

**CLIMBING OUT OF THE HOLES WE'VE DRILLED:
REORGANIZING E&P AND OILFIELD SERVICE COMPANIES**

**JOHN F. HIGGINS
ERIC M. ENGLISH
AMY L. TELLEGEN**
Porter Hedges LLP
1000 Main Street, 36th Floor
Houston, Texas 77002

PATRICK KELLEY
Ireland, Carroll & Kelley, P.C.
6101 South Broadway Avenue, Suite 500
Tyler, TX 75703

TABLE OF CONTENTS

	<u>Page</u>
I. INTRODUCTION	1
II. Unique Issues for Service Companies	1
A. Reduced Demand and Profit-Per-Job.....	1
B. Typically Asset-Based Lenders	1
C. Service Company Bankruptcies Are Similar To Bankruptcy Cases for Other Operating Businesses.....	2
i. Section 363 Asset Sales Are Common	2
ii. Role of Secured Lenders in Section 363 Sales and Sales Free And Clear under Section 363(F).....	5
III. Unique Issues for E&P Companies.....	6
A. Types, Perfection, and Priority of Liens	6
i. Liens in Favor of Interest Holders	6
ii. M&M Liens	7
iii. Selected M&M Lien Issues.....	8
iv. Bank Liens	9
v. Priority of Liens	11
B. Orders Permitting Debtors to Pay Interest Holders and Lease Operating Expenses	12
C. Unwinding of Hedges and Safe Harbor Discussion	13
D. Nature of Oil and Gas Leases as Real Property Interests or Executory Contracts	14
i. Executory Contracts under 365(d)(4)	14
ii. Oil & Gas Leases as Executory Contracts	15
iii. Joint Operating Accounts (“JOAs”) and Farmout Agreements as Executory Contracts.....	17
iv. Determining whether to Assume, Reject, or Assign Executory Contract.....	18
v. Requirements for Assumption: Cure of Existing Defaults and Adequate Assurance of Future Performance Going Forward.....	19
IV. Avoiding Environmental Obligations in the Purchase and Sale of Oil and Gas Assets. ...	20
A. Plugging and Abandonment Obligations	20
B. Assigning Post-Sale Plugging and Abandonment Obligations in a 363 Sale.....	21
C. Environmental Claims Held by the United States Government	22
V. The Role of Private Equity and Other Funds.....	23

I. INTRODUCTION

The current pricing environment has placed severe strain on oilfield service companies and exploration and production companies alike. A number of companies in these industries have already filed for bankruptcy protection, as outlined in **Exhibit A** hereto. Among the recent bankruptcy filings by service companies are: CCNG Energy Partners, LP, A&B Valve and Piping Systems, LLC, and Tex-Line, Inc. Among the recent bankruptcy filings by exploration and production companies are: RAAM Global Energy Company, Samson Resources Corp., Dune Energy Inc., Quicksilver Resources Inc., Milagro Oil & Gas, Inc., Sabine Oil & Gas Corp., Black Elk Energy Offshore Operations LLC,¹ and ERG Resources LLC. Against this backdrop, and with the continuing uncertainty about commodity prices, it is important to understand the fundamental differences in bankruptcy cases involving service companies and exploration and production companies.

This article summarizes the bankruptcy framework for service companies and exploration and production companies and explores the salient legal and business issues faced in each type of case.

II. UNIQUE ISSUES FOR SERVICE COMPANIES

A. Reduced Demand and Profit-Per-Job

Service companies will face significant pressures in a Chapter 11. Turning an operational profit will be difficult because these companies are chasing fewer jobs resulting at best in lower profit margins. A few of the better capitalized companies (usually divisions or subsidiaries of much larger entities) may price certain jobs at or even below cost for the purpose of maintaining their crews and expand market share, making it more difficult for a smaller specialty service company to compete, especially while trying to reorganize.

B. Typically Asset-Based Lenders

This excess service company capacity (crews and equipment) compared to demand will cause valuations for service company debtors and/or their hard assets will suffer. First, discounted cash flow valuations will be lower, making it harder debtors to make or meet realistic projections needed to effectuate a plan or to even stay in bankruptcy for the time needed to confirm a plan. Selling excess equipment to raise cash and/or reduce debt also becomes much more problematic because the few buyers who do exist are usually those who can afford to stack and maintain the equipment until a better pricing environment exists. Trying to sell assets in this type of a market with fewer qualified buyers will obviously result in much lower net prices if the assets can be sold at all.

While this obviously paints a somewhat bleak scenario, counsel for both debtors and secured lenders need to keep in mind not just each party's legal rights and obligations but consider the practical ramifications as well. While a lender may have every right to foreclose,

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

what is the lender going to do with those assets once foreclosure has occurred? Is it going to stack and maintain the equipment itself at considerable additional cost? If the debtor, presumably knowledgeable about the industry, cannot find a buyer for the company or its assets, how is the lender going to do a better job? Negotiating these issues on both sides will require knowledge not only of the current market for service companies but the direction, and how fast, you think it may be going.

