

IEL 69th Annual Oil &
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What Happens to My Lawsuit?
When Bankruptcy and Litigation Collide

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Bankruptcy 101

Common Types of Bankruptcy Cases

Chapter 7

- **Liquidation**
- **Company no longer in charge**
- **Chapter 7 trustee runs the case**

Chapter 11

- **Plan**
- **Reorganization or Liquidation**
- **Company remains in charge of its estate**

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Chapter 7

- A petition may be filed when a business is badly in debt and unable to service that debt or pay its creditors.
- A trustee is appointed almost immediately to sell all the assets and distribute the proceeds to the creditors.
- The business ceases operations unless continued by the trustee.
- Filing a petition could mean that all employees will lose their jobs.
- Larger companies can sell entire divisions to other companies during the liquidation.

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Chapter 11 – Liquidation

- Chapter 11 can also be used to liquidate the assets of the business and pay the creditors from the realization.
- A chapter 11 liquidation often will obtain a greater realization for the creditors than a Chapter 7 bankruptcy.

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Chapter 11 – Reorganization

- A chapter 11 filing is usually an attempt to stay in business while a bankruptcy court supervises the "reorganization" of the company's contractual and debt obligations.
 - › Debt Restructure
 - › Liquidation
- In most instances the company remains in control of its business operations as a "debtor-in-possession," and is subject to the oversight and jurisdiction of the court.

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Chapter 11 Players

- Debtor and Debtor-in-Possession (DIP)
- Committees
 - › Unsecured creditors
 - › Bondholders
 - › Equity holders
- Secured Creditors
 - › DIP financing/cash collateral
 - › Adequate protection
 - › Valuation of collateral
 - › First and second lien lenders

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Chapter 11 Players

- The U.S. Trustee
- Vendors
 - › Suppliers, including reclaiming sellers
- Contract Counterparties
 - › Landlords
- Investors and claims traders
- Employees
- Independent directors

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Priority of Claims – Payment Ladder

- **Owner** [e.g. non-consent relinquished interest, unrecorded assignments in certain circuits]
- **Secured Claim** [e.g. M&M Liens, Operator's liens, Producers' Liens]
- **Administrative Claim** [e.g. post-petition costs of doing business, professional fees and expenses]
- **Priority Unsecured Claim** [e.g. certain wage claims, certain tax claims]
- **Unsecured Claim**
- **Equity**

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Rights of Unsecured Creditors

- Without collateral to secure your claim, you will be an unsecured creditor
- Dependent on unencumbered assets of the bankruptcy estate to pay your claim
- Unsecured creditors are generally last in line
- Because of this last-in-line position, you benefit most by a thorough monitoring of the affairs of the bankruptcy case

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Mitigating Risks – Litigation

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Settlements

- 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.

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Removal, Venue, & Jurisdiction

- 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.
- 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.
- Removal is a remedy that is available to all parties, not just debtors.
- Venue is carefully selected in bankruptcy and often times used as a litigation tactic
- In light of Stern, jurisdiction has become the source of many disputes.

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D&O Claims

- Directors and officers (“D&Os”) of financially distressed companies often face litigation and the risk of personal liability.
- D&Os often make difficult decisions, which may be scrutinized and second-guessed after a bankruptcy filing.
- Bankruptcy trustees and unsecured creditor committees looking for post-bankruptcy recoveries often scrutinize such decisions.
- Treatment of D&O policy proceeds within a bankruptcy case is another issue that parties should carefully consider. While the policy itself is likely property of the bankruptcy estate, the proceeds may be treated differently.

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Mitigating Risks – Pre-Bankruptcy Planning

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Assess your counterparty

- *An ounce of prevention is worth a pound of cure.*
- The best contractual defense is choosing the right counterparty
 - › How solvent is your counterparty?
 - › Is counterparty a special purpose entity?
 - › What due diligence have you conducted on counterparty (eg, credit check, Dunn and Bradstreet assessment, general reputation)?
 - › Should you request additional security may be required (parent guaranty, performance bond, letter of credit, cash collateral, other)?
 - › Is the contract in question likely to be considered an executory contract, which could be discharged in bankruptcy if your counterparty files for protection?

