

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

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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

assignee) will perform the contract in the future.³³ On the other hand, if the debtor has not defaulted on the contract, the debtor may simply assume the contract, subject to court approval, without providing cure, compensation or adequate assurance of future performance.³⁴

[5] Applicability of § 365 to Mineral Leases

The question of whether § 365 is applicable to mineral leases remains, largely, an unresolved legal question. While the MMS and the Middle District of Louisiana have taken the position that mineral leases are subject to treatment under § 365 of the Bankruptcy Code, one court has rejected this contention, at

proposal to apply all pre- and post-petition arrearages over 18 months, the remaining lease period, did not constitute prompt cure).

³³ 3 *Collier on Bankruptcy* ¶365.05[3]. Assumption of an executory contract does not provide an absolute guarantee that a debtor will fully perform under the contract after assumption. Rather, even after a debtor has assumed an executory contract, it may later attempt to reject the contract. 11 U.S.C. § 365(g). The converse is not true, *i.e.*, a debtor may not assume a contract after it has previously rejected the contract. *See* 11 U.S.C. § 1123(b)(2) (permitting assumption or rejection in a plan of reorganization of executory contracts “not previously rejected”); *Nostas Assocs. V. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996).

³⁴ However, in *In re Panaco, Inc.*, No. 02-37811 (Bankr. S.D.Tex filed July 16, 2002), the court issued a Memorandum Opinion dated December 9, 2002, in connection with an order compelling assumption of an offshore joint operating agreement, in which the court stated: “The argument that somewhere during the production life of the well enough money will be made available to fund [an] escrow account is insufficient.” Accordingly, whether and how adequate assurance of future plugging and abandonment costs will be provided for would seem to be subject to a case by case analysis.

least with respect to Louisiana state mineral leases. In *In re WRT Energy Corp.*,³⁵ the Bankruptcy Court for the Western District of Louisiana expressly found that a standard Louisiana oil and gas mineral lease was not an “executory contract,” within the meaning of § 365 of the Bankruptcy Code. The District Court for the Middle District of Louisiana, however, has found to the contrary. In *Texaco, Inc. v. Louisiana Land and Exploration Co.*,³⁶ the court held that state mineral leases are subject to assumption or rejection, pursuant to § 365 of the Bankruptcy Code. Until this question is conclusively decided, the potential for a debtor to reject a mineral leases may be subject to legal challenge.³⁷

[6] “P&A” Specific Assumption/Rejection Problems

The recently enacted amendments to the Bankruptcy Code further complicate the treatment of decommissioning liabilities. If, assuming a debtor assumes the operating agreement or lease that gives rise to plugging and abandonment liability, § 365, as recently amended, leaves open a question as to whether a debtor or trustee has to cure “impossible,” “nonmonetary” obligations. Although it may be somewhat of a leap to categorize plugging and abandonment

³⁵ 202 B.R. 579 (W.D. La. 1996).

³⁶ 136 B.R. 658 (M.D. La. 1992).

³⁷ In contrast, joint operating agreements, which often times are the instruments through which a party assumes plugging and abandonment liabilities, are executory contracts subject to assumption or rejection pursuant to 11 U.S.C. § 365. See *Wilson v. TXO Production Co.*, 69 B.R. 960 (N.D. Tex. 1987). Therefore, all parties who have an interest in a state or federal mineral lease must be cognizant of the fact that these agreements, to the extent they are the sole source of a party’s decommissioning liability, are subject to rejection in a bankruptcy proceeding.

obligations as impossible to perform or as “nonmonetary” obligations, the ultimate interpretation of this provision remains an open question. Finally, in the event of a rejection, an argument exists that plugging and abandonment liabilities should be treated just as any other rejection damages – *i.e.*, as unsecured claims. Although the authority cited below suggests that this result should not be allowed, it remains an issue that must be considered.³⁸

[7] Abandonment Power

11 U.S.C. § 554³⁹ provides, in relevant party: “After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.” As with most powers, a bankruptcy trustee’s abandonment power is limited; therefore, the question arises as to whether this power may be exercised as a means of abandoning estate property burdened by environmental liabilities, including, for example, decommissioning obligations.⁴⁰

[8] 28 U.S.C. § 959 and *Midlantic National Bank v. New Jersey Department of Environmental Protection*

28 U.S.C. § 959(b) provides: “...a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in

³⁸ Indeed, the question of whether operating agreements and mineral leases may be assumed or rejected at all is a question that has given rise to conflicting authority on the matter. The MMS, however, has taken the position that federal oil and gas leases are executory contracts subject to assumption or rejection.

