<u>Cases and Strategies for Solvent Operators and Non-Operators</u>

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When a solvent operator or non-operator is faced with the bankruptcy or insolvency of a working interest owner, operator, or successor in interest, many different considerations come into play. This paper will discuss just a few problems that might arise, all of which can be dealt with by competent bankruptcy counsel: lien analysis and priority, setoff rights, contract assumption and rejection, restrictive covenants, operatorship, and plugging and abandonment obligations.

I. Issues with Mineral Leases

Energy assets are creatures of contract. As a starting point, it is crucial that operators and non-operators alike understand the status of the underlying mineral lease itself. Often, issues regarding preservation of mineral leases including payment of royalties are or should be addressed in a bankruptcy case's First Day Motions, and should therefore be on one's radar. For instance, a non-operator is critically interested in whether or not the bankrupt operator is current on all of the lease obligations including payment of royalties under the lease. Further, if an operator is in bankruptcy, other lease issues may be implicated, including: whether or not it is commercially feasible for production or other lease preservation activities to continue, whether the debtor-operator is subject to a shut-in order as the "shot clock" begins until the lease terminates on its own due to lack of performance, whether the mineral lessor demands additional security (i.e., BOEM supplemental bond demand), and whether the operator's interest is subject to pending assignment.

Classification of mineral leases is subject to some uncertainty under the Bankruptcy Code. With respect to mineral leases on federal lands (including OCS leases), the lease treatment has not been definitely adjudicated but the federal government asserts that it's leases are executory contracts (or leases) subject to § 365 of the Bankruptcy Code. Section 365(a) permits the trustee or debtor in possession to reject an executory contract or unexpired lease.[2] In other words, a debtor has the unilateral ability to get out of an executory contract because it is burdensome, unfair or otherwise economically beneficial to do so — something it cannot do absent the Bankruptcy Code.[3] Alternatively, if the debtor assumes the lease, it must cure any lease defaults and provide adequate assurance of future performance.

Whether state and private landowner leases are considered to be an "unexpired lease" or "executory contract" under § 365 of the Bankruptcy Code is a matter of state law. To further complicate matters, states do not uniformly agree as to whether oil and gas leases are true leases that can be assumed or rejected in bankruptcy. For example, Texas and Mississippi courts have

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[1] The authors wish to thank Steven W. Golden, an associate in the Houston office of Locke Lord LLP, for his assistance in preparing this paper.

[2] 11 U.S.C. § 365(a).

[3] *In re Sky Ventures LLC*, 523 B.R. 163, 166 (Bankr. D. Minn. 2014); *see also* Laura B. Bartell, *Revisiting Rejection: Secured Party Interests in Leases and Executory Contracts*, 103 Dick. L. Rev. 497, 556 (1999).

ruled that mineral leases are real property rights.[4] How an oil and gas interest is characterized in a jurisdiction heavily influences whether or not an oil and gas lease is considered a true lease subject to rejection under § 365.[5] In contrast, state lease classification in Louisiana[6] and Ohio,[7] the law is less clear and may be subject to conflicting opinions.

II. Liens Under a Joint Operating Agreement

A. Priority of Liens

Under an operating agreement ("OA"), it is industry standard for various liens to arise among the operator and non-operator parties. For instance, most OAs grant each counterparty consensual liens in all property subject to the OA and all related collateral, which are intended to secure each party's obligations to other parties under the OA. However, in modern financing arrangements, it is equally common for such transactions to include blanket liens on a debtor's property in favor of the party extending credit. Thus, to the extent a party to an OA is also a debtor on a secured loan, liens arising under an OA may compete with a lender's lien.

Generally, priority of security interests is governed by the rules of filing and perfection; the first to perfect takes top priority. Therefore, it is always advisable to expediently record and perfect an OA in the appropriate jurisdiction, as doing so will ensure that the OA will be afforded higher priority than any subsequent security interest that may arise. What if the OA is left unrecorded, and a subsequent security interest is perfected against the same property subject to the OA?

Two Courts of Appeals—the Fifth and the Sixth—have confronted just this issue, both times recognizing a narrow exception to the normal priority rules. The Fifth Circuit, in *Grace-Cajun*,[8] recognized an exception where a security agreement with a bank provided production proceeds as collateral. Because oil and gas proceeds were taken under the OA after costs were apportioned under the terms of the OA, the Fifth Circuit held that the security interest was a "pledge" and thus subject to the OA. The Fifth Circuit noted that, under Louisiana law, a party can only pledge an interest to the extent that it has an interest to pledge.[9] Therefore, any production proceeds were subject to the obligation to pay well costs under the OA even if the OA was not recorded.

