

**DECOMMISSIONING/PLUGGING AND ABANDONMENT LIABILITIES
IN BANKRUPTCY: WHAT PRIORITY SHOULD THEY BE
AFFORDED?**

By

Mark A. Chavez

Bankruptcy associate with the law firm of Locke Liddell & Sapp LLP

Philip G. Eisenberg

And

Omer F. Kuebel III

*Equity partners with the law firm of Locke Liddell & Sapp LLP practicing in the
areas of energy and bankruptcy law.*

SYNOPSIS

§ 1.01 Basic Environmental Regulations Relating to “P&A”

- [1] MMS Guidelines
- [2] Texas Guidelines
- [3] Louisiana Guidelines

§ 1.02 Basic Bankruptcy Concepts

- [1] Priming Liens and Cash Collateral Usage
- [2] 11 U.S.C. § 365 and Contract Assumption/Rejection
- [3] Effects of Contract Rejection
- [4] Effects of Contract Assumption
- [5] Applicability of § 365 to Mineral Leases
- [6] “P&A” Specific Assumption/Rejection Problems
- [7] Abandonment Power
- [8] 28 U.S.C. § 959 and *Midlantic National Bank v. New Jersey Department of Environmental Protection*

§ 1.03 Administrative Priority for Environmental Liabilities

§ 1.04 Pitfalls for Predecessors in Interest

- [1] Status of Plugging and Abandonment Liabilities as “Imminent Harms”
- [2] “Standing” Type Problem
- [3] 11 U.S.C. § 502(e)

§ 1.05 Conclusion

As of March 2004, approximately \$10 billion in potential “plugging and abandonment” or “decommissioning” obligations¹ have accrued in the Gulf of Mexico.² 4,000 oil and gas platforms lie active in the Outer Continental Shelf of the Gulf and a quarter of these platforms are 25 years old, or more.³ Of these, more than 100 are decommissioned annually, with that figure steadily increasing.⁴ With such staggering financial obligations looming, the question of who will ultimately be responsible for these costs is a legal question that has been getting more and more attention in recent years. Nowhere has the answer to this question become more uncertain than in a bankruptcy context.

Bankruptcy is, by its nature, a financial tool used by companies to shed or restructure burdensome liabilities. Sophisticated debtors are using bankruptcy, not only to restructure debts owed to traditional creditors, such as noteholders, bond holders, and trade creditors, but also as a way of avoiding or subordinating environmental liabilities, including decommissioning obligations. In the

¹ The terms “plugging and abandonment” or “decommissioning” obligations generally refer to the state or federal statutory liabilities that arise at the end of end of an oil or gas well’s useful life and include obligations such as “plugging” of the well, removal of platforms and other facilities, and site clearance. These obligations are described as “decommissioning activities,” as defined in 30 CFR § 250.1700 *et seq.*

² See Monica Perin, *Gulf Hides \$10 Billion Hazard*, HOUSTON BUS. J., Mar. 2004 at www.houston.bizjournals.com/houston/stories/2004/03/29/story1.html.

³ *Id.*

⁴ *Id.*

exploration and production industry, debtors and various creditor and investor constituencies have attempted to utilize bankruptcy to reject oil and gas leases and related agreements in an effort to financially restructure and avoid plugging and abandonment or decommissioning obligations, or as a means of abandoning properties burdened by such liabilities altogether. If, however, a reorganizing exploration and production company attempts to avoid its decommissioning obligations through bankruptcy, the mineral lessor will seek performance of this obligation from the operator, co-lessees or predecessors in interest, in many cases simultaneous to the bankruptcy proceedings.

As a general proposition, the goal of bankruptcy is to allow a debtor to financially rehabilitate by allowing it to restructure or discharge certain pre-petition debts, reject burdensome contracts, and abandon property, under certain circumstances.⁵ The purpose of environmental laws, and more specifically regulations dealing with plugging and abandonment or decommissioning liabilities, however, is to protect the public health, safety and welfare.⁶ Although there is a tension between the bankruptcy goal of rehabilitating a debtor and the environmental statutory schemes, which require decommissioning of oil and gas wells in the interest of public health, safety and welfare, it is reasonably clear that, as between the two, bankruptcy goals must yield to the public interest. This is at

⁵ Deborah E. Parker, *Environmental Claims in Bankruptcy: It's a Question of Priorities*, 32 SAN DIEGO L. REV. 221, 222 (1995).

