STATE BAR *of* TEXAS

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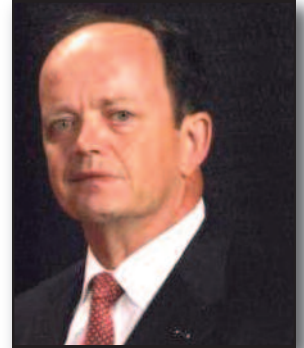
A MESSAGE FROM YOUR CHAIR



Dear Section Members,

With this issue we are addressing a subject on the minds of just about every business person in the State of Texas. What is going to happen to the Oil and Gas industry? Will it survive the current drop in oil and gas prices? What, if any, impact will it have on bankruptcy lawyers? We have never had a special issue newsletter, but now seems as good a time as any.

We have a variety of both legal and economic articles that cover both domestic and and Canadian insolvency legal issues. Everyone's favorite economist, Dr. Perryman has included his comments. Our Chair elect, Bill Wallander, has authored an article which surveys oil and gas bankruptcy issues. The dean of Texas bankruptcy law, Rhett Campbell, has made his input. Aslo we have excellent articles from Louis Strubeck, John Mitchell and Drew McManigle.

Thank you Eric Van Horn for editing this lagniappe edition.

Dear Members,

As Editor in Chief of the Bankruptcy Law Section's Newsletter, I am pleased to have worked with Judge Schmidt in publishing this special edition relating to oil and gas bankruptcy issues – an idea he conceived and worked hard to bring to our members. His ingenuity and support of the Section's newsletter has been greatly appreciated and will be missed as he enters retirement.

With companies in the oil and gas industry continuing to file bankruptcy cases (recently, those filings include ERG Intermediate Holdings, LLC, et. al. (Case No. 15-31858, pending in the Northern District of Texas) and Frac Specialists, LLC, et. al. (Case No. 15-31858, pending in the Northern District of Texas), oil and gas bankruptcy issues should continue to be to importance of bankruptcy and non-bankruptcy practitioners and professionals alike.

If you have a topic or idea relating to an oil and gas bankruptcy issue that you would like to author and publish, please feel free to contact me. This may be the first of multiple special editions of bankruptcy oil and gas issues that will hopefully be of value to our members.

Sincerely,

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Energy Restructuring and Reorganization

This following introduction was originally published by William Wallander, Bradley Foxman, John Napier, and Casey Doherty as part of Energy Restructuring and Reorganization, Texas Journal of Oil, Gas, and Energy Law, 10 Tex. J. Oil Gas & Energy L. 1 (2014) (the "Article"):

Energy production in the United States continues to outpace expectations with an estimated oil production surge of 46% from 2011 to 2014 to the highest levels since 1972. Likewise, production of natural gas in the United States has grown dramatically.[1] These increases have been driven by technology and innovation in the field by those who take the risks in search of the rewards offered by successful exploration and production, and fracking has been one of the core drivers of the current advances in production.[2] These developments have been breathtaking. Increased production in the United States has changed the world energy equation, with the United States having overtaken Saudi Arabia as the largest producer of oil in the world.[3] Commodities can be volatile in their pricing, and it is axiomatic that increased supply without a commensurate increase in demand can lead to lower prices.[4] Externalities impacting prices, although often buffered by various derivative transactions, can also lead to challenging economics and, in some cases, the need for restructuring or reorganization of an affected company's financial affairs.[5] The Article examines many of the key issues that arise in restructurings and reorganizations of energy companies, including upstream, midstream, and downstream companies.

Energy companies facing excess leverage or insufficient cash flow may pursue restructuring strategies out of court and, if necessary, reorganization in court by filing for bankruptcy, most often under Chapter 11 of the United States Bankruptcy Code (Bankruptcy Code).[6] Distressed energy companies will often have alternatives to bankruptcy such as debt modifications, debt refinancings, debt exchanges, asset sales to raise liquidity, equity recapitalizations, forbearance arrangements, and other debt restructuring tools. While the involvement of specific players in any energy restructuring or reorganization will depend on the energy sector and structure, generally speaking, common players in an energy restructuring or reorganization include the company as debtor, management, secured lenders, bondholders, potential asset purchasers, trade vendors, service vendors, oil and gas lessors, contract counterparties under joint operating agreements (JOAs), derivatives counterparties, co-working interest owners, farmors, farmees, production payment counterparties, first purchasers, and equity holders. Additionally, the Bankruptcy Code provides standing under appropriate circumstances for statutory committees of creditors and equity holders, and potentially for appointment of a bankruptcy trustee or examiner.[7]

Eligible entities[8] may use Chapter 11 of the Bankruptcy Code to reorganize their financial affairs. A bankruptcy court provides a forum for dispute resolution of financial distress and enables an eligible company to obtain a breathing period from creditors pursuant to the automatic stay, to borrow funds or use cash collateral on a post-petition basis to fund its business, and to reorganize and discharge debts via a reorganization plan to obtain a fresh start. The Bankruptcy Code permits "Section 363" asset sales free and clear of claims and interests providing purchasers with an open forum for bidding and a "free and clear" asset transfer.[9] Finally, a plan of reorganization provides an eligible debtor with a broad menu of options to reorganize, including restructuring its debts, merging entities, selling assets outright or synthetically, issuing securities, separating operating assets from liquidation and litigation assets, jettisoning burdensome agreements, and emerging with a new set of contracts under which to continue operating its business.

For further discussion and a complete copy of *Energy Restructuring and Reorganization*, please go to http://tjogel.org/journalarchive/Issue10/EnergyRestructuring.pdf.

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1. Timothe Puko & Christian Berthelsen, *Natural-Gas Prices Drop on Greater-Than-Expected Surplus*, WALL ST. J. (July 10, 2014), http://online.wsj.com/articles/natural-gas-prices-drop-on-greater-than-expected-surplus-1405004266.

2. Chip Register, *Technology Is The New Black In The Energy Economy*, FORBES MAGAZINE (July 24, 2014), http://www.forbes.com/sites/chipregister1/2014/07/24/technology-is-the-new-black-in-the-energy-economy/.

3. Grant Smith, *U.S. Seen as Biggest Oil Producer After Overtaking Saudi Arabia*, BLOOMBERG NEWS (July 4, 2014), http://www.bloomberg.com/news/2014-07-04/u-s-seen-as-biggest-oil-producer-after-overtaking-saudi.html.

4. Glenys Sim, *Goldman Forecasts Lower Commodity Prices as Cycle Ends*, BLOOMBERG NEWS (July 16, 2014), http://www.bloomberg.com/news/2014-07-16/goldman-sees-lower-commodity-prices-over-five-years-on-supplies.html.

5. As used in the Article, "restructuring" refers generally to out-of-court processes, and "reorganization" refers generally to in-court processes, most notably, cases under Chapter 11 of the United States Bankruptcy Code.

6. The Bankruptcy Code is codified as 11 U.S.C. §§ 101–1532 (2012).

7. 11 U.S.C. § 1104.

8. Individuals, corporations, partnerships, and other business organizations such as limited liability companies are eligible to be debtors under Chapter 11. *See* 11 U.S.C. §§ 109(d), 101(41). Typically organized as partnerships, a master limited partnership (MLP) is eligible to be a debtor under Chapter 11. MLPs are a growing and significant part of the energy industry. An energy company organized as an MLP does not necessarily raise unique bankruptcy issues. Rather, the particular considerations of an MLP and the segment of the industry in which it operates will drive a bankruptcy filing and the issues in the bankruptcy case.

9. 11 U.S.C. § 363(f).

Energy Buzz: Analyzing Potential Bankruptcies in the Upstream Sector

By: Louis R. Strubeck and Timothy S. Springer
Norton Rose Fulbright US LLP

Oil prices continue to languish in early 2015, prompting many to look ahead toward potential restructuring opportunities. With so much focus on finding the bottom, one can only wonder what may occur before the top is again in view. This article provides some brief context to that intermediate analysis of what may occur. Focusing on the upstream sector of the oil and gas industry, the article examines some differences between oilfield services versus exploration and production companies. E&P operations have a causal relationship with OFS companies, but OFS companies do not enjoy the same flexibility or access to protective hedges. So companies within the two segments of the upstream industry face different challenges to a restructuring rescue through bankruptcy.

To read the full article from the March 9, 2015 edition of *Texas Lawyer*, see http://www.nortonrosefulbright.com/us/knowledge/publications/127637/analyzing-potential-bankruptcies-in-the-upstream-sector.

Oil Price Fallout

By: M. Ray Perryman
Founder/President of The Perryman Group

As recently as the summer of 2014, oil prices were trending above $100 per barrel, and had been in the $90 to $100 range for several years prior. More recently, they have been around and below $50. While current information indicates that this situation is not likely to persist for an extended period as in the 1980s and 1990s, it is nonetheless creating disruptions, slowing activity in the industry, and negatively affecting in the rate of economic growth in oil-producing areas.

There are positive aspects of lower oil prices stemming from industries which use fuel as an input (such as trucking and airlines) and consumers. Consumers spend more given lower fuel prices, which in turn generates economic activity. In normal times, about 70% of the economy is driven by consumer outlays, and wholesale and retail trade is a huge provider of jobs. Lower prices are actually a net positive factor the US economy, but that is not the case in major producing states (such as Texas).

Oil and gas exploration and production is not a huge source of direct employment, but is nonetheless an important economic driver. In Texas, for example, only about 300,000 of the 12 million people working in Texas employed directly in the sector. However, jobs in the industry tend to pay well, capital investments are large, productivity levels are high, and multipliers are significant. Reductions in activity in the industry therefore leads to relatively larger economic fallout than that observed in other sectors.

Clearly, the major oil producing regions will be affected far more negatively than other parts of the state and nation, with notable slowing likely in the extremely rapid pace of growth. The negative impacts of lower prices affect firms throughout the oil industry, including drilling and production, services, pipelines, and other operations necessary to finding and producing oil. Even beyond these types of companies, other businesses will be negatively affected such as restaurants and hotels in major oil-producing regions. Where the economy is more diversified, however, employment losses in energy companies will likely be offset to some extent by gains in other industry groups. In other regions without strong energy-industry ties, lower prices are likely to result in economic gains more than outweighing losses.

