CHAPTER 23

All Good Things Must End
Decommissioning Oil and Gas Facilities
and Bankruptcy Impacts

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All Good Things Must End: Decommissioning Oil and Gas Facilities and Bankruptcy Impacts

I. Introduction

The federal and state regulatory obligations of a lease operator, co-operator or subsequent assignee to conduct decommissioning activities has, due to recent changes in the decommissioning financial regulations, as well as the current financial downturn in the industry and the aging of many off shore assets, created a “trifecta” of unfortunate conditions that significantly impact the lessee’s ability to perform those obligations. This “trifecta” is only complicated by the predicted insolvency, subsequent bankruptcies of many of the smaller operators, potentially mid-size and some larger operators, and the impact a bankruptcy will have on these liabilities. This paper will discuss the “trifecta” of current conditions on the decommissioning obligations: the aging of offshore assets, the continuing industry downturn, and the new regulations that create significant additional financial requirements for lessees. Should these conditions result in a complete inability to conduct decommissioning or establish the new financial requirements, and the oil and gas company files bankruptcy, this paper will discuss the significant impacts of bankruptcy on these obligations and whether the company will be able to survive the bankruptcy process.

II. Aging Assets, Down Market, Increased Regulatory Liabilities – the “Trifecta”

According to The Bureau of Ocean Energy Management ("BOEM") there are 17,841,739 acres of leased land comprising 3,344 total leases in the Gulf of Mexico alone.¹ The Gulf of

¹ BOEM Gulf of Mexico OCS Region Blocks and Active Leases by Planning Area, November 1, 2016; see Attachment “1”.

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Mexico has been the largest region for the number of wells decommissioned (approximately 4,000).² And there are more than 5,000 oil and gas structures on these leases. This does not include the thousands of other platforms off the east or west coast or offshore of other countries. From 2010 – 2014 decommissions averaged approximately 200 per year. In 2015 decommissions average about 145 projects.³ The cost for decommissioning in the Gulf have historically been between $500,000 to $4 million for shallow water structures. Costs increase with water depth due to complexity and size of the structures. These complex structures can comprise hundreds of wells, miles of risers and several ultra-large platforms. Costs for a four-pile structure in 15 meters of water typically costs under $2 million, whereas structures in 100 meters of water will cost nearly double that to dismantle. The North Sea involves much larger structures and costs for one gravity based system with a 22,500 ton topside and a 180,000 ton substructure has an estimated decommissioning cost of $2 billion.⁴ Decommissioning costs are expected to rise from approximately $2.4 billion in 2015 to $13 billion by year 2040, or an increase of 540 percent.⁵ More than 600 structures are expected to be decommissioned in the next five years alone.⁶ It is expected that 2,000 offshore projects will be decommissioned between 2021 and 2040 and the total cost from 2010 to 2040 will amount to $210 billion.⁷

Decommissioning obligations for offshore assets has become increasingly more complex and expensive, due to three primary factors. First, the inventory of many of these structures are

² HIS Markit Offshore Decommissioning Study Report, November 29, 2016
⁵ Id.
⁶ Id.
⁷ Id.
nearing their “end of life” status and the aging structures of those platforms, especially in deep water, are vastly more complex than those in more shallow depths, requiring more complicated and expensive technical requirements for decommissioning. Many of those assets must be decommissioned as their life expectancy is very limited if not gone.

The second factor directly impacting the ability to decommission these wells is the overall downturn in the industry. Cash strapped companies have been delaying the start of the decommissioning process and have been actively skirtig spending money on plugging and abandonment.8 While the number of shut-in wells has increased throughout the last 18 months of depressed commodity prices, decommissioning activity has decreased during the same period. Only 64 structures including pipelines and platforms have been removed in 2016 according to BOEM data.9 Despite the BOEM’s “idle iron” policy requirements that unprofitable wells must be plugged and platforms dismantled five years after they have reached the end of their useful lives, certain loopholes have allowed idle structures to sit in the ocean for decades.10

Historically, larger upstream companies would divest assets that have become expensive to operate resulting in lower margins, typically selling them to small independent operators. These companies are able to operate them at lower costs and obtain better cash flow from these assets, at least initially.11 As the assets diminish beyond a certain point, the independents then divest them to smaller, more speculative specialties companies often in package deals. The assets are divided into cash flow positive and cash flow negative categories. The specialist companies

