Specific issues impacting oil and gas bankruptcy cases

SCOTT OPINCAR | RESTRUCTURING STRATEGIES | JUN 29, 2016

Despite the 80 percent increase in oil prices since February of this year to around $48.85 a barrel as of June 24, 2016, oil companies continue to face diminished cash flows and substantial debt. According to recent reports, around 39 producers have filed for bankruptcy protection in 2016 and approximately 81 producers have filed bankruptcy cases since 2015. This is in addition to the roughly 70 oilfield services companies that have filed for bankruptcy protection in the last two years. McDonald Hopkins recently filed chapter 11 bankruptcy cases for Gulf Chemical & Metallurgical Corp. and its Bear Metallurgical Co. unit (providers of recycling services to oil refiners) on June 14, 2016, with the goal of finding a buyer.

Borrowing base redeterminations conducted in the spring of 2016, tied to the value of a driller’s proven oil and gas reserves that lender’s use to establish an energy company’s creditworthiness twice a year, have resulted in diminished revolving credit lines that have substantially impacted the liquidity of oil companies. According to data published by Reuters, lenders to oil and gas companies have cut the borrowing bases of more than a dozen large producers by roughly $3.5 billion in 2016, a fifth of available credit.

Oil and gas companies experiencing substantially reduced production, low commodity prices, lack of available credit, and fear in the marketplace can find themselves in a rapidly declining death spiral in which they do not have the ability to make interest payments and service debt payment obligations, triggering bond and loan covenant defaults that lead to the exercise of remedies by bondholders and secured lenders. Consequently, a financially distressed oil and gas company must understand, or hire professionals that keenly understand, the specific and unique issues impacting E&P and oilfield service company bankruptcy cases.

The United States Bankruptcy Code and state laws can have a substantial impact on a party’s rights under oil and gas agreements, including leases, joint operating agreements, and farmout agreements. Below are a few examples that highlight specific issues:

LEASES

The nature of an oil and gas lease is determined by state law, which defines property interests. There are two primary theories governing the property law characterization of unsevered oil, gas, and other minerals. The first is the “in place” theory. Under this theory, unless the mineral estate has been severed, one owns all of the oil and gas under the surface land in fee simple determinable (subject to the occurrence of a specified event – lack of production or the failure to pay royalties); however, such ownership of the minerals can be lost by the rule of capture if neighbors begin to drain the resource. This theory applies to states such as Colorado, Oklahoma, Pennsylvania, and Texas. The second is the “non-ownership” theory. Under this theory, no one really owns the gas or oil under the surface, but, as long as the mineral estate has not yet been severed, the surface owner directly over the mineral reservoir has the exclusive right to try and capture the oil or gas. Therefore, instead of ownership, one really has what is called a profit. A profit is just a fancy and technical term for an easement to take the oil. This theory applies to states such as Arkansas, California, Kansas, Montana, New York, Ohio, and West Virginia. Depending on where one lives, the ownership theories can be quite different and lead to completely different results.

Section 365 of the Bankruptcy Code deals with the assumption, assumption and assignment, and rejection of executory contracts and unexpired leases in bankruptcy cases. The Bankruptcy Code does not define the term “executory contract,” but most courts have adopted this definition – a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other. Section 365(a) of the Bankruptcy Code provides, among other things, that a debtor can reject an executory contract, subject to bankruptcy court approval, if the contract is unduly burdensome to the debtor’s estate, irrespective of the adverse impact that rejection may have on the non-debtor party. Courts generally defer to the debtor’s exercise of its business judgment in determining whether to permit rejection of an executory contract, absent a showing that the debtor’s decision was based on bad faith, whim, or caprice. The non-debtor party to a rejected contract, in turn, receives an unsecured claim against the debtor’s estate for breach of contract damages.

Whether or not an oil and gas lease is an executory contract or unexpired lease subject to the provisions of Section 365 of the Bankruptcy Code depends on the character of the lease estate conveyed and the particular state in which the leased property is located. The nature of the property right created varies from state to state and from court to court. Certain courts have held that oil and gas leases are real property interests that run with the land, not personal property interests. In this case, the oil and gas lease is not subject to rejection under Section 365 of the Bankruptcy Code. For example, oil and gas leaseholds in Texas and Pennsylvania are classified as real estate interests. Other courts – for example, in Louisiana and Oklahoma – have ruled that an oil and gas lease is not executory because the lessee’s only remaining obligation is the payment of money and the lessor’s only remaining obligation is the defense of the title to the leased land and not to interfere with the lessee’s drilling operations, thus the breach by one party does not excuse the other party from performing under the lease. On the other hand, courts have ruled that an oil and gas lease creates a license to enter under applicable state law, such as in Kansas, which is an intangible property right and, therefore, an unexpired lease of real property under Section 365(h)(1) of the Bankruptcy Code and subject to rejection.

