2016 HOT TOPICS FOR ENERGY COMPANIES

Thoughts for Officers and Directors of E&P Companies in 2016

The U.S. energy industry has gone through a dramatic period of commodity price decline, a trend which has continued as we start 2016. The headlines are full of stories predicting further price declines or a "lower for longer" outlook. At best, 2016 likely involves further spending cuts, layoffs and limited access to the capital markets for many E&P companies.

For officers and directors, these conditions will present a variety of challenges and novel issues. Companies with relatively strong balance sheets will face difficult decisions about capital allocation and priorities, how to deal with troubled counterparties and presumably how to take advantage of lower costs and distressed asset sales. More leveraged companies will face difficult decisions regarding financing, asset sales and even survival.

We are providing this note to our friends in the industry to help you consider how best to survive these challenging times. Specifically, this note addresses:

- ***Legal duties of officers and directors when managing through distress;***
- ***Key disclosure concerns for public E&P companies;***
- ***Shareholder activism in a lower commodity price environment;***
- ***Dealing with distressed JOA counterparties;***
- ***Considerations for acquiring assets from distressed producers;***
- ***Alternative financing for E&P companies;***
- ***Compensation issues in today's E&P market; and***
- ***Optimizing D&O insurance coverage in a distressed environment.***

Managing Through Distress – Summary of Officers' and Directors' Duties and Key Considerations

Management teams and boards of E&P companies will face difficult questions this year as they focus on navigating through challenging conditions. They will want to be mindful of the fiduciary duties they owe to the company they serve, in particular officers and directors serving on the boards of financially distressed companies whose actions may receive heightened scrutiny.

The nature of officer and director duties do not typically change during financial distress, and those duties always run to the corporate entity, but the residual value beneficiaries of these duties may shift from shareholders to creditors[1]. As corporate law has developed, some of the lore surrounding changing duties of directors serving companies in the so-called "zone of insolvency" has been resolved. At least in Delaware, this issue has largely been put to rest by the Delaware Supreme Court which, in 2007, ruled that directors of corporations "in the zone of insolvency" do not owe fiduciary duties to creditors. Rather, while stockholders are the sole residual stakeholders of a solvent corporation's value, upon insolvency, creditors also become residual stakeholders and gain standing to derivatively sue directors for breaches of fiduciary duty to the corporation.

The determination of when insolvency occurs is a complex concept and one with which courts continue to grapple, often with the benefit of hindsight, by applying various tests popularly divided between "balance sheet" tests (when the company's debts exceed the value of its assets) and "cash flow" tests (when a company is unable to pay its debts as they become due in the ordinary course of business) – depending on the facts and circumstances of the company.

The business judgment rule will most often protect well-informed disinterested officers and directors in making decisions that relate to efforts to maximize the value of an insolvent company. In most jurisdictions, if officers and directors make decisions that are designed to increase the value of the company as a whole, courts typically will not speculate about whether those decisions might benefit some residual claimants more than others. By contrast, when a transaction involves an interested party, courts may view officers' and directors' decisions with heightened scrutiny, and subject such decisions to the more onerous "entire fairness" review.

Officers and directors of distressed companies should ensure that they are well-informed and act in the best interests of the company and its stakeholders. While the business judgment rule can offer protection when a business fails, officers and directors should be aware that their prior actions may be subject to close review and challenged by creditors or their representatives who will be focused on maximizing their recovery. Accordingly, officers and directors of companies in distress should: (i) focus both on the substance of decisions as well as the procedural completeness and fairness of any decisionmaking; (ii) be informed of and receive all reasonably available relevant information; (iii) ask questions, including ensuring the company has considered its reasonable alternatives; (iv) disclose any potential conflicts (e.g., where an officer or director may benefit personally from a transaction or alternative), and take steps to insulate decisionmaking from such conflicts; (v) seek input from advisors on a timely basis; and (vi) ensure the corporate secretary keeps accurate minutes, including documenting that the work done is sufficient to support a conclusion that the board acted on a well-informed basis.

Patience, prudence and proactively addressing issues facing a company in distress are key to avoiding regrettable mistakes. Below are some practical ideas for management and boards of particularly distressed E&P companies to consider as they navigate 2016:

- Conduct regular meetings with management and outside advisors, ensure necessary information is shared, and develop a common understanding of key deadlines and facts. More frequent meetings should be held as the company's financial distress becomes more acute.
- If it appears that the company is or may become insolvent, assemble a contingency planning team and engage with experienced business people and financial and legal professionals.
- Develop a clear understanding of the company's liquidity position and cash flow forecast on a regular basis (more frequent monitoring is standard practice when financial distress is present), as well as any near term potential restrictions on liquidity and sensitivities to various reasonably possible future commodity prices.
- Develop strategic options that anticipate various market scenarios. Overall, insolvent companies have considerable latitude to pursue value-maximizing strategies designed to benefit the enterprise as a whole. However, given continued commodity price volatility and uncertain markets, E&P boards should avoid relying on a single transaction or solution and ensure that alternatives are continuously evaluated. In particular, a distressed company should evaluate all of its options for addressing problems with its capital structure – including capital injections, sales of assets and other types of out-of-court restructurings and, in extreme cases, bankruptcy.
- Communicate with key creditors and critical providers early and often, as dialogue and collaboration often lead to better results, and negative surprises generate results which might have otherwise been avoided or improved.

