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**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION**

IN RE §
§
CANO PETROLEUM, INC., ET AL. § **CASE NO. 12-31549-BJH**
§ **JOINT ADMINISTRATION**
§ **REQUESTED**
§
Debtors. § **(CHAPTER 11)**

**APPLICATION TO EMPLOY THOMPSON & KNIGHT LLP AS
COUNSEL TO DEBTORS AND DEBTORS-IN-POSSESSION**

THE DEBTORS HAVE REQUESTED EMERGENCY CONSIDERATION OF THIS MOTION AND HAS REQUESTED THAT A “FIRST DAY” HEARING BE HELD ON THIS MOTION AT THE COURT’S EARLIEST CONVENIENCE. IF THE COURT IN FACT SETS THIS MOTION FOR AN EMERGENCY OR AN EXPEDITED “FIRST DAY” HEARING, THEN ONLY ATTENDANCE AT THE HEARING IS NECESSARY TO PRESERVE YOUR RIGHTS.

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

Cano Petroleum, Inc. (“Cano”) and its direct and indirect subsidiaries, as debtors and debtors-in-possession (collectively, the “Debtors”), file this *Application to Employ Thompson & Knight LLP* (“T&K”) as *Counsel to the Debtors and Debtors-in-Possession* (the “Application”). In support of this Application, the Debtors incorporate (a) the *Declaration of James R. Latimer, III in Support of Voluntary Petitions, First Day Motions and Designation as*

Complex Bankruptcy Case (the “Latimer Declaration”) and (b) the *Declaration of David M. Bennett and Disclosure of Compensation* (the “Bennett Declaration”) attached as **Exhibit A**.

JURISDICTION AND PROCEDURAL BACKGROUND

1. This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and 157. This matter is a core proceeding pursuant to 28 U.S.C. § 157.

2. Venue is proper in this district pursuant to 28 U.S.C. §§ 1408 and 1409.

3. The statutory predicate for relief requested in this Motion is 11 U.S.C. §§ 327 and 328, as complemented by Rule 2014 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”), and the Local Rules of this Court.

4. On March 7-8, 2012 (March 7, 2012 being the “Petition Date”), the Debtors each filed a voluntary petition for relief under Chapter 11 of Title 11 of the United States Code (the “Bankruptcy Code”), thereby commencing these chapter 11 cases (collectively, the “Cases” or the “Case”).

5. Since the Petition Date, the Debtors have continued to operate and manage their businesses as debtors-in-possession pursuant to Bankruptcy Code §§ 1107 and 1108.

6. The Office of the United States Trustee (the “U.S. Trustee”) has not appointed an official committee of unsecured creditors in this Case.

7. Contemporaneously with the filing of this Motion, the Debtors filed their Emergency Motion for Joint Administration and their Request for Emergency Consideration of First Day Matters.

FACTUAL BACKGROUND

8. The Debtors operate in the oil and natural gas industry and their business strategy historically has included developing and acquiring interests in mature oil fields with established

primary and/or secondary reserves that may possess significant remaining upside exploitation potential by implementing various secondary and/or tertiary enhanced oil recovery techniques.

9. The Debtors have been in business for approximately eight years. Cano initially started as Huron Ventures, Inc. ("Huron"). After Huron merged with Davenport Field Unit Inc. and other entities in May of 2004, Huron changed its name to Cano.

10. Cano is the parent company to (a) Cano Petro of New Mexico ("Cano New Mexico"), a Texas corporation; (b) Ladder Companies, Inc. ("Ladder"), a Delaware corporation; (c) Square One Energy, Inc. ("Square One"), a Texas corporation; (d) Tri-Flow, Inc. ("Tri-Flow"), an Oklahoma corporation; (e) W.O. Energy of Nevada, Inc. ("W.O. Nevada"), a Nevada corporation; (f) WO Energy, Inc. ("WO Energy"), a Texas corporation; (g) W.O. Operating Company, Ltd. ("W.O. Operating"), a Texas limited partnership; and (h) W.O. Production Company, Ltd. ("W.O. Production"), a Texas limited partnership.

11. Cano is a publicly-traded company incorporated in Delaware and its common stock was listed on the NYSE Amex under the trading symbol "CFW." As of January 17, 2012, Cano voluntarily delisted its stock and is currently trading on the OTC Market Place operated by the OTC Markets Group under the symbol "CANO."

