

Morgan Lewis

EVENING IN ENERGY

Issues in Distressed Oil & Gas and Current Markets

June 25, 2020

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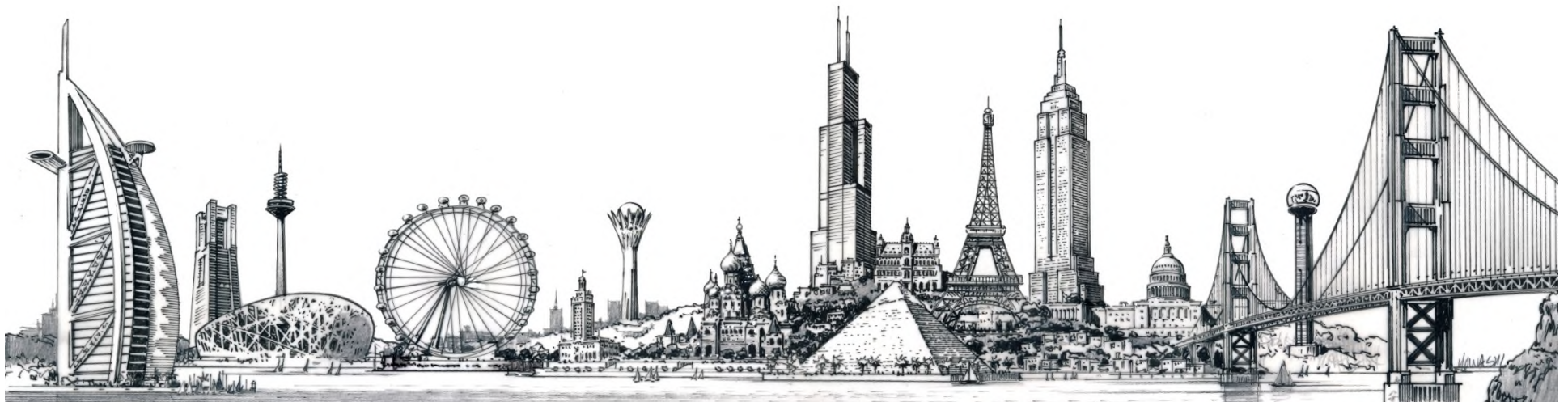
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**EVENING IN ENERGY:
CURRENT ISSUES IN OIL &
GAS BANKRUPTCIES**

June 25, 2020

Andrew Gallo

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Today's Topics

- Treatment of Executory Contracts
- Joint Operating Agreements and Joint Development Agreements
- Midstream Agreements – Running with the Land
- Concurrent FERC Jurisdiction
- Common Issues in 363 Sales

Executory Contract Issues in Oil & Gas Bankruptcies

- Executory Contract defined:
 - “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.”
- The debtor has three options with respect to its Executory Contracts and unexpired leases
 - Reject
 - Assume
 - Assume and assign to a third-party
- Unless compelled, Debtor can do nothing (delay) until required to reject or assume

Joint Operating Agreements and Joint Development Agreements – In Bankruptcy

- Interplay between real property and contract rights
 - JDA and JOA will be considered executory contracts subject to assumption or rejection by a Debtor in bankruptcy
 - However, non-operator also typically has an undivided real property interest in the underlying lease or leases
- General practice has been to continue to make payments under JOAs and JDAs in bankruptcy
 - Where non-operator is the Debtor, payments of amounts due as of the petition date are typically given “critical vendor” treatment and payment is authorized at first or second day hearing
- Operator payments of production revenue not part of the estate and should continue to be paid post-petition

Joint Operating Agreements – Issues Where Operator Files for Bankruptcy

- Options for non-operator counterparties are limited
 - Seek an order compelling the Operator to assume or reject
 - Seek stay relief to enforce rights and remove the Operator
 - Withhold performance until the Operator performs or provides assurance of performance (risky without stay relief)
- Can the Operator be removed for its non-performance?
 - “Ipso facto” clauses unenforceable
 - What about provisions in AAPL JOA Form providing for appointment of interim operating committee in event of operator bankruptcy?
 - Operatorship disputes may be heard by Bankruptcy Court (see *Sanchez Energy*)
 - Non-operators may seek temporary injunction while they litigate a permanent outcome (see *WBH Energy*)

Joint Operating Agreements and Joint Development Agreements – In Bankruptcy

- What happens if the joint operating agreement is rejected?
 - Parties are co-owners, subject to applicable state law
 - Claims against co-owners under the contract (including claims against the Operator by Non-Operator) will be general unsecured claims unless:
 - Memorandum filed prepetition to perfect security interest or,
 - Non-operator can argue for an administrative claim
- Under a Joint Development Agreement, what happens to future carry obligations of a non-operator when rejected?
 - Rejection of the JDA constitutes breach, but non-operator maintains property rights
 - Operator will have claims for rejection damages against the nonoperator in the bankruptcy which could be secured if proper filings are made prepetition
 - Potential rights for setoff and recoupment for future amounts due on account of non-operator's ownership interest