C. Service Company Bankruptcies Are Similar To Bankruptcy Cases for Other Operating Businesses

In many ways, the typical oilfield service company bankruptcy case will resemble the cases of other operating businesses. Standard first day motions, such as motions to pay employee wages, pay utilities, pay insurance premiums, use cash collateral, and obtain post-petition financing should be expected. Likewise, appointment of official committees, negotiations with secured creditors, and the sale of assets under Section 363 of the Bankruptcy Code are commonplace in service company cases.

i. Section 363 Asset Sales Are Common

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 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.*

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 Abbott 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).² 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:

² Portions of this article have been taken from, BUYING AND SELLING OIL & GAS ASSETS IN BANKRUPTCY CASES, J. Higgins, E. English, A. Tellegen, 33rd Annual Advanced Oil, Gas and Energy Resources Law Course, October 1-2, 2015.

- (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).

ii. Role of Secured Lenders in Section 363 Sales and Sales Free And Clear under Section 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 Burbank, 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).

Clear Channel has been criticized and several courts have subsequently authorized free and clear sales under Section 363(f) notwithstanding *Clear Channel*. *See, e.g., In re Jolan Inc.*, 403 B.R. 866 (Bankr. W.D. Wash., April 30, 2009); *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).

In addition, several non-statutory exceptions 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 reverts 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).

Likewise, 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).

The power to sell assets free and clear of liens is balanced by the secured lender's ability to credit bid its debt. In particular, Section 363(k) provides:

At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. §363(k). Thus, secured lenders may credit bid at a Section 363 sale unless the court finds cause to disallow it.³ The ability to credit bid gives secured lenders a great deal of influence in the bidding process, particularly when secured debt exceeds asset value. 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.

III. UNIQUE ISSUES FOR E&P COMPANIES

A. Types, Perfection, and Priority of Liens

i. Liens in Favor of Interest Holders

Traditionally, royalties have been defined as a share of production without deduction of any of the expenses of production. *Heritage Resources, Inc. v Nationsbank*, 939 S.W.2d 118, 121-122 (Tex. 1996). There are different types, including a mineral owner's royalty reserved in the original oil and gas lease, overriding royalties which are carved out of the lessee/operator's working interest, and nonparticipating royalties which are usually created by reservation in a deed of trust. Royalty interests are not property of the estate under Bankruptcy Code Section 541.

Additionally, a true royalty does not technically constitute a debt owed to the royalty owner by the lessee/operator because the royalty owners' share of production and the proceeds of that production are at all times owned by the royalty owner, even to the extent that the royalty

³ The Supreme Court recently held that credit bidding rights exist in a plan context as well. In particular, 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).

owner pays its pro rata portion of taxes allocable to that share of production. *Tenneco West, Inc. v. Marathon Oil Co.*, 756 F.2d 769 (9th Cir. 1985).

Texas also statutorily provides royalty holders and other interest holders a security interest in oil and gas production and the proceeds therefrom. *See e.g.*, TEX. BUS. & COM. CODE § 9.343. For example, Texas law grants an automatically perfected statutory lien to “interest owners” to secure the obligations of the “first purchaser of oil and gas production, as debtor, to pay the purchase price.” TEX. BUS. & COM. CODE § 9.343(a) & (r); *see also In re Tri-Union Development Corp.*, 253 B.R. 808 (Bankr. S.D. Tex. 2000). The operator may qualify as the “first purchaser” under the statute where the “operator . . . receives production proceeds from a third-party purchaser who acts in good faith under a division order or other agreement authenticated by the operator under which the operator collects proceeds of production on behalf of other interest owners.” TEX. BUS. & COM. CODE § 9.343(r)(3).

Additionally, some states, such as Texas, provide for automatic perfection of liens under § 9.343. Liens on proceeds of oil and gas production cannot be avoided by a debtor relying on the strong arm powers set forth in Section 544 of the Bankruptcy code. *See In re Tri-Union Development Corp.*, 253 B.R. 808 (Bankr. S.D. Tex. 2000); *see also J. Aron & Co. v. SemCrude, LP (In re SemCrude, LP)*, 2015 WL 4594516 (D. Del. July 30, 2015). In *SemCrude*, oil and gas producers asserted liens for prepetition delivery of oil and gas. The court disagreed and held that the purchasers were good faith buyers for value under the UCC and took free and clear of the producers’ liens. *Id.* at *11.

Another risk faced by debtors/operators after filing for bankruptcy arises when the lease contains a provision that provides for lease termination in the face of unpaid royalties to royalty owners. Although such termination clauses are rare and may not be enforceable in light of the ipso facto clause of Section 365 and the automatic stay of Section 362, some courts have found them enforceable in bankruptcy. Additional details regarding the implications and enforceability of such clauses are discussed *infra* at 12.

ii. M&M Liens

Mechanic’s and materialman’s liens (“M&M liens”) can be frustratingly complicated, are often misunderstood and could easily be the subject of an all-day seminar with no other topic. Nevertheless, it is vital to understand their impact in an E&P case because they affect everything from the debtor’s ability to use cash collateral to what kind of a plan can be proposed or whether one is feasible at all. Obviously, this presentation cannot cover the entire topic but we provide a summary of the key statutes and analysis of a few recurring issues which should be highlighted.