To put the effects on the overall economy in perspective, based on the current situation, oil prices will likely lead to a loss of 150,000-175,000 Texas jobs next year

when all factors and multiplier effects are considered. Overall job growth in the state would be diminished, but not eliminated. Texas gained over 400,000 jobs last year, and lower oil prices are likely to slow the rate of growth to the 200,000-225,000 per year range. This level is consistent with the growth the state was seeing before the recent spurt in energy activity, and is still a relatively healthy pace of expansion.

For companies directly in the industry, the effects of lower prices are clear: a reduction in profits. Businesses without sufficient financial resources to weather the storm of lower prices are certainly at risk of failure. For well-capitalized firms, however, lower prices are actually creating long-term opportunities as assets become available, equipment prices fall, and talented employees become available. When prices turn around, these companies will be ready and able to capitalize.

The difficulty in predicting just when oil prices will turn around is that a key determining factor right now is political, not economic. There is an oversupply in the market, but that alone would not cut prices in half in a matter of months as we have recently seen. The fact that storage facilities are nearing capacity is another factor. There is also some temporary softening in demand to accompany a surge in production as well as some exchange rate effects as the dollar strengthens, but those also would not alone bring an adjustment of this magnitude. Instead, it is the decision process by key producing nations in OPEC which will most likely lead to the turnaround in prices in the future (which, of course, impacts supply, but, more importantly, expectations).

The geopolitical issues are complicated. OPEC and its less than aligned members have multiple agendas: slowing down the shale boom in the US, keeping Russia in a situation that keeps natural gas flowing to the Ukraine and on to other parts of eastern and western Europe, and discouraging long-term offshore investments. The situation is very complex and has a lot of moving parts, and some of the OPEC nations are desperately in need of higher prices.

My best estimate is that prices will not fall much more and will begin to trend upward later this year, but that is based as much on trying to surmise the likely behavior of OPEC as anything else. The bottom line is that prices are below the sustainable long-term equilibrium level and the consequences are notable on multiple fronts. The longer the situation persists, the more vulnerable firms in the oil and gas business and others dependent on it will become.

About M. Ray Perryman: Dr. Perryman is Founder and President of The Perryman Group (TPG), an economic and financial analysis firm headquartered in Waco, Texas. He is widely regarded as one of the world's most influential and innovative

economists. His complex modeling systems form a basis for corporate and governmental planning around the globe. His thousands of academic and trade articles and presentations span a wide variety of topics, gaining him international respect and acclaim.

Why the Experts are Wrong About the Oil Industry

By Drew McManigle
Prinicpal/Founder of The McManigle Company

The oil & gas industry forecasters, experts and prognosticators are all wrong.

To find the clues to the future of oil & gas and the overall effect on the general economy you don't look back to 2008, you need to go all the way back … to the 80's. 2008 was an anomaly for the entire economy, not just oil & gas. To look back only seven years obfuscates the reality of what has occurred without providing clear historical perspective. The 80's oil & gas bust and its aftermath provide the necessary historical, contextual, operational and economic framework to begin to understand what's happening today, and what will likely happen tomorrow. As a veteran of both the O&G and restructuring industries, I can't forget the 80's bust; it's where I made my bones – and I still have the scars to prove it.

Many forecasters and experts in the early 80's made statements like this one in forecasting future oil prices for 1985: "Conservative estimates project a price of $80 a barrel, even if peace is restored to the Persian Gulf..." *National Geographic, 1981.* Oil then promptly dropped from roughly $40 BBL to lows in the teens, seemingly overnight. In the heat of the chase, almost everyone forgot the principals of cyclical business segments…*what goes up must (and will) come down*.

Here's how it works: Prices wobble and drop like a rock. Rigs and equipment, of all types, get stacked. Asset values decline precipitously and sometimes go to zero. Customers balk at prices. They demand, and get significant price reductions eliminating profitability as businesses "churn cash" to stay afloat. Revenue drops and cash flow dries up. Jobs, many jobs, simply evaporate. Bankers don't lend anymore. They want more collateral, lines reduced, loans paid off…but with what? Delinquencies on everything from trucks to boats to homes and credit cards all rise. The word "default" enters into every day conversations. The business roller-coaster that was so much fun to ride up is now a terrifying free falling elevator. No one knows what's going to happen next. Everyone has an opinion. Oil traders

daily froth the markets. From the petroleum clubs to the coffee shops to the oil fields, everyone hangs on each new analysis and opinion about when oil prices will calm and rise; all seeking consolation where there is none.

In the 80's a little known Oklahoma shopping center bank called Penn Square folds, and it is in retrospect, credited with being partly responsible for the collapse of Continental Illinois National Bank and Trust Company of Chicago which had to write-off some $500 million in loans purchased from Penn Square (mostly oil & gas). Major losses eventually occurred at other banks like Seattle First National Bank, Michigan National Bank, and Chase Manhattan Bank. The MBank system goes bankrupt along with Global Marine and scores of other businesses and "formerly wealthy" individuals. Significant industry consolidations occur. Ripples are felt throughout housing, retail and other business segments. The *bust* from the oil & gas industry creates a *boom* for bankruptcy lawyers and related professionals.

Some theorize that this cycle will be different (e.g. shorter or less severe) because there is non-bank money available from private equity, hedge funds or non-traditional lenders, allegedly all awash in cash, who will swoop in with free flowing billions to save companies and their stakeholders. But, private equity and related firms are the predatory sharks in the business sea. They are all built specifically to find targets, assess and acquire (or lend to) them at the most advantageous moment on the most advantageous terms. The consensus that someone, anyone will step-in and save the O&G industry from future trauma at this early stage of the cycle, seems to me indicative of those exhibiting the early symptoms of the seven stages of loss and grief, beginning with shock and denial heading with a bullet towards bargaining.

Free flowing money created the problems for banks in the 80's and today is no different. Contrary to popular myth, no one has ever "drilled their way out of trouble" and no one has ever solved endemic industry issues by throwing cash at the problem. An industry bailout, by anyone, at this juncture seems at best, premature and at worst, unrealistic.

The recent oil boom was longer. The capital flowing in was greater and ironically the industry was remarkably more successful in producing hydrocarbons, albeit at greater

drilling and production costs, than in decades. This oil & gas down cycle is only six months old and most, if not many, are already trying to find light at the end of the tunnel. Unfortunately, this tunnel is still being dug…

About The McManigle Company: Drew McManigle possesses over 25 years of experience in operational leadership, business turnarounds, bankruptcy and complex litigation. He also has first-hand operating experience in the oil & gas industry where his original business experience was derived in the Permian Basin of West Texas.

Black Gold and the Great White North

By Frank Spizzirri and John E. Mitchell [1]

Distress in North American oil and gas production and development will not be limited to the United States. A significant slow down in the Canadian oil and gas industry has already begun and is expected to parallel the downturn in America. Moreover, many of the major and mid-major producers have assets, interests and operations in both Canada and the U.S. Indeed, *Quicksilver Resources* (Chapter 11 - Bankr. D. Del.) with reserves in British Columbia and Alberta, Canada, and Alberta based Gasfrac (Chapter 15 – Bankr. W.D. Tex.), with reserves in the Eagle Ford Shale, highlight the likely continuance of bankruptcy filings that will involve cross border restructuring of both Canadian and American assets.

To the extent Texas restructuring lawyers are faced with a Canadian insolvency or a Canadian component to a US-based insolvency, they should be familiar with Canadian laws, processes and procedures. However, Texas practitioners need to be careful, as Canadian restructurings are not like hockey, basketball and baseball, where the rules are the same on both sides of the border. Instead, it is more like Canadian football…it looks and feels the same, but the rules are just a little different.[2] This article briefly discusses the various types of bankruptcy, insolvency and restructuring proceedings applicable in Canada.

Overview

Legislative authority in Canada is divided between the federal and provincial governments by subject matter. Constitutionally, bankruptcy and insolvency is a federal responsibility while property and civil rights falls within provincial jurisdiction. Labor and pension law, as well as contracts that create security interests or property rights, is mainly governed by provincial legislation, but the federal government has jurisdiction over certain industries deemed national in scope. Consequently, there is an application of both federal and provincial statutes in insolvency proceedings.

The insolvency regime is primarily governed by two federal statutes that apply across Canada: the Bankruptcy and Insolvency Act (the "BIA") and the Companies' Creditors Arrangement Act (the "CCAA"). In the event of a conflict with provincial legislation, the provisions of the BIA or CCAA will prevail as a result of the doctrine of paramountcy. As well, the Winding-Up and Restructuring Act, an often overlooked element of Canada's insolvency legislation, that deals primarily, but not exclusively, with financial institutions such as banks, trust or insurance companies that are in financial distress. Most reorganizations in Canada are conducted under the BIA or CCAA and this article will focus on those statutes. Typically, the BIA is used for less complicated restructurings or straightforward liquidations of assets. The CCAA is used for more complex restructurings

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[2] For example, in Canadian football, there are only three downs, a 55 yard line sets midfield, and there is no fair catch…to name a few.

and those requiring more time to be completed. In addition, the recently enacted Wage Earner Protection Program Act (the "WEPPA") deals with employee wages in the context of a bankruptcy or receivership.

The BIA applies to a broad range of entities including individuals, corporations, co-operatives, partnerships and estates of deceased individuals. The CCAA applies to companies incorporated under federal or provincial law, or incorporated outside Canada but doing business or with assets in Canada, and income trusts. This article will use the terms "individual" and "company" when discussing who may make use of the BIA and CCAA.

The BIA represents the most complete code, providing substantive provisions dealing with, *inter alia,* the scope and breadth of stays of proceedings, distributional priorities, fraudulent transfers, the sale of assets, the treatment of contracts, interim financings, cross-border proceedings and penalties and sanctions against debtors and their directors for violations under the BIA. The BIA also contains provisions dealing with the appointment of receivers and the rules regarding their conduct. The CCAA is a more flexible statute than the BIA, as it is designed to allow courts more discretion in assisting restructuring corporations. Like the BIA, the CCAA also has substantive provisions dealing with the scope and breadth of stays of proceedings, distributional priorities, fraudulent transfer, the sale of assets, the treatment of contracts, interim financings, and cross-border proceedings.

In 1992 and 1997, major reforms to the insolvency regime in Canada placed increased emphasis on encouraging restructuring rather than bankruptcy. The past decade has seen further review of the insolvency and restructuring laws in Canada in an effort to determine whether such laws were meeting their objectives. The culmination of this review was a number of significant reforms which came into force on 7 July 2008 and 18 September 2009. Overall, the recent reforms reflect a codification of existing practices, but there are also significant new protections for workers and pensioners affected by corporate insolvencies.

