BUYING AND SELLING OIL & GAS ASSETS IN BANKRUPTCY CASES

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I. INTRODUCTION

Given the current pricing environment, a number of exploration and production and oilfield service companies are in serious distress and several have already filed for bankruptcy protection. Among the recent bankruptcy filings in the industry are Samson Resources Corp., Dune Energy Inc., Quicksilver Resources Inc., Hercules Offshore Inc., Milagro Oil & Gas, Inc., Sabine Oil & Gas Corp., Black Elk Energy Offshore Operations LLC,[1] and ERG Resources LLC.[2] Against this backdrop and with the continuing uncertainty about commodity prices, it is important for oil and gas practitioners to understand both the advantages and pitfalls associated with purchasing oil and gas assets in a bankruptcy proceeding.

In addition to the generally applicable considerations for purchasing assets in bankruptcy, the purchase of oil and gas assets in bankruptcy requires consideration of things like allocation of plugging and abandonment responsibility, the treatment of oil and gas leases and royalty interests, and the potential recharacterization of certain interests, such as overriding royalty interests.

This article discusses the procedural vehicles for acquiring property in bankruptcy including through a "363 sale" or a plan of reorganization, the advantages and disadvantages of each, the process for assigning desired contracts, and considerations related to the unique nature of oil and gas assets.

II. PURCHASE OF ASSETS BY MOTION UNDER BANKRUTPCY CODE § 363

The Bankruptcy Code provides two general options for acquiring property from a debtor. First, Section 363(b) permits a debtor in bankruptcy to sell assets upon court approval after notice and a hearing. 11 U.S.C. § 363(b). Second, Section 1123(a)(5) permits a debtor to sell assets, or swap equity, or merge with another entity under a plan of reorganization. *Id.* § 1123(a)(5).

A. General Concepts and Sale of Substantially all Assets

A sale of assets under Section 363(b) has long been a preferred method for acquiring assets because it is generally faster and subject to less a rigorous process than a plan of reorganization. Section 363(b) provides, in relevant part:

> (1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .

11 U.S.C. § 363(b). Thus, a trustee or debtor in possession may sell assets in the ordinary course of business without court approval, and may sell assets outside the ordinary course of business with court approval. *Id.*

[1] The Black Elk case was commenced as an involuntary case by several creditors and was later converted to a voluntary Chapter 11.

[2] The dockets of many large bankruptcy cases are publicly available free of charge on privately-hosted websites, which often can be located using a Google search.

A debtor's decision to sell assets pursuant to Section 363 is reviewed under the business judgment standard. 3 Collier on Bankruptcy ¶ 363.02[4], at 363-18 (Alan N. Resnick & Henry Sommer eds., 16th ed. 2015) ("courts generally apply standards that, although stated various ways, represent essentially a business judgment test"); *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.*), 722 F.2d 1063 (2d Cir. 1983); *In re Integrated Resources, Inc.*, 147 B.R. 650, 656 (S.D.N.Y. 1992) (the presumption is that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the best interests of the company). As applied in the bankruptcy context, the business judgment standard permits the bankruptcy court to determine whether the debtor's decision to sell assets is reasonable, but the court "should not substitute its judgment" for the debtor's. 3 Collier on Bankruptcy ¶ 363.02[4], at 363-19.

Courts are in general agreement that bankruptcy courts should provide substantial deference to a debtor's decision to sell assets, provided that the debtor articulates a legitimate business reason. *In re Lionel Corp.*, 722 F.2d at 1066-1070 (holding that debtor must establish an "articulated business justification, other than appeasement of major creditors"); *In re Abott Dairies*, 788 F.2d 143 (3d Cir. 1986) (adopting the "sound business purpose" test in the Third Circuit); *In re GSC, Inc*., 453 B.R. 132, 174 (S.D.N.Y. 2011) (courts give deference to the debtor as long as there is a "reasonable basis for its business decision") (internal quotations omitted). At least one court has held that it would not approve a Section 363 sale if only secured creditors would benefit. *In re Silver*, 338 B.R. 277 (Bankr. E.D. Va. 2004).

While the business judgment standard is deferential and rarely results in Bankruptcy Court denial of a sale motion, whether or not a debtor may sell substantially all of its assets under Section 363(b) has been the subject of extensive debate, particularly within the Fifth Circuit. In cases like *In re Braniff Airways, Inc*., 700 F.2d 935 (5th Cir. 1983), *Richmond Leasing Co. v. Capital Bank N.A.*, 762 F.2d 1303 (5th Cir. 1985), and *In re Continental Air Lines, Inc*., 762 F.2d 1303 (5th Cir. 1985), the Fifth Circuit placed limitations on the practice, but stopped short of forbidding it. As the court summarized in *In re Continental Air Lines, Inc.*:

> In *Braniff* we recognized that a debtor in Chapter 11 cannot use § 363(b) to sidestep the protection creditors have when it comes time to confirm a plan of reorganization ... [I]f a debtor were allowed to reorganize the estate in some fundamental fashion pursuant to § 363(b), creditor's rights under, [plan of reorganization sections] might become meaningless. Undertaking reorganization piecemeal pursuant to § 363(b) should not deny creditors the protection they would receive if the proposals were first raised in the reorganization plan. At the same time, we fully appreciate that post-petition, pre-confirmation transactions outside the ordinary course of business may be required and that each hearing on a § 363(b) transaction cannot become a mini-hearing on plan confirmation. Balancing these considerations, we hold that when an objector to a proposed transaction under § 363(b) claims that it is being denied certain protection because approval is sought pursuant to § 363(b) instead of as part of a reorganization plan, the objector must specify exactly what protection is being denied. If the court concludes that there has in actuality been such a denial, it may then consider fashioning appropriate protective measures modeled on those which would attend a reorganization plan. *Id.* at 1227.

More recently, in *In re Gulf Coast Oil Corp.*, a now-retired bankruptcy judge in the Southern District of Texas created a multi-factor test for evaluating whether a sale under Section 363(b) should be approved, or whether the sale should be rejected as a clandestine plan of reorganization. 404 B.R. 407, 422-27 (Bankr. S.D. Tex. 2009). While not binding authority, certain judges in the Southern District of Texas continue to follow the *In re Gulf Coast Oil* approach. The *In re Gulf Coast Oil* court set forth the following factors to consider in this determination:

(1) whether there is evidence of a need for speed, e.g., based on the perishable nature of assets or looming, adverse market conditions;

(2) whether there is business justification for sale and sale process, as well as for having sale process proceed apart from confirmation process;

(3) whether the case is sufficiently mature that parties in interest have received adequate notice, have obtained appropriate information, and have been able to participate;

(4) whether the proposed sales process is sufficiently straightforward to facilitate competitive bids;

(5) whether the assets have been aggressively marketed in active market;

(6) whether the fiduciaries that control the debtor are truly disinterested, so that the court can have faith in their business judgment;

(7) whether the proposed sale includes all of the debtor's assets or the "crown jewel" of such assets;

(8) whether the purchaser will receive any extraordinary protections;

(9) burdens of proposing sale as part of plan confirmation process;

(10) who will benefit from the sale;

(11) whether any special adequate protection measures are necessary or possible; and

(12) whether the hearing on proposed sale was true adversary presentation.