Many states, including Texas, Louisiana, and Oklahoma protect the rights of service providers by granting them statutory M&M liens to secure payment for their services. These statutory provisions are summarized below:

a. Texas

Chapter 56 of the Texas Property Code grants a “mineral contractor” or “mineral subcontractor” a lien to secure payment for labor or services related to “mineral activities.” TEX. PROP. CODE ANN. § 56.002. “Mineral contractor” and “mineral subcontractor” are broadly

defined to include, among other things, persons performing labor or furnishing or hauling material, machinery, or supplies used in mineral activities. *Id.* § 56.001(2) & (4). This lien may be secured by filing a lien affidavit with the county clerk of the county in which the property is located, and the contractor has six months from the date of accrual of indebtedness to file the lien affidavit. *Id.* § 56.021. However, the statutory lien may incept back to the date of first work, provided that the lien is otherwise timely filed. *Id.* §53.124(a); *MEG Petroleum Corp. v. Halliburton Servs. (In re MEG Petroleum Corp.)*, 61 B.R. 14, 18 (Bankr. N.D. Tex. 1986). Further, section 56.004 of the Texas Property Code provides that “[t]he lien on material, machinery, supplies, or a specific improvement takes priority over an earlier encumbrance on the land or leasehold on which the material, machinery, supplies, or improvement is placed or located.” TEX. PROP. CODE ANN. § 56.004. If a working interest owner has in fact paid its authority for expenditure (“AFE”), then any subsequently filed M&M lien will not attach to that working interest. TEX. PROP. CODE, Sec. 56.006, *Energy-Agri Products v. Eisenman Chemical Co.*, 717 S.W.2d 651 (Tex. App.—Amarillo 1986, no writ).

b. Louisiana

The Louisiana Oil, Gas, Water Wells Lien Act (“Oil Well Lien Act”) creates a statutory lien and privilege in favor of those who supply labor, services, and/or materials to the oil and gas industry. L. REV. STAT. ANN. § 9:4861 et seq. (1995); *see also Lor, Inc. v. Martin Exploration Co.*, 489 So.2d 1326 (La. App. 1st Cir. 1986); *see generally* Patrick H. Martin & J. Lanier Yeates, Louisiana And Texas Oil & Gas Law: An Overview Of The Differences, 52 LA. L. REV. 769, 847-49 (1992). This lien attaches to a broad class of property enumerated in the statute and includes, inter alia, (a) the oil and gas wells for or in connection with which services or materials are supplied; (b) leases where the same are located; (c) certain related equipment; and (d) all oil and gas produced from the wells and the proceeds thereto inuring to the working interests. LA. REV. STAT. ANN. § 9:4863 (197). Further, under the Oil Well Lien Act, the statutory lien attaches to all property listed in the statute. *Guichard Drilling v. Alpine Energy Servs., Inc.*, 657 So.2d 1307, 1312 (La. 1995) (citations omitted). Similar to Texas law, under the Oil Well Lien Act, the statutory lien relates back in time to the commencement of work as the effective date of the lien. *In re Jack/Wade Drilling, Inc.*, 213 B.R. 493, 498 (Bankr. W.D. La. 1997) (“The lien attaches when the person performs labor or services”).

c. Oklahoma

The applicable Oklahoma statute grants one who provides labor or furnishes material to an owner of a leasehold for oil and gas purposes to claim a lien upon the leasehold, pipeline, lease, equipment and proceeds from the sale of oil and gas benefiting the working interest. 42 Okla. Stat. § 144. The purpose of such liens is to protect the provider of goods or services from a situation in which the owner of the property or leasehold fails to pay for the goods or services provided. *See Davidson Oil Country Supply Co., Inc. v. Pioneer Oil & Gas Equip.*, 1984 OK 65, ¶ 6, 678 P.2d 1268. Such liens give laborers and materialmen a level of protection enjoyed by no other lien holder because such liens have priority from the date the first labor or materials are furnished. *Fourth Nat’l Bank of Tulsa v. Appleby*, 1993 OK 53, ¶ 9, 864 P.2d 827.

iii. Selected M&M Lien Issues

Many attorneys, even those whose practice often involves oil and gas issues, are of the impression that a timely filed M&M lien attaches to the entirety of the working interests for the lease or well on which the services were performed. That is not the case. A properly perfected lien will attach only to the property specifically described in the lien statement whether it be the entire leasehold interest, the pipeline, oil or gas well, the oil and gas lease, the buildings and appurtenances and/or the proceeds from the sale of the oil and gas. *Stanolind Crude Oil Purchasing Co. v. Busby*, 1939 OK 234, ¶ 23, 90 P.2d 876.

