

DISPUTES IN THE OIL PATCH

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INTRODUCTION

- An industry downturn in action
 - Oil price drop... >> RISE?!
 - U.S. rig count nears all time low
 - Contract Disputes
 - Regulatory Disputes
 - IP Disputes
 - Insolvency/Reorganization/Bankruptcy



HORIZONTAL DRILLING ISSUES

- Because of the physical distinctions, the appropriate mechanisms for pooling appropriate for vertical wells is inappropriate for horizontal wells.
- Case construing a contractual provision that requires royalties to be paid on wells on said tract to require the royalty to be allocated among the productive portions of the tracts traversed by the horizontally drilled well

JOA DISPUTES

- Recordation?
- Operatorship
 - Replacement
 - Successor operator controls the property during the pendency of the lawsuit
 - Standard of care (see JOA form 1982, 1989)
- “Subsequent operations”/Non-consent
 - New JOA provisions for horizontal wells
 - A.A.P.L. FORM 610 – 1989, MODEL FORM OPERATING AGREEMENT HORIZONTAL MODIFICATIONS (2013)
- AFE limit on costs?

JOA DISPUTES

- Purchase/Sale of Interests
 - Pref Rts
 - Events that trigger a sale
 - What constitutes a sale
 - Mergers, sales of stock, subs and affiliates
 - Package sales of burdened and unburdened props
 - Mechanics of complying
 - Maintenance of Uniform Interest Provision
- Cost disputes/Joint interest audits
- Conflicts between JOA and AMI (e.g. in Joint Exploration and Development Agreements)

AMI

- Interpretation
 - Conflicts between JOA and AMI (e.g. in Joint Exploration and Development Agreements)
- Enforcement
 - S/F issues
 - Rules against perpetuities
 - AMI's need a duration term. An AMI without a duration term may be unenforceable under the Rule Against Perpetuities.
- Potential Danger
 - Large companies highly active in the vicinity of the contract area may enter into separate operating agreements with overlapping AMIs
- Antitrust Issues
 - Potentially affecting AMI and Joint Venture Agreements
 - Covert agreements (e.g. U.S. v. Aubrey McClendon)

DISPUTES WITH FEDERAL AGENCIES

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“THE OBAMA CLIMATE ACTION PLAN AND THE SOCIAL COST OF CARBON”

“SC – CO₂”

- Clean Power Plan
- DOI review of coal exploration
- DOI proposed rule on venting and flaring at E and P sites
- DOI proposed offshore rule for control of emissions in Gulf and OCS (includes mobile sources)
- Proposed Methane rules (OOOO) for “new “and
- 114 information request for existing sources
- Fracing (DOI rule and challenges to the export on natural gas)
- Proposed EPA RMP rules
- PHMSA regulations

EPA's Breakdown of GHG Emissions by Sector 2012

U.S. GREENHOUSE GAS POLLUTION INCLUDES:



CARBON DIOXIDE (CO₂) 82%

Enters the atmosphere through burning fossil fuels (coal, natural gas, and oil), solid waste, trees and wood products, and also as a result of certain chemical reactions (e.g., manufacture of cement).



FLUORINATED GASES 3%

Hydrofluorocarbons, perfluorocarbons, and sulfur hexafluoride are synthetic, powerful greenhouse gases that are emitted from a variety of industrial processes.