Corporate Legislation

The federal government and each province have their own legislation creating and regulating corporations. For example, the Canada Business Corporations Act (the "CBCA") is the federal act respecting Canadian business corporations, whereas in Ontario, the provincial act for business corporations is the Business Corporations Act (the "OBCA").

These statutes contain provisions to establish and govern corporations created thereunder, and also impose certain restrictions on actions that corporations can take while insolvent and actions (such as issuing dividends) that would render the corporation insolvent.

Both provincial and federal legislation also impose liabilities on officers and directors of a corporation for their actions or omissions in contravention of the statutes and their provisions.

Judicial and Regulatory Framework

Unlike in some jurisdictions, including the US, there is no separate bankruptcy court in Canada. Rather, the provincial Superior Court(s) of each province are vested with bankruptcy and insolvency jurisdiction by virtue of the federal statutes.

The Supreme Court of Canada is the final court of appeal in Canada and hears appeals from all provincial courts of appeal and the federal Court of Appeal. Parties seeking to appeal to the Supreme Court of Canada in most circumstances must seek leave to do so, as there is no automatic right of appeal with respect to matters involving bankruptcy, insolvencies and property rights.

Similar to the United States Trustee, the Office of the Superintendent of Bankruptcy ("Superintendent"), which forms part of the federal Ministry of Industry and Trade, has a general supervisory function over all bankruptcies and all matters to which the BIA applies. The other administrative official is the official receiver: employees of the Superintendent appointed across Canada to deal with the administrative obligations specified by the BIA, such as accepting the documents that are filed in connection with bankruptcy or proposal proceedings as well as monitoring proceedings to determine whether any offenses under the BIA have been committed by a bankrupt.

Trustee in Bankruptcy

The Superintendent licenses and regulates those persons, primarily accountants, who have undergone specialized training to become a trustee in bankruptcy (the "trustee"). The formal role of accountants is a legacy of the UK tradition which underpins Canadian law and is an important point of difference between US and Canadian insolvency practice. The trustee is the main actor in the Canadian insolvency system and is charged with administering bankruptcies and monitoring insolvency proposals and CCAA restructuring proceedings.

Types of Insolvency Administrations

The typical personal insolvency options are:

- Bankruptcy, which entails a liquidation and distribution of assets followed by a discharge from debts at the time of the bankruptcy;
- Proposal to creditors for a binding compromise of debts which if supported by the requisite majority binds all creditors to whom the proposal is made; or
- Consumer proposal for a fast-track binding compromise of debts for individuals with lower debt levels

For an insolvent company, there are more insolvency options available:

- Bankruptcy with the liquidation and distribution of assets, but without any discharge from debts;
- Proposal to creditors;
- Liquidation or restructuring under the CCAA; or

- Court or private receivership proceedings for liquidation and distribution of assets.

These different insolvency proceedings may take place at the same time or run consecutively. For instance, an unsuccessful proposal will result in an automatic deemed bankruptcy of the corporation or individual. It is also common for a receiver to be appointed during or following a proposal, bankruptcy or CCAA proceeding in order to carry out certain goals for secured creditors such as interim asset preservation or marketing and sale of assets. However, a BIA proposal and CCAA proceeding may not run at the same time.

Definition of Insolvent Person

An insolvent person as defined under the BIA as: an individual or company that resides, or has property or business, in Canada; whose liabilities to creditors exceed CAD 1,000; and:

- For any reason is unable to meet his obligations as they generally become due;
- Has ceased paying current obligations in the ordinary course of business as they generally
- The aggregate of whose property is not, at a fair valuation, sufficient, or – if disposed of at a fairly conducted sale under legal process – would not be sufficient to enable payment of all obligations, due and accruing due.

"Person" has an expansive definition and is defined in the BIA as meaning an individual or natural person, a partnership, an unincorporated association, a corporation, a cooperative society or an organization; the successors of a partnership, association, corporation, society or organization; and the heirs, executors, liquidators of the succession, administrators or other legal representatives of a person, according to the law of that part of Canada to which the context extends.

The CCAA does not define "insolvency," and the term has been given a broad meaning to enable rehabilitation under the CCAA.

Meaning of Bankrupt

To be bankrupt in Canada denotes a legal state wherein a debtor has lost the debtor's title, equity and rights in and to the debtor's assets in favor of a trustee that is appointed and in whom the title to, and equity and rights in connection with the assets of the debtor-bankrupt, are vested.

The BIA sets out that only a "debtor" that is an insolvent person may become bankrupt.

The Bankruptcy and Insolvency Act ("BIA")

The purpose of the bankruptcy regime is to allow the bankrupt entity protection from creditors and provide for the orderly and fair liquidation and distribution of the bankrupt's assets to creditors.

Upon bankruptcy, a trustee becomes vested (whereby ownership is transferred by operation of law) with all of the bankrupt's property that is subject to the bankruptcy. The

trustee's rights in the property are subject to the interests of third parties including secured creditors (which generally include lessors under perfected finance leases) and property owners (which generally include lessors under true rental leases). Although the trustee's rights are inferior to those of secured creditors and property owners, and even though secured creditors and property owners are not typically stayed by a bankruptcy, the trustee can require any party claiming rights in an asset in the possession of the trustee to prove its claim in accordance with specified BIA procedures. Until those procedures are exhausted or the trustee consents, the trustee is entitled to remain in possession of the property in issue.

The trustee's primary duties are to collect, preserve and sell the assets of the bankrupt, and to distribute available proceeds to creditors in accordance with their prescribed priorities and pro rata within each class of creditors. The trustee must also investigate the affairs of the bankrupt and transactions entered into prior to bankruptcy.

The BIA provides a broad stay of proceedings which applies to all creditors aside from secured creditors exercising rights to enforce against their security. In certain circumstances, the stay of proceedings may be lifted to permit actions by creditors to proceed. This chiefly happens in situations where there are allegations which, if proven, would survive bankruptcy, such as the bankrupt obtaining property by false pretenses, by fraudulent misrepresentation or by fraud while acting in a fiduciary capacity. In limited circumstances, the stay of proceedings may be extended to a secured creditor realizing its security where the trustee seeks an alternative method of liquidation that would yield recovery for unsecured creditors after the secured creditor is paid in full.

The procedures involved in a corporate bankruptcy are similar to those for individuals. Bankruptcy can occur voluntarily as a result of an insolvent debtor filing an assignment in bankruptcy, or involuntarily as a result of a creditor filing a bankruptcy application in respect of an insolvent debtor.

The Companies' Creditor Arrangement Act ("CCAA")

In comparison to the structured and statute-driven process under the BIA, the CCAA is a court-driven process that offers a flexible and powerful tool for restructuring or liquidating corporations in financial difficulty. Whilst not required, it is not unusual for a single judge to supervise a CCAA case from beginning to end. The considerable judicial involvement and discretion under the CCAA sometimes leads to a more expensive process than under the BIA.

The CCAA has been referred to as the Canadian chapter 11, referring to US Bankruptcy Code chapter 11 proceedings, but there are important differences. For instance, CCAA protection is not automatic and there is no ability to "cram down" classes of creditors by seeking court authorization. The absolute priority rule – which comes into play in the US when a class of similarly situated creditors do not agree with a proposed restructuring –

and the broad doctrine of equitable subordination have not gained traction in Canadian jurisprudence.

The CCAA is intended for use by large corporations, but in fact the threshold requirement to initiate a CCAA reorganization is merely that the corporation, either alone or with its affiliates, has at least CAD 5,000,000 of debt, and that each applicant is insolvent. The real bar to accessing the system for small companies is the extra cost of the court-supervised system under the CCAA.

CCAA Liquidations

The CCAA was originally intended to allow large and complex insolvent company restructurings to take place. However, jurisprudence has developed whereby the CCAA is also used as a tool to liquidate. Sometimes the liquidation leads to a plan of arrangement which provides for the distribution of the proceeds.

However, if priorities are not contested and there is not enough to pay secured creditors in full then the court may simply authorize the termination of the proceedings once the liquidation is complete and authorize distribution to the secured creditors and other priority claimants.

Receiverships

Receivership is a remedy for the enforcement of a secured creditor's rights in which the receiver is empowered to take possession, manage on an interim basis, and then sell the insolvent company's property. It is possible to seek the appointment of a receiver over an individual but this is rarely done. Receiverships are common in Canadian corporate insolvencies and usually involve the liquidation of property or the sale of the insolvent company's business as a going concern. A receivership may be by way of private appointment or by way of court order. Court ordered receiverships can be done under the BIA or under provincial legislation that allows for a court appointed receiver, such as s.101 of Ontario's Courts of Justice Act.

Informal Arrangements – Consensual Agreements

Frequently, before resorting to formal insolvency proceedings, an insolvent company will try to enter into contractual compromise or standstill arrangements with its creditors, usually involving debt repayment or deferral. The advantages of a reaching a consensual agreement with creditors include avoiding the stigma and asset-value erosion of formal insolvency proceedings and the risk of losing all assets or having an ongoing business shut down. However, it is often unrealistic to expect that a complex restructuring with divergent interests can be resolved on a consensual basis.

Informal Arrangements – "Look-see" Appointments

Before restructurings commence, a secured creditor may also, under the terms of its security agreement, appoint an informal monitor, typically a trustee. The purpose of the appointment is for the secured creditor to assess the viability of a restructuring through a

neutral and professional assessment of the debtor's financial difficulties. Recommendations made are not binding on a debtor, but are usually followed so as to avoid losing the support of the secured creditor.

Recent Trends

Restructuring using the Canadian Corporate Statute - A Shift Away from the CCAA/BIA

Over the last few years, there has been an increase in out of court restructurings as an alternative to formal restructurings under the CCAA and the BIA. Hence, the decline in formal insolvency filings. Out of court restructurings are seen as a cheaper, less polarizing process. However, for out of court restructurings to work, a company must have a consensus among creditors, unlike a formal insolvency process, where dissenting creditors within an affected creditor class can be crammed down. For example, under a CCAA restructuring plan of arrangement, only 2/3 in value and majority in number for each creditor class is required to approve the plan and the plan will be binding on all the creditors in that class. Often, the threat of a formal process (and lower recovery to stakeholders) provides bargaining power to the restructuring company.