Id. While this standard is somewhat rigorous, sales of substantially all assets have become fairly routine in many cases.

In other jurisdictions, including popular venues like the District of Delaware and the Southern District of New York, the sale of all assets under Section 363 is less controversial. *See In re Abbots Dairies*, 788 F.2d 143, 150, 14 C.B.C.2d 811, 819 (3d Cir. 1986); *Florida Dep't. of Revenue v. Picadilly Cafeterias, Inc.*, 128 S. Ct. 2326, 2330 n.2 (2008) ("Chapter 11 bankruptcy proceedings ordinarily culminate in the confirmation of a reorganization plan. But in some cases, as here, a debtor sells all or substantially all of its assets under § 363(b)(1) before seeking or receiving plan confirmation"). As a leading bankruptcy treatise concludes: "It is now generally accepted that section 363 allows such sales in chapter 11, even where there is no emergency requiring immediate action." 3 Collier on Bankruptcy, 363.02[3] (Alan N. Resnick & Henry Sommer eds., 16th Ed. 2015).

Two of the most notable Section 363 sales of the past decade occurred in the sales of substantially all of the assets of Chrysler LLC and General Motors Corporation. *See In re Chrysler LLC*, 576 F.3d 108 (2nd Cir.), *judgment vacated as moot*, 175 L.Ed. 2d 61 (2009), *appeal dismissed*, 592 F.3d 370 (2nd Cir. 2010); *In re General Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009). In *Chrysler*, the Bankruptcy Court for the Southern District of New York authorized a Section 363 sale of "Old Chrysler's" assets to "New Chrysler." *In re Chrysler*, 405 B.R. 84, 97-98 (Bankr. S.D.N.Y. 2009). The court reasoned that the sale was permissible under Section 363(b) because Old Chrysler would receive more than fair value in return for the sale of assets to New Chrysler, and all the sale proceeds would be distributed according to the Chapter 11 priority scheme. *Id*. at 97-98. It also noted that New Chrysler was the only entity willing to help Old Chrysler, and that Old Chrysler would be forced into a total liquidation if the court nullified the transaction. *Id.* at 98. The court's central theme in justifying its holding was that the transaction in no way affected the Chapter 11 priority scheme. *Id.*

On appeal, the Second Circuit approved the district court's authorization of the sale free and clear of any existing tort liability (the significance of "free and clear" sales under Section 363 is discussed below). *In re Chrysler, LLC,* 576 F.3d 108, 126-27 (2d Cir. 2009). Although the appeal was dismissed and vacated as moot, the reasoning set forth by the Southern District of New York and the Second Circuit could serve as a model for debtors in possession who wish to sell substantially all of their assets at the beginning of bankruptcy.

B. Sale Free And Clear Of Liens, Claims, and Encumbrances (363(f))

One of the key advantages to a sale of assets under Section 363 is that Bankruptcy Code Section 363(f) authorizes a debtor to sell assets that are a part of the bankruptcy estate free and clear of liens, claims and encumbrances under certain circumstances. *See* 11 U.S.C. § 363(f). Section 363(f) provides as follows:

> The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Thus, a free and clear sale is permitted in a variety of circumstances, including upon consent and in any situation—including in a bankruptcy plan—where the lienholder could be compelled to accept cash in exchange for its lien. However, there is dispute among courts regarding the scope of Section 363(f). In *Clear Channel Outdoor, Inc. v. DB Burband, LLC*, the Ninth Circuit Bankruptcy Appellate Panel issued a controversial decision narrowly reading the "free and clear" provisions of Section 363(f). *See* 391 B.R. 25 (B.A.P. 9th Cir. 2008). The *Clear Channel* court reasoned that: (1) the finality rule set forth in Section 363(m) (discussed below) does not apply to lien stripping under Section 363(f); (2) "aggregate value," as set forth in Section 363(f)(3), refers to a lien's face value, and thus, Section 363(f) lien stripping can only occur when the aggregate face value of all liens secured by the collateral is satisfied; and (3) bankruptcy court cramdown procedures are inapplicable for purposes of Section 363(f)(5).

Several courts, including other courts in the Ninth Circuit, have subsequently authorized free and clear sales under Section 363(f) despite *Clear Channel's* narrow interpretation of the Section. *See, e.g., In re Jolan Inc.*, 403 B.R. 866 (Bankr. W.D. Wash., April 30, 2009) (allowing a sale of assets under §363(f)(5) for an amount less than enough to satisfy all liens because applicable state law provided for the foreclosure of junior liens); *see also In re Boston Generating*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010) (declining to follow *Clear Channel*'s interpretation of "value" in section 363(f)(3) to refer to the face amount of the liens). Most courts have declined to confront *Clear Channel's* substantive holdings because the panel resolved the controversy on a procedural basis. C. Luckey McDowell, *Buyer's Guide to Section 363 Sales*, 32nd Annual Jay L. Westbrook Bankruptcy Conference, Nov. 21-22, 2013, at 14-15.

Several non-statutory exceptions also limit the debtor's ability to sell property free and clear under Section 363(f). For example, if any party disputes the estate's ownership of property to be sold free and clear, the court must determine who owns the property before it may authorize the sale. *See, e.g., Darby v. Zimmerman (in re Popp)*, 323 B.R. 260 (B.A.P. 9 Cir. 2005). Additionally, a court may not authorize a sale free and clear after confirmation of a plan (discussed below) because the property revests in the reorganized debtor upon confirmation and is no longer property of the estate. *In re Golf, LLC*, 322 B.R. 874 (Bankr. D. Neb. 2005).

Additionally, the free and clear sale provision of Section 363(f) does not apply in the following circumstances: (1) if the sale transaction constitutes a merger or consolidation; (2) if the buyer is a mere extension or continuation of the seller; (3) if the transfer of assets to the purchaser amounts to a fraudulent or collusive attempt to avoid the seller's liabilities; and (4) if the purchaser made an express assumption of the seller's liabilities. *In re Savage Indus., Inc.* 43 F.3d 714, 717 n.4 (1st Cir. 1994).

C. Section 363 Sale Are Insulated from Challenge on Appeal by Section 363(m)

Bankruptcy Code Section 363(m) prevents the overturning of a completed sale to a good-faith purchaser in the absence of the stay in bankruptcy appeals. 11 U.S.C. § 363(m). *Nieters v. Sevcik (in re Rodriguez)*, 258 F. 3d 757, 759 (8th Cir. 2001). Section 363(m) helps maximize the sale proceeds for the estate by giving asset purchasers more confidence in the finality of their purchases. Section 363(m) provides as follows:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

The protection provided by § 363(m) applies to assignments of oil and gas leases. *See Hatzelbaker v. Hope Gas, Inc., (In re Rare Earth Minerals)*, 445 F.3d 359 (4th Cir. 2006) (section 363(m) applies to a sale of the debtor's interest in an oil and gas lease that the lessor claimed the debtor had abandoned before bankruptcy).

D. Typical Section 363 Sale Process

In many cases, the debtor will engage an investment banker and begin marketing its assets before filing a bankruptcy petition. This approach is generally preferred because it can help streamline the bankruptcy case and reduce the amount of time the debtor spends in bankruptcy. The marketing process typically involves creating an electronic data room with key documents and contracts, contacting potentially interested parties (both strategic and financial), and engaging in discussions with serious potential purchasers.