Additionally, if a working interest owner has in fact paid its authority for expenditure (“AFE”), then any subsequently filed M&M lien will not attach to that working interest. TEX. PROP. CODE, Sec. 56.006, *Energy-Agri Products v. Eisenman Chemical Co.*, 717 S.W.2d 651 (Tex. App.—Amarillo 1986, no writ). Finally, M&M liens will not attach to the surface rights. 1983 OK AG 38, ¶ 5.

Texas law has provided that oil and gas operators subject to threatened liens by drilling contractors’ subcontractors have a right to protect property from liens and encumbrances through temporary injunction. *Adobe Oilfield Services, Ltd. v. Trilogy Operating, Inc.*, 305 S.W.3d 402 (Tex. App.—Eastland 2010, no pet.) (holding that injunctive relief should be granted to prevent threatened liens from being filed by the drilling contractor’s subcontractors).

Establishing the extent of the valid liens at the beginning of the case is important to what parties have a say in the debtor’s use of cash collateral, to what property an M&M lien actually attaches and whether the debtor/trustee can exercise its avoidance powers under 546(b) to provide value to unsecured claimants. Under section 546(b) of the Bankruptcy Code, a debtor’s lien avoidance powers are “subject to any generally applicable law that . . . permits perfection of an interest in property to be effective against any entity that acquires rights in such property before the date of perfection[.]” 11 U.S.C. § 546(b)(1)(A).⁴

iv. Bank Liens

a. Reserve Based Lenders

Oil and gas lending is a category of asset-based lending which has oil and gas properties as its predominant asset base. The distinguishing attributes and property interests of oil and gas properties, and the operations related to such interests, give rise to the special considerations related to these types of lending transactions. Oil and gas loans are reserve based loans such that the parties to the transaction are relying on production from the oil and gas properties to service the loan payments. Traditional reserve-based oil and gas loans are structured to be revolving in nature where the borrower may borrow, repay and then reborrow at some later point; however, some loans may be structured as term loans where the borrower may only borrow and then repay.

b. Perfection Issues Related to Oil and Gas Assets

⁴ Additionally, Section 362(b)(3) of the Bankruptcy Code expressly excludes the perfection of statutory liens, to the extent consistent with section 546(b) of the Bankruptcy Code, is from the automatic stay.

Oil and gas loans are principally secured by a first priority lien in favor of the lender in the borrower's oil and gas interests and related properties. Although the amount of the loans available will be based on the borrower's proved reserves, all (or some high percentage, e.g., 80% or 90%) of the borrower's oil and gas interests will serve as collateral depending on the nature of the agreed transaction. Generally speaking, the parties to the lending transaction will structure the loan documentation such that following types of properties will be encumbered in favor of the lender: (a) the oil and gas properties and property interests consisting of, and relating to, the borrowing base, (b) the equipment and other goods related to such properties, including, without limitation, processing plants, inventory, pipelines, gathering lines and compressors, (c) accounts and material contracts related to the operation of such properties and transportation and marketing of production, including, without limitation, operating agreements, transportation and storage agreements, and sales agreements, (d) direct or collateral assignments of production and the proceeds thereof, and (e) such other property interests of the borrower and/or other obligors as deemed warranted by the transaction and the financial condition and arrangement of the borrower and/or other obligors, including, without limitation, partnership or joint venture interests and management, supervision and other fees.

The customary loan document to create a security interest in and mortgage lien on the borrower's real property (including oil and gas properties) is an oil and gas deed of trust or mortgage (a "mortgage instrument").⁵ To perfect such security interest in and mortgage lien on real property under Texas law a mortgage instrument must be duly recorded in the county where the property is located. TEX. PROP. CODE § 11.001(a). A properly recorded mortgage instrument provides notice to all persons of the existence of the instrument and is subject to inspection by the public. *Id.* at § 13.002. In other words, a person is charged with "constructive notice of the actual knowledge that could have been acquired by examining public records." *Mooney v. Harlin*, 622 S.W.2d 83, 85 (Tex. 1981).

In a similar regard, a lender should, during the loan documentation phase, examine the borrower's chain to title in and to its oil and gas properties and any rights and interests reserved to other persons in such chain of title. This diligence is necessary because the lender's security interest in and mortgage lien on the oil and gas properties will be subject to the terms of any recorded instruments in the borrower's chain of title. That is, the lender is deemed to have constructive notice of all properly recorded instruments in the borrower's chain of title, including any unrecorded documents referenced therein. *See, e.g., Westland Oil Development Corporation v. Gulf Oil Corporation*, 637 S.W.2d 903 (Tex. 1982). Thus, it is important for a lender to perform title due diligence at the outset of a lending transaction to confirm the nature of a borrower's interest in its oil and gas properties and whether any third party may have rights in such oil and gas properties that may be adverse to the lender's interests.