³⁹ Title 11 of the United States Code is the “Bankruptcy Code” and may be cited as such in this article.

⁴⁰ 6A NORTON BANKR. L. & PRAC. 2D § 149:17.

possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.”

Courts have interpreted § 959 as a limited exception to the broad power of a bankruptcy trustee to abandon property, which is burdensome to the estate. More specifically, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, the United States Supreme Court held “that a bankruptcy trustee may not abandon property in contravention of state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards.”⁴¹ Although the *Midlantic* decision was not based on § 959, the court relied upon § 959(b) to show “that Congress did not intend for the Bankruptcy Code to pre-empt *all* state laws.”⁴² Since *Midlantic*, courts have interpreted § 959 as a “public interest” statute. In enacting it, Congress intended to limit a trustee’s ability operate *carte blanche* to the detriment of the general community. Rather, courts have relied on *Midlantic* in holding that trustees and debtors-in-possession have an obligation to comply with all forms of

⁴¹ *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 507, 106 S.Ct. 755, 762 (1986).

⁴² *In re Scott Housing Systems*, 91 B.R. 190, 196 (S.D. Ga. 1988) (quoting *Midlantic*, 106 S.Ct. at 762).

environmental regulations, which would include decommissioning/plugging and abandonment liabilities.⁴³

In *In re H.L.S. Energy Co., Inc.*,⁴⁴ the Fifth Circuit Court of Appeals concluded: “[u]nder federal law, bankruptcy trustees *must* comply with state law. Furthermore, a bankruptcy trustee *may not* abandon property in contravention of a state law reasonably designed to protect public health or safety.”⁴⁵ “[A] combination of Texas and federal law place[] on the trustee an *inescapable obligation* to plug [] unproductive wells...”⁴⁶ The Fifth Circuit recognized that such environmental obligations could not be abandoned because failing to honor such obligations may “operate[] as a legal liability on the estate, a liability capable of generating losses in the nature of substantial fines every day the wells remain[] unplugged.”⁴⁷ “Anyone possessing the sole operating interest in an unproductive well surely would be happy to abandon that interest, and the concomitant obligation to plug that well. But he cannot, for state [and federal] law require[]

⁴³ *In re Wall Tube & Metal Products Co.*, 831 F.2d 118, 118 (6th Cir. 1987) (holding that a state’s emergency clean-up costs incurred pursuant to federal environmental act were allowable administrative expenses in debtor’s Chapter 7 proceeding); *In re Environmental Waste Control, Inc.*, 125 B.R. 546, 546 (N.D. Ind. 1991) (holding a debtor in possession must comply with environmental clean-up plans ordered by state and federal agencies, notwithstanding the debtor’s claim of insufficient funds).

⁴⁴ 151 F.3d 434, 438 (5th Cir. 1998).

⁴⁵ (internal citations omitted; emphasis added).

⁴⁶ *Id.* (emphasis added).

⁴⁷ *Id.*

well operators to plug their wells.”⁴⁸ While *H.L.S.* limited its holding to post-petition liabilities, *Midlantic*, on which the Fifth Circuit relied, had no such limitation. Moreover, courts have found that these types of environmental obligations cannot be avoided by a bankruptcy estate, even where performing such obligations will exhaust the estate’s resources.

§ 1.03 Administrative Priority for Environmental Liabilities

In *In re Environmental Waste Control, Inc.*,⁴⁹ the court ruled that a Chapter 11 debtor-in-possession was required to comply with its environmental cleanup plans ordered by state and federal agencies, notwithstanding the debtor’s claim of insufficient funds to complete the cleanup and notwithstanding a secured creditor’s claims to the estate’s assets. Environmental Waste Control (“EWC”) was a landfill operator that filed for Chapter 11 bankruptcy protection. In the resulting bankruptcy proceeding, EWC sought to defer the Indiana Department of Environmental Management (“IDEM”) and the United States Environmental Protection Agency (“EPA”) from forcing it to meet certain environmental obligations arising out of EWC’s contamination of groundwater beneath its landfill.⁵⁰ Applying *Midlantic* and *Ohio v. Kovacs*, 469 U.S. 274 (1985), the court determined that “bankruptcy law [will] not allow a trustee in bankruptcy to abandon property in violation of state and local laws designed to protect health and safety.”⁵¹ “[A]nyone in possession of a site, whether a bankruptcy trustee or

⁴⁸ *Id.* at 439.

