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# Decommissioning Oil and Gas Assets: Regulatory Issues, Liability, Managing Disputes, Disposal of Structures and Waste

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

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# All Good Things Must End: Decommissioning Offshore Oil and Gas Facilities and the Impact of Insolvent Operators

## I. INTRODUCTION

Changes to federal and state regulatory obligations of a lease operator, co-operator or subsequent assignee on the requirements for decommissioning activities, including recent changes to the financial regulations attached to decommissioning, along with volatility in the industry and the aging of many offshore assets created a trifecta of negative conditions that significantly impact a lessee's ability to perform those obligations. The trifecta can be further complicated by the insolvency (and subsequent bankruptcy) of smaller operators, potentially mid-size and some larger operators, and the impact insolvency will have on these obligations.

This paper discusses this confluence of conditions complicating decommissioning obligations. Should a lessee come to a complete inability to conduct decommissioning or establish the new financial requirements and file for bankruptcy, there are significant impacts on these obligations and on whether the bankrupt entity will be able to survive the bankruptcy process.

## II. THE "TRIFECTA" -- AGING ASSETS, MARKET VOLATILITY, REGULATORY CHANGES

### A. Aging Assets

According to current Bureau of Ocean Energy Management ("BOEM") statistics, there are in excess of 13 million acres of active leased land comprising 721 producing and 1,830 non-producing leases in the Gulf of Mexico.[1] The Pacific Region has 34 producing leases on 178,529

[1] Bureau of Ocean Energy Management, *Combined Leasing* Report, July 1, 2019. BOEM produces this report monthly, and may be found on the BOEM's website at https://www.boem.gov/Combined-Leasing-Report/. The active lease acreage in the Gulf is down from 17,841,739 acres in 2016, representing 3,344 leases. BOEM, *Gulf of Mexico OCS Region Blocks and Active Leases by Planning Area*, November 1, 2016.

actively leased acres.[2] The Alaska region has 54 active leases (on just over 275 thousand acres) and 3 producing leases (on 10,424 acres).[3]

Between 1947 and 2014, over 50,000 wells were drilled in the Gulf of Mexico and over 7,000 structures installed. During this time span, almost 30,000 of these wells were plugged, more than 25,000 of them permanently. Between 1973 and 2014, 4,611 structures were removed, primarily in shallow water.[4] Researchers at Louisiana State University reported that more than 40% of the decommissioning of shallow Gulf structures was performed in the decade between 2007 and 2016.[5] Only 19 of 112 deep water structures installed between 1966 and 2014 were removed during the same time period.[6]

Commenters noted that the decommissioning rate slowed during the recent slump in oil prices and the ensuing financial pressures on companies in the sector.[7] Industry observers note, however, "there can be little doubt [decommissioning] is picking up again," and that an "intense period of decommissioning is ramping up worldwide."[8]

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[2] *Id.*
[3] *Id.*
[4] GAO-17-642T, Statement of Frank Rusco, Director, Natural Resources and Environment, United States Government Accountability Office, to the House Committee on Natural Resources, Subcommittee on Energy and Mineral Resources, *Offshore Oil and Gas Resources: Information on Infrastructure Decommissioning and Federal Financial Risk*, May 17, 2017.
[5] Mark J. Kaiser and Siddhartha Narra, *Decommissioning Activity on the Decline in the Gulf of Mexico*, Offshore Magazine, August 1, 2018.
[6] *Offshore Oil and Gas Resources: Information on Infrastructure Decommissioning and Federal Financial Risk*, supra.
[7] Selwyn Parker, *Gulf of Mexico: Decommissioning Adds to the Offshore Boom*, Offshore Support Journal, November 20, 2018; Eric Oudenot, Philip Whittaker, and Martha Vasquez, *Preparing for the Next Wave of Offshore Decommissioning*, Boston Consulting Group, April 2018 ("Cash constraints caused by depressed oil prices have been the greatest obstacle" in fulfilling decommissioning obligations).
[8] *Id.*

