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Distressed Energy: Midstream Agreements — Impact on E&P Creditor Recovery

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Exploration and production (“E&P”) companies typically enter into wellhead service contracts (collectively, “Midstream Contracts”) for gathering,¹ processing and transporting oil and gas to market. In exchange for these services and the capital commitment to build a gathering system, the E&P may provide the midstream counterparty (“Midstream Service Provider”) with a dedication of reserves or acreage commitment for performance of the Midstream Contracts. (See Figure 1). A dedication of reserves is intended to assure an adequate utilization of the gathering and pipeline system and is often accompanied by a hydrocarbon purchase contract between the E&P and the Midstream Service Provider. In many cases, Midstream Contracts also include a commitment of a minimum volume of oil or gas (“Minimum Volume Commitment” or “MVC”) that is produced and processed from the land on which the E&P operates, which requires the E&P to pay a fixed fee to the Midstream Service Provider if volume requirements are not met.

Creditors of and potential investors in both the E&P and the Midstream Service Provider should analyze the precise language and mechanics in the relevant party’s Midstream Contracts because the provisions relating to dedication and MVCs will be significant in determining: (1) whether or not the Midstream Contract can be rejected, and (2) how the Midstream Contract claim will be treated in an E&P bankruptcy case. While case law addressing the treatment of midstream agreements is unclear and incomplete, and the outcome in each case is fact-specific and dependent on the law of the state where it is heard, recent bankruptcy case developments (e.g., *In re Sabine Oil & Gas Corporation* and *In re Quicksilver Resources*)² provide some measure of guidance for creditors and investors. Ultimately, the legal analysis of whether a Midstream Contract can be rejected must be incorporated into an economic analysis of these contracts and the alternatives available to the E&P and Midstream Service Provider.

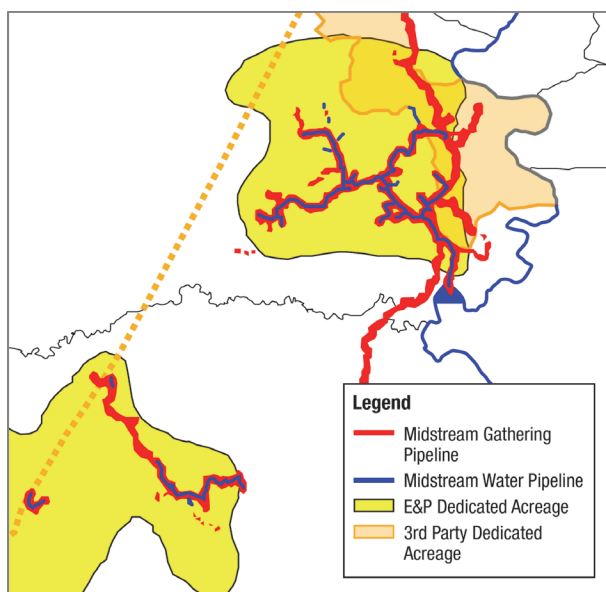


Figure 1

¹ “Gathering” refers to “the process of collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline’s principal transmission system.” Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers Manual of Oil and Gas Terms* 433 (15th ed. 2012).

² In the *Sabine* bankruptcy case, the issues have been fully briefed by the debtors and the midstream gatherer counterparties respectively, and the presiding judge has heard oral arguments and indicated on the record that a bench decision is forthcoming. In the *Quicksilver* bankruptcy case, the debtors have filed a motion to reject executory contracts with certain midstream counterparties (Dkt. 1128). We are monitoring both cases and are happy to respond to any inquiries with respect to either case or the issues set forth in this *White Paper*. The *Sabine* and *Quicksilver* bankruptcy cases are currently pending under the captions *In re Sabine Oil & Gas Corporation, et al.* (Case No. 15-11835) (Bankr. S.D.N.Y.) and *In re Quicksilver Resources Inc., et al.* (Case No. 15-10585) (Bankr. D. Del.), respectively.

