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Restructuring, Insolvency and Investment in the Oil & Gas Industry

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I. Overview of Bankruptcy Basics

A. "Property of the Estate" (Section 541 of the Bankruptcy Code)

1. Section 541 of the Code – This section provides that the commencement of a bankruptcy case automatically creates an estate that broadly includes all of the legal and equitable interests of the debtor in property as of the commencement of the case.

    a. The case is commenced by debtor's filing of a petition under one of the applicable chapters of the Bankruptcy Code (or by an involuntary case filed by qualifying creditors against the debtor).

2. A Chapter 11 debtor generally maintains operational control over the assets of the estate, but the bankruptcy court must approve certain activity.

3. Ordinary Course vs. Non-ordinary Course Transactions – Debtor in possession ("DIP") or the trustee has the ability to use, sell, and/or lease any estate property in the ordinary course of business.

    a. Any use, sale or lease of estate property that is outside of the ordinary course of business must receive prior approval from the bankruptcy court.

B. The Automatic Stay (Section 362 of the Bankruptcy Code)

1. Section 362 of the Code – Very broadly applied to proscribe virtually any collection activity against the debtor or the debtor's property on a pre-petition claim.

    a. One of the fundamental debtor protections that shields the property of the debtor's estate from any claims of or actions by creditors or other parties

    b. Provides debtor a "breathing spell"

2. The automatic stay only applies to the debtor and not to debtor affiliates or non-debtor guarantors. In some instances, bankruptcy courts enjoin actions against non-debtors, but that requires a complaint (an adversary proceeding related to the bankruptcy case) and a hearing on an injunction.

3. The automatic stay does not toll the mere running of time under a contract, and thus it does not prevent automatic termination of the contract.[1]

4. To the extent that a creditor wants to proceed with an action against the debtor outside the bankruptcy, it is necessary to obtain relief from the automatic stay from the Bankruptcy Court.

    a. Grounds for relief:

        i. "For cause," including the lack of adequate protection

            A) Examples include:

                1) bad faith filing

                2) permit litigation to proceed in another forum

[1] *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir. 1984).

3) lack of insurance on collateral

4) failure to make post-petition payments

B) With respect to a stay against property, relief is granted where it can be shown that the debtor does not have equity in the property and such property is not necessary to an effective reorganization.

5. Stipulations for relief from the automatic stay collateral require approval by the court on motion and notice to creditors.

C. Executory Contracts (Section 365 of the Bankruptcy Code)

1. Section 365(a) of the Bankruptcy Code – allows a debtor to "assume" or "reject" an executory contract or unexpired lease, subject to the provisions of such section. "Executory Contract" is a term used to describe contracts and leases where the duties of both debtor and non-debtor have not yet been fully performed.

   a. Includes commercial leases, certain equipment leases, service contracts and license agreements

2. Upon the filing of a bankruptcy petition, a debtor has the right to assume or reject an executory contract in accordance with section 365 of the Bankruptcy Code.[2]

   a. Non-Debtor party is required to continue with performance under the contract.

3. Assumption

   a. In a Chapter 11 case, a debtor has up until plan confirmation to assume or reject an executory contract or unexpired lease of personal property or residential real property. Often assumption and rejection is accomplished by providing for such in the plan.

      i. Debtors will include language in their plans providing for the wholesale "assumption" or "rejection" of all their executory contracts except for those that are specifically identified to receive different treatment.

   b. Unexpired Leases

      i. Leases of non-residential real property must be assumed within 120 days of the bankruptcy filing. Bankruptcy court may extend the 120 days by 90 days for cause.

      ii. For leases of real property, debtor required to perform "all the obligations" under such leases until leases are assumed or rejected

   c. Debtor's decision to assume, assume and assign or reject an executory contract or lease is based on the debtor's exercise of its business judgment. Failure to assume within the time set forth in the Bankruptcy Code results in rejection.

      i. Debtor must assume *cum onere* – with all the benefits and burdens of the executory contract or lease.[3]

[2] 11 U.S.C. § 365(a). *See also N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 528 (1984) (noting that "the authority to reject an executory contract is vital to the basic purpose to a . . . reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization").

d. During time period between petition date and date on which debtor ultimately assumes or rejects an executory contract or unexpired lease, the general rule is that the non-debtor party must continue to perform under the terms of the contract or lease

   i. Debtor also obligated to continue to pay for goods and services

   ii. For executory contracts, debtor's payment obligations limited to the value of the benefit conferred on the debtor as a result of the non-debtor's performance

   iii. With respect to a stay against property, relief is granted where it can be shown that the debtor does not have equity in the property <u>and</u> such property is not necessary to an effective reorganization.

