OIL & GAS RESTRUCTURING AND BANKRUPTCY: WHERE AE WE NOW?

The Honorable Tony M. Davis
United States Bankruptcy Judge, Western District of Texas

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

Introduction

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

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

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

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

Discussion

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

A. General Principles

Bankruptcy most often is a response to severe financial distress and usually is a last resort because of the high cost and risk to the enterprise.[2] Due to the limited

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

[2] In fact, bankruptcy comes with high costs of administration and the need for transparency in business practices and structure. And there is no guarantee that a company that goes into bankruptcy will come out on the other side. Warren, Elizabeth and Westbrook, Jay, *The Success of Chapter 11: A Challenge to the*

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

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

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

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

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

Another all-too-common mistake, particularly with oil and gas assets for which record title may be a complex issue, is to obtain and perfect a lien or a security agreement against the wrong entity. Corporate formalities are recognized in bankruptcy, which typically means that each affiliated debtor will file its own bankruptcy case with each debtor being treated as separate for purposes of, among other things, distributions to creditors.[6]

While affiliated debtors may frequently be jointly administered in bankruptcy, substantive consolidation—treating separate debtors as a single distributive pool—is the

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Critics, 107 Michigan Law Rev. 603 (2008) (approximately 30% to 50% of Chapter 11 cases filed confirm plans).

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

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

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

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

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

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

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

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

B. Maximizing Oil and Gas Lien Value

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

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[7] *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.),* 250 F.3d 955, 958 (5th Cir. 2001); *In re Las Torres Develop. LLC,* 413 B.R. 687, 693 (Bankr. S.D. Tex. 2009).

[8] *In re P.A. Bergner & Co. Holding Co.*, 187 B.R. 964, 983 (Bankr. E.D. Wis. 1995).

[9] *United States v. Ron Pair Enterp., Inc*., 489 U.S. 235, 241 (1989); *Matter of T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997) (junior lienholders only have a secured claim if value of collateral exceeds senior liens).

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

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

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

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

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

applicable counties. To perfect in personalty, parties must file a UCC-1 with the Secretary of State of the operating agreement counterparty's state of incorporation.[11]

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

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

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

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

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

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

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

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

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

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

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

(3) *Statutory Producer's Liens*

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

It is beyond the scope of this article to discuss the perfection of each various producer's lien, but some discussion is helpful. For example, some producer's liens are automatically perfected.[24] However, this is not always the case. To perfect and maintain the New Mexico producer's lien, the interest owners must file a Notice of Lien (similar to notices that are needed to perfect statutory mechanics liens) "after 15 days and within 45 days after payment is due by terms of agreement…."[25] The lien terminates if the notice is not timely filed, and if timely filed, the lien expires one year after the date of the filing of the notice unless an action to enforce the lien is begun.[26]

Even in states that allow automatic perfection, producers may receive better treatment if a UCC-1 is filed. For example, while the Texas producer's lien is automatically perfected under the Texas statute, the bankruptcy court for the District of Delaware held that a producer's lien was subordinate to a contractual secured lender's lien because the Texas producer had not filed a UCC-1 in the state of incorporation of the

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

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

[19] Tex. Bus. & Comm. Code § 9.343.

[20] 52 O.S. § 549.1.

[21] N.M. Stat. Ann. § 48-9-1.

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

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

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

[25] N.M. Stat. Ann. § 48-9-5.

[26] N.M. Stat. Ann. § 48-9-5.

purchaser of the production prior to the contractual secured lender's lien.[27] The lower priority resulted in the loss of approximately $57 million to the Texas owners' interest in the oil and gas proceeds. Thus, in order to ensure the best priority for the Texas producer's lien, producers who are selling on credit should file a UCC-1 in the state of incorporation of the first purchaser of the production rather than rely solely on automatic perfection.