Executory Contracts: Running with the Land

- Agreement contains real property covenants that cannot be rejected where:
 - Covenants in the agreement “touch and concern” a real property interest
 - There was “horizontal privity” between the parties at the time of contracting – covenants created in connection with a real property conveyance
 - Parties intended agreement to “run with the land”
- *Sabine* – Second Circuit finds “take or pay” gas gathering agreement does not run with the land and can be rejected
 - Lack of horizontal privity
 - Transportation of extracted minerals does not “touch and concern the land”

Executory Contracts: Running with the Land

Cases following *Sabine* have reached different conclusions:

- *Monarch Midstream v. Badlands*
 - Colorado bankruptcy court – Utah law
 - Gas gathering and salt water disposal agreements
 - Distinguishes *Sabine* – agreements “touch and concern land” because they specifically reference unproduced reserves
 - Horizontal Privity - agreements entered upon conveyance of the gathering system
- *Alta Mesa*
 - SD Tx (Isgur) – Oklahoma Law (mirrors Texas)
 - Agreements touch and concern land because they burden leasehold rights
 - Granting of real property easements in connection with gathering agreement satisfies horizontal privity
 - Provisions in agreement providing it “runs with the land” establish intent

Executory Contracts: Running with the Land

Where do these cases leave us?

- Rejection of mid-stream contracts with a dedication and that involve a real property conveyance (including easement) can be difficult
- Counterparties have leverage
 - Even if not ultimately successful litigation takes time and effort
 - Could hold up a sale
 - Increases administrative expense of bankruptcy
- Settlements common

Executory Contracts: Concurrent FERC Jurisdiction

- Gas transmission agreements are regulated by FERC pursuant to the Natural Gas Act (“NGA”)
- Filed Rate Doctrine
 - FERC approved contract is akin to federal regulation
 - FERC has exclusive jurisdiction regarding modification or abrogation of any term of the contract
- *Mobile-Sierra* Doctrine
 - To be modified, FERC must determine that filed contract seriously harms public interest
- What does this mean with respect to rejection of filed contracts in bankruptcy?

Executory Contracts: Concurrent FERC Jurisdiction

- *Mirant* (FPA) – 5th Circuit 2004
 - Bankruptcy court has jurisdiction
 - FERC approval not required
 - Higher standard for rejection – equities, public interest
 - Consideration of FERC's views
- *Calpine* (FPA) – SDNY 2006
 - FERC has exclusive jurisdiction
 - Bankruptcy court lacks subject matter jurisdiction to consider rejection
 - Rejection premised solely upon rates
- *Boston Generating* (NGA) – SDNY 2010
 - FERC has concurrent jurisdiction by agreement

Executory Contracts: Concurrent FERC Jurisdiction

PG&E

- FERC Rulings
 - NextEra and Exelon file with FERC prior to bankruptcy
 - FERC rules it has concurrent jurisdiction over rejection
- Bankruptcy Court Ruling
 - PG&E initiates adversary proceeding against FERC post bankruptcy
 - FERC orders of no force and effect
 - Bankruptcy Court can enjoin FERC if necessary
 - Reserves on question of standard for rejection
 - suggests *Mirant* standard

Executory Contracts: Concurrent FERC Jurisdiction

- First Energy Solutions – 6th Cir 2019
 - Bankruptcy court has concurrent but superior jurisdiction
 - FERC proceedings that do not interfere with bankruptcy court are permitted
 - Adopts *Mirant* standard and encourages FERC participation
- Ultra (Bankr. S.D. Tx.)
 - Follows *Mirant* in NGA case
 - Separate FERC proceeding ultimately found to be unworkable
 - FERC participation in bankruptcy court encouraged as interested party
- Chesapeake
 - At least one pre-emptive FERC proceeding filed

363 Sale Issues

- Bankruptcy sales are typically “free and clear” but certain liabilities in Oil & Gas cases cannot be extinguished through a 363 Sale
- M&M Liens must be satisfied – particularly in a credit bid of “junior” debt
 - Releases of actual liens and lis pendens may be necessary
- Property rights cannot be discharged and will “follow” the assets
 - Term ORRI & NPI to the extent not recharacterized
- Contracts “running with the land” will follow the assets
- Plugging and Abandonment Liability

363 Sale Issues

- Current market values speed and efficiency
- More pre-packaged and pre-arranged filings
- *Templar*
 - 363 Sale combined with pre-packaged liquidating plan
 - Effort to combine speed of pre-pack with robust auction process
- Quick sales likely require
 - Satisfaction or assumption of trade claims
 - Particularly M&M Lien claims
 - Payment in full of royalty obligations
 - Financing case wind-down



