What Happens to My Lawsuit?
When Bankruptcy and Litigation Collide

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§ 1.01 Introduction

Long before litigation, there is a commercial relationship that involves the risk that an obligor or counterparty may become insolvent. Taking steps to minimize such risks when interacting with a financially-distressed entity is of particular importance in today's current energy market. The key to successful mitigation of risks and litigation is in anticipating potential issues resulting from troubled financial times and addressing those problems as proactively as possible. As detailed herein, there are several ways to avoid undesirable consequences through various means both inside and outside of the bankruptcy process.

§ 1.02 Impact of Bankruptcy Cases on Litigation Initiated Prior to the Bankruptcy Case

Parties should carefully assess risk and plan accordingly when a litigation opponent is at risk of bankruptcy. Bankruptcies can affect not only the collectability of a judgement, but also the timing, venue, procedural rules, and even substantive issues.

[1] The Automatic Stay

As an initial matter, a key risk in any litigation is that an opponent will file for bankruptcy and the automatic stay will prevent the exercise of the non-debtor party's rights and remedies. Specifically, upon a debtor's bankruptcy filing, the automatic stay – a statutory injunction imposed by the Bankruptcy Code – prohibits non-debtor parties from taking any action to collect a pre-bankruptcy debt or to exercise control over the debtor's property, including the exercise of remedies under contracts with the debtor.[1] This injunction includes the commencement or continuation of litigation against the debtor. The fact that the automatic stay is effective on the date that the debtor files its petition—the "Petition Date"—is of critical importance. The stay is likewise effective regardless of whether the counter-parties are aware of it.

[1] 11 U.S.C. § 362.

Among other things, the automatic stay also temporarily halts any ongoing litigation against the debtor, as well as efforts to perfect a judgment lien. Upon notice of a bankruptcy case or the filing of a suggestion of bankruptcy, parties should immediately refrain from taking any action in ongoing litigation—filing motions, seeking discovery, filing responses, *etc.*—until the court has either lifted or modified the automatic stay to allow the litigation to continue. Any action taken in violation of the automatic stay is not only voidable, but it may also subject the party to sanctions.[2] Thus, the automatic stay can wreak havoc on the timing of litigation by, at the very least, slowing it down considerably.

The automatic stay can also substantially increase the cost of litigation. Not only will the parties incur the regular cost of litigation, but the automatic stay can add the cost of additional motion practice and a contested evidentiary hearing to lift or modify the automatic stay. Debtors often use the threat of this additional cost to gain negotiating leverage. Thus, if a party is concerned that its litigation opponent is a bankruptcy risk, the party should consider the potential added cost of obtaining relief from the automatic stay when budgeting for the lawsuit.

[2] Pre-Bankruptcy Settlement Agreements

Parties should also consider potential risks associated with executing a settlement agreement with a party that is at risk of bankruptcy. Depending on what was executed, such settlements can be avoided and any benefits clawed back as a fraudulent transfer or preference *even if* the settlement was entirely in good faith and has been fully performed.

For example, a court might undo a transaction if the transaction is a so-called "fraudulent transfer." Under section 548 of the Bankruptcy Code, a bankruptcy trustee (or debtor-in-possession):

> may avoid any transfer . . . of an interest of the debtor in property . . . that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
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> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
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> (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
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> (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
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> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

[2] *See* 11 U.S.C. § 362(k)(1) (an individual injured by any willful violation of a stay may "recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages").

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[3]

Subsection (A) is referred to as the "actual fraud" provision, while subsection (B) is referred to as the "constructive fraud" provision. Notably, a good faith business transaction. Including a settlement agreement, may be avoided as constructively fraudulent even if there is no bad faith or actual fraud involved in the transaction. Furthermore, a bankruptcy trustee can also use state fraudulent transfer actions to avoid transfers, which might, among other things, provide a longer statute of limitations.[4] Thus, even transactions that were fully performed years before a bankruptcy may be at risk and unfortunately, the better the settlement was for the non-debtor party, the more likely that such settlement will be challenged or avoided. Debtors and creditors are also keen to challenged pre-bankruptcy settlements in order to gain negotiating leverage over the non-debtor settlement parties, even where it is unlikely that the transaction would actually be avoided.

In addition to fraudulent transfers, settlement agreements may also be challenged as preferences. Under § 547(b), a bankruptcy trustee or debtor-in-possession can avoid any transfer of the debtor's property if: (1) the transfer was to a creditor on account of a pre-existing debt, (2) the debtor was insolvent at the time of the transfer (which is presumed if the transfer occurred within 90 days of the commencement of the case), (3) the transfer occurred within 90 days before the bankruptcy filing (or within a year for transfers to insiders), and (4) the transfer enabled the creditor to receive a larger share of the estate than if the transfer had not been made.[5] Preference actions are subject to a number of defenses, including providing new value in exchange for the payment and transfers made in the ordinary course of the debtor and transferee's business according to ordinary business terms.[6] Nevertheless, it can be costly to prove an affirmative defense, and, as with fraudulent transfer actions, other parties often use this cost to obtain negotiating leverage over the non-debtor party. Accordingly, parties should consider this risk when negotiating settlements with parties that are at risk of bankruptcy.

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[3] 11 U.S.C. § 548(a)(1).

[4] Bankruptcy Code section 544(b), often referred to as the "strong-arm power," allows a trustee to avoid transfers using any "applicable law"—such as state avoidance laws like TUFTA. *See, e.g., In re Pace*, 456 B.R. 253, 265 (Bankr. W.D. Tex. 2011); *Anderson v. Mega Sys., L.L.C. (In re Mega Sys., L.L.C.)*, 2007 WL 1643182, at *9, 2007 Bankr. LEXIS 1957, at *24 (Bankr. E.D. Tex. June 4, 2007) (citation omitted) ("Section 544 of the Bankruptcy Code allows the trustee to step into the shoes of a creditor for the purpose of asserting causes of action under state fraudulent conveyance laws and confers on the trustee the status of a hypothetical creditor or bona fide purchaser as of the commencement of the case."); *see also ASARCO LLC v. Americas Mining Corp*., 404 B.R. 150, 156 (S.D. Tex. 2009) ("Trustees and debtors in possession use § 544(b) as a conduit to assert state-law-based fraudulent-transfer claims in bankruptcy"); *Stalnaker v. DLC, Ltd. (In re DLC, Ltd.)*, 295 B.R. 593, 601 (8th Cir. BAP 2003) ("Section 544(b) of the Bankruptcy Code gives the bankruptcy trustee whatever avoiding powers an unsecured creditor with an allowable claim might have under applicable state or federal law.").