4. Rejection

   a. Rejection equates to a breach of the lease or contract. Effective date of rejection is the date the rejection is approved by the bankruptcy court. Debtors often request bankruptcy courts to approve rejections on a retroactive basis.

   b. Rejection claim is a pre-petition, unsecured claim. The claim is also subject to a damages cap.

D. Cash Collateral and Adequate Protection

1. Cash Collateral

   a. Section 363 of the Code – Defines "cash collateral" as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents, whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property.[4]

   b. Cash collateral may not be used, sold, or leased in the ordinary course of business unless the creditor with an interest in the collateral consents or the court, after notice and a hearing, authorizes the use, sale, or lease. Because of the often pressing need to use cash to maintain business operations, the court must act promptly to determine whether the creditor's interest in the cash collateral is or will be adequately protected and should schedule the hearing in accordance with the needs of the debtor.[5] Bankruptcy Rule 4001(b) specifies the procedure governing a motion for authorization to use such collateral. Unless the creditor agrees or the court orders otherwise, cash collateral used in the ordinary course of business must be segregated and accounted for.[6] §363(c)(4).

   c. A party with an interest in property being used by the debtor may request that the court prohibit or condition this use to the extent necessary to provide "adequate protection" to the creditor.

2. Adequate Protection

   a. Adequate protection may be required to protect the value of the creditor's interest in the property being used by the debtor. This is especially important when there is a decrease in the value of the property.

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[3] *In re Italian Cook Oil Corp.*, 190 F.2d 994, 997 (3rd Cir. 1951) ("The [debtor] may not blow hot and cold. If he accepts the contract he accepts it cum onere. If he receives the benefits he must adopt the burdens.").
[4] 11 U.S.C. § 363(a).
[5] 11 U.S.C. § 363(c)(3).
[6] 11 U.S.C. § 363(c)(4).

b. The debtor may make periodic or lump sum cash payments, or provide an additional or replacement lien that will result in the creditor's property interest being adequately protected.[7]

3. Short term, or interim cash collateral orders are routinely granted by the bankruptcy courts based on very short notice of a few days but short term use should be limited to expenses which need to be paid immediately to preserve and protect the property.

4. Longer term cash collateral orders, which are sought at a follow up hearing, require a more demanding showing that the debtor's use of cash collateral adequately protects the secured creditors. Longer term orders provide an occasion for the secured creditor to negotiate adequate protection payments and for debtors to attempt to get use of cash collateral for non-essential expenses.

5. Stipulations for use of cash collateral require approval by the court on motion and notice to creditors. The Bankruptcy Rules require disclosures of specified provisions in favor of the secured party and these are frequently rejected by the Court.

II. Issues Unique to Oil and Gas Bankruptcies

A. Characterizations of Oil and Gas Leases under Section 365 of the Bankruptcy Code

1. Intersection of State oil-and-gas law with Section 365 (executory contracts and unexpired leases).

    a. State law governs property rights, and the characterization of a lease as a "true lease" or other form of property interest is a state law determination.

2. The States mostly fall into one of two categories in characterizing the property interest a landowner holds in the oil and gas beneath his or her land.

    a. *Ownership-in-place States*

        i. Landowner has complete ownership of the oil-and-gas beneath their land.

        ii. Landowner's interest in the oil and gas can be divested if the oil and gas moves from beneath the tract.

        iii. <u>Majority theory</u>: applies to states including Colorado, Oklahoma, Pennsylvania and Texas.

    b. *Non-ownership States*

        i. Landowners do not own the oil-and-gas beneath their land, but instead have the exclusive right to explore and develop any oil and gas found there.

        ii. This is a personal property interest.

        iii. <u>Minority theory</u>: applies to including Arkansas, California, Kansas, Montana, New York, Ohio and West Virginia.

[7] 11 U.S.C. § 361.

3. Ownership-in-place

   a. Oil and gas is usually held in fee simple absolute (complete ownership).

   b. Conveyance of the right to drill is not conveyance of a true lease. Rather, courts characterize the transaction as a sale of a fee interest in the oil and gas.

      i. Even if transferred through a document called a "lease".

   c. Usually conveys a fee simple determinable.

      i. Fee simple: right continues indefinitely.

      ii. Determinable: subject to divestment under certain conditions (usually if the lessee fails to produce oil-and-gas in sufficient amounts, pay rents or royalties, or continuously operate).

      iii. The fee simple determinable is not vested at the time of transfer, and only vests on the condition that the transferee commences drilling operations and the production of oil and gas in paying quantities.

