



PROGRAM MATERIALS

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**Steps Producers and Midstream
Companies Can Take to Prepare for
Counterparty Bankruptcies Following
the Pandemic**

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Steps Producers and Midstream Companies Can Take to Prepare for Counterparty Bankruptcies Following the COVID-19 Pandemic

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Agenda

- Secured Creditor Advantages
- Securing Claims Before Counterparty's Bankruptcy Filing
- Assumption/Rejection of Contracts in Bankruptcy
- Practical Oil & Gas Bankruptcy Considerations

SECURED CREDITOR ADVANTAGES

Secured Creditor Advantages

- ***Receipt of Collateral Proceeds and Priority of Payment in Bankruptcy***
 - Secured creditors (“SCs”) receive sale proceeds attributable to their collateral until their claim is paid in full, with any deficiency becoming an unsecured claim – Section 506(b)
 - Unsecured creditors (“UCs”), in contrast, must share pro-rata in any funds remaining after SCs have received their proceeds and administrative expenses have been paid

Secured Creditor Advantages cont.

- ***More Rights than Unsecured Creditors in Chapter 11 Plan Confirmation***
 - If a class of SCs does not vote to accept the chapter 11 plan, the plan must provide that, for each SC in the class:
 - (1) SC retains lien on its collateral and receives cash payments with a present value equal to the value of its collateral as of effective date of the plan;
 - (2) if the property securing the claim is sold as part of the plan, the SC's lien attaches to the proceeds of the sale; or

Secured Creditor Advantages cont.

- (3) the SC receives some other treatment under the plan that confers value equal to the value of its lien (“Indubitable Equivalent”)
 - Section 1129(b)(2)(A)

Secured Creditor Advantages cont.

- ***Greater Influence at Pivotal Moments of Chapter 11 Process***
 - SCs have grounds to object to debtor's motion for use of SC's cash-collateral
 - Debtor must provide "adequate protection" to creditor in exchange for use of cash collateral –Section 363(c)(2)
 - If debtor seeks to grant liens on property to post-bankruptcy lender that takes priority over SC's existing lien on same property, debtor must also provide "adequate protection" to SC – Section 364(d)

Secured Creditor Advantages cont.

- ***Potential for Relief from Automatic Stay***
 - Upon a debtor's filing of a bankruptcy petition, an automatic stay is triggered – Section 362(a)
 - Automatic stay prevents creditors from enforcing or collecting upon debtor's obligations that arose prior to filing of bankruptcy petition.
 - SCs may be entitled to relief from automatic stay to foreclose or repossess collateral:
 - Stay relief for “cause” (e.g., collateral not “adequately protected”) – Section 362(d)(1);

Secured Creditor Advantages cont.

- Stay relief if debtor has no equity in collateral and if collateral not necessary to an effective reorganization – Section 362(d)(2); and/or
- Negotiated resolutions to stay relief motions – may enable SC to obtain concessions from debtor in the course of settling motion

Secured Creditor Advantages cont.

- ***Stronger Defenses Against Preference Actions***
 - SCs may also have better defenses against actions by debtors-in-possession to recover “preference payments”
 - Preference Payments = payments that a debtor made to a creditor within 90 days of bankruptcy filing, if (a) the payment was made on account of antecedent debt owed by the debtor, (b) debtor was insolvent at the time it made payment, and (c) payment left creditor better off than it would have been if payment had not been made and the SC had asserted its claim in a chapter 7 liquidation – Section 547(b)

Secured Creditor Advantages cont.

- SCs may be able to defeat preference actions by establishing that the payment made it no better off than it would have been in a chapter 7 liquidation because it would have received full payment from the liquidation of its collateral in a chapter 7 proceeding
- By contrast, UCs would not be able to make this argument due to a lack of collateral securing its claim

SECURING CLAIMS BEFORE COUNTERPARTY'S BANKRUPTCY FILING

Securing Claims Before Counterparty's Bankruptcy Filing

- ***Contractual Liens***

- Contractual liens may arise pursuant to a variety of oil & gas contracts, including master service agreements (“MSA”), joint operating agreements (“JOA”), leases and purchase and sale agreements
- Producers and midstream companies should review their contracts to assess whether they create contractual liens for their benefit as creditors
- In the JOA context, each working interest owner grants to other working interest owners a lien on its respective working interest in the contract area

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- With respect to MSAs, the contract may provide that the producer/midstream company grants a lien to the service provider on certain of its assets to secure its promise to pay the service provider for the services provided
- In either case, while the underlying agreement creates the lien, to perfect the lien, the parties must also execute a financing statement (and record with the appropriate secretary of state) and a memorandum of the agreement (and record in the applicable real property records)
- Failure to execute and record the financing statement and/or memorandum will render the lien unenforceable and the creditor unsecured