Traditionally, debtors have preferred to negotiate an asset purchase agreement (or similar transaction agreement) with a stalking horse bidder prior to filing a bankruptcy petition. A stalking horse bidder is a proposed purchaser that agrees to submit a binding bid, typically in the form of an executed asset purchase agreement, in exchange for certain protections. These protections safeguard the stalking horse bidder if the debtor ultimately sells its assets to another party, and is triggered if that occurs. The most common stalking horse protections include:

(1) Expense Reimbursement – expense reimbursement can be provided for in the asset purchase agreement between the buyer and the debtor and is subject to court approval. The purpose of expense reimbursement is to protect the buyer from the out of pocket costs associated with due diligence (that may be relied upon by the parties), and negotiating and documenting the transaction, i.e. legal fees, appraisal fees, and diligence fees.

(2) Break-Up Fees[3] – break up fees compensate the stalking horse for the value that its bid provided to the debtor's estate. Many courts approve a fee up to approximately 3% of the bid value.

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[3] The standards for approval of break- up fees and other bid protections, depending on the jurisdiction, are (1) the business judgment standard, (2) the administrative expense test and (3) the "best interest of the estate" test. *See In re Integrated Res., Inc.*, 147 B.R. 650 (S.D.N.Y. 1992) (adopting the business judgment standard); *In re ASARCO, L.L.C.*, 650 F.3d 593 (5th Cir. 2011) (affirming that the business judgment standard was the correct legal standard to apply to certain bid protections); *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 435 (3d Cir. 1999) (applying the administrative expense standard to bid protections); *In S.N.A. Nut Co.*, 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) (applying the best interest of the estate standard). In many cases, the court's analysis may combine or overlap elements of these standards. *See* John D. Bittner, *Introduction to Credit Bidding and Bankruptcy Acquisition Strategies*, 32nd Annual Advanced Business Bankruptcy, February 19-20, 2015.

(3) Non-Solicitation and Exclusivity Rights – buyers have been increasingly negotiating for such rights in purchase agreements. These rights comprise a list of covenants by the debtor in an effort to prevent the emergence of a competing alternative transaction.[4] While such rights limit the debtor's right to "window shop" for new offers, they often allow the debtor flexibility in responding to unsolicited proposals.

(4) Limiting the Scope of the "Fiduciary Out" – traditionally, the "fiduciary out" allows the debtor to terminate the purchase agreement with the buyer and pursue an alternative proposal when doing so is required to satisfy the debtor's fiduciary duty to maximize value. Limitations on the "fiduciary out" include contractual specifications regarding what the debtor must consider in determining whether an offer triggers the fiduciary out.

(5) Increasing the Buyer's Information Rights – increased information rights are designed to provide the buyer more information regarding competing proposals made to the debtor.

(6) Match Rights – this is a less common form of bidder protection. Match rights require the debtor to give the buyer notice before the debtor may terminate the purchase agreement in favor of a competing proposal. Additionally, match rights may require the debtor to negotiate with the buyer before termination to determine whether the buyer can provide a more appealing offer than the competitor.

Recent oil and gas cases involving a either a stalking horse purchaser or a pre-arranged bankruptcy plan transaction include Milagro Oil and Gas, Hercules Offshore, and Samson Resources. A sample of the proposed Contribution Agreement filed in the Milagro Oil and Gas case is attached hereto as **Exhibit A**.

However, an emerging trend in oil and gas cases—exemplified by the Sabine Oil & Gas Corp., Dune Energy, and Quicksilver Resources bankruptcy cases—is that debtors have been forced to file for bankruptcy without an executed asset purchase agreement (or a pre-arranged plan transaction) and without a committed purchaser. In that event, the debtor may still seek approval of bidding procedures (described below) and conduct an auction, but the benefits associated with having a stalking horse bidder—which include setting a price floor, encouraging additional interest, and publicity—are lost. A sample of the proposed form asset purchase agreement filed in the Quicksilver Resources case is attached hereto as **Exhibit B**.

A debtor who has negotiated an asset purchase agreement with a stalking horse bidder prior to filing for bankruptcy will typically file a prompt motion to sell assets pursuant to Section 363 and to approve procedures to govern a bidding and sale process.[5] To maximize value, courts often approve procedures that permit competing bidders to submit offers and participate in an

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[4] Additionally, where there are limited go-shop periods, the non-solicitation provisions of the sale agreement may also include covenants to shut down and extinguish such process at the end of the go-shop period).

[5] In jurisdictions the request to sell assets and the request to establish bidding procedures may be asserted in the same motion.

auction for the debtor's assets. It is common for disputes to arise in connection with bidding procedures, as creditors' committees and competing bidders often seek additional time for submitting competing bids, relaxed standards for becoming bidders qualified to participate in the auction, reduction of the overbid amount, and related items.

After bidding procedures are established, qualified bidders submit competing bids, which are typically made in the form of an asset purchase agreement and marked against the stalking horse bidder's asset purchase agreement or the debtor's form. The debtor will review the bids and typically will select a lead bid to open the auction. The auction often takes place at the offices of the debtor's counsel, but some judges require auctions to occur in the courtroom or other places within the courthouse. It is not uncommon for auctions to be protracted affairs, with numerous negotiations between bidders, the debtor and committees.

Secured lenders often play an important role in Section 363 sales. Section 363(k) allows lenders to credit bit at a Section 363 sale unless the court finds cause to disallow it. *See* 11 U.S.C. § 363(k). The ability to credit bid gives secured lenders a great deal of influence in the bidding process. A common dynamic involves the secured lender bidding against a cash bidder, where the issue becomes how much is the cash bidder willing to bid against what is often a much larger amount of secured debt.

At the conclusion of the auction, the bankruptcy court will hold a hearing to approve the auction results and the sale of assets. After the sale closes, the bankruptcy case typically concludes with the approval of a liquidating plan or conversion to chapter 7 to liquidate the sale proceeds.

III. PURCHASE OF ASSETS OR EQUITY IN A PLAN OF REORGANIZATION

A. Characteristics of a Plan Transaction

i. A plan can include the sale of assets or equity, and affords the debtor great flexibility.

Confirmation of a plan of reorganization traditionally has been the pinnacle of the chapter 11 process. A chapter 11 plan may take many different forms, but common features include classification of claims against the debtor, treatment of claims, discharge of claims, assumption or rejection of executory contracts, releases for key parties, and a means to implement the reorganization—either through a sale of assets, a recapitalization, a debt-to-equity swap, a merger, or some other form. A plan may also include the settlement of disputes, the creation of one or more trusts to liquidate claims and make distributions, and/or provisions related to the reorganized debtor.

As mentioned above, several recent oil and gas cases have involved a prearranged plan of reorganization whereby a transaction has been negotiated and is already approved by key stakeholders on the bankruptcy petition date. Recent examples include Milagro Oil and Gas, Hercules Offshore, and Samson Resources.