[1] *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

- Communicate regularly with counsel regarding litigation threats or suits, operating concerns, and business strategies; it is helpful for counsel to understand the "big picture" when being asked to render legal advice.

- Communicate strategically with management and employees to maintain workforce stability, morale and competency.

- Understand that information, including internal documents and emails, is in most cases discoverable and subject to review by adverse parties, and communications regarded as privileged may (in certain circumstances) be subject to waiver of the privilege by a bankruptcy trustee in the event such trustee is appointed in a chapter 11 case or a case is filed under or converted to chapter 7.

- Do not incur debt that cannot be repaid when mature based on reasonable business expectations.

- Avoid transactions that do not provide the company with reasonably equivalent value.

- Review and maintain adequate property, casualty, and D&O insurance coverage (see below "Optimizing Your D&O Insurance Coverage in a Distressed Environment").

In the event a company files for bankruptcy, the directors will continue to owe fiduciary duties to the bankruptcy estate for the benefit of interested parties to maximize the value of the estate, refrain from self-dealing and treat all parties fairly. The approval of the Bankruptcy Court will be required for non-ordinary course transactions (i.e. substantial asset sales) and will require an evidentiary showing that the proposed transaction is a valid exercise of the business judgment of the board and officers. Such court approval assists in validating the judgment once the company has filed for bankruptcy. Bankruptcy Court approval can assist the directors in fulfilling their duties if the company has filed for bankruptcy.

Disclosure Concerns Facing E&P Companies

In addition to grappling with business and financial problems, distressed E&P companies also face a host of difficult disclosure and other securities law issues. Companies providing annual or quarterly reports to investors should be mindful that shareholders, noteholders, lenders, potential investors, rating agencies, regulators and other stakeholders will focus closely on their disclosures to discern how well the company is positioned to withstand prolonged low commodity prices. One should not assume that "common knowledge" of issues affecting the energy industry generally will satisfy disclosure requirements for a specific company. Two particular areas of disclosure concern for E&P companies are (i) disclosures related to oil and gas reserves and (ii) disclosures in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" on the potential impact of known trends and uncertainties on a company's results of operations, liquidity and financial condition.

Reserves Related Disclosures

In determining oil, natural gas and natural gas liquids reserves for year-end 2015, management and boards of E&P companies will need to carefully consider near-term proved reserve development plans and the impact that current prices and the availability of capital will have on year-end PUD bookings. Given the further declines in oil and gas prices in late 2015 and early 2016 and the expected "lower for longer" price environment, it is expected that many companies will cut capital budgets even further than in 2015, deferring the development of many PUDs beyond 2016 or to the point at which such reserves can no longer be booked as proved under the SEC's five-year development window.[2] In its latest industry outlook, "Oil and Natural Gas Industry—Global: Persistent Weak Prices in 2016 Rein in Capital Spending, Heighten Financing Risk," Moody's Investors Service foresees capital spending reductions of at least 20-25% in 2016 across the industry. These reductions are in part due to limited access to capital, as the pricing impact on reserves reduces or eliminates returns, lowers borrowing bases and restricts access to debt and equity markets. As companies determine whether PUDs can reasonably be developed within the SEC's required five-year window for booking as proved reserves, they should carefully consider what are reasonable assumptions regarding (i) improved future pricing, (ii) cost reductions and (iii) availability of capital in the applicable periods.[3]

As we have previously reported[4], the significant declines in oil and gas prices have triggered heightened scrutiny from SEC staff regarding E&P reserve and impairment disclosures. In particular, the SEC issued comments to several E&P companies requesting that companies provide

[2] Under SEC rules and guidance, undrilled locations can be classified as having proved undeveloped reserves, or "PUDs", only if a development plan has been adopted indicating that they are scheduled to be drilled within five years of the date of initial classification as PUDs, unless "specific circumstances" justify a longer time. The SEC staff has taken a limited view of circumstances that may justify an extension of the five-year development window for PUDs in its Compliance & Disclosure Interpretations (see Question 131.03 at https://www.sec.gov/divisions/corpfin/guidance/oilandgas-interp.htm).

[3] In recent SEC staff disclosure review letters to some reporting E&P companies, the SEC staff has asked how the company expects to meet the reasonable certainty requirements for booking PUDs in the face of significant disclosed or apparent limitations on available funding for development capital.