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[4] *See Tex. Dep't of Parks & Wildlife v. Miranda*, 133 S.W.3d 217 (Tex. 2004).

[5] *Terrell v. Albaugh* (*In re Terrell*), 892 F.2d 469, 471-72 (6th Cir. 1989); *Frontier Energy LLC v. Aurora Energy Ltd.* (*In re Aurora Oil & Gas Corp.*), 439 B.R. 674, 677 (W.D. Mich. 2010).

[6] *Compare In re WRT Energy Corp.*, 202 B.R. 579 (W.D. La. 1996), *with Texaco Inc. v. La. Land & Exploration Co.*, 136 B.R. 658 (M.D. La. 1992).

[7] *Compare In re Frederick Petroleum Corp.*, 98 B.R. 762 (S.D. Ohio 1989), *with In re Gasoil Inc.*, 59 B.R. 804 (Bankr. N.D. Ohio 1986).

[8] *Grace-Cajun Oil Co. No. 3 v. FDIC*, 882 F.2d 1008 (5th Cir. 1989).

[9] *Id.*

Similarly, the Sixth Circuit in *Century Offshore*[10] held a mortgage loan to be subject to an unrecorded OA when the security agreement for the mortgage loan expressly recognized, and repeatedly provided the loan to be subject to, the OA. The Sixth Circuit based its holding on the principle that "[t]he public records doctrine does not prevent the third party from contractually agreeing by express language to subordinate its interest to interests that would otherwise be inferior."[11]

B. *Wilson*: Liens, Setoff, and "The Twilight Zone"[12]

In the 1987 *Wilson* case,[13] the debtor (Wilson) and TXO were party to JOAs, under which TXO served as operator and Wilson as a non-operator. Under the JOAs, TXO billed non-operators for their *pro rata* share of expenses monthly. Separately, TXO also sent each non-operator its *pro rata* share of monthly proceeds from the sale of the oil and gas.[14] Before he declared bankruptcy, Wilson stopped paying his share of expenses, so as a result, TXO applied Wilson's share of the proceeds to cover the unpaid expenses.[15] Once Wilson declared bankruptcy, TXO set aside the proceeds payable to Wilson, claiming it had liens on the funds pursuant to operator's liens provided for under the JOA.[16] Wilson objected to such treatment in the bankruptcy court.

Although noting that the JOA was unrecorded, and thus unperfected, the *Wilson* court noted that unperfected liens are still valid.[17] Therefore, "to the extent that TXO had possession, prepetition, of proceeds of production related to Wilson's working interest, TXO was a secured party in possession of the collateral. As the secured party in possession of collateral, it was entitled to apply those proceeds to Wilson's obligations for operating expenses."[18] The court did note that to the extent that TXO was exercising setoff power, rather than lien power, against Wilson's prepetition royalties, such offsets would be disallowed; because royalty payments are a "distinct right" of Wilson's, separate and apart from operating expenses, the setoff requirement of mutuality was missing.[19]

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[10] *K.E. Resources, Ltd. v. BMO Financial Inc.* (*In re Century Offshore Mgmt. Corp.*), 119 F.3d 409 (6th Cir. 1997).

[11] *Id.*, at 413.

[12] This section borrows from one of the authors' previously published works: Philip Eisenberg, "Addressing the Current Financial Crisis from an Oil and Gas Perspective: From Planning Issues Through Insolvency," 55 ROCKY MTN. MIN. L. INST. 33-1 (2009).

[13] *Wilson v. TXO Prod. Corp.* (*In re Wilson*), 69 B.R. 960 (Bankr. N.D. Tex. 1987).

[14] *Wilson*, 69 B.R. at 962.

[15] *Id.*

[16] *Id.*

[17] *Id.* at 964 ("As between the parties, a lien is valid even though it is not properly perfected. This is true because the financing statement is not the operative document which creates the security interest between the parties; it is merely a public notice which directs one to further information.").

[18] *Id.*

[19] *Id.*, at 965.