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9 Id.
10 Id.
11 Asset Abandonment in Upstream Oil: A Growing threat to the Sector, December 2, 2015, Bardi, Marten Mikhailov and Streubel.
seek to boost production in the former and strive to dispose of the latter as quickly and at a low cost as possible.\textsuperscript{12} This system has worked adequately in the past, transferring an asset three to five times before the asset matured to the point where decommissioning was required. However with the increasing number of mature, aging assets that will ultimately need to be abandoned, and the inability of these assets to make money at the significantly reduced market margins in today’s economy, more and more are requiring decommissioning.\textsuperscript{13} A final problem with these aging assets is that most operators and oilfield service operators have not invested in the development of new technology designed for dedication to abandonment. Most abandonment jobs are performed with the same tools used for drilling and completion. This underinvestment in decommissioning technologies raises upstream costs as well as significantly lengthens the time to complete the decommissioning of a well.\textsuperscript{14}

Compounding matters is the fact that these challenges - downturn in the commodity prices and resulting industry slump, and the significant costs of dismantling, plugging and abandoning aging assets, is exacerbated by the new stiffening regulations enacted this year by the BOEM to establish operators financial assurance responsibility and to ensure they have sufficient resources to timely decommission assets.

The Outer Continental Shelf Lands Act (“OCLSA”) provides the Secretary of the Interior with the authority to require bonds or other forms of financial assurance for oil and gas leases in the Outer Continental Shelf (“OCS”). That authority has been delegated to the BOEM which has promulgated regulations governing the financial assurance requirements. These requirements

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\textsuperscript{12} Id.
\textsuperscript{13} Id.
\textsuperscript{14} Id.
mandate that owners and operators of leases, rights of use and easement ("RUE") and rights-of-way ("ROW") must post general lease surety bonds in amounts from $50,000 - $3,000,000 depending on the type of lease activity.\textsuperscript{15} The regulations also require the holders of OCS leases to post “supplemental bonds” in an amount determined by the Bureau of Safety and Environmental Enforcement ("BSEE") to be adequate for exploration, well planning and development and more importantly, to meet decommissioning responsibilities and to avoid environmental impacts.\textsuperscript{16}

Previously, from 2008 until this year, operators provided financial assurance under the BOEM’s Notice To Lessees - NTL 2008-No7 which stated that if a company had $65 million in net worth and did not have plugging and abandonment liabilities greater than half of its net worth, it was “exempt from providing “additional security” or supplemental bonds pursuant to 30 C.F.R. §556.901(d) and 30 C.F.R. §550.1011.

On July 14, 2016 the BOEM enacted a new policy establishing increased financial assurance requirements for oil and gas decommissioning on the OCS which became effective September 12, 2016. The new requirements listed in the “Notice to Lessees 2016-No1 (NTL 2016-No1) changes the decommissioning requirements in two very fundamental ways. First, it changes the way that BOEM calculates financial strength and reliability of the operators and lessees. Second, it significantly allocates far more capital and resources than previously required to cover decommissioning costs. Now under NTL 2016-No1, updated financial criteria will be utilized to determine the level of “self-insurance” for each company or operator, thus, allowing the BOEM much greater leeway to exercise discretion as to supplemental bonding terms and

\textsuperscript{15} 30 C.F.R. §556.900.  
\textsuperscript{16} 30 C.F.R. §556.901.
amounts. Gone are the days of outright exemption from posting financial assurance or supplemental bonds. Companies will now be required to make an annual showing of the “financial ability to carry out obligations” on each lease, pipeline ROW and RUE. The BOEM will also be able to make an analysis of a company’s ability to pay any time it determines that there has been a “material or adverse change in financial strength or OCS obligations”. Finally, these requirements will apply to each company as if it has a sole interest in the OCS lease or obligation in which it has an interest. No longer will the BOEM allow risk pooling among multiple companies who have a shared interest in a lease, meaning that the BOEM can assign 100% decommissioning liability to any company for any lease in which that company has an interest.

Under NTL 2016-No1, the BOEM has indicated that it will look to five criteria for determining the financial ability to meet future decommissioning obligations.

1) Financial capacity – a company must be able to demonstrate that it can meet both short term and long term financial capacity in excess of its current lease obligations. The company must prove that it meets minimum thresholds for several financial ratios: Cash Flow from Operations/Total Debt; Earnings before interest and taxes/interest expense; return on equity; total debt/capital and total debt/equity.

2) Projected financial strength – that the estimated value of its existing production in the OCS and proven reserves substantially exceeds current and future lease obligations.

3) Business stability – that the company can maintain continuous OCS or onshore operations and production for a period of five years or more.

4) Reliability – the company’s credit rating from Moody’s or Standard and Poor’s and/or trade references.

5) Record of compliance – Have civil penalties been assessed against the company or any of its affiliates? Is the company in compliance with BOEM or BSEE leases, plans and permit terms and conditions? Has the company been cited for
any non-compliance with federal requirements for operation in the OCS? And finally, are there any outstanding debts to the government from non-payment of rents, royalties or inspection fees.