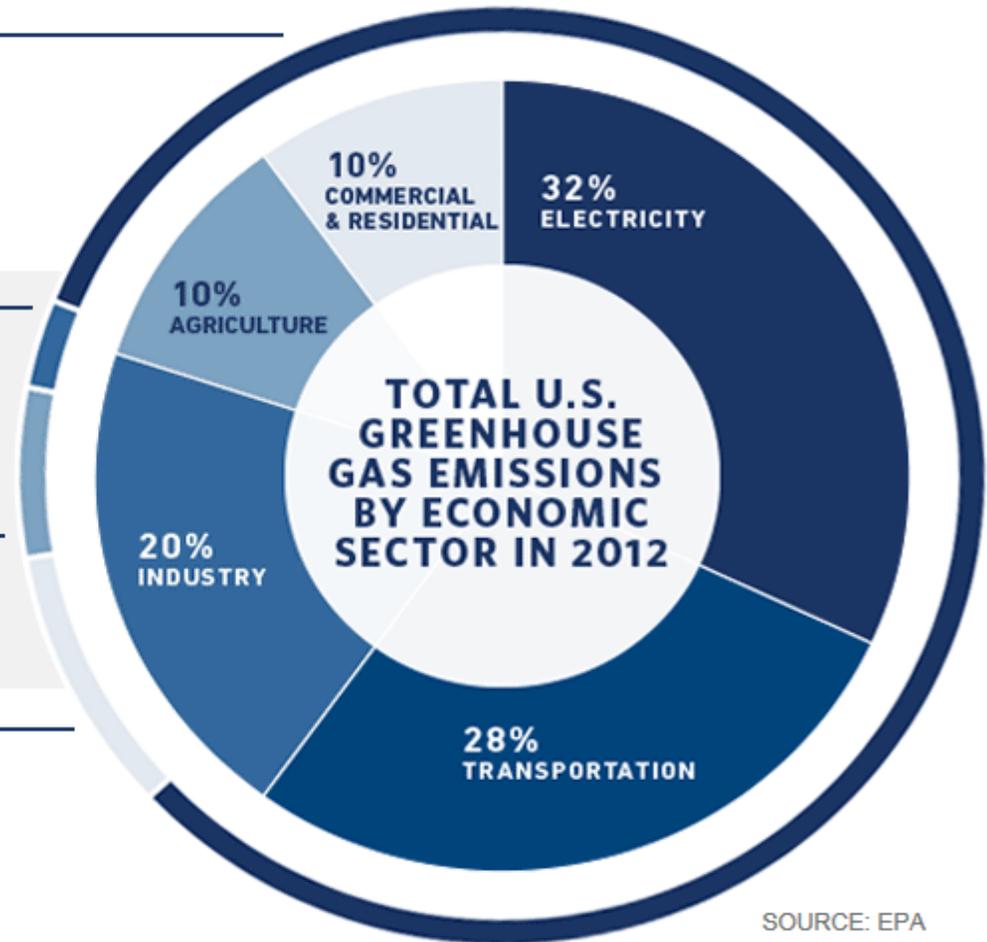
NITROUS OXIDE (N₂O) 6%

Emitted during agricultural and industrial activities, as well as during combustion of fossil fuels and solid waste.



METHANE (CH₄) 9%

Emitted during the production and transport of coal, natural gas, and oil as well as from landfills.



DISPUTES WITH FEDERAL AGENCIES

- Through a Presidential directive there is a coordinated effort among several agencies and departments to reduce greenhouse gas emissions (will quickly highlight current actions by EPA, DOI, DOT, DOC, DOJ and SEC - also refer to Paris COP 21)

<https://www.whitehouse.gov/sites/default/files/image/president27sclimateactionplan.pdf>

- Because of court stay of Clean Power Plan – increased focus on the reduction of methane emissions from E and P facilities
- Emphasis on EPA action because EPA exercises the most enforcement authority. Big picture, the feds are attacking the industry in 3 major ways:
 - Through Rulemaking and Permitting
 - Through Enforcement
 - Through Enhanced Scrutiny of Reporting (Including SEC)

DISPUTES WITH FEDERAL AGENCIES: EPA

– Rulemaking, regulatory process, permits and licenses

- Feds utilizing all rules previously mentioned, plus NEPA, endangered species issues, and FERC action
- OOOO rule for “new” sources – NOTE: existing source subject with modification and aggregation
- [Oil and Gas Operations to be Impacted by Proposed EPA Methane Rule](#)

DISPUTES WITH FEDERAL AGENCIES: EPA

- EPA Data Request for Existing Oil & Gas Sites (114)

NOTE: The new data request" is a rule-making effort, the same as EPA previously tried through enforcement process in Colorado and Pennsylvania

