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Does the oil and gas industry need a special insolvency regime?

White Paper

September 2015

CMS today publishes its 'White Paper' examining whether there is a case for a special insolvency regime in the oil and gas industry.

Stephen Millar, an oil and gas partner in the Energy practice at CMS says, 'The industry is facing continued upheaval from volatile oil prices. We want to start a debate about how we work together to move the industry forward.' Emma Riddle, a restructuring partner at CMS adds, 'We are advising on a number of distressed situations in the sector. The issues involved in the interaction of oil and gas regulation and insolvency regulation are complex. This paper pulls together our thoughts on some of the challenges, and ways that these could be addressed in legislation for the future.'

Speed Read

Restructuring and insolvency regimes have been used in many other industries as a means of cutting excess costs, consolidating market players and improving financial hygiene, with a view to long-term profitability. However, this is not happening in the oil and gas sector to the extent one would expect, despite the current market conditions.

This can be traced back to the regulation of the sector and the difficulties that secured creditors have in enforcing their rights. Regulation affecting oil and gas companies also means that directors are pulled in different legislative directions when trying to comply with their duties.

We suggest that a special insolvency regime for oil and gas companies may address these tensions and set out what this might involve.

This is just the start of the debate: we are inviting feedback and would welcome your thoughts.

Next Steps

We will be hosting a number of roundtables with industry stakeholders following this publication and will report our further findings. If you want to contribute to the debate, please speak to one of the contacts listed at the back of this paper or your usual CMS contact.

Introduction

The worldwide oil and gas market is under huge pressure, with crude prices remaining sub US$55 at the time of writing, and expected to remain sub-US$100 for some time. Whilst the US dollar is for the most part the universal currency of oil, where costs are incurred in local currency, some jurisdictions – notably Brazil – are bearing an additional heavy burden from currency fluctuations. Finally, a number of oil-producing countries are facing continued difficulties from war, social upheaval and corruption.

However, despite these pressures in the sector affecting exploration and production (E&P) companies, there have been few insolvencies involving the direct owners of producing fields, and almost no recent cases in developed fields on the United Kingdom Continental Shelf (UKCS). Two examples of insolvencies involving producing assets are those of the OGX group in Brazil and of Oilexco in the UK.

In the case of OGX, it was lower than expected production levels that pushed the company into '***processo de recuperação judicial***' (judicial recuperation, the Brazilian equivalent of Chapter 11 in the United States) in late 2013. It remains uncertain whether OGX (now OGPar) can successfully exit its restructuring plan. Further declines in production on its fields and the falling oil price, together with the Petrobras 'lava jato' (car wash) scandal and wider economic difficulties continue to put pressure on the group. Meanwhile creditors of its sister group, OSX (a vessel owner and chartering group), have struggled to obtain control of the floating production storage and offloading vessels (FPSOs) located in Brazilian waters and chartered to OGX, as a result of the strategic desire of regulators to maintain production for as long as possible.

Oilexco North Sea Limited (ONSL), the UK subsidiary of the Canadian group, entered administration in the UK in 2009. It was at one point the most prolific driller on the UKCS, holding interests in a number of fields, principally Huntington. Premier Oil plc acquired ONSL, with it being rescued through a voluntary arrangement (a UK form of compromise with creditors) to exit administration. While this was ultimately a successful solution in ensuring continued production, stakeholders' views of the outcome might form part of the reason as to why so few other E&P companies have been placed in insolvency in the UK to date.

The more common approach of creditors and other stakeholders has been to try to avoid an insolvency procedure altogether and seek a consensual workout of the obligations of the insolvent debtor. Where this has not been possible, the parent entity has usually entered an insolvency process, with its officeholders looking to 'work out' the subsidiary entities through sales or consensual settlements with counterparties. A recent example of this approach has been that of Afren plc; of course it may be the case that further insolvencies in the group become inevitable if a consensual solution at that level cannot be found. This approach requires counterparty co-operation and often the supervision or intervention of government agencies.