[4] See "SEC Staff Scrutinizes E&P Company Disclosures" http://www.velaw.com/Insights/SEC-Staff-Scrutinizes-E-P-Company-Disclosures/.

quantified disclosure regarding the impact of lower commodity prices on (i) previously reported reserve quantities, including any proved undeveloped reserves that are no longer expected to be developed within five years of initial booking; and (ii) future asset impairment charges, particularly any impairment charges that are reasonably expected in the next quarter.[5] If current commodity prices would have a material impact on previously reported reserves or are expected to result in further near-term impairments, the SEC staff has insisted that E&P companies give quantitative disclosure regarding these effects in their periodic reports. The potential for additional impairment charges may well require quantitative disclosures due to the continued declines in the twelve-month first-day-of-the-month average oil and natural gas prices used for valuing and estimating proved reserves under SEC reporting rules.[6]

MD&A Disclosures

An E&P company's liquidity and access to capital are critically followed measures given current market conditions. Because oil and gas is a capital-intensive industry where continued investment and expansion is paramount, many companies have historically held limited cash and cash equivalents on hand as the majority of excess cash was invested into new projects to increase production and reserves. In the past, E&P companies addressed this concern either through a series of capital market financings, increased bank borrowings or sales of working interests or other participating drilling interests to other parties. These traditional sources of capital for E&P companies have become more limited, particularly for substantially leveraged producers, at a time when most oil and gas companies are experiencing severely reduced or even negative operating cash flows due to lower oil and gas prices.

Due to these financing constraints, it is especially critical that companies provide investors with a clear and up-to-date picture of their ability to generate or access cash and meet existing and known, or reasonably likely, cash requirements, over both the short and long term. In particular, E&P companies should consider including detailed disclosure on (i) amounts and certainty of future cash flows, together with the pricing assumptions that were used to generate these estimates, (ii) expected capital expenditures and other known and reasonably likely cash requirements, and the portion of such expenditures that are committed versus discretionary, (iii) proposed sources of capital, the limitations on accessing such sources and the sufficiency of such liquidity to meet cash needs under various reasonably anticipated price environments and (iv) any known trends or uncertainties that could impact liquidity or capital resources. Such trends and uncertainties resulting from protracted low commodity prices should include impacts on E&P companies' borrowing base redeterminations. E&P companies with significantly lower reserves and unhedged production risk further borrowing-base reductions, potentially requiring repayment of existing loans and triggering a liquidity crunch if they are unable to access sufficient capital to do so. Attention should also be given to compliance with credit facility covenants and the ability to make the representations (including solvency and going concern representations) necessary to draw down on credit facilities. Disclosure should clearly identify applicable uncertainties and the implications of not being able to access funds when needed. The company should also identify provisions that could trigger an early repayment of debt or require additional collateral support, or otherwise create additional financial obligations. If the company expects that an amendment or waiver will be required from its lenders under its credit facilities within the next 12 months, it should disclose the potential covenant compliance issue and any related potential event of default or cross default, as well as a discussion of how it is managing that issue.

Risk Factors

Issuers should carefully review, update and revise risk factors when drafting this year's annual report on Form10-K to ensure they have provided adequate information to investors about the specific, material risks faced by the applicable company. Additionally, E&P companies should add, revise or update risk factors in their quarterly reports on Form 10-Q. Well-drafted, unambiguous risk factors can serve as a safeguard against liability for forward-looking statements under Section 27 of the Securities Act and Section 21E of the Exchange Act safe harbors, as well as the judicially derived "bespeaks caution" doctrine.

When drafting risk factors relating to the impact of commodity prices or other macro trends or events, E&P companies need to carefully tailor their disclosures to specifically address how these trends or events specifically impacts its own operations. For instance, it is not enough to have a generic risk factor that states if the company does not make investments to replace reserves, reserves will decline – issuers should specifically address their specific capital plans and the likely impact on reserves, as well as address the impact of further declines in commodity prices on the reserve base and impairments as discussed above. Similarly, if a risk has started to materialize, the risk factor should not be discussed generally, conceptually or theoretically—it should describe specifically what has already occurred and then set forth the risks going forward.

[5] The SEC staff's comments have generally been predicated on Item 303(a) of Regulation S-K and SEC Release No. 33-8350, which the staff views as requiring quantification of the impact of known trends, demands, commitments, events and uncertainties to the extent that information necessary for such quantification is reasonably available.

[6] As of December 31, 2015, the twelve-month first-day-of-the-month average benchmark spot oil and natural gas prices were $50.25 per barrel of West Texas Intermediate ("WTI") oil and $2.587 per MMBtu Henry Hub spot natural gas, which are substantially above spot market prices as of the date of this release.