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Things can change quickly

- In 1998 oil fell below \$11/bbl; in 2008, it rose to over \$140/bbl; in 2015, it hit \$45/bbl; and in 2016, oil at its lowest was \$27/bbl and \$52/bbl at its highest.
- Who is at risk in an environment with highly volatile commodity prices?
 - › Oilfield service companies
 - › Companies with heavily hedged positions (if they guessed wrong about prices)
 - › Companies with a lot of debt (difficulty with repayment, risk of borrowing base re-determinations, and credit downgrades)
 - › ***Anybody else in the oil and gas business***

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What remedies did you negotiate under the contract?

- If counterparty breaches, or you reasonably believes it may about to breach, what are your contractual remedies, and are they clear?
 - › Can you cease performing if counterparty breaches or threatens?
 - › Do you have a right to specific enforcement?
 - › Do you have self-help remedies (e.g. offset rights)?
 - › Can you advance bill the counterparty or require cash on delivery going forward?
 - › Can you require counterparty to post additional security or collateral support as a condition to further performance?
 - › Can you terminate the agreement?

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Pre-Bankruptcy planning – Operator's lien under JOA

- AAPL JOA grants a lien to operator on the non-operator's interest in the minerals covered by JOA; but the lien will still need to be perfected (typically requires filing)
 - › Need to file of record a memorandum of JOA, with a sufficient description of the lien rights and the properties covered thereby,
- Operator's Liens - Federal leases in the Gulf of Mexico– federal law adopts the state law of the adjacent state (e.g. Texas and Louisiana)
- Have lenders subordinated their liens to Operator's lien (if liens are prior to the JOA)?
- Consider adding to Miscellaneous provisions additional protections for operator (e.g. ability to advance call entire AFE; ability of operator to require non-operator to post additional capital, etc.)

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Other remedies pre-default & post-default under JOA

- Does JOA or contract allow you to advance bill (COPAS often allows operator to advance bill for expenditures expected in next 30 days)?
- Under many JOA's, remedies after default include:
 - › Advance cash call for all outstanding amounts owed in contract area
 - › Suspension of rights
 - › Deem defaulting party a non-consent party
 - › Suit for damages
 - › Attorney fees

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Decommissioning, plugging and abandonment liabilities regarding offshore GOM assets

- Offshore JOA allocation of P&A liabilities related to federal GOM assets:
 - › JOA typically allocates plugging and decommissioning liability to those who participated in the wells, platforms or facilities
 - JOA contract claims if co-interest owner fails to pay
 - Lien rights may not be helpful (as P&A liability may exceed value of asset now)
 - › Are there sufficient plugging and decommissioning bonds maintained by operator to cover the P&A liability?

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Decommissioning, plugging and abandonment liabilities regarding offshore GOM assets (Continued)

- Even though BOEM/BSEE will first look to operator of record as responsible party, federal law creates joint and several liability for decommissioning, plugging and abandonment for any party who installs or owns (or previously owned) wells, platforms or facilities on federal leases
- What if you sold (or desires to sell) its GOM Assets? You still retain joint and several liability under federal law.
 - So...**
 - › Is Buyer solvent (able to support Buyer's indemnity)?
 - › Is Buyer willing to post a separate bond or security?
 - › Does JOA provide contractual claims against current owners, or secondary liability for seller/assignor?

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Nonoperators may have plugging obligations

- **Sec. 89.012. DUTY OF NONOPERATOR.** If the operator of a well fails to comply with Section 89.011 of this code, each nonoperator is responsible for his proportionate share of the cost of the proper plugging of the well within a reasonable time, according to the rules of the commission in effect at the time the responsibility attaches.

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Types of Bankruptcy Notices

- Case Commencement
- First Day Hearing
- Proof of Claim/Bar Date
- Meeting of Creditors
- Phone Call from Debtor
- Critical Vendor Notification
 - › Email or Letter
 - › Letter to Vendors
- Assumption/Rejection Notice

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Automatic Stay

- Self-executing injunction, constituting an order issuing from bankruptcy court
- Prohibits creditors for taking actions to collect on pre-petition debts
- Actions against a debtor taken in violation of a stay is void and without effect

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Automatic Stay

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Purpose of Bankruptcy

- “Breathing spell”
 - › Stay of actions
- “Fresh start”
 - › Discharge of certain debts (or injunctions against collection)
 - › The debtor has no liability for discharged debts

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Debtor's Goals in Bankruptcy

- To classify gas contracts as utilities (Midstream)
- To assume contracts without curing defaults
- If prices increase, set aside sales of oil and gas properties in previous four years as fraudulent transfers (less than reasonably equivalent value)
- If prices decrease, set aside purchases of oil and gas properties as fraudulent transfers (less than reasonably equivalent value)