Wilson is perhaps best known, though, for its discussion of the "twilight zone" that occurs with regard to executory contracts. Under section 365 of the Bankruptcy Code, a debtor has the ability to assume, reject, or assume and assign its rights under an executory contract or unexpired lease.[20] However, it does not need to do so with any immediacy, even though the executory contract is unenforceable *against* a debtor, though it is enforceable *by* a debtor.[21] The period of time, therefore, between the filing of a bankruptcy petition and the debtor's section 365 treatment of the executory contract is a sort of "twilight zone" for contractual counterparties.[22]

Finding that the terms of the JOA did not govern the relationship between the debtor and contractual counterparties, the *Wilson* court held that the law of co-tenancy governs the relationship between the parties in the twilight zone.[23] While this holding, on its face, may not seem to be an unreasonable result, the concepts presented in *Wilson*, if followed, could have far-reaching effects. Moreover, the concepts presented in *Wilson* may run contrary to other principles of bankruptcy, including the well-accepted proposition that a contract not yet assumed or rejected can terminate pursuant to its own terms. In analyzing *Wilson*, consideration should be given to the fundamental tenet of bankruptcy law that the Bankruptcy Code "does not grant [a] debtor . . . greater rights and powers under [a] contract [the debtor] had outside of bankruptcy."[24] Indeed, the filing of a bankruptcy does not even prevent the termination of a contract pursuant to its own terms.[25]

In spite of its flaws *Wilson* is already limited in multiple different ways. For instance, as mentioned in section II *infra*, covenants that run with the land cannot be treated by section 365, and thus no "twilight zone" exists when a restrictive covenant is at issue.[26] Courts squarely hold that debtors cannot use section 365 to reject only portions of an integrated agreement; a debtor cannot pick and choose what to assume and what to reject.[27] Therefore, to the extent that an executory clause is part of an integrated contract with a covenant running with the land, it could be argued that rejection is impermissible.[28]

III. Free and Clear Sale Issues Under 11 U.S.C. § 363(f)

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[20] 11 U.S.C. § 365.

[21] *Wilson*, 69 B.R. at 965-66 (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 532 (1984)).

[22] *Id*.

[23] *Id.*, at 966.

[24] *Aetna Cas. & Surety Co. v. Gamel*, 45 B.R. 345, 349 (N.D.N.Y. 1984) (quoting *In re Nashville White Trucks, Inc.*, 5 B.R. 112, 117 (M.D. Tenn. 1980)).

[25] *Id.*

[26] *Beeter v. Tri-City Property Mgmt. Svcs., Inc.* (*In re Beeter*), 173 B.R. 108, 116 (Bankr. W.D. Tex. 1994). *See also Foothills Tex., Inc. v. MTGLQ Investors, L.P.* (*In re Foothills Tex., Inc.*), 476 B.R. 143, 149 (Bankr. D. Del. 2012) (discussing ORRIs).

[27] *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (1996) ("Where an executory contract contains several agreements, the debtor may not choose to reject some agreements within the contract and not others.")

[28] It should also be noted that an exception to the automatic stay exists in the context of recoupment across an operating agreement. *Herod v. Southwest Gas Corp.* (*In re Gasmark Ltd.*), 193 F.3d 371 (5th Cir. 1999).

Bankruptcy provides debtors with the ability to sell their assets to third-party purchasers through section 363 of the Bankruptcy Code. If that sale is conducted outside the ordinary course of debtor's business, as large-scale sales of assets typically are, it will be subject to scrutiny by the bankruptcy court after notice and a hearing.[29] One of the principal benefits of section 363 to a debtor is the fact that it permits, in certain circumstances, a sale "free and clear of any interest in [the debtor's] property."[30] Stated differently, the Bankruptcy Code provides debtors with the unique ability to sell its assets without any of the liens, claims, or other encumbrances burdening the sold property. This fact, however, can prove troublesome for solvent counterparties.

In *Energytec*,[31] the debtor, an owner and operator of gas pipelines, sought to sell a certain pipeline system to Red Water Resources under section 363(f). Newco, through a series of transactions predating the bankruptcy case, had an interest in a transportation fee to be paid by Energytec based on the amount of gas flowing through the pipeline. Pursuant to the original conveyance, the interest in transportation fees was to "run with the land," and Newco had a security interest and lien on the entirety of the pipeline system to secure the fee's payment. Newco also had the right to consent to any assignment of its interest in the pipeline.

Energytec, in executing the asset sale, sought to convey the pipeline to Red Water free and clear of Newco's interest in transportation fees and right to consent to any assignment of its interest. Newco, obviously, objected, arguing that its interests were covenants running with the land, and therefore could not be extinguished, even in a 363(f) sale.

In analyzing whether Newco's rights to transportation fees and consent to assignment were covenants running with the land, the court recalled five factors necessary to establish a covenant running with the land: (1) it touches and concerns the land; (2) it relates to a thing in existence or specifically binds the parties and their assigns; (3) it is intended to run with the land; (4) the successor to the burden has notice; and (5) there was privity of estate when the covenant was made.[32] At issue in *Energytec* were the first and fifth issues—"touch and concern" and privity.

