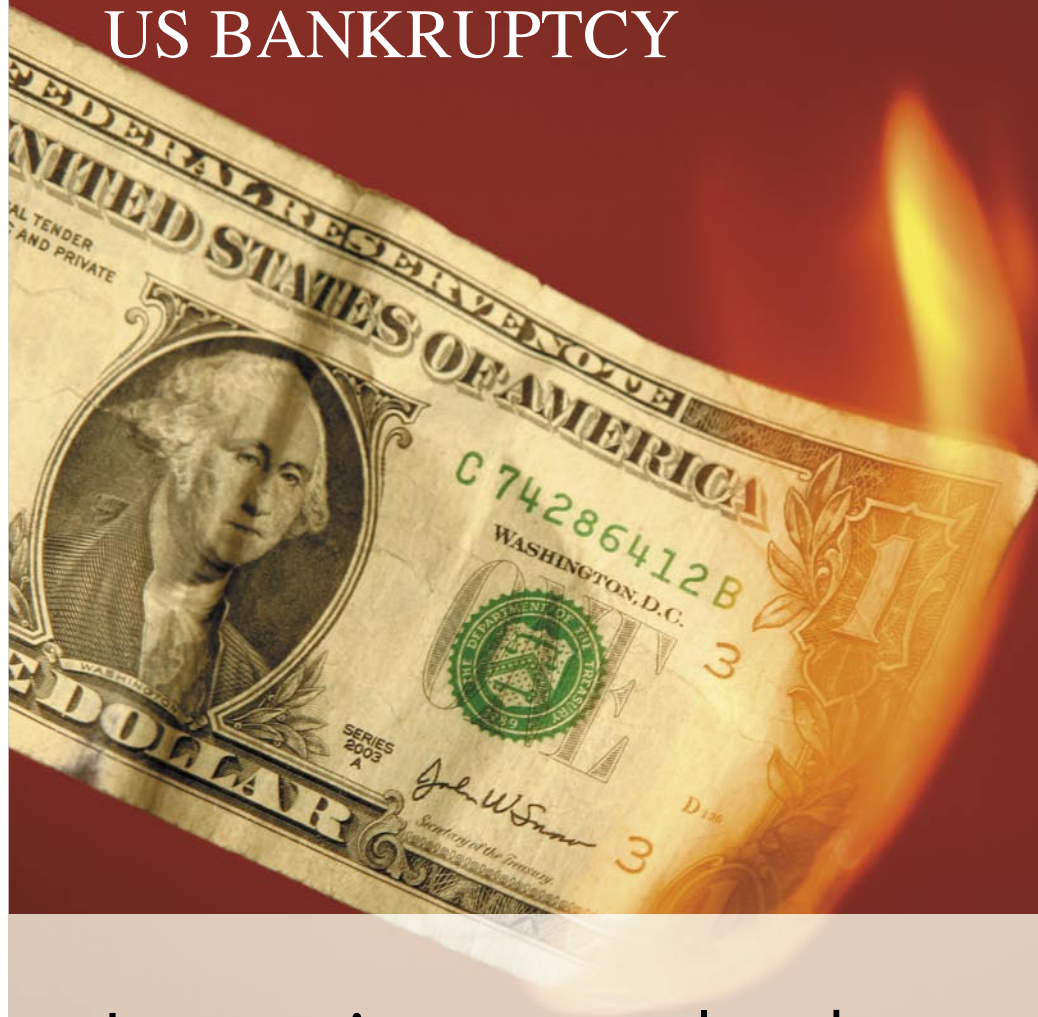


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Lessons in energy related restructurings

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TEXAS

Lessons in energy related restructurings

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If Texas were still a separate country it would have the 15th largest economy in the world. Although Texas has a diversified economy, it remains very closely tied to the oil and gas industry and current energy pricing has had a significant impact on the State. In September 2008, 946 active oil and gas rigs were operating in Texas; a year later, it was down to 380 – a decline of approximately 60 percent. Likewise, the value of oil and gas production fell by over 53 percent and over 71 percent, respectively. In July 2008, Texas produced \$3,518,200,000 worth of crude oil. By July 2009, the production value had fallen to \$1,636,800,000. Similarly, natural gas sales in July 2008 were \$3,706,480,000, falling to \$1,059,220,000 by July 2009. This dramatic and rapid decrease in oil and gas production values has resulted in an equally dramatic increase in restructuring engagements. We predict that many more are on the horizon.

Energy restructurings involve each facet of the industry but currently seem to focus on the Exploration and Production Companies (E&P). While the underlying causes of a financial crisis in an E&P company are usually falling oil and gas prices that often result in an over-leveraged situation, arriving at a bank-

ruptcy solution can be very complex.