⁴⁹ 125 B.R. 546 (N.D. Ind. 1991).

⁵⁰ *Id.*

⁵¹ *Id.* at 550.

anyone else, may not maintain a nuisance, ... or refuse to remove the source of such conditions.”⁵² The court held that “[w]hile EWC may never have the financial ability to complete the environmental cleanup process, the public interest dictates that it at least begin that process without delay.”⁵³ Such is the case even where claims by secured creditors exist. Where environmental clean-up is required, a secured creditor’s “position regarding its priority over the estate’s assets must yield in light of the competing environmental harms.”⁵⁴ In short, the court concluded that “[t]he applicable legal authority suggests that EWC must comply with environmental law and pursue cleanup and corrective action at the landfill, **regardless of its financial insolvency...**[and despite] the futility of corrective action.”⁵⁵ Such “reality does not divorce EWC from its legal duties.”⁵⁶

Similarly, in *In re Wall Tube & Metal Products Co.*,⁵⁷ the Sixth Circuit recognized that “[n]either the Court nor Congress has granted a trustee in bankruptcy power that would lend support to a right to abandon property in contravention of state or local laws designed to protect public health or safety...Congress has expressly provided that the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public

⁵² *Id.* at 550 (internal quotations omitted).

⁵³ *Id.* at 552.

⁵⁴ *Id.* at 552.

⁵⁵ *In re Environmental Waste Control, Inc.*, 125 B.R. at 552 (emphasis added).

⁵⁶ *Id.*

⁵⁷ 831 F.2d 118 (6th Cir. 1987).

health and safety.”⁵⁸ In *In re Wall Tube & Metal Products Co.*, the debtor occupied a property under a twenty-year lease where it manufactured automobile bumpers, outdoor furniture, steel tubing and other metal fabrications. These manufacturing processes resulted in hazardous waste that were drummed up and stored on site. Prior to bankruptcy, the facility was shut down and the inspector for the Tennessee Department of Health and Environment (“TDHE”) discovered the waste, issued a notice of violation of the Tennessee Hazardous Waste Management Act of 1977 and recommended immediate disposal of the waste.

Once the Debtor filed for bankruptcy under Chapter 7, the trustee was notified of the aforementioned violations and the Chapter 7 trustee gave notice of his intent to convey most of the property to its original lessors. Despite the court’s approval of these conveyances, other drums and tanks containing hazardous waste remained on the debtor’s estate, which constituted four separate “threatened release locations” of hazardous substances.” On May 2, 1985, the State filed a request for administrative expense treatment of its expenses incurred as a result of debtor’s violations of environmental laws.

In finding that the State’s costs were recoverable as administrative expenses, the court analyzed two interrelated issues. First, the court addressed whether § 959(b) requires a Chapter 7 liquidating trustee to comply with the State’s hazardous waste statute. In addressing this issue, the court quoted *Midlantic* and stated “[n]either the Court nor Congress has granted a trustee in bankruptcy power that would lend support to a right to abandon property *in*

⁵⁸ *Id.* at 121-22 (emphasis in original).

contravention of state or local laws designed to protect public health or safety...Congress has expressly provided that the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public health and safety.”⁵⁹ As such, the court determined that the Debtor’s “trustee, under [these] circumstances, could not have abandoned the property...It [therefore] follows that if the Wall Tube trustee could not have abandoned the estate in contravention of the State’s environmental law, neither then should he have *maintained or possessed* the estate in continuation violation of that same law. Otherwise, the result avoided in *Midlantic* would (and in this case did) remain – an ongoing, potentially disastrous health hazard without remedy from those at fault. The only difference here is that the danger arose because of the trustee’s and the debtor’s failure to correct the violation, not because of the trustee’s exercise of the abandonment power as in *Midlantic*.”⁶⁰ Because Debtor failed to comply with its environmental obligations, “the State was compelled to remedy the environmental health hazard at public expense.”⁶¹

Having found that § 959(b) requires a debtor to comply with applicable environmental regulations,⁶² the court next turned to whether the expenses

⁵⁹ *Id.* at 121-22 (emphasis in original).

