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DISCUSSING THE TRENDS

Q&A with Mitchell A. Seider

4 Key Restructuring Considerations for Distressed E&P Companies

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"For distressed exploration and production (E&P) companies and their lenders, there can be many significant legal issues associated with restructuring," according to Latham & Watkins partner Mitchell Seider.

Seider is a partner in Latham's New York office and global Co-chair of the Restructuring, Insolvency & Workouts Practice. He focuses his practice on business reorganizations and financial restructurings and regularly represents secured lenders, bond holders, creditors' committees and debtors in chapter 11 cases and workouts.

1. Termination of Oil and Gas Leases for Non-production

Seider: The habendum clause in an oil and gas lease defines the term of the lease. The clause typically provides for a fixed primary term and sets forth certain conditions that the lessee must satisfy in order for the lease to continue in a secondary term, such as commencement of operations to obtain production or continuous "production in paying quantities." If the conditions in the habendum clause are not met, the lease may terminate automatically.

A company that is liquidity constrained may be at risk of losing valuable leases. Among the features of chapter 11 is a provision that allows the debtor an opportunity to assess whether leases that are executory are economically beneficial or burdensome. Contracts that are beneficial may be assumed, and those that are burdensome may be rejected. Whether a particular contract is subject to assumption or rejection will often turn on underlying state law.

Within the major oil and gas producing states, there is no uniformity on the question of whether an oil and gas lease conveys ownership rights. Ownership rights may make the lease not subject to assumption or rejection. Texas and New Mexico, for instance, take an ownership approach to the oil and gas lease and it appears that North Dakota does as well. In a state where an oil and gas lease does not convey an ownership right, the lease may be subject to assumption or rejection in chapter 11 — Wyoming and New York appear to take this approach. Lastly, in some states like Alaska it is uncertain whether the lease conveys an ownership right.

2. Liability for the Costs of Well Plugging and Abandonment

Seider: Under state and federal law, E&P companies are obligated to plug and abandon (P&A) a well after operations cease. Offshore P&A liability can be very significant. Companies operating offshore on the outer continental shelf (OCS) are obligated to plug a well within one year of the end of production and must comply with requirements set forth by the Bureau of Ocean Energy Management (BOEM).

The BOEM requires companies operating offshore to provide basic bonding for their P&A obligations; the amount of bonding that the BOEM requires is discretionary. Companies that fail to meet certain financial thresholds may also be required to provide supplemental bonding, potentially in substantial amounts. To show financial ability to meet P&A obligations, a company typically must show a minimum net worth, have a minimum debt-to-equity ratio and provide audited financial statements.

If an operator becomes a debtor under the bankruptcy code, the priority of its bonding obligations may have a material impact on its ability to reorganize and on distributions to its creditors. Priority is critical because claims that receive administrative expense priority must be satisfied in cash in full as a condition to exiting from chapter 11 via a plan of reorganization. Whereas general unsecured claims may be satisfied with less than payment in full.

While there is very little case law on how P&A obligations stack up versus other claims in chapter 11, there are several practical rules to keep in mind. Generally obligations that arise after the start of the bankruptcy case are entitled to administrative expense priority. Obligations that arise before the commencement of the case are generally considered to be general unsecured claims. However, there is case law finding that where an obligation arose before bankruptcy but continued during bankruptcy — and the obligation was one affecting public health and safety — the obligation was entitled to administrative priority.

3. Oil and Gas Contractor Liens

Seider: In many jurisdictions, oil and gas contractors receive statutory liens to secure payment for labor performed or equipment furnished. Some states incorporate such liens in the state's general mechanics' and materialmen's (M&M) statute, while other states have separate statutes specifically addressing oil and gas contractor liens.

Oil and gas liens typically attach to the entire leasehold estate on which the labor was performed or the materials furnished, and they may include the wells, pipelines and other equipment or fixtures located on the property or used in the oil and gas operations. In some states, the lien also attaches to the proceeds of the production.

The differences between holding an unsecured and a secured claim are dramatic for the creditor and the obligor on the claim. Outside of chapter 11, a secured creditor has the right to follow applicable state law procedures and then foreclose and take ownership of the assets securing its unpaid claim. In chapter 11, at a minimum secured creditors are entitled to receive the value of their interest in the assets that secure their claims.

Secured creditors in chapter 11 have other material rights as well. These include the right to adequate protection of their interests in their collateral as a condition to the debtor using cash proceeds of their collateral. They also have the right to adequate protection as a condition to the debtor pledging their collateral to secure senior debt financing. Again, state law will determine when a contract's lien attaches and the scope of the property that becomes subject to the contractor's interest as a secured claim.