Failure to meet these requirements will result in an Order requiring the Company to post additional surety bonds, pledge of U.S. Treasury Securities or a “tailored financial plan” within 60 days of the date the company received the Order. Such plans could take the form of escrow accounts, guarantees, surety bonds, treasury securities or payments over time. You may even deposit monies into a “lease specific abandonment account” under which the BOEM has set up specific criteria to establish adequate funding to ensure compliance.\(^\text{17}\) This can even include a requirement that the operator provide to BOEM an overriding royalty or production payment obligation to satisfy the financial assurance requirements.\(^\text{18}\)

The real issue, however, is that the surety bond market is very limited, especially for the smaller companies with limited assets. In addition to the bond market being very limited, the costs of the premiums are extremely expensive and the collateral required can be as much as 100\% of the bond. Failure to comply with these additional supplemental bond/financial assurance requirements will result in the BOEM or BSEE suspending production, canceling leases, or seeking civil penalties including temporary restraining orders, injunctions or “other appropriate remedies” to enforce compliance with the regulations that the company decommission its assets.\(^\text{19}\)

It is also important to note that the government also has the authority under these regulations to also seek criminal penalties for any violation whereby a person “knowingly and willfully”

\(^{17}\) 30 CFR §556.904.

\(^{18}\) 30 CFR §556.904(e).

violates any provision or regulation under the Outer Continental Shelf Lands Act which are “designed to protect health, safety, or the environment or conserve natural resources”.20

What events lead to the significant increase in the financial assurance requirements? The BOEM maintains that the former bonding requirements were originally drafted to address risks associated with the non-payment of rents and royalties on leases and for non-compliance with laws and regulations, not to address significant costs of decommissioning. However, it must be considered that the BOEM has faced several recent bankruptcies of operators who simply did not have the financial wherewithal to address huge decommissioning obligations and the existing bonds were completely inadequate to cover those obligations – thus creating the fear by the government that these bankruptcies will cause those decommissioning obligations to be covered by the government and taxpayers.

What are the predicted effects of these new financial requirements and supplemental bonds? The news media and many industry trade journals have predicted dire consequences from the new decommissioning obligations.

“Opportune estimates that the offshore drilling and service industries will lose approximately $9 billion of future revenue over the next 10 years as a direct result of the new NTL….The NTL will result in reduced offshore drilling and production, particularly in the shallow water of the OCS…The NTL will result in sharply lowering US royalty revenue as operators scale back production…The NTL will cause reduced revenues and operations for companies serving the OCS offshore industry, resulting in a commensurate loss of jobs and community/tax revenues along the Gulf Coast, particularly in Texas and Louisiana. Smaller independent oil and gas operators will be unable to obtain the required supplemental bonding: the NTL will become a catalyst to spur the bankruptcy risk from which it was intended to protect the U.S. taxpayer.”21

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20 43 U.S.C. §1350(c).
21 New BOEM regulations threaten Independent Gulf of Mexico operators, Opportune, Josh Sherman, September 9, 2016.
Given that more than 150 oil and gas companies have filed for bankruptcy over the last 18 months, these predictions may, unfortunately, have a basis in reality.\(^{22}\)

III. Impacts of Bankruptcy

Should these dire predictions come to pass, then operators will either have to sell off assets, or if unable to do so the decommissioning obligations could drive a company into bankruptcy. To understand the ultimate effect of the bankruptcy, we should look at both the statutory and regulatory framework surrounding the authority the government has over these oil and gas assets and decommissioning obligations, and how the bankruptcy process will impact both the Debtor and other parties equally liable for these decommissioning liabilities.


The Outer Continental Shelf Lands Act (OCSLA) 43 U.S.C. §§ 1331-56, gives the United States jurisdiction over the mineral resources found in submerged lands in the OCS.\(^{23}\) The OCS includes an area extending from the offshore state boundary to at least 200 nautical miles from that boundary out in the ocean.\(^{24}\) The Secretary of the Interior controls the disposition of mineral resources in the OCS through oil and gas leases.\(^{25}\) Requiring a debtor to comply with the decommissioning obligations attendant to its Leases, including the retirement of inactive wells, plugging and abandonment of those wells and the submission of performance bonds, is a primary goal of the Department of the Interior as the environmental steward of the

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22 Dangers in the Deep: a $40BN time bomb threatening the Gulf, pg. 5.
It is the objective of the United States that (1) the OCS be developed “subject to environmental safeguards” and (2) operations be conducted in safe manner to “prevent or minimize the likelihood of occurrences that may cause damage to the “environment or to property, or endanger life or health.”