         A) For instance, Pennsylvania interprets an oil-and-gas lease as initially conveying a title that is inchoate and allows for exploration and development. The fee simple determinable only vests if the development is successful pursuant to the contracted terms.[8]

4. Non-ownership

   a. Landowner does not have a property interest in the oil and gas and is unable to convey a fee in it.

   b. Instead, the property owner can lease its own interest in the right to search for and produce oil and gas on the land (personal property).

5. Ownership-in-place rule vs. non-ownership rule will be a major factor in determining whether it is an executory contract or unexpired lease subject to the assume and reject provisions of § 365.

   a. In an ownership-in-place state:

      i. Conveyance of a fee simple determinable is a sale and not treated as an unexpired lease or executory contract.

      ii. Ability of a debtor to assume or reject an oil-and-gas lease will depend on whether the interest has already vested in the lessee.

      iii. Until the fee simple determinable vests, an oil-and-gas lease is still a contract that could be subject to § 365. Once the oil and gas is found and produced, the executory nature of the contract transforms into a real property interest.[9] *Powell* concerned a development that had not produced as of the petition date. The court determined that the lessor had a contractual interest, not a fee simple determinable, and that the lease

[8] See *Powell Dev. Co. v. Anadarko E&P Co., (In re Powell),* 482 B.R. 873, 875 (Bankr. M.D. Pa. 2012)

[9] Some courts have determined that the date of the bankruptcy petition is the relevant date to determine if the oil exploration had produced and thus vested the fee simple determinable.

in question was "clearly" a lease of real property under § 365(m) subject to assumption or rejection.

b. Non-ownership State:

i. The lease agreement is a lease, before and after oil and gas is found or produced, and subject to § 365.

6. Implications of section 365(h) to oil-and-gas leases.

a. 365(h) covers the treatment of leases in real property when the debtor is the lessor.

i. Debtor's rejection of the lease (when debtor is lessor):

A) Debtor no longer has to perform its covenants under the lease in the future.

B) However, it **does not** terminate the lease completely so as to divest the lessee of its interest in the property — the lessee has the option of retaining its lease interest (staying in the property until the original terms of the lease are up).[10]

C) The lessee may also elect to treat the lease as terminated and assert a claim for damages for breach.

b. Oil-and-gas lease is probably "lease of real property" under 365(h).

i. Applies in a non-ownership State or in an ownership-in-place State before vesting

c. Case law is not clear about the consequence if a debtor/lessor in an oil-and-gas lease rejected the lease

i. Presumably the lessee would have the right to remain in possession of the property, but it is unclear whether that right would include the ability to produce and sell the oil and gas.

B. Funds Held in Trust by Debtor Lessee – Property of the Estate?

1. Frequently in the oil and gas industry, investors and others are assigned undivided interests in oil and gas properties and these interests are not recorded until a well becomes commercially viable. If the assignor (often the lessee of an Outer Continental Shelf ("OSC") lease), the rights of the assignees, the trustee, and the creditors are often in dispute.

2. Section 541 of the Bankruptcy Code – Provides that essentially all property of the debtor, wherever located, becomes property of the estate.

a. It is for state or applicable non-bankruptcy law to create or define property interests.[11]

b. Section 541(d) excludes from the estate is any property where the debtor holds legal, but not equitable title.

3. While it appears that § 541(d) would protect the unrecorded interest holders, the "strong arm clause" in the Code may allow the trustee to avoid these interests.

[10] 3-365 Collier on Bankruptcy P 365.11

[11] *See Butner v. United States*, 440 U.S. 48, 54-55 (1979); *Patterson v. Shumate*, 504 U.S. 753, 758 (1992).

a. Section 544(a) of the Bankruptcy Code – gives the trustee the rights of a judicial lien creditor, a creditor who has levied execution, and a bona fide purchaser ("BFP") of real estate. Consequently, trustee could use her "strong arm powers" to avoid an unrecorded oil and gas assignment if the rights could be defeated by a judicial lien creditor, a creditor who has levied execution, or a BFP.

b. Unrecorded title is equitable title, and in most jurisdictions, a BFP can cut off interests of an equitable owner.