⁶ See e.g., 30 C.F.R. § 250.107 (providing that operators conducting oil and gas operations in the Outer Continental Shelf must "protect health, safety, property and the environment" through compliance with various general safety requirements).

least true where the party seeking such relief is the sovereign, or an arm of the sovereign exercising police power. Where, however, the party seeking that finding is co-liable to the sovereign with the debtor for such environmental obligations, the issue takes on a new shape.⁷

Part I of this article discusses the general statutory schemes that establish decommissioning liabilities and, in certain instances, establish predecessor in interest liability for such obligations. Part II outlines general bankruptcy law principles and precedent, which must be applied in order to determine the proper treatment of plugging and abandonment liabilities in bankruptcy. Part III presents an analysis through which it becomes evident that decommissioning obligations should be afforded the highest priority in bankruptcy and must be paid by debtor, irrespective of its financial situation. This result is consistent with the relevant sections of the bankruptcy code and the more reasoned opinions issued by the federal courts. Part IV addresses the pitfalls that may lie for a debtor's predecessor in interest who, like the debtor, may be liable for plugging and abandonment obligations under applicable law. Part V concludes that, based upon the foregoing, plugging and abandonment obligations should be afforded administrative expense priority, however, the ability of a predecessor in interest to pursue a claim on its own behalf may be limited.

§ 1.01 Basic Environmental Regulations Relating to “P&A”

[1] MMS Guidelines

The Mineral Management Service (“MMS”) is a section of the

⁷ This is true even where contractual indemnities exist as between the debtor and the co-liable party.

Department of the Interior, which oversees the nation's Offshore Minerals Management Program.⁸ The agency's role is to manage leasing of acreage for oil and gas development and to ensure that these operations are conducted safely and that the environment is protected.⁹ In order to protect the public health and safety, the MMS requires owners and operators of oil and gas leases to complete certain decommissioning actions at lease termination. These regulations are codified at 30 CFR § 250.1700 *et seq.* "At the end of lease operations, oil and gas lessees must plug and abandon wells, remove platforms and other facilities, and clear the lease site sea floor."¹⁰ Furthermore, the MMS requires that companies owning a record title interest in or operating on the Outer Continental Shelf post financial security to ensure that such decommissioning activities are performed.¹¹ Such financial security may consist of financial guarantees, site specific cash escrows or surety bonds.¹² As an additional precaution, the MMS regulations provide that if a lessee or operator "cannot or does not extinguish its...P&A Obligations, and if the Surety Bonds are not called, or if the Surety Bonds prove insufficient to pay for all P&A Operations, then the MMS may also call upon the Co-Lessees and Predecessors in Title for payment because such entities are co-responsible with"

⁸ See MMS's webpage at www.mms.gov/offshore (last visited November 1, 2005).

⁹ *Id.*

¹⁰ Gerald W. Schlieff, Statement on behalf of National Oceans Industries Association, *et al* (July 22, 2002) (available at http://www.unr.edu/mines/mlc/presentations_pub/NV_BTFR/f4Gerald.pdf); 30 C.F.R. §§ 250.1710-11; 256.52.

¹¹ *Id.*

¹² *Id.*

the lessee.¹³ 30 C.F.R. 256.62(d) states:

You, as assignor, are liable for all obligations that accrue under your lease before the date the Regional Director approves your request for assignment of the record title in the lease. The Regional Director's approval of the assignment does not relieve you of accrued lease obligations that your assignee, or subsequent assignee, fails to perform.

Therefore, even after a party has assigned its rights in a federal mineral lease, it remains potentially liable for obligations its assignee fails to perform.

