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Offshore Decommissioning Liability And Bankruptcy

Law360, New York (April 5, 2017, 11:44 AM EDT) -- Although decommissioning is not a new concept to the energy industry, the need and obligation to carry out decommissioning activities has significantly increased over the last five years. This increase is, in large part, due to drastic changes in the economic viability of oil projects and a complicated — ever-changing — geopolitical landscape.

Edward Ripley

In turn, accounting for decommissioning obligations has often turned into a game of “hot potato” prompting both litigation and governmental intervention. This article discusses two important lessons regarding decommissioning liability of offshore installations in the context of U.S. bankruptcy proceedings.

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The term “decommissioning” is the industry’s preferred term for activities necessary to manage and dispose of oil and gas infrastructure, and to minimize or eliminate the environmental footprint once a producing well or field is no longer economically viable. However, this term is not traditionally found in first or even second generation oil and gas contracts.

In fact, decades ago, energy companies simply turned over installations to the host government upon expiration of the relevant contract, and walked away without worrying about decommissioning obligations. So what has changed? Governments, both federal and state, have acknowledged the need to account for decommissioning obligations so that taxpayers are not forced to pay for these significant costs.

Industry players too have implemented socially and environmentally friendly policies. Nowadays, most owners, operators and investors understand the need to meet decommissioning obligations at the end of a project. It goes without saying that a few lessons have been learned along the way:

Learn About Decommissioning Obligations In Advance

Lesson No. 1: Learn about offshore decommissioning obligations under international and national law at the outset of a project, or at least years before the contract is set to expire.

Both international and national law regulate decommissioning obligations. International law, however, offers little guidance on who bears liability for decommissioning activities.

There are two main international law instruments regulating decommissioning: (i) the Geneva Convention on the Continental Shelf (Geneva Convention); and (ii) the United Nations Convention on the Law of the Sea (UNCLOS). The Geneva Convention is considered the first reference point in international law for decommissioning obligations. It requires that any installations that are abandoned or disused be entirely removed.

The United States of America ratified the Geneva Convention which entered into force on June 10, 1964. The stringent removal provision from the Geneva Convention has arguably been superseded by a more flexible provision contained in UNCLOS.

Although the United States has not ratified UNCLOS, energy companies with producing assets in the United States should not dismiss it since it provides flexibility and its provisions can be considered customary international law.

In the United States, decommissioning obligations are regulated by both federal and state law. Federal law establishes at least three overarching obligations: (i) the obligation to remove infrastructure after lease termination and to do so in a manner that "does not cause undue or serious harm or damage to the human, marine, or coastal environment" [30 CFR § 250.1703, et seq.]; (ii) lessees and owners of operating rights, and holders of a right-of-way are jointly and severally liable for meeting decommissioning obligations [30 CFR § 250.1701]; and (iii) record title owners retain decommissioning liability even after relinquishment of their interest in operating rights [30 CFR § 556.604].

A survey of state law on decommissioning liability is outside the scope of this article, but it should be underscored that oil and gas producing states have enacted legislation that often mirrors these federal obligations. The key lesson here is that the industry must be well versed in international and national decommissioning obligations and understand the associated costs to avoid surprises years after selling or transferring ownership and/or operating rights.

Prepare For Decommissioning Costs

Lesson No. 2: Make adequate provisions to cover decommissioning costs and structure contracts as if counterparties will eventually be subject to bankruptcy proceedings.

Although it may not be preferable for oil and gas investors, there is a strong case for funding decommissioning costs upfront: decommissioning costs are more likely to be recovered if there is a provision or funding process to do so throughout the life a project.

In other words, decommissioning costs should be set aside separate and apart from the counterparties' normal operating accounts and classified as costs necessary to develop and/or operate a project so that they can be recovered as operating costs or tax deductions while the project or the counterparty is financially healthy. Sellers should not rely on a combination of the purchase and sale agreement's contractual indemnity and/or third party surety that only covers a fraction of the estimated decommissioning costs.

Similarly, decommissioning liability becomes a foreseeable issue in bankruptcy proceedings. If an owner and/or operator files for bankruptcy, then there is significant risk that the debtor will not have funds available to pay for its decommissioning liability.

