Unsecured Creditor Perspectives in Energy Restructurings

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This Practice Note provides guidance and advice to unsecured creditors in energy restructurings. This Note specifically addresses restructurings in the oil, gas, and coal industries and the strategies that unsecured creditors may use to increase the likelihood and amount of any distribution.

A variety of factors has made it difficult for companies in the oil, gas, and coal industries to stay afloat in recent years. In particular, oil and natural gas prices have plummeted, primarily due to increased supply and, regarding oil, declining demand.

For example:

- Crude oil prices are hovering at near ten-year lows, largely due to:
  - a growing supply, including Iran's return to the international oil market after sanctions were lifted recently; and
  - declining demand due to insipid economic growth and increased interest in energy efficient vehicles.
- Natural gas prices have suffered a steep and prolonged decline, primarily from:
  - excess supply due to increased exploration; and
  - increased production of shale gas resulting from technological advancements in the development of hydraulic fracturing technology (fracking).
- Coal prices have declined as demand for both thermal coal (primarily used to produce energy) and metallurgical coal (used in the production of coke and in the integrated steel mill process) has decreased significantly (see Box: The Case of Coal).

Aside from these macroeconomic pressures, oil, gas, and coal companies also suffer from significant debt obligations, environmental obligations, and in some instances, particularly in the coal industry, legacy liabilities owed to current and former employees. Due to the confluence of these factors, energy restructurings are on the rise, with:

- More than 40 oil and gas companies filing for bankruptcy in 2015 (see Crude Oil Storage – January 27, 2016).
- More than 26 coal companies filing for bankruptcy in recent years (see The Carbon Tracker Initiative, The US Coal Crash: Evidence for Structural Change (March 2015)).

The trend in energy bankruptcies is for companies to negotiate with secured lenders prepetition and enter into bankruptcy with prepackaged or prenegotiated reorganization plans (see *Practice Note, The Prepackaged Bankruptcy Strategy* (9-503-4934) and see *Chart, Timeline of a Prepackaged Bankruptcy Case* (9-504-0794)). In many instances, these plans involve a section 363 sale (see *Practice Note, Buying Assets in a Section 363 Sale: Overview* (1-385-0115) and see *Chart, Timeline of a Section 363 Sale* (3-385-0751)) or a debt-for-equity swap, focused on a quick Chapter 11 exit (usually enforced in DIP financing, cash collateral, or sale orders involving tight milestones) with a plan for the prepetition secured lenders to own the business post-emergence (see *In re Arch Coal, Inc.,* Case No. 16-40120, Dkt. No. 156 (Bankr. E.D. Mo. Jan. 21, 2016 (w-002-4402))).

With energy bankruptcy cases on the rise and operating on tight timelines, it is increasingly crucial for unsecured creditors to be able to quickly and efficiently identify issues and develop solutions to maximize value. This Practice Note provides guidance to unsecured creditors involved in restructurings in the oil, gas, and coal industries, as well as strategies that unsecured creditors may use to increase the likelihood and amount of any distribution.

DERIVING VALUE FOR UNSECURED CREDITORS IN ENERGY RESTRUCTURINGS

There are several strategies unsecured creditors can use to protect and derive value in energy restructurings, including:

- Protecting the debtor's tax attributes (see Protect the Debtor's Tax Attributes).
- Challenging prepetition liens (see Challenge Prepetition Liens).
- Anticipating valuation issues (see Anticipate Valuation Issues).
- Considering exit opportunities (see Consider Exit Opportunities).

PROTECT THE DEBTOR'S TAX ATTRIBUTES

Many energy companies have been operating at a loss for years and likely have incurred significant net operating losses (NOLs) and net unrealized built in losses (see *In re Patriot Coal Corp.,* Case No.

15-32450 (Bankr. E.D. Va.) (Dkt. No. 452 Jul. 2, 2015) (*w-002-4404*); *In re Alpha Nat. Res., Inc.,* Case No. 15-33896 (Bankr. E.D. Va.) (Dkt. No. 475 Sept. 17, 2015) (*w-002-4403*). These tax attributes can have tremendous value to a debtor's estate as they may be used under the Internal Revenue Code (IRC) to offset future income or gain. Accordingly, it is crucial for unsecured creditors to ensure that adequate measures are put in place to fully preserve any tax attributes.

Limits on Claims and Equity Trading

To protect these tax attributes, a debtor typically files a motion to limit the trading of claims and equity interests during the bankruptcy case because any such trading may impact the debtor's ability to use these tax attributes in the future (see *Practice Note, Bankruptcy Claims Trading: Basic Concepts* (5-526-6247)).

Specifically, if a debtor experiences an "ownership change" for tax purposes, which may be triggered by an exchange of debt for equity under a plan of reorganization, the tax attributes may become severely limited. However, under an IRC safe harbor (see IRC section 382(l)(5)), the debtor's tax attributes are protected if old creditors and equity security holders (those holding claims or interests for 18 or more months before the petition date) hold at least 50% of the stock in the new company post-reorganization.