4. The Trustee's Strong Arm Powers v. § 541(d)

a. Unrecorded interest owners would argue that because they hold an equitable interest, the property interest is not property of the estate because the debtor holds only legal title and not an equitable interest.

i. Courts are split on the issue. The Ninth and Seventh circuits have held that that § 544 is not limited by § 541(d).[12] The Fifth and Tenth Circuits held that § 541(d) prevails over the Trustee's avoidance power.[13]

5. The jurisdictions that favor § 541(d) over the trustee's strong arm powers, often conduct a constructive trust analysis.[14] Most situations regarding an unrecorded interest in an oil and gas property do not involve situations which would give rise to a constructive trust.[15]

6. Perhaps, if Congress intended § 541(d) to limit the reach of the trustee's strong arm powers under § 544, it could have referenced § 544 in § 541(d) as it did in § 541(b)(4), which explicitly makes § 544(a)(3) inapplicable regarding farmout agreements.

C. Property of the Estate Excludes (a) Interest of Counterparty to "Farmout Agreement" and (b) Prepetition Transfers of Production Payments

1. Common farmout agreement

a. "Farmout agreements" are used to distribute capital risk in the oil and gas industry. Typically, a lessee or owner of mineral rights (the "farmor") agrees to assign the lease, or some portion of it, or a percentage of the owner's interest, to a third party (the "farmee," usually a drilling company) at such time as the third party drills and completes construction of an infrastructure, such as a well.[16]

b. Common terms of the farmout include:

i. Farmee agrees to drill a well to a certain depth, and, if hydrocarbons are found, agrees to complete it as a producing well, at the sole cost and expense of the farmee;

ii. Farmee agrees to keep the well and the lease free of liens; and

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[12] *See Chbat v. Tleel (In re Tleel)*, 876 F.2d 769, 773 (9th Cir. 1989); *Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir. 1989).
[13] *Sandoz v. Bennett (In re Emerald Oil Co.)*, 807 F.2d 1234, 1238 (5th Cir. 1987); *Turley v. Mahan & Rowsey, Inc. (In re Mahan & Rowsey, Inc.)*, 817 F.2d 682, 584 (10th Cir. 1987); *Vineyard v. McKenzie (In re Quality Holstein Leasing)*, 752 F.2d 1009, 1013 (5th Cir. 1985) (dictum).
[14] *See City Nat'l Bank of Miami v. Gen. Coffee Corp. (In re Gen. Coffee Corp.)*, 828 F.2d 699, 706-07 (11th Cir. 1987), *cert. denied* 485 U.S. 1007 (1988).
[15] *Wilson v. Parson (In re Jones)*, 77 B.R. 541, 550 (Bankr. N.D. Tex. 1987) (finding lack of constructive trust on behalf of non-operating working interest owners where non-operating working interest owners failed to record their interests).
[16] *See* H. WILLIAMS & C. MEYERS, OIL AND GAS TERMS, p.262 (1981).

iii. If the farmee complies with the farmout and completes a successful well, then the farmor agrees to assign to the farmee an interest in the acreage surrounding the well.

2. Farmouts Under The Bankruptcy Code

a. A farmout agreement "is almost certainly an executory contract."[17]

b. The Code defines a farmout agreement as "a written agreement in which— (A) the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and (B) such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property."[18]

i. The term "farmout" under the Bankruptcy Code has been "interpreted more broadly than is typical in the oil and gas industry."[19]

3. Property of the Estate: the Carve Out of Farmouts

a. As executory contracts, farmout agreements are subject to rejection. Congress amended the Bankruptcy Code after debtor farmors were receiving windfalls by rejecting farmout agreements where farmees had already performed and drilled a successful well.

b. Under, § 541(b)(4), property of the estate does not include: "(4) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that – (A)(i) the debtor has transferred or has agreed to transfer such interest pursuant to a farmout agreement; and (ii) but for the operation of this paragraph, the estate could include the interests referred to in clause (i) only by virtue of section 365 or 544(a)(3) …"

i. Thus, interests in a farmout agreement (primarily when the debtor is the farmor) are excluded from property of the estate so long as:

A) the interest is in liquid or gaseous hydrocarbons;

B) the debtor entered into the farmout agreement prior to bankruptcy;[20] and

C) the estate's claim to include the interest is based either on rights under § 365, or on the trustee's status as a *bona fide* purchaser under § 544(a)(3).

1) Inclusion of § 544(a)(3) is likely so that a farmee's right to an earned assignment cannot be defeated because the farmee's interest is not of record.