The decommissioning obligations, including bonds on active leases to ensure proper decommissioning, take on particular importance because “idle infrastructure poses a potential threat to the OCS environment,” and “the presence of idle platforms may harm navigation safety.” To address those concerns, federal law requires OCS lessees perform decommissioning on inactive wells and submit bonds to secure the lessee’s decommissioning performance on active wells.

The specific regulatory requirements apply to the following entities:

(a) Lessees and owners of operating rights are jointly and severally responsible for meeting decommissioning obligations for facilities on leases, including the obligations related to lease-term pipelines, as the obligations accrue and until each obligation is met.

(b) All holders of a right-of-way are jointly and severally liable for meeting decommissioning obligations for facilities on their right-of-way, including right-of-way pipelines, as the obligations accrue and until each obligation is met.

(c) In this subpart, the terms “you” or “I” refer to lessees and owners of operating rights, as to facilities installed under the authority of a lease, and to right-of-way holders as to facilities installed under the authority of a right-of-way.

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30 30 C.F.R. §250.1700, et. seq.
The obligation to undertake decommissioning responsibilities first occurs when the owner/operator does any of the following:

(a) Drills a well;
(b) Installs a platform, pipeline or other facility;
(c) Creates an obstruction to other users of the OCS;
(d) Are or becomes a lessee or the owner of operating rights of a lease on which there is a well that has not been permanently plugged according to this subpart, a platform, a lease term pipeline, or other facility or an obstruction;
(e) Are or becomes the holder of a pipeline right-of-way on which there is a pipeline, platform, or other facility, or an obstruction; or
(f) Re-enters a well that was previously plugged according to this subpart.\(^{31}\)

The regulations also require that all wells be plugged and abandoned within one year after the applicable federal oil and gas lease expires.\(^{32}\) Additionally, the regulations provide that platforms and other facilities are to be removed and the site remediated within one year after the lease or right-of-way terminates.\(^{33}\) Further, BSEE can order plugging a well if it determines that the well poses a hazard to safety or the environment or is not “useful for lease operations and is not capable of oil, gas…production in paying quantities.”\(^{34}\)

As described above, the failure to meet decommissioning requirements, including the new “supplemental bonding” requirements, constitutes a violation of the terms of an OCS lease and avails the government of the remedies outlined in 43 U.S.C. § 1350, including temporary restraining orders and injunctive relief. If an OCS lessee fails to meet bonding obligations, The

\(^{31}\) 30 C.F.R. §250.1725.
\(^{32}\) 30 C.F.R. §250.1725.
\(^{33}\) 30 C.F.R. §250.1725.
\(^{34}\) 30 C.F.R. §250.1711.
BOEM may suspend operations, initiate actions to cancel the lease, or other appropriate action, including requiring the immediate decommissioning of the facility.\textsuperscript{35}

[2] **Texas Decommissioning Obligations**

Texas law applies to onshore wells and to an area offshore extending up to three geographical miles from the state’s coast.\textsuperscript{36} The Texas Natural Resources Code states the decommissioning obligations is to be enforced by the Texas Railroad Commission.\textsuperscript{37} This section provides that: “…the protection of water and land of the state from pollution or the escape of oil and gas is in the public interest.” Under the Administrative Code, well operators must plug a well that has been inactive for a year or longer.\textsuperscript{38} Failure to plug and abandon an inactive well could result in civil fines of up to $10,000 per day if such failure “could” result to harm to the environment.\textsuperscript{39}

While the Texas regulations also require financial assurance, those requirements are significantly less than what is now being required by BOEM and BSEE. Further, Texas maintained a service fund paid into by operators as a fee on each barrel of oil sold. The fund is used to plug any well where the operator does not have the funds to do so. The State then seeks to recover those costs from the operator, if possible. It is uncertain if the fund is sufficient to cover decommissioning obligations if more and more operators are forced into bankruptcy by the increased decommissioning cases.

\textsuperscript{35} 30 C.F.R. §556.900(h), 30 CFR 250.173, 30 CFR 500, subpart N.
\textsuperscript{36} 43 U.S.C. §1312.
\textsuperscript{38} 16 Tex. Admin. Code §3.14(b)(2) (2007) (“Plugging operations on each dry or inactive well shall be commenced within a period of one year after drilling or operations cease and shall proceed with due diligence until completed.”)
\textsuperscript{39} Tex. Nat. Res. Code §85.381.
Can a Debtor in Bankruptcy Avoid Decommissioning Obligations?