In *Samson Resources*, the debtors filed their Chapter 11 petition on September 17, 2015. In the First Day Declaration, the debtors describe a proposed debt-to-equity conversion whereby existing equity interests will be canceled out and the second lien debt holders will obtain new equity interests and backstop a $450 million rights offering, thereby infusing fresh capital in the company. Samson's claims that this cash infusion would permit the company to restart operations and sustain the reorganized business through the period of depressed oil and gas prices. Notably, Samson reached this proposed deal with its second lien lenders after months of dual-track negotiations between Samson, its second lien lenders, and its noteholders. The competitive nature of this dual-track negotiation serves as a source of encouragement for oil and gas companies facing financial distress in light of weak commodity prices.

ii. Creditors must approve the plan (more than half in number of creditors holding at lease 2/3 in amount of claims).

A bankruptcy plan may only be confirmed if creditors vote to accept it. Acceptance or rejection of a bankruptcy plan is determined on a class-by-class basis. A class of claims accepts a plan where creditors holding claims at least two-thirds in amount and more than one-half in number of claims actually cast in that class vote in favor of the plan. *See* 11 U.S.C. § 1126(c). In other words, complete creditor approval is not necessary for acceptance. The calculation is performed based on the actual votes cast and there is no minimum quorum of votes required. (i.e. if only one claim in a class casts a vote, then that claim controls the class). The numerosity and value requirements are conjunctive; if only one is satisfied, the class is deemed to have voted against the plan.

iii. The plan must satisfy numerous legal requirements.

Bankruptcy Code Section 1129 provides that a court **shall confirm** a plan if the requisite creditors (both in amount and number) vote in favor and the plan satisfies certain legal requirements. Plan confirmation can be either consensual or non-consensual. Section 1129(a) governs consensual confirmation. It contains 16 paragraphs, each setting forth requirements that must be met to confirm the plan. A summary of the salient provisions of Section 1129(a) that apply to corporate debtors is below:

- The plan and the plan proponent must comply with the applicable provisions of the Bankruptcy Code.

- The plan must be proposed in good faith and not by any means forbidden by law.

- Payments by the plan proponent, the debtor, or anyone acquiring property or issuing securities under the plan must be approved by the Bankruptcy Court as reasonable.

- The plan proponent must disclose the identity of post-confirmation directors and officers and any insider to be retained by the reorganized debtor.

- The "best interests of creditors rule": With respect to each impaired class of claims or interests, each holder of a claim or interest of such class has either accepted the plan or will receive value under the plan that is not less than what the party would have received in a Chapter 7 liquidation.

- Each class of claims or interests has either accepted the plan or is not impaired under the plan.[6]

- All priority claims, including certain employee claims and tax claims, must be paid in full, in some cases with payments made over a five year period.

- All administrative claims must be paid in full.

- At least one class of claims that is impaired under the plan must accept the plan, ignoring acceptance by any insiders.

- The "feasibility" test: Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization.

- Fees payable to the U.S. Trustee's office must be paid.

- Certain retiree benefits must be continued post-confirmation.

See 11 U.S.C. § 1129(a).[7]

If all of the foregoing requirements are satisfied, the Bankruptcy Court shall confirm the plan. *See id.* In one sense, then, plan confirmation is subject to less discretion than a Section 363 sale, which requires consideration of the debtor's business judgment. However, as the foregoing list indicates, plan confirmation is no easy task and requires creditors to vote in favor of the plan and for the plan proponent (usually the debtor) to satisfy numerous requirements.

If not all classes of creditors vote in favor of the plan, Section 1129(b), which governs non-consensual confirmation, may yet provide an avenue for confirmation. Section 1129(b) incorporates all but one of the paragraphs of section 1129(a), omitting only the requirement that all classes consent or be unimpaired. 11 U.S.C. §1129(b)(1); *see* 7 Collier on Bankruptcy ¶ 1129.01 (Alan N. Resnick & Henry Sommer eds., 16th ed. 2015). Section 1129(b) also adds two important requirements: (1) that the plan not unfairly discriminate against dissenting classes, and (2) that the plan's treatment of such dissenting classes be fair and equitable. 11 U.S.C. § 1129(b)(2).

A detailed analysis of these requirements is beyond the scope of this article, but in summary, a plan is fair and equitable with respect to holders of secured claims if they retain their liens, receive the present value of their collateral and a deferred cash payments equal to their entire claim or otherwise receive the indubitable equivalent of their claim. *See* 11 U.S.C.§§ 1129(b)(2)(A), 1111(b). For unsecured creditors, the fair and equitable test is satisfied if the "absolute priority rule" is satisfied. That rule provides that an unsecured creditor's claim must

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[6] If this requirement is not satisfied, then the plan may still be confirmed, but it must satisfy the requirements in Section 1129(b) for a non-consensual confirmation.

[7] For a complete list of all plan confirmation requirements please refer to the statute and for a detailed discussion of plan confirmation, *see* 7 Collier on Bankruptcy, 1129.02 (Alan N. Resnick & Henry Sommer eds., 16th Ed. 2015).

either be paid in full or no creditor junior in priority can be paid anything on such junior claim. *Id.* § 1129(b)(2)(B).

iv. Plan Transactions May Be Subject to Competing Offers.

While seeking to consummate a transaction in a plan of reorganization may reduce the risk of facing competing bidders, it does not eliminate that risk. One of the best ways to reduce the risk of a competitive auction is for a buyer to negotiate a sale transaction that is embodied in a plan of reorganization that is supported by the debtor's key stakeholders before filing for bankruptcy. By obtaining agreement with the key stakeholders (usually documented in a restructuring support agreement or plan support agreement), a buyer or debtor can present a pre-arranged transaction to the bankruptcy court, may be able to obtained shortened timelines, and reduce the risk of a competitive auction.

Nonetheless, an auction process may be required, even under a plan, if a competing bidder surfaces or if there is a substantial amount of secured debt and the holders of secured claims insist on it. These parties may argue that without an auction, there is no "market test" for the value of the assets and no assurance that value is being maximized for the benefit of creditors.

Another prominent issue is credit bidding rights for secured creditors in the context of a plan of reorganization. In a recent case, the Supreme Court held that a chapter 11 plan that provides for the sale of collateral free and clear of a secured creditor's lien must permit the creditor to credit bid in order to satisfy the cramdown requirements of Bankruptcy Code Section 1129(b)(2). *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 132 L.Ed. 2d 967 (2012).

In *RadLax*, the debtor's plan contemplated an auction to sell assets to the highest bidder free and clear of liens, claims, and encumbrances. The plan proposed to pay the senior secured lender's secured claim from the net sale proceeds and provided a term note to pay the unsecured portion of the lender's claim. At least one potential cash bidder refused to participate in the auction unless the lender was prohibited from credit bidding and the bidding procedures so provided.

There was no dispute that Section 1129(b)(2)(A)(ii) expressly references, and requires, credit bidding. However, the debtor argued that it was proceeding under subsection (iii)—which provides for satisfaction of the "fair and equitable" standard for secured creditors by providing the secured creditor with the "indubitable equivalent" of their claims. Section 11 U.S.C. § 1129(b)(2)(A)(iii). The debtor argued that the cash proceeds from the auction provided the secured lender with the "indubitable equivalent" of its secured claim. The bankruptcy court and the Seventh Circuit Court of Appeals rejected the debtor's argument, holding that Section 1129(b)(2)(A) does not permit debtors to sell an encumbered asset free and clear of a lien without permitting the secured creditor to credit bid. The Supreme Court affirmed in a unanimous decision.