What's at Stake?

Midstream Providers have argued that midstream contracts with acreage dedications and language identifying such interests as “covenants that run with the land” are not property of the E&P’s bankruptcy estate and not capable of being rejected as an executory contract. If Midstream Providers are correct, they would have significant leverage in renegotiating the terms of services with E&Ps, and the resulting decrease in the size of asset pool available for the E&P’s creditors could lead to substantially diminished recoveries. In response, E&Ps and their creditors have argued that dedications merely create for a service provider a contractual interest that may be rejected in bankruptcy, resulting in a prepetition general unsecured claim for the damages flowing from rejection.

The dedication language and mechanics of a Midstream Contract can be granular and esoteric, but they require careful analysis given their potential implications in a bankruptcy case. To illustrate, based on Texas law — where oil or gas in the ground is real property, but once separated from the earth, becomes personal property — a provision that purports to dedicate an interest in the E&P’s oil or gas “in place” (i.e., in the ground) would seem to create a covenant running with the land, whereas one dedicating an interest in its oil or gas “as and when produced” (i.e., at the surface or wellhead) may be read by a court to create a mere contractual interest.³ (See Figure 2).

To determine whether or not Midstream Contracts are executory agreements that can be rejected, a bankruptcy court will likely consider numerous factors, including: (1) the parties’ expressed intent to create (or not create) a conveyance of a real property interest or covenant that runs with the land; (2) the point at which such interest is deemed fully vested; (3) real property filings recorded or agreed to be recorded; (4) holder(s) of title to production; (5) rights to control and risk for losses; (6) definition of the dedicated interests (i.e., minerals in place, production or both); (7) the E&P’s right to sell or transfer minerals and leases with or without binding successors and assigns; and (8) the existence of MVCs.

