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Distress and Bankruptcy in the Oil & Gas Market

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Distress and Bankruptcy in the Oil & Gas Market[1]

INTRODUCTION

With the recent precipitous decline in commodity prices, the industry is facing a historic wave of oil and gas restructuring and bankruptcy cases which has brought to the forefront the need to manage and mitigate counterparty risks. However, significant declines in oil and gas prices have also historically generated opportunities to acquire assets at bargain prices. Thus, oil and gas bankruptcies are generating both substantial risks and significant opportunities. This paper explores both the substantial risks (Section I) and the means of accessing the significant opportunities (Section II) that arise simultaneously in industry-wide oil and gas restructuring and bankruptcy cycles.

DISCUSSION

I. Mitigating Counterparty Risk

Consider the array of commercial and business relationships in the oil and gas industry. In each case, there is a discrete set of bankruptcy risks to manage:

Agreement	**Risk of Bankruptcy**
Joint Operating Agreement	Any joint interest owner
Service Contract	Contract counterparty
Sale Contracts	Buyer or seller
Lease	Lessee
Purchase and Sale Agreement	Buyer or seller, even after closing has occurred
Production Payment	Grantor

There are three general categories of risk that a contract counterparty faces: (i) credit risk; (ii) avoidance risk; and (iii) business risks. When thought of as a timeline of risks, those categories loosely represent: risk to current transactions (by the risk of nonpayment); risk arising from past transactions (by the risk of avoidance); and risk to transactions in the future (by the risk of loss of future value). These risks can and should be managed and mitigated both prior to and during a bankruptcy case.

[1] Cassandra Sepanik Shoemaker, Kathleen V. Wade, and Steve J. Levitt of Thompson & Knight LLP contributed to this article.

1. Mitigating Credit Risk by Obtaining and Perfecting a Security Interest and/or Lien

A. General Principles

Due to the limited resources available to repay creditors, pre-bankruptcy general unsecured claims and open-account debts often are paid either pennies on the dollar or not at all. Given this present-tense risk of non-payment or non-performance by the counterparty, the risk that the counterparty will become bankrupt should be considered from the beginning of the contractual relationship. Obtaining a lien or security interest to secure a claim under a contract is a first line of defense. However, a lien or security interest only provides protection in bankruptcy if it is timely and properly perfected against the correct party.

For example, an all-too-common mistake, particularly with oil and gas assets for which record title may be a complex issue, is to obtain and perfect a lien or a security agreement against the wrong entity. Corporate formalities are recognized in bankruptcy, which typically means that each affiliated debtor will file its own bankruptcy case with each debtor being treated as separate for purposes of, among other things, distributions to creditors.[2] While affiliated debtors may frequently be jointly administered in bankruptcy, substantive consolidation—treating separate debtors as a single distributive pool—is the exception, rather than the rule. Thus, it is crucial for the counterparty seeking to establish secured status in a bankruptcy case to ensure that the lien or security interest is obtained from, and perfected against, the record owner of the property.

Further, as discussed in more detail below, the steps required to perfect the liens and security interests available to secure different oil and gas contracts will vary with the nature of the contract. Thus, if a client suspects that a contract counterparty may be at risk of filing bankruptcy, particular care should be taken in advance to identify all of the potential liens that might be available and ensure that such liens are properly perfected. Such liens may include liens available to protect counterparties to joint operating agreements, statutory mechanic's and materialman's liens, and statutory producer's liens.

The timing of perfection is also important. In practice, to be of value in bankruptcy, the lien or security interest should be perfected contemporaneously with the attachment of the lien or security interest. Perfection of the lien or security interest after the fact will result in a preference or avoidance risk to the counterparty if the debtor files bankruptcy within ninety days of perfection.[3] Moreover, the lien or security interest only has value to the extent that the value of the underlying property exceeds the amount of any prior liens against the same property.[4] Since the priority of a lien or security interest often is based upon first to file, value that otherwise could be captured in a bankruptcy case often is lost by a delay in perfection and resultant loss of priority to intervening liens.

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[2] *In re Fernandes*, 346 B.R. 521, 522 (Bankr. D. Nev. 2006).
[3] *In re P.A. Bergner & Co. Holding Co.,* 187 B.R. 964, 983 (Bankr. E.D. Wis. 1995).
[4] *Matter of T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997) (junior lienholders only have a secured claim if value of collateral exceeds senior liens).