The Supreme Court rejected the Debtor's interpretation of subsection (iii) to permit precisely what subsection (ii) proscribed. According to the Court, that reading was "hyperliteral and contrary to common sense" and violated a well-established canon of statutory interpretation—that the specific governs the general. *See RadLAX*, 132 S.Ct. at 270. The Court held that subsection (iii) was a catch-all provision that covered auctions, but it did not govern credit bidding because it is specifically addressed in subsection (ii). Ultimately, this was an easy issue for the Supreme Court. Left unresolved, however, is whether a court in the plan context may limit credit bidding for cause, as provided in Section 363(k).

B. Comparison of Section 363 Process and Bankruptcy Plan Process

Below is a comparison of certain key characteristics of transactions under Section 363 and under a plan of reorganization.

i. Time Required

<u>363 Sale</u>: A motion to sell assets can be heard on 21-days' notice and bankruptcy courts have discretion to shorten notice for cause shown. Fed. R. Bankr. Proc. 2002(a)(2); 6004.[8] If the debtor also seeks approval of bidding procedures, an order approving bidding procedures will be entered first, and only after the auction process is completed will the court consider entry of a sale order under Section 363. If the debtor has commenced a marketing process prior to the bankruptcy, it is possible to obtain approval of bidding procedures, conduct an auction, and obtain entry of a sale order in as little as 30-45 days. An order approving the sale of assets under Section 363 is automatically stayed for 14 days, unless the bankruptcy court orders otherwise. Fed. R. Bankr. Proc. 6004(h).

<u>Plan</u>: A plan of reorganization must be accompanied by a disclosure statement, and in most situations, the disclosure statement must be approved prior to soliciting votes on a plan.[9] Approval of a disclosure statement can be heard on 28-days' notice, and following approval thereof, consideration of a plan can be heard on 28-days' notice. Fed. R. Bankr. Proc. 2002(b). Thus, the ordinary plan process takes at least 60 days.

ii. Standard for Approval

<u>363 Sale</u>: Business judgment standard, although some courts may closely scrutinize, and may not approve, sales of substantially all of a debtor's assets under Section 363.

<u>Plan</u>: The requirements in Bankruptcy Code section 1129 must be satisfied (as described above). The plan must also be accepted by more than half in number of voting creditors holding at least 2/3 in amount of claims voted.

iii. Flexibility

<u>363 Sale</u>: Flexibility to purchase desired assets and obtain assignment of desired contracts, but limited ability to include more elaborate provisions, including treatment of claims, settlement of disputes, and cancellation of existing equity.

[8] The contents of such notice must comply with Bankruptcy Rule 2002(c)(1).

[9] There is an exception in small business cases, where the disclosure statement and plan may be considered together and may be contained in the same document. 11 U.S.C. § 1125(f).

Plan: Substantial flexibility to purchase assets, purchase equity, restructure debt, engage in a merger or other business combination, discharge claims, and settle disputes.

IV. TREATMENT OF DESIRED CONTRACTS

An "executory contract" is a contract is under which the obligations of both parties are so far underperformed that the failure of either party to perform would be a material breach. *See* Vern Countryman, *Executory Contracts and Bankruptcy: Part I,* 57 Minn. L. Rev. 439, 460 (1973). In short, both parties must have remaining material obligations.

Section 365 of the Bankruptcy Code gives the debtor the option to reject, assume or assume and assign its executory contracts in bankruptcy.

A. Are Oil And Gas Leases Executory Contracts?

Section 365(d)(4) provides that an unexpired lease of non-residential property will be deemed rejected and surrendered to the lessor unless the debtor, within one hundred twenty (120) days of the bankruptcy petition date, assumes, assumes and assigns, rejects, or gets an extension of the deadline. This provision raises the question whether an oil and gas lease is an executory contract.

The question of whether an oil and gas lease constitutes an executory contract is highly dependent on whether applicable state law classifies the type of interest created by an oil and gas lease as a real property ownership interest or something else, like a license. If, under state law, the grant of an oil and gas lease is treated as a transfer of real property to the debtor lessee, then the oil and gas lease is not likely to be classified as an executory contract. Not surprisingly, this issue has been addressed by courts considering oil and gas leases from traditional oil producing states like Texas and Louisiana. Unfortunately, the law from other states is less developed. Below is a summary of certain jurisdictions.

- **Texas**

An oil and gas lease is not an executory contract under Texas law because the lease constitutes a conveyance of an ownership interest in real property. *Cherokee Water Company. v Forderhause*, 641 S.W.2d 522, 525 (Tex. 1982); *see also Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002) ("A Texas mineral lease grants a fee simple determinable to the lessee."). The law in Texas is well developed and makes clear that Section 365 of the Bankruptcy Code is inapplicable. *See River Prod. Co. v. Webb (In re Topco., Inc.*), 894 F.2d 727, 739 n.17 (5th Cir. 1990); *see also Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70 (Bankr. S.D. Tex. 1996) ("A mineral lease in Texas is a determinable fee. It is not a lease or other form of executory contract that a debtor may assume or reject.").

- **Louisiana**

In Louisiana, whether oil and gas leases are considered executory contract for the purposes of Section 365 remains a controversial and undecided issue. Where the debtor wanted to assume leases and clearly had the ability to perform, some Louisiana courts have ruled oil and gas leases to be executory contracts. *Texaco Inc. v. Louisiana Land Exploration Co.*, 136 B.R.

658, 668 (Bankr. M.D. La. 1992); *see also In re Ham Consulting Co./William Lagnion/JV*, 143 B.R. 71, 73-75 (Bankr. W.D. La. 1992) (finding Louisiana mineral lease not an unexpired lease but is executory contract under Section 365). Other Louisiana judges have rejected this analysis and held that oil, gas and mineral leases in Louisiana are not executory contracts under Section 365. *See, e.g., In re WRT Energy Corp.*, 202 B.R. 579, 583-84 (Bankr. W.D. La. 1996) (lease was not an executory contract because the lessors' failure to perform under the lease would not constitute a material breach excusing the lessee's performance, but would only delay performance); *see also Delta Energy Resources, Inc. v. Damson Oil Corp.*, 72 B.R. 7, 11 (Bankr. W.D. La. 1985) (finding Louisiana mineral leases to be rights to incorporeal immovables and not "conventional leases" contemplated by Section 365).

- **Oklahoma and New Mexico**

Oklahoma and New Mexico also characterize oil and gas leases as conveyances of real property, and thus, the leases are not considered executory contracts. *See In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (determining oil and gas lease is fee estate in real property and therefore not within purview of Section 365); *In re Clark Resources*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986) (finding, under Oklahoma law, oil and gas lease is not executory contract or unexpired lease under Section 365); *In re Antweil*, 91 B.R. 65 (Bankr. N.M. 1989) (holding that oil and gas leases are not executory contracts).

- **Kansas and Ohio**

In Kansas and Ohio, oil and gas leases are considered executory contracts. *See, e.g. In re J.H. Land & Cattle Co., Inc.*, 8 B.R. 237, 239 (Bankr. W.D. Ok. 1981) (holding oil and gas leases to be executory contracts in Kansas because Kansas law considers them personal property and a profit a prendre); *In re Integrated Petroleum Co., Inc.*, 44 B.R. 210 (Bankr. N.D. Ohio 1984) (holding oil and gas leases treated as executory contracts under Ohio law).