12. The Debtors' workforce, which at one time consisted of approximately 50 employees, now consists of only 27 part-time and full-time employees and 14 contract workers. Nearly all workers at the executive corporate level are independent contractors. After recent departures, the Debtors' Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") were replaced with new management, which is committed to maximizing the value of the Debtors' assets and businesses.

13. The Debtors' operations and assets are located onshore in the United States, in Texas, New Mexico, and Oklahoma. The Debtors have five principal producing properties which are located in: (a) Carson, Gray, and Hutchinson Counties, Texas (the "Texas Panhandle Properties"); (b) Nowata County, Oklahoma (the "Nowata Properties"); (c) Chavez and Roosevelt Counties, New Mexico (the "Cato Properties"); (d) Lincoln County, Oklahoma (the "Davenport Properties"); and (e) central Texas (the "Desdemona Properties").

14. The Debtors' oil and gas business depends heavily on the availability of capital and liquidity. Substantial capital expenditures are needed for the exploitation and the development of crude oil and natural gas reserves. The Debtors' current liquidity constraints have all negatively impacted the Debtors business and their ability to meet their obligations to secured lenders and trade creditors. As of September 30, 2011, the Debtors reported total assets of approximately \$63.4 million and total liabilities of approximately \$116.3 million on their unaudited and unreviewed consolidated balance sheets.

15. On December 17, 2008, the Debtors entered into a \$120.0 million *Amended and Restated Credit Agreement* (the "Senior Secured Debt" or the "Senior Credit Agreement") with Union Bank, N.A. ("Union" or the "Senior Pre-Petition Agent") and Natixis (together with Union, the "Senior Secured Lenders"). The Senior Secured Lenders contend that the current amount outstanding under the Senior Credit Agreement is \$60.6 million, with no further borrowing capacity.

16. The Senior Credit Agreement required the Debtors to hedge certain risks relating to oil and gas productions, namely protections against commodity price fluctuations and interest rate fluctuations on the Senior Secured Debt. Consequently, the Debtors entered into certain commodity swap contracts. Due to the termination of certain commodity hedges and an interest

rate hedge on August 22, 2011 and September 9, 2011, respectively, the Debtors owe an additional \$3.8 million in Senior Secured Debt.

17. On December 17, 2008, the Debtors also entered into a \$25 million Subordinated Credit Agreement (the “Junior Credit Agreement”) with UnionBanCal Equities, Inc. (“UBE” or the “Junior Pre-Petition Agent”), as the Administrative Agent. UBE asserts that the Debtors currently owe \$16.6 million under the Junior Credit Agreement (the “Junior Secured Debt”).

18. The Senior Secured Debt and the Junior Secured Debt are secured by substantially all of the Debtors’ assets. The Debtors are in default under the Senior Credit Agreement and the Junior Credit Agreement (collectively, the “Credit Agreements”).

19. The Debtors’ declining revenues, continued losses, borrowing constraints, loan defaults and limited-to-no capital availability forced the Debtors to drastically reduce costs, replace management and hire financial advisors to assist in a strategic process.

20. After a lengthy marketing process and substantial discussions with the Pre-Petition Lenders, the Debtors entered into a *Stock Purchase Agreement* dated March 7, 2012 (the “Stalking Horse SPA”) with NBI Services, Inc. (the “Stalking Horse”). In accordance with the Stalking Horse SPA, the Debtors agreed to sell and the Stalking Horse agreed to buy all newly-issued stock in Cano under a plan of reorganization for \$47.5 million in cash, subject to higher and better offers through a competitive auction process (the “Bidding Process”).

21. Contemporaneously with the execution of the Stalking Horse SPA and the negotiation of a motion to approve bidding procedures (the “Bid Procedures Motion”), the Debtors, along with the Pre-Petition Lenders and the Stalking Horse, entered into that certain *Plan Support and Lock-Up Agreement* dated March 7, 2012.

22. The Debtors filed these Cases to effectuate a sale of their equity interests and/or assets. The filing of these Cases and the confirmation of the Plan are the Debtors' best option to preserve and maximize the value of their assets and businesses.

23. Additional information regarding the Debtors' businesses, the Stalking Horse SPA, the Plan (including the treatment of all claims), the Bidding Process, and the events leading to these Chapter 11 Cases is contained in the Latimer Declaration..