AN EVENING IN ENERGY: OBSERVATIONS ON DISTRESS IN THE ENERGY INDUSTRY

June 2020

CONFIDENTIAL AND PROPRIETARY

INTRODUCTION

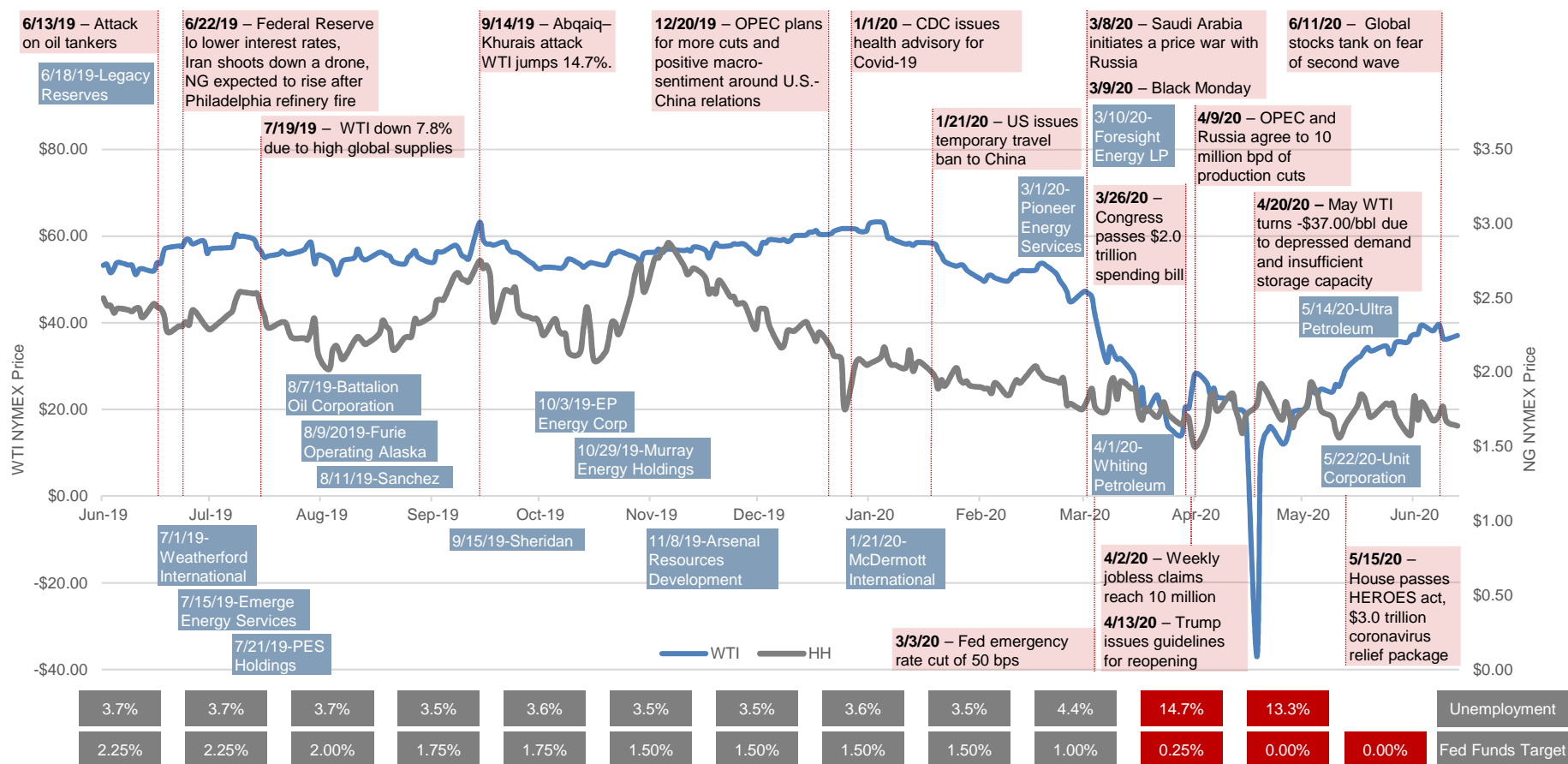
Following more than four years of depressed pricing, diminished capital markets activity, and limited asset development, restructuring activity in the energy markets has increased significantly, with continued distress on the horizon.

Key Discussion Points

- **Pricing** – stability and implications in light of recent dynamics and volatility
- **Supply, capacity, and demand** – expectations and current observations
- Selected observed **themes in recent bankruptcy filings**
 - Relationship between **RBL lenders and junior capital**
 - **Business plans** – assumptions, drivers, achievability, and defensibility
 - **Administrative costs** – professional fees are significant
 - **Process interruption** for 2019 cases – cases on the cusp had to pivot
 - **Valuation** – limited M&A activity, stress on historical upside value
 - **Incentive plans** – pre-petition management retention and post-filing
- **Market outlook** – a number of chapter 22's to date; more distress likely
- **Management/lender dynamics** – advice for managing through this cycle

