



Cleaned Out by Bankruptcy

A Primer on Environmental Cleanup Duties in Bankruptcy

Introduction¹

For the oil and gas industry, bankruptcy has become commonplace. From the beginning of 2015 through September 2019, nearly 200 North American oil and gas producers filed for bankruptcy protection, restructuring more than \$100 billion in debt.

In theory, bankruptcy gives a company a fresh start, wiping away debts to give a firm a fighting chance at making a profit. **But what about cleanup responsibilities?** When an oil and gas company files for bankruptcy, is it still on the hook for plugging old wells and cleaning up contaminated sites?

The simple answer is: **Yes, oil companies are still responsible for cleanup—even after bankruptcy.** Although bankruptcy erases many liabilities, federal bankruptcy law does not let oil companies dodge responsibility for plugging old wells, rehabilitating drilling sites, or cleaning up contamination.

This has profound implications for investors. When a company declares bankruptcy, investors may hold out hope that they'll still recover some of their money in the bankruptcy process. But bankruptcy law is clear: cleanup obligations have high priority in bankruptcy, which can make it harder for creditors to recover money from bankrupt companies.

A Bankruptcy Primer

The federal bankruptcy process creates an orderly way for a company to resolve its *financial liabilities*—that is, its legal and contractual obligations to pay cash to other parties.

The process has been likened to a cascading waterfall.² Federal law groups creditors into “pools,” sorted in order of priority. Just as the top pool of a cascade must be filled before any water can spill into the next pool, creditors in a higher-priority pool must be paid in full before any money can “spill” into a lower pool. If the money runs out, creditors in lower pools will be left unpaid.³

Federal bankruptcy law specifies which creditors are put into each pool. At the very

¹ Unless otherwise cited, the information in this briefing paper has been adapted from Greg Rogers, of Eratosthenes, LLC, *Accounting for Environmental Liabilities in Bankruptcy*, September 2016. Any errors of fact or interpretation are the responsibility of IEEFA.

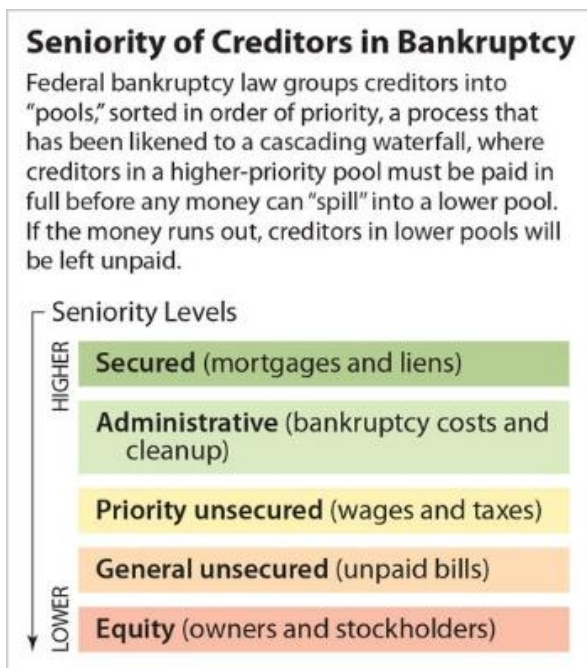
² See, *inter alia*, Janney Corporate Credit, *Bankruptcy Primer*, July 27, 2016.

³ Investopedia, *Which Creditors Are Paid First in a Liquidation?*, updated July 1, 2019.

top of the bankruptcy cascade are *secured creditors*—those with a legal right to take possession of the debtor’s property. Mortgages are an example of secured debt, since a bank can repossess a home if a borrower stops making mortgage payments.⁴ Similarly, some corporate debt is secured by some or all of a company’s assets. Secured creditors’ recovery may be limited by the value of the collateral that secures their debt: if \$50 million dollars in debt is backed by assets that are only worth \$20 million dollars, then the creditor may only recover \$20 million.

Directly below secured creditors lie “administrative” claims for expenses that arise in the bankruptcy process itself. Administrative expenses are sometimes described as *super-priority* claims because they vault ahead of all other unsecured claims. As we will see below, administrative claims can include cleanup and other environmental liabilities.

Below administrative claims come some specific unsecured claims, such as unpaid wages and taxes. These are followed by general unsecured claims, such as money owed to vendors, followed by various subordinated claims. **At the very bottom are the owners—including stockholders—who have no legal right to a payout in bankruptcy until all other claims are paid.**



Typically, a bankrupt company holds an auction to sell its assets and distributes any proceeds to creditors based on the order of priority. After all money is distributed in the bankruptcy “cascade,” the court cancels the company’s remaining debts, even if it means that some creditors will never be repaid.

But that’s not the end of the story. Many health, safety, and environmental laws create *non-financial liabilities*, which are legal duties to deliver specific goods or services. Legal obligations to clean up contaminated sites, dispose of hazardous wastes, or decommission oil and gas wells are all examples of non-financial liabilities. Unlike financial debts, ***non-financial liabilities cannot be wiped out in the bankruptcy process.*** Even after declaring bankruptcy, a company is still on the hook for its cleanup liabilities.

Cleanup Obligations Have High Priority in Bankruptcy

As soon as a company begins drilling a well, constructing an offshore oil platform, or building a pipeline, it incurs a cleanup duty—called an “asset retirement obligation”—that endures until the asset is fully retired.

⁴ Investopedia, *Secured Debt*, updated March 11, 2016.