RELATIONSHIP WITH T&K

24. Since May 29, 2009, T&K has represented the Debtors in connection with corporate, securities, public reporting and certain other matters. Included in the matters for which T&K has been retained is the Debtors' on-going restructuring efforts. In recent months, that representation has turned to advice to and representation of the Debtors in the potential sale of the company or its assets and preparation for a chapter 11 filing.

25. The Debtors, as debtors-in-possession, desire to employ T&K as their attorneys to (a) give the Debtors legal advice with respect to the Debtors' powers and duties as debtors-in-possession, the continued operation of the Debtors' business, and the management of the Debtors' property; and (b) perform all legal services for the Debtors, which may be necessary throughout the Case.

26. The name, mailing address and telephone number of the lead attorney from T&K who will be attorney of record is:

David M. Bennett
THOMPSON & KNIGHT LLP
1722 Routh Street, Suite 1500
Dallas, Texas 75201
Phone: 214-969-1700
Fax: 214-969-1751

RELIEF REQUESTED

27. By this Application, the Debtors request that this Court enter an interim order (the “Interim Order”), pending entry of a final order or the Interim Order becoming a final order (the “Final Order”) (a) employing and retaining T&K as attorneys to represent the Debtors in connection with various matters, including the Debtors’ commencement and prosecution of the Case as described herein, and (b) scheduling a final hearing on this Motion within 21 days of entry of the Interim Order (the “Final Hearing”). Pursuant to Bankruptcy Code Section 328(a), the Debtors request that this Court authorize the retention of T&K under a general retainer in accordance with T&K’s normal hourly rates.

28. Bankruptcy Code Section 327(a) provides that this Court may approve the employment of counsel for a chapter 11 debtor that “do[es] not hold or represent an interest adverse to the estate, and that are disinterested persons.”¹ As a result of its past representation of the Debtors, T&K is familiar with the Debtors’ business and affairs and other legal matters. T&K has stated its desire and willingness to act in the Case and render the necessary professional services as counsel to the Debtors.

29. Relief should be granted under the current circumstances pursuant to Bankruptcy Rule 6003 because the Debtors would face irreparable harm if required to proceed in the Case for any amount of time unrepresented by counsel. The Debtors, therefore, respectfully request that this Court consider the Application with the other “first day” motions and grant the relief requested herein immediately on an interim basis and, thereafter, on a final basis, unless an objection thereto is filed with this Court within 21 days after entry of the Interim Order. If such an objection is timely filed, the Debtors request that this Court hold a final hearing on this

¹ 11 U.S.C. §§ 327(a), 1107(b).

Application. The Debtors request that the Interim Order remain in effect, notwithstanding any objection to this Application, until further order of this Court.

BASIS FOR RELIEF

30. Obtaining approval to employ and retain counsel as expeditiously as possible, and on an interim basis pending final approval, is necessary to avoid the irreparable harm that Debtors would inevitably face if required to proceed in the Case unrepresented.²

31. The Debtors have chosen T&K because of T&K's extensive experience, knowledge and established reputation in energy reorganizations and debt restructurings under chapter 11 of the Bankruptcy Code. The Debtors have selected T&K as bankruptcy counsel because the Debtors believe that T&K is well-qualified to represent them as debtors-in-possession in the Case. T&K has extensive experience and knowledge in the field of business reorganizations pursuant to chapter 11 of the Bankruptcy Code. T&K has expertise, experience and knowledge practicing before bankruptcy courts and has represented debtors, lenders, committees, investors, shareholders, and purchasers. T&K is a full-service legal firm with experience and expertise in other legal areas that will be affected during this reorganization. Further, T&K has represented the Debtors since May 2009. As a result, T&K has become familiar with the Debtors' business operations and financial affairs, as well as many of the legal issues that are likely to arise during the course of the Case. If the Debtors are required to retain counsel other than T&K, it will incur additional expense and delay. Accordingly, the Debtors believe T&K will provide the most efficient representation available to the Debtors. The Debtors believe that T&K possesses the requisite resources and is highly qualified and uniquely able to represent the Debtors' interests in the Case.