Therefore, if claims and equity trading are not limited during the bankruptcy case, there may not be a sufficient number of old creditors and equity security holders to take stock in the new company. The debtor then runs the risk that it would not qualify for the IRC safe harbor on emergence from bankruptcy and have limited or no ability to use these tax attributes.

Despite these consequences, in some cases, a debtor may be discouraged by its large creditors and equity security holders from filing a motion to limit the trading of claims and interests because its constituents desire to maintain the ability to trade claims and interests freely during the course of the bankruptcy case. Where a debtor has not filed a motion to limit the trading of both claims and interests, unsecured creditors should carefully consider whether the debtor has sufficiently protected its tax attributes.

CHALLENGE PREPETITION LIENS

DIP financing and cash collateral orders typically include stipulations by the debtor regarding the extent and validity of the debtor's prepetition secured debt. These orders also contain a deadline by which a creditors' committee or any other party in interest may seek to challenge those stipulations (see *Practice Note, Chapter 11 Creditors' Committees: Powers of Committees: Perform Watchdog Functions* (*1-508-8252*)). This challenge period provides a meaningful opportunity for unsecured creditors to bring value into the debtor's estate by either:

- Challenging the extent or validity of prepetition liens and claims.
- Seeking to claw back payments made by a debtor to a secured creditor during the preference or fraudulent transfer period or for less than reasonably equivalent value.

These challenges may increase the likelihood or amount of distributions to unsecured creditors. During its investigation into the extent and validity of a prepetition lender's liens and claims, the creditors' committee (and other parties in interest) should pay particular attention to:

- Liens on as-extracted collateral (see Liens on As-Extracted Collateral).
- Mortgages on leasehold interests (see Mortgages on Leasehold Interests).
- Mortgages on real property (see Mortgages on Other Real Property Interests).

Liens on As-Extracted Collateral

A lender that has a lien on oil, gas, or other minerals in the ground may also have a lien on these materials as they come out of the ground (referred to as "as-extracted collateral" as defined in section 9-102(a)(6) of the Uniform Commercial Code (UCC)). As-extracted collateral is distinct from oil, gas, and minerals that are owned by the debtor and either:

- In the ground.
- Extracted from the ground before the grant of a lien.
- Purchased by the debtor from a third party.

Unsecured creditors should examine whether the secured lender has properly perfected its interest in as-extracted collateral, and perfection can occur in one of two ways:

- Most well drafted mortgages contain language allowing the mortgage to double as a personal property financing statement regarding as-extracted collateral. In this case, the property may remain subject to a lien once extracted by the debtor. Even if the mortgage also serves as a personal property financing statement, disputes may still arise regarding the extent of the secured lender's lien.
- If the real estate mortgage does not contain the necessary language or is otherwise insufficient, a secured lender may have entered into a security agreement and filed a UCC financing statement in the debtor's state of incorporation to perfect its lien on the as-extracted collateral. This manner of perfecting a security interest is also the manner in which a secured lender perfects its interest on the debtor's other oil, gas, and minerals (that is, those owned by the debtor before the grant of a lien or those purchased by the debtor from a third party) (see *Practice Note, Finance Fundamentals: Security Interests v. Other Liens* (6-520-2472)).

Mortgages on Leasehold Interests

In coal cases where drilling or mining operations are common, it is not unusual to see leasehold interests where the mineral estate is severed from the surface estate. In a coal company restructuring involving valuable leasehold interests, unsecured creditors must analyze these leases to preserve the value of those leasehold interests for the benefit of unsecured creditors.

Where a coal company debtor leases rather than owns the property on which it conducts its mining operations, unsecured creditors should evaluate whether the leases and security interests cover the surface rights or the mineral rights, or both.

Once it is confirmed that the debtor has an interest in the mineral estate and the prepetition lender purports to have a security interest in the mineral estate, unsecured creditors must consider whether the lease is permitted to be pledged by its terms, in addition to whether any security interest has been validly granted and perfected.

As part of this analysis, unsecured creditors should determine whether the lease includes either:

- An anti-encumbrance clause, which expressly prohibits a lessee from granting a security interest in a lease to a third party without the lessor's consent.
- An anti-assignment clause, which expressly prohibits a lessee from assigning a lease without the lessor's consent.

Under certain state laws, anti-assignment clauses are viewed to prohibit encumbrances as well. Where one of these provisions is present in a lease, unsecured creditors should investigate whether the debtor has received either:

- Consents from the applicable lessors authorizing the grant of security interests.
- Waivers from the lessors waiving any restriction on transfers, assignments, or mortgages.

If these documents are not available, unsecured creditors may argue that the lender does not have a valid lien.

This analysis for coal company restructurings may be crucial for unsecured creditors. The value attributable to the debtor's leases and associated coal reserves may be preserved for the benefit of unsecured creditors in the event the bankruptcy court holds the mortgages on leaseholds as invalid.

