JONES DAY

DECEMBER 2014

COMMENTARY

Energy Update: Risk and Opportunity Amid Falling Oil Prices

What Happens When Oil Prices Go Down and Stay Down?

The mainstream media have been trying to predict, on almost a daily basis, the causes of, and the winners and losers (mostly focused on the latter category) resulting from, the current volatility in oil and gas prices. Regardless of the cause, as of the end of November 2014, the American price for crude oil fell to $66.15, its lowest price in the past four years, and the Brent price for oil fell to $70.15.[1] Industry insiders believe that a sustained drop below $75 a barrel could force some energy companies to sell assets at depressed prices.[2] As is the case with most industries, depressed prices are likely to bring both new opportunities and new challenges to energy sector investors. We can comfortably conclude that a prolonged decrease in prices will create opportunities in the oilfield services and upstream sectors for distressed M&A and special situation financings such as royalty transactions and rescue financings.

As oil prices decline, all producers will experience a decrease in revenue (putting hedges aside), but the major effects of continued low prices will be felt by producers that already have liquidity problems or are exploring and producing from high-cost production areas. This is particularly true for producers engaged in shale production from more cost-intensive formations and/or producers that have secured financing based on a higher forecast of forward pricing. Deutsche Bank recently surmised that 40 percent of United States shale oil production scheduled for 2015 would be uneconomic below $80 a barrel.[3] Those producers that find themselves on the wrong side of the price divide may be forced to make difficult decisions.

In addition to reducing producers' revenues, an extended drop in oil prices may limit some producers' access to credit. Because borrowing bases for revolving lines of credit are often tied to the value of a company's oil and gas reserves, a prolonged decrease in price may adversely affect credit availability. In effect, extended periods of low oil prices often hit struggling oil producers with a one–two punch: reduced revenues and reduced access to credit.

Will There Be an Increase in Royalty Transactions as a Source of Liquidity?

To increase their liquidity, some oil producers may choose to sell royalty interests based on oil production. For instance, a volumetric production payment ("VPP") entitles the holder to receive a specific volume of production, whereas a monetary production payment ("MPP") gives the holder the right to receive a fixed

© 2014 Jones Day. All rights reserved.

dollar amount generated from production. An overriding royalty interest ("ORRI") pays the holder a percentage of proceeds from the sale of oil production.

The more oil prices decrease, however, the more difficult it may be for oil producers to raise liquidity through VPPs, MPPs, and ORRIs. As oil prices drop, future VPPs will require larger volumes of oil in exchange for the same bump in liquidity, while MPPs will require the value of oil production to be no less than a specific dollar amount, meaning in effect that more production will be required to meet that target as oil prices drop. Similarly, the value of ORRIs is directly tied to the price that oil production will bring, so lower oil prices tend to devalue ORRIs.

Are Royalty Investors Still Suffering From an *ATP* Hangover?

Any investors considering a VPP, MPP or ORRI transaction with an oil producer should become familiar with the *ATP Oil & Gas* bankruptcy case, which provides a cautionary tale for energy investors for a variety of reasons, including the fact that ATP waged war on its royalty investors at the outset of the case.

As we noted in a prior Jones Day *Commentary*[4] regarding the *ATP Oil & Gas* bankruptcy case, the United States Bankruptcy Court for the Southern District of Texas found in January 2014 that there were issues of material fact regarding whether certain term overriding royalty transactions created prior to the bankruptcy petition should be characterized as debt financings or real property transactions. In a bankruptcy context, this characterization is crucial, because if a transaction is characterized as a loan, the hydrocarbons at issue belong to the debtor, and the grantee of the royalty interest is considered to be a creditor of the estate. In contrast, if the transaction is viewed as a true ORRI, which is typically a real property transaction, the hydrocarbons will be considered to belong to the grantee of the royalty interest and will not be property of the debtor's bankruptcy estate.

In refusing to grant a motion for summary judgment filed by the royalty owner, the bankruptcy court noted that the question of whether an ORRI transaction should be characterized as a loan or as a real property transaction is highly fact specific. In particular, the court focused on whether income from the ORRI fluctuated depending upon revenue from oil produced from the properties (making the transaction seem more like creation of a real property interest), or whether income was relatively constant (making the transaction seem more like a loan). Despite clear contractual language indicating that the parties intended the transaction to create a real property interest, the bankruptcy court denied summary judgment. The energy industry was surprised by this decision, since it called into question transactions that were once thought to be beyond challenge.

In a further development in the case, Bennu Oil and Gas, LLC ("Bennu") purchased many of the assets at issue from the bankruptcy estate, including the estate's claims to recharacterize most, if not all, of the prepetition royalty transactions. After the purchase was completed, Bennu decided to stop all litigation against the royalty owners, presumably recognizing the uphill battle it was facing. Although Bennu's decision not to pursue the recharacterization appeared to moot the questions litigated in the summary judgment motion, recent developments have indicated that this may not be true. The debtor's case was converted to a chapter 7 bankruptcy on June 26, 2014. As a result, the bankruptcy estate is now being administered by a chapter 7 trustee, who has taken the position that he can challenge certain royalty transactions connected to leases that were not sold to Bennu. In contrast, Bennu argues that it bought all of the estate's claims to recharacterize, and it has asked the court to prohibit the chapter 7 trustee from prosecuting any of the recharacterization claims. A hearing on this issue is currently scheduled for early January 2015. Therefore, although it is still unclear whether the bankruptcy court will come to a final ruling on any of the royalty transactions in *ATP*, energy sector investors should closely follow continued developments in this case.

What Do Lower Oil Prices Mean for Distressed M&A?