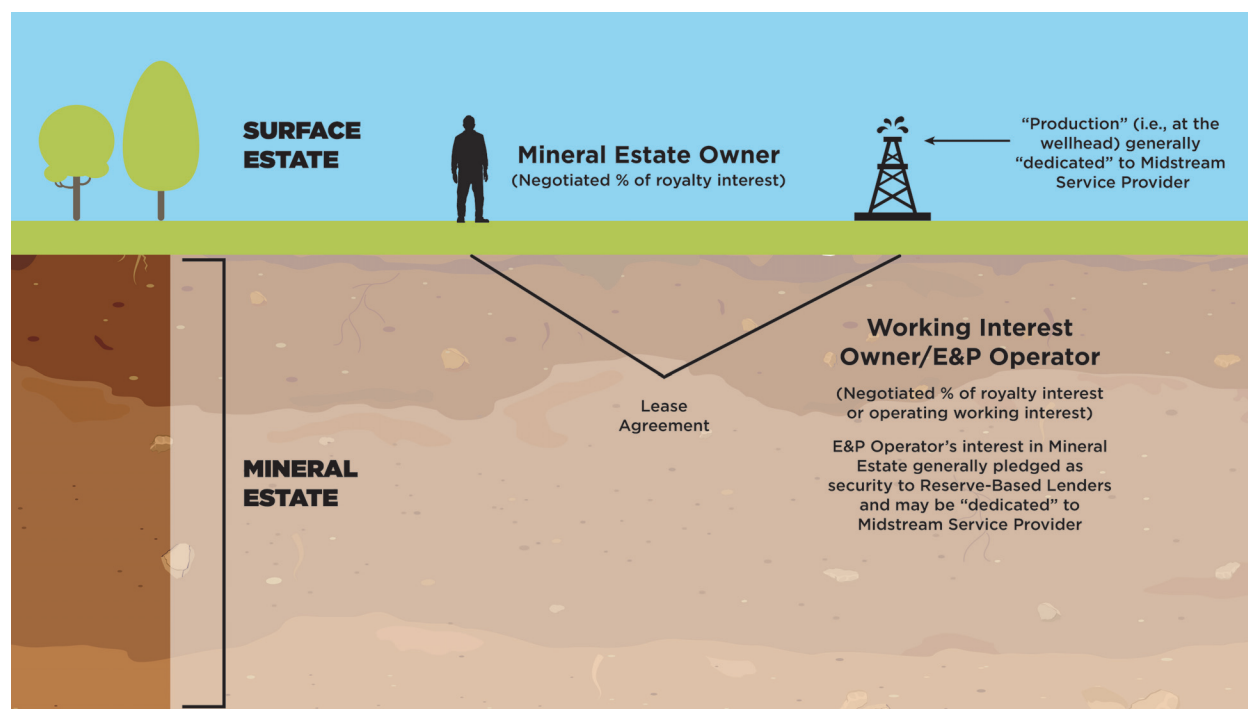


Figure 2

³ Under Texas law, once minerals are produced, they cease to be real property and instead become personalty. See, e.g., *Sabine Production Co. v. Frost Nat. Bank San Antonio*, 596 S.W.2d 271, 276 (Tex. App. 1980) (“Once minerals have been severed from the reservoir or strata wherein they were originally contained, such minerals ... become personalty.”); *Colorado Interstate Gas Co. v. Hunt Energy Corp.*, 47 S.W.3d 1, 10 (Tex. App. 2000) (“Once oil or gas has been severed from the ground, it becomes personalty.”); *Riley v. Riley*, 972 S.W.2d 149, 155 (Tex. App. 1998) (citing *Phillips Petroleum Co. v. Adams*, 513 F.2d 355, 363 (5th Cir. 1975) (under Texas law, “[o]il and gas are realty when in place and personalty when severed from the land by production”).

Priority of Dedication and Minimum Volume Commitment

Secured creditors to E&Ps historically may have given little thought to the possibility of competing claims by Midstream Providers, because it was generally accepted by market participants that any such claims would be junior to the secured creditors' claims in the E&P's bankruptcy case. Recently, however, some Midstream Providers have argued that even though no transfer of any interest in the debtor's mineral estate took place, the dedications in their Midstream Contracts are actually real property interests or covenants running with the land that are not subject to the preexisting liens or claims of any of the debtor's other creditors and should receive payment — in amounts calculated based on any MVC and remaining contract term — prior to any cash flowing into the creditor waterfall, or be afforded an elevated payment priority in the E&P's bankruptcy.

Midstream Contract Rejection and Treatment of Claims

A distressed E&P may determine that its Midstream Contracts render development of its assets uneconomical, especially where such a contract includes an MVC that is not being satisfied or is too expensive. Under Section 365 of the Bankruptcy Code, an E&P debtor has the ability to “reject” executory contracts.⁴ Rejection means that the E&P debtor may, with the bankruptcy court's approval, choose to stop performing under the contract, leaving the counterparty with a prepetition unsecured damages claim that will be paid pro rata with other unsecured creditors.⁵

A covenant running with the land, however, is treated as attached to the underlying real property, and therefore, may not be capable of being rejected. A dedication that is deemed to be a covenant running with the land could thus dilute other creditors' recoveries, potentially including those of senior secured claims, by siphoning value from the mineral estate. The case law regarding interpretation of dedication provisions — whether as real property interests, a covenant that runs within the land, some type of “senior interest” or mere contractual rights — is unsettled, and some dedications may not fit neatly into a single category. Even if it appears in the express terms of the document and real property records indicate that an interest in the mineral estate or leases has been conveyed by dedication, it may be that a dedication is not one of the state law-recognized ways of transferring such an interest and, accordingly, that no such interest has, in actuality, been transferred.⁶

The inclusion of MVCs may make a Midstream Contract more prone to rejection if the E&P is unable to satisfy the MVC, thereby forcing the E&P to pay additional fees when it is not meeting the minimum volume. MVCs also may be viewed as inconsistent with a real property interest or covenants running with the land, as the credit support they provide may be viewed as less consistent with transfers of the risks associated with ownership and more consistent with an unsecured borrowing.