- **North Dakota, Mississippi, and Wyoming**

Courts in North Dakota, Mississippi, and Wyoming have not expressly addressed whether an oil and gas lease is considered an executory contract in bankruptcy, however, they have addressed whether an oil and gas lease is considered a real property interest or a true lease.

In North Dakota, an oil and gas lease is considered a real property interest rather than a true lease. *See, e.g., Messersmith v. Smith,* 60 N.W.2d 276 (N.D. 1953) (referring to and treating a mineral lease as a deed of real property); *Petroleum Exchange v. Poynter*, 64 N.W.2d 718, 726 (N.D. 1954) (oil, gas and mineral leases are transfers of interests in real property). Because the lessee holds a real property interest and not a "lease" interest, it appears that Section 365 is not applicable. The North Dakota bankruptcy court recently affirmed in *Great Plains Royalty Corp. v. Earl Schwartz Co.* that oil and gas leases are interests in real property in North Dakota, although it made no Section 365 determinations. No. 68-00039, 2015 Bankr. LEXIS 883, at *52-54 (Bankr. N.D. Mar. 18, 2015)

Likewise, under Mississippi law an oil and gas lease appears to transfer an interest in real property. *See Chevron U.S.A., Inc. v. State*, 578 So.2d 644 (Miss. 1991) ("As to the minerals, an oil and gas lease is a deed as such term is usually employed. It may be described in real property terms as a conveyance of an estate in fee simple defeasible" absent a contract modifying the nature of the conveyance) (internal quotations omitted).

Under Wyoming law, however, it appears that an oil and gas lease does not convey an ownership right. *Shepperd v. Boettcher & Co., Inc*., 756 P.2d 182 (Wyo. 1988) (reasoning that a fractional working interest owner with no right to control the surface "has certain contractual rights and obligations by contract, but not by property ownership").

- **Outer Continental Shelf ("OCS") Leases and Section 365**

For offshore oil and gas leases, a prospective purchaser first must determine whether state or federal law applies to the lease, which depends on where the leased interests are located. Generally, state law applies to the area extending up to three (3) geographical miles from the state's coast. *See* 43 U.S.C. § 1312. Federal law governs the area extending from the offshore state boundary to at least two hundred (200) nautical miles from the shore. This offshore area is known as the Outer Continental Shelf ("OCS"). *See* 43 U.S.C. § 1331(a). Leases located in the OCS are governed by federal law.

The United States typically will argue that an OCS lease is a true lease under Section 365, rather than an interest in real property. *See, e.g., NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.),* No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014); *see also* 43 U.S.C. § 1331-1356a (2006) (using the term "lease" to characterize the property interested granted by the United States to OCS lessees). Moreover, the typical federal lease merely provides rights to extract minerals, and expressly states that no ownership rights in a mineral interest are being conveyed. However, some authors have suggested that "an OCS lease is clearly a form of property right, created by statute." Rhett Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, Texas Journal of Oil, Gas, and Energy Law Symposium, January 21-22, 2010, at 5.

In *ATP*, the United States argued that OCS leases were unexpired leases subject to section 365 of the Bankruptcy Code and that the instrument conveying an OCS lease is also an executory contract subject to section 365. Many practitioners were hopeful that the *ATP* court would evaluate the government's argument and resolve the issue of whether an OCS lease is an executory contract and/or an unexpired lease; however, the court declined to provide clear answers. Thus, the question of whether an OCS lease is a true lease or an executory contract under Section 365 remains an undecided issue.

B. Joint Operating Accounts ("JOAs") and Farmout Agreements Often Are Executory Contracts.

11 U.S.C. § 101(21A) defines a farmout agreement as a written agreement in which —

a. the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and

b. such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property.

Farmout agreements that have not been fully performed usually are treated as executory contracts by the Bankruptcy Code and are subject to all applicable executory contract provisions, including Section 365 assumption or rejection. Charles Beckham, et al., *Oil and Gas Leases: They're Not Just in Texas Anymore; They're Fracking Everywhere!*, 32nd Annual Jay L. Westbrook Bankruptcy Conference, November 21-22, 2013, at 4-5. Applying Section 365(i) executory contract provisions to farmout agreements can create many different consequences, depending on whether the debtor is the farmor or the farmee. *See id.*

It is not entirely clear whether JOAs are treated as executory contracts subject to assumption or rejection under Section 365. If the non-operator has continuing obligations under a JOA, the agreement could be classified as an executory contract. *See Wilson v. TXO Production Corp. (In re Wilson)*, 69 B.R. 960 (Bankr. N.D. Tex. 1987). Importantly, though, the *Wilson* decision does not support labeling all JOAs as executory contracts because JOAs are often highly complex and may contain both executory and non-executory provisions. Beckham, et al., *supra* at 6-8. For example, operators and non-operators often have contractual lien rights, which operate independently of whether the agreement is assumed or rejected, but the lien may be avoided if it is not perfected by recording. *See* Rhett G. Campbell, *The 10 Things You Ought to Know About Oil & Gas Bankruptcy (And Probably Didn't Know to Ask)*, 26th Annual Advanced Business Bankruptcy Course, 2008, at 4.

When a JOA is an executory contract, disputes may arise in the time period before the debtor assumes or rejects the agreement. *See, e.g., NLRB v. Bildisco & Bildisco,* 465 U.S. 513 (1984); *see also Wilson v. TXO Prod. Corp. (In re Wilson)*, 69 B.R. 960, 965 (Bankr. N.D. Tex. 1987). In *NLRB*, the Supreme Court held that after a debtor commences a chapter 11 proceeding but before it assumes or rejects executory contracts, the contracts remain enforceable by the debtor but not against the debtor. 465 U.S. at 532. In *Wilson*, the court held that the JOA does not govern the rights of either party during the Twilight Zone, but rather, the laws of co-tenancy govern. 69 B.R. at 966. Regardless, eventually the operating agreement will be either assumed or rejected. If the operating agreement is assumed, the debtor's acts prior to assumption or rejection will be measured as though the contract was actually in effect for the entire time period. Rhett Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, Texas Journal of Oil, Gas, and Energy Law Symposium, January 21-22, 2010, at 28.

C. Are Production Payments and Overriding Royalty Interests Executory Contracts?

In Texas, an overriding royalty interest generally is an interest in real property. *See, e.g., Sheffield v. Hogg*, 124 Tex. 290 (1934). Because royalty interests are considered real property interests of the production payment owner, the interest should be excluded from property of the production payment seller's bankruptcy estate generally under Section 541(a), and specifically under Section 541(b)(4)(B). *See* Jeffrey S. Munoz, Financing of Oil and Gas Transactions, 4 TEX. J. OIL GAS & ENERGY L. 223, 234 (2009).

Despite this general rule, In *NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, Judge Marvin Isgur of the Southern District of Texas found that issues of material fact existed regarding whether certain prepetition term overriding royalty transactions ("ORRIs") were properly characterized as real property transactions, or whether they were more accurately characterized as debt financings. No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014).