Proper drafting is of utmost importance when it comes to the mortgage instrument. The reason being that faulty drafting may have unintended consequences when it comes to perfecting the lender's mortgage lien. One such instance is the use of a general⁶ (or blanket) collateral

⁵ Under Texas law, oil and gas properties, including oil and gas leases, are real property interests. TEX. BUS. & COM. CODE § 26.01.

⁶ Global or blanket descriptions of grantor's real property wherever located in a specific city, county or state are sufficient to satisfy the Statute of Frauds, even if other tracts are also specifically described. *Witt v. Harlan*, 2 S.W.

description in a mortgage instrument versus a specific (or narrow) collateral description. The latter description may result in an unintended limitation on the lender's collateral. That is, the lender may find itself with only a perfected lien on a very specific set of collateral when it actually intended to mortgage all of the borrower's oil and gas assets. Another potential lien perfection issue arises in connection with the oil and gas properties described in or attached to the mortgage instrument. Under the Texas Statute of Frauds, a mortgage instrument must contain a property description sufficient to identify the particular party with reasonable certainty. *Morrow v. Shortwell*, 477 S.W.2d 538, 539 (Tex. 1972). If an oil and gas property is not described with legally sufficiency (e.g., county/parish book and page reference) then the lender will have an unperfected mortgage lien on such property.

c. Valuation Issues

An oil and gas lender's principal focus is the proved producing reserves of the borrower's oil and gas properties. Such reserves establish the borrowing base of the loan, and together with all related properties, establish the oil and gas property basis of the collateral. Borrowing bases are typically redetermined by the lender semi-annually based on a third party-prepared or internally-prepared reserve report provided by the borrower.

Each oil and gas lender providing a borrowing base will make its own calculation of collateral value when determining the borrowing base at each redetermination date. This is done by applying a "risk factor" to each component of the proved reserve category in the reserve report. Each lender has its own approach, but typically lenders will give value to 100% of Proved Developed Producing Reserves (PDP) and perhaps 75% of Proved Developed Non-Producing Reserves (PDNP) and 50% of Proved Undeveloped Reserves (PUD). These calculations are further adjusted (i.e., "risked") and limited by the lenders by others variables. For example, most lenders will not allow the PUD portion to contribute more than a certain percentage of the aggregate borrowing base (such as 20% or 30%) and there may be further limits if a large percentage of PDP comes from one or two wells only. When valuing and redetermining the borrowing base, most reserve-based credit facilities also allow the lenders to consider the business, financial conditions and debt obligations of the particular borrower and other factors the lender customarily deems appropriate (e.g., commodity price projections, projections of production, operating expenses, operating cost escalators and general and administrative expenses).

Thus, a lender's valuation of a borrower's oil and gas properties may vary from lender to lender based on factors and conditions largely out of control of the borrower.

v. Priority of Liens

When more than one creditor has a security interest in an E&P debtor's collateral, generally the first creditor to perfect their security interest has priority over the other under Texas law. *See* Tex. Prop. Code § 13.0001. The priority rules also apply to joint operating agreements. "Therefore, it is always advisable to expediently record and perfect an operating agreement in

41 (Tex. 1886); *see, e.g., Baker Hughes Oilfield Operations, Inc. v. Union Bank of Cal. N. Am. (In re Cornerstone E&P Co.)*, 436 B.R. 830 (Bankr. N.D. Tex. 2010).

the appropriate jurisdiction, as doing so will ensure that the [operating agreement] will be afforded higher priority than any subsequent security interest that may arise.” O. Kuebel, III, *Cases and Strategies for Solvent Operators and Non-Operators*, State Bar of Texas Oil, Gas, and Energy Resources Law, October 1-2, 2015, at 1-2.

In *Grace-Cajun Oil Co. No. 3 v. FDIC*, the Fifth Circuit Court of Appeals held that where a lender’s collateral included production proceeds and such proceeds were taken under the operating agreement after costs were apportioned under the terms of that agreement, the security interest was a “pledge” and thus subject to the operating agreement. 882 F.2d 1008 (5th Cir. 1989). Because a party can only pledge an interest that it has, any production proceeds were subject to the obligation to pay well costs under the operating agreement. *Id.*

Similarly, in *K.E. Resources, Ltd. v. BMO Financial Inc. (In re Century Offshore Mgmt. Corp.)*, the Sixth Circuit held a mortgage loan to be subject to an unrecorded operating agreement when the security agreement for the mortgage loan expressly recognized, and repeatedly provided the loan to be subject to, the operating agreement. 119 F.3d 409 (6th Cir. 1997). The Sixth Circuit reasoned that “[t]he public records doctrine does not prevent the third party from contractually agreeing by express language to subordinate its interest to interests that would otherwise be inferior.” *Id.* at 413.