4. The Debtor Farmee and Pre-Petition Assignments

a. Issues may arise if the debtor is the farmee and has promised to assign interests in the farmout acreage to another party.

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[17] *In re Texaco, Inc.*, 79 B.R. 560, 563 (Bankr. S.D.N.Y. 1987).
[18] 11 U.S.C. § 101(21A).
[19] *TransTexas Gas Corp. v. Forcenergy Onshore, Inc.*, No. 13-10-00446-CV, 2012 WL 1255218 (Tex. App. – Corpus Christi 2012, *pet. denied*).
[20] *See In re Cassetto*, 475 B.R. 874, 878 n.1 (Bankr. N.D. Ohio 2012) (noting that the "exclusion from property of the estate . . . does not apply . . . because the Debtors expressly acknowledge that their interest in the subsurface oil and gas had not been transferred prior to the Petition Date").

b. As an executory contract, the debtor may assume the farmout agreement. Those promised to be assigned an interest in the farmee's earned acreage may argue that their interest falls within the scope of § 541(b)(4)(A)(i) and should be excluded from the estate as their interests are "pursuant to a farmout agreement." Such argument will only likely prevail if the debtor's ability to perform under the farmout agreement is related to the cash or capital infusion contributed by third party.[21]

5. Prepetition Transfers of Production Payments

a. Essentially, a production payment is "a specified volume or value of hydrocarbons produced from a particular property."[22]

b. The Bankruptcy Code defines the term "production payment" as a "term overriding royalty satisfiable in cash or in kind – (A) contingent on the production of a liquid or gaseous hydrocarbon from particular real property; and (B) from a specified volume, or specified value, from the liquid or gaseous hydrocarbon produced from such property, and determined without regard to production costs."[23]

i. The term "term overriding royalty" is defined by the Bankruptcy Code as "an interest in liquid or gaseous hydrocarbons in place or to be produced from particular real property that entitles the owner thereof to a share of production, or the value thereof, for a term limited by time, quantity, or value realized."[24]

c. In the 1994 amendments to the Bankruptcy Code, Congress recognized the real property transfer nature of overriding royalty interests and modified section 541 to exclude from property of the estate production payments sold by the debtor prior to the bankruptcy filing.[25]

6. Section 541(b)(4)(B)'s Protection to Recipients of Production Payments

a. Section 541(b)(4)(B) provides, in relevant part, that property of the estate does not include:

i. any interest of the debtor in liquid or gaseous hydrocarbons to the extent that –

A) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property

B) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 542 of this title; . . . .[26]

b. In NGP Capital Resources Company v. *ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No. 12-03443, 2014 WL 61408 (Bankr. S.D. Tex. Jan. 6, 2014), ATP Oil & Gas conveyed overriding royalty interests ("ORRI") to investors. These ORRIs were to constitute production payments, excluded from property of the estate. The court ruled

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[21] Mitchell E. Ayer,*S. 7.06 The § 541(B)(4) Safe Harbor for Recipients of Farmouts from Debtors in Bankruptcy*, 34 E. MIN. L. FOUND. § 706 (2013).
[22] 5-541 *Collier on Bankruptcy* ¶ 541.20 (16th ed. 2015).
[23] *See* 11 U.S.C. § 101(42A).
[24] *See*11 U.S.C. § 101(56A).
[25] *Clarification of Section-by-Section on H.R. 5116*, 103rd Cong. E.2204 (1994) (Statement of Hon. Jack Brooks).
[26] 11 U.S.C. § 541(b)(4).

(applying Louisiana law) that the ORRIs could be recharacterized as debt, and denied a request for a judgment as a matter of law. The court reasoned that the proper characterization of the transactions hinged on the actual nature of the transaction.

i. This ruling suggests that despite the long-standing treatment of these transactions as real property transfers, a bankruptcy trustee or debtor could recharacterize a term ORRI as unsecured financing.

D. Joint Operating Agreements ("JOA") as Executory Contracts

1. Background on JOAs

a. JOAs are common in the industry; they allow collaboration and govern relationships between working interest owners in the ownership, development, and operation of oil and gas property.

b. Typically, parties to a JOA involve working interest co-owners who own undivided fractional oil and gas leasehold interests and the operator, often an investor with the largest working interest.

c. JOAs usually identify the property interests of the parties in the leases and property, commit the parties to participate in operations on the contract area (and provide procedures for resolving disputes), contain provisions setting forth funding of work and the effect of failing to fund; include covenants to keep the working interests free and clear of liens, and provide for sharing expenses and allocating liability with respect to joint operations.[27]

d. In most JOA situations, a party proposes a capital operation and the other parties have a certain number of days to either consent or not consent. Parties that elect to participate will be required to pay their share of the costs in accordance with the terms of the JOA. "Non-consent" status frequently comes with a penalty.