Decommissioning in the Gulf has averaged 150 to 250 structures per year since the 1980's,[9] with a total of 5,048 structures removed through 2017.[10] As noted above, the vast majority of decommissioning activities have been of structures at a depth of less than 100 meters.[11] The Interior Department estimated in 2015 that approximate costs to remove shallow water fixed platforms ranged from $85,000 to $4.6 million.[12] Costs increase with retiring deep-water structures not only because of increased water depth, but also due to the complexity and size of the structures more typical of deep water projects.[13] Interior's estimate to remove a deep water floating structure and associated equipment was at least $30 million.[14]

These estimated costs are especially significant given that the next wave of decommissioning will come to those deep-water facilities. Approximately 2,000 wells at higher depths are expected to require plugging and abandonment in the near term, about 25% of the total.[15] In a study completed in late 2016, the authors estimated more than 600 structures were expected to be decommissioned in the next five years, with 2,000 more to follow through 2040.[16] As these structures age out, 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.[17] The total cost from 2010 to 2040 will amount to $210 billion for the Gulf alone.[18]

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[9] *Preparing for the Next Wave of Offshore Decommissioning*, supra.
[10] *Decommissioning Activity on the Decline in the Gulf of Mexico*, supra.
[11] Other sources, such as the Government Accountability Office, separate "shallow" from "deep" at 400 feet. *See*, Rusco Statement, *supra*, at 2.
[12] Rusco Statement, *supra*, at 15.
[13] *Id.*; *see also*, Rusco Statement, *supra*, at 4-6.
[14] *Id.*
[15] *Id.*
[16] *HIS Markit Offshore Decommissioning Study Report*, November 29, 2016. https://news.ihsmarkit.com/press-release/energy-power-media/decommissioning-aging-offshore-oil-and-gas-facilities-increasing-si.
[17] *Id.*
[18] *Id.*

Decommissioning obligations for offshore assets have become increasingly more complex and expensive, due to three primary factors: (1) the inventory of many of these structures are nearing their "end of life" status; (2) the aging structures of those platforms, especially in deep water, are vastly more complex than those in more shallow depths; (3) 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 already expired.

**B. Market Volatility**

Also directly impacting the ability to decommission inactive wells is volatility in the industry. During the recent market downturn, cash strapped companies delayed the start of the decommissioning process and actively skirted spending money on plugging and abandonment.[19] While the number of shut-in wells increased throughout the period of depressed commodity prices, decommissioning activity also decreased during the same period. Only 64 structures including pipelines and platforms had been removed from Gulf waters January through September 2016.[20] Despite the BOEM's "idle iron" policy that unprofitable wells must be plugged and platforms dismantled within five years of reaching the end of their useful lives, certain loopholes have allowed idle structures to remain in the ocean for decades.[21]

Historically, larger upstream companies would divest higher expense, lower margin assets, typically selling them to small, independent operators. The independents are able to operate these

[19] *Dangers in the Deep: a $40BN time bomb threatening the Gulf*, Debtwire Investigations Report, September 12, 2016.
[20] *Id.*
[21] *Id.*

declining assets at lower costs and obtain better cash flow, at least initially.[22] As the revenue generated from the assets diminish beyond a certain point, the independents then divest them to smaller, more speculative specialties companies, often in package deals. These specialists then divide the assets into cash flow positive and cash flow negative categories. They then seek to boost production in the former, and strive to dispose of the latter as quickly and at as low cost as possible.[23]

An asset under this system could be transferred three to five times before it matured to the point where decommissioning is required. However, with the increasing number of assets aging out and the inability of these assets to achieve economic margins in periods of market downturn, an increasing number require decommissioning.[24]

Further complicating the retirement of these aging assets is that most operators and oilfield service companies have not invested in the development of new technology designed specifically for abandonment. Most abandonment jobs are performed with the same tools used for drilling and completion; this underinvestment in decommissioning technologies raises upstream costs and significantly lengthens the time to complete the decommissioning of a well.[25]

### C. Increased Regulation and Financial Assurance Requirements

In addition to market volatility and the significant costs of asset retirement, stiffened regulations enacted by the BOEM in 2016 further complicate matters.