The following is a non-comprehensive summary of typical risk factors and MD&A topics relating to the current pricing environment which should be evaluated for discussion in 2016 Risk Factors and MD&A for E&P companies:

- Quantification of the impact of low prices (under 2015 year-end SEC pricing, current pricing and/or estimates of future pricing) on further near-term impairments and proved reserve volumes and PV-10 reported at year-end.
- Impact of low prices and reduced revenues and rates of return on capital expenditure plans, including PUD development commitments.
- Borrowing base outlook and likelihood of further reductions.
- Ability to meet lending criteria – debt covenant compliance, including current and projected financial ratios looking forward at least 12 months, recent and future modifications of covenants and ratios, solvency and going concern representations as conditions to lending, and consequences of not meeting criteria.
- Changes to trade credit – trends in service and supply company payment terms.
- Changes and risks in P&A liability requirements, including increased cash collateral and bonding and impact of the loss of exempt status.
- Impact of insolvency of joint interest owners.
- Impact of limited hedging opportunities and roll off of existing hedges under current futures pricing.
- Impact of decreased production and related revenues, including the impact and potential consequences of production shut-ins on firm delivery obligations and leases.
- Ability to meet financial commitments over next 12 months and source of funds.
- Ability to pay preferred and common dividends and consequences of non-payment of accrued dividends (i.e., voting rights, Form S-3 eligibility).
- Potential for and consequences of going concern "substantial doubt" conclusions under credit agreements and accounting rules. (See also pending new ASC Update No. 2014-15).

Shareholder Activism in a Lower Commodity Price Environment

Shareholder activism has become of significantly increased concern to the boards of directors of E&P companies. Activist hedge funds, which acquire small stakes in public companies and push aggressively for change using the threat of a proxy fight, have been remarkably successful in recent years. In 2015, there were more than 270 reported shareholder activism campaigns and 105 proxy fights, and activists were successful in obtaining board representation in 58% of those campaigns. In most instances, activists are demanding the sale of a company, the sale or spin-off of assets or divisions (including MLP drop-downs), share repurchases, special dividends, changes to management and board composition, or other corporate governance changes.

Activists are increasingly targeting companies in the energy sector. Many activist investors believe that oil prices have or may bottom soon, and have started to build stakes in energy companies for the 2016 proxy season. In recent months, well-known activists such as Carl Icahn, Third Point, Elliott Management and Raging Capital disclosed investments in the energy sector. In November 2015, the first proxy contest in the newly distressed energy space erupted when Group 42 and BLR Partners sought to replace the majority of the directors of VAALCO Energy.

Activists are attracted to the energy sector for several reasons. First, as a result of depressed stock prices, it has never been cheaper to acquire a significant stake in an oil and gas company. Second, many energy companies have assets that can be divested or spun off to create short-term gains. Lastly, there is a notion, however inappropriate, that the entrepreneurial "wildcatter" culture in the energy sector has resulted in weaker checks and balances on corporate governance.

Advance preparation against an activist is the best means to a good defense. Energy companies are advised to:

- Assemble a small team of specialists – key executives, lawyer, banker, and public relations firm – to be prepared to respond promptly and to analyze the company as an activist would.
- Monitor the shareholder base and implement an ongoing investor outreach program.
- Pay attention to the early warning signs such as "say-on-pay" votes or high numbers of withhold votes in annual meetings.
- Periodically evaluate the board using criteria including directors' length of tenure, experience, age, and independence.
- Ask counsel with experience in proxy fights to review the company's bylaws for suitability in a proxy contest.
- Examine strategic alternatives proactively and pre-emptively to address issues that may make the company vulnerable to an activist campaign (e.g., non-core asset divestitures).

Dealing with Distressed JOA Counterparties

Current commodity prices also mean that E&P companies and their officers and directors need to identify and monitor contracts with distressed counterparties.

Most oil and gas properties are operated under joint operating agreements ("JOAs") among the working interest owners in the properties.

Typical JOAs have provisions designed to protect the interests of each party in a situation involving the financial distress of one of the parties to the JOA. These include provisions that (i) state that the liability of the parties shall be several and not joint or collective, (ii) limit the liability of each party to its proportionate share of the costs of developing and operating the contract area, (iii) grant each party a lien and security interest in the interest in the leases and equipment, personal property, contract rights, accounts and general intangibles to secure the obligations of each party under the JOA and (iv) state that the operator is an independent contractor and shall not be deemed an agent of the non-operators.

Other provisions in typical JOAs would appear to be useful in bankruptcy, but in practice are of little benefit. One example is the provision that states that if an operator becomes insolvent or bankrupt it shall be deemed to have resigned as operator. This is an "ipso-facto" clause that is not enforceable under the federal bankruptcy code. Other examples include default and remedy provisions which give the non-defaulting parties certain rights against the defaulting party and withhold certain rights from the defaulting party. In bankruptcy the "automatic stay" would prevent the non-defaulting party from exercising these rights and remedies without the bankruptcy court's approval.