The court first easily concluded that there was "vertical privity" because there was a clear succession of ownership leading to Newco.[33] At issue was "horizontal privity," which requires the original parties have "simultaneously existing interests" as either landlord/tenant or grantor/grantee.[34] Noting that it was unclear whether it was even a requirement in Texas, the court nonetheless found there to be horizontal privity between the original parties to the agreement.[35] In rejecting an alleged similarity between a Texas state court case,[36] the court

[29] 11 U.S.C. § 363(b)(1).

[30] 11 U.S.C. § 363(f).

[31] *Newco Energy v. Energytec, Inc.* (*In re Energytec, Inc.*), 739 F.3d 215 (5th Cir. 2013).

[32] *Energytec*, 739 F.3d at 221 (citing *Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987)); *Ehler v. B.T. Suppenas Ltd.*, 74 S.W.3d 515, 521 (Tex. App. – Amarillo 2002).

[33] *Id.*, at 222.

[34] *Id.*

[35] *Id.*, at 223.

noted that Newco's rights were created at the same time as the pipeline's conveyance, thereby satisfying any requirement of horizontal privity.[37]

Next, the court turned to the requirement that the interests "touch and concern" the land. Newco, relying on a Texas Supreme Court case,[38] argued that an interest touches and concerns land if, among other things, it affects the value of the land either positively or negatively.[39] Contrarily, Energytec relied on a Fifth Circuit case,[40] which held that more was required under Texas law that mere effect on value does not cause an interest to touch and concern land; it must affect the owner's use or interest in the property itself. In holding that Newco's interests touch and concern the land, the court noted that the fees due to Newco are "for the use of real property" that "impact the owner's interest in the pipeline."[41]

Although the result in *Energytec* is certainly fact-specific, it provides a framework under which parties to oil and gas contracts can assess their counterparties' rights and obligations, particularly in the context of free and clear sales under section 363(f).[42]

IV. Plugging and Abandonment Issues

A. Section 554 Abandonment of Property of the Estate

Under a joint operating agreement, expenses necessary to complete plugging and abandonment are generally apportioned amongst the parties to the agreement. However, where one or more parties fails to contribute to the plugging and abandonment, the parties are generally jointly and severally liable to contribute towards such operations. Therefore, whether a bankrupt party to a joint operating agreement will be discharged of its obligation to contribute to decommissioning operations is of significance to the other parties to the agreement. Often, a debtor will attempt to use its power under section 554 to abandon property in order to divest itself of property burdened by regulatory obligations such as plugging and abandonment.

The section 554 abandonment power, however, is not absolute. The Supreme Court in *Midlantic*[43] held "that a trustee may not abandon property in contravention of a state statute or

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[36] *Wayne Harwell Props. v. Pan Am. Logistics Ctr., Inc.*, 945 S.W.2d 216, 218 (Tex. App.—San Antonio 1997, writ denied).

[37] *Id.*

[38] *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982).

[39] *Energytec*, 739 F.3d at 224.

[40] *El Paso Refinery, LP v. TRMI Holdings, Inc.* (*In re El Paso Refinery, LP*), 302 F.3d 343 (5th Cir. 2002).

[41] *Energytec*, 739 F.3d at 224.

[42] Similarly, *Energytec* can be used in the context of 11 U.S.C. § 365—executory contracts and unexpired leases—as a covenant running with the land cannot be rejected using that mechanism. *See, e.g. Beeter v. Tri-City Property Mgmt. Svcs., Inc.* (*In re Beeter*), 173 B.R. 108, 116 (Bankr. W.D. Tex. 1994).

[43] *Midlantic Nat'l Bank v. N.J. Dep't of Env. Protection*, 474 U.S. 494 (1986).

regulation that is reasonably designed to protect the public health or safety from identified hazards."[44] That holding, however, was limited in a footnote:

> This exception to the abandonment power vested in the trustee by § 554 is a narrow one. It does not encompass a speculative or indeterminate future violation of such laws that may stem from abandonment. The abandonment power is not to be fettered by laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm.[45]

Lower courts subsequently split in interpreting this footnote from *Midlantic*. The majority of courts focused on the latter portion of the footnote, holding that the exception to section 554 only arises when the harm to the general public is *imminent*.[46]

A few courts in the Fifth Circuit, however, have eschewed the imminence requirement seemingly enumerated in *Midlantic*. In *H.L.S. Energy*,[47] for instance, the Fifth Circuit simply did not mention *Midlantic*'s footnote. Instead, it stated:

> [A] bankruptcy trustee may not abandon property in contravention of a state law reasonably designed to protect public health or safety. And there is no question that under Texas law, the owner of an operating interest is required to plug wells that have remained unproductive for a year . . . Thus, a combination of Texas and federal law placed on the trustee an inescapable obligation to plug the unproductive wells . . .[48]

The bankruptcy court in *American Coastal Energy*,[49] relying on *H.L.S. Energy*'s interpretation of *Midlantic*, went even further:

> The Court reads the Supreme Court's *Midlantic* opinion to require the Court to determine whether the debtor is violating a statute "reasonably designed to protect the public health or safety from identified hazards," not the extent to which particular conduct imposes actual and imminent threats. This Court need not make a determination whether the environmental hazard presents an imminent or identifiable harm. It is enough that the [] claim arises from a state law designed to protect the public from an identified hazard.[50]

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[44] *Id.*, at 507.