There is a great reluctance, even among traditionally forceful creditor groups, to take enforcement action in the sector. Directors of insolvent E&P companies are also under huge conflicting pressures to balance regulatory and creditor interests. This does matter. Restructuring and insolvency regimes have been used in many other industries as a means of cutting excess costs, consolidating market players and improving financial hygiene, with a view to long-term profitability. The same need to implement change is present in the oil and gas industry. Failure to do so can result in 'zombie' companies with little or no ability to invest, develop and grow, damaging the wider economy for a longer period.

The reason for this cautious stance is the level of government regulation of oil and gas ownership and its attendant risks. This needs to be examined to consider whether regulation enables the level of market consolidation required and enables international players to enter new markets. The oil and gas market is of huge political importance globally; in many of the key regimes it is the only or main source of a government's revenue. In others, such as the UK, it remains an important source of government revenue and employment. Outside the United States, unproduced hydrocarbons are owned by sovereign states and not the owner of land and the strategic importance of hydrocarbons are recognised by United Nations General Assembly Resolution 1803 which declares the '*right of peoples and nations to permanent sovereignty over their national wealth and resources*'. As a consequence, the regulation of exploration, development and production activities; the ownership of unproduced hydrocarbons; the requirements for decommissioning; and the import and export of vessels and equipment required to facilitate such programmes are tightly controlled. This is true to a greater or less degree, whether in a free-market environment such as the UK or a more controlled economy such as Brazil.

The regulatory restrictions imposed on E&P companies inhibit the usual operation of insolvency regimes (these are explored in detail in the 'Key Regulatory Challenges' section below). It is harder to monetise assets, harder

and more risky for secured creditors to enforce and more difficult for insolvent debtors to jettison liabilities. Further, there is often a tension between the need to realise value for creditors and the demands of regulation, putting directors under huge pressure. These pressures are generated by political considerations and public policy and the need to maintain oil production and revenues, without cost to the state. If this is the case, should there be a special insolvency regime for E&P companies?

This question is considered by reference to the UK regime but it is equally relevant in other jurisdictions.

Special regimes in the UK

Since the early 1990s when the first 'special' regimes were introduced for railways and water, there has been a proliferation of 'special' insolvency regimes in the UK. It is useful to examine the key special regimes and their characteristics and consider whether the lessons and utility of those regimes could be applied to the oil and gas sector.

In order to distinguish 'special' regimes, it is important to identify the key elements of a 'usual' regime. All insolvency processes can be said to have some common characteristics that are relevant in considering a special regime. The first is that they provide a mechanism for gathering in the assets of an insolvent debtor and distributing those assets to the debtor's creditors in accordance with their respective interests. Secondly, in general terms, creditors will be treated equally, unless there are reasons of public policy or law to favour them: for example creditors holding certain types of security, tax authorities and employees are often treated more favourably than other creditors. Third, there will be a different treatment for debts incurred prior to the date of insolvency, compared with those incurred by the insolvent debtor during its insolvency process, usually with post-insolvency debts enjoying absolute or limited priority. Fourth is that there will be a mechanism to examine transactions that occurred prior to the date of the insolvency, with a view to ensuring that the insolvent debtor has all of the assets that it should have, and that creditors do not receive more than their 'fair share'.

A usual regime has as its guiding principle the interests of creditors and their rights to recover value; commercial promises and other types of interest are disregarded. So, in a UK administration (non-terminal insolvency proceeding) for example, there is a single purpose with three hierarchical parts: (a) to rescue the company as a going concern; (b) to achieve a better outcome for creditors as a whole than would be achieved by the company going into insolvent liquidation (a terminal insolvency process) or (c) realising property to make a distribution to one or more secured or preferential creditors.

The key difference between a 'usual' regime and a 'special' regime is that the latter recognises that in certain sectors and situations, the rights of creditors (such as finance providers, counterparties and tax authorities) are not paramount. The 'special' purpose and achieving that special purpose are the key outcomes. In the UK, the first special regimes were those applicable to railways and water, and, until recently, special regimes were limited to some of those businesses that were previously in public ownership: (among others) rail, water and electricity distribution/ transmission.