Despite the protections built into typical JOAs, dealing with a bankrupt working interest owner can be a painful experience for the other parties to the JOA.

The provisions of the JOA stating that the liabilities of the parties are not joint and several are not binding on third parties or governmental authorities. In fact, certain obligations may create joint and several liabilities for the parties to the JOA. For example, obligations under jointly owned oil and gas leases, including obligations to royalty owners, may be joint and several. In addition, obligations with respect to regulatory and environmental compliance may be joint and several under applicable laws.

Often the bankrupt working interest owner owes money to one or more other parties to the JOA. If the bankrupt working interest owner is a non-operator, it may not have paid all that it owes for operations conducted prior to the commencement of the bankruptcy case. If the bankrupt working interest owner is the operator, there are a variety of potential issues. The operator may have received advances from the non-operators under the advance billing procedures in the JOA that have not been applied to actual operations. A non-operator may be able to minimize some of these risks associated with advances made by it by arranging for the funds advanced to be held in a segregated account until they are applied to the payment of applicable costs. If the operator is marketing production on behalf of the non-operators, it may have received payments for production that have not been disbursed to non-operators and others such as royalty owners. A non-operator may be able to reduce the risks associated with the operator's handling of production proceeds by taking its share of production in kind and separately marketing such share, or if it is not practical to take in kind and separately market production, arranging to receive payment for its share of production directly from the production purchaser. The operator may also owe vendors for services and equipment that have been provided, but which have not been paid. Depending on the law of the state involved, the vendors may have the right to hold the non-operators responsible for such unpaid amounts and/or assert liens against the interests of the non-operators in the jointly owned lease and wells with respect to which the services and equipment were provided.

The best protection that a solvent working interest owner has for amounts that are owed by a bankrupt working interest owner or for which a solvent working interest may become responsible as a result of the bankruptcy of a working interest owner is the lien and security interest granted to each party to the JOA by the other parties. To be effective, however, these liens and security interests need to be properly perfected under applicable state laws. This is normally done by filing a memorandum of the JOA in the applicable public records and as a financing statement in the applicable filing office(s). Unfortunately, experience has shown that the filings to perfect these liens and security interests are often not made or not made in accordance with applicable legal requirements. In addition, even if the filings are properly made, the value of the liens and security interests granted to the solvent working interest owners may be impaired if liens and security interests have previously been filed and perfected by other parties against the same assets to secure debt or other obligations of the bankrupt working interest owner.

In this era of distressed counterparties, all companies and their officers and directors should continually monitor the financial condition of their counterparties, evaluate the exposure that they may have in the event of an insolvency of a counterparty and review their JOA relationships to make sure that proper filings have been made to perfect the liens and security interests granted in the JOAs.

Considerations for Acquiring Assets from Distressed Producers

For opportunistic E&P companies, lower commodity prices have or may create significant acquisition opportunities. Distressed producers are facing increased pressure from their lenders and creditors to pay down debt by selling off assets and bankruptcy filings may facilitate more attractive asset valuations. According to BDO USA LLP's annual ***Energy Outlook Survey***, 75% of energy CFOs expect M&A activity to rise in the coming year, up from 56% last year.

When acquiring oil and gas assets from a distressed producer outside of bankruptcy, a buyer and its officers and directors should consider and evaluate:

- Potential fraudulent transfer risks that could arise if the seller files for bankruptcy following closing. The federal bankruptcy code allows for fraudulent transfer claims to be brought within two years of a transaction closing, but some states have even longer statutes of limitations for similar claims under state law. In general, fraudulent transfer claims may allow creditors of the selling entity or a trustee in a seller's future bankruptcy to claw back transactions if the seller was deemed to be insolvent at the time of sale and did not receive reasonably equivalent value, factors which may be evaluated with the benefit of hindsight.
- The ability of the seller to satisfy its covenant and indemnification obligations under the purchase agreement. Many buyers will rely on escrows, holdbacks or collateral security to support these covenant and indemnity obligations, including obligations with respect to retained liabilities such as pre-closing environmental or tax obligations or retained litigation. Particular consideration should be given to how the seller's obligations under the purchase agreement will be treated if the seller later files for bankruptcy and elects to reject the purchase agreement as an executory contract or otherwise default on its obligations.
- Residual liabilities under split contracts and agreements that could saddle the buyer with complete liability if the seller fails to satisfy its obligations. For example, a seller may have a single processing agreement covering all of its assets. If the buyer acquires a portion of the seller's assets and an interest in the processing agreement, the buyer may inadvertently become jointly and severally liable with the seller under that processing agreement.
- Structuring any purchase and sale agreement to mitigate the risks arising from a "hanging" agreement in the event an agreement has been executed but not closed prior to a bankruptcy filing.