2. JOAs in Bankruptcy

a. A JOA may be characterized as an executory contract,[28] subject to rejection by a debtor.

i. Note: as a "complex instrument of interdependent provisions,"[29] JOAs may contain both executory and non-executory provisions. A bankruptcy court may creatively treat a JOA as divisible and allow the debtor to assume and reject some provisions and prohibit the assumption or rejection of provisions non-executory in nature.[30]

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[27] JOAs are typically based on forms issued by the American Association of Petroleum Landmen ("AAPL"). The last form was updated in 1989. *See* Timothy W. Dowdy, *A.A.P.L. Form 610 Model Operating Agreement: Selected Provisions Impacting Onshore Producing Property Transfers*, 47 ROCKY MTN. MIN. L. INST. 13 (2001).

[28] *See, e.g., Wilson v. TXO Prod. Corp. (In re Wilson)*, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987) (noting that "[joint] operating agreements are executory contracts" as non-operators had continuing obligations under the agreements so long as oil or gas were produced from the wells in question).

[29] Gary Conine, *Property Provisions of the Operating Agreement - Interpretation, Validity and Enforceability*, 19 TEX. TECH L. REV. 1263 (1988).

[30] *See, e.g., Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co*., 83 F.3d 735, 741-742 (5th Cir. 1996) (holding that where a personal property lease embraces several distinct agreements, some of which are executory and others fully or substantially performed, only the executory portions of the document are subject to rejection).

b. The “Twilight Zone”

i. Assuming the bankruptcy court treats the JOA as an executory contract, issues arise as to the time period between the petition date and any rejection or assumption of the JOA.

ii. Supreme Court has held that during this time, an executory contract is enforceable only *by* the debtor and not *against* the debtor.[31]

A) But, the Supreme Court also noted that in the event the debtor chooses to continue to receive benefits from a counterparty prior to assuming or rejecting the executory contract, the debtor is obligated to pay for the reasonable value of those services which, depending on the circumstances, may be what is specified in the contract.[32]

iii. The time period between the petition date and rejection/assumption, where the executory contract is enforceable by, but not against, a debtor, has been referred to as the “twilight zone.”[33]

iv. During the “twilight zone,” the *Wilson* court found that there was no enforceable contract and the local law of co-tenancy applied.

A) Pursuant to co-tenancy law in Texas, when one co-tenant incurred expenses beneficial to the property, that co-tenant could subtract its reasonable costs from the oil and gas received before accounting to the non-participating co-tenant for their share of production.[34]

B) The *Wilson* court ruled that post-petition production could be charged against post-petition obligations.[35] The debtor could offset the post-petition benefits, however it was still required to account to the counterparty as the debtor was still receiving the benefits of the oil and gas production.[36]

C) Some legal commentators have criticized the ruling of *Wilson* court, labeling it a “harsh” and “improper” result.[37]

c. Rejection

i. After rejection, the non-debtor counterparty would hold a general pre-petition unsecured claim.

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[31] *N.L.R.B.. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984).
[32] *Id.*
[33] *See, e.g., id.* at 532; *United States ex rel. U.S. Postal Serv. v. Dewey Freight Sys, Inc.*, 31 F.3d 620, 624 (8th Cir. 1994); *In re Broadstripe, LLC*, 402 B.R. 646, 656 (Bankr. D. Del. 2009); *Interstate Gas Supply, Inc. v. Wheeling Pittsburgh Steel Corp. (In re Pittsburgh-Canfield Corp.)*, 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002); *In re Wilson*, 69 B.R. at 966.
[34] *In re Wilson*, 69 B.R. at 965-66.
[35] *Id.*
[36] *Id.*
[37] Rhett G. Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, 5 TEX. J. OIL GAS & ENERGY L. 265, 303-04 (2010); *see also* Charles A. Beckham Jr. et. al., *Oil and Gas Leases: They're Not Just in Texas Anymore; They're Fracking Everywhere!*, 32ND ANNUAL JAY L. WESTBROOK BANKRUPTCY CONFERENCE, NOVEMBER 21-22, 2013, AUSTIN, TEXAS, p. 7 (questioning the holding of *Wilson*).