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[22] Francois Bardi, Ivan Marten, Oleg Mikhailov, Henning Streubel, *Asset Abandonment in Upstream Oil: A Growing threat to the Sector*, Boston Consulting Group, December 2, 2015.
[23] *Id.*
[24] *Id.*
[25] *Id.*

The House Committee on Natural Resources, Subcommittee on Energy and Mineral Resources asked GAO to "review Interior's management of potential federal liabilities associated with the decommissioning of offshore oil and gas infrastructure."[26] As the GAO reported to Congress, as of October 2015 the Department of the Interior held or required only $2.9 billion in bonds and other financial assurances to cover $38.2 billion in decommissioning liabilities.[27] The remaining $33 billion is attributable to Interior's financial strength test, which allowed it to waive bonding requirements.[28] GAO concluded this "use of financial strength tests in lieu of bonds poses risks to the federal government."

As of 2016, the federal government had not incurred decommissioning costs since a lessee bankruptcy in 1989.[29] However, BOEM noted at least 17 OCS operators facing financial distress or bankruptcies between 2015 and 2017. In several presentations by its Gulf of Mexico Region Director, Mike Celata, BOEM publicly stated BOEM expected the increase to continue.[30] The perceived financial risk to the government and the financial distress and/or bankruptcy in the industry prompted the change in regulations.

The Outer Continental Shelf Lands Act ("OCLSA") grants the Secretary of the Interior the authority to require bonds or other forms of financial assurance for oil and gas leases in the Outer Continental Shelf ("OCS"). Interior delegated that authority to the BOEM, which

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[26] *Id.* at 3.
[27] Rusco Statement, *supra*, at 1.
[28] *Id.*
[29] The 1989 bankruptcy led to the institution of the first decommissioning-specific bond requirements in 1993. GAO-16-40, Frank Rusco, Director, Natural Resources and Environment, United States Government Accountability Office, to the House Committee on Natural Resources, Subcommittee on Energy and Mineral Resources, *Offshore Oil and Gas Resources: Actions Needed to Better Protect Against Billions of Dollars in Federal Exposure to Decommissioning Liabilities*, December 2015, at 2.
[30] *See, e.g.*, Mike Celata, *Bonding or Other Financial Assurance*, BOEM Presentation, at 12. The presentation may be found at www.boem.gov/Bonding-Financial-Assurance-Presentation-Mike-Celata/.

promulgated regulations governing the financial assurance requirements. These requirements 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.[31] 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.[32]

Under prior regulations, from 2008 to implementation of the new regulations in 2016, operators provided financial assurance under the BOEM's Notice To Lessees - NTL 2008-No7. The Notice provided 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, BOEM enacted the new policy which established increased financial assurance requirements for oil and gas decommissioning on the OCS. The new regulations became effective September 12, 2016. The revised requirements contained in Notice to Lessees 2016-No1 (NTL 2016-No1) changed the decommissioning requirements in two very fundamental ways: (1) it change the way BOEM calculates financial strength and reliability of operators and lessees; (2) it requires significantly far more capital and resources than previously to cover decommissioning costs. Under NTL 2016-No1, updated financial criteria are utilized to determine the level of "self-insurance" for each company or operator, allowing BOEM much greater leeway to exercise

[31] 30 C.F.R. §556.900.
[32] 30 C.F.R. §556.901.

discretion as to supplemental bonding terms and amounts. Outright exemptions from posting financial assurance or supplemental bonds appear to be a thing of the past with this NTL. 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. BOEM can also perform 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 apply to each company as if it has a sole interest in the OCS lease or obligation in which it has an interest. BOEM no longer allows risk pooling among multiple companies who have a shared interest in a lease; instead, BOEM can assign 100% decommissioning liability to any company for any lease in which that company has an interest.

NTL 2016-No1 lists five criteria BOEM considers in 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 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 –the estimated value of the company's 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 – whether civil penalties have 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, whether the

> company has been cited for any non-compliance with federal requirements for operation in the OCS, and whether are there any outstanding debts to the government from non-payment of rents, royalties or inspection fees.

