Locke Lord LLP

Managing Energy Sector Distress

March 12, 2015

Atlanta | Austin | Boston | Chicago | Dallas | Hartford | Hong Kong | Houston | Istanbul | London | Los Angeles | Miami | Morristown | New Orleans
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Managing Energy Sector Distress Program

March 12, 2015

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Attorneys & Counselors

MANAGING ENERGY SECTOR DISTRESS OUTLINE

I. Introduction (Bill/David – 4:00 - 4:10)

- Opening remarks
- Panel Introduction
- Outline of presentation –

    A. Lessons learned from past cycles and early in this cycle: Discussions of market sectors, current trends, and hot topics

    B. Management of bankruptcy process

    C. Distressed acquisitions process and pitfalls

    D. Key tax considerations

    E. Q&A

II. Presentation (4:10 – 4:50)

    A. Lessons learned from past cycles and early trends in this cycle by market sectors,

        1. Upstream – profiles early results, hot topics

            (a) ATP – BOEM financial responsibility

            (b) First wave of new filings

            (c) Hot topics

        2. Services – profiles, early movement, hot topics

            (a) MSA/rate reduction / bankruptcy treatment of MSA

            (b) New filings

            (c) Shale/onshore – pressure

3. Midstream/Trading

    (a) Lessons Learned – SemCrude, Lehman, and others

    (b) Covenants vs. Contracts

    (c) LNG Projects

4. Downstream

    (a) Impact of spinoffs

    (b) Low margins risks – Lyondell Bassell Lessons

    (c) Collateral Coverage Defaults – Flying J Lessons

B. Management of Bankruptcy Process – Creditor Perspective

    1. Best practices to identify and mitigate bankruptcy risks

    2. Overview of Bankruptcy Process

C. Distressed Acquisition

    1. Energy Reorganization in Bankruptcy…or lack thereof?

    2. Asset Sale/Liquidation Process in Bankruptcy

    3. Debt to Equity Conversion / Balance Sheet Drivers

    4. Distressed Acquisitions without bankruptcy / Pitfalls

D. Tax Considerations (Ken Simon outline) (4:50 – 5:15)

    1. Cancellation of Debt Income

    2. Tax Issues in Acquiring Distressed Debt

    3. Net Operating Loss Limitations

    4. Equity or Phantom Equity Incentive Interests

E. Q&A (5:15 – 5:30)

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Introduction

- **David Patton**
  Houston Partner and Co-Chair of the Energy Practice Group

- **Bill Swanstrom**
  Houston Partner and Co-Chair of the Energy Practice Group

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MANAGING ENERGY SECTOR DISTRESS OUTLINE OF PRESENTATION

A. Lessons Learned from Past Cycles and Initial Observations on the Current Cycle
B. Management of Bankruptcy Process and Counterparty Financial Risk
C. Distressed Acquisitions – Process and Pitfalls
D. Key Tax Considerations
E. Discussion / Q&A

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1 Year Crude Oil Prices

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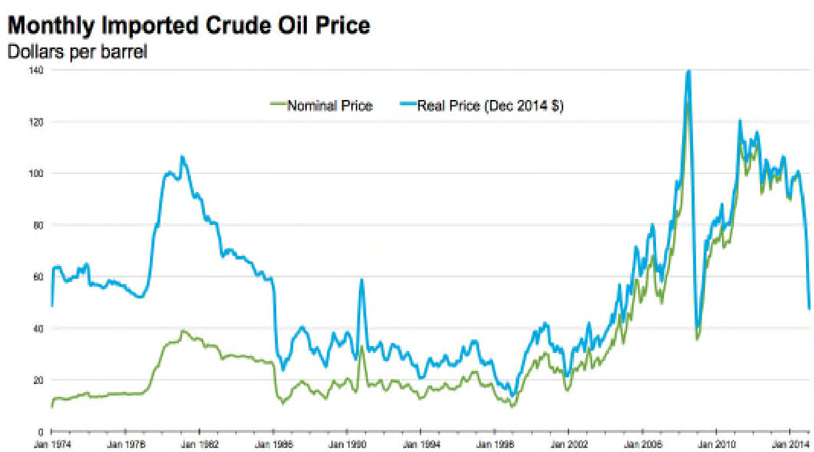
40 Years Crude Oil Prices (inflation adjusted)



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"The Past is Prologue" Lessons Learned / Early Trends by Sector

1. Upstream – ATP, new filings, hot topics
2. Services – Rate Reduction Pressure, new filings, hot topics
3. Midstream / Trading – Semcrude, Lehman, covenants vs. contracts, and LNG
4. Downstream – Spinoffs, low margins / Lyondell and collateral coverage defaults – Flying J

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"An Ounce of Prevention…" Managing Bankruptcy Process

1. Identify Exposure Early
   - Risk Management Team
   - Threshold Financial Review Criteria
2. Quantify Exposure – Past, Current, and Future
3. Mitigation / Restructuring Plan
   - Additional Security
   - Adequate Assurance
   - Improve Cash Position
   - Termination
4. Bankruptcy Response Plan

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"Bankruptcy is Not a Spectator Sport" Bankruptcy Process Management

1. Automatic Stay, Exceptions, and the "Twilight Zone"
2. First Day Motions / Orders - Shape Case on a Rocket Docket
   - DIP Financing / Cash Collateral Orders Impair 3rd Party Rights
   - Critical Vendor Status
   - Budget
   - 503(b)(9) - Reclamation and Other Rights
3. File Proof of Claim
   - BAR DATE / File Early
   - Evaluate Administrative Claim Stats
4. Plan Treatment, Confirmation & Distribution
5. Preference of Fraudulent Transfer & Other "Chapter 5" Litigation

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Catching the "Falling Knives" Distressed Acquisitions

1. Very Few "Stand Alone" Reorganizations
2. Bankruptcy Sales: Liquidations (of Collateral)
   - Big Gap on "bid" vs. "ask" early in this cycle
   - Sale Motion / Order
     - Bid Procedures
     - Form APA – Asset Lists
     - "Stalking Horse" Protections
     - Bid Qualifications
     - Timing – Bids / Auction
     - Sale Order / Plan Requirement (Braniff concerns)

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Distressed Acquisitions (continued)

3. "Plan" Acquisitions – Conversion of Debt to Equity
   - Balance Sheet Recapitalization through Plan
   - Pre-Petition Creditor (or Creditor Class) Converts to New Equity
   - Secured Debt – Assumed, Restructured, Replaced, Retired
   - Pay Administrative / Priority Claims
   - Special Treatment
     - Trade Debt
     - Contract Assumption
     - NOLs
     - Future Capital Needs

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	Pre-Petition Balance Sheet	**Post Confirmation Balance Sheet**
Assets:	$250,000,000	$250,000,000
Liabilities:		
- Secured	$60,000,000	$50,000,000
- Bond	$150,000,000	-
- Trade	$25,000,000	$25,000,000
- Other	$20,000,000	$20,000,000*
- Tax	$10,000,000	$10,000,000*
Total Liabilities	$265,000,000	$105,000,000
NEW WORTH	**($15,000,000)**	**$145,000,000**

*Payment of secured, priority, and trade debt may be "financed" through plan process

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"Why Swim with the Sharks"
Distressed Acquisitions – Outside Bankruptcy

1. Bankruptcy Process Risks include:
   - High Cost of Administration
   - Timing Considerations
   - Uncertainty in Bidding Process
2. Bankruptcy Process Reward – free & clear assets
3. Roadblocks and Pitfalls
   - Secured Lenders and Release of Security Rights
   - Incohate Liens
   - Undisclosed Liabilities
   - Contract Transfers
   - Litigation Risks – Successor Liability & Fraudulent Transfers

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Key Tax Considerations

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Tax Considerations

- Cancellation of Debt Income
- Tax Issues in Acquiring Distressed Debt
- Net Operating Loss Limitations
- Equity or Phantom Equity Incentive Interests

Cancellation of Debt Income

- If a creditor forgives all or part of a debt, the debtor generally recognizes COD income
- Exceptions to COD Income:
  - Discharge occurs in bankruptcy
  - Discharge occurs while taxpayer is insolvent
  - Certain debt for equity exchanges
  - Debt is “qualified real property business indebtedness” or
  - Debt is “qualified farm indebtedness”
- Exclusions because of bankruptcy or insolvency will reduce the tax attributes of the taxpayer