PRICING, FILINGS, AND ECONOMIC ACTIVITY

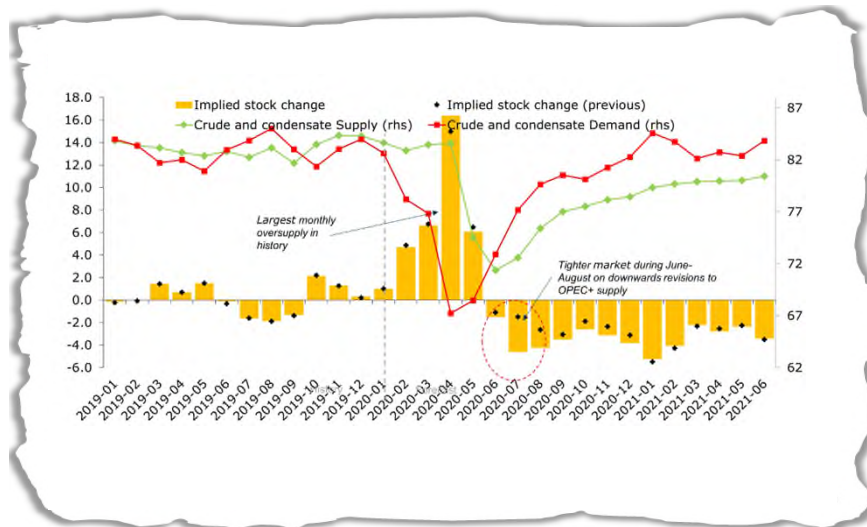
- Continued **pressure from OPEC** and **global economic concerns** associated with COVID-19 have driven prices to **unprecedented lows**
- Uncertainty reigns** and depressed prices continue to **impair the underlying value** of E&P assets
- Even amid a relative oil price rebound, most basins are uneconomic; **gas has remained steady but low**



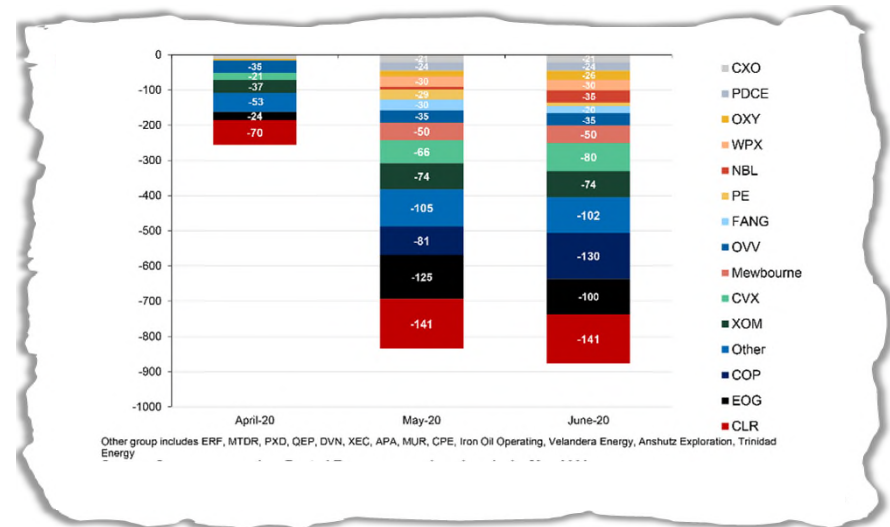
SUPPLY, DEMAND, AND CAPACITY

- Many producers considered **shut-ins and curtailments** amid historically low prices, in response to reduced demand and offtake uncertainty as net **realized prices** – after transportation and other midstream costs – **were uneconomic**
- However, the recent price recovery has **improved net economics** for many of the at-risk producers
- Forecast **production curtailments are being reversed** as net economics have improved
- But will continued **supply growth be too much for demand**, given the current uncertainty in the economy? And how will OPEC+ respond as U.S. producers increase production?