B. Orders Permitting Debtors to Pay Interest Holders and Lease Operating Expenses

In any proceeding where the lessee/operator is the debtor, it’s is vitally important to assess exactly what rights and obligations the royalty owners possess. For instance, a failure to timely pay the royalties also may allow various royalty owners to assert damage claims against the debtor. As explained above, royalty owners are sometimes found to hold a security interest in the production and its proceeds, thus, unpaid royalty owners may assert statutory liens upon certain of the Debtors’ assets.

Additionally, if the lease contains a clause permitting lease termination in the event royalties are not paid, the debtor should take action to prevent the loss of an income generating asset to the estate. Although such termination clauses may not be enforceable in light of the ipso facto clause of Section 365 and the automatic stay of Section 362, some courts have found them enforceable in bankruptcy. *See, e.g., Trigg v. United States (In re Trigg)*, 630 F.2d 1370, 1372-75 (10th Cir. 1980) (holding under the former Bankruptcy Act and former Bankruptcy Rule 11-44, that automatic contractual termination as a consequence of nonpayment was not stayed post-petition); *In re Tudor Motor Lodge Assocs., Ltd. P’ship*, 102 B.R. 936, 949 (Bankr. D. N. J. 1989) (agreeing with a collection of cases applying *Trigg* in a Code setting); *see also Good Hope Refineries, Inc. v. Benavides*, 602 F.2d 998, 1002 (1st Cir. 1979) (automatic termination of an oil

and gas lease for nonpayment of delay rental does not constitute a “proceeding” within the meaning of the Bankruptcy Act’s automatic stay provisions).⁷

Based on these potential issues, and given most debtors’ goal to facilitate a smooth transition into chapter 11, it has become commonplace for debtors to file a first day motion to pay both pre- and post-petition lease operating expenses (to avoid M&M liens) and to make all undisputed payments to interest holders (to avoid first purchaser liens and potential termination of oil and gas leases). *See, e.g. In re Milagro Holdings, LLC, et al.* (Case No. 15-11520-KG); *see also, In re Quicksilver Resources, Inc.*, Case No. 15-10585 (LSS) (Bankr. D. Del. April 15, 2015); *In re TriDimension Energy, L.P.*, Case No. 10-33565 (Bankr. N.D. Tex. June 29, 2010); *In re Edge Petroleum Corp.*, Case No. 09-20644 (Bankr. S.D. Tex. Oct. 5, 2009); *In re Pac. Energy Res., Ltd.*, Case No. 09-10785 (KJC) (Bankr. D. Del. June 10, 2009); *In re Crusader Energy Group Inc.*, Case No. 09-31797 (Bankr. N.D. Tex. Apr. 2, 2009).

For example, in the Sabine bankruptcy, the debtors filed a Motion to Authorize Payment of Working Interest Disbursements and Royalty Payments in the Ordinary Course with their first day pleadings (the “Motion”). *In re Sabine Oil & Gas Corporation*, No. 15-11835 (Bankr. S.D.N.Y, Jul. 15, 2015) Doc. No. 11. In the Motion, the debtors argued that the court should permit the payment of royalty and working interest owners in the ordinary course because any funds related to royalty interests or working interest disbursements were not debtor property and because payment of the royalty and working interest owners was necessary to prevent perfection of the royalty owners’ liens and irreparable harm to the debtors’ estates. *Id.* The United States Bankruptcy Court for the Southern District of New York entered a final Order Authorizing Payments in the Ordinary Course of Business on August 16, 2015. *In re Sabine Oil & Gas Corporation*, No. 15-11835 (Bankr. S.D.N.Y, Aug. 16, 2015) Doc. No. 178.

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. Nonetheless, courts have been willing to enter broad orders even though it effectively results in the payment of, in many cases, most of the debtor’s prepetition trade debt.

C. Unwinding of Hedges and Safe Harbor Discussion

Commodities and derivative contracts often include provisions providing for automatic termination, liquidation or acceleration in the event of default caused by bankruptcy or insolvency. Such provisions would typically be unenforceable *ipso facto* clauses pursuant to Section 365(e) of the Bankruptcy Code, which provides as follows:

(e)(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not

⁷ If the debtor is not the first purchaser, it may be insulated from this process because another party is responsible for distributing production proceeds. If a debtor signs a division order with first purchaser and the royalty owners under which the first purchaser agrees to make the payments owing to on account of the purchase and sale of oil and gas, the funds utilized to pay the royalty and working interest owners may not flow through the debtor. Likewise, the debtor may receive only its portion of the proceeds from the sale of the oil and gas to the first purchase.

be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title...

11 U.S.C. § 365(e)(1).

However, the BAPCPA amendments to the Bankruptcy Code enacted in 2005 created certain “safe harbors” to enhance protection for the non-debtor parties to certain derivatives and commodities contracts. Specifically, new Section 556 explicitly exempts certain contracts and parties from the reach of Section 365(e)(1).