Cancellation of Debt Income: Corporations vs. Partnerships

- Bankruptcy or Insolvency Exception:
  - A corporate debtor has no COD income if the **corporation** is in bankruptcy or insolvent
  - For partnerships, bankruptcy and insolvency exceptions apply at the partner level
    - Each partner recognizes its allocable portion of the COD income
    - Only if the **partner** is in bankruptcy or insolvent will the exclusion apply

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Cancellation of Debt Income: Corporations vs. Partnerships

- Debt for Equity Exchange (Corporate Debtor):
  - If a shareholder contributes corporation's own debt, debtor is treated as having satisfied debt with an amount of money equal to the shareholder's **adjusted basis** in the debt
    - Shareholder-creditor does not recognize gain or loss and increases basis in stock by their basis in debt
  - If a debtor corporation issues stock to a creditor in satisfaction of its debt, debtor is treated as having satisfied debt with an amount of money equal to the stock's **FMV**
    - In some situations, creditor may recognize gain or loss on the exchange

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Cancellation of Debt Income: Corporations vs. Partnerships

- Debt for Equity Exchange (Partnership Debtor):
  - Debtor partnership is treated as having satisfied debt with an amount of money equal to the **FMV** of the partnership interest
    - Non-recognition transaction for creditor; deferral of any loss

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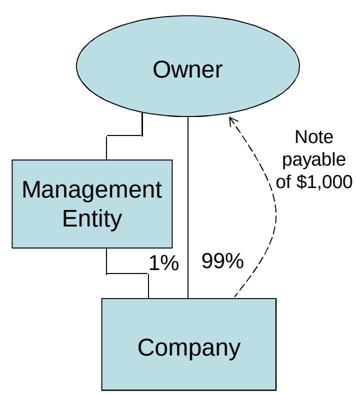
Cancellation of Debt Income: Corporations vs. Partnerships (Example)

- Owner owns 100% of Company
- Company has Note payable to Owner of $1,000 and Owner has $1,000 basis in Note
- Owner contributes Note to Company and receives equity worth $300, the total FMV of Company
- If Company is a corporation, there is no COD income
- If Company is a partnership, COD income recognized of $700 with no bad debt deduction
- Planning opportunity?



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Tax Issues in Acquiring Distressed Debt

- In certain cases, acquirer may be required to recognize taxable income with no cash (or insufficient cash) to pay tax (i.e., phantom income)
  - Original Issue Discount (OID) and Market Discount rules
  - Loan Modification
  - Foreclosures

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Tax Issues in Acquiring Distressed Debt: Original Issue Discount vs. Market Discount

- OID rules apply where Note is issued with a stated interest rate less than the applicable federal rate (AFR) or PIK interest
- OID rules require lender to recognize interest income over the term of the Note
- Purchaser of Note steps into seller's shoes

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Tax Issues in Acquiring Distressed Debt:
Original Issue Discount vs. Market Discount

- Market discount applies to purchase of existing debt
- The excess of face amount of Note over the purchaser's basis in the Note is treated interest equivalent
- Discount accrues on a straight line basis over remaining life of Note unless taxpayer elects constant yield accrual
  - Allows taxpayer to defer more of the market discount recognition
- Unlike OID, market discount is taken into income as payments are made

Tax Issues in Acquiring Distressed Debt:
Loan Modification

- "Significant modification" of debt after acquisition could trigger exchange treatment
- If basis is less than the face amount of the Note, income recognition required
- What is a "significant modification?"
  - Treasury Regulations contain a number of bright-line tests and safe harbors
  - Analysis requires all modifications to be viewed in the aggregate

Tax Issues in Acquiring Distressed Debt: Foreclosures – Creditor's Consequences

- Gain or loss recognized on difference between FMV of property and basis in Note
- Not uncommon to pay less for Note than FMV of collateral to compensate for foreclosure risks (e.g., bankruptcy, legal costs, etc.)
- Gain on foreclosure sale can often be ordinary income

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Tax Issues in Acquiring Distressed Debt: Foreclosures – Debtor's Consequences

- Foreclosure on property is considered exchange to the extent of FMV of property
- Gain or loss recognized on difference between FMV of property and basis in assets
- If FMV of property is less than the amount of the debt, and if the deficiency is forgiven, the debtor recognizes COD income equal to the deficiency (subject to possible exceptions)

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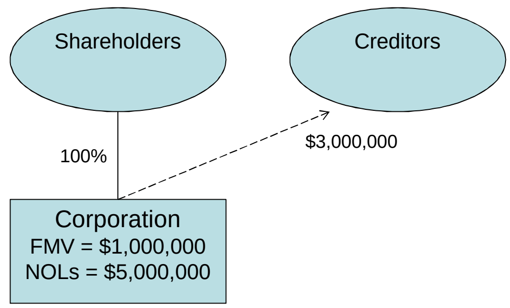
Net Operating Loss Limitations:
Corporations Outside of Bankruptcy

- Following an "ownership change", corporation's use of pre-change NOLs are limited
  - Ownership change occurs if one or more shareholders who own at least 5% before or after a transfer increase their ownership by more than 50 percentage points
  - Annual NOLs limited to value of the corporation pre-ownership change times the "long-term tax-exempt rate" (2.67% currently)
  - If corporation does not continue operations for at least two years post-change, none of the NOLs can be utilized post-change (retroactive to first post-change tax year)

Net Operating Loss Limitations:
Corporations In Bankruptcy

- NOL limitations are relaxed for corporations reorganizing under Title 11
  - Shareholders and creditors of corporation prior to the change in ownership must own stock after the change possessing at least 50% of the voting power and economic value of the corporation
  - Creditors must generally have held debt at least 18 months prior to bankruptcy filing or debt must have arisen out of ordinary course of business of the debtor
  - NOL carryforward does not include any interest paid or accrued in the 3 taxable years prior to and the taxable year in which the reorganization occurs
  - A second ownership change within 2 years following reorganization will cause the corporation to lose ability to utilize any NOLs post-change (retroactive to first post-change tax year)

Net Operating Loss Limitations



- Assume Creditors convert debt to equity representing 75% of the stock of Corporation
- Ownership change occurs
- Annual NOLs limited to $26,700 per year
- If Corporation is in bankruptcy, no annual NOL limitation is applicable

Equity or Phantom Equity Incentive Interests

- Incentive interest holders may hold equity or phantom equity that is so far underwater they lose motivation
- In many cases, new classes of incentive interests can be created that have thresholds based off of the distressed value
- Must be careful in structuring new equity or phantom equity to ensure that immediate taxable income (and possible penalties) will not be recognized by management

Q&A

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Philip Eisenberg

Partner

A leader in the Firm's energy, commercial and maritime litigation, creditors rights and bankruptcy groups, Philip Eisenberg represents major corporate clients focused on high profile offshore and oil and gas and energy-related matters both domestically and internationally involving all aspects of offshore matters, commercial dealings and regulatory agency work. Mr. Eisenberg relies on his many years of experience in the offshore and energy industry at ChevronTexaco, where he served in various capacities including senior counsel.

Representative Experience

- Counsel to several major energy company and offshore Deepwater groups for all aspects of contractual and liability matters; including first response to major offshore casualties such as Petronius, Thunderhorse and Typhoon; and joint interest matters related to the Macondo Oil Spill Incident, drafting and negotiating drilling, exploration and construction contracts; joint venture, partnership and other transaction structures; insurance and indemnity matters; and dispute resolution, including international arbitration.
- Extensive involvement in representing various creditor interests in numerous oil and gas and energy related bankruptcies and reorganizations including counsel to creditors or participation with Unsecured Creditors Committees in such matters as Panaco, TriUnion, Contour Energy, Kodiak, Cronus, Golden Oil, TDC Energy, Watson Energy, Babcock and Wilcox, Forceenergy, WRT, BT Operating, Sun Drilling, Reichmann Oil and Gas, Heritage Standard, ATP Oil and Gas, Delta Petroleum and Capco Inc.
- Extensive involvement in representing various creditor interests in marine company bankruptcies and restructurings including related to Friede Goldman Halter, Superior Offshore, Deep Marine, Torch, Inc., the Macondo Oil Spill Incident, GoodCrane Inc., MPF Inc. and ODS International Inc.
- Recent involvement in several lawsuits and disputes arising from property transactions; including the handling of preferential purchase rights, areas of mutual interest, volumetric production payments, determining responsibility for and securing funding of plugging and abandonment obligations, insurance and indemnity provisions, and production handling.