GLOBAL OIL SUPPLY AND DEMAND



NET EXPECTED OIL PRODUCTION CURTAILMENTS

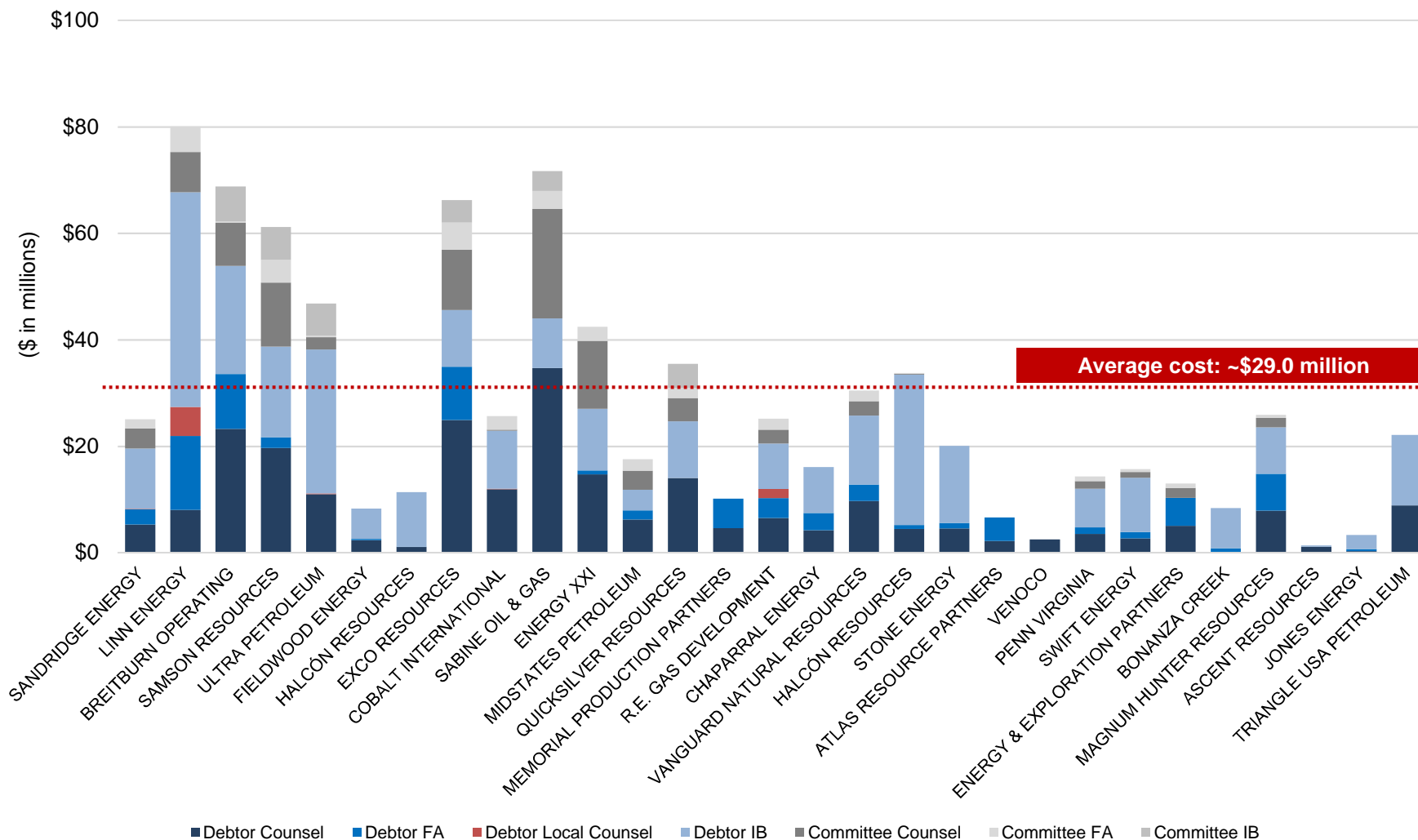


THEMES IN RECENT BANKRUPTCY FILINGS

- **Banks and senior lenders** taking a more active role
 - Setting terms
 - Seeking new money
 - Aggressively negotiating exits
 - Increasing scrutiny of reserve reports' projections for sizing borrowing bases
 - Willingness to own assets
- **Junior capital** continues to seek concessions to effect an exit
 - Balking at new money
 - Covenant and borrowing base holidays
 - Lower pricing
- **Business plans** under increased scrutiny
 - Production assumptions vs. demand
 - Hedging – management wants to avoid, in a recovering market while creditors want downside protection. Existing positions being analyzed for monetization optionality
 - Sustainability of midstream
 - Development of PUDs and capex
 - Are trough LOE assumptions reasonable and sustainable?
 - G&A rightsizing
 - Valuation sensitivities

THEMES IN RECENT BANKRUPTCY FILINGS (CONT'D)

- Professional fees are often significant in energy bankruptcies.



Notes:

- 1) Professional fees are exclusive of lender or ad hoc professionals
- 2) Fees reflect costs incurred from petition date through emergence
- 3) Based on sample of 29 bankruptcies with total debt ranging between \$730.0 million and \$8.3 billion

THEMES IN RECENT BANKRUPTCY FILINGS (CONT'D)

- **Process interruption** for 2019 cases
 - Price decline disrupted several processes as bidders/presumptive owners reconsidered
 - For example: Approach, EP Energy, Alta Mesa, Kingfisher, etc.
- **Valuation** remains a challenge
 - Market is closed
 - Sellers and fulcrum stakeholders do not want to monetize at the bottom
 - Limited transactions to inform desktop analyses – shift to fundamental analyses
 - Stress on upside assets within a portfolio – extrinsic value
- **Incentive plans**
 - Pre-petition retention plans for key executives
 - Post-petition retention for rank and file
 - Post-petition contingent incentive payments for management
 - What is appropriate in-light of industry macro environment?

THEMES IN RECENT BANKRUPTCY FILINGS (CONT'D)

Pre-petition management incentive plans are increasingly approved by the boards of E&P companies.

