their product into the global commodities system. The terms of a gathering agreement negotiated when oil was anticipated to remain at $90 a barrel become unsavory to a producer when oil is at $40 a barrel; at some point, the floor commitment in a typical gathering

agreement can turn that agreement into an albatross around the producer's neck when the market crashes.

That element is now playing itself out in dozens of oil and gas bankruptcy cases, where oil and gas producers are moving to reject unfavorable gathering agreements pursuant to Section 365 of the Bankruptcy Code, and midstream companies are fighting back, contending that such agreements are not executory contracts. The threshold issue in these cases is the extent to which such agreements – in particular, the terms that dedicate real estate to the gathering venture – create real property interests (covenants) that "run with the land." The midstream companies have consistently argued that the agreements create interests that run with the land and, as a result, the agreements cannot be rejected.

While it is not binding on other courts, the bankruptcy court in the Southern District of New York recently reached the first decision in this open and untested area in the *Sabine Oil & Gas Corporation* case. The *Sabine* court held that (a) rejection of the leases was a valid exercise of the debtors' business judgment, and (b) the gathering agreements did not create covenants that run with the land under Texas law. *In re Sabine Oil & Gas Corporation*, 2016 WL 2603203 (Bankr. S.D.N.Y. 2016); *In re Sabine Oil & Gas Corporation*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016). Shortly after this decision, similar disputes between producers and midstream companies in two other large oil and gas cases were resolved by settlement. *See In re Quicksilver Resources Inc.*, Case No. 15-10585 (Bankr. D. Del. 2015); *In re Magnum Hunter Resources Corporation*, Case No. 15-12533 (Bankr. D. Del. 2015).

It is difficult to assess the extent to which *Sabine* is a shot across the bow of midstream companies which are already struggling in the wake of the economic tsunami impacting the producers. *Sabine* may be correct under Texas law but a different result may occur under Oklahoma law, or a different bankruptcy judge may simply approach the analysis differently. It would seem, however, that *Sabine* has shifted the balance of power in favor of producers in their battles with midstream companies as this industry sector continues to struggle.

Other Common Issues: Farmout Agreements and Liens

A farmout agreement documents the transfer of an oil and gas lease from the "farmor" to a "farmee" in exchange for the farmee's commitment to drill additional wells. This is a way for the farmor to shift the risk and cost of drilling to a third party in exchange for a royalty interest in the completed well. As a rule, the transfer is completed when the farmee drills the first well, which puts the farmee at risk if it has an assignment and the farmor files for bankruptcy before the transfer has been consummated. To ameliorate that risk, Section 541(b)(4) creates a safe harbor for the farmee, providing that (with some conditions) farmout agreements are not property of the bankruptcy estate. This prevents the debtor from using powers inherent in bankruptcy cases to reject or modify the farmout agreement if the farmee has completed or substantially completed the material conditions that entitle the farmee to transfer of the lease.

Two types of liens are typically material in an oil and gas bankruptcy – (a) mechanic's and materialman's liens, and (b) producers liens. The former protects creditors of the debtor; the latter protects the debtor.

Mechanics and materialman's liens protect the companies and individuals that provide goods and services to wells and production facilities. These liens typically attach to the structures to which goods and services were committed, but may also extend to the leasehold interest in a well and the proceeds of that well. In some cases, such liens can prime preexisting secured liens if certain procedural requirements are met. The Bankruptcy Code allows mechanic's and materialman's liens to be perfected after the petition date if state law permits perfection of an after-acquired interest in property against a preexisting lien.

A production lien grants the producer a lien on oil and gas sold to third parties to secure payment, which may itself be contingent on downstream transactions. Once oil and gas is transferred to a party providing transportation or other downstream services, the product will be subject to the liens impacting those downstream parties absent the security provided by a production lien. To ensure that third party lenders are aware of these liens, it is common practice to file UCC financing statements.

Cross Border Approach in the Oil and Gas Sector: An Opportunity for a Strategic Use of Comity?

As noted above, there has been little cross-border bankruptcy activity in this sector in the current wave of insolvencies. Many oil and gas producers have state- or region-specific operations. Even *Quicksilver Resources*, with significant interests in both the U.S. and Canada, elected to file its chapter 11 and Canadian proceedings involving certain affiliates as separate proceedings, with no legal connection between them and no attempt to use orders in one jurisdiction to bind interests in the other.

Assume, however, that an oil and gas producer has significant interests in, for example, Texas, and significant interests in Alberta. This producer has the option of filing in the U.S. under the Bankruptcy Code or under the Companies' Creditors Arrangement Act ("CCAA") in Alberta. It has generally been the pattern that a company with significant U.S. interests that files in both countries will ask the Canadian court to recognize the U.S. proceeding as the main proceeding, with the goal of obtaining orders in the U.S. that will be recognized and binding in Canada. However, an oil and gas producer may decide that the arc of case law on a key issue in the U.S. is unfavorable, and propose to use the Canadian proceeding as the main proceeding, with a goal of obtaining relief from the Canadian court that may be recognized by the U.S. court (under the principle of comity) and thus binding in the U.S. even if the U.S. court may have ruled differently had the issue been presented to it directly.

As an example, Metcalfe & Mansfield Alternative Investments II Corp and affiliates, in the asset-backed commercial paper market, filed a CCAA proceeding on March 17, 2008 in the Ontario Superior Court of Justice. In that proceeding, Metcalfe obtained, as part of its Plan of Compromise

and Arrangement, an order that extended releases and a broad litigation injunction to non-debtor participants in Metcalfe's restructuring. The nondebtor releases and injunctions were reviewed and approved by a Canadian appellate court.

On November 10, 2009, the monitor of the Metcalfe Canadian proceeding filed a chapter 15 petition in the Southern District of New York, requesting recognition of the Canadian proceeding as a foreign main proceeding and an order recognizing and enforcing the nondebtor releases and injunction granted in the Canadian plan. The U.S. bankruptcy court recognized the proceeding, and ultimately concluded that, under principles of comity in chapter 15 cases, it would recognize and enforce the Canadian nondebtor releases and plan injunction, "even if those provisions could not be entered in a plenary bankruptcy case." *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).

There are limits to comity. Both countries recognize a public policy exception to recognition of a foreign judgment, and a U.S court, for example, could reject the judgment of a Canadian court if it found the judgment to be materially counter to U.S. public policy. Furthermore, the complex property interests in oil and gas cases are creatures of state law, and it is unclear the extent to which a Canadian court, interpreting (for example) Texas law, would come to a different conclusion than a U.S. court on the same issue. Still, an oil and gas company with the opportunity to do so should consider a cross-border approach that seeks relief from a Canadian court on an issue affecting the company generally that it may not be able to obtain in a U.S. bankruptcy court, and have that relief made binding through a chapter 15 proceeding.