Professional History

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Practices

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Business Litigation & Dispute Resolution
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Energy Litigation
Energy Trading/Marketing
Environmental
International Energy
LNG
International Admiralty & Maritime
International Energy & Project Finance
Energy

Industry Groups

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Education

J.D., Louisiana State University Law Center, 1984

B.S., Accounting, Brooklyn College, 1981

Bar Admissions

Texas, 2002
New York, 1986
Louisiana, 1984

- Of Counsel, Locke Liddell Sapp LLP (2002-2003)
- Senior Counsel, ChevronTexaco (2001-2002)
- Senior Counsel, Texaco (1999-2001)
- Senior Attorney, Texaco (1993-1999)
- Attorney, Texaco (1986-1993)

Publications & Presentations

- Speaker, "Caution to the Unwary: The Fallout to the Drilling Industry from the ATP Bankruptcy," 2014 IADC Contracts & Risk Management Conference, October 15, 2014
- Co-Author, "Locke Lord QuickStudy: Fifth Circuit Holds Payments Under Electric Requirements Contract Exempt from Preference Avoidance," Locke Lord, August 21, 2012
- Speaker, "Joint Operating Agreements and Financial Distress," Council of Petroleum Accountants Societies' (COPAS) Joint Interest Standing Committee Winter 2010 National Meeting, January 28, 2010
- Author, "Addressing the Current Fiscal Crisis from an Oil and Gas Perspective: From Planning Issues Through Insolvency," 55 Rocky Mt. Min. L. Inst. 33-1, 2009
- Co-Author, "Decommissioning/Plugging and Abandonment Liabilities in Bankruptcy: What Priority Should They be Afforded?," published in conjunction with the Center for American and International Law's 57thAnnual Conference on Oil and Gas Law, Spring 2005

Omer F. "Rick" Kuebel, III

Partner

Rick Kuebel has extensive experience in oil, gas, and energy related bankruptcies and corporate restructuring solutions. Mr. Kuebel has represented numerous energy companies in business litigation or arbitration matters and regulatory disputes involving oil and gas exploration, development, transportation, refining and marketing.

Mr. Kuebel has acted as counsel in numerous commercial and regulatory disputes arising from offshore exploration prospects including Macondo, Atlantis, Thunder Horse, Petronius, Who Dat, Mad Dog, West Delta and the Cook Inlet.

Additionally, he provides counseling for real and mineral property transactions, including acquisitions, development, finance, joint operations, and divestitures and represents creditors in commercial collection litigation, property litigation, enforcement of security rights, and bankruptcy litigation.

He has represented a number of major energy companies in energy or energy-related industry restructurings and bankruptcies, including Lyondell Basell, SemCrude, Flying J, Enron (North America), Getty Petroleum Marketing, EOTT, ATP, Panaco, Contour Energy, TDC Energy, Watson Energy, TransTexas Oil and Gas, Forcenergy, WRT, Alma and Equinox, Rand Energy, NARCO, AP Green, Farmland Industries, PG&E, Babcock and Wilcox, Bethlehem Steel, and Friede Goldman Halter. In addition, he has formed or represented unsecured creditor committees in several reorganizations for companies such as Evans Industries, the Fairgrounds, WRT Energy, Jitney Jungle, Delchamps, Forcenergy, Friede Goldman Halter, Orion Refining, Lundy Enterprises, Valentine Paper and WFA (West Feliciana Paper Mill).

Professional Affiliations and Awards

- Named to *Louisiana Super Lawyers* by *Law & Politics* magazine (2008-2015)
- Advisory Board Member, Institute for Energy Law
- Member, American Bankruptcy Institute
- Member, Turnaround Management Association
- Named, *The Best Lawyers in America,* Bankruptcy and Creditor-Debtor Rights Law
- Recognized for Bankruptcy/Restructuring in *Chambers USA, America's Leading Lawyers for Business* (2010-2014)
- Named, Top Lawyer in New Orleans, Bankruptcy Section, *New*

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Education

J.D., Loyola University School of Law, New Orleans, 1992

B.A., Economics, Tulane University, 1986

Bar Admissions

Louisiana, 1992

Court Admissions

U.S. District Court for the Southern District of Texas
U.S. District Court for the Eastern District of Louisiana
U.S. District Court for the Middle District of Louisiana
U.S. District Court for the Western District of Louisiana
U.S. Court of Appeals for the Fifth Circuit
U.S. District Court for the Southern District of New York (pro hac vice)
U.S. District Court for the District of Delaware (pro hac vice)

Orleans Magazine (2009-2014)

Publications & Presentations

- Speaker, "Caution to the Unwary: The Fallout to the Drilling Industry from the ATP Bankruptcy," 2014 IADC Contracts & Risk Management Conference, October 15, 2014
- Bankruptcy Faculty, "RMMLF Short Course on Federal Offshore Oil & Gas Leasing and Development," January 24, 2013
- Co-Author, "Locke Lord QuickStudy: Fifth Circuit Holds Payments Under Electric Requirements Contract Exempt from Preference Avoidance," Locke Lord, August 21, 2012
- Co-Author, "Locke Lord QuickStudy: Stern v. Marshall," Locke Lord, June 27, 2011
- Panelist, "Bankruptcy Issues for Today's Litigators," Institute for Energy Law 61st Annual Oil and Gas Law Conference, February 18, 2010
- Author, "Decommissioning/Plugging and Abandonment Liabilities in Bankruptcy: What Priority Should It Be Afforded?," January 18, 2006

U.S. District Court for the Northern District of Texas
U.S. District Court for the Southern District of Mississippi (pro hac vice)

David Patton

Partner

David Patton is co-chair of the Firm's Energy Practice Group. He has over 35 years of experience in various legal aspects of the oil and gas industry, including acquisitions and sales of assets or equity interests, drafting and negotiating leases, contracts, and agreements related to field operations. Mr. Patton has represented clients in connection with surface use conflicts, day to day exploration and development activities, and the resolution of oil and gas disputes. In addition, he was lead attorney in over $4 billion in oil and gas property transactions in 2011-2013. He is a frequent speaker on oil and gas issues and is active in the Rocky Mountain Mineral Law Foundation and the State Bar of Texas.

Professional Affiliations and Awards

- Fellow, Texas Bar Foundation
- Named to *Houston Business Journal's* "Who's Who in Energy" (2013)
- Sustaining Life Member, Texas Bar Foundation
- Named, 2012 Houston Oil & Gas Law Lawyer of the Year by *Best Lawyers*
- Named, Nationwide Leader, Litigation: Energy & Natural Resources, *Chambers USA's* Leading Lawyers in America
- Named, *Best Lawyers in America,* Oil and Gas Law (2010 - 2015)
- Named, Super Lawyer by *Texas Monthly* magazine (2011 - 2013)
- Program Chair, State Bar of Texas Oil, Gas and Energy Resources Law Section 75th Anniversary Celebration (October 2013)
- Program Chair, Rocky Mountain Mineral Law Foundation 59th Annual Institute, Spokane, Washington (July 2013)
- Program Chair, Ernest E. Smith Oil, Gas and Mineral Law Institute, University of Texas, (2009 & 2011)
- Planning Committee, Ernest E. Smith Oil, Gas and Mineral Law Institute, University of Texas (2009 - 2012)
- Planning Committee, State Bar of Texas Advanced Oil, Gas and Energy Resources Course (2008 - 2012)
- Planning Committee, State Bar of Texas Advanced Real Estate Drafting Course (2009)
- Executive Committee, Rocky Mountain Mineral Law Foundation (2009 - 2011)
- State Bar of Texas Oil, Gas and Energy Resources Law Section
  - Chair (2014 - 2015)
  - Chair Elect (2013 - 2014)
  - Vice Chair (2012 - 2013)

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Education

J.D., University of Houston Law Center, 1977

B.A., The University of Texas at Austin, 1973

Bar Admissions

Texas, 1977

- Secretary (2011 - 2012)
- Treasurer (2010 - 2011)
- Editor, State Bar of Texas Oil, Gas and Energy Resources Law Section Report (2009 - 2010)
- Member, State Bar of Texas
- Council of the Oil, Gas and Energy Resources Law Section (2007 - 2014)
- Trustee, Rocky Mountain Mineral Law Foundation (representing State Bar of Texas, 2009 - 2014); (2003 - 2006, at large)
- Other RMMLF Activities:
  - Member Site Selection Committee
  - Member Special Institutes Committee
  - Chairman, Houston Regional Planning Committee, Annual Institutes (2002 - 2013)
- Advisory Director, Center for American and International Law
- Member, Advisory Board of the Texas Journal of Oil, Gas and Energy Law
- Member, Houston Bar Association
- Member, College of the State Bar of Texas
- Director, South Texas Chapter, Federal Bar Association (2002 - 2005)
- Member, Board of Litigation of Mountain States Legal Foundation (2006 - 2008)
- Oil & Gas Co-Chairman, Rocky Mountain Mineral Law Foundation Annual Institute (2004)