[2] Texas Guidelines

In Texas, the regulatory agency governing oil and gas operations is the Texas Railroad Commission. It was established “in 1891 under a constitutional and legislative mandate to prevent discrimination in railroad charges and establish reasonable tariffs. It is the oldest regulatory agency in the state and one of the oldest of its kind in the nation.”¹⁴ The Railroad Commission “has four regulatory divisions that oversee the Texas oil and gas industry, gas utilities, pipeline and rail

¹³ *In re Tri-Union Development*, 314 B.R. 611, 616 (Bankr. S.D. Tex. 2004). While *In re Tri-Union* dealt specifically with surety bonds, MMS regulations allow for other forms of security to be used to guarantee the performance of decommissioning obligations. Specifically, 30 C.F.R. § 256.52 allows for alternative forms of security to be pledged, including, but not limited to, U.S. Department of the Treasury securities, as well as alternative types of security instruments, so long as the Regional Director determines that the “alternative security protects the interests of the United States to the same extent as the required bond.” Alternative forms of security may include site-specific trusts or similar financial guarantees.

¹⁴ Texas Railroad Commission website at <http://www.rrc.state.tx.us/about/index.html>.

safety, safety in the liquefied petroleum gas industry, and the surface mining of coal and uranium.”¹⁵ With respect to its regulations governing a lessee’s plugging and abandonment obligations, it provides that an "Operator"¹⁶ is primarily responsible to plug a well. The definition of "Operator" makes clear that a current operator remains liable for these environmental liabilities until certain requirements are met, such as a new operator acknowledging plugging liability on Railroad Commission approved forms, and obtaining the required financial assurances, consisting of either a Commission approved bond or other form of acceptable financial security.¹⁷ A failure to meet these requirements may leave an Operator burdened with “P&A” liability, even in the event of an assignment.

¹⁵ *Id.*

¹⁶ TEX. NAT. RES. CODE ANN. § 89.002(a)(2) provides: ““Operator” means a person who assumes responsibility for the physical operation and control of a well as shown by a form the person files with the commission and the commission approves. The commission may not require a person to assume responsibility for a well as a condition to being permitted to assume responsibility for another well. In the event of a sale or conveyance of an unplugged well or the right to operate an unplugged well, a person ceases being the operator for the purpose of Section 89.011 only if the well was in compliance with commission rules relating to safety or the prevention or control of pollution at the time of sale or conveyance and once the person who acquires the well or right to operate the well: (A) specifically identifies the well as a well for which the person assumes plugging responsibility on forms required and approved by the commission; (B) has a commission-approved organization report as required by Section 91.142; (C) has a commission-approved bond or other form of financial security under Sections 91.103-91.107 covering the well; and (D) places the well in compliance with commission rules.”

¹⁷ *Id.*; *see also* TEX. NAT. RES. CODE ANN. § 91.104, which provides: “BONDS, LETTERS OF CREDIT, AND CASH DEPOSITS. (a) The commission shall require a bond, letter of credit, or

Additionally, if an Operator fails to comply with their plugging and abandonment obligations, all working interest owners are responsible for their proportionate share of P&A liability.¹⁸ Therefore, if an operator were to assign some but not all of its interests in a well, choosing to remain as a working interest owner, or if its assignee failed to comply with the applicable statutes, the old operator could remain liable for its proportionate share of P&A liability.

[3] Louisiana Guidelines

In Louisiana, plugging and abandonment of oil and gas wells is subject to the authority of the Commissioner of Conservation.¹⁹ Under this authority, the

cash deposit to be filed with the commission as provided by Subsection (b) of this section. (b) A person required to file a bond, letter of credit, or cash deposit under Section 91.103 who is an inactive operator or who operates one or more wells must, at the time of filing or renewing an organization report required by Section 91.142, file: (1) an individual bond as provided under Section 91.1041; (2) a blanket bond as provided under Section 91.1042; or (3) a letter of credit or cash deposit in the same amount as required for an individual bond under Section 91.1041 or a blanket bond under Section 91.1042.”

¹⁸ TEX. NAT. RES. CODE ANN. § 89.012 provides: “If the operator of a well fails to comply with Section 89.011 of this code, each nonoperator is responsible for his proportionate share of the cost of the proper plugging of the well within a reasonable time, according to the rules of the commission in effect at the time the responsibility attaches.” Moreover, most operating agreements state that the operator will collect the proportionate share of P&A costs from the non-operating working interest owners.