[45] *Id.*, at fn. 9.

[46] *See, e.g., Borden, Inc. v. Wells-Fargo Bus. Credit* (*In re Smith-Douglass, Inc.*), 856 F.2d 12, 15 (4th Cir. 1988); *Commonwealth Oil Ref. Co., Inc. v. E.P.A.* (*In re Commonwealth Oil Ref. Co., Inc.*), 805 F.2d 1175, 1185 (5th Cir. 1988); *In re Howard*, 2015 WL 4505941, No. 00-51897, at *10 (Bankr. S.D. Miss. July 23, 2015); *In re Old Carco LLC*, 406 B.R. 180, 204 (Bankr. S.D.N.Y. 2009); *In re Unidigital, Inc.*, 262 B.R. 283, 286-87 (Bankr. D. Del. 2001).

[47] *Texas v. Lowe* (*In re H.L.S. Energy Co., Inc.*), 151 F.3d 434 (5th Cir. 1988).

[48] *Id.*, at 438 (internal citations omitted).

[49] *In re American Coastal Energy, Inc.*, 399 B.R. 805 (Bankr. S.D. Tex. 2009).

[50] *Id.*, at 813 (internal citation omitted).

B. Administrative Expense Priority

Often, a non-debtor, such as the government or a solvent coventurer, will complete the plugging and abandonment obligations of the debtor and will subsequently seek administrative expense priority in the bankruptcy for the costs of the remediation. Whether costs associated with environmental remediation can be afforded administrative expense priority, rather than treatment as a general unsecured claim, seems to depend on the circumstances of the expense.

Section 503(b)(1) provides for administrative expense priority for the "actual, necessary costs and expenses of preserving the estate."[51] Shortly after *Midlantic*, numerous courts held that remediation costs could be given administrative priority.[52] This is not the case, however, in all circumstances. In *Route 21 Associates*,[53] the debtor, MHC, was contractually obligated to reimburse Route 21 Associates a percentage of remediation costs as well as perform various monitoring tasks.[54] After MHC declared bankruptcy, Route 21 Associates filed an administrative expense claim for the amount representing the contractually agreed-to percentage of costs that were performed by Route 21 Associates pre-petition.[55] In distinguishing *Chateaugay* and denying administrative priority to the claim, the *Route 21 Associates* court noted that, unlike in the earlier case, the debtor in *Route 21 Associates* did not currently own or operate the remediated land.[56] Applying a pre-*Chateaugay* Second Circuit test, the court found that the claim was not administrative because (1) it arose out of a pre-petition agreement, not a post-petition transaction and (2) the remediation did not benefit the estate because the debtor did not own or operate the site post-petition.[57]

In a different context, the First Circuit in *Munce's*[58] allowed monies related to environmental remediation as an administrative expense. In *Munce's*, the debtor was notified of environmental law violations by the Department of Environmental Services (DES), none of which the debtor fixed.[59] DES brought a pre-petition action against Munce's in state court on account of those violations, and was issued a preliminary injunction. After Munce's failed to comply with the injunction, DES filed a motion for contempt, which was pending when Munce's declared bankruptcy.[60] After the stay was lifted as to the contempt action, the state court issued

[51] 11 U.S.C. § 503(b)(1)(A).

[52] *See, e.g., United States v. LTV Corp.* (*In re Chateaugay Corp.*), 944 F.2d 997, 1010 (2d Cir. 1991) ("If property on which toxic substances pose a significant hazard to public health cannot be abandoned, it must follow . . . that expenses to remove the threat posed by such substances are necessary to preserve the estate.").

[53] *Route 21 Assocs. of Belleville, Inc. v. MHC, Inc.*, 486 B.R. 75 (S.D.N.Y. 2012).

[54] *Route 21 Assocs.*, 486 B.R. at 80.

[55] *Id.*

[56] *Id.*, at 92-93.

[57] *Id.* at 92-93 (citing *Trs. of the Amalgamated Ins. Fund v. McFarlin's, Inc.*, 789 F.2d 98, 100 (2d Cir. 1986)).