3. The Debtor Operator

   a. If the debtor is the operator under a JOA, the terms of the JOA may provide that the operator is deemed to have resigned under the JOA upon a bankruptcy filing.

      i. However, such a designation may create an automatic stay violation under § 362 of the Bankruptcy Code.

      ii. Further, bankruptcy court under § 365(e)(1) will typically not enforce any *ipso facto* clause in a JOA that provides for the removal of an insolvent operator.[38]

      iii. Also, some JOAs provide that in the event of the operator's bankruptcy, an interim operating committee will control operations until the debtor elects to either accept or reject the JOA.

   b. Operator will be able to enforce the terms of the JOA before assuming or rejecting it, but "consideration for doing so is the debtor's being bound by the same terms of the JOA during the same period."[39]

4. The Non-Operator Debtor

   a. Issues could arise when a non-operator debtor continues to accept performance under the JOA post-petition and later decides to reject the JOA.

      i. *Wilson* court found that the law of co-tenancy, rather than the terms of the JOA, governs the relationship during the "twilight zone."[40]

      ii. But, Supreme Court held that during this period, an executory contract, such as a JOA, remains enforceable *by* the debtor, *but not against* the debtor. If any benefits are received from the JOA, the non-operator debtor will become bound by the same terms of the agreement.[41]

E. Joint Ventures – The Risk of One of the Members Filing for Bankruptcy; Exposure To Other Members

1. Due diligence

   a. A party contemplating entering into a joint venture agreement should conduct a thorough analysis of the other party's financial conditions, lending arrangements and state of entity organization.

   b. A non-operating party should also insist that the operator conduct the same type of diligence with regard to any party with whom the operator contracts for the purchase, gathering, and/or marketing of gas.

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[38] Section 365(e)(1) provides, "[n]otwithstanding a provision in an executory contract . . . an executory contract . . . of the debtor may not be terminated or modified . . . solely because of a provision in such contract or lease that is conditioned on—(A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title".

[39] Rhett G. Campbell, *Energy Bankruptcy--Developments, Issues and the Uniform Commercial Code*, STATE BAR OF TEXAS, 21ST ANNUAL ADVANCED OIL, GAS & ENERGY RESOURCES LAW COURSE (2003).

[40] *In re Wilson*, 69 B.R. at 966.

[41] *N.L.R.B.. Bildisco & Bildisco*, 465 U.S. at 531.

2. Joint Ventures and JOAs

   a. Members of the joint venture (JV) should include provisions and set out procedures in the JV agreement that the JV will follow in a case of a bankruptcy proceeding.

   b. Section 541 of the Bankruptcy Code – This Section defines "property of the estate" broadly, including "all legal or equitable interests of the debtor in property as of the commencement of the case." The JV members should develop a protocol for separately identifying JV property so that such property is not deemed "property of the estate" when one of the JV members files for bankruptcy. By keeping JV assets separate from member assets, should one of the JV members file for bankruptcy, the JV will have the ability to continue day-to-day operations.

      i. The debtor's interest in the JV is an asset of the bankruptcy estate. This includes bank accounts and equipment, which could be deemed property of the estate if careful records and separate accounts are not maintained.

      ii. All property of the JV should be titled in the JV's name, and bank accounts should be maintained in the name of and under the control of the JV, and not in the name of the individual JV members.

      iii. Commingled property will automatically be deemed property of the estate, and it may be difficult or impossible to disentangle those assets.

   c. Section 365(a) of the Code – This Section allows a debtor, subject to court approval, to assume or reject any executory contract or unexpired lease of nonresidential real property. Unless the JV was already winding down, the JV agreement is generally considered an executory contract that may be assumed by the debtor, and assumption of an executory contract requires court approval.

      i. Most courts will apply the business-judgment test to determine whether assumption or rejection is appropriate. This standard requires that the court approve the debtor's business decision unless that judgment is the product of bad faith, whim or caprice.

      ii. The entire contract must be assumed or rejected, absent consent of the counterparty. Under § 365(b), the contract may not be assumed unless the debtor first cures most defaults or provides "adequate assurances" that any defaults will be cured.