Where it is not possible to implement an out of court restructuring because of the required consensus, recently, the Canada Business Corporations Act ("CBCA") is being used as an alternative to the CCAA, to implement a restructuring. Although the CBCA is not fundamentally an insolvency statute, section 192 of the CBCA establishes a statutory procedure by which a company can seek court approval for an arrangement that effectively implements a restructuring.

The advantages of a CBCA restructuring process over a CCAA restructuring process are that it is generally cheaper, faster, does not involve all of the creditors (just debt and equity), and has less stigma associated with it. In addition, equity holders have a greater chance of preserving some value, versus in a CCAA restructuring where equity is at risk of being wiped out entirely. The major differences include that the CBCA is used to implement strictly a financial restructuring.

Under section 192 of the CBCA, only those companies that satisfy the statutory three-part test (meet the statutory requirements, put forward the arrangement in good faith and that the arrangement is fair and reasonable) can obtain court approval for a plan of arrangement. Although section 192 states that a corporation must not be insolvent to avail itself to the provision, courts have permitted insolvent companies to participate in an arrangement where one or more parties applying for court approval were solvent, or alternatively, where the insolvent applicant would be solvent after completing the arrangement. Further, courts only approve a section 192 arrangement if it is fair and reasonable. This requires a determination of "whether the court may conclude that an intelligent and honest business person, as a member of the class concerned and acting in his or her own interest, might reasonably approve of the plan".

In addition to a financial restructuring, the CCAA enables a company to implement an operational restructuring - such as disclaimer of contracts, leases, employees. It also imposes a broad "stay of proceedings" preventing creditors from enforcing or taking any

action against the corporation for breach of commitments or terminating agreements, thus giving a corporation some breathing room.

Distressed Mergers & Acquisitions

Under a distressed scenario, a company now typically commences efforts to sell the company. It then files for CCAA protection, after which management of the debtor company has the breathing space necessary to continue in its efforts to sell the company. The company is marketed as a going concern, as opposed to a liquidation, with job preservation being a fundamental driver and factor in the court approval process. Once a buyer is found, the court approves the sale transaction (without shareholder or bulk sales act approval) and issues a vesting order, vesting title in the assets to the buyer free and clear of all liens, security interests and encumbrances all of which are transferred to the proceeds of sale.

Recently, Canadian courts have adopted the US concept of "stalking horse" bid procedures to sell distressed businesses. Under this process, the distressed company engages in a sale process, selects a stalking horse bid and enters into an agreement of purchase and sale with the stalking horse bidder which is approved by the court. The court also approves an auction process to market test the initial bid. Subsequent bidders' offers are based on substantially similar terms as the stalking horse agreement of purchase and sale and the purchase price must be greater than the stalking horse purchase price by a defined amount. If another bid is accepted, then the stalking horse bidder receives a break fee and expense reimbursement for the lost deal.

DIP Loans - Threats to Priority

In 2013, the Supreme Court of Canada addressed the issue of the super-priority status of a DIP financier over the assets of a CCAA debtor (see Sun Indalex Finance, LLC v. United Steelworkers, 2013 SCC 6).

While the Supreme Court of Canada ultimately held that the super-priority status of a DIP financier over the assets of a CCAA debtor (including over pension trust claims), the impact of the decision on a secured lender is still significant. By virtue of the Ontario Personal Property Security Act,[3] the Pension Benefits Act (Ontario) deemed trust claimants have a priority over a lender's security interest in the "accounts" and "inventory" of a borrower. The case did not change this priority rule, but increased the scope of the potential quantum of the priority.

Cross-Border Insolvencies

Canada adopted a modified version of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency in the 2009 amendments to the BIA and CCAA. Part XIII of the BIA and Part IV of the CCAA aim to provide mechanisms for dealing with cross-border insolvencies and to promote:

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[3] RSO 1990, cP.10.

- Cooperation between the courts and other competent authorities in Canada with those of foreign jurisdictions in cases of cross-border insolvencies;
- Greater legal certainty for trade and investment;
- Fair and efficient administration of cross-border insolvencies that protects the interests of creditors, other interested persons and debtors;
- The protection and the maximization of the value of debtors' property; and
- The rescue of financially troubled businesses to protect investment and preserve employment.

Classification of a Foreign Proceeding

The starting point under both the BIA and CCAA is an application for recognition of a foreign proceeding by a foreign representative. The representative, who is appointed in the foreign proceeding, applies to the Canadian Court to have the foreign proceeding recognized under either Part XIII of the BIA or Part IV of the CCAA.

The definition of "foreign representative" differs in the BIA and CCAA, with the CCAA definition being focused on monitoring for the purpose of reorganization. Both definitions, however, contemplate the appointment in the foreign proceeding of a person as the foreign representative.

There is a subtle difference in the application of Part XIII of the BIA and Part IV of the CCAA, with the latter being aimed at foreign proceedings for the purpose of reorganization only and the BIA being aimed at foreign proceedings for the purpose of either liquidation or reorganization.

The BIA defines "foreign proceeding" as a judicial or an administrative proceeding, including an interim proceeding, in a jurisdiction outside Canada dealing with creditors' collective interests generally under any law relating to bankruptcy or insolvency in which a debtor's property and affairs are subject to control or supervision by a foreign court for the purpose of reorganization or liquidation. This definition is broad enough to include liquidation proceedings, reorganization proceedings and receiverships. The CCAA defines "foreign proceeding" more narrowly insofar as it is limited to proceedings that are for the purpose of reorganization.

Under the BIA and the CCAA, the Court is required to make an order recognizing the foreign proceeding if the foreign representative satisfies the Court that the proceeding is a foreign proceeding and that the applicant is the foreign representative appointed in that proceeding.

Further Classification of a Foreign Main Proceeding or Foreign Non-Main Proceeding

A foreign proceeding must then be recognized as either a "foreign main proceeding" or a "foreign non- main proceeding". A foreign main proceeding is a proceeding that is commenced in the jurisdiction where the insolvent company has its center of main interest (often referred to as "COMI") and a foreign non-main proceeding is a proceeding in any

other jurisdiction. A foreign main proceeding will be afforded greater deference than a foreign non-main proceeding.

Additional Cross-Border Observations

Some of the features of the Canadian insolvency landscape that are worth noting include the following:

Pace of Proceedings

The pace of proceedings in Canada is generally quicker than in the United States. This speed of action tends to favor secured creditors and property owners by keeping restructuring processes short and by preventing assets from being trapped for extended periods of time inside insolvency estates.

Support of Major Financiers

It is much more difficult for a debtor to restructure without the support of its major financiers. There are many reasons for this, including an underlying finance-friendly culture and a legacy of the United Kingdom's commercial law and its tradition of protecting domestic banks.

No Creditors' Committees in Canada

Another difference between American and Canadian practice is that there are effectively no creditors' committees in Canada. In a bankruptcy, at the first meeting of creditors, a form of creditors' committee is elected (the "inspectors"). However, the inspectors have no right to funding from the estate, no standing in court as a committee, and no independent power to manage the estate or initiate litigation. They therefore tend to play a very limited role. In CCAA proceedings, there is judicial discretion to create and fund committees, but it is still an exceptional remedy, rather than the rule.

Conclusion

In summary, Canadian bankruptcy laws are very similar to US laws, but practitioners should be careful when faced with cross border proceedings with our neighbors to the North. As with any cross border issue, competent foreign counsel should be consulted, as needed. Let's hope Texas bankruptcy lawyers and Canadian bankruptcy lawyers have many opportunities to do so in the future, eh?

After the Gold Rush: Managing the Risks of the Distressed Oil & Gas Counterparty[1]

By: David M. Bennett with Rhett G. Campbell

INTRODUCTION

Inherent in the oil and gas business and, indeed, in all commercial relationships is the risk that an obligor or counterparty may become financially troubled. With the recent decline in commodity prices, there is a heightened need to manage and mitigate risks that arise when interacting with a financially troubled entity.

Consider the array of commercial and business relationships in the oil and gas industry. In each case, there is a discrete set of bankruptcy risks to manage:

Agreement	Risk of Bankruptcy
Joint Operating Agreement	Any joint interest owner
Service Contract	Contract counterparty
Sale Contracts	Buyer or seller
Lease	Lessee
Purchase and Sale Agreement	Buyer or seller, even after closing has occurred
Production Payment	Grantor

There are three general categories of risk that a contract counterparty faces: (i) credit risk; (ii) avoidance risk; and (iii) business risks. When thought of as a timeline of risks, those categories loosely represent: risk to current transactions (by the risk of nonpayment); risk arising from past transactions (by the risk of avoidance); and risk to transactions in the future (by the risk of loss of future value). These risks can and should be managed and mitigated both prior to and during a bankruptcy case.

DISCUSSION

I. Mitigating Credit Risk by Obtaining and Perfecting a Security Interest and/or Lien

A. General Principles

[1] Cassandra Sepanik Shoemaker and Steve J. Levitt of Thompson & Knight LLP contributed to this article.

Bankruptcy most often is a response to severe financial distress and usually is a last resort because of the high cost and risk to the enterprise.[2] Due to the limited resources available to repay creditors, pre-bankruptcy general unsecured claims and open-account debts often are paid either pennies on the dollar or not at all. Given this present-tense risk of non-payment or non-performance by the counterparty, the risk that the counterparty will become bankrupt should be considered from the beginning of the contractual relationship. Obtaining a lien or security interest to secure a claim under a contract is a first line of defense. However, the steps required to perfect the liens and security interests available to secure different oil and gas contracts will vary with the nature of the contract.

(1) *Common Pitfall: Failure to Perfect a Security Interest and/or Lien*

A lien or security interest only provides protection in bankruptcy if it is timely and properly perfected. While, in the absence of bankruptcy, lien rights are enforceable by the lienholder against the debtor,[3] once bankruptcy is filed, in most cases, an unperfected lien or security interest is of little or no value.

A debtor in bankruptcy has sweeping "strong arm" powers that, under Bankruptcy Code Section 544, permit the trustee to avoid unperfected liens or security interests.[4] Once an unperfected lien or security interest is avoided, the creditor will be left as a general unsecured creditor down the bankruptcy payment waterfall with a reduced recovery, if any. Upon the filing of a bankruptcy case, the automatic stay prevents a holder of an unperfected lien from perfecting its contractual security interest in the debtor.[5] Thus, after the petition date, the holder of an unperfected contractual lien or security interest holder in most cases will have little recourse other than its rights as an unsecured creditor.