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

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

II. Mitigating Risk Through Setoff and Recoupment

A. <u>General Principle</u>

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

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[27] *In re SemCrude, L.P.*, 407 B.R. 140 (Bankr. D. Del. 2009).
[28] 52 O.S. § 549.7.
[29] 52 O.S. § 549.7.
[30] 52 O.S. § 549.2(11)(b).

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

A related contractual risk-mitigation principle is recoupment. Setoff applies to mutual debts between the same parties standing in the same capacity, but does not require that the debts arise out of the same agreement. Recoupment, on the other hand, is the netting of obligations within or among the same agreement.[36] Thus, recoupment is more narrowly applied.[37] However, recoupment is not subject to the automatic stay.[38] Therefore, a contract counterparty should consider whether the netting of amounts owed to and owed by a debtor are so closely tied together contractually that recoupment, not setoff, may be applicable.

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

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

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

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

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

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

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

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

B. **<u>Special Oil & Gas Issue: Reliance of Buyers and Sellers on Master Netting Agreements</u>**

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

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

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

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

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

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

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

[43] 399 B.R. 388, 393 (Bankr. D. Del. 2009), *aff'd* 428 B.R. 590 (D. Del. 2010).

[44] *Id.* at 392.

> 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***.[45]

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

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

The court also held that it did not matter that Chevron and the other parties had contractually agreed to triangular setoffs.[48] In fact, the court explained that none of the cases that allegedly observed a contractual exception "actually upheld or enforced an agreement that allows for a triangular setoff; each and every one of these decisions have simply recognized such an exception in the course of denying the requested setoff or finding mutuality independent of the agreement."[49] Thus, the court held that private agreements cannot confer mutuality on non-mutual debts.[50]

Since it was decided, a number of courts have expressly agreed with the analysis in *SemCrude*.[51] The Fifth Circuit, however, has not yet weighed in on the enforceability of contractual triangular setoff in bankruptcy.[52] Nevertheless, given the trend described

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[45] *Id.* at 391.
[46] *Id.* at 392–93.
[47] *Id.* at 393–94.
[48] *Id.* at 397.
[49] *Id.* at 394.
[50] *Id.* at 397.
[51] *See In re Lehman Bros.*, 458 B.R. 134, 141 (Bankr. S.D.N.Y. 2011) ("[This] Court agrees with the SemCrude court — triangular setoff is not (and never was) permitted under the Bankruptcy Code. Despite the pre-petition agreement of the parties, the cross-affiliate netting urged by UBS simply is not available due to lack of mutuality."); *Sass v. Barclays Bank PLC (In re Am. Home Mortg., Holdings, Inc.)*, 501 B.R. 44, (Bankr. D. Del. 2013) ("This Court concurs entirely with Judge Shannon's decision [in Semcrude]."); *Steadfast Ins. Co. v. Woodside Group, LLC (In re Woodside Group, LLC)*, Case No. 6:08-bk-20682, 2009 Bankr. LEXIS 4360 at *15 (Bankr. C.D. Cal. Dec. 30, 2009); *In re Arcapita Bank B.S.C.(c)*, Case No. 12-11076, 2014 Bankr. LEXIS 2237 at *9–10 (Bankr. S.D.N.Y. May 20, 2014) ("Courts consistently find debts to be mutual only when they are in the same right and between the same parties…. The fact that the setoff was provided for by contract does not alter this conclusion.") (internal citations omitted).
[52] *See In re Eng. Motor Co.*, 426 B.R. 178, 189 (Bankr. N.D. Miss. 2010) ("It is therefore unnecessary for this Court to determine whether as a matter of law parties may vitiate the mutuality requirement in § 553 by

above, the utility of master netting agreement provisions which purport to create triangular setoff rights is highly suspect.

III. Mitigating § 365 Contract Risk

A. General Principles

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

B. Special Oil & Gas Issues

(1) *Characterization of Oil and Gas Leases*

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

In almost all hydrocarbon producing states, an oil, gas, and/or mineral lease conveys a real property interest to the lessee.[55] Thus, for the most part, an oil and gas

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entering into an agreement that expressly contemplates a triangular setoff, since such an agreement clearly does not exist under the facts presented here.").