III. Investing in Distressed Oil and Gas Companies

A. Key Concepts for Protection of Debt Investment in a Bankruptcy

1. Timing and Process of a § 363 Sale – "…after notice and a hearing, [a Debtor] may use, sell or lease, other than in the ordinary course of business, property of the estate."[42]

   a. Section 363 of the Bankruptcy Code governs all Chapter 11 asset sales, except for sales proposed as part of a reorganization or liquidating plan. A § 363 sale is made by motion on a relatively short 20-day notice to creditors.

   b. Notice is to be sent to all creditors, or the unsecured creditors' and must contain a description of the terms and conditions of the sale, along with a time specification for filing objections.[43]

[42] 11 U.S.C. § 363(b)(1).
[43] FED. R. BANKR. P. 2002.

c. It is not necessary for creditors or interest holders to approve such a sale, although they certainly have the right to object. Provided there are no objections in response to the notice, a hearing or court approval may not even be required.[44]

2. Factors in Considering Whether to Approve a § 363 Sale – When a bankruptcy court considers whether to approve a § 363 sale, it uses the "business justification" standard, which is comprised of several factors sometimes referred to as "Lionel factors", named after a Second Circuit case.[45] These factors include:

   a. The value of the assets to the estate as a whole;

   b. The elapsed time since the bankruptcy filing;

   c. The likelihood that a plan of reorganization will be proposed and confirmed in the near future;

   d. The effect of the proposed sale on the ability to put together a future plan of reorganization;

   e. How much can be raised from the sale compared to the appraised value; and

   f. Whether the asset is increasing or decreasing in value.

3. Advantages to a § 363 Sale

   a. One advantage of a § 363 sale is the ability to realize value on assets that may be losing value. The debtor can file a § 363 motion and try to maximize the recovery for creditors.

   b. Traditionally, debtors used § 363 to sell discrete assets, specific business units or subsidiaries, but now is being used more and more to sell substantially all of debtors' assets/businesses.

   c. Sales under § 363 generally are free and clear of liens and encumbrances and, although the free and clear language in § 363 omits the word "claims," bankruptcy courts have been willing to provide the maximum protections possible to buyers.[46]

4. Credit Bidding Under § 363(k)

   a. Purpose of Credit Bidding

      i. Section 363(k) of the Bankruptcy Code provides secured creditors the right to "credit bid" the value of their debt in certain auctions or sales of their collateral—effectively exchanging all or a portion of the secured creditors' debt for the assets securing it.

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[44] *In re Robert L. Hallamore Corp*., 40 B.R. 181, 183 (Bankr. D. Mass 1984) ("In the absence of objections or counter-offers, a sale in accordance with Section 363 Rules [sic] 2002 and Rule 6004 does not require court approval…[I]n the absence of a dispute, there is no judicial involvement in and no court supervision of a sale.").

[45] *See In re Lionel Corp*., 722 F.2d 1063 (2d Cir. 1983).

[46] The debtor may sell property free and clear of any interest in such property of an entity other than the estate, only if: (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. 11 U.S.C. § 363(f).

ii. Credit bidding provides protection to a secured creditor against the sale of the creditor's collateral at a depressed price without the need to commit additional cash.

b. Process Under § 363(k)[47]

i. This process usually takes two to three months. The debtor usually starts the process by identifying a "stalking horse" or a party who is willing and able to buy the assets.

ii. The debtor negotiates an asset purchase agreement with that stalking horse and, at the conclusion of the negotiation, the debtor drafts a bid procedures motion suggesting how it proposes to sell the assets.

iii. There are then two court hearings. The first is a bid procedures hearing. At that hearing, the court approves the bid procedures motion and the debtor goes about marketing the assets.

iv. The debtor wants to find the highest possible bid. If the debtor finds one or more other bidders during the marketing phase, then an auction will be held. The marketing phase usually lasts 30 to 45 days.

v. The debtor holds the auction. The stalking horse bids against the others. A winner is chosen. The debtor then goes to court for the second hearing to ask approval for the winning bid and completes the sale.[48]

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[47] In recent years, debtors seeking to "cram down" secured creditors (i.e. deny secured creditors their credit bid rights) by selling assets through a chapter 11 plan have had mixed results, but the United States Supreme Court has now held that a chapter 11 plan that provides for the sale of assets cannot be confirmed over the objection of a class of secured creditors if it does not also provide for the right of that secured creditor class to credit bid. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065 (2012), However, even after *RadLAX*, courts have indicated a willingness to limit credit bid rights of secured creditors if there is "cause" to so limit those rights. See *In re Fisker Automotive Holdings, Inc.*, 501 B.R. 55 (Bankr. D. Del . 2014); *In re Free Lance-Star Publishing Co.*, 2014 WL 2505627 (Bankr. E.D. Va. 2014).

[48] Other concerns exist (not the subject of this paper) for protecting interests of debt holders out of bankruptcy, and equity holders both in and out of bankruptcy.