Sabine

Midstream Contract rejection is being litigated in the *Sabine* bankruptcy case. In *Sabine*, the debtors filed a motion to reject two gathering agreements. The counterparties (the “Gatherer Counterparties”) opposed rejection on the basis that their contracts contained covenants that ran with the land and were not capable of being rejected. The Gatherer Counterparties relied heavily on the U.S. Court of Appeals for the Fifth Circuit's decision in *In re Energytec Inc.*, 739 F.3d 215, 221 (5th Cir. 2013), which held that certain interests securing fees owed to an affiliate of the seller of a gas pipeline were covenants running with the land and therefore could not be rejected. One critical difference, however, is that the *Energytec* court considered an encumbrance on production passing through a gathering system and the gathering system itself *after the wellhead*; the facts in *Sabine* (and the issue with many other Midstream Contracts) concern a possible covenant running with the land *before the wellhead* and as part of the mineral estate interest.⁷

⁴ The “Countryman” definition of an executory contract, which has been accepted by most courts, is “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Depending on the language and mechanics of a Midstream Contract, it may be considered “executory” under the Countryman definition — thereby subjecting it to rejection under Section 365. Prof. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 458-62 (1973).

⁵ See 11 U.S.C. § 365; *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984) (“Damages on the contract that result from the rejection of an executory contract ... must be administered through bankruptcy and receive the priority provided general unsecured creditors.”)

⁶ Texas courts determining whether a mineral estate (or any right therein) has been conveyed consistently require the grant of an *interest in the mineral estate*. See *French v. Chevron*, 871 S.W.2d 276 (Tex. App. 1994).

⁷ Further, the beneficiary of the covenant running with the land in the *Energytec* case benefited from a security interest and lien on the pipeline system that generated the fee subject to the covenant running with the land. This security interest influenced the court as the recovery may be the same, or similar, whether a claim is based on a covenant running with the land or is a secured claim. The court noted, “Newco's interests, including a transportation fee, security interest and rights to consent to assignments, are covenants running with the land.”

This distinction and whether the dedication covers “production” or an interest in the mineral estate (i.e., leases and oil and gas in the ground) is critical.

The *Sabine* litigation is currently ongoing, but the issues raised by the debtors and the Gatherer Counterparties discussed below are instructive. While no decision has yet been rendered, after hearing oral arguments on the specific contracts subject to rejection, the bankruptcy court judge advised the parties that she is “inclined” to rule that the dedications at issue in *Sabine* are not covenants running with the land and that the contracts could therefore be rejected.

Breakdown of Claims

Timing and use of the gathering system also impact a Midstream Provider’s potential claim against an E&P debtor. A Midstream Contract claim may arise from activity or damages that accrued: (1) from utilization of the Gathering System before the Chapter 11 petition was filed, which gives rise to a prepetition unsecured claim; (2) in connection with rejection of a contract, for the remaining term of the contract and MVC fees (e.g., from an E&P debtor’s rejection of a Midstream Contract, which gives rise to a prepetition damages claim); or (3) from an E&P debtor’s post-petition utilization of the Midstream Provider’s services, which may give rise to a higher priority administrative claim.