Publications & Presentations

- Co-Author, "Locke Lord QuickStudy: No Duty to Protect the Levee Districts' Interest in the "Buffer Zone"," Locke Lord LLP, March 4, 2015
- Contributor, "Locke Lord's Energy Calendar 2013 (September/October)," Locke Lord, August 29, 2013
- Contributor, "Locke Lord's Energy Calendar 2013 (July/August)," Locke Lord, July 27, 2013
- Contributor, "Locke Lord's Energy Calendar 2013 (May/June)," Locke Lord, April 30, 2013
- Contributor, "Locke Lord's Energy Calendar 2012 (November/December)," Locke Lord, October 30, 2012
- Contributor, "Locke Lord's Energy Calendar 2012 (September/October)," Locke Lord, August 30, 2012
- Contributor, "Locke Lord's Energy Calendar 2012 (July/August)," Locke Lord, July 3, 2012
- Contributor, "Locke Lord's Energy Calendar 2012 (May/June),"

Locke Lord, April 27, 2012
- Contributor, "Locke Lord's Energy Calendar 2012 (March/April)," Locke Lord, February 28, 2012
- Speaker, "Dealing With Financial Distress in the Energy Industry," Rocky Mountain Mineral Law Foundation Special Institute, February 2010
- Author, "2009 Supplemental Index By Topic," State Bar of Texas Oil, Gas and Energy Law Section Report, September 15, 2009
- Author, "Expansion of Chapter 92 of Texas Natural Resources Code," State Bar of Texas Oil, Gas and Energy Law Section Report, June 2008
- Speaker, "Doing the Deal: Buying and Selling Offshore and Onshore Oil and Gas Properties," Institute for Energy Law Annual Meeting, 2008
- Speaker, "Surface Damage Acts and the Accommodation Doctrine," Ernest E. Smith Oil, Gas and Mineral Law Institute, University of Texas, April 2008
- Speaker, "Continuing Liability of a Lessee After Assignment," Rocky Mountain Mineral Law Foundation Annual Institute, July 2007
- Speaker, "Oil & Gas Agreements—The Production and Marketing Phase," Rocky Mountain Mineral Law Foundation Special Institute, 2005
- Speaker, "Oil and Gas Issues and Conflicts with Surface Use (Including Surface Waivers)," South Texas College of Law Real Estate Conference, June 2005
- Speaker, "Operating Agreements and Other Agreements Among Production Owners—Developing the Prospect After the Test Well," Rocky Mountain Mineral Law Foundation Special Institute: Oil & Gas Agreements: The Production and Marketing Phase, May 2005
- Speaker, "Negotiating a Surface Use Agreement for Private Lands," Rocky Mountain Mineral Law Foundation Special Institute: Development Issues and Conflicts in Modern Gas and Oil Plays, November 2004
- Speaker, "Development Issues in Modern Oil & Gas Plays," Rocky Mountain Mineral Law Foundation Special Institute, 2004

Community Involvement

- Past Chairman, Baseball USA
- Past President, Spring Branch Memorial Sports Association

Ken Simon

Partner

Ken Simon practices tax and corporate law and is the Managing Partner of the Firm's Houston office. Mr. Simon has experience representing purchasers, sellers, issuers, and investors in connection with acquisitions, mergers, joint ventures and dispositions, and public offering and private placement of debt and equity securities. He focuses on the representation of entrepreneurs and private equity, and the use of limited partnerships, master limited partnerships, joint ventures, limited liability companies, and other business entities. Mr. Simon also represents individuals and business enterprises in federal, state, and local tax planning for a variety of complex transactions and financings. He holds leadership positions at Locke Lord and in the Houston community.

Representative Experience

- Represent institutional investors, developers, sponsors, promoters and individuals in negotiating complex partnership agreements, limited liability company agreements, and shareholder and buy-sell arrangements.
- Represent investors and sponsors in negotiating governing documents and analyzing related tax issues in connection with investments in private equity funds, hedge funds and other alternative investment vehicles.
- Represent master limited partnerships in structuring, tax and partnership matters, including analysis of formation, reorganization and securities offerings issues.
- Represent employees and senior executives in structuring and implementing tax deferred compensation arrangements and other incentive compensation and equity plans.
- Serve as primary tax counsel to various types of tax exempt organizations, including large non-profit organizations.
- Represent individuals and entities in connection with federal income tax controversies with the Internal Revenue Service, including assistance at all administrative levels and in litigation.

Professional History

- Partner, Locke Lord LLP
- Managing Partner, Houston Office (2011 - Present)
- Co-Financial Partner, Locke Lord LLP (2007 - Present)
- Management Committee Member, Locke Liddell & Sapp LLP (2000 - 2007)

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Mergers and Acquisitions
Private Equity
Retail
Tax Controversy

Industry Groups

Retail

Education

J.D., with high honors, The University of Texas School of Law, 1984
Beta Gamma Sigma
Phi Delta Phi
Order of the Coif

B.B.A., with highest honors, Accounting, The University of Texas at Austin, 1982

Bar Admissions

Texas, 1985

Court Admissions

U.S. Tax Court

- Administrative Partner, Locke Liddell & Sapp LLP (1995 - 2002)
- Certified Public Accountant, State of Texas (1986)

Professional Affiliations and Awards

- Member, State Bar of Texas
  - Past Chair, Partnership and Real Estate Tax Committee
- Member, Houston Bar Association
  - Board of Directors, Tax Section
- Member, American Bar Association
  - Member, Committee on Partnerships, Section of Taxation
- Member, American Institute of Certified Public Accountants
- Member, Texas Society of Certified Public Accountants
- Named, *The Best Lawyers in America*, Tax Law (2013-2015)

Publications & Presentations

- Speaker, "The Current Landscape for Master Limited Partnerships," Locke Lord LLP Energy Breakfast, September 17, 2013

Community Involvement

- Chair, Board of Directors, Make-A-Wish Foundation (2011 - 2012)
  - Member, Executive Committee (2010 - 2012)
- Member, Board of Directors, Greater Houston Partnership
- Member, Board of Directors, Central Houston
- Member, Board of Directors, Teach for America
- Member, Board of Directors, Catching Dreams Foundation
- Member, Board of Trustees, The Kayser Foundation
  - Secretary/Treasurer
- Congregation Beth Israel
  - Past Member, Board of Trustees
  - Chair, Leadership Development Committee (2007 - 2010)
- American Heart Association
  - Past Member, Board of Directors
- Arthritis Foundation, Houston Chapter
  - Past Member, Board of Directors
- Graduate of Center for Houston's Future Leadership Forum

Bill Swanstrom

Partner

Bill Swanstrom serves as co-chair of the Firm's Energy Practice Group. He has over 25 years of experience working with energy companies in their significant acquisition, divestiture, project development and finance activities. He is a regular speaker and writes on energy M&A and project development issues. Mr. Swanstrom also has substantial experience in energy private equity transactions, representing both investors and companies. He is a regular speaker and writes on energy M&A and project development issues. Mr. Swanstrom is recognized in *Chambers USA* as "an incredibly talented lawyer who is an excellent resource for clients."

Representative Experience

- Represented The Energy & Minerals Group in its formation of a joint venture to develop midstream infrastructure in the Utica Shale.
- Represented Helix Energy Solutions Group in the $620 million sale of its oil and gas subsidiary to Talos Energy.
- Represented Martin Midstream Partners L.P. in its $275 million sale of East Texas and Northwest Louisiana natural gas gathering and processing assets to CenterPoint Energy.
- Represented Eagle Rock Energy Partners, L.P. in its acquisition of processing plants and a 2,500 mile gathering system from BP America Production Company.
- Represented Crestwood Midstream Partners LP in its $900 million acquisition of Quicksilver Gas Services, a publicly-traded master limited partnership, its $338 million acquisition of midstream assets from Frontier Gas Services, LLC, and its $377 million acquisition of midstream assets from Antero Resources.
- Represented High Sierra Energy, LP in its merger with NGL Energy Partners LP.
- Represented The Energy & Minerals Group, a large energy private equity fund, in a $700 million joint venture with MarkWest Energy Partners to develop gathering and processing assets in the Marcellus Shale and in its subsequent $2 billion sale of its interest to MarkWest Energy.
- Represented Veolia in its sale of its marine services division to Brasbunker.
- Represented Zephyr Gas Services (a portfolio company of Dorado) in its $185 million sale to Regency Energy Partners.
- Representing major integrated energy company in its development of one of the largest proposed wind farms in the world.
- Represented NATCO in its $800 million stock-for-stock merger with

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Global Investment
Mergers and Acquisitions
Private Equity
International
International Corporate & Commercial Transactions
International Energy & Project Finance

Education

J.D., with high honors, The University of Texas School of Law, 1988
Chancellors,
Order of the Coif,
Texas Law Review

B.A., *summa cum laude*, English and Economics, Southern Methodist University, 1984
Phi Beta Kappa

Bar Admissions

Texas, 1988

Cameron.