Why does this characterization matter? The Bankruptcy Code requires that a debtor in bankruptcy must decide, within 120 days after filing a bankruptcy petition, whether to assume or reject an unexpired lease or executory contract on “non-residential real property.” This time limit may be extended, without the lessor’s consent, up to a total of 210 days from the bankruptcy filing, by order of the bankruptcy court. However, should the debtor fail to take action prior to the expiration of the 120-day period, or fail to assume a lease within either the 120-day period, or if extended, the 210-day period, the lease may be terminated as to the bankruptcy debtor. Thus, a lessor will either have its lease assumed, and all obligations brought current (as provided by bankruptcy law requiring a cure of defaults upon “assuming” a contract), or the lease will essentially be terminated and the lessor will be free to release the mineral interest rights to another party. On the other hand, if the mineral “lease” is determined to be a real property right, and not a “lease” or executory contract, the limitations imposed by the Bankruptcy Code will not apply and a "lessor" cannot demand cure of all prepetition obligations as a condition to the assumption of the oil and gas "lease" by the lessee.

JOINT OPERATING AGREEMENTS

In the upstream oil and gas sector, joint operating agreements, joint drilling ventures, and other corporate structures with multiple partners are the norm. A joint operating agreement is a contract where two or more parties agree to undertake a common task to explore and exploit an area for hydrocarbons. The parties to the agreement can be broadly classified as operators and non-operators. The operator is typically responsible for the day-to-day management and operation of the field. It is generally not liable for any loss of production or revenues as a result of its decisions except in cases of gross negligence and/or willful misconduct. Non-operators typically answer cash calls and are not involved in the day-to-day management and operation of the field.

Joint operating agreements give rise to credit risk for all of the working interest owners which are parties to the agreements, both operators and non-operators. For instance, operators frequently make advances on behalf of non-operators for both capital expenditures and lease operating expenses. Upon the bankruptcy of the non-operator, claims for both capital expenditure amounts and for unpaid lease operating expenses will be prepetition claims against the non-operator. Operators, on the other hand, often market hydrocarbons for the non-operators which, prior to the operator's payment (most often in arrears) of the proceeds of the sale of such hydrocarbons, means that the non-operator will be taking the credit risk of the operator. In that circumstance, the bankruptcy of the operator will result in the non-operators being left with claims for hydrocarbons that have been produced and sold prior to the bankruptcy case. In order to reduce this risk, the terms of joint operating agreements often include reciprocal contractual liens to secure the performance of the counterparty. The manner of perfecting the lien and security interest in a joint operating agreement varies depending on applicable state law. Parties to joint operating agreements should be careful to make sure that their liens are properly perfected.

Most bankruptcy courts have treated joint operating agreements as executory contracts because the exploration and development obligations are ongoing on the properties and thus, there always remain unperformed duties owing to the other party or parties to the agreement. In these cases, the assumption, assumption and assignment, and rejection of joint operating agreements are subject to the provisions of Section 365 of the Bankruptcy Code.

FARMOUT AGREEMENTS

A farmout agreement is defined under Section 101(21)(A) of the Bankruptcy Code to mean a written agreement in which the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property (farmor) agrees or has agreed to transfer or assign all or a part of such right to another entity; and such other entity (farmee), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property. If the farmout agreement has not been fully performed by both parties, courts generally treat the farmout agreement as an executory contract that the debtor may assume or reject under Section 365 of the Bankruptcy Code. Section 541(b) of the Bankruptcy Code provides a safe harbor to protect companies that have spent time, effort, and capital farming-in to a particular lease but who have not yet received an assignment of the farmed-in property from the farmor when the farmor files for bankruptcy protection. Section 541(b)(4) of the Bankruptcy Code excludes the earned portion of farmout agreements from the definition of "property of the bankruptcy estate," as long as the interest is in liquid or gaseous hydrocarbons transferred or agreed to be transferred. Because the interests that the debtor has already transferred or agreed to transfer are not considered "property of the estate," the debtor-farmor cannot reject the farmout agreement to invalidate a farmee's right to receive an assignment of its interest. The debtor may not defeat the farmee's right to an assignment simply because the farmee's interest is not of record.

SCOTT OPINCAR

Read More