² See *In re First NLC Fin. Serv., LLC*, Bankr. LEXIS 14466 (S.D. Fla. Jan. 28, 2008) (finding that interim approval of an application to employ counsel was proper under Bankruptcy Rule 6003 upon the debtor's demonstration that lack of counsel pending a final hearing and order could have "devastating" effects on the debtor's estate).

SCOPE OF REPRESENTATION

32. The Debtors contemplate that T&K will render legal services to the Debtors as needed throughout the Case. Generally, the legal services that T&K will render may be summarized, in part, as follows:

- a. Advising the Debtors of their rights, powers, and duties as debtors-in-possession under the Bankruptcy Code;
- b. Advising the Debtors concerning, and assisting in, the negotiation and documentation of financing agreements, debt restructurings, and asset securitization;
- c. Reviewing the nature and validity of agreements relating to the Debtors' interests in real and personal property and advising the Debtors of their corresponding rights and obligations;
- d. Reviewing the nature and validity of liens or claims asserted against the Debtors' property and advising the Debtors concerning the enforceability of those liens and claims;
- e. Advising the Debtors concerning preference, avoidance, recovery, or other actions that it may take to collect and to recover property for the benefit of the estates and their creditors, whether or not arising under chapter 5 of the Bankruptcy Code;
- f. Preparing on the Debtors' behalf all necessary and appropriate applications, motions, pleadings, draft orders, notices, schedules, statements, and other documents, and reviewing all financial and other reports to be filed in the Case;
- g. Advising the Debtors concerning, and preparing responses to, applications, motions, complaints, pleadings, notices, and other papers that may be filed and served in the Case;
- h. Counseling the Debtors in connection with the formulation, negotiation, and promulgation of a plan of reorganization and related documents;
- i. Performing all other legal services for and on the Debtors' behalf that may be necessary or appropriate in the administration of the Case and the Debtors' businesses;
- j. Working with and coordinating efforts among other professionals, including co-counsel and other special counsels as may be retained by the Debtors, to attempt to preclude any duplication of effort

among those professionals and to guide their efforts in the overall framework of the Debtors' reorganization; and

- k. Working with professionals retained by other parties-in-interest in the Case to attempt to structure a sale of the Debtors' assets or consensual plan of reorganization for the Debtors.

33. The nonexclusive services described above are essential to the Debtors' successful reorganization. The Debtors may, from time to time, request that T&K undertake specific matters beyond the scope of the responsibilities set forth above. Should T&K agree, in its sole discretion, to undertake any such matters, the Debtors seek authority herein to employ T&K for such matters, in addition to those set forth above, without further order of this Court.

PAYMENT OF FEES AND EXPENSES

34. The Debtors paid T&K a retainer of approximately \$250,000 in connection with this matter. In addition to the retainer, total pre-petition payments aggregate \$935,276.50 for bankruptcy services rendered on the Debtors' behalf in contemplation of or in connection with the Case. This amount was paid from Debtors' operating cash funds. The Debtors contemplate that T&K, joined by other professionals employed in the Case, will file further motions requesting the entry of an administrative order providing for monthly payment for legal services, subject to final approval by the Court.³

35. The Debtors have agreed, subject to the fee application process and this Court's approval, to pay T&K based on time spent in rendering legal services on an hourly basis in accordance with its ordinary and customary hourly rates for cases of this nature as in effect on the date services are rendered. The hourly rates of the T&K attorneys expected to perform legal services hereunder are \$315.00 for the most junior associate who is likely to work on these matters to \$740.00 for the most senior partner who is likely to work on these matters. The

³ If, at the conclusion of the Case, T&K's fees and expenses ultimately are approved in an aggregate amount less than the amount of the Retainer, T&K will return any remaining portion of the Retainer to the Debtors.

standard hourly rate of the T&K professionals to perform services hereunder ranges from \$125 to \$740.00. Additionally, the Debtors have agreed to reimburse T&K for its out-of-pocket expenses for rendering services.

36. Each professional's rate will be clearly reflected in the invoices and fee application. T&K will maintain detailed records of costs and expenses incurred in connection with its legal services and these will be set forth in detail in monthly invoices and fee applications.

37. The Debtors understand that T&K's hourly rates are subject to periodic review (generally annually) to reflect changes in the economy, experience, and other factors. T&K, to the extent possible, attempts to observe the prevailing rates for legal services rendered by attorneys of comparable expertise in similar cases in the relevant jurisdiction. Accordingly, an individual attorney's rates in other cases may be lower or higher than those charged in this engagement, depending on prevailing rates in the various jurisdictions.