EPA aggressive efforts to slash methane emissions from O&G operations

- [Advocates Urge EPA To Immediately Curb Oil & Gas Activities' Air Toxics](#)
(March 30, 2016)
- [McCarthy Touts Planned ICR As Basis For Strong Oil & Gas Methane Curbs](#)
(March 30, 2016)
- [Timing, Legal Questions Linger Over EPA Existing Oil & Gas Methane Plan](#)
(March 30, 2016)

DISPUTES WITH FEDERAL AGENCIES: EPA

- [Oil & Gas Sector Sees Challenges For EPA Crafting Scope Of Methane ICR](#)
(March 30, 2016)
- [AIR POLLUTION: Revised EPA monitoring regs take effect in April](#)
- [41 companies join EPA effort to slash methane emissions](#)
(March 30, 2016)
- [EPA Launches Voluntary Methane Control Program](#), but the membership list mostly includes utility companies with natural gas interests, not firms involved in exploration and production, and whom EPA doesn't regulate.
- [API group slams EPA's voluntary methane program](#)
(April 1, 2016)

DISPUTES WITH FEDERAL AGENCIES: EPA

- EPA Data Request For Existing Oil & Gas Sites
- Chart: *EPA's Own Data Blows Away Claims That Natural Gas Causes Global Warming*
 - The Sierra Club and other environmental groups have long claimed that the environmental advantages of hydraulic fracturing are negated by increased methane emissions.
 - The EPA states that only carbon dioxide contributes more to global warming than methane, which is responsible for 10 percent of all U.S. greenhouse gas emissions. The EPA own data shows that methane emissions have declined as fracing increased natural gas production, but the EPA still wants to closely regulate methane to reduce global warming.
 - EPA claims that methane rules are needed to address climate change, yet the rule the agency is proposing would avoid a mere 0.004 degrees of warming by 2100,” Dr. Katie Brown, EID. “Meanwhile, natural gas is the reason the United States has achieved such dramatic reductions in greenhouse gases, and EPA’s costly rules could end up curtailing progress. So is this really about emissions?”

DISPUTES WITH FEDERAL AGENCIES: EPA

Enforcement

["We need another Noble \[incident\]"](#)

quote from Cynthia Giles, the Assistant Administrator for OECA, March 31, 2016 at ABA conference

[Noble: \\$73 million dollars in operational changes, \\$4.5 million penalty to EPA and Colorado](#)

DISPUTES WITH FEDERAL AGENCIES: EPA

- April 2015 - Noble Energy, one of the top two drillers in Weld County, CO and one of the leaders in helping form the state's strict new methane emissions regulations last spring, agreed to pay a \$4.95 million fine, plus spend another \$8.5 million on environmental mitigations to combat the rampant volatile organic compound emissions throughout Colorado.
- Settlement agreement to a federal and state investigation into the violations of the Clean Air Act was announced Wednesday, whereby the Environmental Protection Agency stated the company agreed to spend roughly \$60 million in the next four years to upgrade its systems to reduce emissions coming from older equipment in the field. That's a number Noble did official's dispute, however. The company did agree to pay an additional to \$4.5 million to fund environmental mitigation projects, \$4 million on supplemental environmental projects and pay a \$4.95 million civil penalty.

DISPUTES WITH FEDERAL AGENCIES: EPA

Next Generation Compliance and Imaging technology

- EPA's recent shift toward next generation compliance, which focuses more on data than inspections, is the collection of information EPA could use to target facilities for enforcement and provide backing for private parties' toxic tort claims.
 - [Inside EPA](#)
- EPA's increased use of infrared technology to monitor E&P operations
- See Greenies ["Share the Truth" project](#)

DISPUTES WITH FEDERAL AGENCIES: EPA

- Reporting

- SEC action and the threat of RICO action for historically "under disclosing" the impacts of climate change of the entity's activities.
- Shareholder actions that can flow from that, e.g. Plains Pipeline. See HB Client Alert
- Scrutiny of electronic reporting and data mining
- EPA Risk Management Plan program (RMP) - increased scrutiny of reports and whether facilities "follow their plans"
- EPA's more onerous GHG reporting mandates than those for trad'l EOR activities
- [Enhanced Oil Recovery Operators \(EOR\) Operators Raise Legal Concerns Over Existing Source Performance Standards \(ESPS\) GHG Reporting Burdens](#)

