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Lessons from Energy Bankruptcies and Workouts

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The rush of energy companies executing workout agreements or filing for bankruptcy dramatically slowed a few years ago, as the price of oil increased and businesses discovered new oil and gas fields in South Texas. However, given the uncertainty of oil and gas pricing and the increasing costs of drilling and completing oil and gas wells, financial pressures again may begin to increase, meaning that lawyers for lenders to energy companies may find their loan documents under the bankruptcy microscope.

That microscope will zoom in on any payments to creditors in the 90 days prior to any bankruptcy filing that the debtor thus can avoid as a preference. It also will disclose any liens that are not perfected and that the debtor thus can avoid. In other words, it may reveal the creditors' inability to obtain the full value of the collateral underlying the loan.

While hoping for the best, lenders' counsel should advise their clients to prepare for the worst.



Just as new technologies result in new energy plays, the last spate of bankruptcies and workouts resulted in new issues regarding the extent, perfection and enforcement of liens. Included are issues regarding proper interpretation of after-acquired property clauses, assumption of joint exploration agreements and leases, the rights of lenders and potential purchasers to confidential information, and leases.

- *After-acquired property clauses.* These clauses are familiar components in real estate and energy lending. At its most basic, such a clause creates a lien on any property the borrower acquires after the lender makes the loan, usually limited to property within the county where the deed of trust is located.

There are two general components to valuing an oil and gas lease: 1. production, which includes proved, probable and possible reserves, and 2. undeveloped acreage. Lenders generally base an oil and gas loan upon actual production from the lease, rarely on the value of the entire oil and gas lease.

It is not unusual for energy borrowers to refuse to grant a lender a lien on undeveloped property, particularly when the amount of the loan does not take into account the value of undeveloped acreage. As the borrower drills and develops the property, new production creates

value, and an energy lender often will include the new production in its determination as to the amount by which it will increase the availability under the loan.

A lender needs to review the deeds of trust and related filings at regular intervals to ensure that the new production actually is subject to its liens. This happens through the lender timely recording deeds of trust against newly acquired leases or rights acquired under joint exploration agreements. Lenders should not rely upon the debtor's obligation not to grant competing liens, as only a perfected lien is a defense to intervening liens — particularly those asserted by unpaid vendors — if a debtor files bankruptcy.

- *Joint operating and development agreements.* Drilling and completing horizontal wells is an expensive proposition, so energy companies frequently enter into agreements to develop property jointly. Those agreements usually require all parties' consent to any assignment of rights under the agreement.

A lender with a properly drafted security agreement can obtain and perfect a lien on such contracts. Also, it is not unusual for a lender to obtain a security interest in the benefits from such agreements, such as the right to obtain assignments of leasehold interests.

However, a purchaser's rights (and thus the value of the lender's collateral) in the event of a foreclosure may depend solely on whether the third party to the agreement can be compelled to consent to an assignment.

To obtain the right to foreclose and assign such an agreement, a lender may 1. obtain in the joint development agreement the right to assign that agreement without the third party's consent; 2. require the lender's consent before the debtor can enter into a significant joint development agreement — a point when the debtor may have the greatest leverage in negotiating access for the lender; or 3. contractually agree on a description of an acceptable assignee, i.e., with criteria for financial ability, net worth or experience.

• *Confidential information.* Even if the lender has the right to acquire and/or assign the debtor's interest in joint operating and development agreements, an issue may arise as to what information the borrower may provide to potential third parties without the consent of all parties to the underlying agreement. Again, where possible, the lender should not only acquire the right to all confidential, proprietary and/or trade secret information under the agreement but also should attempt to acquire the right to share such information with potential purchasers. Such a right should be subject to an appropriate confidentiality agreement.

Therein lies another issue. The lender will want the confidentiality agreement to maximize interest in the property. However, other parties to the agreement will be more focused on maximizing the protection of the confidential information and restrictions on use of such information.

If the lender and other parties cannot reach an agreement, a lender may be forced to declare a default on an otherwise performing loan. If the borrower is forced into bankruptcy, it may be possible to

seek a ruling from the bankruptcy court as to the form and substance of confidentiality agreements with potential purchasers.

While the bankruptcy courts will sympathize with the need to protect a debtor's confidential and proprietary information, it also will understand the need to allow complete access to qualified purchasers to maximize the bankruptcy estate. The ability to share with and ultimately transfer information to potential purchasers may be an issue regardless of whether the debtor or the lender sells the property.

Similar confidentiality issues may arise in connection with other contracts, including seismic licenses and petrophysical analysis contracts and consortiums. For example, if the debtor paid \$500,000 to obtain the rights to core data in a certain geographic area, it will affect a potential purchaser's opinion of value if that purchaser has the right to step into the debtor's shoes to obtain access to such data.


And lawyers should not forget about employee noncompete and confidentiality agreements. Potential purchasers also may find value in having the ability to enforce those types of agreements. A lender should ensure it has a security interest in such agreements and the ability to assign those agreements to potential purchasers.

• *Leases.* Today's energy lessor is a sophisticated player with experienced counsel. Relatively new provisions in leases may include automatic termination of the lease if the lessee does not timely pay uncontested royalties, rights to terminate if the lessee breaches a surface-use agreement, a requirement that the lessor consent to any assignment, and the right of the lessor to



acquire and use all seismic and other confidential information.

Because standard terms may have changed to the detriment of the lender, lenders' lawyers need to review the leases underlying the collateral, including any extensions, modifications and renewals of such oil and gas leases.

While hoping for the best, lenders' counsel should advise their clients to prepare for the worst. This relatively quiet time for energy workouts and bankruptcies is the ideal opportunity for a thorough review of loan documents and an exploration of other avenues to maximizing collection. 



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