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Debtor's Goals in Bankruptcy

- Object to proof of claim
 - › Amount
 - › Classification
- Void offset rights
- Sue for preference

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Your Goal in Bankruptcy

- Get to the top of the ladder
- Elevate the unsecured claim to a higher status
 - › Administrative Claim
 - › Reclamation Claim
 - › Critical or Essential Trade Vendor

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Mitigating Risks – Perfection

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Understand the Value of Your Liens/Security Interests

- In an age of highly-leveraged companies and mezzanine lending, **you must consider the impact of modern financing practices on the value your liens if there are senior liens ahead of you.**
- If a secured lender's lien is recorded in advance of the recordation of the JOA, upon the filing of the bankruptcy, the secured lender's lien may consume all the available value and leave the counterparty to the JOA with a wholly unsecured claim.

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Perfect Your Lien/Security Interest

- In bankruptcy, a lien or security interest only provides protection if it is timely and properly perfected.
- Once bankruptcy is filed, unperfected liens or security interests have little or no value.
- Bankruptcy allows the debtor to avoid the unperfected lien or security interest and reduces the claimant to an unsecured creditor.
- Automatic Stay prevents perfection post-petition.

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Perfect Lien/Security Interest Against Correct Counter-Party

- Record title can be complex issue
- Corporate formalities are recognized in bankruptcy
- Each affiliate or subsidiary has its own bankruptcy case
 - › Each debtor has separate property for distribution to its creditors (not those of its parent or affiliates)
- A pledge that is given by an entity that did not actually hold an interest in the property will typically be treated as a nullity and thereby unsecured.

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Perfect Your Lien/Security Interest ASAP

- 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 after the fact could result in a preference if the counter-party files bankruptcy within 90 days of perfection.
- The lien or security interest only has value to the extent the underlying property exceeds the amount of any prior liens against the same property.

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Joint Operating Agreements – Non-Operator's Bankruptcy

- Operators frequently make advances on behalf of non-operators for both capital expenditures and lease operating expenses.
- Upon a non-operator's bankruptcy, claims for both capital expenditure amounts and for unpaid lease operating expenses will be pre-petition claims against the non-operator.
 - › Subject to automatic stay
 - › File proof of claim

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Joint Operating Agreements – Operator's Bankruptcy

- Operators often market hydrocarbons for the non-operators which, before 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.
- An operator's bankruptcy will result in the non-operators being left with claims for hydrocarbons that have been produced and sold before the bankruptcy case.

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Joint Operating Agreements – Securing Claims

- JOA usually includes reciprocal contractual liens to secure the counter-party's performance.
- Perfection = executing, acknowledging and recording a memorandum of the operating agreement
 - › Land records of the county or counties where the lands are located
- To perfect personal property, you must file a UCC-1 with the Secretary of State of the operating agreement counterparty's state of incorporation

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Owners with Unrecorded Assignments

- The debtor has the status of a bona fide purchaser ("BFP") for value without actual notice
- In the absence of a rehabilitative exception to the rule, the debtor can use this BFP status to keep the asset for the benefit of all creditors, in derogation of the rights of the unrecorded interest owner.
- In most jurisdictions, the BFP can take title and cut off the interests of an equitable but unrecorded owner.
- The Bankruptcy Code has a conflict in the plain language of section 541(d) and section 544(a)(3). The courts have split over which section predominates.

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Owners with Unrecorded Assignments – Constructive Trust

- Even in those jurisdictions which resolve the conflict, to prevail is that the unrecorded interest owner must establish his ownership under applicable non-bankruptcy law. In most reported opinions, this means litigating whether a constructive trust is found to exist in favor of the unrecorded assignee.
 - › Texas requires:
 - (1) breach of informal relationship of special trust or confidence arising prior to and apart from the transaction or actual fraud,
 - (2) unjust enrichment, and
 - (3) tracing to an identifiable res.

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File Claim

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20-Day Administrative Claims

- Section 503(b)(9) entitles a seller to an administrative expense claim for the value of goods that were received by the debtor within 20 days of the commencement of the case and sold in the ordinary course of the debtor's business.
- The seller need not demand reclamation under §546(c)(1) to be entitled to an administrative expense under §503(b)(9).
- Administrative expense claims come ahead of unsecured claims.

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Reclamation Rights in Bankruptcy

- 45 days after the date of receipt of such goods by the debtor; or
- Not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.
- Many states have granted statutory liens to protect sellers so that the seller will have a secured claim for hydrocarbons sold but not paid as of the filing.