Mortgages on Other Real Property Interests

The conveyance and perfection of a security interest in real property is governed by the real estate laws of the jurisdiction in which the real property is located. A mortgage generally contains a granting clause that conveys a security interest in the estate to the lender. Then, to perfect this security interest, the lender generally must record a mortgage in the local jurisdiction where the real property is located.

State law may vary regarding the level of specificity required in a granting clause. In a recent decision, the Bankruptcy Court for the District of Delaware held that, under Texas law, a blanket lien on all of the debtor's real property interests in the State of Texas was valid. Specifically, the mortgage granted a lien on:

"All of the rights, titles, interests of every nature whatsoever now owned or hereafter acquired by the Mortgagor in and to the Oil and Gas Properties described in Exhibit A and all other rights, titles, interest and estates, and every part and parcel thereof."

(See *In re Quicksilver Res., Inc.,* Case No. 15-10585, Dkt. No. 1029 (Bankr. D. Del. Jan. 8, 2016) (*w-002-0622*).)

Unsecured creditors should carefully review any mortgages to ensure that the conveyance is sufficiently described under applicable state law and the mortgage is filed in the applicable jurisdiction.

ANTICIPATE VALUATION ISSUES

In energy restructurings, the value of the debtor is largely based on the value of the relevant commodity. As a result, the distributable value may fluctuate significantly during the course of the case, particularly where the case is expected to last one year or more. Depending on analysts' views on the value of those commodities in the near future, unsecured creditors may be inclined to speed the case up or slow the case down to maximize value.

For example, if the value of the relevant commodity is expected to increase significantly during a six- to nine-month period (where the increased value is expected to offset the costs associated with the debtor's operations in bankruptcy), unsecured creditors may be inclined to seek a longer sale process to ensure that potential bidders are maximizing their offers.

CONSIDER EXIT OPPORTUNITIES

Where value is not immediately apparent in an energy restructuring, debtors, creditors, and their professionals need to be creative in finding ways to maximize value for the benefit of all constituents. In particular, parties should consider maximizing value by using:

- Atypical sales (see Sale Strategies).
- Tax-driven exit strategies (see Tax-Driven Exit Strategies).

Sale Strategies

In many instances, a debtor (and perhaps a lender serving as a stalking horse bidder) enters a bankruptcy case with plans to sell the debtor's valuable assets and leave behind the debtor's nonperforming assets. These nonperforming assets frequently include assets with significant environmental or other liabilities. If possible, unsecured creditors should encourage the debtor to find a potential purchaser for these nonperforming assets or even seek a potential purchaser themselves. Even if a potential purchaser is not willing to pay money for the nonperforming assets, unsecured creditors may still benefit from a purchaser that assumes liabilities or provides other benefits (see *Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview: Key Advantages of Section 363 Sales* (*1-385-0115*)). For example, the reduction of meaningful liabilities reduces the size of the claims pool and increases the recoveries available for the remaining unsecured creditors.

In the Patriot Coal bankruptcy, the debtors entered bankruptcy with a plan to sell their core operating assets for the benefit of their estates. While in Chapter 11, the debtors and the creditors' committee engaged in an extensive marketing process to find competing purchasers both for their core and non-core assets. The debtors' assets ultimately were sold under the plan, where the core operating assets were sold to one party and the remaining, non-core assets were sold to a second party, avoiding facility shutdowns and job loss. The purchaser of the non-core assets agreed to assume several significant liabilities, including:

- All liabilities regarding assumed permits.
- Certain post-closing regulatory violations and obligations.
- Mine operating or safety compliance matters related to the condition of the purchased assets.
- Certain Black Lung liabilities.
- Certain environmental liabilities under consent decrees affecting the purchased assets.

The plan also gave unsecured creditors a portion of the equity of the non-core asset purchaser, which allowed the creditors to share in the purchaser's potential future success resulting from this atypical sale (see *In re Patriot Coal Corp.,* Case No. 15-32450, Dkt. No. 1615 (Bankr. E.D. Va. Oct. 9, 2015) (*w-002-0624*)).

Similarly, in the Walter Energy bankruptcy, the stalking horse purchaser did not bid on some non-core assets, including certain mines for thermal and metallurgical coal and a metallurgical coke plant. The debtor ultimately found another bidder that paid a nominal cash consideration ($1) for these assets. However, that bidder also assumed approximately $38 million of the debtors' liabilities, including:

- $2.15 million in cure costs.
- $8.89 million of current liabilities, including employee wages.
- $26.4 million of reclamation obligations (see *Practice Note, Reclamation Rights in Bankruptcy* (*7-506-5441*)).
- $231,000 of key employee retention liabilities.

Absent the sale, the cost of liquidating the non-core assets, including reclamation claims and a total shutdown of the coke plant, likely would have exceeded $100 million. The sale of the non-core assets as a going concern also provided the best opportunity for continued employment of the 373 employees operating these assets (see *In re Walter Energy, Inc.,* Case No. 15-02741, Dkt. Nos. 1820 (*w-002-0625*), 1863 (Bankr. N.D. Ala. Feb. 8, 2016) (*w-002-0626*)).