Additionally, a distressed seller may have filed for bankruptcy protection and is attempting to sell its assets through a so-called Section 363[7] sale process. Although a Section 363 sale process is similar to a traditional upstream sales process, there are certain unique differences.

- The Section 363 sale process typically begins with a marketing process by the seller and its advisor with the goal of signing a stalking horse purchase agreement with an initial bidder. In the event that a stalking horse bidder is found, the seller will typically offer inducements to the bidder in the form of a nominal, negotiated breakup fee and other bidding protections, and obtain quick court approval for the protections. The seller then holds an auction and allows other potential buyers to outbid the stalking horse bidder. If the stalking horse bidder loses the auction, the seller will be entitled to payment of the breakup fee. The decision of a potential buyer on whether to be a stalking horse bidder or wait for the auction will be an important strategic decision depending upon, among other things, the likelihood of other bidders, and structural advantages that can be obtained by negotiating the base purchase agreement.
- The purchase agreement in a Section 363 sale will be highly negotiated, but it may not contain customary purchase price adjustment mechanisms, such as expense and revenue adjustments based upon an effective time and adjustments for title and environmental defects.
- The seller may require bidders to complete all of their title and environmental due diligence prior to the auction.
- Given the strong desire of creditors for certainty of price and closing, there will typically be limited conditions to closing and post-closing covenants.
- Generally, the parties will not be required to obtain third party consents in connection with a Section 363 sale as the bankruptcy court has the authority to allow the transaction to close over these consents.
- The buyer typically has the right to pick and choose which contracts it wants to assume in connection with the Section 363 sale, although the buyer may be required to pay any cure costs associated with contracts that it assumes.
- Attention should be paid to applicable state laws (or if applicable, federal U.S. or tribal law) as the treatment of oil and gas interests may be critical to the ability of the bankruptcy court to approve the transfer of assets free and clear of related liabilities.
- There is typically very limited or no post-closing indemnification by the debtor in a Section 363 sale; however, the bankruptcy process generally allows the buyer to acquire the seller's assets free and clear of pre-closing liens, claims and encumbrances. Additionally, in some instances, buyers are able to negotiate to standalone escrows and indemnities for known liabilities (such as environmental liabilities) that the buyer will be required to assume. Also, as a practical matter, post-closing covenants or further assurances are typically fairly

[7] Section 363 refers to a section of the federal bankruptcy code that allows sales of assets outside the ordinary course of business.

limited in bankruptcy sales due to the post sale liquidation and wind-down of the seller after the sale.

- In addition to the involvement of the seller, the buyer should expect to deal extensively with the seller's primary creditors, especially secured creditors or committees of unsecured creditors.

Alternative Financing for E&P Companies

As commodity prices have declined, stock offerings and high yield debt markets have become more difficult for E&P companies. Fortunately, for companies seeking capital to take advantage of acquisition opportunities, fund development costs or reduce leverage, several financing alternatives remain available and are being increasingly accessed.

Private equity and other domestic and international funds have large amounts of uncommitted private capital – some of which is designated for opportunistic investments in the E&P sector. These funds are primarily targeting opportunities to partner with qualified operators in the acquisition of (i) developed assets that can be bought at prices that can provide a reasonable return based on current forward market commodity prices and (ii) development opportunities that have been substantially "de-risked" and can be developed profitably based on current forward market commodity prices. The investments are typically structured as a co-investment by the fund with the operator in the acquisition or development opportunity.

AcquisitionCos: Investments structured for acquisition opportunities have become known as "AcquisitionCos." In the "AcquisitionCo" structure, the operator and the investor jointly fund the purchase price and jointly own the acquired assets. The operator would be designated the operator of the assets under a typical industry JOA. Typically the investor would fund the largest share of the acquisition and would own the largest interest in the assets until the investor has realized a certain return on its investment, at which time the investor's interest in the assets would decrease and the operator's would increase.

DrillCos: The "DrillCo" structure is similar, except that the assets to be developed are already owned by the operator. The investor agrees to fund a certain percentage of the development costs in exchange for an interest in the assets to be developed. The operator is designated as operator of the assets under a typical industry JOA. After the investor has realized a certain return on its investment, its interest in the assets would decrease and the operator's interest would increase.

Asset Monetizations: Another source of capital is the monetization of non-core assets. Non-core exploration and production assets may be leases or portions of leases that are fully developed or which cannot be developed as profitably as other assets in a company's portfolio.

Midstream assets, such as gathering facilities and processing plants that companies may own in connection with their producing assets, constitute another type of non-core asset that can be divested and monetized through a joint venture without giving up reserves or upstream development opportunities. In a typical sale or a joint venture by a producer with respect to its midstream assets, it would enter into gathering and processing agreements with the purchaser of the assets (in the case of a joint venture, the new joint venture), providing for the purchaser or the joint venture, as applicable, to continue to provide gathering and processing services to the producer's wells in exchange for certain gathering and processing fees. In this way the producer continues to be able to utilize the midstream assets (and in the case of a joint venture, certain controls over the development of the midstream assets) in connection with its producing operations with no or reduced capital investment obligations relating to such midstream assets.