(March 16, 2016)

DISPUTES WITH FEDERAL AGENCIES: SEC

- January 2016 – SEC’s Plans to Determine If Additional Action Is Needed on Climate-Related Disclosure Have Evolved



United States Government Accountability Office
Report to the Honorable Matthew
Cartwright, House of Representatives

January 2016

SUPPLY CHAIN RISKS

SEC’s Plans to
Determine If
Additional Action Is
Needed on Climate-
Related Disclosure
Have Evolved

GAO-16-211

DISPUTES WITH FEDERAL AGENCIES: SEC

- [Exxon Mobil must allow climate change vote: SEC](#)
- [Calls for SEC to probe Shell on climate change](#)

DISPUTES WITH FEDERAL AGENCIES: EPA

QUERY: What practical steps can E and P entities take to minimize exposure and/or deal with rules, data gathering and enforcement?

CAUTION: Unemotional review of requirements and impacts on operation

CONSIDER: Challenge the rules and data requests when have concerns (can mitigate costs by coordinating with trade organizations and creating non-profit coalitions).

EVALUATE: Know your operations, and have well documented company RMP and compliance plans in place.

KNOW your regulators before there is an issue.

Consider the benefits and liabilities associated with EPA's requests for operators to go beyond compliance in enforcement settlements.

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DISPUTES WITH FEDERAL AGENCIES: EPA

Additional issues related to Fracing

- Fracing risk to groundwater
 - EPA multi-year study – 6/15 draft report
 - To be revised.... Find support for groundwater contamination, and therefore need for federal rules
 - Expect EPA activist response to any complaint that fracing/oil and gas operations has contaminated groundwater
 - Activist response to any complaint that fracing/oil and gas operations has contaminated groundwater
- [Can the CWA be a problem for oil and gas operators?](#)

DISPUTES WITH FEDERAL AGENCIES: EPA

- [BLM Fracing Rule](#)
- The BLM rule on hydraulic fracturing (March 20, 2015)
- Industry says: Adds redundant regulations for oil and natural gas development on federal and Indian lands, and will particularly discourage investment and job creation in the West.
- On September 30th, 2015, Wyoming Federal Judge Scott W. Skavdahl granted a preliminary injunction of the BLM hydraulic fracturing rule...
 - Finding that “Congress has not authorized or delegated to the BLM authority to regulate hydraulic fracturing...” Judge Skavdahl found that the Independent Petroleum Association of America (IPAA) and Western Energy Alliance are likely to prevail in their challenge to the rule as arbitrary and capricious, and that the states of Colorado, North Dakota, Utah and Wyoming and the Ute Tribe showed that BLM had exceeded its authority.
- [Feds defend fracing rule against judicial hold](#)

DISPUTES WITH FEDERAL AGENCIES: EPA

- “Because Congress has never excluded hydraulic fracturing from BLM’s expressly delegated authority, the district court erred,” the federal lawyers said. “Furthermore, substantial scientific and technical evidence in the record supports BLM’s expert conclusion that today’s greatly expanded hydraulic-fracturing operations pose a risk to groundwater, especially if well casings are inadequately designed or constructed.”