(2) *Common Pitfall: Perfecting a Security Interest and/or Lien Against the Wrong Counterparty*

Another all-too-common mistake, particularly with oil and gas assets for which record title may be a complex issue, is to obtain and perfect a lien or a security agreement against the wrong entity. Corporate formalities are recognized in bankruptcy, which typically means that each affiliated debtor will file its own

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[2] In fact, bankruptcy comes with high costs of administration and the need for transparency in business practices and structure. And there is no guarantee that a company that goes into bankruptcy will come out on the other side. Warren, Elizabeth and Westbrook, Jay, *The Success of Chapter 11: A Challenge to the Critics*, 107 Michigan Law Rev. 603 (2008) (approximately 30% to 50% of Chapter 11 cases filed confirm plans).

[3] *In re E.M. Williams & Sons, Inc.*, No. 08-3055-KRH, 2009 WL 2211727 at *2,n.6 (Bankr. E.D. Va. 2009); *In re Kwan Hun Baek*, 240 B.R. 633, 635 (Bankr. M.D. Fla. 1999).

[4] *Knotsman v. West Loop Savings Association (In re Newman)*, 993 F.2d 90 (5th Cir. 1993).

[5] 11 U.S.C. § 362(a)(4) (staying any act to create, perfect, or enforce any lien).

bankruptcy case with each debtor being treated as separate for purposes of, among other things, distributions to creditors.[6]

While affiliated debtors may frequently be jointly administered in bankruptcy, substantive consolidation—treating separate debtors as a single distributive pool—is the exception, rather than the rule.[7] In the absence of substantive consolidation of all the debtors, a pledge that was originally given by an entity that did not actually hold an interest in the property will typically mean that the purported lien or security interest is treated as a nullity and that the holder of the security agreement is a general unsecured creditor in the bankruptcy case. Thus, it is crucial for the counterparty seeking to establish secured status in a bankruptcy case to ensure that the lien or security interest is obtained from, and perfected against, the record owner of the property.

(3) *Common Pitfall: Failure to Perfect a Security Interest and/or Lien As Soon As Possible*

In practice, to be of value in bankruptcy, the lien or security interest should be perfected contemporaneously with the attachment of the lien or security interest. Perfection of the lien or security interest after the fact will result in a preference or avoidance risk to the counterparty if the debtor files bankruptcy within ninety days of perfection.[8] Moreover, the lien or security interest only has value to the extent that the value of the underlying property exceeds the amount of any prior liens against the same property.[9] Since the priority of a lien or security interest often is based upon first to file, value that otherwise could be captured in a bankruptcy case often is lost by a delay in perfection and resultant loss of priority to intervening liens.

In an age of highly-leveraged companies and mezzanine lending, it is important to consider the impact of modern financing practices on the value of contractual liens for junior secured creditors. If, for example, the lien of the secured financier is recorded in advance of the recordation of a joint operating agreement (with an imbedded reciprocal lien among the parties to the JOA as set forth in greater detail below), upon the filing of a bankruptcy case, the lien in favor of the secured financier may consume all the available value and leave the counterparty to the JOA with a wholly unsecured claim. This reality of modern finance highlights the need to record and perfect a lien or security interest as soon as possible to ensure the highest priority possible upon the filing of a bankruptcy case.

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[6] *In re Fernandes*, 346 B.R. 521, 522 (Bankr. D. Nev. 2006).
[7] *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.)*, 250 F.3d 955, 958 (5th Cir. 2001); *In re Las Torres Develop. LLC*, 413 B.R. 687, 693 (Bankr. S.D. Tex. 2009).
[8] *In re P.A. Bergner & Co. Holding Co.*, 187 B.R. 964, 983 (Bankr. E.D. Wis. 1995).
[9] *United States v. Ron Pair Enterp., Inc.*, 489 U.S. 235, 241 (1989); *Matter of T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997) (junior lienholders only have a secured claim if value of collateral exceeds senior liens).

B. Maximizing Oil and Gas Lien Value

Thus, to maximize value to a secured creditor once bankruptcy is filed, a lien or security interest should be perfected against the correct counterparty contemporaneously with the attachment of the lien or security interest. But the manner of attachment and perfection will vary with the type of lien and applicable state law.

(1) *Securing Claims Arising Under Joint Operating Agreements*

Joint Operating Agreements give rise to credit risk for all of the working interest owners which are parties to the agreements, both operators and non-operators. For instance, operators frequently make advances on behalf of non-operators for both capital expenditures and lease operating expenses. Upon the bankruptcy of the non-operator, claims for both capital expenditure amounts and for unpaid lease operating expenses will be prepetition claims against the non-operator. Operators, on the other hand, often market hydrocarbons for the non-operators which, prior to the operator's payment (most often in arrears) of the proceeds of the sale of such hydrocarbons, means that the non-operator will be taking the credit risk of the operator. In that circumstance, the bankruptcy of the operator will result in the non-operators being left with claims for hydrocarbons that have been produced and sold prior to the bankruptcy case.

In order to reduce this risk, the terms of joint operating agreements ("JOA") often include reciprocal contractual liens to secure the performance of a counterparty. For example, Section VII.B of the A.A.P.L. Form 610-1989 Model Form Operating Agreement, which is one of the most commonly used forms of operating agreements, includes a reciprocal contractual lien and security interest in both current and future acquired real property located within the "Contract Area," and a security interest in the currently-owned and after-acquired personal property and fixtures related to the real property.

The manner of perfecting the lien and security interest in a joint operating agreement will vary with applicable state law. In order to ensure the enforceability and priority of such liens and security interests in the underlying oil and gas interests, the parties must perfect these interests by executing, acknowledging and recording a memorandum of the operating agreement in the appropriate land records of the county or counties where the lands are located.[10] If a Contract Area

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[10] *See, e.g., Amarex, Inc. v. El Paso Natural Gas Co*., 772 P.2d 905, 906–07 (Okla. 1987) ("The operator's lien created by the A.A.P.L. Form 610-1977 Model Form Operating Agreement is a contractual lien. In order to perfect such a contractual lien against a working interest owner's real property rights, an operator must file an operating agreement in the land records of the county or counties where the lands are located. Such an instrument must be executed, attested and acknowledged in accordance with the statutory formalities found in Title 16 of the Oklahoma Statutes."); W*estland Oil Dev. Corp. v. Gulf Oil Corp*., 637 S.W.2d 903 (Tex. 1982) (reference to an operating agreement in the chain of title placed competing interests on notice of the operating agreement); La. R.S. § 32:217 ("In lieu of filing an [operating]

under an operating agreement is located in two or more counties, parties should record the memorandum in all applicable counties. To perfect in personalty, parties must file a UCC-1 with the Secretary of State of the operating agreement counterparty's state of incorporation.[11]

In addition to a contractual lien, at least one state grants operators of pooled units a statutory lien on participating interests in the unit. Under Oklahoma law, operators of pooled units are granted statutory liens to secure the costs of operation.[12] These liens may be perfected by filing a land-record filing that shows the unit approval and the participation of particular leases or interests.[13]

(2) *Statutory Mechanic's and Materialman's Liens*

Mechanic's and materialman's liens, or their equivalent, are available in most states to protect contractors who furnish labor and materials that are used in the drilling of oil and gas wells.[14] These liens are often independent of, and can be obtained in addition to, other liens such as contractual liens granted in operating agreements[15] and are intended to ensure that the property owner does not receive added value from the contractor's work without paying for it. Some states expressly extend such liens to protect operators, even if they are not themselves the provider of the labor or materials in question.[16]

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agreement as provided in R.S. 31:216, the parties thereto may file a declaration signed by them, or signed by any person designated in the agreement as the general operator or agent of the parties, describing the lands affected by the mineral rights that are the subject of the agreement, stating in general terms the nature or import of the agreement, and stating where the agreement may be found. The recording officer of the parish in which the declaration is filed may copy into his records only the declaration, without the exhibit attached thereto. The declaration when so filed shall serve as full and complete notice of the agreement to the same extent as if the original agreement had been filed and recorded.").

[11] *Arrow Oil & Gas, Inc. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 112, 136 (Bankr. D. Del. 2009)

[12] *See* 52 O.S. §287.8 (voluntary pooled unit liens); 52 O.S § 87.1(e) (forced pooled unit liens).

[13] *See TCINA, Inc. v. NOCO Inv. Co.*, 95 P.3d 193, 195 (Okla. Ct. App. 2004) (interpreting operator's liens that arise under 52 O.S. §287.8); *see also GasRock Capital, L.L.C. v. EnDevCo Eureka, L.L.C.*, 313 P.3d 1028 (Okla. Ct. App. 2013) (holding that an operator's lien subject to 52 O.S. §287.8 was perfected by the land-record filing of a notice of approval of the unit, and that it was "inconsequential" when drilling services were performed).

[14] For example, such a lien is provided in Texas (TEX. PROP. CODE ANN. §§ 56.001-56.045), Oklahoma (42 O.S. § 144), Louisiana (La. Rev. Stat. Ann. § 9:4862), and Mississippi (MS. Code Ann. § 85-7-131).

[15] *See Amarex, Inc. v. El Paso Natural Gas Co*., 772 P.2d 905, 906–07 (Okla. 1987) (holding that an operator who has obtained a contractual lien created by the A.A.P.L. Form 610-1977 Model Form Operating Agreement is not precluded from also obtaining and perfecting a lien for labor performed or materials furnished under the entirely separate and independent statutory procedure set forth in 42 O.S. §§ 144 and 146).

[16] *See, e.g., See Amarex, Inc. v. El Paso Natural Gas Co*., 772 P.2d 905, 910–11 (Okla. 1987) ("Managerial functions qualify as labor within the mechanic's lien statute. The operator manages the development of the non-operator's leaseholds. Even under a strict construction of the statute, there appears to be no reason why the services performed in the operation of an oil and gas well should not be within the 'labor and services' provision of 42 O.S. 1981 § 144."); *Kenmore Oil Co. v. Delacroix*, 316 So. 2d 468, 469 (La. App. 1 Cir. 1975) (operator entitled to Louisiana statutory labor and material lien); *Compadres, Inc. v. Johnson Oil & Gas Corp.*, 547 So. 2d 382, 386 (La. App. 3 Cir. 1989) (same); MS. Code Ann. § 85-7-131 ("As to oil and

Most states impose a number of technical requirements for the perfection of a mechanic's and materialman's lien.[17] If the statutory prerequisites are not met, the holder typically will be an unsecured creditor. On the other hand, if the lien is properly perfected, the beneficiary of a statutory lien may receive elevated bankruptcy treatment. Further, unlike contractual liens, the perfection of a statutory lien is not subject to the automatic stay.[18] Thus, the beneficiary of a statutory lien may perfect its mechanic's and materialman's liens even after the bankruptcy petition date.