In *ATP*, the debtor indicated to its ORRI holders that it planned to recharacterize a number of ORRIs as debt financings. The Judge examined the "economic substance" of the purported ORRIs to determine whether they were actually more like debt instruments than real property conveyances. *Id.* The Judge reasoned that the instruments at issue contained characteristics of both real property conveyances and financing transactions, and thus, summary judgment was inappropriate. *Id.* This finding introduces the possibility that a bankruptcy trustee may be able to recharacterize such transactions as loans, which would disadvantage the royalty owners. In *ATP* and more generally, this determination is a fact specific and summary judgment appears unlikely.

D. Requirements for Assumption: Cure of Existing Defaults and Adequate Assurance of Future Performance Going Forward

Section 365(b) sets forth the requirements a trustee must satisfy before it may assume an executory contract. Section 365(b) provides as follows:

> (1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
>
> > (A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;
> >
> > (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
> >
> > (C) provides adequate assurance of future performance under such contract or lease.

i. Strategy regarding assuming and rejecting contracts

In the process of conducting due diligence, the buyer will identify desired assets. Some of the assets are likely to be executory contracts and unexpired leases that are necessary for operating the business going forward. While some buyers seek a blanket assignment of "all executory contracts," it is preferable to develop a schedule of contacts that the buyer has determined are necessary or beneficial. The bankruptcy plan or sale documents would then provide for assumption and assignment of only those contracts and a rejection of the rest.

Plan or sale transactions that include the assumption and assignment of "all contracts" are risky because the buyer could be acquiring unknown and potentially significant liabilities. For example, in the recent case of *Noble Energy vs. Conoco-Phillips*, the predecessor of Noble Energy purchased assets and obtained assignment of contracts from a predecessor of Conoco-Phillips in a bankruptcy case. 462 S.W.3d 255 (Tex. App.—Houston [14th Dist.] 2015, pet. filed Aug. 15, 2015). The plan of reorganization in that case provided that unless a contract was listed on a schedule of rejected contracts, the contract "shall be assumed by the Debtors and assigned to the [Buyer]." In other words, the plan accomplished the opposite of what the authors recommend herein—it contained an assumption and assignment of **all contracts**, subject to the specific exclusion of listed contracts to be rejected.

In the *Noble* case, the contract that later became an issue was not listed on the rejection schedule, and thus, Noble arguably obtained an assignment of that contract. That contract included an indemnity obligation and Conoco later made an indemnity demand after an environmental lawsuit was filed in Louisiana.

A Houston state district court held that Noble did not receive an assignment of the relevant contract, but the 14^{th} Court of Appeals reversed and rendered on that point, holding that Noble assumed the contractual obligations. *Id.* The court held that, consistent with well-accepted bankruptcy law, assumption of a contract also comes with the burden of all contractual obligations. In other words, the court held that a buyer cannot choose to assume only the benefits of a contract—a limitation on the general rule that a buyer of assets in bankruptcy can choose assets is wants and leave liabilities behind.

Porter Hedges filed an amicus brief in support of a petition for review to the Texas Supreme Court on behalf of Plains All American Pipeline—which was not involved in the case but buys assets out of bankruptcy from time to time. The brief argued that the court of appeals misapplied the language of the plan and that the contract at issue was not assumed. The brief also argued, on the basis of Third Circuit authority, that assumption of a contract and assignment of a contract are two separate powers under Section 365 of the Bankruptcy Code. And even though a debtor must **assume** an entire contract, the debtor may **assign** only certain provisions. This view is consistent with both the language and policy of the Bankruptcy Code—which is intended to maximize interest in a debtor's assets, and thus, value for the estate. The petition for review remains pending in Texas Supreme Court. Regardless of the outcome, the safer approach for a buyer is to only assume those contracts that it has identified as being beneficial.

E. Executory Contracts Can Be Assumed and Assigned as Part of An Asset Sale under Section 365 or a Plan Transaction.

Section 365(f) provides that a trustee may assign an executory contract to a third party if it assumes the contract as required by Section 365(b) and provides adequate assurance that the assignee will continue performing under the contract—even in most situations where the contents contains anti-assignment language.

The full text of Section 365(f) is as follows:

(1) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

(2) The trustee may assign an executory contract or unexpired lease of the debtor only if—

(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

(3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

V. SPECIAL CONSIDERATIONS INVOLVING THE PURCHASE OF OIL AND GAS ASSETS

A. Assumption of Executory Contracts and Payment of Contract Cure Costs

As discussed above, many contracts common in oil and gas businesses may be executory contracts under the Bankruptcy Code. For example, joint operating agreements, pending farmout agreements, and vendor contracts may qualify as executory contracts. It is important for the buyer to identify those contracts that may be executory and clearly communicate to the debtor which ones will be the subject of assumption and assignment.

Another key negotiating issue with respect to contracts is responsibility for "cure costs" that must be paid for the debtor to assume contracts. If the debtor has not been keeping trade creditors paid current, there may be significant cure costs that have accrued. In many situations, the debtor lacks the funds to pay cure costs and can negotiate for the buyer to pay them as part of the transaction.

B. Allocation of Plugging and Abandonment Liabilities

The issue of a whether a plugging and abandonment ("P&A") claim is entitled to administrative priority and who is a responsible party for P&A liabilities is a prominent issue. In Texas, the obligation to P&A a well arises when drilling operations are commenced, and P&A operations must be commenced on a well within one year from the date that drilling or operations cease. 16 Tex. Admin. Code § 3.14(b). If one party pays the P&A cost, that party may be entitled to indemnity or contribution from other parties who either are or were owners of undivided interests.

The Fifth Circuit, interpreting Texas law, has held that P&A liabilities are entitled to administrative claim priority if the debtor's liability to P&A accrued under state law (as opposed to contract) and a failure to comply with state law would result in further liability under state law. *State v. Lowe (In re HLS Energy Co., Inc.)*, 151 F.3d 434. 438-39 (5th Cir. 1998). The Supreme Court also has reasoned that a debtor must comply with state law as well as 28 U.S.C. § 959(b) and may not abandon property in violation of a state law reasonably designed to protect the public health and safety. *Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Protection*, 474 U.S. 494, 503-05 (1986).

Often, P&A and other environmental responsibilities are addressed by a debtor and a purchaser in a sale agreement, which sets forth the parties' respective responsibilities post-sale. For example, in the Milagro bankruptcy, Milagro and its proposed purchaser, White Oak Resources VI, LLC ("White Oak"), agreed to divide post-sale responsibilities, including P&A obligations, as follows:

> From and after Closing, except to the extent related to or the subject matter of Retained Obligations or Retained Contracts, White Oak assumes and hereby agrees to fulfill, perform, pay and discharge (or cause to be fulfilled, performed, paid and discharged) all obligations and Losses arising from, based upon, related to or associated with (i) the Assets, the operation and ownership of, or conditions first existing, arising or occurring with respect to the Assets after the Effective Time;….; (iii) notwithstanding the provisions set forth in clause (i) above, **all P&A and Environmental Costs arising on or after the Effective Time**; and (iv) **notwithstanding the provisions set forth in clause (i) above, all Plugging and Abandonment obligations arising before, on or after the Effective Time** (collectively, the "Assumed Obligations"). Except for the Assumed Obligations, it is expressly understood and agreed that White Oak shall not assume, be obligated to pay, perform or discharge, and Milagro shall retain, pay, perform and discharge all other obligations and Losses of Milagro.
>
> *See* Exhibit A (emphasis added).