- Acting as project counsel in representing the Rockies Express joint venture in developing the largest gas pipeline built in the U.S. in the last 25 years.
- Represented a large domestic electricity generation company in a series of power plant sales totaling approximately 1500 MW in generation.
- Represented PSI in its acquisition of gas processing assets from Williams.
- Worked with Caledonia Gas Storage in its sale to Iberdrola.
- Represented Parsons E&C (one of the largest U.S. engineering companies in the energy business) in its $240 million sale to The Worley Group, an Australian company in the same business. Have continued to represent the combined company – WorleyParsons - in a number of acquisitions both domestically and internationally.
- Represented major energy company in its acquisition of 1700 MW of electricity generation assets in New York for purchase price in excess of $1 billion.
- Represented ONEOK in its $1.4 billion acquisition of Koch's NGL assets.
- Represented major international commodity company in its $150 million acquisition of TEPPCO's ownership interest in Mont Belvieu Storage Partners, which owns significant NGL storage and transportation assets.
- Represented a major private equity fund in its acquisition and subsequent sale of a Gulf Coast oilfield services company for over $100 million.
- Represented the largest independent gas storage company in the U.S. in its recapitalization transaction with one of the world's largest private equity funds.

Professional History

- Partner, Locke Lord LLP

Professional Affiliations and Awards

- Executive Committee, Greater Houston Energy Collaborative (part of the Greater Houston Partnership)
- Co-Chair, Energy Policy Council, Greater Houston Partnership
- Recognized as one of the Top 5 M&A lawyers in Texas in *Texas Lawyer's 2012 Go-To Lawyer Guide*
- Board of Directors, Institute for Energy Law
- Steering Committee, Houston Technology Center Energy Initiative

- Executive Committee, Global Energy Management Institute
- Board of Directors, Rice Alliance
- Member, University of Houston Energy Advisory Board
- Fellow, Texas Bar Foundation
- Member, Federal Energy Bar Association
- Member, Houston Bar Association
- Member, State Bar of Texas
- Recognized as One of the Top Mergers and Acquisitions Attorneys in Texas by *Chambers USA*
- Recognized as Texas Super Lawyer by *Texas Monthly* Magazine
- Named, *The Best Lawyers in America*, Energy Law (2013-2014)

Publications & Presentations

- "Locke Lord's Bill Swanstrom Named to HBJ's '2014 Who's Who in Energy'," October 3, 2014
- Presenter, "Mexican Energy Reforms - Current Reforms Affecting the Oil & Gas Industry," Locke Lord LLP CLE, September 23, 2014
- "Energy Transactional Issues Focus of *Law360* Q&A With Locke Lord's Bill Swanstrom," July 21, 2014
- Speaker, "The Current Landscape for Master Limited Partnerships," Locke Lord LLP Energy Breakfast, September 17, 2013
- Contributor, "Locke Lord's Energy Calendar 2013 (September/October)," Locke Lord, August 29, 2013
- Contributor, "Locke Lord's Energy Calendar 2013 (July/August)," Locke Lord, July 27, 2013
- Contributor, "Locke Lord's Energy Calendar 2013 (May/June)," Locke Lord, April 30, 2013
- Summit Chair, "Infocast 7th Annual Midstream Summit," February 26, 2013
- Contributor, "Locke Lord's Energy Calendar 2012 (November/December)," Locke Lord, October 30, 2012
- Contributor, "Locke Lord's Energy Calendar 2012 (September/October)," Locke Lord, August 30, 2012
- Summit Chair, "Infocast Marcellus & Utica Infrastructure Summit," July 11-12, 2012
- Moderator, "How to Overcome the Transportation Network Bottlenecks of the Eagle Ford Shale," Eagle Ford Infrastructure Finance & Development Summit, San Antonio, June 20-21, 2012
- Moderator, "Eagle Ford, Permian, Avalon, Bone Springs and Wolfcamp Session," 5th Annual Platts Midstream Development & Management Conference, Houston, May 8-9, 2012
- Moderator, "MLP Perspectives: New Developments, New

Opportunities," Infocast's 6th Annual Midstream Summit, Houston, February 1, 2012
- Presenter, "Infrastructure REITs in the Energy Industry," Locke Lord LLP CLE, January 12, 2012
- Moderator, "Bakken Infrastructure Investment Opportunities for Capital Providers," Infocast Bakken Infrastructure Finance & Development Summit, Denver, October 24-26, 2011
- Presenter, "Infrastructure REITs in the Energy Industry," Locke Lord LLP CLE, October 20, 2011
- Moderator, "Private Equity and Investment Perspectives Regarding Marcellus Infrastructure," Infocast Marcellus Infrastructure Finance & Development Summit, Pittsburgh, October 3-5, 2011
- Moderator, "Producer Requirements – What Midstream Infrastructure is Needed and Where?," 4th Annual Platts Midstream Development & Management Conference, Houston, May 12-13, 2011
- Moderator, "Private Equity Perspectives on the Market," Infocast 5th Annual Midstream Summit, Houston, March 1-3, 2011
- Moderator, "M&A, JVs, and MLPs – Climate and Recent Activity," 3rd Annual Platts Midstream Development & Management Conference, Houston, May 20-21, 2010
- Moderator, "Equity Investors' Perspectives on Distressed Deals," Infocast Distressed Gas Asset Acquisition Symposium, Houston, November 10, 2009
- Moderator, "Wind Power—Regulatory, Infrastructure and Workforce Issues," Texas/European Union Wind Energy Symposium, College Station, Texas, October 27, 2009
- Co-Author, "Private Equity Helps Projects Through Rough Patch," National Law Journal, October 26, 2009
- Moderator, "Private Equity's Perspectives on Investment Opportunities in Midstream Projects, including Pipelines, NGL, Storage and LNG Terminals," Infocast Pipeline Renaissance Summit, Houston, June 10-12, 2008
- Presenter, "Texas Energy Policy: What Government Leaders Need to Know," Locke Lord LLP CLE (Houston), February 21, 2008

Community Involvement

- Executive Committee and Board of Directors, Junior Achievement
- Board of Directors, Texas Business Hall of Fame
- Board of Directors, Society for the Performing Arts

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Managing Energy Sector Distress

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Locke Lord is one of the world's preeminent energy law firms. Our extensive industry experience dates back to the opening of the Firm's Houston office in the early 1900s. As the industry evolved globally, Locke Lord has actively represented clients in all aspects of the energy value chain.

Additionally, Locke Lord's first-rate international team of bankruptcy, restructuring, insolvency and tax lawyers in offices around the world provides experience and depth in virtually every aspect of energy bankruptcy matters. Our representations include oil & gas companies, power plants, marine companies, drilling contractors and state senate committees. Our deep capabilities in energy-related bankruptcies allow for extensive involvement in commercial collection litigation, property litigation, enforcement of security rights, bankruptcy litigation, cancellation of indebtedness and related tax issues. Our team provides counseling for distressed transactions, including distressed asset acquisitions and divestitures, joint operations, regulatory implications, tax consequences and other financial and tax risks.