[5] *See, e.g.*, *Liberty Mut. Ins. Co. v. Holloway*, 556 Fed. Appx. 299, 302 n. 4 (5th Cir. 2014).

[6] *See* 11 U.S.C. 547(c).

[3] Removal, Venue, and Jurisdiction

[a] Removal

Outside of bankruptcy, parties may carefully choose to file a lawsuit in a preferred venue that is convenient for witnesses and lawyers, has favorable judges or a sympathetic jury pool, *etc*. This careful planning can be upended if a litigation counterparty files bankruptcy, however.

Bankruptcy courts have extraordinarily broad personal and subject matter jurisdiction to hear any issue that arises in, arises under, or is even related to a bankruptcy case.[7] Virtually any litigation against a debtor will relate to a bankruptcy case, because any monetary judgment (and many non-monetary judgments) will impact the available assets a bankruptcy estate has to distribute to creditors.[8]

Moreover, given the broad jurisdiction of bankruptcy courts, parties can remove existing litigation to the bankruptcy court pursuant to 28 U.S.C. § 1452(a), which provides:

> A party may remove any claim or cause of action in a civil action other than a proceeding before the United States Tax Court or a civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.[9]

An alternative to the automatic stay is to seek removal under 28 U.S.C. 1452. This remedy is available to all parties, not just debtor parties.[10] Rule 9027 of the Federal Rules of Bankruptcy Procedure governs the procedure for removal and remands. It also sets the deadlines for filing a notice of removal. Many cases that are ongoing before a bankruptcy case may be removed to the bankruptcy court where the judge may not be as sympathetic. And while a bankruptcy judge can remand the case back to the original venue "on any equitable ground"[11]—including for the convenience of the parties, the efficient administration of justice, *etc.*—parties should at least be prepared for the risk that the bankruptcy judge rules against remand. A decision not to remand can substantially increase costs, especially where litigation was relatively far along, as the parties will need to start over and educate the bankruptcy judge on issues with which the prior judge was already familiar.

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[7] *See* 28 U.S.C. § 1334(b) ("Except as provided in subsection (e)(2), and notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.").

[8] *See, e.g.*, *In re Wood*, 825 F.2d 90, 93 (5th Cir. 1987) (holding that claims are "related to" a debtor's bankruptcy case for jurisdictional purposes if such claims "could conceivably have [an] effect on the [Debtor's] estate").

[9] 28 U.S.C. § 1452(a).

[10] *See, e.g.*, 28 U.S.C. 1452 ("A **party** may remove any claim or cause of action in a civil action") (emphasis added); *Shared Network Users Group, Inc. v. WorldCom Techs., Inc*., 309 B.R. 446, 449 (E.D. Pa. 2004) ("Unlike § 1446, any party including a plaintiff may remove an action under § 1452.").

[11] 28 U.S.C. § 1452(b).

If a case is removed to bankruptcy court, and the court refuses to remand it back to the original court, parties will also be subject to the federal rules of bankruptcy procedure and federal rules of evidence, which may differ from the procedural and evidentiary rules in the original case. Parties should consider the effects of the differences in the rules on their litigation strategy.

[b] Stern Claims

One of the most confusing issues for many clients is the treatment of so-called "Stern Claims"—*i.e.* claims that bankruptcy judges are constitutionally prohibited from determining on a final basis (absent the consent of the parties) despite specific statutory authorization to do so. While the full treatment of such claims is beyond the scope of this article, a brief discussion will help parties identify key risks.

In summary, certain types of claims that rely primarily on state-law—such as fraudulent transfer claims brought under state statutes such as TUFTA and breach of fiduciary duty claims—are classified as "core" claims under 28 U.S.C. §§ 157(b)(1). Congress has authorized bankruptcy courts to finally adjudicate such claims.[12] However, in a landmark decision, the United States Supreme Court held that it was unconstitutional for bankruptcy judges to issue binding opinions on such claims, which were soon called "Stern Claims," because bankruptcy judges are not appointed for life like other so-called "Article III" district court judges.[13] When dealing with such claims, bankruptcy judges are only allowed to issue non-binding findings of fact and conclusions of law, which are reviewable *de novo* by district courts unless, as clarified by the Supreme Court in a later case, the parties consent to allow the bankruptcy judge to issue a final ruling.[14]

The *Stern* and *Wellness* opinions have caused all kinds of issues for parties litigating against bankrupt debtors. For instance, expensive litigation can ensue regarding whether a particular claim is or is not a "Stern Claim" in the first place. Further, once a claim is designated as a "Stern Claim," if any party does not consent to final adjudication, the litigation will likely need to be tried twice: once in front of the bankruptcy judge who will issue a non-binding ruling, and again in front of a district court who will review the issues *de novo*. Thus, there could be twice the litigation costs, as well as the risk of the losing party getting two bites at the apple. Parties should consider such risks when planning a litigation strategy.

[4] D&O Policies

Directors and officers ("D&Os") of financially distressed companies often face litigation and the risk of personal liability. In connection with the operation of a struggling company, D&Os must make numerous difficult decisions, which may be scrutinized and second-guessed after a bankruptcy filing. In particular, bankruptcy trustees and unsecured creditor committees looking for post-bankruptcy recoveries often scrutinize such decisions. As such, the treatment of D&O policy proceeds within a bankruptcy case is another issue that parties should carefully

[12] 28 U.S.C. §§ 157(b)(1).

[13] *See generally Stern v. Marshall*, 564 U.S. 462, 131 S. Ct. 2594, 180 L. Ed. 2d 475 (2011).