Tax-Driven Exit Strategies

Unsecured creditors also should consider whether any tax-driven exit strategies may enhance value for the benefit of unsecured creditors. For example, an energy company can spin off its eligible energy assets and operations into a master limited partnership (MLP) to maximize value to unsecured and other creditors that are receiving equity in the reorganized entity.

To qualify as an MLP, a company must generate at least 90% of its income from oil, natural gas, and coal. An MLP is a publicly traded investment vehicle that combines the tax benefits of a limited partnership with the liquidity of a publicly traded company. Specifically, the income or gains must derive from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of certain fuel types (see 26 U.S.C. § 7704(d)(1)(E)). MLPs pass their profits directly to investors because they must pay out most of their earnings as dividends.

OTHER STRATEGIES FOR UNSECURED CREDITORS

VENUE

A court may transfer a case from one venue to another "in the interest of justice" or "for the convenience of the parties" (see 28 U.S.C. § 1412). The decision to transfer venue is within a court's discretion and based on an "individualized, case-by-case consideration of convenience and fairness" (see *Gulf States Expl. Co. v. Manville Forest Prod. Corp.* (*In re Manville Forest Prod. Corp.*), 896 F.2d 1384, 1391 (2d Cir. 1990)).

The choice of venue is a strategic decision for the debtor. Creditors may be inclined to challenge the debtor's choice of venue, particularly in energy bankruptcy cases that are filed in jurisdictions away from the debtor's primary business operations. Unsecured creditors, such as the company's employees, retirees, unions, and lessors, may prefer that the case be located locally to facilitate their participation in the bankruptcy proceedings. This is particularly important for creditors in cases involving significant labor and employment issues, such as the potential rejection of collective bargaining agreements or modification of retiree benefits.

Debtors, on the other hand, may choose to file away from the location of their primary operations for various reasons, including an effort to minimize employee participation or to avoid or take advantage of certain case law in other jurisdictions:

- In the Fourth Circuit, courts have allowed coal operators to sell their assets free and clear of Coal Act liabilities (see *In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 584 (4th Cir. 1996)). Therefore, a debtor seeking to take advantage of that rule may be inclined to file in the Fourth Circuit, assuming that venue was available to them (28 U.S.C. § 1408).
- A coal operator with significant obligations under a collective bargaining agreement that is eligible to file both in the Second and Third Circuits may opt to file in the Second Circuit, which provides more flexibility for debtors in making modifications to these agreements due to the court's interpretation of section 1113 of the Bankruptcy Code (see *Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82 (2d. Cir. 1987)).
- In the original Patriot Coal bankruptcy case, creditors challenged the debtor's choice of venue on the basis that the debtors manufactured venue in the Southern District of New York by incorporating two affiliates in New York shortly before the petition date. Specifically, the creditors sought to transfer the case to the location of the coal mines in the Southern District of West Virginia. The court declined to "swap one party's perceived home field advantage for another", noting that it is not in the "interest of justice" to move the case to a forum that is simply more empathetic to the miners and unions. The court ultimately determined to transfer venue of the bankruptcy cases to the Eastern District of Missouri, where the debtors' headquarters were located (see *In re Patriot Coal Corp.,* Case No. 12-12900, Dkt. No. 1629 (Bankr. S.D.N.Y. Nov. 27, 2012) (*w-002-0627*)).

Patriot Coal offers an unusual outcome, as courts generally defer to a debtor's choice of forum where venue is proper under section 1408 of the Judicial Code (see *In re Enron Corp.*, 284 B.R. 376 (Bankr. S.D.N.Y. 2002)). While creditors may find value in seeking to transfer venue to a local jurisdiction, challenging venue may be an uphill battle. Because the venue decision has already been made by the debtor, courts generally defer to a debtor's decision if venue is proper under the statute.

For more information on bankruptcy venue issues generally, see *Practice Note, Venue in Bankruptcy Proceedings* (*7-614-3645*).

DIP FINANCING AND CASH COLLATERAL ORDERS

Unsecured creditors should be wary of secured lenders seeking to strengthen their position by exerting leverage over energy companies prepetition while negotiating the terms of a prepackaged or prenegotiated bankruptcy plan.

Even though energy companies typically draw on the remainder of their revolving loans (if available) to ensure they have sufficient cash heading into bankruptcy, increasingly they are entering into rich cash collateral agreements and DIP financing agreements, in some instances borrowing money they do not need, that provide significant adequate protection payments to prepetition secured lenders and additional liens on unencumbered assets.

For more information on DIP financing generally, see *Practice Note, DIP Financing: Overview* (*1-383-4700*).

As an initial matter, unsecured creditors must consider whether the financing is truly necessary to help in the debtor's reorganization by asking the following questions:

- Is the debtor receiving cash or is the prepetition debt being rolled up into postpetition financing (see *Practice Note, Roll-Up DIP Financing* (*1-386-8691*))?
- What are the proceeds being used for?
- Does the debtor need this cash to continue operating the business while in Chapter 11?