A prepetition claim may arise for as-yet-unpaid-for services rendered by the Midstream Provider and generally will share in the recovery pool pro rata with other unsecured creditors.⁸ A rejection damages claim would arise after a Midstream Contract is rejected, as discussed above, and would also result in a prepetition general unsecured claim for damages flowing from the rejection and established by the counterparty in an amount reflecting the total remaining value due under the contract.⁹ A post-petition administrative claim, on the other hand, may arise after a debtor utilizes the services of the Midstream Provider during the pendency of its bankruptcy case. Valid post-petition administrative claims must be paid in full in cash before any plan of reorganization can be confirmed,¹⁰ thereby ensuring that the Midstream Provider receives payment ahead of general unsecured creditors and potentially diluting their recovery pool.¹¹

State Law Application: Covenants Running with the Land

The issue of whether or not the contract creates a real property interest is governed not by bankruptcy law, but by applicable state law. Often, that applicable state law is Texas law, which provides that a covenant running with the land is not created simply by being denominated as one in a contract.¹² Instead, under Texas law, a covenant runs with the land when:

- 1) There is privity of the estate;
- 2) The covenant touches and concerns the land;
- 3) The covenant relates to a thing in existence or specifically binds the parties and their assigns;
- 4) The covenant is intended by the original parties to run with the land; and
- 5) The successor to the burden has notice.¹³

Of course, Texas law does not apply in other states; each state has its own statutes and case law that require tailored consideration. Nonetheless, an analysis of the required elements in Texas for a covenant that runs with the land is instructive for investors and creditors that wish to evaluate the likelihood of a dilution in the value of their claims against an E&P debtor. The first, second, and fourth elements above are likely to be the most heavily contested.

⁸ State law statutory liens may spring in connection with prepetition and post-petition utilization of the midstream system; however, such amounts due to such use are less likely to materially impact creditor recoveries than the potential for a secured liquidated damages claim spanning the entire remaining term of the contract.

⁹ See 11 U.S.C. § 365.

¹⁰ See 11 U.S.C. § 1129(a)(9).

¹¹ See 11 U.S.C. §§ 507(a)(2), 503(b).

¹² See, e.g., *Musgrave v. Brookhaven Lake Property Owners Ass’n*, 990 S.W.2d 386, 395 (Tex. App. 1999) (holding that terminology relating to the parties’ intent is not dispositive of whether an obligation runs with the land).

¹³ See *Inwood North Homeowners’ Ass’n v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987).

Privity of the Estate

The Texas Supreme Court has held that privity of the estate is required for a covenant to run with the land. However, the court has not clarified whether this “privity” requirement refers solely to “vertical privity,” or whether “horizontal privity” is required as well. Horizontal privity requires a relationship between the original parties to a covenant at the time the covenant was made. Such a relationship may be created by a grant of a legally recognized interest in real property; the covenant takes the form of a promise made by the recipient of that interest. Vertical privity requires a successor relationship between a transferor and transferee of a property bound by a covenant.

Requirements to Establish Vertical and Horizontal Privity	
Vertical Privity Requirements	<ol style="list-style-type: none">1. Relationship between transferor and transferee of property bound by the covenant; and2. Covenant contained in a grant of land or grant of some property interest in the land
Horizontal Privity Requirements	<ol style="list-style-type: none">1. Relationship between the original parties to the covenant at the time it was made; and2. Covenant contained in a grant of land or grant of some property interest in the land

Texas intermediate appellate courts have interpreted the “privity” requirement to include both vertical and horizontal privity, holding that “for a covenant to run with the land, the covenant must be made, and must be contained in a grant of land or in a grant of some property interest in the land.”¹⁴ However, in *Energytec*, the Fifth Circuit cast some doubt on the viability of the horizontal privity doctrine, noting that it was guided, but not bound, by the decisions of these intermediate courts. In *Sabine*, one of the Gatherer Counterparties argued that horizontal privity was present because the covenants at issue were granted by the debtor directly to the counterparties; however, the debtors may have strong counter-arguments, as no grant of an interest in the mineral estate coincided.