Federal law requires the Debtor in bankruptcy to manage the bankruptcy estate in accordance with state and federal law, which includes obligations to prevent environmental damage. This compliance requirement extends to Debtor’s compliance with laws on decommissioning of oil and gas wells. Due to this, the Debtor does not, in the bankruptcy, have the right or ability to ignore compliance with these obligations even if to do so would relieve the Debtor of financial obligations, like the financial assurance obligations or the decommissioning obligations, and provide the Debtor with the ability to effectively reorganize.

The Supreme Court in Midlantic, in the bankruptcy context, held the requirement that a Debtor must comply with health and environmental obligations, includes restricting debtor’s (or trustee’s) ability to abandon property in contravention of any regulation or law that is designed to protect the public health or safety from environmental hazards. Thus, because the plugging and abandonment requirements under the decommissioning regulations are specifically designed to prevent environmental hazards, a debtor cannot ignore those obligations and abandon the assets.

The Fifth Circuit relied upon Midlantic specifically to address plugging and abandonment obligations for decommissioning wells. In the case of Matter of H.L.S. Energy, the Fifth Circuit ruled specifically that “under federal law, bankruptcy trustees must comply with state law... and there is no question that under Texas law, the owner of an operating interest is

40 28 U.S.C. § 959(b); see, e.g., In re H.L.S. Energy Co., 151 F.3d 434, 438 (5th Cir. 1998); In re Am. Coastal Energy Inc., 399 B.R. 805, 809 (Bankr. S.D. Texas. 2009) (“Bankrupt debtors are no different from any citizen in that they must comply with state and federal laws.”)
41 Id. at 8410-12.
43 H.L.S. Energy, 151 F.3d 434 (5th Cir. 1998).
required to plug wells that have remained unproductive for a year.” Thus, the Trustee was not allowed to either abandon the wells “in contravention of a state law reasonably designed to protect public health or safety,” or to escape the obligation to address the plugging and abandonment requirements. More importantly, the Fifth Circuit held that this decommissioning obligation was an “actual and necessary” expense of administering the bankruptcy estate pursuant to 11 U.S.C. §503. In the bankruptcy context, the order of payment to creditors is generally is that administrative expenses are paid first. Those are considered to be the “actual and necessary” expenses of administering the estate, (current bills, certain tax obligations, certain wage claims, professional fees etc.) Next in priority of payment is secured claims, then unsecured claims and finally, equity claims. The Fifth Circuit in *H.L.S. Energy* made clear that the decommissioning obligations stood to be paid first with other administrative expenses.

There has been some inconsistency in case law on the Debtor’s right to abandon oil and gas assets and avoid the administrative expense characterization of the decommissioning obligations – based primarily on arguments on exactly when those obligations “accrue.” In some mostly older cases, courts have allowed for the abandonment of wells holding that the *Midlantic* limitation on abandonment was a narrow “exception” which only applied in cases where there was some imminent or substantial endangerment or harm to public health or safety.  

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44 Id. at 438.
45 Id. at 438.
46 Id.
47 *In re Howard*, 533 B.R. 532,545 (Bankr. S.D. Miss. 2015); see also, *In re Allied Natural Gas Corporation*, 99-33127 (USBC SDTX); *In re Tri-Union Development Corporation*, 03-44908 (USBC SDTX); *In re Cronus Offshore, Inc.*, 05-36492 (USBC SDTX).
However, most courts have decided the decommissioning obligations are post-petition obligations allowing for administrative expense status. For instance, in *American Coastal Energy*, the debtor argued that the decommissioning obligations were not administrative expenses under U.S.C. §503(b)(1)(A) because those obligations arose before the bankruptcy was filed, or “pre-petition.” The court disagreed and said that these were not the same type of obligations as typical vendor trade obligations and because these obligations continued post-petition:

A debtor’s obligation to expend funds to bring the estate into compliance with a state health and safety law is not contingent upon whether the obligation arose before or after the bankruptcy filing. State law imposes a continuing duty to plug the wells at issue. That continuing state law health and safety duty makes the plugging obligation a post-petition obligation that has pre-petition antecedents. Accordingly, with respect to these environmental liabilities, whether the liability arose pre-petition or post-petition produces an analysis that is superficial. The analysis must focus not on just when the obligation arose, but whether the obligation continues to arise anew with the passage of each day.

Thus, despite under these facts the decommissioning obligation first accrued when the wells were initially drilled, the plugging and abandonment and related decommissioning obligations continue post-petition until “each obligation is met,” which the majority of courts characterize as administrative claims.