These questions help determine the motives behind the financing and whether the additional obligations are truly necessary or merely a guise to promote the lender's interests.

In the Energy Future Holdings bankruptcy, the debtors initially filed motions to approve three DIP financing facilities. The debtors admitted that one of these financing facilities, the "EFIH Second Lien DIP", was not necessary from an operational or debt-service perspective. The proceeds of this DIP were instead intended to be used to refinance the debtors' second lien notes and pay certain of the lenders' claims. Under the EFIH Second Lien DIP, the debtors were required to pay more than $40 million in aggregate cash transactions fees and significant monthly interest payments to the lenders. Various parties filed objections to the EFIH Second Lien DIP, arguing that the total cost of the EFIH Second Lien DIP significantly exceeded the cost of leaving the debtors' second lien notes in place, particularly in light of the fact that there was no ongoing obligation to make postpetition interest payments on the debtors' second lien notes. After vehement opposition by various creditor constituencies, the debtors ultimately withdrew their motion for approval of the EFIH Second Lien DIP (see *In re Energy Future Holdings Corp.,* Case No. 14-10979, Dkt. No. 477 (Bankr. D. Del. May 15, 2014) (*w-002-0628*), Dkt. No. 1697 (Bankr. D. Del July 25, 2014) (*w-002-0629*)).

For more information on typical objections to DIP financing agreements, see *Practice Note, DIP Financing: Creditors' Committee Objections* (*0-614-1555*).

ENVIRONMENTAL ISSUES

Because environmental issues are often implicated in energy restructurings, unsecured creditors should consider how environmental issues may impact recoveries. Due to significant governmental regulations in the oil, gas, and coal industries, governmental agencies are usually more involved in these cases. Where environmental liabilities are particularly expensive or cannot be discharged, governmental agencies may have the ability to drive the outcome of the case.

In the Hovensa LLC bankruptcy, the debtor faced significant liabilities to the Environmental Protection Agency (EPA) and the Government of the Virgin Islands (GVI) related to environmental compliance matters. Specifically, the debtor had significant obligations under the Resource Conservation Recovery Act (RCRA) and other laws for remaining hazardous and non-hazardous materials and waste located near the debtor's oil refinery.

During the Chapter 11 process, the GVI actively participated in the bankruptcy case to ensure that the debtor satisfied its remediation and other obligations. During the auction for the sale of substantially all of the debtor's assets, the GVI played a pivotal role in the negotiations, demanding, and ultimately receiving:

- A concession fee of $100 million to be paid to the GVI directly from the sale proceeds.
- A commitment from the purchaser to operate the oil storage facility for at least 25 years.
- A commitment from the purchaser to employ a minimum of 80 full-time workers (at least 80% of which must be long-term USVI residents).
- A transfer of land and housing units to the GVI that were previously owned by the debtor.

In addition to these concessions, the debtor also agreed to create and fund an environmental response trust to be responsible for paying remediation costs and overseeing the remedial actions agreed among the debtor, the EPA, and the GVI (see *In re Hovensa, LLC,* Case No. 15-10003, Dkt. No. 467 (Bankr. D. VI. Dec. 17, 2015) (*w-002-0630*)).

Therefore, governmental agencies (such as the GVI) may have significant influence over a bankruptcy case involving environmental liabilities that are nondischargeable or entitled to administrative priority.

Unsecured creditors also should consider that, in some instances, a debtor may not be able to escape its environmental obligations by selling its assets. In coal cases for example, a sale may be difficult or impossible to consummate where mine reclamation liabilities are so extensive that no purchaser is willing to assume the liabilities. In these cases, a debtor may be inclined to abandon the valueless assets. However, the US Supreme Court has held that a debtor cannot simply abandon its hazardous properties in a bankruptcy case in contravention of a statute designed to protect public health or safety (see *Midlantic Nat. Bank v. New Jersey Dept. of Envtl. Prot.*, 474 U.S. 494 (1986)). Therefore, even when abandonment is in the debtor's best interest because it is cheaper than the continued use or sale of the property, a debtor may not abandon its oil, gas, or coal property that is subject to certain environmental liabilities.

STRATEGIES FOR SPECIFIC CREDITOR GROUPS

EMPLOYEES: RIGHTS UNDER SECTIONS 1113 AND 1114 OF THE BANKRUPTCY CODE

Coal companies may have significant obligations to their employees and retirees under benefit plans required by federal legislation and under collective bargaining agreements (CBAs), which are negotiated between unions and employers to establish the work terms between the employer and its employees.