Touching and Concerning the Land

The Texas Supreme Court has acknowledged that the tests used to determine whether a covenant touches and concerns the land “are far from absolute.”¹⁵ However, the court has noted two tests that have been applied in Texas:

- 1) A covenant will run with the land “if it affected the nature, quality, or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it”; and
- 2) “If the promisor’s legal relations in respect of the land in question are lessened — his legal interest as owner rendered less valuable by the promise — the burden of the covenant touches or concerns the land; if the promisee’s legal relations in respect to the land are increased — his legal interest as owner rendered more valuable by the promise — the benefit of the covenant touches and concerns the land.”¹⁶

In *Sabine*, the Gatherer Counterparties alleged that the dedications touch and concern the land because the debtors seek to use their mineral interests to produce hydrocarbons, and because market rates for gas and transportation could render their mineral interests either more or less valuable. Where contracts specifically dedicate an interest in “production” as opposed to an interest in the mineral estate, however, this argument may not survive scrutiny.

¹⁴ *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. 2013).

¹⁵ *Westland Oil Dev. Corp v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

¹⁶ *Id.*

Parties' Intent

Under Texas law, the language used in an agreement is the primary evidence of intent.¹⁷ A valid transfer of an interest in the mineral estate requires “operative words or words of grant showing an intention of the grantor to convey an interest to the grantee.”¹⁸ In addition, courts “attempting to ascertain the intention of the parties ... must look to the entire instrument in the light of the stated covenant.”¹⁹ Texas appellate courts have also held that where an agreement inures to the benefit of successors and assigns, this is suggestive (but not determinative) of an intent for a covenant to run with the land.²⁰

In *Sabine*, the Gatherer Counterparties argued that the gathering agreements expressly state that the dedications are covenants running with the land and contain provisions specifying that the agreement is enforceable by, and binding on, the parties' successors and assigns. The *Sabine* debtors did not specifically dispute these arguments; rather, they simply reiterated their previous position that the debtor did not convey any interest to the counterparties in a manner recognized by state law.

Whether the parties to an agreement (in *Sabine* or in any E&P bankruptcy) actually intended to convey a covenant running with the land may be evident from the specific interests actually conveyed. Under Texas law, a mineral estate contains five interests: (1) the right to develop; (2) the right to lease; (3) the right to receive bonus payments; (4) the right to receive delay rentals; and (5) the right to receive royalty payments.²¹ Bonus payments, delay rentals and royalties “have a well understood meaning in the oil and gas business” as interests in real property.²² The presence of several or all of these elements as part of a dedication may persuade a court that the intent of the parties was to convey an interest in the mineral estate.

MVC Compared with Production Payments

The legal status of certain of these interests, such as the right to receive royalty production payments, can be particularly confounding in this regard. Production payments may be construed or characterized as either conveyances of real property (“true sales”), or as disguised financings or borrowings that are merely contractual in nature. Under Texas law, production payments, whether volumetric or dollar-denominated, are real property interests if they are dependent on production from the mineral estate.²³ However, where the production payments contain provisions for minimum net volume, fixed duration, minimum interest rate thresholds and/or minimum payments due, which are not correlated with production or market risks associated with commodity prices, the contract may be recharacterized as a disguised financing (i.e., borrowings), regardless of its label.

In this regard, dedication provisions with an MVC may be somewhat analogous to certain types of production payments; whether such agreements should be characterized as real property interests or contractual obligations will be highly dependent on the terms of the agreement. If a Midstream Provider is entitled to payments regardless of whether oil and gas are produced from the mineral estate (e.g., from MVCs), such an agreement could be more likely to be characterized as a contractual interest that could be rejected by an E&P in bankruptcy.²⁴

‘Free and Clear’ Sales Under Section 363

The resolution of the *Sabine* litigation may bring some level of clarity as to whether certain types of dedications are covenants running with the land. But even in *Sabine*, the debtors acknowledged they had additional Midstream Contracts in place with explicit language that appeared to meet all state law requirements for a dedication to be recognized as a covenant that ran with the land. As a result, the debtors did not attempt rejection. Further, even if a

¹⁷ See *Perry Homes v. Cull*, 258 S.W.3d 580, 606 (Tex. 2008).