Failure to meet these requirements results 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. A "tailored financial plan" could take the form of escrow accounts, guarantees, surety bonds, treasury securities or payments over time. BOEM set up specific criteria to establish adequate funding in the form of monies on deposit in a "lease specific abandonment account" as an alternative to ensure compliance.[33] The "tailored financial plan" can even include a requirement that the operator provide overriding royalty or production payment obligation in favor of BOEM.[34]

The real issue, however, is that the surety bond market is very limited, especially for the smaller companies with limited assets. Furthermore, the premium costs are extremely high, and the collateral required can be as much as 100% of the bond. Failure to comply with increased bond/financial assurance requirements will result in BOEM or BSEE suspending production, canceling leases, seeking civil penalties, temporary restraining orders, injunctions, or "other appropriate remedies" to enforce compliance.[35] It is also important to note that the government also has authority under these regulations to seek criminal penalties for any violation whereby a person "knowingly and willfully" violates any provision or regulation under the OCSLA "designed to protect health, safety, or the environment or conserve natural resources."[36]

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[33] 30 CFR §556.904.
[34] 30 CFR §556.904(e).
[35] 30 CFR §250.173, 30 CFR 500, subpart N, 43 U.S.C. §1350(a).
[36] 43 U.S.C. §1350(c).

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 faced several 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 government's fear that industry bankruptcies will cause decommissioning obligations to default to the government and taxpayers.

The news media and many industry trade journals predicted dire consequences from the new decommissioning obligations. For example:

> "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."[37]

Given the number of oil and gas companies that filed for bankruptcy between 2015 and the present, these predictions may, unfortunately, have a basis in reality.[38]

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[37] *New BOEM regulations threaten Independent Gulf of Mexico operators*, Opportune, Josh Sherman, September 9, 2016.

[38] *Dangers in the Deep: a $40BN time bomb threatening the Gulf*, pg. 5.

In April 2017, President Trump issued Executive Order 13795, which directed the Department of the Interior to re-examine some recent limitations on offshore oil and gas development. Then-Secretary Zinke issued Secretarial Order 3350 on May 1, 2017, which instructed BOEM to review the NTL 2016-No1 and report on options for revising or rescinding it. However, as of July 30, 2019, the NTL remains active and no report has been made public.[39]

## III. IMPACTS OF BANKRUPTCY

Should these dire predictions come to pass, then operators will 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 a 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.

### A. The Federal Decommissioning Obligations

The OCSLA gives the United States jurisdiction over the mineral resources found in submerged lands in the OCS.[40] The OCS includes an area extending from the offshore state boundary to at least 200 nautical miles from that boundary into the ocean.[41] The Secretary of the Interior controls the disposition of mineral resources in the OCS through oil and gas leases.[42] 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

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[39] *See* https://www.boem.gov/notices-to-lessees-and-operators/. Harvard Law School's Environmental & Energy Law Program keeps a "Regulatory Rollback Tracker" which includes the status of NTL 2016-No1 and other offshore regulations. https://eelp.law.harvard.edu/regulatory-rollback-tracker/.
[40] 43 U.S.C. §1332(1).
[41] 43 U.S.C. §1331(a).
[42] 43 U.S.C. §1337(a)(1).

submission of performance bonds, is a primary goal of the Department of the Interior as the environmental steward of the OCS.[43] 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 which may cause damage to the "environment or to property, or endanger life or health."[44]

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."[45] 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.[46]

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

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[43] 43 U.S.C. §1332.
[44] 43 U.S.C. §1332(3), (6).
[45] *Cutting Underwater Techs. USA, Inc. v. Con-Drive, LLC*, No. 09-387, 2011 WL 1103679, 2011 U.S. Dist. LEXIS 29325, at *24-25 (E.D. La. Mar. 22, 2011) (citing BOEM, Notice to Lessees and Operators No. 2010-G05, Decommissioning Guidance for Wells and Platform 1).
[46] 30 C.F.R. 250.1700-1754 and 30 C.F.R. 556.900 – 901..

installed under the authority of a right-of-way.[47]

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.[48]

The regulations also require that all wells be plugged and abandoned within one year after the applicable federal oil and gas lease expires.[49] 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.[50] 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."[51]

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

[47] 30 C.F.R. §250.1700, *et. seq.*
[48] 30 C.F.R. §250.1702.
[49] 30 C.F.R. §250.1710.
[50] 30 C.F.R. §250.1725.
[51] 30 C.F.R. §250.1711.