The railway special administration regime, which was created in 1993 and used in 2001 in the case of Railtrack plc (the UK rail infrastructure owner), has as its purpose, '*(a) the transfer to another company, or (as respects different parts of its undertaking) to two or more different companies, as a going concern, of so much of the company's undertaking as it is necessary to transfer in order to ensure that the relevant activities may be properly carried on; and (b) the carrying on of those relevant activities pending the making of the transfer.*' In other words, Railtrack could continue to operate as usual while a solution was found, notwithstanding the interests of creditors. Similarly the energy[1] regime's special purpose is that '*the company's system is and continues to be maintained and developed as an efficient and economical system*' and to achieve this that either the company is rescued or a transfer is effected of all or relevant parts of its business. Similar provisions apply to water and sewage companies.

In each case, the 'special purpose' displaces the usual purpose of returning money to creditors. Further, the insolvency officeholder is authorised to expend funds that would otherwise be returned to those creditors to further that 'special purpose', even if it will not realise value. More recently, 'special' regimes have been introduced in the finance sector. Following the 2008 banking crisis, which in the UK resulted in both the 'usual' administration of Lehman Brothers International (Europe) (LBIE) and the government rescues of Lloyds TSB and RBS

[1]In this context, 'energy' special administration applies to companies holding a licence granted under section 6(1)(b) or (c) of the 1989 Act (transmission and distribution licences for electricity) or a licence granted under section 7 of the Gas Act 1986 (licensing of gas transporters).

through innovative lawyering and ad hoc legislative measures, it was determined a new 'special' regime was required. The UK government introduced 'bank insolvency' and 'bank administration' for deposit-taking financial institutions where the principal purpose of the process was to maintain the rights of depositors and ensure the integrity of the banking system. These were coupled with government powers to effect 'partial property transfers', which could be used forcibly to transfer parts of a UK deposit-taking financial institution to a third party. Similar regimes were introduced for building societies. More recently, the investment bank[2] 'special' insolvency regimes have created mechanisms to ensure that clients of investment banks can access client monies and client assets as soon as possible and also provide a regime to permit a fair distribution where there are insufficient client monies and client assets for a full distribution following irregularities.

Other recent introductions include a 'special' regime for energy suppliers, in addition to the existing regime, where the objective is to continue supply at the lowest reasonable cost that it is practicable to incur either by rescuing the company as a going concern or effecting transfers of all or part of its business.

There are examples in other sectors where there is no special regime but public criticism of the effects of insolvency have made it difficult to follow the usual rules to achieve the purpose of administration for the benefit of creditors. Examples include:

— **Care homes for elderly or disabled persons:** there is no special regime but creditors were forced to consider public policy issues. In the UK case of Southern Cross, a large elderly residential care group, the directors of the group, landlords and other creditors were put under significant political pressure to preserve and continue the business, notwithstanding that in economic terms this was not in the interests of creditors. This of course was morally and politically completely rational but not at all consistent with the insolvency laws that actually applied to the company.

— **Law firms:** there have been a large number of law firm insolvencies in both England and Wales. While client monies are treated as trust monies on insolvency and so are ring-fenced from creditor claims (although the legal basis for this is not as clear as one might expect), the regulatory body for solicitors in England and Wales, the Solicitors' Regulatory Authority (SRA), also requires, for example, insolvency officeholders to ensure that client records are retained and stored in accordance with SRA principles, even though clients are not creditors and the costs of storage are significant. There is no benefit to creditors in taking this action but it is seen as essential to prevent the SRA exercising its powers to intervene (take over) a practice.

Once one accepts that there are scenarios where a greater public good or political objective is more important than a free market solution, the question then arises as to which other sectors should have a 'special' regime, and whether oil and gas exploration should be one of those sectors.

In assessing this question, it is useful to look at the UK oil and gas regulatory regime and consider the public policy objectives behind it.

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Oil and Gas Regulation in the UK

Oil and gas is a highly regulated industry where participants need a licence, concession or other contractual right from the applicable regulatory body in order to undertake exploration and production operations. In the UK, many of the relevant powers (other than decommissioning of offshore oil and gas installations and pipelines, which remains the responsibility of DECC) have recently transferred from the Department of Energy and Climate Change (DECC), to its executive agency, the Oil and Gas Authority (OGA): although historically insolvencies have been addressed by DECC, for simplicity OGA is used below. The OGA, issues licences through competitive licensing rounds. The UK government's take from oil and gas activities is derived from taxation and the nominal annual area rental fee, while the licensees are entitled to take and use any production they 'win' from the licensed E&P activities.