We are pleased to present our full spectrum of services to you. Our representations include:

- The Official Committee of Unsecured Creditors of WBH Energy, LP
- The Trustee in the liquidation and disposition of major energy-related assets.
- Various creditor interests in numerous oil and gas and energy related bankruptcies and reorganizations including counsel to creditors or participation with Unsecured Creditors Committees in such matters as Panaco, TriUnion, Contour Energy, Kodiak, Cronus, Golden Oil, TDC Energy, Watson Energy, Babcock and Wilcox, Forceenergy, WRT, BT Operating, Sun Drilling, Reichmann Oil and Gas, Heritage Standard, ATP Oil and Gas, Delta Petroleum, Capco Inc., Lyondell Basell, SemCrude, Flying J, Enron (North America), Getty Petroleum Marketing, EOTT, TransTexas Oil and Gas, Alma and Equinox, Rand Energy, NARCO, AP Green, Farmland Industries, PG&E, Bethlehem Steel, Virgin Oil/Offshore and Friede Goldman Halter.
- CITGO Petroleum Corporation, the chairman of the Official Committee of Unsecured Creditors in the CIC Industries bankruptcy.
- El Paso Electric Company in its Chapter 11 bankruptcy.
- Numerous power producers and swap contract counter-parties in connection with the Chapter 11 bankruptcy of Enron Corporation and its affiliates.
- Gazpromneft in the multi-billion dollar bankruptcy of the Yukos Oil Company and certain affiliates.
- A generator and major nuclear power plant participant in the Cajun Electric bankruptcy.
- The California State Senate Utility Committee in the California electricity crisis.
- Several major energy company and offshore Deepwater groups on all aspects of contractual and liability matters; including first response to major offshore casualties such as Petronius, Thunderhorse and Typhoon.
- Various creditor interests in marine company bankruptcies and restructurings related to Superior Offshore, Deep Marine, Torch, Inc., the Macondo Oil Spill Incident, GoodCrane Inc., MPF Inc. and ODS International Inc.
- The Administrators of various UK subsidiaries of Enron in connection with cross-netting agreements entered into pre-administration.

BANKRUPTCY & RESTRUCTURING TEAM OFFERS LONG-TERM STRATEGIES

- Representing a major offshore drilling contractor with operations in the Gulf of Mexico in its Chapter 11 case.
- Counseled and resolved a lawsuit brought by a Chapter 11 post-confirmation Litigation Trust against a major energy company seeking over $1.3 billion as a purported fraudulent transfer.

About the Firm

Locke Lord Edwards is a full-service, international law firm that ranks among *The American Lawyer's* top U.S. law firms, created by the merger of Locke Lord LLP and Edwards Wildman Palmer LLP in January 2015. Our team of approximately 1,000 lawyers has earned a solid reputation in complex litigation, regulatory and transactional work.

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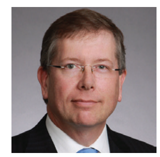

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Chapter 33
ADDRESSING THE CURRENT FINANCIAL CRISIS FROM AN OIL AND GAS PERSPECTIVE: FROM PLANNING ISSUES THROUGH INSOLVENCY

Philip Eisenberg
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Houston, Texas

Synopsis

§ 33.01 Introduction*[1]

Volatile commodity prices, economic turmoil, and the era of tight credit require energy companies to reevaluate fundamental business practices and understand the often complex and ever-changing world of bankruptcy. Merely hoping that a supplier or customer does not file bankruptcy, or sitting back and allowing the bankruptcy process to run its course, is no longer a smart business practice (if it ever was). Creditors must fight to protect their interests in bankruptcy court now more than ever, and that requires careful planning prior to bankruptcy and an astute understanding of the issues faced by energy companies in bankruptcy cases, not to mention the assistance of experienced bankruptcy counsel.

The consequences of a supplier or customer filing for bankruptcy protection can be devastating to an energy company that is not properly prepared or able to protect its rights. Unsecured debt may be repaid at cents on the dollar, if at all. Operating agreements and other executory contracts may be rejected or assigned to a third party. Liens may be stripped from collateral securing the lien, leaving a secured creditor to wait in line with unsecured creditors. Predecessors in interest may be liable for plugging and abandonment liabilities, and if that's not scary enough, most disputes will be heard on the debtor's home court—in a U.S. Bankruptcy Court.

A well-prepared energy company, however, can position itself to best protect against potential bankruptcy filings of suppliers or customers, take advantage of potential opportunities arising from the bankruptcy process, and in the worst case scenario, at the very least, understand and account for this almost inevitable occurrence. Planning for a bankruptcy and understanding the key concepts and issues discussed herein will go a long way towards protecting the interests of an energy company in the bankruptcy context.

This chapter will briefly discuss prefiling issues that arise in the weeks and months prior to a bankruptcy filing, from the perspectives of the debtor and the creditors. Next, this chapter will provide the reader with a very basic, but important, summary of the bankruptcy process and important concepts to keep in mind when dealing with a bankrupt company. Finally, this chapter will examine current issues being debated and discussed in

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*Cite as Philip Eisenberg, "Addressing the Current Financial Crisis from an Oil and Gas Perspective: From Planning Issues Through Insolvency," 55 *Rocky Mt. Min. L. Inst.* 33-1 (2009).

[1] The author acknowledges the contributions of Mark Anthony Chavez, Counsel with the ExxonMobil Law Department in Fairfax, Virginia, both as a dear friend over the years and with regard to various aspects of the chapter; and Joseph DiRago, an associate with Locke Lord Bissell & Liddell in Houston, for his keen eye and sharp pen.

bankruptcy courts throughout the nation that are presenting challenges to precepts taken for granted by energy companies in a non-bankruptcy setting. The topics include: (1) arbitration rights in bankruptcy; (2) the twilight zone, where no creditor wants to go; (3) triangular setoff no longer available; (4) lien stripping in the wake of *Clear Channel*; (5) plugging and abandonment liabilities in bankruptcy; and (6) hidden liens. The outcome of these issues will significantly impact energy companies, their suppliers, and customers.

§ 33.02 Pre-Bankruptcy Planning

Pre-bankruptcy planning is a different animal depending on whether the process is viewed from the debtor's perspective or that of a creditor. With the exception of an uncommon involuntary case, debtors know that a bankruptcy filing is going to occur before the petition is actually filed. The extent to which a debtor plans a bankruptcy filing depends on many factors, including: the debtor's financing options and deadlines; the sophistication of the debtor's counsel and advisors; trial dates or other deadlines in major litigation; employee pay schedules; amount of inventory; and time of year (for cyclical businesses), to name a few. Some debtors may file bankruptcy the day after a negative ruling in litigation, while others spend months preparing for either a prepackaged or prearranged bankruptcy filing. While exceptions exist, most sophisticated debtors prefer to have post-petition financing lined up before entering bankruptcy because, in most Chapter 11 cases, a successful reorganization is dependent on post-petition financing. Other than that, however, the extent to which a debtor prepares for bankruptcy varies significantly.

Besides timing and financing issues, debtors may also plan in other ways. Often debtors reach out to key creditor constituencies to determine if deals can be worked out prior to filing. Debtors may plan programs to keep customers and employees, or even solicit votes for a plan of reorganization, all prior to the actual bankruptcy filing. There are few limits on the extent to which a debtor may plan for a bankruptcy filing. In fact, in one case, a debtor was able to do so much planning pre-petition that its plan of reorganization was confirmed in three days![2]

One factor that has been adding a new dimension to the current financial crisis is lenders' strict enforcement of covenants included in credit facilities. Loan agreements are often wrought with covenants controlling the actions of the borrower. For example, covenants may dictate the amount or value of assets that the borrower must maintain or the number of sales that must

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[2] *In re* Davis Petroleum Corp., 385 B.R. 892, 909–910 (S.D. Tex. 2008), *vacated and remanded*, The Nancy Sue Davis Trust v. Davis Petroleum Corp., 402 B.R. 203 (S.D. Tex. 2009).

be made. If any covenants are broken, lenders may require a repayment of the entire loan or lower the amount of the credit facility. Strict enforcement of these covenants is exacerbating the current financial crisis, leading many companies, including energy companies, to bankruptcy. A recent example is the bankruptcy case of *In re Energy Partners, Ltd.*[3] In this case, the debtor's borrowing base was reduced by $38 million, which sum was required to be repaid to the lender in a lump-sum payment in under a month. Unable to satisfy this requirement, Energy Partners was forced to file for bankruptcy protection.