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, BOEM may suspend operations, initiate actions to cancel the lease, or other appropriate action, including requiring the immediate decommissioning of the facility.[52]

### B. 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.[53] The Texas Natural Resources Code requires the decommissioning obligations be enforced by the Texas Railroad Commission.[54] The Natural Resources Code's statement of policy declares "…the protection of water and land of the state from pollution or the escape of oil and gas is in the public interest."[55] Under the Texas Administrative Code, well operators must plug a well that has been inactive for a year or longer.[56] 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.[57]

While the Texas regulations also require financial assurance, those requirements are *significantly* less than what is now 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.[58] It is uncertain if the fund is sufficient to cover

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[52] 30 C.F.R. §556.900(h), 30 CFR 250.173, 30 CFR 500, subpart N.
[53] 43 U.S.C. §1312.
[54] TEX. NAT. RES. CODE § 89.001; 16 TEX. ADMIN. CODE §3.14.
[55] TEX. NAT. RES. CODE § 89.001.
[56] 16 TEX. ADMIN. CODE §3.14(b)(2) ("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….")
[57] TEX. NAT. RES. CODE §85.381.
[58] *See*, https://www.rrc.state.tx.us/oil-gas/environmental-cleanup-programs/oil-gas-regulation-and-cleanup-fund/.

decommissioning obligations if more and more operators are forced into bankruptcy by the increased decommissioning cases.

### C. 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, including obligations to prevent environmental damage.[59] This compliance requirement extends to the debtor's compliance with laws on decommissioning of oil and gas wells.[60] Because of this requirement, the bankruptcy debtor does not have the right or ability to ignore compliance with these obligations, even if to do so would relieve the Debtor of financial obligations. This is true even if discontinuing the financial assurance obligations or the decommissioning obligations would provide the debtor with the ability to effectively reorganize.

The Supreme Court in *Midlantic* 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.[61] 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* to address plugging and abandonment obligations for decommissioning wells. In *H.L.S. Energy,* the Fifth Circuit specifically ruled that "under federal law, bankruptcy trustees must comply with state law and there is no question that under

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[59] 28 U.S.C. § 959(b); *see, e.g., Texas v. Lowe (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, 810 (Bankr. S.D. Texas. 2009) ("A bankruptcy petition is not a grant of immunity. Bankrupt debtors are no difference from any citizen in that they must comply with state and federal laws.").

[60] 399 B.R. at 810-12.

[61] *Midlantic Nat'l Bank v New Jersey Dept. of Envt'l Prot.*, 474 U.S. 494, 502, 106 S. Ct. 755 (1986).

Texas law, the owner of an operating interest is required to plug wells that have remained unproductive for a year."[62] 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.[63] 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.[64] Generally, the order of payment to creditors in a bankruptcy 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.). The Fifth Circuit in *H.L.S. Energy* made clear that the decommissioning obligations stood to be paid first with other administrative expenses.[65]

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 regarding exactly when those obligations "accrue." Some courts 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.[66]

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[62] 151 F.3d at 438.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *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,*[67] 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."[68] 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.[69]

Thus, despite the fact 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,"[70] which the majority of courts characterize as administrative claims.