Section 1113 of the Bankruptcy Code sets out the standards and procedures for rejection or modification of prepetition CBAs and provides the exclusive means for assumption or rejection of CBAs in Chapter 11. Specifically, section 1113 requires that the following requirements be met for a debtor to reject a CBA:

- The debtor must make a proposal to the applicable union or authorized representative to modify the CBA.
- The proposal must be based on the most complete and reliable information available at that time.
- The proposed modifications must be "necessary" to permit the debtor's reorganization.
- The proposed modifications must treat the creditors, debtor, and all affected parties fairly and equitably.
- The debtor must provide the applicable union or authorized representative with relevant information as necessary to evaluate the proposal.
- From the date of the debtor's proposal to the date of the bankruptcy court hearing on the proposed rejection of the CBA, the debtor must meet with the authorized representative at reasonable times.
- During these meetings, the debtor must confer in good faith in an attempt to reach mutually satisfactory modifications to the CBA.
- The union or authorized representative must refuse to accept the debtor's proposal without good cause.
- The balance of the equities must clearly favor rejection of the CBA.

(§ 1113, Bankruptcy Code.)

Section 1114 of the Bankruptcy Code, which is generally modeled on section 1113, sets out similar criteria for the modification of retiree benefits.

There is a split in authority on how to interpret the statutory requirement that the proposed modifications be "necessary" to permit the debtor's reorganization:

- The Third Circuit has interpreted necessary to mean only what is necessary to meet the "somewhat shorter term goal of preventing the debtor's liquidation" (see *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am.*, 791 F.2d 1074, 1089 (3d Cir. Pa. 1986)).
- The Second Circuit has adopted a more flexible standard, interpreting necessary as including "necessary, but not absolutely minimal, changes that will enable the debtor to complete the reorganization process successfully" (see *Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82 (2d. Cir. 1987)).
- Other interpretations exist in other jurisdictions. Where there is limited case law, the bankruptcy courts have some latitude in determining whether modification or rejection is appropriate.

While sections 1113 and 1114 set out detailed standards and procedures that protect employees and retirees, unsecured creditors should beware of attempts by debtors to pre-determine the outcome of CBA or retiree benefit negotiations. In particular, unsecured creditors should look out for provisions in sale or DIP financing orders and agreements that require the debtor to terminate or modify employee or retiree benefits or require the debtor to make a final decision on an unfairly expedited schedule.

RETIRED COAL MINERS: FEDERAL COAL INDUSTRY RETIREE HEALTH BENEFIT ACT OF 1992 (COAL ACT)

The Coal Act (26 U.S.C. §§ 9701-9722 (2006)) requires coal companies obligated under CBAs to pay for the health care costs of their retirees, as well as costs associated with retirees promised medical benefits by a coal producer that is no longer in business, also known as orphan retirees. Under the Coal Act, coal companies must make annual contributions based, in part, on the number of eligible retired miners and their dependents, including orphan beneficiaries, assigned to them by the Social Security Administration.

Some courts have eroded the Coal Act's protections by allowing debtors to modify or eliminate their Coal Act obligations in bankruptcy. For example, some courts have held that a debtor's Coal Act obligations can be modified if the requirements of section 1114 are followed (see *In re Horizon Nat. Res. Co.*, 316 B.R. 268, 272 (Bankr. E.D. Ky. 2004); *In re Walter Energy, Inc.*, 542 B.R. 859, 883 (Bankr. N.D. Ala. 2015)). Several courts have also found that a debtor can sell its assets free and clear of Coal Act obligations under section 363(f) of the Bankruptcy Code (see *In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 584 (4th Cir. 1996)).

DISABLED COAL MINERS: BLACK LUNG BENEFITS ACT

The Black Lung Benefits Act (30 U.S.C. §§ 901-944 (2015)) provides monthly payments and medical benefits to coal miners disabled by black lung disease (pneumoconiosis), and their dependent survivors, arising from the miners' employment in or around the nation's coal mines. The last coal mine operator for which the miner worked for a period of at least one year is typically responsible for the payment of benefits. However, when the responsible coal mine operator is no longer financially capable of making the benefit payments, the Black Lung Disability Trust Fund makes the benefit payments to the miner and seek reimbursement from the operator.

The Black Lung Benefits Act allows the Black Lung Disability Trust Fund to file a lien against the responsible coal mine operator. If the operator is a debtor in a bankruptcy case, that lien creates a claim with the same priority as a tax claim. If the claim is not paid, the operator's officers can be held liable for the obligation. As a result, black lung claims are usually paid in full in bankruptcy. Courts may also modify the automatic stay to allow black lung claims and actions to proceed in the ordinary course of business (see *In re Walter Energy, Inc.,* Case No. 15-02741, Dkt. No. 508 (Bankr. N.D. Ala. Aug. 19, 2015) (*w-002-0631*)).

CONTRACT COUNTERPARTIES

Oil and gas producers often enter into gathering and processing agreements with midstream companies involved in the transportation, storage, and wholesale marketing of, among other things, natural gas, oil, and other hydrocarbons. These agreements enable production companies to transport these products using the midstream gatherer's infrastructure.

In re Sabine Oil & Gas Corp.