[2]Institutions distinguished by being authorised to conduct investment business such as holding client monies or client assets.

Alternative contracting models are used in other jurisdictions, such as the production sharing model where the international oil and gas companies (IOCs) obtain E&P rights and, potentially, a share in production or production revenues pursuant to a production sharing contract (PSC or PSA) with the national petroleum company as concessionaire on behalf of the relevant government or state. This structure is particularly popular in countries that cannot afford to develop their own infrastructure as under a PSA the IOCs typically bear all exploration and development costs (and therefore prospectivity risk) through to commercial production. Upon commencement of commercial production, the IOCs become entitled over time to recover their investment costs and a variable profit share (declining as aggregate field production or the IOC's IRR increases) from production revenues, with the balance of production or production revenues being allocated to the concessionaire or the State.

The UK Offshore model

Focusing on the UK offshore 'in-round' model, one or more parties will apply for a production licence from the UK government, through the OGA, in one of the regular licensing rounds. If the application is successful, the licensees are awarded a Licence that will cover exploration, appraisal, production and decommissioning activities and require certain work obligations to be met within set time periods.

In order to share expertise, costs and risks, two or more companies usually club together to apply for a Licence. It is important to note that all licensees are jointly and severally liable to the OGA for the performance of work and payment obligations under the licence. The purpose of this is to ensure that private industry and not the tax payer ultimately pays for hydrocarbon exploration. Where there are multiple licensees, these parties (typically referred to in industry parlance as 'co-venturers') regulate their unincorporated joint venture relationship and allocate costs and benefits from the licensed activities among themselves via a joint operating agreement (JOA). UKCS JOAs tend to be variations on the standard form produced by the industry group, Oil & Gas UK but other industry representative bodies such as AIPN produce template JOAs, as do the larger E&P companies themselves.

Common to all JOAs is that one party will act both as a co-venturer and as the Operator of the joint venture, directing day-to-day operations and contracting with third parties on behalf of the licensees for the conduct of the licensed activities. The licensees are responsible for paying the costs of the joint venture in accordance with their respective percentage interests under the JOA and exercising oversight of the Operator through the joint operating committee established under the JOA. The other point of note is that the standard JOA contains provisions that provide, on the default of a party, for the other parties to take over the defaulting party's share of production and ultimately its interest in the licence and field. While these should in theory provide a smooth transfer of operations from an insolvent JOA party to a solvent JOA party, in practice the industry debates about the effectiveness of these provisions (which are ongoing) and the reluctance of solvent JOA parties to crystallise additional liability mean that – to our knowledge – they have never actually be exercised in full in the UK market.

Key Regulatory Challenges

There are four key regulatory matters that are relevant to the ability to restructure oil and gas companies active in the UKCS, and are driven by public policy considerations.

Transfers of licence interests

Licences are not freely transferrable. The OGA's consent must be obtained to any transaction that purports to transfer an interest in or benefit deriving from a licence. Additionally, whilst the OGA's consent is not specifically required to a change of control of a licensee (as opposed to a transfer of a licence), there are circumstances in which the OGA can seek to revoke a licence on the basis of a change of control. As a result, market practice is to seek a 'comfort letter' from the OGA that it will not exercise its rights under the licence upon the proposed change of control.

The public policy consideration is that a government will be keenly interested in who can control and have an influence in the means of oil production. This has recently been starkly illustrated in the case of LetterOne, where the UK government made it clear that the ownership of UKCS fields, including the flagship Breagh field, by entities backed by Russian oligarch Mikhail Fridman was not acceptable.

This means that the OGA's involvement and consent in any restructuring process is critical, as the transferee of a business or company will only be able to have certainty as to the asset if it knows that the OGA is supportive.

Ownership

In the UK, ownership of the oil or gas in the ground does not pass from the Crown to the licence holders until extraction; this is contrary to the position in (for

example) the US but is the typical position in other jurisdictions. For this reason, the restrictions imposed under the terms of the licence are not limited to ownership of the licence/licence holder but also as to how licence holders can exploit their interest in oil that has not yet been extracted. In brief, any arrangement for the sale of (or the grant of an interest in) future production where the consideration is paid in advance of extraction will require OGA consent.