KEY OBSERVATIONS

- Published executive compensation plans have increased in frequency:
 - **7 plans approved since industry turmoil in March 2020**
- Average CEO and CFO retention payment of **\$1.4 million** and **\$0.6 million**, respectively.
 - Average CEO Retention Payment as % of Base Salary is **221.3%**
 - Average CFO Retention Payment as % of Base Salary is **157.4%**
- The highest Retention Payments and Retention as % of Base Salary factors have been **observed in 2020**.
- As bankruptcy becomes more prevalent in the industry, **there are no indications that such retention payments will decrease in frequency or value**.

SELECT PREFILING RETENTION PAYMENTS SUMMARY¹

CEO Summary	Base Salary	Retention Payment	Total Compensation	Retention as % of Base Salary
Mean	\$ 655,439	\$ 1,442,064	\$ 2,097,503	221.3%
Median	\$ 675,000	\$ 1,000,000	\$ 1,750,000	180.0%
Max	\$ 1,000,000	\$ 6,397,750	\$ 7,212,750	785.0%
Min	\$ 327,500	\$ 411,250	\$ 950,000	63.3%

CFO Summary	Base Salary	Retention Payment	Total Compensation	Retention as % of Base Salary
Mean	\$ 398,081	\$ 641,122	\$ 1,039,204	157.4%
Median	\$ 381,500	\$ 546,500	\$ 908,334	122.6%
Max	\$ 575,000	\$ 2,200,000	\$ 2,640,000	500.0%
Min	\$ 280,000	\$ 269,701	\$ 590,000	69.2%

KEY ASSUMPTIONS

- Data compiled from public E&P filings **since 2016**, wherein pre-filing Executive Retention payments where made.
- Over 100 companies researched, with over 30 having Management Incentive Plans.
- Compensation information considered if made public through SEC filings.

25 | 1. Note that data is aggregated from select Company filings as noted in Key Assumptions (Base Salary and Retention Payment will not necessarily sum to Total Compensation)

MARKET OUTLOOK

- **Chapter 22's** – too much debt last time around and limited operational improvement
 - Ultra
 - Halcon/Battalion
 - Arsenal
 - Vanguard/Grizzly
- Price improvement is likely **superficial**
- More restructurings are **on the horizon** and **potential market consolidation**
- >\$150.0 billion in high yield debt coming due in 2021 and 2022
- Limited availability for liquidity and new capital infusion
- Fall **borrowing base season**
 - Hard look at those not in imminent distress (a relative term) this spring
 - Will reflect environment of continued price depression – especially for gas companies – and limited development activity to bolster asset base
 - Hedge roll-offs
 - G&A levels
 - Price deck and cost assumptions
 - Production run off without liquidity to promote undeveloped reserves

MANAGEMENT/LENDER DYNAMIC: LOOKING FORWARD

RBL LENDERS: EXPECTED BEHAVIOR

- **Sober assessment** of market and options in the near term
- **Earlier** engagement
- A more **aggressive** approach
- **Quicker** and more **decisive** action
- More **frequent and direct dialogue** with management teams
- Appetite for **operational realignment** and cost reduction
- **Tighter** borrowing bases
- **Honest conversations** about the path forward
- Potential **partnering to own** assets
- Exits that encourage long-term liquidity and not a “kick-the-can” mentality

MANAGEMENT RESPONSE

- Be **proactive and honest** – get in front of problems quickly and preserve all credibility
- Get **creative** and **drive the conversation** with **actionable solutions**
- **Aggressive is fine** – it often leads to action – but be commercial
- **Reduce costs** – particular focus on G&A
- Keep **the right people** around
- Manage your **vendors and working capital**
- Know your **liquidity situation**
- Acknowledge the current market, but **maintain a longer-term view** – partner for the upside
- **Protect yourself** – D&O coverage and independent boards
- **Retain the right professionals** and seek their counsel and guidance – your stakeholders will

Speaker Biography



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Andrew Gallo is an accomplished trial lawyer and bankruptcy attorney that focuses his practice on bankruptcy and bankruptcy related litigation with an emphasis on creditors' rights. Andrew counsels secured and unsecured creditors, equity holders and investors Chapter 11 Cases and out of court restructurings. He litigates complex creditors' rights cases in state and federal (including bankruptcy) courts, with specific experience in fraudulent transfer and lender liability cases. Andrew serves as the deputy leader of the firm's bankruptcy and restructuring practice area and also serves as co-leader of the firm's Energy Industry Team. Andrew has had multiple engagements representing creditors and other parties-in-interest in distressed situations that relate to the Oil & Gas industry.

Previously, Andrew was a law clerk for Judge Sidney H. Stein, United States District Court for the Southern District of New York. Before joining Morgan Lewis, Andrew was a partner in the financial restructuring practice at another international law firm, where he helped run the training programs for litigation associates.