[14] *See generally Wellness Intern. Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 191 L. Ed. 2d 911 (2015).

consider. While the policy itself is likely property of the bankruptcy estate, the proceeds may be treated differently. In particular, where a D&O policy covers only directors and officers, as opposed to also covering the company for indemnity to the directors and officers or for liability against the company for the directors' and officers' actions (such as for securities claims), the proceeds are generally *not* considered property of the estate.[15] In such situations, the automatic stay would not apply and directors and officers could access insurance proceeds for use in the defense of claims.

On the other hand, courts are split regarding the proceeds of policies that cover not only the officers and directors, but also the company itself. For such policies, an argument can be made that any amount paid to the directors and officers limits the potential proceeds payable to the estate, and therefore, the estate has an interest in the proceeds such that the automatic stay will apply.[16] In such a situation, directors and officers would need to seek to lift or modify the automatic stay to access any proceeds for payment of legal fees or otherwise. And while courts have generally granted requests to use proceeds to pay legal fees, subject to various conditions,[17] there is at least some risk that the delay or limits imposed by the courts can pose substantial risks for directors and officers.

§ 1.03 Managing Counterparty Risks Related to Distressed Oil & Gas Entities

[1] General Principles

In order to mitigate counterparty risks prior to litigation or bankruptcy, understanding what might happen to a contract within the bankruptcy process is helpful. Parties face several challenges when their contract counterparty files for bankruptcy relief. In addition to the imposition of the automatic stay discussed above, a bankruptcy filing may allow a debtor to alter "executory contracts" and "unexpired leases" as provided in Section 365(a) of the Bankruptcy Code. Thus, not only may a party's rights be suspended by the automatic stay, the rights and remedies available to such party may be drastically changed during the bankruptcy process.

[a] Treatment of Executory Contracts and Unexpired Leases in Bankruptcy Cases

[i] Threshold Issue – Is a Contract an "Executory Contract" or "Unexpired Lease?"

Executory contracts can be a highly litigated area in bankruptcy. Whether a contact is an "executory contract" or "unexpired lease" may have a wide-ranging impact on its treatment within a bankruptcy case and many times will determine if litigation ensues. Executory contracts and unexpired leases are subject to Bankruptcy Code section 365, which, as described in more detail below, may allow a debtor to assume, assume and assign, or reject such contract.[18] On the

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[15] *See, e.g., In re Louisiana World Exposition, Inc.*, 832 F. 2d 1391, 1399 (5th Cir. 1987); *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 513 (Bankr. D. Del. 2004).

[16] *See, e.g., In re CyberMedica, Inc.*, 280 B.R. 12, 17 (Bankr. D. Mass. 2002); *In re Eastwind Group, Inc.*, 303 B.R. 743 (Bankr. E.D. Pa. 2004).

[17] *See, e.g., In re Arter & Hadden, LLP*, 335 B.R. 666 (Bankr. N.D. Ohio 2005).

[18] 11 U.S.C. § 365.

other hand, non-executory contracts and contracts that are not treated as unexpired leases may not be assignable or rejectable.

Although the term "executory contract" is not defined in the Bankruptcy Code, most courts, including the Fifth Circuit, generally hold that an "executory contract" is a contract under which the obligations of both the debtor and the non-debtor counterparty are so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.[19] Stated differently, "[u]nless both parties have unperformed obligations that would constitute a material breach if not performed, the contract is not executory under § 365."[20] Notably, Section 365 of the Bankruptcy Code applies only to contracts and leases in effect as of the bankruptcy filing date.[21]

Furthermore, while the term "unexpired lease" seems straightforward, whether an oil and gas "lease" is treated as an unexpired lease actually depends on non-bankruptcy law and therefore differs based on where the lease is located.

Counterintuitively, the nature and classification of the rights created or conveyed by an oil and gas lease is a matter of non-bankruptcy law.[22] In almost all hydrocarbon producing states, an oil, gas, and/or mineral lease conveys a real property interest to the lessee.[23] In such states, an oil and gas lease creates a presently vested interest in real property that is *not* subject to Section 365 of the Bankruptcy Code even if the parties call the agreement a "lease."

On the other hand, oil and gas leases are treated as "unexpired leases" in certain states, which means they can be assumed, assumed and assigned, or rejected pursuant to Bankruptcy Code section 365.[24] Accordingly, determining whether the oil and gas "lease" is an actual lease for purposes of section 365 is critical and, depending on the jurisdiction and sophistication of counsel, may or may not be a litigated issue.

[ii] Twilight Zone

As described below, a debtor is eventually required to make a decision as to whether to assume, assume and assign, or reject executory contracts and unexpired leases. Before this

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[19] *NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (U.S. 1984); *In re Murexco Petroleum, Inc*., 15 F.3d 60, 63 (5th Cir. 1994); *Sharon Steel Corp. v. National Fuel Gas Distrib. Corp.,* 872 F.2d 36 (3d Cir. 1989).

[20] *See In re Columbia Gas Systems, Inc.,* 50 F.3d 233 (3d Cir. 1995). This definition of an executory contract, referred to as the "Countryman test," was first articulated by, Professor Vern Countryman in his article, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439 (1974), and became part of the Bankruptcy Code's legislative history. H.R. REP. No. 95-595, 95th Cong., lst Sess. 347 (1977).

[21] 11 U.S.C. § 365(c).

[22] *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).

[23] *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).

[24] *See, e.g.*, *UTICA Nat'l Bank & Trust Co. v. Marney*, 661 P.2d 1246, 1248 (Kan. 1983) (holding that an oil and gas lease is personal property, not real property, under Kansas law); *In re J. H. Land & Cattle Co*., 8 B.R. 237, 239 (W.D. Okla. 1981) (finding that under Kansas law, an oil and gas lease is within the reach of Bankruptcy Code § 365 and may be rejected by a debtor with court approval).

decision, however, a question that often arises is what rights and obligations each party has during the period after the petition date (which triggers the automatic stay) but before the debtor has made its choice.

For a non-debtor party, the answer is unfortunately that the debtor may force the non-debtor to perform while the debtor is in this so-called "twilight zone" *even if* the debtor has breached the contract or lease and has not yet cured the breach or provided adequate assurance of future performance.[25] And despite criticism,[26] the debtor is relieved of the duty to perform while in the "twilight zone."[27] To compound this risk, in a typical 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.[28] Thus, the "twilight zone" is not necessarily a short period.