C. Treatment of "Prior Consent" Provisions

Consent to assignment or prior consent provisions in oil and gas contracts frequently create issues in oil and gas bankruptcy transactions. While such provisions may be enforceable under non-bankruptcy law, they can be avoided under the safe harbor provision of Section 365(f)(1). As discussed above, Section 365(f)(1) provides that a trustee may an executory contract or lease "notwithstanding a provision in an executory contract or unexpired lease of the debtor…that prohibits, restricts, or conditions the assignment of such contract or lease." Notably, this section is only applicable if the contract or unexpired lease is considered an executory contract.

Unsurprisingly, this requirement causes problems in Texas and other jurisdictions in which oil and gas leases are not considered executory contracts. In such jurisdictions, the applicability of the safe harbor provision will hinge upon whether the consent to assignment requirement is a personal covenant of the leaseholder/debtor, or whether it is a burden on title of the lease itself as a condition subsequent or a covenant running with the land. *See* 3 ERNEST E. SMITH AND JACQUELINE LANG WEAVER, TEXAS LAW OF OIL AND GAS § 16.5[A][4], p. 16-29 (2d ed. LexisNexis Matthew Bender 2009) (internal citations omitted). A covenant running with the land is part of the character of the real property in the hands of the debtor, and thus, it is not an executory contract capable of being rejected. However, a personal covenant in a contract with the debtor is not tied to the land; thus, 365(f)(1) will apply and the debtor should be free to assign the property without regard to the consent requirement.

D. Considerations Regarding Discharge of Environmental Claims held by the United States Government

Potential purchasers of oil and gas assets should be aware of the unique limitations placed on the dischargeability of environmental claims held by the U.S. Government. The Department of Justice ("DOJ"), on behalf of the Environmental Protection Agency ("EPA") recently expressed concerns about the proposed plan of reorganization in the Milagro bankruptcy based on its concerns regarding a perceived discharge of non-dischargeable environmental claims.

First, the DOJ argued that the proposed plan might be construed to discharge certain equitable remedies under federal environmental law, which are not "claims" under the bankruptcy code, and therefore are not dischargeable under 11 U.S.C. § 1141(d). *See* 11 U.S.C. § 101(5) (a "claim" includes a "right to an equitable remedy for breach of performance if such performance gives rise to a right to payment…"); *In re Davis*, 3 F.3d 113, 116-17 (5th Cir. 1993) (equitable remedies that do not fall within the Code's definition of claim cannot be discharged).

Second, the DOJ argued that certain of the debtor's acts before confirmation of the plan are not subject to discharge under the plan because environmental claims may "arise" after confirmation even if events related to the debtor's liability occurred pre-confirmation. *See, e.g., In re Reading Co.*, 115 F.3d 1111 (3rd Cir. 1997) (environmental claims arise when all the elements of a cause of action accrue or a sufficient relationship exists with respect to the claim to give rise to fair contemplation). Finally, the DOJ argued that the release of non-debtor environmental liabilities in bankruptcy is inappropriate. *See, e.g., In re Continental Airlines*, 203 F.3d 203, 212-13 (3rd Cir. 2000).

To resolve these concerns, the DOJ proposed the following language regarding the dischargeability of environmental claims:

> 21. Any purported assumption and/or assignment of any interests in any federal oil, gas, or mineral leases ("Federal Leases") pursuant to the Plan and/or its implementing documents will be ineffective absent the consent of the United States.
>
> 22. Except to the extent already paid by the Debtors, the obligations for any amounts owed to the United States under any Federal Leases sought to be assumed and/or assigned pursuant to the Plan must be ratified and assumed by White Oak and shall be paid in full, in cash, as soon as practicable by the later of (i) the Closing Date; or (ii) when due in the ordinary course. If White Oak does not pay these amounts by the deadline set forth above, late payment charges will be due on the untimely payment at the rate established at 30 C.F.R. § 1218.54. Moreover, without limiting the foregoing, nothing in this Order or any document implementing the Plan shall be interpreted to set cure amounts or to require the United States to novate or otherwise consent to the assumption or assignment of any interest in the Federal Leases. The rights of the United States to offset or recoup any amounts due under, or relating to, any contracts, agreements or other interests are expressly preserved.
>
> 23. Notwithstanding any other provision in this Order or any document implementing the Plan, the United States Department of the Interior ("Interior") shall retain the right to perform any post-confirmation audit and/or compliance review on the Federal Leases, and if appropriate, collect from the Reorganized Debtors and/or White Oak any additional monies owed by the Debtors on the Federal Leases prior to the assumption and/or assignment of the Federal Leases, without those rights being adversely affected by these bankruptcy proceedings. The Reorganized Debtors and White Oak, as applicable, will retain all defenses and/or rights, other than defenses and/or rights arising from the bankruptcy, to challenge any such determination; provided, however, that any such challenge must be raised in the United States' administrative review process leading to a final agency determination by the Office of Natural Resources Revenue. The audit and/or compliance review period shall remain open for the full statute of limitations period established by the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (30 U.S.C. § 1701, et seq.).
>
> 24. Nothing in this Order or any document implementing the Plan addresses or shall otherwise affect any decommissioning obligations and financial assurance requirements under the Federal Lease(s) that must be met by White Oak on the Federal Lease(s) going forward as (i) agreed by between White Oak and Interior; or (ii) determined by the Interior after any applicable administrative review process.

E. Provisions Providing Lease Termination for Nonpayment of Royalties

Lease provisions allowing a royalty owner to terminate a mineral lease for nonpayment of royalties can cause issues in bankruptcy because they could be construed to allow termination of the lease for nonpayment of prepetition royalties, notwithstanding the ipso facto clause of Section 365 and the automatic stay of Section 362. Regardless of whether such clauses are enforceable in bankruptcy, a common solution is for the debtor to present a motion to the court to approve payment of prepetition royalties.

These motions, which often include a request for authority to pay lease operating expenses and other oil and gas interest holders, have become fairly routine despite their potential breadth. In many oil and gas cases the payment of such claims effectively resolves the claims of the majority of trade creditors, minimizing their role in the case. This may be helpful from an operations perspective, but it may leave control of the case to unsecured bondholders, and may limit the ability to obtain an impaired accepting class of creditors, which is a requirement for plan confirmation.

F. Possible Re-Characterization of ORRIs/NPIs.

As discussed above, an important issue that arose in *NGP v. ATP*, and that is likely to be present in other cases, is whether ORRIs or NPIs granted by the debtor are conveyances of real property interests or disguised financing transactions. *See NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014). A bankruptcy court will likely examine the economic substance of such transactions to determine whether they are more accurately characterized as real property conveyances or debt instruments. Ultimately, this determination is a fact specific and summary judgment on the issue is unlikely.

VI. CONCLUSION

While many of the legal issues and procedures involved in the purchase of assets in bankruptcy are well established, sales involving oil and gas assets add both complexity and uncertainty. It is imperative to understand not only the general rules and process for pursuing a transaction under Section 363 or a bankruptcy plan, but the specific issues regarding things like allocation of P&A liabilities, assumption of contracts, and potential recharacterization of oil and gas interests. In many of these areas the law still developing and we expect that the current wave of oil and gas bankruptcies will present new questions, and hopefully, additional guidance.