The lien will typically relate back to the date upon which labor was first commenced or materials were first furnished, even if notice of the lien is not required to be filed until a later date. An oil and gas contractor's lien will typically have priority over all other liens and encumbrances attaching to the property subsequent to the date the oil and gas lien arises. In some states, the date of preference for all contractor lien claimants relates back to the first date of work of the earliest contractor lien claimant. In other states, priority will be determined based on the date each claimant commences work.

Each state's M&M or other oil and gas lien statute contains nuances and should be consulted directly in determining the rights of all parties. Lenders to distressed E&P companies should be particularly mindful of where their borrower operates and the status of the borrower's obligations to its contractors as these contractors may have rights that are equal to or in some cases may be senior to the rights of those money-borrowed lenders.

4. Treatment of Interests in Oil and Gas Production

Seider: The operator's obligation to pay royalties is a contract right and, therefore, a prepetition claim for unpaid royalties would typically be treated as an unsecured claim in a bankruptcy case. Some states, such as Texas, New Mexico, North Dakota, Kansas, and Oklahoma, provide for statutory liens to protect the rights of working interest owners and royalty owners who have gone unpaid. Typically, a producer's or royalty owner's lien attaches to the production and the proceeds thereof and will be treated as a purchase money security interest for purposes of priority.

The application of the statute to royalty interest owners may hinge on how the obligation to pay the purchase price to the royalty owner is construed. For example, due to the fact that a royalty owner of oil production is typically given a right to a percentage of the oil produced, the owner is often considered a "seller" and, therefore, a lienholder under the Texas statute. Royalty owners of gas production, who are more commonly paid in cash, are not.

Royalty owners may have another form of protection if the oil and gas lease provides for termination of the lease after non-payment of royalties. Such provisions are enforceable in some states, including Texas. The automatic stay under Section 362 of the Bankruptcy Code does not preclude termination because the failure to pay royalties causes the lease to terminate automatically and, in jurisdictions like Texas that treat oil and gas leases as conveyances of real property, the ipso facto clause of Section 365 of the Bankruptcy Code will not apply.

Section 541 of the Bankruptcy Code governs property of the debtor's estate. An overriding royalty interest (ORRI) or net profits interest (NPI) is typically conveyed as an interest in real property, which is excluded from the debtor's estate. The Bankruptcy Code excludes from the debtor's estate "any interest of the debtor in liquid or gaseous hydrocarbons to the extent that…the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from which such production payment is transferred." 11 U.S.C. § 541(b)(4)(B).

"Production payment" is defined as a type of "term overriding royalty" or "an interest in liquid or gaseous hydrocarbons in place or to be produced from particular real property that entitles the owner thereof to a share of production, or the value thereof, for a term limited by time, quantity, or value realized." 11 U.S.C. §§ 42(A) and 56(A). Section 541(b)(4)(B) of the Bankruptcy Code provides a safe harbor for assignees of production payments. Section 541 codifies the view that assignees of production payments take title to the property, which then ceases to be property of the estate.

The safe harbor excludes from the estate production payments that are assigned "to an entity that does not participate in the operation of the property from which such production payment is transferred." This language may be read to imply that the safe harbor is only available to assignees who provide financing, and not to assignees who received production payments as compensation. There is little case law on this issue, and debtors and operating assignees may dispute whether the assigned interests in production payments should be excluded from the debtor's estate.

For these safe parties, this safe harbor assures that the future streams of revenue that they will receive for their interests will not be subject to cancellation or alteration through a plan of reorganization. For the debtor's creditors however, there may be very strong incentive to have these interests recharacterized as financings rather than conveyances through litigation in the bankruptcy case. The reason for this is that successful recharacterization will make the hydrocarbons that are the subject of these interests property of the bankruptcy estate, and the claims of the holders of these interests will then be subject to treatment under a plan of reorganization. Once these claims or interests become subject to treatment under a plan, the holders are therefore at risk of receiving discounted value on an absolute as well as a time-adjusted basis for their interests.

While there is not a great deal of case law on recharacterization of ORRIs, NPIs and production payments, there is a considerable amount of case law on recharacterizing conveyances or sales as financings. These cases by-in-large are varied, and they are also quite complex. As a result, parties who have what they believe to be ORRIs, NPIs and production payments with distressed counterparties should understand very carefully the risks that they may have of potential recharacterization in a bankruptcy case.

For More Information

- Oil and Gas Restructurings: Exploration and Production Companies Face Unique Issues
- What Lenders and Investors in E&P Companies Need To Know As Oil Prices Drop
- Restructurings and Distressed Investing — Planning the Perfect Exit

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