To mitigate such risk, a non-debtor counterparty may, in appropriate cases, seek to shorten the time period for a debtor to assume or reject an agreement.[29] Acceleration of the debtor's time period to assume or reject an agreement may force a debtor to assume a contract that is necessary to the debtor's operations. Most bankruptcy courts, however, will be reluctant to force a debtor to prematurely assume an executory contract (and pay the attendant cure claims) if the value of the contract to the debtor's estate or the outcome of the case is uncertain. This strategy nevertheless represents the best option for many non-debtor counterparties to mitigate the twilight zone risk.

[iii] Assumption of Executory Contracts and Unexpired Leases

A debtor may be able to assume executory contracts or unexpired leases with beneficial terms *even if* the debtor has breached the contract or lease agreement.[30] A debtor's power to do so is limited and many times can be the genesis of litigation.

As an initial matter, the debtor's decision to assume an executory contract or unexpired lease will generally be upheld if it is a proper "business judgment"—i.e. the contract or lease is valuable to the debtor.[31] Further, however, if the debtor has breached the contract or lease, the debtor is also required to "cure" such defaults, or provide adequate assurance that they will promptly cure such defaults, before they will be allowed to assume the contract.[32] To assume a

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[25] *See, e.g.*, *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984); *United States* ex rel. *U.S. Postal Serv. v. Dewey Freight Sys, Inc.*, 31 F.3d 620, 624 (8th Cir. 1994); U*niv. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1075 (3d Cir. 1992); Inte*rstate Gas Supply, Inc. v. Wheeling Pittsburgh Steel Corp. (In re Pittsburgh-Canfield Corp.)*, 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002).

[26] Rhett G. Campbell, A Survey of Oil and Gas Bankruptcy Issues, 5 Tex. J. Oil Gas & Energy L. 265, 303-04 (2010) (calling this interpretation of the law "harsh" and "improper").

[27] *See In re Mirant Corp.*, 303 B.R. 319, 328 (Bankr. N.D. Tex. 2003); *Krafsur v. UOP (In re El Paso Refinery, L.P.)*, 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996).

[28] *See* 11 U.S.C. § 365(d)(2).

[29] 11 U.S.C. § 365(d)(2); *Texas Importing Co. v. Banco Popular de Puerto Rico*, 360 F.2d 582, 583 (5th Cir. 1966).

[30] *See generally* 11 U.S.C. § 365.

[31] *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1309 (5th Cir. 1985) ("business judgment" test for decisions to accept or reject executory contracts).

[32] 11 U.S.C. §§ 365(b)(1)(B) and (C); *In re Rare Earth Minerals*, 445 F.3d 359, 362 (4th Cir. 2006).

contract, a debtor is also required to provide "adequate assurance" that the debtor will be able to perform the obligations under the contract after assumption.[33] Thus, for example, a debtor left with insufficient capital to make lease payments on an ongoing basis should not be allowed to assume the contract. One final requirement is that the debtor must assume the entire contract or lease; the debtor cannot assume a contract or lease piecemeal or "cherry-pick" the most favorable provisions of the contract or lease while rejecting the unfavorable provisions.[34]

Thus, counterparties face various risks related to the assumption of contracts, including, (a) being forced to continue to work with a debtor who has previously breached an agreement and in doing so impaired the relationship between the parties, (b) facing ongoing feasibility concerns with the reorganized debtor, and/or (c) being required to work with a new management team of a reorganized debtor with whom the counterparty is not familiar. Each of these risks should be considered in advance by counterparties of potentially insolvent debtors.

[iv] Assumption and Assignment of Executory Contracts and Unexpired Leases

A debtor also has the extraordinary power to assume a contract that they have previously breached. A debtor may even be able to assign an executory contract or unexpired lease *despite* an express contractual provision prohibiting such assignment.[35] Bankruptcy, therefore, interposes the risk that a debtor will assume and assign a contract without needing the consent of the contract counterparty. 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.

Similarly, a debtor may be able to assume or assume and assign an executory contract or unexpired lease despite a provision within the contract prohibiting a change of control. For example, a contract may prohibit a party from changing ownership and/or management. Yet, through the bankruptcy process, a reorganizing debtor may change both ownership and management, and force the counterparty to accept performance from the newly controlled entity through the use of Bankruptcy Code section 365.

To assume and assign a contract, the debtor must first cure any prior breaches and provide adequate assurance that the assignee will perform in the future. Accordingly, substantial litigation may result if a debtor attempts to assign a contract to a party that is not qualified to perform, and counterparties should carefully analyze the credentials of an assignee.

[v] Bankruptcy Claims for Rejection of Executory Contracts and Unexpired Leases

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[33] 11 U.S.C. §§ 365(b)(1)(B) and (C); *In re Rare Earth Minerals*, 445 F.3d 359, 362 (4th Cir. 2006).

[34] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984); *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985) (the debtor must accept the contract as a whole); *In re Foothills Texas, Inc.,* 46 B.R. 143,153 (Bankr. D. Del. 2012) (As a general rule, the decision to assume or reject a contract "is an all-or-nothing proposition.").

[35] *See* 11 U.S.C. § 365(f).

If a contract or unexpired lease is not necessary for the debtor's continued operations, or for the debtor to realize value from its assets in connection with a sale, the debtor may reject the contract and the affected creditor's cause of action for breach of contract will relate back to the date immediately preceding the filing of the debtor's bankruptcy petition.[36] As such, a claim arising from the rejection of a lease is treated as a "pre-bankruptcy" claim that must be presented and allowed through the normal claims administration process.[37] If the contract or unexpired lease is secured by a valid, perfected lien, the claim may be treated as secured.[38] Otherwise, the claim will be a general unsecured claim that could be paid pennies on the dollar.[39]

The debtor is usually given deference in its choice to reject contracts it believes to be unnecessary or onerous.[40] As long as the decision to reject the contract or unexpired lease is a proper "business judgment," the bankruptcy court is likely to uphold a debtor's decision to reject the contract or lease.[41] For counterparties that have secured favorable contracts with the debtor before bankruptcy, there will be a substantial risk that the debtor will reject such contract and/or attempt to renegotiate it on more favorable terms. Thus, a counterparty to a potentially insolvent debtor should, if possible, attempt to mitigate this risk by considering whether the counterparty can obtain similar goods or services from a source other than the debtor in the event that the contract is rejected.