On the other hand, creditors are often limited in their pre-bankruptcy planning. While it is usually difficult to determine beforehand, a creditor that suspects a customer or supplier may file for bankruptcy in the near future should seek the advice of a bankruptcy attorney. There are often issues involving avoidable transfers, reclamation of goods, setoff, and perfection of liens that should be considered. It would be prudent for every company that extends credit to review its procedures to determine if it is too exposed in the event of a potential bankruptcy filing by a customer or other recipient of its credit. For example, a creditor could limit the amount of credit extended to financially struggling customers or provide for prepayment procedures. However, such measures could cost creditors a customer and negatively affect the creditor's defense to a potential suit to recover avoidable preferences. Suppliers often rely on the ordinary-course-of-business defense to shield themselves from preference exposure, but changing credit terms may indicate that the relationship was not business as usual and therefore the ordinary-course-of-business defense may be jeopardized. Creditors may also try to perfect liens against the potential debtor's property immediately before a suspected bankruptcy filing, although these liens may be subject to avoidance if perfected within 90 days of the bankruptcy filing. The safest bet for creditors is to seek the advice of a seasoned bankruptcy attorney.

§ 33.03 Bankruptcy Basics

[1] Property of the Estate

Upon filing for bankruptcy, an estate is established to hold the majority of the debtor's pre-petition property. A detailed list of the property included in the estate can be found in section 541(a) of the Bankruptcy Code,[3.1] while

[3] *In re* Energy Partners, Ltd., *et al.*, case no. 09-32957, pending in the United States Bankruptcy Court for the Southern District of Texas, Houston Division, proposed Disclosure Statement at 13-15 (Docket No. 134).

[3.1] Title 11 of the United States Code is the "Bankruptcy Code" and may be cited as such in this chapter.

section 541(b) identifies property that is not included in the estate. The debtor, as debtor in possession, or the trustee, may use or sell property of the estate in the ordinary course of the debtor's business, pursuant to section 363 of the Bankruptcy Code. However, any other use of the property must be approved by the court.

[2] Automatic Stay

When a person or entity files for bankruptcy, a stay is automatically placed on all proceedings and certain actions affecting the debtor. A comprehensive list of such activities that are stayed can be found in section 362(a) and includes things like commencing or continuing lawsuits, acting to gain control of property of the estate, creating or perfecting liens, and acting in any way to collect a debt against the debtor. On the other hand, a list of activities that are not stayed can be found in section 362(b), and includes things like the commencement of actions regarding domestic support issues, criminal actions against the debtor, and other public policy exceptions. If unsure whether an action violates the automatic stay, the safest policy is to request court approval. A creditor may seek to modify or lift the automatic stay, which is permitted when cause (including the lack of adequate protection) is present, or if the debtor does not have any equity in the property sought and such property is not necessary to the debtor's effective reorganization.[4]

[3] DIP Financing and Use of Cash Collateral

[a] Cash Collateral

Often a lender holds a security interest in the debtor's cash. This cash, which is subject to the security interest, is called cash collateral, and may only be used by the debtor if the lender is provided adequate protection of its interest in such cash. Adequate protection may be provided by the debtor to the lender in various forms, but two of the most common forms of adequately protecting a creditor's interest in cash collateral are proof that the creditor has an equity cushion (the amount of the collateral is valued more than the creditor's interest in the collateral) and periodic monthly payments.

[b] DIP Financing

Debtor-in-possession financing (known as DIP financing, or sometimes referred to as the DIP) is one of the most important aspects of any Chapter 11 reorganization. The availability of financing often means the difference between reorganization and liquidation. Because of its importance, the Bankruptcy Code authorizes debtors to incur DIP financing secured by

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[4] 11 U.S.C. § 362(d).

a senior lien on property already encumbered by a lien, so long as the previous lienholder's interest is adequately protected and the trustee is unable to obtain credit without granting a senior lien. As in a request to use cash collateral, adequate protection may be provided by the debtor to the lienholder in various forms.

[4] Executory Contracts and Unexpired Leases

[a] Definition of Executory Contract

One of the key tools the Bankruptcy Code provides a debtor is the ability to assume or reject executory contracts and unexpired leases. Specifically, 11 U.S.C. § 365(a) provides: "the trustee,[5] subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." The concept is that the debtor's rights in those agreements are preserved by the bankruptcy filing so that the debtor may assume agreements beneficial to the estate and reject burdensome ones. 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.[6] "The purpose of § 365 is to enable a troubled debtor to take advantage of a contract that will benefit the estate by assuming it or, alternatively, to relieve the estate of a burdensome contract by rejecting it."[7]

While the benefits to a debtor of being able to assume or reject executory contracts are self-evident, the debtor's ultimate decision on whether to assume or reject a particular agreement is also of critical importance to the non-debtor party. Indeed, whether a debtor decides to assume or reject an agreement will have a substantial effect on the priority afforded to a non-debtor's claim.

[b] Effect of Assumption

If an executory contract is assumed, any liability of the debtor under the assumed contract will be classified an administrative expense of the debtor's estate.[8] In order for a debtor to assume an executory contract, however, the debtor must satisfy three requirements: (1) cure any monetary

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[5] A 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).

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

[7] *In re* Hardie, 100 B.R. 284, 285 (Bankr. E.D.N.C. 1989) (citation omitted).

[8] Nostas Assocs. v. Costich (*In re* Klein Sleep Prods., Inc.), 78 F.3d 18, 29–30 (2d Cir. 1996).

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.[9] In other words, the contract must be brought back into compliance with its terms, there must be compensation for pecuniary loss to the creditor,[10] and there must be adequate assurance that the debtor (or its assignee) will perform the contract in the future.[11] 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.

While the principles of contract assumption and rejection, as discussed above, are well established, there remains a good deal of confusion with respect to the status and treatment of the debtor's pre-petition contracts between the time the debtor files for bankruptcy protection and the time the debtor makes its decision to assume or reject such agreements. This chapter will address in further detail below the requirements of the parties to a contract during the "twilight zone" and analyze the case of *In re Wilson*.

[c] Effect of Rejection

Confusion with respect to the effect of contract rejection has resulted in a great deal of inconsistency in executory contract law. However, in the past several years, bankruptcy courts, followed by several courts of appeals,

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[9] 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).

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

[11] 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. *See* 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).

have rendered decisions clarifying the effect of rejection of an executory contract. These courts have adopted the conclusion that rejection of an executory contract is not a "revocation or repudiation or cancellation" but is rather a decision by the bankruptcy estate not to assume the contract because the contract does not represent a favorable investment of estate resources.[12]

Thus, courts have increasingly held that rejection is treated as a breach, rather than a termination of the contract.[13] More specifically, rejection is treated as a breach of the contract immediately before the debtor's petition was filed.[14] Therefore, rejection does not cause a contract and its terms to vanish. The substantive rights of the parties to the contract are not changed by rejection.[15] Indeed, the post-rejection rights and obligations of the debtor and the non-debtor are exactly the same as they would have been had the debtor first breached the contract and then filed for bankruptcy.[16]

Practically speaking, however, 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 non-debtor party to file a proof of claim for unsecured pre-petition and rejection damages.[17] In other words, typically a creditor's breach of contract claim will rank below administrative expense claims, priority claims, and secured claims. In a complex Chapter 11 bankruptcy, this may mean that 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.

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[12] Michael T. Andrew, "Executory Contracts in Bankruptcy, Understanding 'Rejection,' " 59 U. Colo. L. Rev. 845, 848 (1988).

[13] Medical Malpractice Ins. Assoc. v. Hirsch (*In re* Lavigne), 114 F.3d 379, 386-87 (2d Cir. 1997); *In re* Continental Airlines, 981 F.2d 1450, 1459 (5th Cir. 1993); *In re* Modern Textile, Inc., 900 F.2d 1184, 1191 (8th Cir. 1990); Leasing Service Corp. v. First Tennessee Bank, Nat'l Ass'n, 826 F.2d 434, 436-37 (6th Cir. 1987); 3 Collier on Bankruptcy ¶ 365.09 (15th ed. rev. 1999).

[14] *Continental Airlines*, 981 F.2d at 1459.

[15] Societe Nationale Algerienne v. Distrigas Corp., 80 B.R. 606, 608 (D. Mass. 1987) (recognizing that rejection of an executory contract is not an "avoiding power" under which a debtor is freed from all aspects of the contract).

[16] *In re* Alongi, 272 B.R. 148, 154 (Bankr. D. Md. 2001) (citing Sir Speedy v. Morse, 256 B.R. 657 (D. Mass. 2000)).

[17] 11 U.S.C. §§ 365(g), 502(g).