(3) *Statutory Producer's Liens*

When oil and gas production is sold on credit without a security agreement to secure the purchase price, the producer will bear significant risk of nonpayment if the purchaser declares bankruptcy as the producer will have a mere unsecured claim. Some states, however, including Texas,[19] Oklahoma,[20] New Mexico,[21] and Louisiana,[22] have enacted statutes that grant royalty owners, producers and other oil and gas interest owners a statutory security lien to secure payment of the purchase price for that production.[23]

It is beyond the scope of this article to discuss the perfection of each various producer's lien, but some discussion is helpful. For example, some producer's liens are automatically perfected.[24] However, this is not always the case. To perfect and maintain the New Mexico producer's lien, the interest owners must file a Notice of Lien (similar to notices that are needed to perfect statutory mechanics liens) "after 15 days and within 45 days after payment is due by terms of agreement…."[25] The lien terminates if the notice is not timely filed, and if timely filed, the lien expires one

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gas wells, the operator thereof shall have a lien upon the interest of each nonoperator owner of an interest in the mineral leasehold estate for the nonoperator's proportionate part of the labor, material and services rendered by the operator or for the operator's account on behalf of each nonoperator in the drilling, completion, recompletion, reworking or other operations of the oil and gas well.").

[16] 11 U.S.C. §§ 362(b)(3), 546(b)(1); *Meek Lumber Yard v. Houts (In re Houts),* 23 B.R. 705, 706 (Bankr. W.D. Mo. 1983).

[17] LA. REV. STAT. ANN. § 9:4802; TEX. PROP. CODE ANN. §§ 56.001-56.045 (Vernon 2010). Texas Property Code section 56.021 provides: (a) Not later than six months after the day the indebtedness accrues, a person claiming the lien must file an affidavit with the county clerk of the county in which the property is located; (b) Not later than the 10th day before the day the affidavit is filed, a mineral subcontractor claiming the lien must serve on the property owner written notice that the lien is claimed.

[18] 11 U.S.C. §§ 362(b)(3), 546(b)(1); *Meek Lumber Yard v. Houts (In re Houts),* 23 B.R. 705, 706 (Bankr. W.D. Mo. 1983).

[19] Tex. Bus. & Comm. Code § 9.343.

[20] 52 O.S. § 549.1.

[21] N.M. Stat. Ann. § 48-9-1.

[22] La. C.C. Art. 3227.

[23] Mississippi grants a lien to royalty owners to secure the payment of the royalty proceeds. *See* Miss. Code Ann. 53-3-41. Unlike the other liens, however, a producer who is not also a royalty owner would not be protected.

[24] *See* Tex. Bus. & Comm. Code § 9.343; 52 O.S. § 549.1.

[25] N.M. Stat. Ann. § 48-9-5.

year after the date of the filing of the notice unless an action to enforce the lien is begun.[26]

Even in states that allow automatic perfection, producers may receive better treatment if a UCC-1 is filed. For example, while the Texas producer's lien is automatically perfected under the Texas statute, the bankruptcy court for the District of Delaware held that a producer's lien was subordinate to a contractual secured lender's lien because the Texas producer had not filed a UCC-1 in the state of incorporation of the purchaser of the production prior to the contractual secured lender's lien.[27] The lower priority resulted in the loss of approximately $57 million to the Texas owners' interest in the oil and gas proceeds. Thus, in order to ensure the best priority for the Texas producer's lien, producers who are selling on credit should file a UCC-1 in the state of incorporation of the first purchaser of the production rather than rely solely on automatic perfection.

On the other hand, unlike Texas, following the *Semcrude* decision, the Oklahoma legislature amended the producer's lien statute in an attempt to ensure both automatic perfection and first priority to producer lienholders. Whereas in Texas a producer's lien may have lower priority than other article 9 interests, the Oklahoma statute purports to grant producers an automatically perfected lien that has first priority over other competing article 9 security interests even if the competing interests are first-in-time.[28] The sole exception to this grant of priority is a permitted lien.[29] A "permitted lien" under the Oklahoma statute is a "validly perfected and enforceable lien created by statute, rule, or regulation of a governmental agency for storage or transportation charges . . . . owed by a first purchaser in relation to oil or gas originally purchased under an agreement to sell."[30] Thus, a permitted lien is a narrow exception to the otherwise broad superior priority granted in favor of first sellers of production by the Oklahoma producer's lien statute.

While the Oklahoma statute was amended to attempt to address the problems created by the *Semcrude* decision, the amendments have not been fully tested. Thus, it may be prudent for producers to file a UCC-1 in the state of incorporation of the purchaser of the production despite the protection purportedly offered under Oklahoma law.

II. Mitigating Risk Through Setoff and Recoupment

A. General Principle

[26] N.M. Stat. Ann. § 48-9-5.
[27] *In re SemCrude, L.P.*, 407 B.R. 140 (Bankr. D. Del. 2009).
[28] 52 O.S. § 549.7.
[29] 52 O.S. § 549.7.
[30] 52 O.S. § 549.2(11)(b).

In many cases, counterparties to oil and gas agreements will have reciprocal payables and receivables owed and owing to each other. For example, a producer which has entered into a gathering agreement (in which hydrocarbons produced at the well head are physically sold to the gatherer) may simultaneously have an obligation to pay for ongoing gathering services (an account payable) and an obligation to be paid for hydrocarbons which are being continuously purchased by the gatherer (an account receivable).

A right of setoff is analogous to a security interest[31] and arises where counterparties have reciprocal debts and obligations. In some circumstances, accounts payable and accounts receivable may be set off against each other. In bankruptcy, parties can offset "mutual" debts (i.e. debts between the same parties standing in the same capacity) that arose prior to the commencement of the bankruptcy case.[32] The Bankruptcy Code does not create a right of setoff; it merely preserves setoff rights created under applicable non-bankruptcy law and then only to the extent that the conditions of § 553 have been satisfied.[33] Thus, the threshold determination in every case involving § 553 is the source of the alleged setoff right. Recognizing the right of setoff in bankruptcy often allows the creditor holding the right to recover a greater percentage of its claim than other creditors who have no setoff entitlement.[34] However, the automatic stay prevents a contract counterparty from offsetting an account payable against an account receivable in the absence of modification of the automatic stay.[35]

A related contractual risk-mitigation principle is recoupment. Setoff applies to mutual debts between the same parties standing in the same capacity, but does not require that the debts arise out of the same agreement. Recoupment, on the other hand, is the netting of obligations within or among the same agreement.[36]

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[31] The right to offset is termed the right to "setoff" in the Bankruptcy Code. 11 U.S.C. § 553(a); *In re Supreme Beef Processors, Inc*., 391 F.3d 629 (5th Cir. 2004).

[32] *See* 11 U.S.C. § 553(a); *Braniff Airways Inc. v. Exxon Co., USA,* 814 F.2d 1030, 1036 (5th Cir. 1987) (mutuality requirement for setoff was met because the debt was incurred prepetition); *Matter of United Sciences of America,* 893 F.2d 720, 723 (5th Cir. 1990) (bank's setoff was not in violation of the Bankruptcy Code since the bank's agreement created the mutuality of the debts between the parties); *In re Bevill, Breler & Schulman Asset Mgmt. Corp*., 896 F.2d 54, 59 (3d Cir. 1990) (bank's possession of interest payments does not constitute a mutual debt for purposes of setoff because bank was merely a trustee); *In re Davidovich*, 901 F.2d 1533, 1538 (10th Cir. 1990) (former partner was not entitled to offset for amount allegedly owed to him pursuant to debtor's post-petition default because did not meet "mutuality" requirement).

[33] *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18-19 (1995) (noting that "no federal right of setoff is created by the Bankruptcy Code" but that "whatever right of setoff otherwise exists is preserved in bankruptcy"); *In re McMahon*, 129 F.3d 93, 96 (2d Cir. 1997) ("In determining recoupment and setoff rights, we apply nonbankruptcy law."); *In re Coreland Corp.*, 967 F.2d 1069,1076 (5th Cir. 1992) (noting that "Section 553(a) permits creditors to set off mutual, prepetition claims and debts with the debtor if such setoff would be recognized under nonbankruptcy law").

[34] *See Cumberland Glass Mfg. Co. v. De Witt and Co.*, 237 U.S. 447, 455 (1915).

[35] *In re Szymanski,* 413 B.R. 232, 240 (Bankr. E.D. Pa. 2009).

[36] *In re Holford,* 896 F.2d 176, 178 (5th Cir. 1990); *In re Brown*, 325 B.R. 169, 175-76 (Bankr. E.D. La. 2005).

Thus, recoupment is more narrowly applied.[37] However, recoupment is not subject to the automatic stay.[38] Therefore, a contract counterparty should consider whether the netting of amounts owed to and owed by a debtor are so closely tied together contractually that recoupment, not setoff, may be applicable.

B. Special Oil & Gas Issue: Reliance of Buyers and Sellers on Master Netting Agreements

Thus, in order to setoff debts in bankruptcy, the following conditions must be met: (1) the creditor must hold a pre-petition claim against the debtor; (2) the creditor must owe a pre-petition debt to the debtor; (3) the claim and debt must be mutual obligations; and (4) the claim and debt each must be valid and enforceable.[39] Within the oil and gas industry, parties often negotiate for the right to offset debts owed to corporate affiliates with debts owed by different corporate affiliates through master netting agreements. However, such agreements are vulnerable in bankruptcy.