[b] Setoff, Tri-Party Netting, and Recoupment

[i] Setoff

In many cases, counterparties to oil and gas agreements will have reciprocal payables and receivables owed and owing to each other. For example, an operator-debtor may owe a non-operating counterparty for production sold on the non-operating counterparty's behalf, while the non-operating counterparty may owe the operator-debtor for unpaid JIBs.

A right of setoff is analogous to a security interest[42] 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 before the commencement of the bankruptcy case.[43] The Bankruptcy Code does not create a right of setoff;

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[36] 11 U.S.C. § 365(g), 502(g).

[37] *In re Continental Airlines*, 981 F.2d 1450, 1459 (5th Cir. 1993).

[38] *Id.*

[39] *Id.*

[40] *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1309 (5th Cir. 1985) (courts apply the "business judgment" test for decisions to accept or reject executory contracts).

[41] *Id.*

[42] 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).

[43] *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

rather, it merely preserves setoff rights created under applicable non-bankruptcy law and then only to the extent that the conditions of Bankruptcy Code section 553 have been satisfied.[44] Thus, the threshold determination in every case involving Bankruptcy Code section 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.[45] The automatic stay, however, prevents a contract counterparty from offsetting an account payable against an account receivable in the absence of modification of the automatic stay.[46]

[ii] Tri-Party Netting Agreements

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.[47] 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. Unfortunately, many clients do not realize that such agreements may not be enforced 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.[48] 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.[49] 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

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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).

[44] *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").

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

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

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

[48] *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)).

[49] *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.'").

circumstances.[50] 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 "mutuality," setoff is not allowed between three parties, even if the other parties are affiliates of each other—e.g. A owes B $500 and C (B's subsidiary) owes A $400—and even if the parties contractually agree to offset non-mutual debts.

For example, in *In re Semcrude, L.P.*,[51] 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).[52] 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 ***and their affiliates***.[53]

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."[54] 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.[55]

The court also held that it did not matter that Chevron and the other parties had contractually agreed to triangular setoffs.[56] 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

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[50] *See, e.g. In re Semcrude*, 399 B.R. at 394.
[51] 399 B.R. 388, 393 (Bankr. D. Del. 2009), *aff'd* 428 B.R. 590 (D. Del. 2010).
[52] *Id.* at 392.
[53] *Id.* at 391.
[54] *Id.* at 392–93.
[55] *Id.* at 393–94.
[56] *Id.* at 397.

agreement."[57] Thus, the court held that private agreements cannot confer mutuality on non-mutual debts.[58]

[iii] Recoupment

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.[59] Thus, recoupment is more narrowly applied.[60] Recoupment is not subject to the automatic stay.[61] 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.

[2] The Most Common Types of Oil & Gas Contracts Involved in Bankruptcy Litigation

[a] Operating Agreements – Operator's Liens

Most operating agreements involve various material ongoing obligations by each party. For example, the operator usually has ongoing obligations to operate the mineral leases, to collect and distribute production proceeds, to bill and collect JIBs, *etc.*, while non-operators often have ongoing material obligations to pay JIBs, not to interfere with operations, to indemnify the operators in certain situations, *etc.* Accordingly, operating agreements are typically considered "executory contracts" subject to Bankruptcy Code section 365.[62]

As executory contracts, operating agreements present numerous litigation risks to counterparties. First, during the twilight zone, counterparties may be required to perform while the debtor is temporarily relieved from performance. For instance, operators frequently make advances, on behalf of non-operators, for both capital expenditures and lease operating expenses. Upon the bankruptcy of a non-operator, claims for both capital expenditure amounts and for unpaid lease operating expenses may be pre-petition claims against the non-operator debtor that are uncollectible during the twilight zone period.

Operators, on the other hand, often market hydrocarbons for the non-operators, in which case the non-operator takes on the credit risk of the operator-debtor. In that circumstance, the operator's bankruptcy may result in the non-operators being left with mere claims for hydrocarbons that have been produced and sold before the bankruptcy case. Indeed, litigation can ensue over whether prepetition amounts owed by an operator-debtor to non-operating

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[57] *Id.* at 394.

[58] *Id.* at 397.

[59] *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).

[60] 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).

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

[62] *Wilson v. TXO Prod. Corp. (In re Wilson)*, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987).

working interest owners are property of the estate, subject to a mere claim by the non-operating party, or whether such amounts are held in trust by the debtor-operator, such that they are subject to immediate turnover to the non-operators.

Similarly, where a lease can be terminated for non-payment of royalties, an operator-debtor will often seek permission to pay prepetition amounts owing to royalty owners in order to avoid forfeiture of valuable leases. Accordingly, operator-debtors that intend to ultimately cure any pre-petition breaches in order to assume or assume and assign operating agreements often move for permission to pay pre-petition amounts owed to non-operating working interest owners and royalty owners and courts frequently grant such requests.[63] Indeed, this issue is so widely accepted and routine that the Bankruptcy Court for the Southern District of Texas instituted a local rule that requires debtors to segregate funds that may be due to working interest owners, royalty owners, or others in order to protect counterparties and further promote the efficient processing of oil and gas debtor businesses in Chapter 11.[64]

Beyond the twilight zone, counterparties run the risk that an operator-debtor could assume an operating agreement despite a prior breach of such an agreement. Or, an operator-debtor could attempt to assign an operating agreement to a party that is not qualified to operate the properties. If the bankruptcy court approves the assignment, not only is there a risk of reduced revenues, but there could also be an increased risk that the new operator will operate the property poorly and incur substantial environmental remediation liabilities. Operating agreement counterparties should therefore carefully consider the proposed treatment of such operating agreements to ensure that any prior breaches are promptly cured and any assignees are capable of performing in the future.