[58] *Munce's Superior Petroleum Prods., Inc. v. N.H. Dept. of Env. Svcs.* (*In re Munce's Superior Petroleum Prods., Inc.*), 736 F.3d 567 (1st Cir. 2013).

[59] *Munce's*, 736 F.3d, at 569.

[60] *Id.*

contempt sanctions against Munce's, with which the debtor did not comply. DES subsequently received an award of contempt penalties, which the state court assessed from the date of the post-petition granting of the contempt motion.[61] DES sought for this award to be given administrative priority.

On appeal, the First Circuit affirmed the administrative classification. The court found that under Supreme Court precedent, "post-petition tort damages caused by the [debtor] can be treated as 'actual and necessary' costs of the estate, regardless of whether they are beneficial to the estate, and so may qualify for administrative priority."[62] Despite the debtor's insistence that the fine was as a result of pre-petition conduct, the First Circuit disagreed, finding that the fine was assessed for failure to comply with the state court's post-petition contempt order.[63]

In oil and gas cases specifically, the *H.L.S. Energy* and *American Coastal Energy* courts, as well as the court in *ATP Oil & Gas*,[64] considered whether plugging and abandonment obligations would be classified as administrative expenses. In *H.L.S. Energy*, the debtor sold its most productive assets through bankruptcy, leaving their converted-to chapter 7 estate saddled with a number of properties in need of P&A—obligations that accrued after H.L.S. filed for bankruptcy. Pursuant to an agreement with the State of Texas, the state plugged and abandoned the wells, and charged the costs to H.L.S. Energy's estate. At issue in *H.L.S. Energy* was whether those costs should be afforded administrative priority.

Following its conclusion, discussed *supra*, that the bankruptcy trustee could not simply have abandoned the property, the Fifth Circuit determined that the fulfillment of the estate's obligation to comply with Texas state law regarding P&A is an undeniable benefit to the estate.[65] Because Texas law compelled P&A of the unproductive wells, they "operated as a legal liability on the estate, a liability capable of generating losses in the nature of substantial fines every day the wells remained unplugged."[66] The court therefore concluded that Texas' claim for P&A would be given administrative priority.

Judge Isgur, in *American Coastal Energy*, faced a slightly different question, but ultimately came to the same conclusion. In *American Coastal Energy*, unlike in *H.L.S. Energy*, the obligation to plug and abandon accrued before the debtor filed for bankruptcy. The question in *American Coastal*, which was left unanswered by *H.L.S. Energy*, was "whether a well-plugging expense incurred by a state agency post-petition to remedy a pre-petition environmental obligation is also an actual and necessary expense that benefits the estate" and is therefore entitled to administrative treatment.[67] After analyzing *Midlantic* and precedent from the Second, Third, and Sixth Circuits, the *American Coastal* court concluded that "expenses incurred to

[61] *Id.*, at 569-70.

[62] *Id.*, at 571 (citing *Reading Co. v. Brown*, 391 U.S. 471, 485 (1968)).

[63] *Id.*

[64] *In re ATP Oil & Gas Corp.*, 2014 WL 1047818, No. 12-36187 (Bankr. S.D. Tex. March 18, 2014).

[65] *H.L.S. Energy*, 151 F.3d at 438.

[66] *Id.*

[67] *American Coastal Energy*, 399 B.R., at 809.

comply with state or federal environmental or safety laws are actual and necessary costs of preserving the estate" and are therefore entitled to administrative priority.[68]

In *ATP*, Judge Isgur again considered an issue related to the treatment of P&A claims in bankruptcy.[69] There, ATP and ATP IP, a non-debtor affiliate of ATP, were co-liable on P&A obligations of a certain property. ATP contracted with Omega to perform the P&A. The debtor argued that Omega's expenses should not be administrative because a non-debtor was also liable for the P&A obligations.[70] The court held that "a debtor's obligation to expend funds to bring the estate into compliance with a state health and safety law does not change just because another entity has the same obligation."[71]

V. Treatment of Executory Contracts and Unexpired Leases

The Bankruptcy Code provides debtors the ability to unilaterally assume, reject, or assume and assign executory contracts and leases, a powerful ability not available outside bankruptcy.[72] In so doing, a debtor can choose to deal with contracts in the most economically beneficial manner, even if doing so would prove detrimental to its contractual counterparties.

Generally speaking, courts find that joint operating agreements are executory contracts subject to treatment under section 365.[73] Joint operating agreements, however, often contain provisions like operator's liens, security interests, or recoupment or offset rights, all of which a solvent operator would want to preserve unimpaired. Furthermore, simply because the Bankruptcy Code provides debtors with the section 365 power, it does not come without limitation.