Compensation Issues in Today's E&P Market

With the share prices of many companies in the E&P sector currently distressed, it is likely that proxy advisory firms and institutional shareholders will increase pressure on executive pay practices with respect to both the amount of compensation (and its connection to performance) as well as the method of payment (cash versus equity). Ultimately, boards should make decisions that are in the best interest of the company. This means that boards should use their own discretion to review, implement and administer compensation policies that award appropriate amounts subject to appropriate terms. Therefore, while we do not believe that boards should be bound to follow the advice of proxy advisory firms or other entities putting pressure on executive pay practices, we do believe boards should be aware of the guidelines these entities follow.

Pay-for-Performance in an Underperforming Sector

Due in part to pressure from Institutional Shareholder Services ("ISS") and influential institutional investors, public companies are shifting larger portions of executive compensation programs to performance-based awards. Accordingly, boards and their compensation committees may want to perform an annual analysis of whether there is appropriate alignment between the compensation paid to executives and the company's strategic objectives and performance.

Investors and their advisors will be sensitive, in an underperforming sector, to performance targets that result in pay-out even where absolute performance is negative. To respond to this concern, some boards may choose to implement absolute performance targets rather than relative targets that can provide for payment when the company outperforms a nevertheless poor performing peer group. Alternatively, companies utilizing relative performance may cap payments where absolute performance is negative. For example, providing that awards will pay-out at the cap instead of maximum level where the company's negative total shareholder return outperforms the peer group.

Additionally, directors could consider using different metrics in short term versus long term goals. For example, if total shareholder return is a component of the company's long term incentive compensation awards, different criteria could be considered for the company's annual incentive bonus plan.

Equity Compensation

In 2015, ISS began using the Equity Plan Scorecard ("EPSC") to evaluate proposals for shareholder approval of new or amended equity compensation plans. In formulating an EPSC score for a company, ISS reviews (i) plan cost, (ii) plan features and (iii) grant practices. Although a full review of the EPSC and ISS metrics is beyond the scope of this summary, there are certain components of the EPSC that boards of E&P companies might consider when making equity compensation decisions.

- *Number of Shares* – In determining the cost of an equity plan, ISS reviews a plan's three-year burn rate relative to industry peers. Because depressed share prices require the grant of more shares to keep equity compensation on the same level as prior years, boards and compensation committees could consider granting phantom equity awards that are settled in cash, as these awards typically do not count against shares approved for issuance under most equity plans. Obviously, this strategy may pose challenges in a cash constrained environment and boards need to consider the potential maximum dollar amount that could become payable with respect to such awards.

- *Egregious Plan Features* – Certain "egregious" plan features (in the view of ISS) continue to result in a nearly-automatic "against" vote from ISS on a company's equity plan. As such, boards may want to review their plans to determine if the plans contain any of these provisions. These provisions include: (i) liberal change in control definitions (as discussed below); (ii) plans that allow repricing or a cash buyout of underwater stock options or stock appreciation rights without shareholder approval; (iii) plans that are vehicles for a pay-for-performance disconnect; and (iv) other plan features or company practices that are detrimental to shareholder interest such as tax gross-ups related to plan awards or reload options.

Change in Control

Given current commodity prices, E&P companies may increasingly be subject to hostile transactions and/or become attractive takeover targets. Boards may want to review the change in control definitions used in their compensation plans to ensure they are appropriately structured to fit within their companies' business objectives in this environment. However, boards should keep in mind that equity plans with liberal change in control definitions (such as a very low buyout threshold or a change in control occurring upon signing an agreement for a transaction rather than consummation), coupled with a provision for automatic full vesting upon a change in control, are likely to receive a negative recommendation from ISS.

Optimizing Your D&O Insurance Coverage in a Distressed Environment

In a distressed environment, it is important to review the company's insurance program for directors and officers to ensure that the program provides the broadest coverage possible, including in the event of bankruptcy or insolvency. A company bankruptcy does not shield individual officers or directors (or limited partnership or LLC analogs) from personal lawsuits alleging claims such as breach of fiduciary duties or securities fraud. In fact, there is a heightened risk that the directors and officers will be sued when a company is distressed. For example, prior to insolvency, only shareholders can bring derivative claims on behalf of a company. Once a company is insolvent, however, creditors can gain standing to bring claims against former directors and officers for breach of fiduciary duty.