Another risk is that the operating agreement could be rejected. Post-rejection, the working interests are not eliminated, but the operation of the properties may be governed by the laws of co-tenancy rather than the more specific provisions of the operating agreement.[65] Both operators and non-operators often face substantial credit risk related to a rejected operating agreement. To reduce this risk, the terms of a joint operating agreement ("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

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[63] *See, e,g. In re Parallel Energy LP*, Dkt. No. 84, Case No. 15-12263 (KG) (Bankr. D. Del. Dec. 2, 2015); *In re Endeavour Operating Corp.*, Dkt. No. 147, Case No. 14-12308 (Bankr. D. Del. Nov. 6, 2014); *In re Memorial Production Partners LP*, No. 17-30262 (MI) (Bankr. S.D. Tex. Jan. 23, 2017) [Dkt. No. 120]; *In re Duer Wagner III Oil & Gas LP*, Dkt. No. 146, Case No. 15-41961 (Bankr. N.D. Tex. Aug. 13, 2015); *In re Sabine Oil & Gas Corp*., Case No. 15-11835 (Bankr. S.D.N.Y. July 16, 2016).

[64] *See* Procedures for Complex Chapter 11 Cases for the United States Bankruptcy Court for the Southern District of Texas § 7(B) ("**Postpetition treatment of royalty, suspense accounts, and other accounts containing funds attributable to third parties.** All funds received after the petition date that are attributable to an overriding royalty, working interest owner and third party funds shall be maintained by the debtor in a segregated account so designated. Proceeds to which claims under § 9.343 of the Texas Business and Commerce Code may attach may be subject to the Court's order regarding use of cash collateral. Purchasers who purchase from a First Purchaser (as defined in § 9.343) in the ordinary course of business may make payment into a cash collateral account in satisfaction of § 9.343 and discharge any continuing lien on severed mineral. Any lien that would have otherwise attached shall attach to proceeds so deposited into the cash collateral account.").

[65] *Wilson v. TXO Prod. Corp. (In re Wilson)*, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987).

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.

Merely obtaining such a lien, however, will not offer any protection in bankruptcy unless the lien is also perfected before the petition date. 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,[66] 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.[67] Once an unperfected lien or security interest is avoided, the counterparty 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.[68] 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.

To ensure the enforceability and priority of operating liens and security 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.[69] If a Contract Area under an operating agreement is located in two or more counties, parties should record the memorandum in all applicable counties. For further protection, parties should also file a UCC-1 with the Secretary of State of the operating agreement counterparty's state of incorporation.

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

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[66] *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).

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

[68] 11 U.S.C. § 362(a)(4) (staying any act to create, perfect, or enforce any lien).

[69] *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] 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.").

each affiliated debtor will file its own bankruptcy case with each debtor being treated as separate for purposes of, among other things, distributions to creditors.[70]

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.[71] 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.

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.[72] These liens may be perfected by filing a land-record filing that shows the unit approval and the participation of particular leases or interests.[73]

Another way to mitigate litigation and potential credit risk involves statutory liens, often called mechanic's and materialman's liens, that are granted to contractors who furnish labor and materials that are used in the drilling of oil and gas wells.[74] These liens, discussed in greater detail in section 1.03(2)(b), are often independent of, and can be obtained in addition to, other liens such as contractual liens granted in operating agreements.[75] Some states expressly extend such liens to protect operators, even if they do not provide physical labor or materials.[76] Unlike

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[70] *In re Fernandes*, 346 B.R. 521, 522 (Bankr. D. Nev. 2006).

[71] *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).

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

[73] *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).

[74] Many states provide such liens. For example, such a lien is provided in Oklahoma (42 O.S. § 144), Louisiana (La. Rev. Stat. Ann. § 9:4862), and Mississippi (MS. Code Ann. § 85-7-131).

[75] *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).

[76] *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 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

contractual liens, the perfection of a statutory lien is not subject to the automatic stay.[77] Thus, operators should check to see whether state law extends protection to them as this may offer some protection to operators that failed to perfect their contractual lien before the petition date.

Finally, because operators and non-operators often have mutual debts, parties to operating agreements may be able to mitigate litigation and credit risk through setoff and recoupment, which are described in detail in section 1.02(1)(b).

[b] Service Contracts – Mechanics and Materialmen's Liens

Parties that provide goods and services to a potentially insolvent debtor face substantial risks as well. However, 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.[78] These liens are often independent of, and can be obtained in addition to, other liens such as contractual liens granted in operating agreements[79] 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.[80]

Most states impose a number of technical requirements for the perfection of a mechanic's and materialman's lien.[81] If the statutory prerequisites are not met, the holder typically will be a

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of each nonoperator in the drilling, completion, recompletion, reworking or other operations of the oil and gas well.").

[77] 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).

[78] 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).

[79] *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).

[80] *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 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.").

[80] 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).

[81] 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.

general 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.[82] Thus, the beneficiary of a statutory lien may perfect its mechanic's and materialman's liens even after the bankruptcy petition is filed.

[c] Oil and Gas Sales Contracts – 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,[83] Oklahoma,[84] New Mexico,[85] and Louisiana,[86] 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.[87]

To discuss the perfection of each various producer's lien is beyond the scope of this article, but some discussion is helpful. For example, some producer's liens are automatically perfected;[88] 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…."[89] The lien terminates if the notice is not timely filed, and if timely filed, the lien expires one year after the date of the filing of the notice unless an action to enforce the lien is begun.[90]

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, in the *Semcrude* decision, 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.[91] The lower priority resulted in the loss of approximately $57 million to the Texas owners' interest in the oil and gas proceeds. Thus, 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.

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[82] 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).

[83] Tex. Bus. & Comm. Code § 9.343.

[84] 52 O.S. § 549.1.

[85] N.M. Stat. Ann. § 48-9-1.

[86] La. C.C. Art. 3227.

[87] 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.

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

[89] N.M. Stat. Ann. § 48-9-5.

[90] N.M. Stat. Ann. § 48-9-5.

[91] *In re SemCrude, L.P.*, 407 B.R. 140 (Bankr. D. Del. 2009).