Recently, in *In re Sabine*, the US Bankruptcy Court for the Southern District of New York determined that gas gathering agreements may be rejected under section 365 of the Bankruptcy Code. Sabine, an energy exploration and production company with onshore oil and natural gas properties, sought to reject two gas gathering agreements with two midstream gatherers. These agreements generally obligated Sabine to dedicate certain oil, gas, and condensate from specific properties to the midstream companies. These agreements further committed Sabine to deliver these products in agreed-on minimum amounts and, in the event of a shortfall, make a deficiency payment to the midstream companies. The midstream companies, in turn, were obligated to construct, operate, and maintain gathering facilities to provide certain services to Sabine. In bankruptcy, Sabine sought to reject these contracts on the basis that it was not financially viable for it to deliver the minimum amounts set out in the agreements and, absent rejection, Sabine must make costly contractual deficiency payments. The midstream companies argued that the covenants to dedicate the products and pay the fees are covenants that run with the land and are not subject to rejection. The court ultimately determined that the covenants do not run with the land under Texas law and that rejection of the gas gathering agreements was appropriate (see *In re Sabine Oil & Gas Corp.*, 2016 WL 2603203 (Bankr. S.D.N.Y. May 3, 2016); and see *Legal Update, In re Sabine: Binding Ruling Authorizing Rejection of Midstream Oil & Gas Agreements* (*w-002-2648*)).

The Sabine decision appears to provide greater leverage to oil and gas producers to negotiate better terms on gathering agreements when in financial distress and facing potential insolvency. As state law governs whether a covenant runs with the land, the outcome in future cases may vary depending on the jurisdiction. To protect gathering contracts from rejection, pipeline operators should consider enlisting the help of local counsel.

ROYALTY INTEREST HOLDERS

Mineral estates frequently are divided into fractional interests. A landowner (typically owning both the surface and mineral rights to the land) may enter into a lease with an exploration and production (E&P) company, granting it a working interest or the exclusive right to explore, drill, and produce oil and gas from the mineral estate. In exchange, the landowner typically retains a royalty interest, which is a percentage share of the oil and gas that is produced from the leased land, free of any production costs (other than the landowner's share of certain post-production costs). The E&P company may then carve out various fractional interests from its working interest, including, for example, overriding royalty interests (ORRIs), net profits interests (NPIs), and production payments (PPs) (§ 101(42A), Bankruptcy Code). Each of these interests grants the holder the right to receive some portion of the production from the working interest.

The interests held by fractional interest holders generally are not property of the estate. Specifically, the safe harbor set out in section 541 of the Bankruptcy Code protects assignees of production payments or ORRIs from having their oil and gas interests included in the bankruptcy estate. (§ 541(b)(4)(B), Bankruptcy Code). In some recent cases, however, parties have challenged the debtor's or working interest owner's conveyance of a fractional interest and sought to recharacterize it as a disguised loan instead.

Where this argument is successful, the fractional interest holder becomes a creditor of the debtor's estate and the asset becomes a part of the bankruptcy estate. Whether a court is willing to recharacterize a sale agreement as a financing transaction depends in part on applicable state property laws.

Courts also consider various other factors, including, for example, whether the agreement provides the fractional interest owner with either:

- A share of the oil or gas produced.
- Specific payments designed to provide the fractional interest owner with a specified return on investment.

(See *NGP Capital Res. Co. v. ATP Oil & Gas Corp.* (*In re ATP Oil & Gas Corp.*), 2014 WL 61408 (Bankr. S.D. Tex Jan 6, 2014).)

To protect against these arguments in bankruptcy, fractional interest holders should be careful to structure their transactions in a manner that supports a true sale finding rather than a disguised loan.

TRADE CREDITORS

Trade creditors in energy restructurings face many of the same issues as trade creditors involved in bankruptcy cases in other industries. One of the most important considerations for a trade creditor in any industry is to negotiate with the debtor to be included on the critical vendors list (see *Practice Note, Critical Vendor Status in Bankruptcy* (*1-518-9996*)). Most debtors seek entry of a court order early in the bankruptcy case authorizing them to pay critical vendors. Once this order is entered, the debtor has authority to repay the identified critical vendors up to a specified cap. This is the simplest way for a trade creditor to secure repayment in full and the primary way for a trade creditor to receive payment while the bankruptcy case is pending.

Unsecured creditors should be aware, however, that the critical vendors order may condition payments on the agreement of these vendors to continue supplying products or services to the debtor throughout the bankruptcy case under the parties' normal and customary trade terms or under other trade terms that are favorable to the debtors. The debtor also may impose additional requirements, subject to court approval, on parties seeking this special treatment.

PREFERENCE DEFENDANTS: UNUSUAL PREFERENCE DEFENSES

A creditor that has not validly perfected its security interest before the petition date is:

- Treated as an unsecured creditor.
- Subject to preference liability in bankruptcy.

In contrast, a creditor with a validly perfected security interest is not subject to preference liability because a transfer to a creditor that has recourse to the value of its collateral in a Chapter 7 liquidation does not satisfy the preference requirement that a creditor obtain more than it may have received in a Chapter 7 liquidation (see *Practice Note, Liquidation Analysis: Best Interests of Creditors Test* (*6-616-6331*)).