**IV. Obligations of Third Parties to Undertake the Decommissioning Obligations**

As described above, the larger oil and gas companies routinely sell off assets/leases to smaller, less financially secure entities where the margins to operate those leases are small and the profits are dwindling. It is likely these smaller operators will be unable to withstand the

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49 *Id.* at 808.3
50 *Id.*, at 811.
51 30 C.F.R. §250.1702(a)-(f).
“trifecta” of aging assets, industry downturn and new expensive decommissioning obligations, and will likely be the first to file for bankruptcy protection. If so, the majors who are predecessors-in-interest (or perhaps co-lessees) will likely find themselves obligated to make either financial assurance payments to the applicable regulatory agency for decommissioning of oil wells or undertake the decommissioning obligations at their own expense, and then seek reimbursement from the bankruptcy estate.

There are certain regulations that govern the sale or assignment of leases and the subsequent liabilities of the prior and current lessee/operator. An entity may assign its lease in the following circumstances:

(a) With BOEM approval, you may assign your whole, or a partial record title interest in your entire lease, or in any aliquot(s) thereof.

(b) With BOEM approval, you may sever all, or portion of, your operating rights.

(c) You must request approval of each assignment of a record title interest and each sublease for an operating rights interest. Each instrument that transfers a record title interest must describe, by aliquot parts, the interest you propose to transfer. Each instrument that severs an operating rights interest must describe, by officially designated aliquot parts and depth levels, the interest proposed to be transferred.52

Once those obligations and rights have been assigned, the assignor remains liable:

If you assign your record title interest, as an assignor you remain liable for all obligations, monetary and non-monetary, that accrued in connection with your lease during the period in which you owned the record title interest, up to the date BOEM approves your assignment. BOEM’s approval of the assignment does not relieve you of these accrued obligations. Even after assignment, BOEM or BSEE may require you to bring the lease into compliance if your assignee or any subsequent assignee fails to perform any obligation under the lease, to the extent the

52 30 C.F.R. §556.700.
obligation *accrued before* approval of your assignment. 53(emphasis added)

Finally, a record title holder’s sublease of operating rights likewise remains liable:

(a) A record title holder who subleases operating rights remains liable for all obligations of the lease, including those obligations *accruing after* BOEM’s approval of the sublease, subject to §556.604(e) and (f). (emphasis added)

(b) Neither the sublease of operating rights, nor subsequent assignment of those rights by the original sublessee, nor by any subsequent assignee of the operating rights, alters in any manner the liability of the record title holder for nonmonetary obligations.

(c) Upon approval of the sublease of the operating rights, the sublessee and subsequent assignees of the operating rights become primarily liable for monetary obligations, but the record title holder remains secondarily liable for them, as prescribed in 30 U.S.C. §1712(a) and § 556.604(f)(2).54

The result is these regulations create continuing liability for decommissioning obligations and plugging and abandonment requirements for predecessors and assignors. If current operators and assignees fail to undertake these liabilities, since these obligations “accrued” before the transfer or assignment, and the liabilities continue to exist post-transfer, assignors remain liable.

By way of example, in *GOM Shelf*55 the Court looked to 30 C.F.R. §250.1702(d), which as stated above, the decommissioning obligations “accrue” when the operator “becomes a lessee or the owner of operating rights of a lease on which there is a well that has not been permanently plugged according to this subpart, a platform, a lease term pipeline, or other facility or an

53 30 C.F.R. §556.710.
54 30 C.F.R  §556.711.
obstruction.” Since the plugging and abandonment liabilities occurred before the assignment, the assignment would not relieve the assignor of their decommissioning liabilities.56

If such liabilities fall to the predecessor or co-lessee, can the predecessor or co-lessee recover its costs for the decommissioning obligations in the bankruptcy? Only in limited circumstances. Because the above-referenced regulations allow joint and several liability of the debtor and predecessor entities to BOEM and BSEE, then the debtor and predecessor are “co-liable” parties for these decommissioning obligations. The predecessor would have a “contingent” claim against the debtor for cost expended for the plugging and abandoning the wells. Contingent claims are difficult to recover in a bankruptcy. This is because the Bankruptcy Code57 provides that if the claim is “contingent” or “unliquidated” (because it is not yet paid) at the time it would be normally be allowed or disallowed by the Court, then it is disallowed:

…the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claims of a creditor, to the extent that –

…(B) such claim for reimbursement or contribution is contingent a of the time of allowance or disallowance of such claim for reimbursement or contribution;58

Once the predecessor or co-lessee pays the claim, it is no longer “contingent” or “unliquidated,” and the predecessor can file a claim in the bankruptcy. By way of example, in

Tri-Union Development, the bankruptcy court disallowed the contingent liability claims for

56 Id. at *10.
57 Section 502(e)(1).
decommissioning obligations brought by predecessors and co-lessees until those parties undertook the liabilities and actually paid the claims. 59

At that point, the issue becomes what type of claim the predecessor or co-lessee has? As discussed above, decommissioning obligations have been held by many courts to be administrative claims against the estate – or first in priority, because they are “actual” and “necessary” expenses of the existing debtor under 11 U.S.C §503. 60 But the right of a predecessor to assert the claim as administrative expense depends on when those liabilities are actually paid by the predecessor. Should the predecessor undertake the decommissioning liabilities either after the deadline has passed to file a proof of claim – “the bar date” or certainly after the plan has been voted on and approved, then the predecessor has lost the opportunity to make a timely administrative claim. Even if the predecessor does undertake the decommissioning liabilities in sufficient time to assert an administrative claim, there’s no guarantee that the debtor will have sufficient resources in the estate to satisfy those administrative claims, as will be seen below.