First, Rule 6006(c) provides that notice must be given of proposed treatment under section 365 to any contractual counterparties and other parties in interest.[74] Courts have interpreted this rule to require "meaningful" notice that is "reasonably calculated" to apprise the contractual counterparty of the intended disposition of the contract before the contract can be treated under § 365.[75] A counterparty, therefore, should always seek clarity when the treatment of a contract is unclear. For instance, a solvent counterparty may be signatory to multiple contracts with a bankruptcy debtor. That solvent counterparty will want to ensure that the

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[68] *Id.*, at 812.

[69] Relatedly, the *ATP* court was asked to consider whether non-P&A expenses could be afforded administrative priority when those expenses were to repair and maintain the debtor's property. Concluding that repair and maintenance helped to preserve assets for a potential (though never consummated) sale, Judge Isgur permitted administrative treatment of those expenses. *In re ATP Oil & Gas Corp.*, 2014 WL 1047818, at *5-7.

[70] *ATP*, 2014 WL 1047818, at *7.

[71] *Id.*

[72] 11 U.S.C. § 365.

[73] *Wilson*, 69 B.R. at 965-66.

[74] Fed. R. Bankr. P. 6006(c).

[75] *See, e.g.*, *Paradigm Air Carriers, Inc. v. Tex. Rangers Baseball Partners* (*In re Tex. Rangers Baseball Partners*), 498 B.R. 679, 705 (Bankr. N.D. Tex. 2013); *Republic Health Corp. v. Coral Gables, Ltd.* (*In re REPH Acquisition Co.*), 134 B.R. 194, 199 (N.D. Tex. 1991).

treatment of each contract is done with particularity and clarity so that none of its rights are prejudiced.

Second, a party seeking to assume or assume and assign an executory contract cannot discharge debts associated with that contract. Pursuant to section 365, before an executory contract can be assumed and assigned, any defaults must be cured.[76] This includes any unpaid amount of money under the contract.[77] As a practical matter, if it is undisputed that there is *some* amount due and owing under the contract, the debtor will propose a cure amount. Counterparties, however, should be careful to ensure that the proposed cure amount actually represents the actual cure amount; failure to raise an objection effectively waives the deficiency.

Perhaps most importantly, solvent counterparties should always ensure that the contract that they are party to is, in fact, executory; if an agreement is not an executory contract or unexpired lease, it cannot be treated under section 365. While the term "executory contract" is not defined in the Bankruptcy Code, it is generally accepted to mean contracts on which performance remains due on both sides, such that the nonperformance of one party would constitute a material breach excusing performance by the other party.[78] For instance, under some state laws, an oil and gas lease is not considered to be a true lease, but is rather an interest in real property, and therefore is not subject to treatment under section 365. Parties should therefore ensure that a contract proposed to be treated under section 365 is "executory enough" to actually receive such treatment.

VI. Section VII.B of the Model Form Joint Operating Agreement

Section VII.B of the 1989 A.A.P.L. Model Form Joint Operating Agreement provides for multiple protections that can be used when a counterparty faces bankruptcy. One of the most powerful protections provided for in section VII.B is security; each party to the JOA grants to its counterparty a security interest in all of its property to ensure performance of the JOA. Such property includes all leases, working interests, ORRIs, and operating rights, as well as all extracted oil and gas, accounts, and inventory. Section VII.B also provides for recordation and perfection of the security interest, and further states that the lien is afforded first priority. Further, section VII.B provides for interest on unpaid amounts under the JOA.

Because of the security interest granted under section VII.B, each party can exercise its rights under the Uniform Commercial Code. Additionally, if any party to the JOA fails to pay its share of expenses, the other parties can collect such unpaid amounts from a purchaser of oil and gas produced. Section VII.B further provides for setoff. Setoff "allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A."[79]

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[76] 11 U.S.C. § 365(b)(1).

[77] *Official Comm. of Unsecured Creditors v. Aust* (*In re Network Access Solutions Corp.*), 330 B.R. 67, 76 (Bankr. D. Del. 2005).

[78] *See* Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 (1973).

[79] *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995) (internal citation omitted).

VI. Operatorship: How to Replace Your Non-Operating Operator

Where the operator under a JOA is bankrupt or approaching bankruptcy, a solvent non-operator may desire to step in to continue production. Changing operatorship is one potential strategy for a solvent non-operator. Many JOAs provide for situations, such as an operator's inability to continue operations, under which parties to a JOA can elect a replacement. A Texas state court case, *Tri-Star*,[80] illustrates how this might be accomplished.