For more information about preferential transfers generally, see *Practice Note, Preferential Transfers: Overview and Strategies for Lenders and Other Creditors* (*6-381-6416*).

There are various potential defenses to preference liability, but several of these defenses may be especially valuable to creditors in energy restructuring cases.

Inchoate Lien Defense

The inchoate lien defense applies to statutory lien creditors that receive payment during the preference period by an insolvent debtor and, as a result of the payment, forego the filing of a lien affidavit. In this circumstance, a plain reading of the Bankruptcy Code subjects the statutory lien creditor to preference liability because the creditor did not perfect its lien before the petition date. However, a majority of courts have held that payments made by a debtor to a statutory lien creditor during the preference period, which results in the creditor taking no affirmative steps to perfect its statutory lien rights, are not avoidable as preferences (see *Official Comm. of Unsecured Creditors of 360Networks* (*USA*) *Inc. v. AAF-McQuay, Inc.*, 327 B.R. 187 (Bankr. S.D.N.Y. 2005); *Cimmaron Oil Co. v. Cameron Consultants, Inc.*, 71 B.R. 1005 (N.D. Tex. 1987)).

Contract Assumption Defense

The contract assumption defense applies to a creditor that is paid by an insolvent debtor during the preference period under an executory contract and the debtor assumes that contract during the Chapter 11 case. While these payments may seem to be straightforward preferences, courts exempt these payments from avoidance because the Bankruptcy Code requires a debtor to "cure all defaults, assure future performance, and make the other contracting party whole" under section 365 of the Bankruptcy Code before assuming a contract.

Permitting a preference suit after assumption of an executory contract undermines the intent and purpose of section 365. Therefore, where a debtor assumes its contract with a creditor, the debtor can no longer satisfy the preference requirement that a creditor obtain "more than it would otherwise have received" in a Chapter 7 liquidation (see *Pirinate Consulting Grp., LLC, as litigation trustee of the NP Creditor Litig. Tr. v. Avoca Bement Corp.*, 517 B.R. 508 (Bankr. D. Del. 2014)). This defense may be particularly useful to counterparties to oil and gas supply agreements, oilfield services agreements, and agreements for the purchase, sale, and distribution of commodities in energy restructurings.

To take advantage of this defense, a counterparty preference defendant should investigate whether:

- Its contract was assumed, either separately or in bulk, under a plan or omnibus assumption order.
- The allegedly preferential payments were received in connection with the assumed contract (in which case, they are arguably protected by the contract assumption defense), or some other transaction involving the debtor (in which case they may not be protected).

Payments to Fractional Interest Holders

Courts have recently considered whether payments by a debtor to a fractional interest holder during the preference period may be avoided. In several recent cases, courts have narrowly interpreted the safe harbor of section 541 of the Bankruptcy Code, leaving holders of fractional oil and gas interests at risk that their agreements may be recharacterized as disguised loans (see Royalty Interest Holders). To the extent a fractional interest is recharacterized as a financing arrangement, any payments made under those agreements may be subject to avoidance as preferences (see *Tow v. Sankaty ATP, LLC*, No. 12-36187, 2015 WL 1093568 (Bankr. S.D. Tex. Mar. 10, 2015)).

PRACTICAL CONSIDERATIONS FOR UNSECURED CREDITORS IN ENERGY RESTRUCTURINGS

Despite the unique issues involved in energy restructuring cases, creditors must always keep in mind that a bankruptcy case in the oil, energy, or coal industry is still a bankruptcy case, so all of the usual rules apply. However, unsecured creditors can manage certain risks in restructuring bankruptcies by keeping certain strategies in mind:

- Identify the debtor's valuable assets and be creative in developing ways to derive value from those assets for the benefit of unsecured creditors.
- Consider other strategies that may benefit or provide leverage for unsecured creditors.
- Evaluate strategies that may be used by individual creditor groups and, in a creditors' committee representation, consider the impact of those strategies on unsecured creditors as a whole.

THE COAL INDUSTRY

Thermal coal prices have fallen during the last decade as global consumption has waned significantly as countries move towards cleaner energy sources, such as natural gas.

For example, the US has confirmed a 10% year-on-year decline in coal consumption in 2015, largely due to increased use of natural gas and renewable energy (see US Energy Information Administration, Coal Production and Prices Decline in 2015, Jan. 8, 2016).

Even China, which has been one of the largest importers of thermal coal during the last two decades, has begun steering away from high energy-intensive industrial growth, replacing coal with other energy sources. Similarly, metallurgical coal prices have declined dramatically, in part due to strength of the US dollar against other currencies in coal producing countries, such as Australia, which has resulted in significantly increased sources of seaborne supply. This increased supply significantly exceeds demand growth, as China's demand for steel has waned due to its economic slowdown as the Chinese Central Government's economic policy transitions from industry and manufacturing towards service and consumer spending.