Under normal circumstances, directors and officers have two sources of funds available for the defense of claims against them: (1) indemnification from the company and (2) D&O insurance. If the company is insolvent or bankrupt, indemnification from the company has little to no value. Ideally, D&O insurance protects directors and officers and their personal assets from claims brought by company shareholders or creditors. But there are many D&O policies available on the market, the scope of coverage varies among policies, that coverage is far more negotiable than many companies realize, and the claims history of different carriers varies widely. Directors and officers should consider working with counsel and an experienced broker to optimize their D&O coverage.

If a bankruptcy filing becomes necessary, there are often disputes over whether a company's D&O policy or its proceeds are property of the estate. These questions arise because most D&O policies provide a single policy limit that is shared among three types of typical coverage: "Side A," for the directors and officers when they are not indemnified by the company or not otherwise insured; "Side B," for reimbursement of the company when it indemnifies directors and officers; and "Side C," for certain claims against the company itself. Because of this, even when directors and officers are entitled to draw on the policy to fund the defense and settlement of claims against them, creditors or the bankruptcy trustee may argue that the directors and officers should not be allowed to deplete the available insurance because it is property of the estate. In an attempt to preserve a potential asset of the estate, bankruptcy courts may monitor or impose some limitations on the insurer's ability to pay for claims against directors and officers. Fortunately, there are ways to mitigate these risks.

First, directors and officers should consider whether the amount of D&O insurance is sufficient as well as review the terms of coverage. It may make sense to purchase additional coverage limits, though this needs to be balanced against higher premium costs, as well as the fact that new coverage layers are likely to be subject to a so-called "warranty application", which may allow an insurer to later rescind coverage if statements made in the application turn out to be untrue. Waiting too long to obtain additional coverage in the face of deteriorating financial conditions can limit or eliminate options.

In considering whether D&O limits are sufficient, directors and officers should remember that D&O policy limits are normally shared among several insureds, which may include former as well as current directors and officers, the company itself, the company's subsidiaries or controlled entities, and the directors and officers of those entities. If D&O limits are shared among a large number of individuals and entities, particularly in situations in which those constituencies might face differential claims or liabilities, directors and officers should consider additional coverage and whether supplemental coverage accessible only to particular groups of insureds is desirable.

As insurance programs vary, each policy should be reviewed in its entirety for potential coverage issues. However, directors and officers should pay particular attention to the following provisions, which can prove to be coverage headaches in financial distress or bankruptcy situations:

- The "priority of payments" clause specifies the order in which the insurer must make payments in the event of the company's bankruptcy or, potentially, other conflicts among persons with an interest in the policy proceeds. This is important because D&O insurance is so-called "wasting insurance"; policy limits are generally eroded dollar for dollar as money is spent on defense costs, settlements, or judgments. The better "priority of payments" clauses for directors and officers specify that the insurer must pay Side A claims first, followed by Side B claims, followed by Side C claims.

- Most D&O policies contain a "bankruptcy and insolvency" provision stating that bankruptcy of the company shall not relieve the insurer of its obligations under the policy, and, in the event of the company's bankruptcy, the insurer, directors and officers, and the company shall work together to obtain relief for the benefit of the directors and officers from any stay or injunction on the policy proceeds. Some D&O policies expressly require the insurer to advance expenses on behalf of directors and officers that would usually fall within the retention if the company is unable to indemnify them because of the company's bankruptcy or insolvency.

- Most D&O policies contain an "Insured v. Insured" exclusion that bars coverage for claims asserted by one insured (e.g., the company) against another insured (e.g., a former officer or director). In the past, some claims asserted by a bankruptcy trustee against "directors and officers" have fallen within the scope of the Insured v. Insured exclusion. Many D&O policies issued today include language to prevent this problem, but policies should be reviewed to ensure that such language is included and clear. Some insurers will agree to limit the "Insured v. Insured" exclusion in some way (e.g., changing it to an "Insured v. Entity" exclusion) to provide broader coverage generally. Many insurers will agree to remove the "Insured v. Insured" exclusion entirely from a Side A DIC policy.

- Some excess D&O policies contain clauses requiring actual payment by the underlying insurer of full policy limits before the excess insurer can be required to pay. This has caused problems for insured directors and officers where the primary insurer has raised some coverage defenses and agreed to a below-limits settlement with the directors and officers. U.S. courts have increasingly agreed that, following a below-limits settlement with a primary insurer (or other carrier lower in the insurance tower), directors and officers cannot reach the excess limits if the excess policies contain such language. Many excess insurers are willing to negotiate this language or modify.

- To the extent financial distress leads a company to enter into an M&A or other similar transaction, the companies involved typically must review the D&O insurance to avoid coverage gaps.

More generally, D&O insurance terms and conditions can in many cases be negotiated (often with no change in premium) in ways that are far more favorable to directors and officers than the carriers' standard forms. Competent insurance brokers and insurance lawyers can assist companies with managing these issues.

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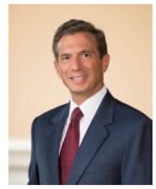

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