38. T&K will also seek reimbursement of actual and necessary expenses pursuant to Bankruptcy Code Section 330. Expenses for which reimbursement will be sought include, among other things, telephone and telecopier toll and other charges, mail and express mail charges, special or hand-delivery charges, photocopying charges (\$0.10 to \$0.12 per page), document processing, travel expenses, as well as non-ordinary overhead expenses such as secretarial overtime. All such expenses shall be within the standards normally enforced by the Bankruptcy Court in the Northern District of Texas. All compensation and reimbursement of expenses will be subject to approval of this Court as required by the Bankruptcy Code.

DISCLOSURE CONCERNING CONFLICTS OF INTEREST OR PRIOR RELATIONSHIPS

39. T&K's employment is necessary and in the best interest of the Debtors and their estate. T&K meets the standards for being retained under Bankruptcy Code § 327(a), as modified by Bankruptcy Code § 1107(b), for the following reasons.

40. To the best of the Debtors' knowledge, and subject to the disclosures described in the Bennett Declaration, T&K does not hold or represent an interest adverse to the Debtors' estates in the matters for which T&K is proposed to be retained.

41. To the best of the Debtors' knowledge, and based on the Bennett Declaration, T&K does not have an interest materially adverse to the interest of the Debtors' estates or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the Debtors, or for any other reason. T&K is not a creditor, an equity security holder, or an insider of the Debtors. T&K is not and was not, within two years before the Petition Date, a director, officer, or employee of the Debtors. Thus, T&K is a "disinterested person" as that phrase is defined in Bankruptcy Code §§ 101(14) and 1107(b).

42. To the best of the Debtors' knowledge, T&K has no connections with the Debtors, their creditors, their respective attorneys, the U.S. Trustee, any person employed in the Office of the United States Trustee for this region, or any other party-in-interest, except as disclosed in the Bennett Declaration.

43. As disclosed in the Bennett Declaration, T&K has represented certain parties listed therein who may be parties in interest in this case, but T&K does not and will not represent said parties in this case. T&K will conduct an ongoing review of its files to ensure that no disqualifying circumstances exist or arise. If any new material facts or relationships are discovered or arise, T&K will supplement its disclosure to the Court.

44. Because this Application is being filed on the Petition Date, pursuant to Local Rule 2014-1, the employment of T&K should be approved effective as of the Petition Date, with T&K having the right to seek compensation for services rendered on and after that date.

Notice

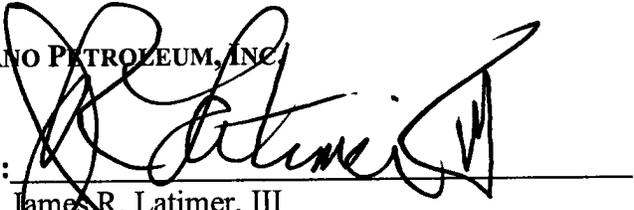
45. Notice of this Application has been provided to (a) Union Bank, N.A., (b) Natixis Financial Products, Inc.; (c) UnionBanCal Equities, Inc; (d) the Debtors' 30 consolidated largest unsecured creditors; (e) NBI Services, Inc.; (f) the Office of the United States Trustee for the Northern District of Texas, (g) the Office of the United States Attorney for the Northern District of Texas, (h) the Securities and Exchange Commission; (i) the Internal Revenue Service; (j) the Railroad Commission of Texas; (k) State of New Mexico Energy Minerals; and (l) Oklahoma Corporate Commission. The Debtors submit that in view of the facts and circumstances that the notice provided for herein is fair and adequate and no other or further notice is necessary.

WHEREFORE, the Debtors request that the Court enter an order (a) authorizing the Debtors to retain and employ Thompson & Knight LLP as their counsel in the Case on an interim basis pending entry of a final order or the Interim Order becoming a final order, with compensation to be paid as an administrative expense in such amounts this Court may deem reasonable; and (b) granting such other and further relief as this Court deems proper, both at law and in equity.

DATED: March 8, 2012

Respectfully submitted,

CANO PETROLEUM, INC.

By: 

James R. Latimer, III
Chief Executive Officer