⁶⁰ *Id.* at 122 (emphasis in original).

⁶¹ *Id.* at 122.

⁶² Although § 959(b) refers only to “state” laws, the courts in both *Saravia v. 1736 18th Street, N.W., L.P.*, 844 F.2d 823 (D.C. Cir. 1988) and *In re St. Mary Hosp.*, 86 B.R. 393, 398 (E.D. Penn. 1988) concluded that 28 U.S.C. § 959(b) requires a debtor to conform with applicable federal, state and local law in conducting its business.

incurred were an actual, necessary cost and expense of preserving the estate. The court answered this question in the affirmative and held “it proper that the response costs incurred by Tennessee and recoverable under [applicable regulations] be deemed an administrative expense.”⁶³ These expenses are “actual and necessary, both to preserve the estate in required compliance with state law and to protect the health and safety of a potentially endangered public.”⁶⁴ The court reached this conclusion after analyzing authority finding that “the power of a trustee must yield to the governmental interests in health and safety, *which includes using assets of the estate for the necessary cleanup.*”⁶⁵ The only difference between *Midlantic* and *In re Wall Tube & Metal Products Co.*, is that, in the latter, the danger arose because of the trustee’s and the debtor’s failure to correct the violation, not because of the trustee’s exercise of the abandonment power, as in *Midlantic*.⁶⁶ Thus, reading both cases in tandem, the logic of the cases suggests that under either circumstance, a debtor would be required to comply with its environmental obligations, whatever they may be.

§ 1.04 Pitfalls for Predecessors in Interest

[1] Status of Plugging and Abandonment Liabilities as “Imminent Harms”

⁶³ *Id.* at 123.

⁶⁴ *In re Wall Tube & Metal Products Co.*, 831 F.2d at 124.

⁶⁵ *Id.* at 123 (emphasis in original).

⁶⁶ *Id.* at 122.

In *In re McCrory*,⁶⁷ the court recognized that the *Midlantic* decision prohibited abandonment of property where such abandonment would “aggravate already existing dangers by halting security measures” and where no “formulation of conditions that [would] adequately protect the public’s health and safety” had been made.⁶⁸ The *In re McCrory* court, however, applying *Midlantic*, found that the *Midlantic* analysis was not satisfied; where “required clean-up could be deferred;” where the site at issue was being leased to “another tenant who conducted substantially the same operations” at the site; where there was not an “imminent harm to public health or safety;” and where “there [was] no indication that any state agency threatened to close operation or require[] immediate clean-up.”⁶⁹ Although, unlike in *In re McCrory*, no other tenant generally steps in to pick-up abandoned P&A liabilities, there exists the possibility that a court could find, as in *In re McCrory*, that outstanding plugging and abandonment liabilities do not pose an “imminent harm to public health or safety.” In such an instance, the court could likewise conclude that property burdened by such liabilities may be abandoned by the estate, potentially leaving predecessors in interest fully liable to the mineral lessor for all such expenses, pursuant to the relevant regulations cited earlier. Although an argument can be made that P&A liabilities are not obligations that can generally be deferred, but instead are obligations that must be completed in order to avoid imminent harm to health and public safety; without

⁶⁷ 188 B.R. 763 (S.D.N.Y. 1995).

⁶⁸ *Id.* at 768 (quoting *Midlantic*, 106 S.Ct. at 757).

⁶⁹ *Id.* at 769.

binding authority on the matter, it is difficult to tell how a particular court may rule with respect to the treatment of such liabilities.

[2] “Standing” Type Problem

Section 1109(b) of the Bankruptcy Code provides:

A party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or an indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.

While it would stand to reason that a predecessor in interest facing the possibility of being strapped with millions of dollars in environmental liabilities would most certainly fall within the broad definition of “party in interest,” the cases cited above seem to suggest that courts are generally only receptive to holding a debtor’s “feet to the fire” with respect to environmental obligations when the sovereign takes the lead. Therefore, to the extent a predecessor in interest’s “claim” arises solely via its environmental co-liability with the debtor, it is placed in quite a precarious position. Indeed, as discussed below, in such an instance, a predecessor in interest may be left without any claim until it is forced to pay upon the debtor’s liability.

[3] 11 U.S.C. § 502(e)

§ 502(e)(1) of the Bankruptcy Code provides that “the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that –

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution

As per its terms, in order for a creditor's claim to be disallowed pursuant to § 502(e)(1)(B) it must be demonstrated that a creditor's claim is a claim: (i) on which the creditor is co-liable with the debtor; (ii) is contingent in nature; and (iii) is for reimbursement or contribution.