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.[92] The sole exception to this grant of priority is a permitted lien.[93] 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."[94] 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, despite the protection purportedly offered under Oklahoma law, producers should still file a UCC-1 in the state of incorporation of the purchaser of the production.

Another issue commonly arising in the context of oil and gas sales contracts is the unenforceability of tri-party master netting agreements, as described in detail in section 1.02(1)(b)(ii). Since it was decided, a number of courts have expressly agreed with the analysis in *SemCrude*.[95] While it is clear that tri-party offsetting is generally not allowed in the Fifth Circuit,[96] the Fifth Circuit has not weighed in on whether tri-party offsetting will be enforced when the parties have expressly contracted to do so.[97] Nevertheless, despite the fact that the

[92] 52 O.S. § 549.7.

[93] 52 O.S. § 549.7.

[94] 52 O.S. § 549.2(11)(b).

[95] *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).

[96] *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.'")

[97] *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.").

Fifth Circuit has not yet ruled on this issue, it is likely that courts in the Fifth Circuit will follow the clear trend that prohibits contractual tri-party offsetting in bankruptcy. Thus, clients should be aware that master netting agreements may not be enforced if a counterparty files for bankruptcy.

[d] Purchase and Sale Agreements – Contingent Claims

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. Before consummation, a purchase and sale agreement is almost certainly an executory contract subject to rejection by the bankrupt debtor.[98] 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.[99] 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 debtor. For example, a buyer may have outstanding indemnity obligations (*e.g.*, for plugging 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.[100] 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.

Predecessors-in-title that are parties to a fully consummated purchase and sale agreement may also be jointly and severally liable for plugging and abandonment or other remediation obligations. 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.[101] Therefore, the issue often arises as to whether a debtor may exercise its "abandonment" power to abandon property burdened by regulatory obligations.

[e] Plugging and Abandonment Claims

Several state or federal obligations that may arise at the end of an oil or gas well's useful life.[102] Such obligations include "plugging" of the well and removal of facilities from the site and are defined as "plugging and abandonment" ("P&A") or "decommissioning activities"

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[98] *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).

[99] FED. R. BANKR. P. 3002(c).

[100] 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).

[101] 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.

[102] *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.

pursuant to 30 CFR § 250.1700*, et. seq*. Moreover, to protect the United States from incurring a financial loss, the Department of the Interior 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.[103]

Bankruptcy 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.[104] Moreover, the Fifth Circuit has held that P&A liabilities are 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.[105]

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 for—are satisfied by the operator or assumed by any successor.

[f] Farmout Agreements

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.[106] 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.[107] 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 distinction 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

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[103] 30 CFR § 256.52. The United States requires supplemental bonds for costs associated with specific oil and gas facilities, abandonment and site clearance.

[104] *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. 579.

[105] *Texas v. Lowe (In re H.L.S. Energy Co.),* 151 F.3d 434, 437 (5th Cir. 1998).

[106] 11 U.S.C. § 541(b)(4).

[107] *See In re Resource Technology Corp.*, 254 B.R. 215, 222 n.2 (Bankr. N.D. Ill. 2000).

bankruptcy.[108] 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: (1) 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 (2) 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 "pass through" the bankruptcy case with a reduced risk of impairment of its pre-bankruptcy contractual rights..

[g] Gathering Agreements

A recent issue that has been the subject of bankruptcy litigation and had wide-ranging effects across the oil and gas industry is the treatment of gathering agreements in bankruptcy cases. Many gathering agreements provide that the gatherer has the exclusive right to gather on a particular property and/or that the producer must pay deficiency payments if the amount gathered drops below a certain minimum threshold. Midstream companies often included language in such agreements stating that the agreements "run with the land" (i.e. the real property oil & gas leases), which is intended to ensure that such obligations cannot be rejected in a bankruptcy case.

Whether a covenant "runs with the land" has major implications in a bankruptcy case. For example, under certain circumstances, a debtor can sell real property free and clear of interests in the property.[109] Debtors, however, cannot sell real property free and clear of covenants that run with the real property, and a buyer will be burdened with such covenants.[110] Additionally, while executory contracts can typically be rejected, covenants running with real property interests cannot be rejected even if they are included in executory contracts.[111] The difference in the treatment of the gatherer could be enormous: if the exclusive right to gather does not run with the land, the agreement could be rejected and the gatherer would likely have a mere unsecured claim for damages on account of which they may receive pennies on the dollar. On the other hand, if the exclusive right is a covenant running with the land, the gatherer could enjoin attempts by a debtor to reject the agreement and contract with a new gatherer.

A covenant is a promise respecting the use of real property, which creates either an obligation for an owner of such property to do something on or with the real property (an affirmative covenant, such as a promise to build a fence around the land) or an obligation for an

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[108] 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).

[109] *See* 11 U.S.C. § 363(f).

[110] *See In re* Energytec, Inc., 739 F.3d 215 (5th Cir. 2013) (sale of pipeline was not free and clear of covenants running with pipeline).

[111] *See In re Banning Lewis Ranch Co., LLC*, 532 B.R. 335, 345-46 (Bankr. D. Colo. 2015) (despite rejection, because the agreements in question were of the type that run with the land, they remain valid and enforceable and binding on the debtor's successors-in-interest); *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994) (restrictive covenants are not subject to rejection under section 365).

owner of such property *not* to do something on or with the real property (a negative covenant, such as a promise not to build anything other than a single family residence on the land).[112] A "real covenant" or "covenant that runs with the land" is a covenant that can be enforced not only against the original promisor, but also against the promisor's successors and assigns, and, vice versa, can be enforced not only by the original promisee, but also by the promisee's successors and assigns.[113]

Determining whether a covenant runs with the land is difficult for two reasons. First, the elements are complex, and often turn on minute distinctions. As one professor complained: "[i]n U.S. property law, no rules are more arcane and anachronistic than those governing real covenants."[114] Second, the mere inclusion of language stating that a covenant runs with the land is not conclusive.[115] Rather, regardless of whether an agreement states that a covenant runs with the land, a covenant does not run with the land unless certain elements are met, such as: (1) the covenant "touches and concerns the land;" (2) the covenant relates to a thing in existence or specifically binds the parties and their assigns; (3) the covenant is intended by the original parties to run with the land; and (4) the successor to the burden has notice of the covenant.[116] Texas courts have historically also required horizontal privity—*i.e.* that the covenant is created as part of a conveyance of an interest in the real property that is allegedly burdened with the covenant.[117]

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[112] David Thomas, *How Far Does the Covenant Run? Covenants that Run With the Land in Oil and Gas Transactions*, 53 Rocky Mountain Mineral Law Inst. 19, at 5 (2007).