Selected Representations:

- Served as lead counsel to the Official Committee of Unsecured Creditors in the White Star Petroleum bankruptcy case in the Western District of Oklahoma.
- Serves as counsel to the RBL and DIP Lenders in the bankruptcy of Templar Energy.
- Represents Samson Energy Company, LLC and affiliated entities in defense of a multi-billion dollar fraudulent transfer case brought by the litigation trustee in the Samson Resources bankruptcy case.
- Served as counsel for a group of unsecured noteholders in the bankruptcy case of Ultra Petroleum in the litigation of over \$320 million in claims related to payment of make-whole premiums and post-petition default rate interest.
- Served as counsel for a group of senior-secured first lien and DIP lenders in the bankruptcy case of ATP Oil & Gas Corporation, including in connection with their successful credit bid in the case.

Speaker Biography



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Amy Kyle represents leading financial institutions in connection with a broad range of finance-related matters, with a particular focus on the transportation and energy industries. She acts as lead agent's counsel in syndicated financings for companies that operate in all modes of transportation, lease transportation equipment, or engage in international and domestic shipping. Amy's experience also includes Agent and creditor group representations in debtor in possession and special situations financing arrangements, especially in the transportation and energy industries.

Amy's representation of agents, arrangers, and lenders in syndicated finance transactions spans a wide range of industries and types of transactions, from highly leveraged secured deals to high-grade credits and from transportation to technology, energy, and general industrial. Amy often represents agents and other creditors in workouts and restructurings, both in and out of court. Her experience extends to debtor-in-possession financing, exit financing, and sales under section 363 of the Bankruptcy Code as well as rescue financing and special situations lending. Recent examples include the bankruptcies of Templar Energy LLC, Tidewater Inc., Energy Futures Holdings, ATP Oil & Gas, TBS Shipping, Visteon, and Pacific Energy.

Selected Representations:

- Represent a working interest owner and contract counterparty in Sanchez Energy Corporation bankruptcy.
- Represent administrative agent for a syndicate of lenders in the amendment and restructuring of a senior secured reserve-based credit facility to Templar Energy LLC. Templar Energy LLC filed for bankruptcy in the District of Delaware in June 2020, represent the administrative agent for prepetition and debtor in possession lenders in Templar's bankruptcy.
- Represented administrative agent for a lender group in a complex restructuring of Tidewater Inc. and its subsidiaries through a prepackaged bankruptcy.
- Represented a group of senior-secured first lien and DIP lenders in the bankruptcy case of ATP Oil & Gas Corporation.
- Represented a significant prepetition creditor and the largest holder of Debtor in Possession Loans to EFIH in the Chapter 11 cases of Energy Futures Holdings Corp and its subsidiaries filed in District of Delaware.

SPEAKER BIOGRAPHIES



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Sean is a partner at Opportune and co-leads the firm's restructuring practice. Sean has worked across the entire energy spectrum and in the manufacturing space. Sean specializes in restructurings, valuation, business insurance claims, damage analyses and forensic investigations. Sean's experience includes leading numerous energy restructuring projects, both in and out of court, the negotiation of complex business interruption claims, as well as damage analyses and investigations related to asset misappropriation schemes and financial statement fraud. Prior to joining Opportune, Sean worked as a Manager in the Dispute and Investigation practices of Navigant Consulting Inc, Deloitte & Touche, US and Deloitte & Touche, UK.

Sean graduated from Texas A&M University, magna cum laude, with a BBA in Accounting and a MS in Finance. Sean currently serves as the Trustee to ERG Resources and on the Risk Advisory Board of an independent gas trading and marketing company.

SELECTED EXPERIENCE

Endeavour, Aspect Energy, ATP Oil & Gas, Black Stone Minerals, Crimson, Edge Petroleum, EnerVest, Geokinetics, Global Geophysical, GMX, Kingfisher Midstream, EP Energy, Approach Resources, Exco, White Oak, Samson Resources, NuStar Energy, SandRidge Energy, Targa Resources, TVA, UBOC, UDS (Valero Energy), Alcoa, GE, Goodman, ERG Resources, Titan, Whiting Petroleum



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Ryan is a partner at Opportune and co-leads the firm's restructuring practice. He focuses on financial and operational restructuring, and has significant experience in reorganization plan development, negotiation and implementation, recapitalizations, distressed valuation, effecting forbearances, waivers, and amendments, capital raising, distressed M&A, liquidity management, business plan development and review, and litigation support. Ryan has advised debtors, creditors, and equity holders on restructurings and special situations – both in- and out-of-court across the energy spectrum and in other related industries. Prior to joining Opportune, Ryan was a vice president in the restructuring group at Duff & Phelps Securities (f/k/a Chanin Capital Partners). Before that, he worked at Panagos Katz Situational Investing – a special situations fund. He began his career in the leveraged finance group at J.P. Morgan.

Ryan earned a B.A., magna cum laude, in International Relations from Tufts University and a J.D. from Wake Forest University School of Law.