The predecessors and co-lessees would also have the ability to assert contribution claims against other co-liable lessees or predecessors in the chain of title for costs expended in undertaking plugging and abandonment obligations of the debtor, whether or not BOEM or BSEE seek to have the others undertake those liabilities during the bankruptcy. This has the additional benefit of subrogating those costs to the economic rights of the United States, again providing the predecessor with an administrative claim in the debtor’s bankruptcy. 61

60 See, e.g. American Coastal Energy, 399 B.R. at 616.
V. Real World Examples

How has this worked in actual bankruptcies? The first major bankruptcy in which these obligations were tested was the ATP Oil & Gas Corporation bankruptcy case filed in Houston.62 Bear in mind, however, that most of the issues surrounding the decommissioning obligations in this case occurred before the BOEM introduced the new financial assurance requirements. Many feel that the ATP case was actually the catalyst for the BOEM instituting the new financial requirements given the total inability of the debtor to pay for decommissioning its wells. The government became seriously concerned that this would result in those obligations falling to the government and ultimately, the tax payers.

In the ATP case, the Debtor entered into a settlement agreement with the BOEM and Department of the Interior whereby the Debtor would undertake the decommissioning obligations for their “Idle Iron Blocks” leases (those leases which hold no further utility) and the Debtor would pay for the decommissioning liabilities rather than post supplemental bonds or provide alternate financial security. The Debtor also attempted to set up five Decommissioning Trust Agreements to undertake the decommissioning obligations for other leases by payment of three separate installments for the plugging and abandonment work. Despite these measures, the Debtor still did not have sufficient funds to decommission all its assets and the BOEM looked to Anadarko as the predecessor-in-interest on some of the properties, previously owned by Anadarko, to undertake the decommissioning liabilities and prevent health and environmental impacts. Despite a hard fight and a ten year interval since assignment, Anadarko had to undertake $100 million in liabilities associated with the transferred leases. Although the Court

62 Id.
was actually sympathetic with Anadarko’s plight in having to undertake the decommissioning liabilities, it ruled that as in most circumstances in bankruptcy, Anadarko undertook that credit risk when it assigned the leases to ATP:

The Court is not unsympathetic to Anadarko. It may be forced to bear a substantial cost as a result of ATP’s financial woes. Nevertheless, like many things in a bankruptcy case, the cost that Anadarko may bear is a reflection of the credit risk it took. Anadarko sold a portion of the Gomez Properties to ATP, and required ATP to bear the financial burden of plugging and abandonment in accordance with the applicable federal law. This unfortunate position is no different from that of any other creditor that relies on the promise of performance from an eventually failed entity.63

To make matters worse, although Anadarko did undertake those decommissioning liabilities in sufficient time to assert an administrative claim in the estate, the Debtor converted to a Chapter 7 liquidation and was simply out of money. Anadarko, unfortunately, was stuck with the expense and only recovered 1% of the $100 million it was required to pay.

In the case of Black Elk Energy,64 shortly after the case was filed BSEE issued a “shut in” order due to non-compliance issues, in large part because the Debtor was unable to comply with bonding obligations for decommissioning. BSEE then filed a claim against the estate for over $700 million in decommissioning liabilities. Eventually, under the order approving the bankruptcy plan, the Debtor set up a liquidating trust into which the Debtor’s OCS leases (but for those discussed below) were transferred.65 It became the liquidating trust’s responsibility to sell those leases and return cash to the bankruptcy estate. The liquidating trustee pursuant to the Decommissioning Agreement between the liquidating trust and the government, was also

63 Id. at *3.
64 In re Black Elk Energy Offshore Operations, Case No. 15-34287 (Bankr. S.D. Tex)
65 Id. In order to effect the decommissioning of one’s assets, the liquidating trust and the federal government entered into a “Decommissioning Agreement.”
required to undertake those decommissioning obligations utilizing “government assets,” defined as bond proceeds and moneys obtained from a litigation trust during the pendency of the bankruptcy. Any assets remaining in the government’s possession or care after all decommissioning obligations were finalized, if any, escheated to the United States.\textsuperscript{66} However, one of the predecessors in liability was able to protect itself from these decommissioning liabilities as is described in the next section.