In an E&P case, the players always include an oilfield service provider who can usually assert liens created by state statute in oil and gas producing state, financial institutions (banks and funds) spread among one or more tranches of debt, lessors and others who are entitled to receive royalties (and who may also be able to assert statutory liens), and general unsecured creditors. The assets generally consist of properties that are currently producing oil and/or natural gas, and non-producing properties.

Falling prices immediately impact the value of the remaining reserves, often leading to a re-determination of the borrowing base. Covenants tied to asset value or income are often breached when price declines are as dramatic as occurred over the last 12 months. The resulting ‘liquidity event’ – the refusal of lenders to advance further funds accompanied by demands for immediate repayment – can cause a cascading loss of valuable leases. For example, post 1988 leases contained more landowner-friendly provisions such as ‘continuous drilling’ provisions. A failure to satisfy such a provision usually results in a loss of the lease, save that acreage held by a producing well. As it is not in the lenders’ or creditors’ interests to cause the debtor to lose potentially valuable lease rights as a consequence of the cut-off of lender funding and the resulting inability to comply with continuous drilling obligations, a thoughtful conversation between the debtor and its lenders is critical to ensure that important assets are preserved.

The exit strategy for E&P cases is often the 363 sale. However, the complexity of oil and gas leases, the number of oilfield service providers with potential statutory liens, issues of lien priorities and fluctuating prices, the process of determining the value of the properties and the anticipated recovery for each constituency is often much more difficult and time-consuming than in non-energy cases.

At least in Texas, oil and gas leases are considered to be a defeasible interest in real property. However, once production has occurred, that interest (the well and certain surrounding acreage) generally is not subject to being lost – that is, the interests are ‘held by production’. However, the right to develop the remainder of the lease not held by production may still be forfeited through a failure to comply with a

provision for continuous drilling. Also unlike other real estate, the Bankruptcy Code in Section 363(h) restricts the sale of the interest of a co-owner, which includes the interests of other working interest, royalty interest and overriding interest owners. Moreover, the debtor’s interest in each lease is not necessarily static as the issue of ownership may be further complicated by agreements which the debtor may have with third parties. For example, it is not uncommon for a debtor to have an agreement to earn acreage (by drilling) on a lease in which it owns no leasehold interest (a ‘farm-in’) or where a third party may earn acreage from the debtor where the debtor is the leasehold owner (a ‘farmout’).

With many E&P companies having interests in hundreds if not thousands of leases, determining the extent, validity and priority of liens is often complicated. A further twist is that the place of filing is not necessarily uniform as to all statutory liens. There is no centralised filing of liens in oil and gas leases, so perfection of statutory mineral liens for oilfield service providers requires a filing in the county where the lease is located. However, where a state’s law (like Texas) provides for a non-uniform provision granting an Article 9 lien on production and proceeds of production for ‘first purchasers’, if the recent decision in *SemCrude* is followed, these statutory liens must be filed not in the county where the property is located, but in the state where the debtor is located. *Arrow Oil & Gas, Inc., et al. v. SemCrude, L.P., et al.*, Adversary Case No. 08-51444 (*In re: SemCrude, L.P., et al., Case No. 08-11525* (BLS)). As debtors add leases, earn acreage and farm-out lease rights, lenders need to be vigorous in their monitoring of the status of the collateral and making any necessary amendments to their documents of perfection. During the previous credit environment, lenders were not always insistent on taking a security interest in all properties or even in all producing properties because product prices were increasing. During that same period, the escalating prices prompted many E&P companies to go on a lease acquisition and drilling binge. Thus, there may be significant changes in the portfolio of properties owned by E&P companies since the filing of the lenders’ mortgages or deeds of trust.

Even if the borrower agrees to grant new ▶▶

While the underlying causes of a financial crisis in an E&P company are usually falling oil and gas prices that often result in an over-leveraged situation, arriving at a bankruptcy solution can be very complex.

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liens as a part of an adequate protection or cash collateral negotiation, issues with the oilfield service providers asserting liens on those leases will complicate the process. As with some other real property interests in Texas, first in time prevails, but not necessarily first to record. Generally speaking, under Texas law an oilfield service provider's mineral lien attaches from the date of the first work – and the lien doesn't actually have to be filed until six

months after the date of last work. Thus, it is possible for mineral lien claimants to have superior liens even if nothing appears of record. It is crucial to develop a clear understanding of these lien issues as early as possible. Indeed, the lien priority issues are often a driving factor behind a plan of reorganisation and, therefore, a primary consideration when managing a restructuring.

Although all cases have multiple competing

constituencies, the potential dynamic among the interested parties in an E&P restructuring can be particularly complicated in an environment of dramatically lower prices. As the largest oil and gas producing state in the country, the current Texas experience with energy related restructurings has valuable lessons to teach, and likely will continue to have such lessons to offer throughout the first part of the next decade. ■



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