Section 556 provides as follows:

The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination or acceleration of a commodity contract...because of a condition of the kind specified in Section 365(e)(1) of this title...*shall not be stayed, avoided or otherwise limited by operation of any provision of this title or by the order of a court* in any proceeding under this title.

11 U.S.C. § 556 (emphasis added). Thus, Section 556 permits parties to a broad array of contracts to terminate contracts and obtain any underlying collateral. *See id.*

D. Nature of Oil and Gas Leases as Real Property Interests or Executory Contracts

i. Executory Contracts under 365(d)(4)

Another important issue in E&P cases is the treatment of oil and gas leases, and if necessary, protecting them from automatic termination under Bankruptcy Code section 365(d)(4). Most courts accept the premise that an “executory contract” is a contract in 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. 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.

ii. Oil & Gas Leases as Executory Contracts

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. *Shepherd 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**

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.

iii. Joint Operating Accounts (“JOAs”) and Farmout Agreements as 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. *See Wilson v. TXO Production Corp. (In re Wilson)*, 69 B.R. 960 (Bankr. N.D. Tex. 1987). However, *Transtexas Gas Corp. v. Forcenergy Onshore, Inc.*, 2012 WL 1255218, at *6 (Tex. App.—Corpus Christi April 12, 2012), held that a JOA contained covenants running with the land. Thus, it is possible that a multi-faceted contract may be considered executory and still contain non-executory provisions. In addition, both operators and non-operators to JOA may have contractual lien rights that exist regardless of whether the contract is assumed or rejected.

When a JOA is an executory contract, disputes may arise in the time period before the debtor assumes or rejects the agreement. 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. *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 *Wilson*, the court held that the JOA does not govern the rights of either party during the “Twilight Zone,” but rather, the default laws of co-tenancy govern. 69 B.R. at 966. However, if the operating agreement ultimately is assumed, the rights and responsibilities of the parties will be determined by reference to the JOA, not default state law rules.

iv. **Determining whether to Assume, Reject, or Assign Executory Contract**

Section 365(f) also provides that a trustee may assume, reject, or assign executory contracts as part of an asset sale under Section 363 or a Plan Transaction.

In the process of conducting due diligence, the buyer will identify desired contracts and those contracts it prefers to reject. 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 contracts 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 14th 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 it 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.

Additionally, in states that treat oil and gas leases as executory contracts, rejection may or may not give rise to rights under Section 365(h). For example, *In re J.H. Land & Cattle Co.*, 8 B.R. 237 (Bankr. W.D. Okla. 1981), the court held that a Kansas oil and gas lease created only an interest in personal property rather than a possessory property interest. Thus, Section 365(h) didn’t apply.

v. 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.

IV. AVOIDING ENVIRONMENTAL OBLIGATIONS IN THE PURCHASE AND SALE OF OIL AND GAS ASSETS.

Generally, a purchaser of oil and gas assets can't exclude statutory environmental obligations associated with the assets from its purchase. Likewise, a debtor generally can't discharge its statutory environmental liability associated with such assets. However, buyers and sellers can limit or discharge *contractual* liability for certain environmental obligations, such a contractual obligation to plug and abandon ("P&A") wells.

A. Plugging and Abandonment Obligations

The issue of who is a responsible party for plugging and abandonment ("P&A") obligations is a prominent one. Under a joint operating agreement ("JOA"), plugging and abandonment costs are generally apportioned amongst the parties to the agreement. Under JOAs, the parties are generally jointly and severally liable to contribute towards such operations. Thus, if one party to a JOA is discharged of its contractual obligation to contribute to P&A costs, the other parties to the agreement will be disadvantaged. Debtors may attempt to use their power under section 554 to abandon property in order to divest themselves of property burdened by regulatory obligations such as plugging and abandonment.

However, P&A obligations are also statutorily imposed. Courts have limited a debtor's ability to strategically avoid statutory P&A obligations by abandoning leases.

The Supreme Court in *Midlantic Nat'l Bank v. N.J. Dep't of Env. Protection* held "that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards." 474 U.S. 494, 507 (1986). That holding, however, was limited in a footnote:

This exception to the abandonment power vested in the trustee by § 554 is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm.

Id. at fn. 9.

Lower courts subsequently split in interpreting this footnote from *Midlantic*. The majority of courts focused on the latter portion of the footnote, holding that the exception to section 554 only arises when the harm to the general public is *imminent*. See, e.g., *Borden, Inc. v. Wells-Fargo Bus. Credit (In re Smith-Douglass, Inc.)*, 856 F.2d 12, 15 (4th Cir. 1988); *Commonwealth Oil Ref Co., Inc. v. E.P.A. (In re Commonwealth Oil Ref Co., Inc.)*, 805 F.2d 1175, 1185 (5th Cir. 1988); *In re Howard*, 2015 WL 4505941, No. 00-51897, at *10 (Bankr. S.D. Miss. July 23, 2015); *In re Old Carco LLC*, 406 B.R. 180, 204 (Bankr. S.D.N.Y. 2009); *In re Unidigital, Inc.*, 262 B.R. 283, 286-87 (Bankr. D. Del. 2001).