The last recent Houston case of note is \textit{Energy XXI Ltd.} filed April 14, 2016.\textsuperscript{67} The Debtor had approximately $226 million in lease or area bonds issues to BOEM for the decommissioning obligations at the time it filed for bankruptcy. However, BOEM in April 2015 had demanded another $1 billion. The company reached an agreement with BOEM to initially supply another $150 million in supplemental bonds, but the BOEM later indicated that this was not sufficient. The Debtor came up with an additional $21 million and entered into a “Long Range Plan” with the BOEM for financial assurance prior to the filing of the bankruptcy, which will require the Debtor to provide additional financial assurance over time. That document was deemed to be confidential and not disclosed as part of the Plan. Last month, the Debtors Plan was approved by the Bankruptcy Court, wherein the Debtor proposed to retain all of its oil and gas leases and to assume all obligations for decommissioning liabilities as required by the BOEM, as well as pay any financial assurance required by the BOEM.

But here, one of the predecessors in interest, Exxon Mobil, was issued $225 million in undrawn letters of credit by the Debtor as financial security under a purchase and sale agreement \textit{at the time} the Debtor bought the leases. These letters of credit were specifically to guarantee the

\textsuperscript{66} Id.
\textsuperscript{67} \textit{Energy XXI, Ltd.}, 16-31928 (USBC)(SDTX).
decommissioning liabilities of those leases sold to the Debtor by Exxon. So these letters of credit stood as good security for those liabilities. Clearly, this is one of the best success stories to come out of these types of bankruptcy cases!

VI. How Can You Protect Your “Predecessor” Company?

As can be seen from the Anadarko example in the ATP case, even if you are fortunate enough to get an administrative claim, it may not result in much recovery if the Debtor is truly cash/asset strapped. There are some other suggestions to prevent your company from having to “step up to the plate” as a predecessor or co-lesser. First, consider creating a Plugging and Abandonment Escrow Account (“P&A” Escrow) and an Escrow Security Agreement (“ESA”) in your Purchase and Sale Agreement (“PSA”) when you assign your rights in the OCR leases to another entity. This was done effectively in Black Elk Energy Offshore Operations. Various Merit Management Partners entities had entered into a PSA with Black Elk to assign various OCS leases and created a P&A Escrow in which the parties agreed to retain $60 million and retained a security interest in the funds through the ESA. Merit retained rights in the account to allow it to undertake appropriate actions and take over the account if a governmental entity required plugging and abandonment activities for the leases assigned. This agreement also designated the company to undertake the plugging and abandonment work at a fixed price. Black Elk was required to fund a portion of the P&A obligations, but if it could not, then it issued promissory notes to Merit for the amount Merit needed to take out of the fund. That promissory note was then secured by the cash collateral held by the P&A bonding companies, such that Merit could then reimburse the P&A Escrow Account from those bonding sureties once it paid for the decommissioning obligations and obtained reimbursement from the sureties. This
scenario allowed compliance with federal decommissioning requirements, reduced the risk of an oil spill, resolved many safety and compliance issues. It also did so at a decommissioning cost already fixed by contract, which was beneficial to a cash strapped estate. Finally, this allowed the BOEM, upon completion of the decommissioning work, to cancel the requirement for supplemental bonding. At this point, the bonding companies could release the cash collateral held to secure the supplemental bonds. Admittedly, this only applied to those leases assigned to Black Elk by Merit, and Debtor, Black Elk still retained liabilities for other wells. This financial arrangement benefited the Debtor’s estate because those decommissioning obligations were not a drain on the bankruptcy, and it could focus on the other P&A liabilities. Merit, as the predecessor, was also protected from incurring the kind of liability faced by Anadarko.

VII. Conclusion

The unfortunate trifecta now faced by the industry with aging offshore assets, very low commodity prices, and new, more significant financial assurance requirements by BOEM and BSEE for decommissioning obligations, has and may continue for the foreseeable future, forced small to mid-sized operators into bankruptcy. It has been predicted that offshore drilling and service industries will lose approximately $9 billion of future revenue over the next 10 years as a result of these factors (assuming a $75/bbl price). But with more creative financial transactions, including escrow agreements and retaining security interests in those escrow accounts and bonding instruments, predecessors can protect themselves from the potential overwhelming decommissioning liabilities that will inevitably arise in the future.

68 New BOEM regulations threaten Independent Gulf of Mexico operators, Opportune, Josh Sherman, September 9, 2016.
ATTACHMENT 1