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- ***Judgment Liens***

- Contrary to an agreed-upon contractual lien, a judgment lien is a non-consensual lien may arise when a producer/midstream company, as creditor, brings suit against a debtor and obtains a judgment for the unpaid amount
- Upon obtaining the judgment, the creditor should file an abstract of judgment in the counties in which the debtor owns real property, the effect of which is to create a lien on the debtor's non-exempt real property located in those counties

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- If a bankruptcy proceeding is commenced within 90 days of perfecting the judgment lien, the debtor may succeed in avoiding the lien as a preferential transfer, if:
 - The debtor is insolvent; and
 - The lien renders the creditor better off than it would have been if payment had not been made and the creditor asserted its claim in a chapter 7 liquidation
- By quickly perfecting the judgment lien, therefore, a creditor can commence the 90 day preference window, in turn, bettering its chances that the window expires before the debtor commences its bankruptcy proceeding

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- ***Statutory Mineral Liens***
 - In addition to contractual liens and judgment liens, the property laws of most oil & gas producing states provide statutory mineral liens that benefit oilfield service providers or other persons providing labor or services that relate to “mineral activities”
 - See e.g., *In re PADCO Energy Servs., LLC*, 610 B.R. 96, 114 (Bankr. W.D. La. 2019) (citing *In re Heritage Consol., L.L.C.* 765 F.3d 507, 511-12 (5th Cir. 2014) (“Texas courts have repeatedly noted that the mineral lien statute is ‘designed to protect laborers and materialmen’ and should be liberally construed”))

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- Because mineral liens are a product of state statute, parties should carefully consult their state laws to assess the processes necessary to secure, perfect and enforce the mineral lien and the scope of the mineral lien
- Under the Texas Property Code, “a mineral contractor or subcontractor has a lien to secure payment for labor or services related to the mineral activities.” Tex. Prop. Code § 56.002
- “Mineral activities” include “digging, drilling, torpedoing, operating, completing, maintaining, or repairing an oil, gas or water well, and oil or gas pipeline, or a mine or quarry” Tex. Prop. Code § 56.001(1)

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- Notwithstanding the broad construction of “mineral activities,” however, to be benefit from the mineral lien, the claimant’s activities must generally facilitate the potential production of oil & gas
- *See e.g., Big Three Welding Equipment Co. v. Crutcher, Rolfs, Cummings, Inc.*, 229 S.W.2d 600 (Tex. 1950) (contractor’s lien denied for services rendered in dismantling, removing, hauling pipeline because such services did not constitute operations, maintenance or repair of pipeline within then meaning of statute)

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- In order to properly secure the claim, mineral lien claimants should also ensure they follow the procedures set forth in the particular lien statute, including those relating to filing deadlines, notice requirements, and other required information
- In Texas, the claimant must file an affidavit with the county clerk of the court in which the property is located not later than 6 months after day the indebtedness accrues. Tex. Prop. Code § 56.021
- Liens are state specific

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- Although the automatic stay typically prohibits a creditor from perfecting its lien (thereby rendering the creditor unsecured), Section 546(b) provides an exception to the automatic stay to allow a creditor to perfect mineral liens after the debtor's bankruptcy filing, as long as:
 - (1) the creditor could perfect its lien under applicable state law; and
 - (2) applicable state law provides that bona fide purchasers for value would take subject to such liens

Securing Claims Before Counterparty's Bankruptcy Filing cont.

- Under the Texas mineral lien statute, the mineral lien may be enforced only by a judgment of a court foreclosing the lien and ordering the sale of the property subject to the lien. Tex. Prop. Code § 56.041
- To timely obtain the judgment, the claimant must file suit in the county in which the lien is recorded within the later of:
 - (1) 2 years from the date the lien affidavit is filed; and
 - (2) 1 year from the date that the materials or services were last furnished under the contract.
 - Tex. Prop. Code § 56.041

ASSUMPTION/ REJECTION OF CONTRACTS IN BANKRUPTCY

Assumption/Rejection of Contracts in Bankruptcy

- ***Debtor's Contract Rights in Bankruptcy***
 - Section 365 affords debtors certain rights with respect to executory contracts (i.e., contracts in which both parties have remaining material performance obligations)
 - With the court's approval, the debtor may either assume, assign or reject the contract
 - Debtor's rejection power is limited, however – contracts forming real property covenants are not executory, and therefore may not be rejected

Assumption/Rejection of Contracts in Bankruptcy

- ***In re Sabine Oil & Gas Corp.*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016)**
 - NY bankruptcy court applying Texas law held that covenants contained in debtors' gathering agreements did not contain covenants that ran with the land (i.e., real property covenants)
 - Bankrupt debtors sought to reject gathering agreements pursuant to Section 365, but midstream service providers opposed rejection request on basis that agreements contained covenants that ran with land