## IV. THIRD PARTY OBLIGATIONS FOR DECOMMISSIONING

As described above, 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

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[67] *In re American Costal Energy,* 399 B.R. 805 (Bankr. S.D. Tex. 2009)
[68] *Id*. at 808.3
[69] *Id.,* at 811.
[70] 30 C.F.R. §250.1702(a)-(f).

declining. It is likely these smaller operators will be less able to withstand the "trifecta" of aging assets, industry volatility (or downturn) and new, expensive decommissioning obligations. This leaves them in a more vulnerable position, and are the most likely to file for bankruptcy protection. If this is true, 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:

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

2. With BOEM approval, you may sever all, or portion of, your operating rights.

3. 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.[71]

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

[71] 30 C.F.R. §556.700.

subsequent assignee fails to perform any obligation under the lease, to the extent the obligation ***accrued before*** approval of your assignment. [72]

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).[73]

The result of these regulations is the creation of a 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* 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

[72] 30 C.F.R. §556.710 (emphasis added).
[73] 30 C.F.R §556.711 (emphasis added).

obstruction."[74] Since the plugging and abandonment liabilities accrued before the assignment, the assignment would not relieve the assignor of their decommissioning liabilities.[75]

If such liabilities fall to the predecessor or co-lessee, the predecessor or co-lessee can recover its costs for 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 because the Bankruptcy Code 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… [76]

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

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[74] *GOM Shelf, LLC v. Sun Operating Limited Partnership*, 4:06-CV-3444, 2008 U.S. Dist. Lexis 25636, 2008 WL 901482 (S.D. Tex. Mar. 31, 2008); *see also, Total E&P USA, Inc. v. Marubeni Oil & Gas (USA), Inc.*, 4:16-CV-2671, 2018 U.S. Dist. Lexis 144407 (S.D.Tex. June 28, 2018) (bankrupt ATP's predecessor in interest Total found liable for decommissioning costs).

[75] *Id.* at *10.

[76] 11 U.S.C. §502(e)(1)(B).

decommissioning obligations brought by predecessors and co-lessees until those parties undertook the liabilities and actually paid the claims. [77]

The issue then 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.[78] But the right of a predecessor to assert the claim as an 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, *i.e.*, "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.[79]

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[77] *In re Tri-Union Dev. Corp.*, 314 B.R. 611 (Bankr. S.D. Tex. 2004).
[78] *See, e.g. American Coastal Energy*, 399 B.R. at 616.
[79] *In re ATP Oil & Gas Corp.*, 12-36187, 2013 Bankr. Lexis 2608, 2013 WL 3157567 (Bankr. S.D. Tex. June 19, 2013).

## V. REAL WORLD EXAMPLES

The first major bankruptcy in which these obligations were tested was the ATP Oil & Gas Corporation bankruptcy case filed in Houston.[80] 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 to undertake the decommissioning liabilities and prevent health and environment 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 was actually sympathetic with Anadarko's plight in having to

[80] *Id.*

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.[81]

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 *Black Elk Energy*, 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.[82] 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.[83] 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 required to undertake those decommissioning obligations utilizing "government assets," defined as bond proceeds and moneys

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[81] *Id.* at *3.
[82] *In re Black Elk Energy Offshore Operations*, No. 15-34287 (Bankr. S.D. Tex).
[83] *Id.* In order to effect the decommissioning of the assets, the liquidating trust and the federal government entered into a "Decommissioning Agreement."

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.[84] However, one of the predecessors in liability was able to protect itself from these decommissioning liabilities as is described in the next section.

Another case of note is *Energy XXI Ltd.* At the time it filed for bankruptcy, it had approximately $226 million in lease or area bonds issued to BOEM for its decommissioning obligations. 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.[85] That document was deemed to be confidential and not disclosed as part of the Plan. The Debtors Plan was eventually 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.[86]

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 *at the time* the Debtor bought the leases. These letters of credit were specifically to guarantee the decommissioning liabilities of those leases Exxon sold to the Debtor. So these letters of credit

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[84] *Id*.
[85] *Energy XXI, Ltd.,* No. 16-31928 (Bankr. S.D.Tex).
[86] *Id.*

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-lessor. 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.

The PSA further required Black Elk to fund a portion of the P&A obligations, but provided that in the event it could not, then Black Elk 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, and 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, low commodity prices, and new, more significant financial assurance requirements by BOEM and BSEE for decommissioning obligations has forced small to mid-sized operators into bankruptcy. Commenters have 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).[87] 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.

[87] Josh Sherman, *New BOEM regulations threaten Independent Gulf of Mexico operators*, Opportune, September 9, 2016.