[53]

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

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

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

[55] *E.g., Foothills Texas, Inc., et al., v. MTGLQ Investors, L.P.* (*In re: Foothills Texas, Inc.*), 476 B.R. 143 (Bankr. D. Del. 2012); *In re WRT Energy Corp.*, 202 B.R. 579 (Bankr. W.D. La. 1996); *In re Frederick*

lease creates a presently vested interest in real property that is not subject to Section 365 of the Bankruptcy Code.

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

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

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

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

While a debtor decides whether to assume or reject an executory contract or unexpired lease, the non-debtor party must continue to perform under the contract.[60] During that 'gap period', the non-debtor party will bear the risk and uncertainty that

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Petroleum Corp., 98 B.R. 762 (S.D. Ohio 1989); *In re Hanson Oil Co.*, 97 B.R. 468 (Bankr. S.D. Ill. 1989).

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

[57] 43 U.S.C. § 1337.

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

[59] 11 U.S.C. § 365(f).

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

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. In certain circumstances, a creditor may seek to reduce this uncertainty by seeking to shorten the time period for a debtor to assume or reject an agreement.[61]

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

IV. Purchase and Sale Agreements

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

Creditors arguably must file such contingent claims, which arise under fully consummated agreements, or risk losing them.[66] When a party to a purchase and sale agreement has been given notice of the bankruptcy of a counterparty, consideration should be given to what, if any, ongoing claims may exist against the debtor. For example, there may be outstanding indemnity obligations on the part of the buyer (e.g.,

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[61] 11 U.S.C. § 365(d)(2); *Texas Importing Co. v. Banco Popular de Puerto Rico*, 360 F.2d 582, 583 (5th Cir. 1966). In a Chapter 11 case, a debtor has until confirmation of a plan (which, in some cases, may take a year or longer) to assume or reject an executory contract in the absence of a court order shortening that time period. *See* 11 U.S.C. § 365(d)(2).

[62] *E.g., In re Cano Petroleum, Inc.*, No. 12-31549, 2012 Bankr. LEXIS 3281 (Bankr. N.D. Tex. July 18, 2012).

[63] *River Production Co. v. Webb (In the Matter of Topco, Inc.)*, 894 F.2d 727, 730 (5th Cir. 1990).

[64] *See* 11 U.S.C. § 365(b)(1)(B) & (C).

[65] *See* 11 U.S.C. § 365 and *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37, 45-6 (D. R.I. 1999) (finding the agreements at issue to be executory because the agreements remained substantially unperformed by both parties).

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

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

V. Mitigating Regulatory Risks

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

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

Courts have generally held that a debtor's abandonment power does not allow release from such obligations, finding that, under federal law, debtors must comply with state law.[71] Moreover, the Fifth Circuit has held that P&A liabilities are entitled to administrative claim priority if the plugging obligations accrued post-petition under state

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

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

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

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

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

law because the debtor cannot avoid such liability and, thus, the expenses are "necessary" and beneficial" to the estate under an administrative claim analysis.[72]

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

VI. Mitigating Risks Related to Farmouts and Production Payments

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

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

Thus, if a counterparty is choosing, for example, between a conveyance of a production payment or a claim that is secured by a claim on property of the estate, in many cases, the former is preferable because the production payment should "pass through" the bankruptcy case with a reduced risk of impairment of its pre-bankruptcy contractual rights.

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[72] *Texas v. Lowe (In re H.L.S. Energy Co.),* 151 F.3d 434, 437 (5th Cir. 1998).
[73] 11 U.S.C. § 541(b)(4).
[74] *See In re Resource Technology Corp.*, 254 B.R. 215, 222 n.2 (Bankr. N.D. Ill. 2000).
[75] 11 U.S.C. § 541; *but see* 11 U.S.C. § 363(f) (permitting bankruptcy trustee to force a sale of a co-owner's interest along with the debtor's interest in property).

CONCLUSION

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