Assumption/Rejection of Contracts in Bankruptcy

- Under Texas law, a covenant runs with the land when:
 - (1) it touches and concerns the land;
 - (2) it relates to a thing in existence or specifically binds the parties and their assigns (i.e., there is privity of estate between the parties);
 - (3) it is intended by the original parties to run with the land; and
 - (4) the successor to the burden has notice

Assumption/Rejection of Contracts in Bankruptcy

- The *Sabine* court held that covenants in gathering agreements did not run with the land for two primary reasons:
 - (1) the covenants did not touch and concern the land because the “mineral dedications concern[ed] only minerals extracted from the ground, which indisputably constitute personal property, not real property, under Texas law”
 - (2) the court found that there was no horizontal privity between the parties because the gatherer was not granted property interests in the underlying mineral interests

Assumption/Rejection of Contracts in Bankruptcy cont.

- ***In re Alta Mesa Resources, Inc.*, No. 19-03609, 2019 Bankr. LEXIS 3859 (Bankr. S.D. Tex. 2019)**
 - Texas bankruptcy court applying Oklahoma law held that debtors' midstream gathering agreements formed real property covenants that ran with the land, and therefore could not be subject to rejection under Section 365
 - Court noted that “the requirements to form a real property covenant in Texas mirror those in Oklahoma,” but “[t]he Court assumes the unique facts in *Sabine* led to that court’s conclusions [to the contrary].”

Assumption/Rejection of Contracts in Bankruptcy cont.

- Court found that all elements required to form a real property covenant under Oklahoma law were satisfied:
- The gathering agreements touched and concerned the oil and gas leases because “both the benefits and burdens of the covenants affect[ed] the value of Alta Mesa’s real property”
 - “Unlike in *Sabine*, where the court focused its inquiry on a fee mineral estate, the relevant starting point here is Alta Mesa’s leasehold interests”
 - “In the context of an oil and gas lease, the surface easement is integral to the lessee’s ability to realize the value of its mineral reserves”

Assumption/Rejection of Contracts in Bankruptcy cont.

- “Without the surface easement, the lessee cannot capture reserve hydrocarbons”
- Additionally, the surface easements “directly burden Alta Mesa’s interest” because it restricts the debtors’ use of the surface land for drilling or exploration” and thus “there is a logical connection between both the burden and the benefit of the covenants and Alta Mesa’s real property.”

Assumption/Rejection of Contracts in Bankruptcy cont.

- The court also found that horizontal privity existed because the gathering agreements gave the gatherer a surface easement to construct and maintain the gathering system
 - “Although less than a fee simple estate, the easements conveyed to Kingfisher a possessory interest in the leasehold estate. The surface easement is integrally tied to the purpose of an oil and gas lease. The conveyance of the easements to Kingfisher is enough to show horizontal privity with respect to the gathering agreements.”

Assumption/Rejection of Contracts in Bankruptcy cont.

- Finally, the court found that the parties intended for the agreements to bind successors, based on language stating that the covenants “run with the land”; on language requiring the dedications to be recorded; and on language requiring the parties to obtain affirmation that a transferee will uphold the party’s obligations under the agreement
- *Alta Mesa* is in accord with *In re Badlands Energy, Inc.*, 608 B.R. 854 (Bankr. D. Colo. 2019)(Colorado court applying Utah law in context of 11 U.S.C. § 363 sale held that gathering/processing and salt water disposal agreements created covenants that “ran with the land”)

PRACTICAL OIL & GAS BANKRUPTCY CONSIDERATIONS

Practical Oil & Gas Bankruptcy Considerations

- Analysis of Duties of Officers and Directors
 - Solvent Corporations
 - Zone of insolvency
 - Duties in Bankruptcy
- Opportunities to Consider in a Chapter 11 Proceeding
 - Debtor's distribution of assets
 - Creditor's acquisition of distressed assets
 - Out-of-Court Restructuring
 - Section 363 Sales
 - Formal Restructuring

Practical Oil & Gas Bankruptcy Considerations cont.

- Contract Issues:
 - As discussed above, the bankruptcy code allows for the assumption, assignment or rejection of executory contracts
 - Whether or not these agreements can be assumed and/or rejected can have a major impact on the economics of midstream companies
- Credit Bid Issues:
 - Who will own distressed assets in the future?
 - It is thought that many big banks are considering taking back assets and attempting to wait out current historic lows in commodity prices
 - Rights of SCs to bid their debt in a bankruptcy sale can have an impact on how and when distressed assets are transferred

Questions?



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