These restrictions mean that, in a distressed scenario, raising monies against future production, or entering into a forward sale, is challenging. 'Reserve based lending' facilities are available for proven reserves for an entity with some producing assets; many of the smaller independent companies in distress have only exploration assets with little or no current production. Therefore the inability to provide title to unproduced hydrocarbons means 'asset based' arrangements – the common recourse of distressed businesses – can be impossible where new security arrangements will be commercially unacceptable. It is possible through an OGA 'Open Permission' to create floating charge security or an English law fixed charge over a licence interest but, given the difficulty in monetizing that right without further consents, this is not as valuable a right as it might seem and is not security directly over an asset. Some further drawbacks of security over certain assets, specifically a party's interest in field installations and pipelines, are addressed in the 'Decommissioning Liabilities' section below.

Effect on insolvency on licences

The OGA has powers to terminate a licence on insolvency, though in most modern licences this revocation right may only apply in respect of the licence interest of the insolvent licence holder. The OGA also has powers to terminate a licence against all licence holders if there is a breach of other licence obligations, for example the obligation to pay annual licence fees when due. Furthermore as explained above, the OGA has consent rights in respect of the transfer of interests by asset sale and in any contract that has the effect of a transfer in production that has not yet been extracted.

The OGA will commonly hold a parent company guarantee for the work and payment obligations of a licensee under its licences. This can also cause difficulties in restructuring scenarios.

Decommissioning Liabilities

One of the most significant and unpredictable costs of operating an offshore oil or gas field is its decommissioning. Under the Petroleum Act 1998, DECC can impose liability for decommissioning on a wide group of people having an interest in an installation or pipeline, including licensees, participants (who may differ from the licensees) and companies associated with a licensee or a participant. DECC even has power to impose liability on previous licensees and their associated companies, although, to date, it has not exercised this power. DECC may serve notice (a 'Section 29 notice') on any relevant parties to submit a decommissioning programme and once that programme has been approved by the Secretary of State, the parties who submitted the programme are jointly and severally liable to carry it out. Once a decommissioning programme is approved, the Secretary of State can request financial security from those who submitted it.

As each entity is jointly and severally liable for the performance of the decommissioning programme, licensees usually enter into a decommissioning security agreement (a DSA) to ensure that one party is not on the hook for all of the decommissioning costs. Under the terms of a DSA, each party agrees to provide security for their share of the decommissioning costs, which normally takes the form of a letter of credit or a parent company guarantee. However, where a company becomes insolvent or some other specified trigger occurs (for example, the expiry of a letter of credit that is not replaced or the decline of the parent guarantor's credit rating below a minimum specified level), the DSA will normally require that an amount equal to the insolvent company's share of the decommissioning liabilities is paid into a trust account. At law, DSA payments are ring-fenced in an insolvency.

The fall in energy prices is particularly critical if the 'trigger date' for making decommissioning provisions under the DSA is based on the estimated net value of the remaining reserves in a licensed area reaching a specified proportion of the estimated net costs of decommissioning the relevant facilities. This is because, given currently depressed oil prices, the specified figure is likely to be reached a lot more quickly than anticipated. Clearly, where provisions are to be made by letter of credit or cash payment into escrow, this can put an additional and perhaps unbearable strain on already struggling companies. An initial step being considered by E&P companies is the amendment of the terms of existing DSAs to reflect the provisions of the decommissioning relief deed agreed between the industry and the UK government, which essentially permits current tax reliefs on decommissioning expenditures to be 'locked in' in anticipation of future decommissioning activities, with this enhanced degree of certainty allowing the cost of decommissioning to be calculated on a post-tax, rather than pre-tax, basis, thereby potentially deferring the trigger date under the DSA.

Public Policy

If one considers the regulatory controls set out in the previous section, there are clear policy considerations driving their imposition:

The five principles:

— Oil and gas are strategic assets and cannot be solely a concern of the private sector;

— there are political concerns about the ownership and control of oil and gas production;

— there are economic benefits to the host government in encouraging exploring and appraising potential new sites of production;

— there are economic and strategic benefits to the host government in continued oil and gas production; and

— economic costs of exploration, development and production must be borne by the private sector and not by government.