TYPES OF PRIVATE DISPUTES

- Loan Issues
 - [Coming to the Oil Patch: Bad Loans to Outnumber the Good](#)
- Lease Disputes
 - Termination by Lessor
 - Pugh Clause
 - TCOP
 - Continuous drilling provisions in leases
 - Extending leases beyond their primary terms
 - Implied covenant of reasonable development
 - Lessee attempting to hold lease with an uneconomic well
 - Can't use shut-in payments to extend lease if the issue is mechanical or low price. Well must be capable of producing in paying quantities

TYPES OF PRIVATE DISPUTES

- Royalty Disputes
 - Allocation of post-production costs between operator (WIOs) and RIs
 - Class action suits
- Surface Owner v Mineral Owner Disputes (Accommodation Doctrine)
- Nuisance Claims (Neighboring land owner v. operator / pipeline)
 - [EnLink Asks Texas Justices To End \\$2M Pipeline Noise Case \(3/30\)](#)
- Operator/Service Company Disputes
 - MSAs, Drilling contracts
 - Revisions?
 - Allocation of risk of loss in O&G ops
- Farmouts
 - Recorded?
 - Earned interests w/o assignments

What Remedies Do Midstream Companies Have with Production Shortfalls of Contracted E&P Volumes?

Upstream Dilemmas Require Midstream
Responses

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How did we get here?

- Oil and gas industry is, and always has been, extremely creative from a financial perspective
- Upstream - 1/3 for a 1/4
- Need to construct gathering facilities/systems to deliver product to market
 - Lease terms
 - JOA
- Need to finance such construction
- Create a revenue stream to service the debt
- Segregate liabilities between E&P and G&P
- Different owners in each of E&P and G&P
- Different types of investors in each of E&P and G&P
 - Different risk tolerances
 - Desire to direct revenue streams (business and personal)

Further context

- What does “gathering and processing” mean?
- What does “midstream” mean?
- Absence of “black letter” law
- Facts in each case are different
- Each “system” is different
 - Wellhead
 - Lease boundary
 - Contract Area/JOA
 - Easements/ROWs
 - Various diverse combinations of the above

Further context

- Gathering and Processing Agreements are different
 - Different parties with different needs
 - Address different situations on the ground
- Gathering and Processing Agreements within a system are different
- Relevant “Midstream“ Agreements might address:
 - Gathering
 - Processing
 - Transportation/Transmission
 - Any combination

E&P Bankruptcy

- In re Sabine Oil & Gas Corporation, et. al. (Case No. 15-11835) (Bankr. S.D.N.Y.)
- In re Quicksilver Resources, Inc., et. al. (Case No. 15-10585) (Bankr. D. Del.)
- Magnum Hunter

Relevant Contract Provisions

- Dedication of Reserves
 - Produced Minerals
- Acreage Commitment
- Minimum Volume Commitment
- Jurisdiction

Why Should We Care?

- E&Ps in bankruptcy and their secured creditors want to maximize their value
 - Debt for equity swap
 - Possible rejection of contract
 - Loss of value in contract
 - Loss of revenues
 - Transportation fees
 - Processing fees
 - Minimum volume commitment
 - Loss of subject acreage

Executory Contracts

- Covenants running with the land are not property of the E&P's estate and cannot be rejected
- A service contract creating a contractual interest can be rejected (prepetition general unsecured claim)

In re Sabine Oil & Gas Corporation, et. al.

- Sabine did not seek to reject all of its gathering agreements
- Nordheim Agreements
 - Agreed to “dedicate” to the “performance” of the agreement all of the gas produced from a designated area and deliver such gas to Nordheim
 - Nordheim agreed to
 - Gather, treat, dehydrate, and re-deliver gas to Sabine
 - Construct gathering system
 - Minimum annual volume commitment/deficiency payment
 - Agreement itself is a covenant running with the land
 - Separate conveyance of land for facilities

In re Sabine Oil & Gas Corporation, et. al.

- HPIP Agreements
 - Agreed to “dedicate” to the “performance” of the agreement certain leases owned by Sabine and the oil, gas, and water produced from the wells located on the land subject to those leases and deliver that oil, gas, and water to HPIP.
- HPIP agreed to:
 - Construct, operate, and maintain gathering facilities to provide certain services with respect to the products delivered by Sabine
 - Handling Agreement addressed disposal services for water and acid gas

In re Sabine Oil & Gas Corporation, et. al.