¹⁸ *MASGAS v. Anderson*, 310 S.W.3d 567, 570 (Tex. App. 2010).

¹⁹ *Billington v. Riffe*, 492 S.W.2d 343, 346 (Tex. App. 1973).

²⁰ See *Monfort v. Trek Resources, Inc.* 198 S.W.3d 344, 355 (Tex. App. 2006).

²¹ *In re Estate of Slaughter*, 305 S.W.3d 804, 808 (Tex. App. 2010).

²² *Id.*

²³ See, e.g., *Tenant v. Dunn* 110 S.W.2d 53, 57 (Tex. 1937) (holding that oil and gas royalties retained by the lessor of a mineral estate “whether payable in kind or in money ... [are] present interests in land”).

²⁴ For an overview of investing in oil and gas royalties, please see the SRZ *White Paper* “[Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations.](#)”

Midstream Contract is found to be (or contains) a covenant running with the land, an E&P debtor may still be able to sell the underlying land free and clear of that interest pursuant to Section 363(f)(5) of the Bankruptcy Code.

Under Section 363(f)(5), a debtor may sell property of the estate free and clear of any third party's interest in the property if "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."²⁵ Based on existing case law, it is possible that a debtor could sell "free and clear" of a covenant running with the land pursuant to Section 363(f)(5) because the Midstream Provider could be compelled to accept money satisfaction of its interest. In *Energytec*, the debtor sold a pipeline system that was burdened by a security interest and lien securing the debtor's obligation to pay the transportation fee. The sale was approved by the bankruptcy court as well as by the district court on appeal, but the district court's judgment was ultimately vacated and remanded for further proceedings.²⁶ The jurisprudence remains unsettled as to when a Midstream Provider may be compelled to accept money satisfaction of its covenant running with the land under Section 363(f)(5).

The outcome of a Section 363 sale may depend heavily on the status of an E&P's Midstream Contracts and any rejection damages claims. First, the resolution of Midstream Contract issues may provide the opportunity for a more economic agreement to be put in place, which in turn may facilitate drilling, profitability and the receipt of higher bids from any interested buyers. Second, as illustrated in the *Quicksilver Resources* bankruptcy case, it is less likely that a potential buyer will be willing to purchase assets that are subject to a battle over rejection damages claims; instead, the buyer may want to have Midstream Contract issues resolved before consummation of the sale.

In *Quicksilver Resources*, the debtor commenced a process to sell substantially all of its assets via a Section 363 sale process. The winning bidder for Quicksilver's Barnett Shale assets, Bluestone Natural Resources II ("Bluestone"), conditioned its bid on the rejection of certain Midstream Contracts with Crestwood Midstream Partners. While it is possible that the bidder and Crestwood may settle, or agree to amend and assume and assign a modified version of the Midstream Contract, by its actions Bluestone has made it clear it is not interested in buying into a contract rejection dispute.

Conclusion

Midstream Contract claims may significantly impact the recovery value of a creditor's claim against an E&P debtor's estate, and uncertainty over treatment of Midstream Contracts may impair asset sale prospects. Depending on the precise language used and applicable state law, dedication provisions could be classified by a court either as mere contractual interests granted within the scope of a services agreement, or as covenants that run with the land or conveyances of real property to a third party. Should a court reach the latter finding, secured and unsecured E&P creditors alike may face significant claim dilution. While the cases discussed in this *White Paper* are instructive, they are far from the last word on the issue of how dedications of reserves and MVCs will be interpreted in any given situation.

²⁵ 11 U.S.C. § 363(f)(5).

²⁶ *Newco Energy, Inc. v. Energytec, Inc.*, 2012 WL 4627028 (E.D. Tex. 2012), *vacated and remanded sub nom, In re Energytec, Inc.*, 739 F.3d 215 (5th Cir. 2013).

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