SELECTED EXPERIENCE

Atari, Approach Resources, ATP Oil & Gas, BPZ Energy, Burkhalter Rigging, Chem RX, Chiyoda International Corporation, Duer Wagner, EdgeMarc Energy, Endeavour Operating, Echo Energy, Energy Conversion Devices, Extreme Plastics Plus, Exco, Extraction Oil & Gas, EP Energy, Friendly Ice Cream Corporation, FirstEnergy, Global Geophysical Goodrich Petroleum, Halcon, Hayes Lemmerz, HearUSA, Idearc, Kingfisher Midstream, Linn Energy, McDermott, MMFX Technologies Corp., Nebraska Book Company, New Source, Omega Navigation, PetroQuest, Samson Resources, SandRidge Energy, Sanchez Oil & Gas, Seahawk Drilling, Six Flags, Sheridan, Stallion, Swift Energy, Trico Marine Services, Truvo Group, Ultra Petroleum, Unit Corporation, Warren Resources, Whiting Petroleum

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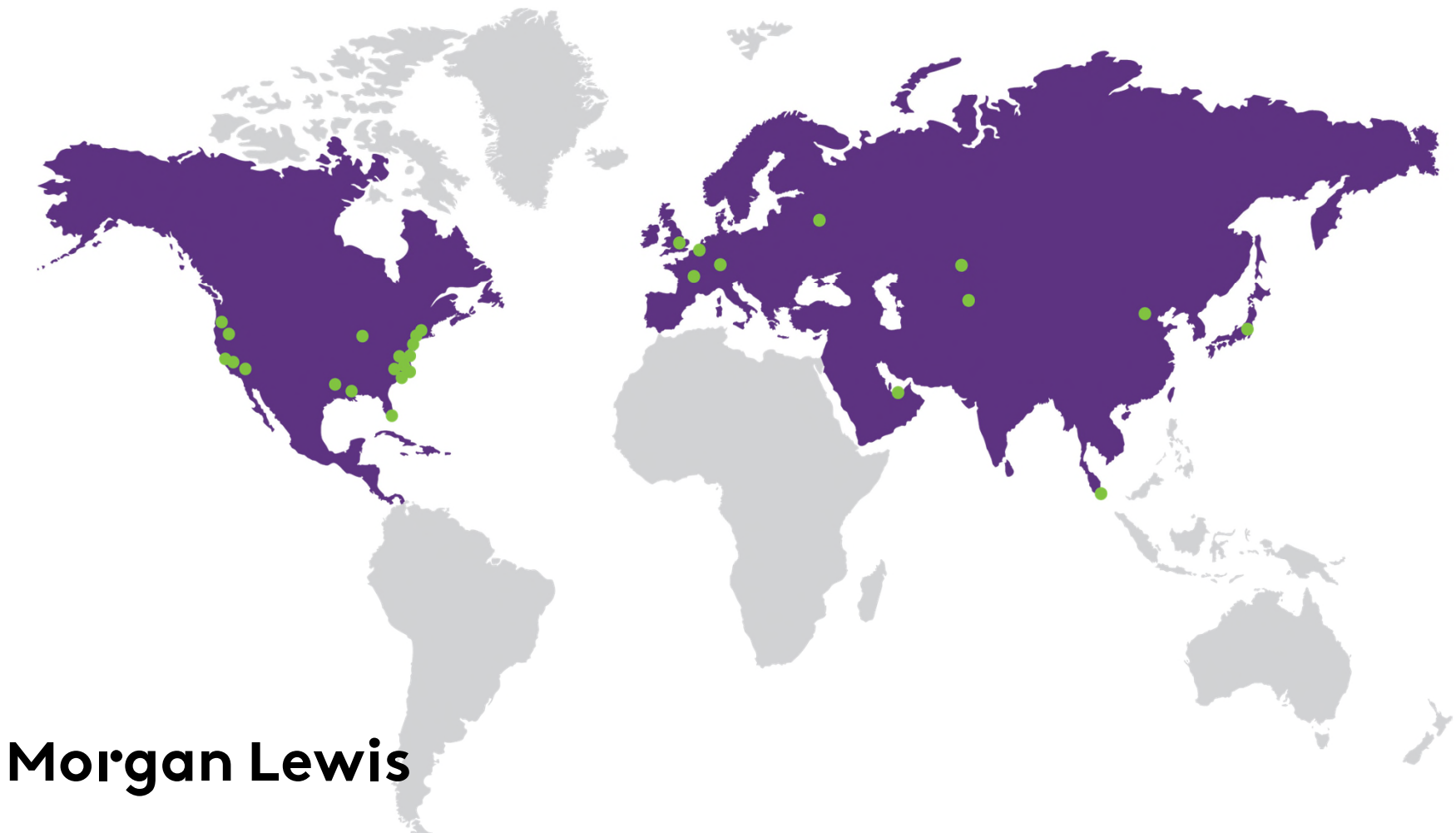
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