[113] *Id.*

[114] *Id.* at 3. *See also In re* Sabine Oil & Gas Corp., Case No. 15-11835 (SCC), Transcript of Hearing (the "Sabine Transcript") on February 2, 2016 at 127:2–3 (Bankr. S.D.N.Y.) (stating that in order to determine whether a covenant runs with the land requires the application of "arcane tests").

[115] *See Musgrave v. Brookhaven Lake Property Owners Ass'n*, 990 S.W.2d 386, 395 (Tex. Ct. App. 1999) ("[T]erminology . . . is not dispositive [as to] an obligation intended to run with the land…."); *Clear Lake Apartments, Inc. v. Clear Lake Utilities Co*., 537 S.W.2d 48, 50 (Tex. Civ. App. 1976) (holding that an exclusive agreement to obtain utilities services from a particular company was not a covenant running with the land despite express language in the contract that the covenant "shall constitute covenants running with Said Land…"). *See also In re Jenkins*, 74 B.R. 440, 445 (Bankr. N.D. Ga. 1987) ("[L]anguage in an instrument of conveyance or contract cannot create a covenant running with the land merely by stating that the interest conveyed is such….").

[116] *In re Energytec Inc*., 739 F.3d 215, 221 (5th Cir. 2013) (*citing Inwood North Homeowners' Ass'n v. Harris*, 736 S.W.2d. 632, 635 (Tex. 1987)). Notably, the elements to determine whether a covenant runs with the land depend on state law, and therefore, the elements may vary depending on the state in which the leases are located.

[117] *See* Westland Oil Development Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 910–11 (Tex. 1982); Ehler v. B.T. Suppenas Ltd., 74 S.W.3d 515, 521 (Tex. App.—Amarillo 2002) ("There must also be privity of estate between the parties when the covenant was made."); Wayne Harwell Properties v. Pan American Logistics Center, Inc., 945 S.W.2d 216, 218 (Tex. Ct. App. 1997); Panhandle & S.F. Ry. Co. v. Wiggins, 161 S.W.2d 501, 505 (Tex. Ct. App. 1942); Clear Lake Apartments, Inc. v. Clear Lake Utilities Co., 537 S.W.2d 48, 51 (Tex. Ct. App. 1976), aff'd as modified 549 S.W.2d 385 (Tex. 1977); MPH Production Co., Inc. v. Smith, 2012 WL 1813467, *2 (Tex. Ct. App. 2012); El Paso Natural Gas Co. v. Amoco Production Co., No. 12083, 1992 WL 43925, at *11 (Del. Ch. Mar. 4, 1992) (finding that it is "established under Texas law that [a] covenant may only be validly created as part of the conveyance of an interest in the land burdened with the covenant"); Talley v. Howsley, 170 S.W.2d 240, 243 (Tex. App. 1943) (noting that a covenant running with the land "only runs with the land conveyed to or by the covenantor"). As discussed in more depth below, the Fifth Circuit Court of Appeals questioned whether privity was a required element under Texas law, and cited favorably to the Restatement (Third) of Property Servitudes, which rejected privity as a requirement and criticized a Texas case as being in a minority of modern cases requiring

For years, many midstream companies included “running with the land” language in gathering agreements and believed that such language would protect them in the event of a bankruptcy. However, in *In re Sabine Oil & Gas Corp*., the District Court for the Southern District of New York affirmed a decision by the Bankruptcy Court for the Southern District of New York that gathering agreements may not “run with the land,” but rather may be rejectable executory contracts.[118] In particular, the court held that the gathering agreements did not “touch and concern” the leases despite express language in the agreements that the gathering agreements ran with the leases.[119] Thus, the court authorized the rejection of the agreements, saving Sabine an alleged $115 million in future value, while the midstream companies were left with mere unsecured claims.

After the initial bankruptcy court decision, this issue arose in numerous other bankruptcy cases across the country.[120] Each of these cases ultimately settled, allegedly on terms that were unfavorable to the midstream companies, as the parties decided to avoid the risk of litigation. Nevertheless, the issue is likely to arise in many other bankruptcy cases in the future, and midstream parties should carefully plan for the risk that its counterparty will reject its contract in a bankruptcy case.

§ 1.04 Summary

The risk of bankruptcy or insolvency by a litigation party or a contract counterparty is inherent in oil and gas-related transactions, particularly given the recent precipitous decline in commodity prices. 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 and reduce the amount of litigation in connection with the case.

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horizontal privity. *See In re* Energytec Inc., 739 F.3d 215, 222 (5th Cir. 2013). Thus, while it appears that horizontal privity is currently required, that may not be true in the future.

[118] 567 B.R. 869, 877 (S.D.N.Y. 2017).

[119] *Id.*

[120] *See, e.g.*, Debtors’ Motion for Entry of an Order (I) Authorizing the Debtors to Reject Certain Executory Contracts With Texas Gas Transmissions, LLC and (II) Granting Related Relief, *In re Magnum Hunter Res. Corp*., No. 15-12533 at 1-2 [Dkt. No. 561] (Bankr. Del. Feb. 19, 2016); Debtors' Motion for an Order Authorizing and Approving Rejection of Certain Executory Contracts with Affiliates of Crestwood Midstream Partners LP, *In re Quicksilver Res. Inc*., No. 15-10585 at 4; Debtors' Motion for Entry of an Order (I) Authorizing the Debtors to Reject Certain Executory Contracts With The Dakota Midstream Parties and (II) Granting Related Relief Filed by Emerald Oil, Inc., *In re Emerald Oil*, No. 16-10704 at 1-2 [Dkt. No. 362] (Bankr. Del. June 3, 2016).