¹⁹ LA. PRAC. ENVTL. COMPL. § 4-45 (citing LA. REV. STAT. ANN. § 30:4(C)(1)(a)(iv)); *see also* LAC 43:XIX (known as “Statewide Order 29-B.”). Statewide Order 29-B is a section of the Louisiana Administrative Code that regulates off-site storage, treatment and/or disposal of exploration and production waste generated from drilling and production of oil and gas wells.

party primarily responsible for proper plugging and abandonment of wells is the “owner.”²⁰ As defined, the owner includes the person who has or had the right to operate the well.²¹ The Louisiana Mineral Code further provides that “[a]n assignor or sublessor is not relieved of his obligations or liabilities under a mineral lease unless the lessor has discharged him expressly and in writing.”²² The comments to this section of the code make clear that the “original lessee remains bound to the original lessor and cannot discharge himself by the device of subleasing. The original lease is unaffected by the sublease.”²³ “[I]t is the intent of this article to retain the concept that the prime lessor can continue to demand performance from his lessee unless he has released him in writing.”²⁴ Even where the State of Louisiana consents to the assignment of the relevant oil and gas lease, this approval does not operate to discharge the original lessee from its contractual obligations under the lease; this includes plugging and abandonment obligations.²⁵ As a result, just as with the MMS regulations, even after an

²⁰ *Id.* (citing LA. REV. STAT. ANN. § 30:4(C)(1)(b)).

²¹ *Id.* (citing LA. REV. STAT. ANN. § 30:3(8)).

²² LA. REV. STAT. ANN. § 31:129.

²³ Comments to LA. REV. STAT. ANN. § 31:129.

²⁴ *Id.*

²⁵ *Id.* (citing *Davis Oil Co. v. TS, Inc.*, 962 F.Supp. 872 (E.D. La. 1997), *rev'd* 145 F.3d 305; *Chevron U.S.A., Inc. v. Traillour Oil Co.*, 987 F.2d 1138 (5th Cir. 1993) (holding that by assuming all obligations of ownership in an oil and gas lease, successors in interest to original purchaser of lease assumed only real obligations running with the lease, which were obligations running in favor of original lessor, and there was no express assumption of purchaser’s personal obligations to seller of lease with regard to obligation to plug and abandon wells.)).

assignment of interest, lessees of oil and gas interests need to be cognizant of their remaining environmental obligations and responsibilities even after an assignment of such interests is consummated. This remains the case even where, as is the norm, the predecessor in interest has included contractual indemnities as part of the transfer of interest to a party that ultimately becomes a debtor in bankruptcy. Often, if not always, these typical provisions do little, if anything, to insulate the predecessor in interest from potential liability.

§ 1.02 Basic Bankruptcy Concepts

As noted above, bankruptcy, despite its negative stigma, can be a valuable financial tool that allows a debtor to restructure or indeed shed certain liabilities. As is described more fully below, bankruptcy provides a debtor with more than a few arrows in its quiver that may be used to deal with significant liabilities, including P&A and decommissioning liabilities.

[1] Priming Liens and Cash Collateral Usage

11 U.S.C. § 364(d)(1) provides: “The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien...” Upon the commencement of a bankruptcy reorganization, it is imperative that a debtor immediately obtains access to funds in order to continue in operation. Access to such funds can come in the form of a grant to use “cash collateral” of a secured creditor in exchange for adequate protection, or by virtue of authorization of additional debt financing. In this latter situation, a debtor’s post-petition lender may, as an incentive to lend to a bankrupt debtor, be granted senior liens on all

property of the estate. The result of such a grant is the subsequent subordination of competing secured (and unsecured) claims, which may include security rights held by other creditors, such as predecessors in interest. Indeed, in some instances, lenders have sought to subordinate obligations associated with properties, such as plugging and abandonment liabilities. As a result, where such priming liens are sought by lenders either as collateral for a post-petition loan or as “adequate protection” for the use of cash collateral, other creditors must analyze the full effect such a grant may have on their interests, including the effect of such a priming lien on environmental liabilities associated with the propert(ies) in question.