This is true in the UK. It is even more the case in Brazil and other countries in Latin America where much of the rise in prosperity, especially since the discovery of the pre-salt fields in 2007, can be attributed to continued growth of an oil economy. Where oil and gas is a key plank of a country's economy, it is understandable that the five principles could be pursued even where that requires intervention by the state.

The five principles and insolvency

The five principles can be fundamentally at odds with the aims of an insolvency process. If production is uneconomic, there is no free market reason to continue production. The rights of creditors could best be protected by entering an insolvency process and realising whatever value from cash could be achieved. However, this does not generally happen. Governments make it clear that licence terms must be honoured; that production must continue and, in some jurisdictions, that assets must remain in production even if the contractual terms on which those assets (for example FPSOs) are being provided for use are not honoured.

As this is the case, one questions whether it might be more transparent if a special regime were introduced for E&P assets. This could address both (a) the five principles, making it clear exactly how they would be protected and enforced and (b) by doing so, make it easier to use an insolvency process to restructure an E&P company, by making the interaction of regulation and insolvency more transparent.

Therefore, if one were to propose such a regime, what would it look like?

E&P Special Administration Regime

As set out earlier in this paper, the key difference between a 'usual' regime and a 'special' regime is the purpose of the insolvency process. The special purpose of administration of an E&P company could be:

(a) where the company has an interest in a producing asset, to continue production; (b) where the company is a licensee with unperformed minimum work obligations, to complete those minimum work obligations, especially with respect to firm well commitments.

in each case at the lowest reasonable cost that it is able to incur while either achieving the rescue of the company as a going concern or transferring all or part of its business to achieve that purpose.

The principal effect of this change would be to ensure, beyond doubt, that licence fees and other amounts due under the licence, together with JOA liabilities necessary to continue production or complete minimum work obligations, would be payable in priority to other amounts for a limited period in order to achieve the special purpose, whether or not this would result in reduced recoveries by creditors.

Further, where the holding of a licence is considered a liability rather than an asset, there could be a compulsory disclaimer and assumption procedure, triggered by the OGA rather than the officeholder, to enable the OGA to require JV parties formally to take on licence and JOA obligations, similar to that available in liquidation in respect of other liabilities. There would be a standard calculation of the liability or asset created by the transfer. In many ways, this would be to give statutory effect to the default provisions found in the standard JOA. This goes further than the current termination rights because it would apply directly to the JOA and not just the licence, and it would enforce the default rights at a fair value.

Other associated contractual arrangements and rights would need to be included in the regime.
In return for this increased control, there could be explicit

protections for secured creditors in relation to potential liability in taking control of E&P companies through the appointment of an officeholder. This would include a specific exclusion making it clear that secured creditors could not be served with 'Section 29' notices in relation to decommissioning simply by reason of exercising enforcement rights. At present, fear of liability for pollution, HSE and other issues, especially where the insolvent debtor is the operator, provides a real stumbling block to effective appointment notwithstanding that the real associated risks of liability are small.

Additionally, secured creditors could obtain the ability to enforce security directly over E&P assets without needing an OGA consent as to the identity of the transferee, if the transferee is already the holder of a UKCS licence. Provided that the transferee was itself solvent there could be no continuing right for the OGA to terminate for the insolvency of the transferor. Further, this could allow 'cherry-picking' of viable licences. This would enable consolidation and provide a valuable tool to secured creditors to facilitate continued operations.

In summary, there would be greater scope for government intervention but also greater certainty for secured creditors in exercising their rights.

This is of course based on the UK model. In other jurisdictions, where (for example) a combination of the courts and the regulatory authorities have permitted insolvent E&P companies to continue to utilise equipment without paying for it in order to achieve the strategic purposes outlined above (for example in relation to OSX1 and OSX3 in Brazil), a more transparent procedure would be to provide for this in the relevant regulations and set out how, in the specified circumstances of non-payment, the equipment provider is ultimately to be compensated.