"Mutuality" means that the debt being offset is due from the same person or entity to whom the person attempting to offset the debt owes an obligation.[40] Because of the mutuality requirement in section 553(a) of the Bankruptcy Code, courts have routinely held that triangular setoffs (i.e. when a party (A) offsets the debt owed *by* one party (B) against the debt owed *to* another party (C)) are impermissible in bankruptcy.[41] Further, because each corporation is a separate entity from its affiliates, a subsidiary's debt may not be set off against the credit of a parent or other subsidiary, or vice versa, because no mutuality exists under the circumstances.[42] Thus, in non-bankruptcy terms, setoff is only allowed between two parties—e.g. A owes B $500 and B owes A $400—who have mutual debts. Due to the "mutuality" requirement, setoff is not allowed between three parties, even if the other parties are affiliates of each other—e.g. A owes B $500 and

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[37] Recently, some courts have applied recoupment even more narrowly. *See, e.g.*, *Sacramento Mun. Util. Dist. v. Mirant Americas Energy Mktg., LP (In re Mirant Corp.)*, 318 B.R. 377, 381 (Bankr. N.D. Tex. 2004) (holding that recoupment should be narrowly applied and that an "overpayment or something like it" such as " harm to a creditor or benefit to a debtor in excess of that contemplated by the Code" must be shown to justify recoupment).

[38] *In re Holford*, 896 F.2d 176, 179 (5th Cir. 1990); *In re McWilliams*, 384 B.R. 728, 729 (Bankr. D.N.J. 2008).

[39] *See, e.g.*, *In re Eng. Motor Co.*, 426 B.R. 178, 186–87 (Bankr. N.D. Miss. 2010).

[40] *See In re Semcrude*, L.P., 399 B.R. 388, 393 (Bankr. D. Del. 2009), *aff'd* 428 B.R. 590 (D. Del. 2010) (interpreting 11 U.S.C. § 553(a)).

[41] *See, e.g., id.* at 393-94 (collecting cases); *Sherman v. First City Bank of Dallas (Matter of United Sciences of Am., Inc.)*, 893 F.2d 720, 723 (5th Cir. 1990) ("The mutuality requirement is designed to protect against 'triangular' setoff; for example, where the creditor attempts to setoff its debt to the debtor with the latter's debt to a third party."); *Louisiana, Office of Cmty. Dev. v. Celebrity Contrs., Inc. (In re Celebrity Contrs., Inc.)*, 524 B.R. 95, 110 (Bankr. E.D. La. 2014) ("The mutuality requirement is strictly construed….Thus, '[t]he threshold requirement of mutuality is that the relevant claim and debt exist between the 'same parties,' meaning simply enough that, whereas A and B may offset their mutual obligations, A may not offset an obligation that it owes to B against a debt that B owes to C.'").

[42] *See, e.g. In re Semcrude*, 399 B.R. at 394.

C (B's subsidiary) owes A $400—and even if the parties contractually agree that such debts may be set off.

For example, in *In re Semcrude, L.P.*,[43] Chevron and 3 affiliates of SemGroup, L.P. entered into various contracts. The result was that Chevron owed $1,405,878 to SemCrude, while 2 affiliates of SemCrude owed Chevron $10,228,439 ($6,925,633 owed by SemFuel and $3,302,806 owed by SemStream).[44] Chevron asked the court to lift the automatic stay so that it could offset the debts because the parties had entered into a contract that included netting provisions that provided that:

> in the event either party fails to make a timely payment of monies due and owing to the other party, or in the event either party fails to make timely delivery of product or crude oil due and owing to the other party, the other party may offset any deliveries or payments due under this or any other Agreement between the parties *<u>and their affiliates</u>*.[45]

The court denied the motion, and held that Chevron was not permitted to effect such a setoff against the debtors because "section 553 of the [Bankruptcy] Code prohibits a triangular setoff of debts against one or more debtors in bankruptcy as a matter of law due to lack of mutuality."[46] Additionally, the court found that:

> because each corporation is a separate entity from its sister corporations absent a piercing of the corporate veil, 'a subsidiary's debt may not be set off against the credit of a parent or other subsidiary, or vice versa, because no mutuality exists under the circumstances.' Allowing a creditor to offset a debt it owes to one corporation against funds owed to it by another corporation -- even a wholly-owned subsidiary -- would thus constitute an improper triangular setoff under the Code.[47]

The court also held that it did not matter that Chevron and the other parties had contractually agreed to triangular setoffs.[48] In fact, the court explained that none of the cases that allegedly observed a contractual exception "actually upheld or enforced an agreement that allows for a triangular setoff; each and every one of these decisions have simply recognized such an exception in the course of denying the requested setoff or finding mutuality independent of the agreement."[49] Thus,

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[43] 399 B.R. 388, 393 (Bankr. D. Del. 2009), *aff'd* 428 B.R. 590 (D. Del. 2010).
[44] *Id.* at 392.
[45] *Id.* at 391.
[46] *Id.* at 392–93.
[47] *Id.* at 393–94.
[48] *Id.* at 397.
[49] *Id.* at 394.

the court held that private agreements cannot confer mutuality on non-mutual debts.[50]

Since it was decided, a number of courts have expressly agreed with the analysis in *SemCrude*.[51] The Fifth Circuit, however, has not yet weighed in on the enforceability of contractual triangular setoff in bankruptcy.[52] Nevertheless, given the trend described above, the utility of master netting agreement provisions which purport to create triangular setoff rights is highly suspect.

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[50] *Id.* at 397.

[51] *See In re Lehman Bros.*, 458 B.R. 134, 141 (Bankr. S.D.N.Y. 2011) ("[This] Court agrees with the SemCrude court — triangular setoff is not (and never was) permitted under the Bankruptcy Code. Despite the pre-petition agreement of the parties, the cross-affiliate netting urged by UBS simply is not available due to lack of mutuality."); *Sass v. Barclays Bank PLC (In re Am. Home Mortg., Holdings, Inc.*), 501 B.R. 44, (Bankr. D. Del. 2013) ("This Court concurs entirely with Judge Shannon's decision [in Semcrude]."); *Steadfast Ins. Co. v. Woodside Group, LLC (In re Woodside Group, LLC)*, Case No. 6:08-bk-20682, 2009 Bankr. LEXIS 4360 at *15 (Bankr. C.D. Cal. Dec. 30, 2009); *In re Arcapita Bank B.S.C.(c)*, Case No. 12-11076, 2014 Bankr. LEXIS 2237 at *9–10 (Bankr. S.D.N.Y. May 20, 2014) ("Courts consistently find debts to be mutual only when they are in the same right and between the same parties…. The fact that the setoff was provided for by contract does not alter this conclusion.") (internal citations omitted).

[52] *See In re Eng. Motor Co.*, 426 B.R. 178, 189 (Bankr. N.D. Miss. 2010) ("It is therefore unnecessary for this Court to determine whether as a matter of law parties may vitiate the mutuality requirement in § 553 by entering into an agreement that expressly contemplates a triangular setoff, since such an agreement clearly does not exist under the facts presented here.").

III. Mitigating § 365 Contract Risk

A. General Principles

It is important to remember that being a creditor in a bankruptcy is one thing; being an owner is something very different.[53] Accordingly, counterparty risk may be drastically different depending on whether a contract qualifies as an "executory contract" or "unexpired lease" under the Bankruptcy Code. In particular, debtors may reject executory contracts and unexpired leases, in which case the other party may be left with a mere unsecured claim for damages.

B. Special Oil & Gas Issues

(1) *Characterization of Oil and Gas Leases*

The majority of oil and gas contracts (e.g., operating agreements, participation agreements, area of mutual interest agreements, development agreements, take-or-pay contracts, etc.) are executory contracts governed by section 365 of the Bankruptcy Code. The nature of the rights created or conveyed by an agreement is a matter of non-bankruptcy law.[54]

In almost all hydrocarbon producing states, an oil, gas, and/or mineral lease conveys a real property interest to the lessee.[55] Thus, for the most part, an oil and gas lease creates a presently vested interest in real property that is not subject to Section 365 of the Bankruptcy Code.

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> Ownership of property rights before bankruptcy is one thing; priority of distribution in bankruptcy of property that has passed unencumbered into a bankrupt's estate is quite another. Property interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable, mortgages, liens, or simple priority of rights, are of course not a part of the bankrupt's property and do not vest in the trustee. The Bankruptcy Act simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors. So here if the surety at the time of adjudication was, as it claimed, either the outright legal or equitable owner of this fund, or had an equitable lien or prior right to it, this property interest of the surety never became a part of the bankruptcy estate to be administered, liquidated, and distributed to general creditors of the bankrupt. This Court has recently reaffirmed that such property rights existing before bankruptcy in persons other than the bankrupt must be recognized and respected in bankruptcy.

Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135-36 (1962) (citations omitted) (emphasis added).

54 *Butner v. United States*, 440 U.S. 48 (1979) (the Bankruptcy Code does not create or define property interests but leaves that for state law or for applicable non-bankruptcy law).

55 *E.g., Foothills Texas, Inc., et al., v. MTGLQ Investors, L.P.* (*In re: Foothills Texas, Inc.*), 476 B.R. 143 (Bankr. D. Del. 2012); *In re WRT Energy Corp.*, 202 B.R. 579 (Bankr. W.D. La. 1996); *In re Frederick Petroleum Corp*., 98 B.R. 762 (S.D. Ohio 1989); *In re Hanson Oil Co*., 97 B.R. 468 (Bankr. S.D. Ill. 1989).

However, the Bureau of Ocean Energy Management ("BOEM") and the Bureau of Safety and Environmental Enforcement ("BSEE") of the Department of Interior (the "DOI") have stated the apparent position of the United States government that a federal lease is subject to rejection under section 365.[56] The DOI reasons that federal leases are governed by federal, rather than state, law and are subject to disposition under sections 365 and 541 of the Bankruptcy Code based on the plain language of the Outer Continental Shelf Lands Act ("OCSLA"), which language includes the statement that OCS leases are "rental agreements to use real property."[57]

Although many cases have addressed the issue of whether a mineral lease is a true lease or an executory contract under section 365 (and, for example, in Texas have determined they decidedly are not),[58] none have considered this issue with respect to a federal OCS lease. Nonetheless, it is typical for the OCS and other governmental agencies to take the position that government oil and gas leases are not conveyances of an interest in real property and are, in fact, subject to Section 365 of the Bankruptcy Code.

(2) *Assumption and Assignment of Oil and Gas Leases*

As discussed above, a debtor may, subject to court approval, assume and assign "executory contracts" and "unexpired leases." Anti-alienation provisions which limit or prohibit the assignment of a contract or lease are unenforceable in bankruptcy.[59] Therefore, a debtor for the most part has the power to assign a contract or lease without the consent of contract counterparties, which would be required in the absence of bankruptcy. For example, a debtor could assume and assign an operating agreement over the objection of the non-operating joint interest owners, even if, in the absence of bankruptcy, consent of the non-operator would have been a necessary condition to such assignment.