There are pending bankruptcy cases where the debtor filed for bankruptcy after terminating operations because it did not have the monies necessary to pay for decommissioning.[1] While initiating bankruptcy proceedings triggers an automatic stay on creditor and collection acts and proceedings against the debtor and its property, the stay does not apply to police and regulatory powers.

So, even if an energy company is a bankruptcy debtor, federal or state agencies (e.g., the U.S. Department of the Interior (DOI) responsible for managing the U.S. oil and gas program) can: (i) order that decommissioning take place; (ii) intervene in bankruptcy proceedings; (iii) look into the chain of title and find a prior or co-operator/owner who is jointly and severally for the decommissioning obligation; and/or (iv) ensure that a purchaser of bankruptcy assets assumes and provides third-party surety bonds to pay for decommissioning obligations.

For example, the DOI intervened in ATP Oil & Gas Corporation's bankruptcy proceedings. The DOI first objected to ATP's sale of its assets because the sale would not provide enough funds to cover ATP's decommissioning obligations. The DOI only withdrew its objection after the ultimate purchaser, Bennu Oil & Gas LLC (Bennu), committed to create a $44.25 million trust to address ATP's decommissioning obligations.

The trust was to be administered by the Bureau of Ocean Energy Management. The bankruptcy court then approved the sale over the objections of one of ATP's co-lessees, Fortune Natural Resources Corporation (Fortune). Fortune argued that the trust would not cover ATP's contractual decommissioning obligations to its co-lessees because it was only designed to cover decommissioning obligations in which ATP was solely liable. The Bankruptcy Court overruled Fortune's objection and the sale closed.

Fortune appealed to the district court and the DOI moved to participate as appellee. The district court dismissed Fortune's appeal for lack of standing and mootness. Fortune again appealed. The U.S. Court of Appeals for the Fifth Circuit affirmed the district court's ruling because it found that Fortune did not satisfy the "person aggrieved" test: i.e., Fortune did not show that it would have accessed any funds from the bankruptcy estate had the court not approved the sale and, thus, it was left in the same position.[2]

As a post-script, Bennu and certain affiliates are now debtors in bankruptcy. It remains to be seen how this development will ultimately affect Fortune's exposure to decommissioning obligations.

The most recent drop in oil prices demonstrates the ease with which owners/operators can enter into bankruptcy. Accordingly, energy companies selling properties should structure contracts as if their buyer (or even a subsequent purchaser) will eventually be subject to bankruptcy proceedings.

In practice, this means that energy companies should have a project-specific decommissioning plan upfront, or at least a well-established handle on decommissioning costs, perform due diligence on their buyers and the investors involved in a transaction, and, more importantly, secure decommissioning obligations with appropriate third-party sureties (e.g. designated escrow fund, letters of credit, bonds).

Using a third party surety avoids or mitigates against later risk of default by the buyer. Specifically, if the decommissioning obligations have been liquidated or fixed, case law is unclear on whether that claim is treated in bankruptcy proceedings as (i) an administrative expense with priority over unsecured claims but after secured claims, or (ii) a general unsecured claim.

An administrative claim is preferred because administrative claims must be paid in pull if the debtor is reorganizing. However, as noted, these claims only have value if there are assets remaining after the secured claims are paid. Thus, even having an administrative claim does not guaranty that the claim will be paid.

Further, general unsecured claims typically receive no real recovery in bankruptcy. Thus, structuring transactions to specifically provide for how decommissioning obligations will be met and securing these obligations with a bond posted by a third-party surety, will provide the most protections and risk mitigation.

In short, decommissioning obligations present a challenge to energy companies, especially during difficult economic environments. However, these obligations are foreseeable and can be managed with appropriate preparation and information.

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[1] See, e.g., In re Anglo-Suisse Offshore Partners LLC, Case No. 15-36566, Bankr. S.D. Texas).

[2] Fortune Natural Res. v. U.S. Dep’t of Interior et al., 806 F. 3d 363 (5th Cir. 2015).

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