A few courts in the Fifth Circuit, however, have eschewed the imminence requirement seemingly enumerated in *Midlantic*. In *H.L.S. Energy* for instance, the Fifth Circuit simply did not mention *Midlantic's* footnote. Instead, it stated:

[A] bankruptcy trustee may not abandon property in contravention of a state law reasonably designed to protect public health or safety. And there is no question that under Texas law, the owner of an operating interest is required to plug wells that have remained unproductive for a year . . . Thus, a combination of Texas and federal law placed on the trustee an inescapable obligation to plug the unproductive wells . . .

151 F.3d 434 (5th Cir. 1988).

The bankruptcy court in *American Coastal Energy*, relying on *H.L.S. Energy's* interpretation of *Midlantic*, went even further:

The Court reads the Supreme Court's *Midlantic* opinion to require the Court to determine whether the debtor is violating a statute "reasonably designed to protect the public health or safety from identified hazards," not the extent to which particular conduct imposes actual and imminent threats. This Court need not make a determination whether the environmental hazard presents an imminent or identifiable harm. It is enough that the [] claim arises from a state law designed to protect the public from an identified hazard.

In re American Coastal Energy, Inc., 399 B.R. 805, 813 (Bankr. S.D. Tex. 2009) (internal citation omitted).

B. Assigning Post-Sale Plugging and Abandonment Obligations in a 363 Sale

Often, P&A and other environmental responsibilities are addressed by a debtor and its 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 B** (emphasis added).

C. 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.

V. THE ROLE OF PRIVATE EQUITY AND OTHER FUNDS.

Over the past two decades, private equity firms have become increasingly involved in the landscape of oil and gas companies, both large and small, and their role is usually much more expansive than simply being the equity owner of a company.

Private equity, or what used to be called leveraged buy-out firms, are commonly thought of as investment funds which buy a company, usually by borrowing money against the acquired company's assets. The acquired company is then restructured in a way which makes the acquired company more attractive to sell a few years down the road, either through an initial public offering or otherwise. Theoretically, the private equity firm not only receives a net profit through the sale but also makes money during the interim through management fees, dividends and other charges. This process can work as planned during a period of rising valuations but no so much with oil and gas companies in the current environment.

Bankruptcy lawyers usually begin their analysis of a case by breaking down the major constituencies into categories: debtor, secured creditors, unsecured creditors, etc. In oil and gas cases, those broad categories are further subdivided into royalties, working interest, lien claimants, etc. With often complex capital structures, private equity can simultaneously hold positions in multiple categories, affecting both the filing and conduct of the case.

At the beginning of any case, Chapter 11 Debtor's counsel will explain the fiduciary obligations owed by management during the course of the reorganization process. In most cases, maximizing the value to creditors is a concept easy to understand and carry out. However, explaining to management and/or the private equity representatives on the board can be problematic if there is a history of money moving from the company to the benefit of the private equity ownership group. For instance, it is not unusual for private equity to not only own the company but also to have advanced funds, usually in the form of debt instruments which are repaid on a regular basis, even if non-insider third-party vendors are not. Further, the situation can be exacerbated if those debt repayments, even in the ordinary course, are combined with contractually obligated management fees and other payments. Under these circumstances, respective debtor's counsel needs to be both careful and honest about the likely scenarios to be encountered during a bankruptcy even if doing so results in the company deciding that it simply needs to find another lawyer.

Perhaps the most important role of private equity in oil and gas cases occurs in connection with a debtor attempting to sell assets or the entire company as an operating entity. In this instance, private equity firms are normally going to be substantially involved with all aspects of the sale process, including bidding for those assets. Potential buyers for oil and gas companies and/or their assets are usually composed of other companies in the industry who are looking for long-term, strategic assets which mesh well with their other operations. A bid from a strategic buyer will be calculated based upon how the particular assets being purchased from the debtor will integrate into existing or expanded operations and the functional life of those assets, an analysis based in large part upon traditional cash flow discount calculations. While private equity may also be a competitive bidder, its analysis is often quite different than a strategic bidder because private equity looks at purchases of assets not for their long-term functional value but whether or not those assets can be operated and sold for a profit within a relatively few year's time in other words, their "exit value." Because of the differing types of use and analysis between strategic buyers and private equity firms, it is not unusual for private equity firms to accept a greater degree of risk in making a bid or purchase than would a strategic, long-term operator. Of course, in the bankruptcy sales context, most stakeholders are interested only in the highest value for which the assets can be sold but knowing the universe of potential buyers and for which purpose prospective bidders may want those assets can substantially affect how the debtor markets them.

The bottom line is that regardless of who your client is in an oil and gas bankruptcy, an understanding of the capital structure, who has received benefits from the operating income over relevant time periods and how the money is to be distributed from any asset sale are all critical questions to be both asked and answered prior to the completion of the bankruptcy process.