In *In re Tri-Union Development, Corp.*,⁷⁰ the court was presented with a scenario where several of the debtors predecessors in interest had filed proof of claims based upon their co-liability on the debtors' plugging and abandonment obligations arising under various agreements with the debtors and applicable MMS regulations.⁷¹ Also filing a proof of claim on these obligations was the MMS.⁷² Based upon these seemingly competing claims, the debtor moved to have its predecessors' claims disallowed pursuant to § 502(e). In granting this relief, the court analyzed each of the required factors under this section as follows.

As to the contingency of the predecessors' claims, the court found that a claim remains "contingent," for bankruptcy purposes, until the "the co-debtor has paid the creditor."⁷³ Because the MMS had "yet to call on any of the respondents to fund the P&"A Obligations, the P&A Obligations remain unfunded, and are

⁷⁰ 314 B.R. 611 (Bankr. S.D. Tex. 2004).

⁷¹ *Id.* at 615 n.4

⁷² *Id.* at 616.

⁷³ *Id.* at 616.

thus contingent as envisioned by § 502(e).”⁷⁴ The court reached this conclusion despite the fact that the P&A obligations in question derived not only from applicable federal and state regulations, but also directly from contracts entered into between the debtors and their predecessors in interest.⁷⁵ The court concluded, “that the existence of a separate, direct obligation does not eliminate the application of § 502(e).”⁷⁶ Because “§ 502(e)(1)(B)...was enacted to prevent...competition between a creditor and [its] guarantor for limited proceeds of the estate,” the court found that allowing multiple distributions on a single set of P&A Obligations could not be allowed, despite the fact that the debtors’ obligation to perform derived both from applicable regulations **and** from an independent contractual source.⁷⁷ Hence, the court disallowed the claims of the debtors’ predecessors in interest.

The court in *In re Tri-Union*, however, expressly refrained from addressing the question of whether P&A liabilities constitute an administrative expense of the estate.

⁷⁴ *Id.* at 616.

⁷⁵ *Id.* at 616.

⁷⁶ *In re Tri-Union Development, Corp.*, 314 B.R. at 618.

⁷⁷ *Id.* at 618-19. The court did, however, note that its finding did not “preclude the Respondents’ claims that [were] wholly separate from those obligations on which there is a direct liability...such [] as interest and bond charges that are independent obligations to the Respondents.” *Id.* at 621. The court also found that to the extent a bond issuer guaranteeing P&A liabilities was secured, it “may retain its lien position until such time as its contingent liability is eliminated.” *Id.* at 621.

The Court has carefully reviewed the many authorities provided by the various parties. The issues that must be reconciled by the Court will be substantially different if the Court concludes that there is an imminent threat to the environment rather than a long-term concern that may never pose a serious environmental issue. The Court declines to issue an advisory opinion on the full range of factual possibilities. At confirmation, the Court will consider the nature of the environmental threat and how the Debtors' plan proposes to address the environmental issue.⁷⁸

Because the issue was ultimately settled as between the parties, the court in *In re Tri-Union* never reached the issue of whether the liabilities in question constituted an administrative expense of the estate.

§ 1.05 Conclusion

If bankruptcy courts permit debtors to avoid their decommissioning, plugging and abandonment obligations, such debtors, and subsequent investors in the debtors, would gain a significant advantage over every other similarly situated oil exploration company. As a result, to allow a debtor to avoid its plugging and abandonment obligations undermines the fundamental principal of market competition and allows debtors to use the bankruptcy court as a shelter from the legal duties attached to its trade. Moreover, such efforts fail to formulate conditions that will adequately protect the public health and safety and thus run afoul of 28 U.S.C. § 959(b), the Fifth Circuit's holding *In re H.L.S.* and the

⁷⁸ *Id.* at 627.

Supreme Court's holding in *Midlantic Nat'l Bank v. New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 502 (1986). Therefore, despite the conflicting authority described above, it remains the position of this paper that plugging and abandonment liabilities should be afforded administrative expense priority. However, given the lack of definitive authority on this matter, energy companies must remain cognizant of the significant risks that remain with a predecessor in interests, even after properties burdened by such liabilities are assigned or otherwise disposed of.