These non-financial cleanup obligations hold a special place in bankruptcy, typically ranking as “super-priority” administrative expenses near the top of the bankruptcy cascade. As a result, **courts have held that companies must set aside enough money to cover cleanup obligations after they emerge from bankruptcy.**

The distinction between financial liabilities and non-financial liabilities is key here. When a company has racked up *financial* liabilities under environmental laws—say, past-due fines or unpaid bills for previous cleanup work—bankruptcy law treats those debts as unsecured claims that may never be repaid. But because future cleanup obligations are *non-financial* liabilities, they cannot be discharged in bankruptcy.

Non-financial liabilities, including cleanup obligations, typically pass straight through the bankruptcy process. If the debtor continues to own or operate an asset after bankruptcy, the debtor retains the cleanup obligation. Or if the debtor sells an asset during bankruptcy, the buyer assumes the responsibility for cleanup. Even if a company takes an asset out of service before filing for bankruptcy, it is still on the hook for any unfinished cleanup.

Asset Retirement Obligations Complicate Secured Claims

Even though bankruptcy law puts secured creditors at the top of the bankruptcy cascade, asset retirement obligations can undermine secured claims.

Consider an oil and gas company that has \$1 billion in debt that is secured by a set of oil and gas wells. If the bankruptcy courts determine that the assets actually are worth only \$600 million, then the creditor’s recovery may be limited to \$600 million, rather than the full \$1 billion.

The value of an oil company’s wells, in turn, can be affected by future cleanup costs. Wells that are expensive to plug, or that must be retired soon, are worth less than similar wells with retirement costs that are lower or come later. If the retirement liabilities are high enough, a company’s assets might be worth less than the debt that they secure. In such cases, courts may find that some or all of a creditor’s “secured” debt is actually unsecured, with lower priority in bankruptcy.

Cleanup expenses can pose additional risks to fossil fuel investors. For example, investment funds that are both lenders to and owners of a bankrupt company may be held liable for the entirety of the company’s environmental liabilities—including liabilities unrelated to assets that secure that debt—simply because of their ownership stake in the company.

“Super-Priority” for Cleanup Gives Governments Leverage in Bankruptcy

The “super-priority” status for cleanup gives the federal government and the states leverage to secure significant cleanup funding during bankruptcy cases.

For example, in the Energy Future Holdings bankruptcy, Texas regulators negotiated a \$1.1 billion coal reclamation carve-out with higher priority than all

other unsecured claims. Similarly, in the bankruptcy of former coal giant Alpha Natural Resources, the U.S. Department of the Interior blocked the proposed sale of federal coal leases because the company couldn't satisfy its asset retirement obligations. The government ultimately negotiated significant cleanup funding concessions from Alpha's secured creditors.

In these and other cases, funding for cleanup vaulted ahead of other liabilities and debts, which creates financial risks for fossil fuel investors. Some creditors saw reduced payouts from the bankruptcy process because of the "super-priority" status of cleanup.

Conclusion

North America's fossil fuel industry faces hundreds of billions of dollars of long-term cleanup liabilities.⁵ The industry has drilled more than one million oil and gas wells,⁶ each of which can cost tens or even hundreds of thousands of dollars to plug.⁷ It has built thousands of offshore oil platforms⁸ and hundreds of thousands of miles of oil and gas pipeline.⁹ And as described above, bankruptcy law makes it difficult for companies to use bankruptcy to dodge their responsibilities for cleaning up these assets.

The fossil fuel industry hopes to pay for cleanup by spreading costs over many decades. But this plan poses serious risks for the industry's investors. North America's oil and gas sector already faces severe financial stresses stemming from low energy prices, poor financial returns, and massive amounts of outstanding debt.¹⁰ These stresses have already rendered much of the nation's energy infrastructure unprofitable. Any additional pressures—such as climate-related legislation or litigation, or lower oil or gas demand stemming from the boom in renewable energy—could force companies to retire some of their assets far sooner than expected.

Early asset retirement, in turn, would create compounding risks for fossil fuel investors. Companies forced into early cleanup will see lower cash flows and an elevated risk of bankruptcy. And if a company does enter bankruptcy, hefty cleanup obligations can make it harder for investors to recover money from the bankruptcy process.

Asset retirement obligations represent a profound but underappreciated risk to the solvency and profitability of the oil and gas sector. Investors would be wise to

⁵ See, *inter alia*, Mike De Souza, Global News, *Cleaning up Alberta's oilpatch could cost \$260 billion, internal documents warn*, November 21, 2018.

⁶ FracTracker, *1.7 Million Wells in the U.S. – A 2015 Update*, August 3, 2015.

⁷ Stephanie Joyce and Jordan Wirfs-Brock, *The Rising Cost Of Cleaning Up After Oil And Gas*, October 1, 2015.

⁸ Richard Shaw, et al., Coastal Marine Institute, *Offshore Petroleum Platforms: Functional Significance for Larval Fish Across Longitudinal and Latitudinal Gradients*, December 2002.

⁹ US Department of Transportation, Pipeline and Hazardous Materials Safety Administration, *Annual Report Mileage for Natural Gas Transmission & Gathering Systems*, October 1, 2019.

¹⁰ Clark Williams-Derry et al., Institute for Energy Economics and Financial Analysis, *U.S. Fracking Sector Disappoints Yet Again*, August 2019.

consider the financial risks stemming from cleanup when deciding whether to pour additional money into fossil fuel companies.

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