[2] 11 U.S.C. § 365 and Contract Assumption/Rejection

The Bankruptcy Code empowers a debtor to reject burdensome leases and contracts, including joint operating agreements. Specifically, 11 U.S.C. § 365, entitled “Executory contracts and unexpired leases,” provides, in pertinent part: “...the trustee,²⁶ subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” The term “executory contract” is not defined in the Bankruptcy Code, but generally includes contracts on which performance remains due on both sides, such that the non-performance of one party would constitute a material breach excusing performance by the other party. “The purpose of Section 365 is to enable a troubled debtor to take advantage of a contract that will benefit the estate by assuming it or, alternatively,

²⁶A Chapter 11 debtor-in-possession has the same right to assume or reject under Section 365 as the trustee. 11 U.S.C. § 1107(a).

to relieve the estate of a burdensome contract by rejecting it.”²⁷

Assumption or rejection of a creditor’s executory contract is critical to determining the priority of the creditor’s claim. Section 503(b) of the Bankruptcy Code provides for the allowance of claims for administering the debtor’s estate, or administrative expense claims. Section 503(b) derives its importance from Section 507, which provides that certain categories of claims have priority in distribution of the assets of the estate. The first priority, set forth in Section 507(a)(1), consists of administrative expenses allowed under Section 503(b). A debtor cannot confirm a plan of reorganization unless all administrative expense claims have been paid in cash in full, unless the claimant agrees to other treatment.²⁸ Obligations under an assumed executory contract, including payments to cure any defaults, are classified as administrative expense claims. Thus, a creditor of a Chapter 11 debtor whose claims are administrative expenses has a much higher probability of being paid in full than other types of creditors, particularly unsecured creditors.

[3] Effects of Contract Rejection

If a bankrupt debtor rejects an executory contract, the debtor’s estate will generally lose any benefit from the contract and will be liable for damages for the breach, entitling the nondebtor party to file a proof of claim for unsecured pre-petition and rejection damages.²⁹ In other words, the creditor’s breach of contract

²⁷ *In re Hardie*, 100 B.R. 284, 285 (Bankr. E.D.N.C. 1989).

²⁸ 11 U.S.C. § 1129(a)(9)(A).

²⁹ 11 U.S.C. §§ 365(g), 502(g).

claim will rank below administrative expense claims, priority claims and secured claims. Indeed, in a complex Chapter 11 bankruptcy, the general unsecured creditor class may wait for years to receive only a small distribution amounting to only pennies on the dollar amount of the claims.

[4] Effects of Contract Assumption

As noted above, if an executory contract is assumed, then any liability of the debtor thereafter will be an administrative expense of the debtor's estate.³⁰ In order for a debtor to assume an executory contract the debtor must satisfy three requirements: (1) cure any monetary default or provide adequate assurance that the default will be promptly cured; (2) compensate or provide adequate assurance that the debtor will promptly compensate the other party for any pecuniary loss to the party resulting from the default; and (3) provide adequate assurance of future performance under the contract.³¹ In other words, the contract must be brought back into compliance with its terms, there must be compensation for pecuniary loss to the creditor,³² and there must be adequate assurance that the debtor (or its

³⁰ *Nostas Assocs. V. Costich (In re Klein Sleep Prods., Inc.)*, 78 F.3d 18, 30 (2d Cir. 1996).

³¹ 11 U.S.C. § 365(b); *Pieco, Inc. v. Atlantic Computer Sys., Inc. (In re Atlantic Computer Sys., Inc.)*, 173 B.R. 844 (S.D.N.Y. 1994).

³² As an alternative to immediately curing all defaults at the time an executory contract is assumed, a debtor may seek to provide adequate assurance that the defaults will be "promptly" cured. Promptness is a fact-specific inquiry that may permit a debtor to cure defaults over as long as three years. *See, e.g., In re Coors of N. Miss., Inc.*, 27 B.R. 918, 922 (Bankr. N.D. Miss. 1983) (finding three years is an acceptable cure period, given "prospective longevity of successful business operation"). *But see Motor Truck & Trailer Co. v. Berkshire Chemical Haulers, Inc. (In re Berkshire Chemical Haulers, Inc.)*, 20 B.R. 454 (Bankr. D. Mass 1982) (finding debtor's