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Reclamation Rights

- Hydrocarbons are goods under the UCC.
- The seller of oil and gas has reclamation rights under both the UCC and the Bankruptcy Code.
- Outside of bankruptcy, the seller can reclaim goods for a ten-day period after delivery. That time limit does not apply if a misrepresentation of solvency has been made by the seller in writing.
- One example of a solvency representation that may be included in a sales contract or purchase order:

Buyer hereby represents that it is solvent and that on each delivery this representation shall be deemed renewed unless notice to the contrary is given in writing by the buyer to the seller at or before delivery of goods.

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Mitigating Risks – Bankruptcy Code §365

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Bankruptcy Code § 365 – Executory Contracts

- The majority of oil and gas contracts are executory contracts governed by Bankruptcy Code § 365.
 - › Operating agreements, participation agreements, area of mutual interest agreements, development agreements, take-or-pay contracts, etc.
- Debtors may assume or reject executory contracts and unexpired leases.
- If the debtor rejects your contract or lease, you are merely a holder of unsecured claim for damages.

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Bankruptcy Code § 365 – Executory Contracts

- Enforceable by the debtor but not against the debtor
- Debtor must pay the reasonable value of services received prior to assumption or rejection
 - › Rule is unworkable in context of oil & gas property

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Bankruptcy Code § 365 – Oil and Gas Leases

- Almost all hydrocarbon producing states, an oil, gas, and/or mineral lease conveys a real property interest to the lessee.
- For the most part, an oil and gas lease creates a presently vested interest in real property that is not subject to Bankruptcy Code § 365.

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Bankruptcy Code § 365 – Oil and Gas Leases | Federal OCS Leases

- Both 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.
- 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.”

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Bankruptcy Code § 365 – *In re Sabine Oil & Gas Corp.*

- Applying Texas law, a New York district court recently upheld a decision that allowed an oil and gas producing debtor to reject gas gathering agreements with two midstream service companies under Bankruptcy Code § 365.
- Even though the agreements stated, among other things, that they contained covenants that “run with the land” (i.e., conveyed property rights), the court disagreed and found that the debtor could reject these agreements in bankruptcy primarily because:
 - › The debtor failed to convey any real property interests to the counterparties
 - › The debtor was not limited in the amount of gas and condensate it could produce from the parties
 - › The debtor’s obligations to the counterparties were only triggered once gas and condensate were produced (i.e., at which time the gas and condensate were personal, rather than real, property under Texas law)

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Bankruptcy Code § 365 – *In re Sabine Oil & Gas Corp. (cont.)*

- Agreements did not grant counterparties a royalty interest because the parties did not receive a right to any share of the gas or condensate from the properties.
- The district court also distinguished this case from *In re Energytec*, 739 F.3d 215 (5th Cir. 2013) (which found that a gas gathering agreement did convey real property rights and thus was capable of being rejected in bankruptcy) on two grounds:
 - › 1. When the obligations arose
 - *Sabine*: debtor's obligations to counterparties was triggered upon delivery of the produced gas and condensate
 - *Energytec*: debtor was entitled to a transportation fee upon use of the land
 - › 2. Who was bound by the terms of the agreements
 - *Sabine*: debtor's successors and assigns were bound by terms of the agreements
 - *Energytec*: debtor had to consent to any assignment (i.e., a restraint on alienation)

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Bankruptcy Code § 365 – Before Assumption or Rejection

- While a debtor decides whether to assume or reject an executory contract or unexpired lease, you must continue to perform under the contract
- During that “gap period” or “twilight zone”, you 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 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.
- You may seek to reduce this uncertainty by seeking to shorten the time period for a debtor to assume or reject an agreement

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Bankruptcy Code § 365 – Assumption

- To assume, a debtor must give notice to you and demonstrate, among other things:
 - › (1) that there are no defaults;
 - › (2) that any defaults pursuant to the contract or lease to be to be assigned have or will be cured as a condition to such assignment; and
 - › (3) of ‘adequate assurance of future performance’ under the terms of the contract on the part of prospective buyer/assignee.

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Bankruptcy Code § 365 – Assumption and Assignment

- 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.
- For the most part, the debtor has the power to assign a contract or lease without your consent.
 - › Even if consent would be required outside of bankruptcy.
 - › Can impact successor operator provisions

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Purchase and Sale Agreement

- Before consummation, a purchase and sale agreement is almost certainly an executory contract subject to rejection by the debtor.
- Even after a transaction has been consummated, additional claims need to be taken into account once the debtor enters bankruptcy.
 - › Indemnity claims

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Mitigating Risks – Setoff and Recoupment

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Setoff

- A right of setoff is analogous to a security interest.
- Arises where counterparties have reciprocal debts and obligations.
- Accounts payable and accounts receivable may be set off against each other.