In *Tri-Star*, the Court of Appeals affirmed a trial court's issuance of a temporary injunction. Under a JOA, Tri-Star served as the operator, while Tipperary was a non-operating working interest owner.[81] Pursuant to the terms of the JOA, a majority of the non-operators, including Tipperary, twice voted to remove Tri-Star as operator, replacing it with Tipperary. Tri-Star refused to cede operational control, and Tipperary sought a temporary injunction to remove Tri-Star as operator while the parties litigated the permanent outcome.[82]

The Court of Appeals, in affirming the trial court, evaluated the factors a court must consider in granting or denying an injunction. Importantly, the appellate court stated that the purpose of a temporary injunction is to preserve the *status quo*, "the last, actual, peaceable, non-contested status that preceded the controversy."[83] The Court of Appeals found no error with the trial court's finding that the *status quo* was the affirmative vote to remove Tri-Star and install Tipperary.[84]

Tri-Star's general reasoning has its way into bankruptcy court in the *WBH Energy*[85] case in the Western District of Texas. In an adversary proceeding, U.S. Energy Development ("USED") sought preliminary injunctive relief against the bankruptcy debtors. Under a JOA, WBHEP served as operator, while its affiliate WBHLP and USED were non-operators. As is common in such arrangements, the JOA provided that a bank would hold the a proportionate share of the non-operator's funds in escrow until the operator informed the bank that a qualifying event had occurred. Pre-petition, allegedly, WBHEP was using USED's funds (without USED's knowledge) to cover the share of its non-operator affiliate WBHLP because WBHLP's lender was not extending further credit due to default. As a result, various M&M liens had been filed against the wells and WBHEP was unable to complete drilling operations. Pursuant to the JOA, USED alleged that WBHEP was deemed to have resigned because it was no longer able to serve as an operator. As a result, USED alleged that it had the right to select a new operator.

As a result of the operator's alleged default, USED sought temporary and permanent injunctive relief, seeking to remove WBHEP as operator and installing itself in that role. After briefing and argument, the court granted the preliminary injunction, thereby installing USED as

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[80] *Tri-Star Petr. Co. v. Tipperary Corp.*, 101 S.W.3d 583 (Tex. App.-El Paso 2003, pet. denied).

[81] *Id.*, at 586.

[82] *Id.*, at 586-87.

[83] *Id.*, at 588.

[84] *Id.*

[85] *In re WBH Energy, LP, et al.*, No. 15-10003 (Bankr. W.D. Tex.).

the operator.[86] In its oral opinion, the court cited to *Tri-Star* in granting the preliminary injunction.[87] The court noted that the purpose of its granting the prohibitory injunction is to "maintain[] the status quo and prohibit[] a party from taking action."[88] In issuing the injunction, the court prevented the Debtor from interfering with USED's right to serve as operator because, just as in *Tri-Star*, the *status quo* it was preserving was USED's prepetition-exercised contractual right to operate.[89]

The *WBH* court also discussed the four prerequisite factors to the granting of a preliminary junction: (1) "a substantial likelihood that the movant will prevail on the merits"; (2) "a substantial threat that the movant will suffer irreparable injury if the preliminary injunction is not granted"; (3) "the threatened injury to movant outweighs the threatened harm to the parties sought to be enjoined"; and (4) "granting the injunction will not disservice the public interest."[90] After propounding its findings of fact, the court was able to conclude that USED was able to show a substantial likelihood of prevailing on the merits, even though it need not have shown absolute certainty in that regard.[91] As to the second factor, the *WBH* court noted that USED would suffer irreparable injury because "it has invested significant funds" and further because the Debtors were financially unable to operate the wells in question.[92] As to the final two factors, the court determined that the harm to the Debtors was not outweighed by granting the injunction, and furthermore that the public interest would be served by granting the injunction because the general public would be disserved if the operator "suddenly shut down due to lack of funds."[93]

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[86] Hearing Transcript at 28, *U.S. Energy Dev. Corp. v. WBH Energy Partners, LLC*, No. 15-01006-HCM (Bankr. W.D. Tex. Feb. 9, 2015), ECF No. 44.

[87] *Id.*, at 23-25.

[88] *Id.*, at 23 (citing *Wenner v. Tex. Lottery Comm'n*, 123 F.3d 321, 326 (5th Cir. 1997)).

[89] *Id.*, at 25.

[90] *Id.*, at 21 (citing *Lake Charles Diesel, Inc. v. General Motors Corp.*, 328 F.3d 192, 195-96 (5th Cir. 2003)).

[91] *Id.*, at 26 (citing *Casarez v. Val Verde County*, 957 F.Supp. 847 (W.D. Tex. 1997)).

[92] *Id.*, at 33-35.

[93] *Id.*, at 41.