Distressed M&A Outside of Bankruptcy

Oil producers and oilfield services companies will be most directly affected by the current slump in oil prices. As the viability of new drilling programs decreases and oil producers

are forced to trim capital expenditure budgets, both oil producers and oilfield service providers will become ripe targets for consolidation. The announcement that Halliburton has struck a deal to acquire rival Baker Hughes is the most striking and immediate example. The oilfield services industry is made up of hundreds of companies, the majority of which are relatively small. To see two of the behemoths of the industry combine provides a glimpse into a dynamic that will likely affect smaller companies at least as severely as the large ones.

Oil producers themselves, particularly those structured as master limited partnerships, whose investors measure performance by the amount of quarterly cash flow distributions, will be hard pressed to maintain the pace of growth and distributions seen in recent years. A downward trend in investor returns will result in redeployment of investor dollars away from exploration and production, which will likely also result in consolidation among oil producers.

It is likely that we will see struggling oil producers and oilfield services companies, as they seek to avoid insolvency, looking for suitors with stronger balance sheets and better hedge positions to acquire them. Whether buyers and sellers can find common ground on valuation, and the availability of short-term financing, will largely determine to what extent distressed M&A deals can be consummated outside of the bankruptcy context.

Distressed M&A in Bankruptcy

Although still very early in the cycle, it is possible that a prolonged oil price slump could result in an increase in asset sales through bankruptcy. Buying energy assets out of bankruptcy presents both advantages for the careful investor and potential traps for the unwary.

Generally speaking, the advantages are straightforward. Under Section 363(f) of the Bankruptcy Code, a purchaser can acquire assets from a bankruptcy estate "free and clear" of other "interests," provided that one of certain conditions are met. Although courts have occasionally struggled with the full range of "interests" implicated in "free and clear" sales, courts typically find that property can be sold free and clear of liens and security interests. The ability to purchase assets that are protected by a free and clear court order provides a buyer with a significant advantage that is simply unavailable outside of a bankruptcy setting.

However, purchasers of energy assets should be aware that bankruptcy sales are not always "free and clear" of all liabilities. Oil and gas assets often carry environmental liabilities, and some courts have found that certain types of environmental liabilities may not be cleansed through a bankruptcy sale. In addition, a purchaser will usually not receive any meaningful indemnity protection for any environmental issues that are unknown at the time of the sale. Therefore, buyers should conduct careful due diligence regarding any environmental liabilities, seek a corresponding reduction of the purchase price for any liabilities that they discover, and consider factoring into the purchase price the lack of many traditional post-closing remedies.

In a similar way, plugging and abandonment obligations are usually unaffected by a "free and clear" sale, and purchasers of oil and gas interests typically must comply with existing plugging and abandonment requirements, in part because a failure to comply could result in a safety hazard. Purchasers of oil and gas interests should therefore be prepared to investigate any decommissioning liabilities associated with any purchased assets well before completing a sale.

Another trap for purchasers is the potential for vendor liens on upstream oil and gas assets. If an operator falls behind on payments to the vendors that are servicing operations, as is typical in the months and weeks leading up to a bankruptcy filing, those vendors may respond by placing mechanic's and materialman's liens on the assets. This situation raises at least two distinct issues for any potential purchaser. First, although it is possible to sell "free and clear" of vendor liens, this will be possible only if all lien holders are notified of the sale and given time to object. Therefore, buyers and debtors should carefully investigate and notify all potential lienholders prior to any sale. Second, even if all of the lienholders are notified, it is common for vendors to hold liens on a well that has multiple co-owners. Therefore, even if all liens against a debtor are released, a vendor may still have a valid lien against the other co-owners of a well.

In summary, purchasing assets from a bankruptcy estate can be a unique opportunity to acquire assets free and clear of most interests and liabilities. However, purchasers should perform careful and thorough diligence so as to fully understand the scope of any liens or liabilities associated with the purchased assets.

Conclusion

The effect of falling oil prices may already be working its way through the market, and Jones Day has identified a number of potential energy targets that have exhibited preliminary signs of distress. We would be happy to discuss specific targets upon request, and we are also available to answer any questions or to discuss any of the topics raised in this *Commentary*.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Tom A. Howley
Houston
+1.832.239.3790
tahowley@jonesday.com

Scott Schwind
Houston
+1.832.239.3710
sschwind@jonesday.com

Omar Samji
Houston
+1.832.239.3639
osamji@jonesday.com

Jonathan M. Fisher
Dallas
+1.214.969.4578
jmfisher@jonesday.com

Jeffrey A. Schlegel
Houston
+1.832.239.3728
jaschlegel@jonesday.com

Paul M. Green
Houston
+1.832.239.3892
pmgreen@jonesday.com

Endnotes

1 Clifford Krauss, "Free Fall in Oil Price Underscores Shift Away From OPEC," *New York Times*, Nov. 28, 2014, http://www.nytimes.com/2014/11/29/business/energy-environment/free-fall-in-oil-price-underscores-shift-away-from-opec.html.

2 Mark Curriden, "Declining Oil Prices—Decline in Oil Patch M&A," *Texas Lawbook*, Nov. 4, 2014, http://texaslawbook.net/declining-oil-prices-decline-in-oil-patch-ma/.

3 Chip Register, "As Saudis Target Shale Industry, U.S. Considers a Response," *Forbes*, Nov. 7, 2014, http://www.forbes.com/sites/chipregister1/2014/11/07/as-saudis-target-shale-industry-u-s-considers-a-response/. However, other sources claim that 82 percent of oil producers in the United States have a break-even price of $60 a barrel or lower. *Id*.

4 "*NGP v. ATP*: Should Overriding Royalty Interest Owners Be Concerned?", March 2014.

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our website at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.