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Setoff – Bankruptcy

- In bankruptcy, parties can offset “mutual” debts (i.e. debts between the same parties standing in the same capacity) that arose before the filing of the bankruptcy case.
- The Bankruptcy Code does not create a right of setoff; it merely preserves setoff rights created under applicable non-bankruptcy law.
- You must have the right to setoff outside of bankruptcy and be able to identify the source.
- Automatic stay prevents a contract counterparty from offsetting an account payable against an account receivable.
 - › To setoff, you need relief or modification of the automatic stay.

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Setoff Requirements – Bankruptcy Code §553

- You must hold a pre-petition claim against the debtor
- You must owe a pre-petition debt to the debtor
- The claim and debt must be mutual obligations
- The claim and debt each must be valid and enforceable

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Setoff – Mutuality | Triangular

- “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.
- Because of the mutuality requirement in section 553(a) of the Bankruptcy Code, courts have routinely held that triangular setoffs are impermissible in bankruptcy.
 - › Party (A) offsets the debt owed *by* one party (B) against the debt owed *to* another party (C).

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Setoff – Mutuality | Affiliates

- Each corporation is a separate entity from its affiliates.
- A subsidiary's debt may not be set off against the credit of a parent other subsidiary.
- No mutuality exists between affiliates or subsidiaries.
 - › Even if the parties contractually agree

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Recoupment

- Recoupment is the netting of obligations within or among the same agreement.
- Recoupment is more narrowly applied.
- Recoupment is not subject to the automatic stay.
- You 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.

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Mitigating Risks - Regulatory

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Plugging and Abandonment

- The debtor may seek to abandon interest in unproductive oil or gas wells to relieve the estate of burdensome liabilities.
- A debtor's abandonment power does not allow release from such obligations.
 - › Debtors must comply with state law
- P&A liabilities are entitled to administrative claim priority if the plugging obligations accrued post-petition under state law.

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Plugging and Abandonment

- Sold Property in the Past
- Hear that somebody in the chain has filed
- Contact legal and file claim

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Mitigating Risks – Farmouts and Production Payments

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Safe Harbor Provisions

- The Bankruptcy Code contains a special set of rules (or “safe harbor” provisions).
- To benefit from the Safe Harbor Provisions, you must be
 - › The Farmee (not the farmor), or
 - › The holder of a production payments.

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Safe Harbor Provisions - Farmouts

- Bankruptcy Code defines farmout as any agreement for assignment of an interest in an oil and gas lease that includes, as consideration, operations upon the property
 - Contemplates debtor as farmor.
 - you must be the farmee
- Property of the bankruptcy estate does **NOT** include interests in hydrocarbons where the debtor has agreed to transfer interests pursuant to a farmout agreement.
- Even if a debtor’s rejection of the farmout agreement as an executory contract will not impact your rights as the farmee, at least in respect of any interest that had been earned as of the date of the bankruptcy filing.

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Applicability of § 365 to farmouts?

- Farmout is usually an executory contract.
- § 541(b)(4)(A) prevents farmor/debtor from rejecting and depriving farmee of title.
- Status prior to assignment of farmout interest?
 - › Under § 541(b)(4)(A), NOT property of the estate!
 - › Presumably the Debtor's rights under the farmout agreement ARE property of the estate.
- What if farmee fails to earn the farmout?
 - › Statute makes no provision for interests to become property of the estate.
 - › What to do? No one knows.

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Safe Harbor Provisions - Production Payments

- Production payments are a hybrid, part ownership and part financing device.
- Typically the cash payments by the debtor are NOT property of the estate.
- Attempted codification in § 541(b)(4)(B).
 - › Safe harbor: carved OUT of debtor's estate.
 - › But ONLY if the assignee does NOT participate in operations.
- What if the assignee participates in operations?
 - › No one knows.
- Recharacterization issue
 - › Is it really a production payment? Disguised loan?
 - › The more it looks like a loan . . .
 - › Matter of Senior.


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**“How did you go bankrupt?”
“Two ways. Gradually, then suddenly.”**

— Ernest Hemingway, *The Sun Also Rises*

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T&K Presenter



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