- Debtors Satisfied the Standard for Rejection of the Agreements
 - Permit the trustee or DIP to use valuable property of the estate and to renounce title to and abandon burdensome property
 - Determine if assuming or rejecting a contract would be a good business decision or a bad one
 - Interests of the debtor and its estate are paramount
 - Adverse effects on the non-debtor contract party are irrelevant
 - Would a reasonable business person make a similar decision under similar circumstances
 - Agreements are unnecessarily burdensome
 - Will enter into new gathering agreements with other gatherers on terms more favorable to the Debtors
 - No argument that Debtors decision was result of “bad faith, whim or caprice.”
- Nordheim’s Bankruptcy Court oral argument
 - Legal limitation on Court’s authority in the context of the Motion

In re Sabine Oil & Gas Corporation, et. al.

- Court concludes that it cannot decide substantive legal issues, including whether the covenants at issue run with the land, in the context of a motion to reject, unless such motion is scheduled simultaneously with an adversary proceeding or contested matter to determine the merits of the substantive legal disputes related to the motion.
- Federal Rules of Bankruptcy Procedure 6006 and 9014 are trumped by Second Circuit's decision in *Orion* – a summary proceeding to efficiently review the trustee's or debtor's decision
- Not the time or place for prolonged discovery or a lengthy trial with disputed issues
- No procedural clarity or consensus
- Must rule on the Motion “without deciding in a binding way the underlying legal dispute with respect to whether the covenants at issue run with the land.”
- Finds that decision to reject is “a reasonable exercise of business judgment.”

In re Sabine Oil & Gas Corporation, et. al.

- Covenants At Issue Do Not Run With The Land
 - Real covenant or equitable servitude
 - Under Texas law, a covenant runs with the land when:
 - It touches and concerns the land
 - It relates to a thing in existence or specifically binds the parties and their assigns
 - It is intended by the original parties to run with the land
 - The successor to the burden has notice
 - Horizontal privity
 - “simultaneous existing interests or mutual privity” between the original covenanting parties as either landlord and tenant or grantor and grantee.”
 - Requires some additional transactional element to their relationship other than the covenant usually in the form of a reservation of interest (Energytec)
 - Not present here

In re Sabine Oil & Gas Corporation, et. al.

- Mineral estate consists of:
 - Right to develop (the right of ingress and egress)
 - Right to lease (executive right)
 - Right to receive bonus payments
 - Right to receive delay rentals
 - Right to receive royalty payments
- Does not include:
 - Right to transport and gather produced gas
 - Query: How valuable are the some of the other rights without gathering, transporting and processing?

In re Sabine Oil & Gas Corporation, et. al.

- Covenants do not satisfy the “touch and concern” prong
 - Does the covenant affect “the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it?”
 - Are the promisor’s legal relations in respect of the land in question lessened – his legal interest as owner rendered less valuable by the promise ... [and] if the promisee’s legal relations in respect to the land are increased – his legal interest as owner rendered more valuable by the promise.
 - Arguable that the benefit requirement has been abandoned. (5th Cir.)
 - The covenant “must still affect the owner’s interest in the property or its use in order to be a real covenant.”
 - Covenants concern only Sabine’s interests in the produced hydrocarbons which are personal property under Texas law.
 - Contracted-for services
 - Do not have a direct impact upon the real property from which those products were produced (Query: What is the value of the reserves if the product cannot get to market?)

In re Sabine Oil & Gas Corporation, et. al.

- Energytec – right to consent to assignment was a clear burden
 - Secured by a lien on the entire system
- Sabine lienholders did not approve a conveyance of any interest in the land subject to the liens, and they were not informed of any interest being created in the properties.
- Nordheim’s gathering fee not as directly tied to the promisor’s land as was the case in Energytec.

Conclusion and Take-Aways

- Court did not make any final determination as to whether the covenants at issue run with the land or as to any substantive legal issue other than granting authority to reject the contracts under 365(a)
- Rejection must be reasonable under “business judgment” rule
 - What terms are not “market?”
- Pursue evidence of bad faith, whim, or caprice
- Is perfection of liens a possibility?
- What are realistic alternatives for gathering, transport, processing?
 - Common carrier/common purchaser status/tariff/non-discrimination

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