Addressing the priority of regulatory obligations in insolvency more transparently would, we suggest, have the additional benefit of assisting directors of E&P companies, who are currently caught in the middle between their regulatory and insolvency obligations, which as illustrated do not always neatly coincide.

The problems for directors

At present, directors of E&P companies find themselves in an incredibly difficult position when that company is placed in distress. In the current oil price environment, that distress has been caused by falling oil prices and not necessarily by mismanagement.

In the normal course directors of an English company are required to perform both their statutory and common law duties, which in broad terms are to promote the success of the company for the benefit of shareholders. However, where a company is insolvent or potentially so, this duty can be displaced such that the principal duty is to creditors.

In seeking to comply with duties to creditors, the directors must consider (in very simple summary):

— whether there is a reasonable prospect of avoiding insolvent liquidation and, if not, they must ensure that they are taking every step to minimise loss to creditors;

— whether they are taking steps that could either advantage or disadvantage certain creditors or groups of creditors.

There will be occasions, principally in a buoyant oil market, where the interests of creditors and other stakeholders (such as the OGA) will be completely aligned. However, in the current price environment, this is often not the case, with the two key groups of creditors – financial creditors on the one hand and co-venturers and the OGA on the other, the latter having special regulatory powers – having fundamentally opposed views as to what should happen. Particular tensions can arise around approval of new AFEs and participation and voting in other operating committee decisions. This can leave directors, especially directors with a deep understanding of the industry, in a difficult position.

This unease will only increase once the further provisions of the Small Business Enterprise and Employment Act take effect on 1 October 2015. From that date, the courts, on the application of the Secretary of State, will have additional powers to impose personal liability on directors for losses caused to one or more creditors in respect of behaviour that is the subject of a directors' disqualification procedure. Alternatively the Secretary of State may accept an undertaking to pay compensation without applying to court. Given that failure to pay any monies owned to HMRC is one of the subject points of the test for disqualification, could this principle be extended to other amounts owed to government such that the failure to comply with regulatory obligations to pay licence fees etc. may, like a failure to pay HMRC, result in further potential personal liability for directors.

It could be much more transparent and more certain for directors and other stakeholders if an insolvency regime were devised that enabled the same regulatory matters that drive behaviours prior to insolvency to continue through an insolvency process, enabling directors to comply with their duties with much more certainty.

The contrasting view

There are some obvious and natural objections to the imposition of yet another special administration regime:

— it is inconsistent with a free market economy;

— it is unnecessary;

— it would further complicate the insolvency framework applicable in the UK;

— it will reduce the availability of financing for oil and gas companies, at just the time this is most needed, as the additional costs would be factored into financial covenants.

The first is answered in the earlier part of this paper: oil and gas is not a free market and is already subject to significant state control. The question is how much state control is appropriate and whether this crosses the boundary. We suggest that the introduction of a special regime could simply recognise the level of control that already exists and make the duties and obligations of stakeholders clearer within a defined framework. If one accepts this, it is also the answer to the second objection.

The third objection has some truth. It is arguable that the myriad of special regimes are already too complicated and inconsistently drafted. However, once it is accepted that there are public policy considerations that outweigh the rights of creditors, does it perhaps make sense to have a special set of rules to protect those interests?

The final objection is most difficult to overcome and we look forward to gathering views. In any circumstance where costs or deductions are imposed ahead of the rights of secured creditors, those costs will need to be quantified and taken into account in lending criteria. Further, especially in such a global market, the UK would not wish to create a regime where it was unfavourable to lend, with scarce resources instead being invested elsewhere in the world.

However, it may be right to overcome these objections, such that it could even be argued that it was favourable to secured creditors. At the moment, secured creditors need permission to enforce any security over licence interests, and the risks in enforcing those rights limit the desire to use them. As argued at the beginning of this paper, enforcement and consolidation can actually be a force for dynamism and development in an industry. If it were possible to simplify the transfer regime, at least to other licence holders on the UKCS without permission for example, this could be a sufficiently generous incentive to enable creditor support to be obtained. The same issues arise in other jurisdictions and the UK might, as with other aspects of its regulatory regime, actually benefit from having a clear and transparent system that takes account of all competing interests.

This is the start of the debate. We look forward to gathering your views with a view to reporting the outcome in January 2016.

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