While a debtor decides whether to assume or reject an executory contract or unexpired lease, the non-debtor party must continue to perform under the contract.[60] During that 'gap period', the non-debtor party will bear the risk and uncertainty that results from not knowing whether the contract will be rejected, assumed, or assumed and assigned. Particularly with 'core contracts' that are

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[56] *E.g.*, *NGP Capital Resources Co. v. ATP Oil & Gas Corp.*, Adv. No. 12-03443 (Bankr. S.D. Tex. 2012) [Dkt No. 13] ("[A] Federal Lease is, pursuant to its enabling statutes, a 'rental agreement to use real property' subject to section 365 of the Bankruptcy Code."); *Sonoma Energy Corp.,* No. 08-34430-H4-7 (Bankr. S.D. Tex)[Dkt. No. 116]. On October 1, 2011, the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE), formerly the Minerals Management Service (MMS), was replaced by the Bureau of Ocean Energy Management (BOEM) and the Bureau of Safety and Environmental Enforcement (BSEE) as part of a major reorganization. Bureau of Ocean Energy Management, Regulation and Enforcement, http://www.boemre.gov/ (last visited May. 1, 2015).

[57] 43 U.S.C. § 1337.

[58] *Terry Oilfield Supply Co. v. Sec. Bank, N.A*., 195 B.R. 66, 70 (Bankr. S.D. Tex. 1996).

[59] 11 U.S.C. § 365(f).

[60] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984).

central to a producer's business, the uncertainty surrounding whether such an agreement will be assumed or rejected and whether the counterparty will have sufficient capital to meet its ongoing obligations thereunder can layer on enormous additional risks for capital intensive projects. In certain circumstances, a creditor may seek to reduce this uncertainty by seeking to shorten the time period for a debtor to assume or reject an agreement.[61]

In addition, as more and more Chapter 11 cases culminate in sales of the debtor's assets, debtors (often at the behest of prospective buyers) often link the sale of assets pursuant to section 363 (through a plan of reorganization or otherwise) to assumption and assignment of contracts pursuant to Bankruptcy Code section 365.[62] Assumption and assignment of an executory contract or unexpired lease requires notice to the non-debtor party and a showing, among other things (i) that any defaults pursuant to the contract sought to be assigned have or will be cured as a condition to such assignment and (ii) of 'adequate assurance of future performance' under the terms of the contract on the part of prospective assignee.[63] As sales of all or a portion of the debtors' assets continue to be a preferred exit strategy Chapter 11 debtors, contract counter-parties must take care to track bankruptcy cases for developments which could impact their rights.[64]

IV. Purchase and Sale Agreements

While trading, operating, and vendor agreements are most often impacted when a counterparty enters bankruptcy, there are other agreements impacted in ways that should be taken into account up front. Purchase and sale agreements are one obvious example. Prior to consummation, a purchase and sale agreement is almost certainly an executory contract subject to rejection by the bankrupt debtor.[65] But even after a transaction has been consummated, there may be claims – such as claims for indemnity – that arise under the agreement that need to be taken into account once the debtor enters bankruptcy.

Creditors arguably must file such contingent claims, which arise under fully consummated agreements, or risk losing them.[66] When a party to a purchase and sale agreement has been given notice of the bankruptcy of a counterparty, consideration should be given to what, if any, ongoing claims may exist against the

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[61] 11 U.S.C. § 365(d)(2); *Texas Importing Co. v. Banco Popular de Puerto Rico*, 360 F.2d 582, 583 (5th Cir. 1966). In a Chapter 11 case, a debtor has until confirmation of a plan (which, in some cases, may take a year or longer) to assume or reject an executory contract in the absence of a court order shortening that time period. *See* 11 U.S.C. § 365(d)(2).
[62] *E.g., In re Cano Petroleum, Inc.,* No. 12-31549, 2012 Bankr. LEXIS 3281 (Bankr. N.D. Tex. July 18, 2012).
[63] *River Production Co. v. Webb (In the Matter of Topco, Inc.)*, 894 F.2d 727, 730 (5th Cir. 1990).
[64] *See* 11 U.S.C. § 365(b)(1)(B) & (C).
[65] *See* 11 U.S.C. § 365 and *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37, 45-6 (D. R.I. 1999) (finding the agreements at issue to be executory because the agreements remained substantially unperformed by both parties).
[66] FED. R. BANKR. P. 3002(c).

debtor. For example, there may be outstanding indemnity obligations on the part of the buyer (e.g., for plug and abandonment or other remediation liability) that continue long after consummation of the transaction. Even if these contingent claims have not been liquidated, the Bankruptcy Code in some circumstances permits estimation of these contingent claims in a manner which will permit such claimants to participate in distributions in a bankruptcy case.[67] Accordingly, a proof of claim should be filed under these circumstances or the creditor will risk the loss of the claim (contingent or not) forever.

V. Mitigating Regulatory Risks

When a debtor's property includes interests in unproductive oil or gas wells, the debtor may seek to abandon such interest to relieve the estate of burdensome liabilities pursuant to Bankruptcy Code section 554.[68] Therefore, the issue often arises as to whether a debtor may exercise its "abandonment" power to abandon property burdened by regulatory obligations.

There are several state or federal obligations that may arise at the end of an oil or gas well's useful life.[69] Such obligations include the "plugging" of the well and removal of facilities from the site, and are defined as "plugging and abandonment" ("P&A") or "decommissioning activities" pursuant to 30 CFR § 250.1700*, et. seq*. Moreover, to protect the United States from incurring a financial loss, the DOI has instituted a bonding program for federal lands. Before the DOI will issue a new lease or approve the assignment of an existing lease, the lessee or designated operator is required to obtain a surety bond guaranteeing performance of all contractual and regulatory obligations under that lease.[70]

Courts have generally held that a debtor's abandonment power does not allow release from such obligations, finding that, under federal law, debtors must comply with state law.[71] Moreover, the Fifth Circuit has held that P&A liabilities are

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[67] 11 U.S.C. § 502(c); *Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 957 (2d Cir. 1993).

[68] 11 U.S.C. §554 allows a debtor to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate.

[69] *E.g.,* TEX. NAT. RES. CODE ANN. § 89.011. Texas Natural Resources Code section 89.011 provides: The operator of a well shall properly plug the well when required and in accordance with the commission's rules that are in effect at the time of the plugging.

[70] 30 CFR § 256.52. The United States requires supplemental bonds for costs associated with specific oil and gas facilities, abandonment and site clearance.

[71] *E.g., Texas v. Lowe (In re H.L.S. Energy Co.),* 151 F.3d 434, 437 (5th Cir. 1998)(citing 28 U.S.C. § 959(b) and *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 507 (1986)(holding that a trustee may not abandon property in contravention of a state law reasonably designed to protect public health or safety). *But see In re Shore Co*., 134 B.R. 572 (Bankr. E.D. Tex. 1991)(Violation of state and federal environmental laws must be coupled with a showing that the violation constitutes an imminent and identifiable to limit the trustee's powers of abandonment). Notably, in finding that the trustee was permitted to abandon the contaminated property, the *Shore* Court "place[d] great weight on the lack of activity on the part of a state agency charged with protecting the health and welfare of the people of the State of Texas." 134 B.R. at 579.

entitled to administrative claim priority if the plugging obligations accrued post-petition under state law because the debtor cannot avoid such liability and, thus, the expenses are "necessary" and beneficial" to the estate under an administrative claim analysis.[72]

Because P&A liability can be significant, particularly in the case of offshore wells, a provision for payment of P&A expenses can become a threshold issue in the administration and/or sale of oil and gas properties in offshore bankruptcy cases. In fact, because a bankrupt operator may seek to either transfer or cease operations on a lease, non-operators in the chain of title may need to intervene to ensure that the P&A liabilities —for which they may otherwise be financially responsible—are satisfied by the operator or assumed by any successor.

VI. Mitigating Risks Related to Farmouts and Production Payments

The Bankruptcy Code contains a special set of rules (or "safe harbor" provisions) for both the farmee and the holder of a production payment in the circumstances spelled out by the Bankruptcy Code.[73] If a farmout falls within the bankruptcy safe harbor, then even a debtor's rejection of the farmout agreement as an executory contract will not impact the rights of the farmee, at least in respect of any interest that had been earned as of the petition date.[74] Moreover, a production payment, which meets the statutory definition, is subject to its own safe harbor and is a property right separate and apart from the bankruptcy estate.

The distinction between the holder of a separate property interest (like a production payee or farmee) and a secured creditor is a crucial distinction in bankruptcy. This is because a creditor's separate property interest, for the most part, is not subject to the jurisdiction of the bankruptcy court and, therefore, is not subject to being stripped or modified in bankruptcy.[75] In contrast, if a counterparty is merely a secured creditor, the counterparty's property interest is subject to the increased risk of impact, including a bankruptcy court: (i) permitting a debtor to use the proceeds or revenues from the collateral over the objection of the secured creditor pursuant to Bankruptcy Code section 363(c)(2) and/or (ii) forcing, through a plan of reorganization pursuant to section 1129(b), a modification of repayment terms on the contract counterparty (e.g. a "cramdown").

Thus, if a counterparty is choosing, for example, between a conveyance of a production payment or a claim that is secured by a claim on property of the estate, in many cases, the former is preferable because the production payment should

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[72] *Texas v. Lowe (In re H.L.S. Energy Co.),* 151 F.3d 434, 437 (5th Cir. 1998).
[73] 11 U.S.C. § 541(b)(4).
[74] *See In re Resource Technology Corp.*, 254 B.R. 215, 222 n.2 (Bankr. N.D. Ill. 2000). The language of 541(b)(4)(A) could also be read to insulate unearned acreage as of the petition date; however, no court has directly addressed such issue.
[75] 11 U.S.C. § 541; *but see* 11 U.S.C. § 363(f) (permitting bankruptcy trustee to force a sale of a co-owner's interest along with the debtor's interest in property).

"pass through" the bankruptcy case with a reduced risk of impairment of its pre-bankruptcy contractual rights.

CONCLUSION

The risk of bankruptcy or insolvency by a counterparty is inherent in oil and gas-related agreements, particularly given the recent precipitous decline in commodity prices. However, by considering those risks and implementing strategies to mitigate and manage those risks (both inside and outside of bankruptcy), creditors can better protect themselves, insulate their businesses and minimize the deleterious impact of a counterparty's bankruptcy case.