§ 33.04 Current Topics in Bankruptcy

[1] Enforceability of Arbitration Clauses

[a] General Standard

Arbitration clauses in bankruptcy create a conflict between a party's rights to contract versus the bankruptcy law's desire to prevent debtors from defending suits in multiple forums. Courts have resolved this conflict by enforcing arbitration clauses when matters at issue are non-core or are only "related to" a debtor's bankruptcy proceeding. With respect to "core" matters within a bankruptcy court's jurisdiction, however, courts *may* refuse to order arbitration, but *only if* arbitration would conflict with the purpose of the Bankruptcy Code.[17.1]

[b] Core Proceedings That Must Be Heard in Bankruptcy Court

Much debate is centered on what type of core proceeding must be heard in a bankruptcy court, despite an otherwise enforceable arbitration clause. The *Gandy* court, for example, found that such a conflict existed in the case before it by the fact that the causes of action at issue constituted nearly the entirety of the debtor's estate and by the fact that the dispute in question implicated a central purpose of bankruptcy (i.e., "the expeditious and equitable distribution of assets of the Debtor's estate").[17.2] Under these circumstances, the court concluded that the bankruptcy court could

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[17.1] *See, e.g., In re* Gandy, 299 F.3d 489 (5th Cir. 2002):

> While it is generally accepted that a bankruptcy court has no discretion to refuse to compel the arbitration of matters not involving core bankruptcy proceedings under 28 U.S.C. § 157(b), this court has held that a bankruptcy court may decline to stay a proceeding whose underlying nature derives exclusively from the provisions of the Bankruptcy Code.

Id. at 495. *See also* MBNA America Bank, N.A. v. Hill, 436 F.3d 104 (2d Cir. 2006):

> Bankruptcy courts generally do not have discretion to refuse to compel arbitration of "non-core" bankruptcy matters, or matters that are simply "related to" bankruptcy cases.
>
> . . . .
>
> [E]ven as to core proceedings, the bankruptcy court will not have discretion to override an arbitration agreement unless it finds that the proceedings are based on provisions of the Bankruptcy Code that 'inherently conflict' with the Arbitration Act or that arbitration of the claim would 'necessarily jeopardize' the objectives of the Bankruptcy Code.

Id. at 108 (citations omitted).

[17.2] *Gandy* at 498.

exercise its discretion and refuse to enforce the arbitration provision at issue.[17.3]

In contrast, in *In re Bailey*,[17.4] the court abstained and ordered arbitration of an employment dispute as between the debtor and the debtor's former employer, pursuant to a mandatory arbitration clause contained in the debtor's employment contract. More specifically, the court held as follows:

> [T]he cause of action filed by the Debtor is based on a pre-petition legal right that is not derived from any federal right conferred by the Bankruptcy Code and thus does not conflict with the purpose or provision of the Bankruptcy Code. Therefore, the Court holds that this pre-petition contract claim is simply a state law contract claim that is subject to the arbitration provision in the Agreement.[17.5]

In *In re Hemphill Bus Sales, Inc.*,[17.6] however, the court refused to refer to arbitration the question of whether a distribution contract was validly terminated pre-petition. Although the court acknowledged "[t]he law [in the Fifth Circuit] is settled that in order for a bankruptcy court to have discretion in refusing to enforce an arbitration provision there must be a demonstrated specific conflict between enforcing an arbitration clause and the textual provisions and/or purpose of the Code,"[17.7] it went on to hold that the "[d]isposition of such a significant asset [was] too critical to

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[17.3] *Id.* at 500.

[17.4] 217 B.R. 523 (Bankr. E.D. Tex. 1997).

[17.5] *Id.* at 526; *see also In re* Hydro-Action, Inc., 266 B.R. 638, 650 (E.D. Tex. 2001) ("[The] Court does not possess the discretion to refuse to enforce the arbitration provisions in [ ] contractual agreements . . . [where] there has been no showing whatsoever that enforcement of those provisions would conflict in any way with the purpose or provisions of the Bankruptcy Code.").

[17.6] 259 B.R. 865 (Bankr. E.D. Tex. 2001).

[17.7] *Id.* at 869.

be relegated to a non-judicial body unlikely to have bankruptcy expertise if it happens fortuitously to possess some legal expertise."[17.8]

[c] Effect of Rejection on Arbitration Clauses

A debtor's rejection of a contract *does not* affect a party's ability to initiate arbitration proceedings pursuant to such agreement. In *In re Fleming Companies, Inc.*,[18] the debtor filed a motion to reject a facility standby agreement, which the court granted. Subsequently, however, a dispute arose that related to this agreement, and the debtor filed a motion to compel arbitration, based upon the arbitration clause contained in the rejected facility standby agreement.[18.1] Because the facility standby agreement had been rejected, the counterparty to the contract argued that the debtor had breached the agreement and could not rely on its arbitration provision.[18.2] In rejecting this proposition, the court stated: "A rejection in bankruptcy does not alter the substantive rights of the parties that formed pre-petition. . . . While a debtor may reject a contract in its 'entirety,' it

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[17.8] *Id.* at 868. *See also In re* Mirant Corp., 316 B.R. 234, 239 (Bankr. N.D. Tex. 2004) (holding that arbitration of matters designed to liquidate a claim go to the heart of the bankruptcy process, and are therefore core matters); *In re* Mintze, 434 F.3d 222, 231 (3d Cir. 2006) ("[w]here an otherwise applicable arbitration clause exists, a bankruptcy court lacks the authority and discretion to deny its enforcement, *unless* the party opposing arbitration can establish congressional intent . . . to preclude waiver of judicial remedies for the statutory rights at issue."); *In re* Electric Machinery Enterprises, Inc., 479 F.3d 791 (11th Cir. 2007)

> [W]e hold that the bankruptcy court erred in finding that a determination of how much money, if any, [a creditor] owes [the debtor] is a core proceeding. A determination of whether [a creditor] owes [the debtor] money under their contractual agreement does not involve a right created by federal bankruptcy law, and it is not a proceeding that would arise only in bankruptcy.

Id. at 798 (internal citations omitted).

[18] 325 B.R. 687 (Bankr. D. Del. 2005).

[18.1] *Id.* at 690.

[18.2] *Id.* at 692.

may not invalidate freely negotiated methods of dispute resolution [such as arbitration provisions] as they apply to pre-petition acts."[19]

[2] Twilight Zone

[a] Definition of Twilight Zone

While the principles of contract assumption and rejection, as discussed above, are well established, there remains a good deal of confusion with respect to the status and treatment of the debtor's pre-petition contracts between the time the debtor files for bankruptcy protection and the time the debtor makes its decision to assume or reject such agreements. This period of time is referred to as the "twilight zone" and was addressed in the case of *In re Wilson.*[20]

[b] *In re Wilson*

In *In re Wilson*, the debtor, William B. Wilson (Wilson), brought an adversary proceeding against TXO Production Corp. (TXO) "seeking an accounting and turnover of income withheld by TXO as operator of oil and gas leases in which Wilson own[ed] interests."[21] TXO responded by arguing that the funds in question were "cash collateral of its operator's lien on the Debtor's interests in the wells operated by TXO" and, as such, TXO had the right to withhold the funds from the debtor.[22]

Subsequently, TXO moved for relief from the automatic stay for the purpose of foreclosing on its operator's lien against the debtor's interests in certain oil and gas wells.[23] In support of its motion, TXO cited as grounds for lifting the automatic stay the fact that the debtor "had neither paid his

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[19] *Id.* at 693 (quoting Southeastern Pa. Transp. Auth. v. AWS Remediation, Inc., 2003 WL 21994811 at *3 (E.D. Pa. Aug. 18, 2003)). "[R]ejection of a contract, or even breach of it, will not void an arbitration clause. (In fact, arbitration is only sought if there is a breach of the agreement by one of the parties.) Any different conclusion would allow a party to avoid arbitration at will simply by breaching the contract." *Id.* at 693-94; *see also* Societe Nationale Algerienne v. Distrigas Corp., 80 B.R. 606, 609 (D. Mass. 1987) (holding that arbitration provision is a separate undertaking that survives debtor's rejection of the underlying agreement); *In re* Monge Oil Corp., 83 B.R. 305, 308 (Bankr. E.D. Pa. 1988) ("Rejection [of an executory contract] does not make the contract null and void ab initio; it simply protects the estate from assuming contractual obligations on a priority, administrative basis. . . . Thus, it may not follow from § 365(g)(1) that a rejection of a contract voids a compulsory arbitration clause.").

[20] 69 B.R. 960 (Bankr. N.D. Tex. 1987).

[21] *Id.* at 961.

[22] *Id.*

[23] *Id.*

expenses on the wells nor paid adequate protection" to TXO, pursuant to certain operating agreements between the parties.[24]

Under the operating agreements at issue in *In re Wilson*, TXO controlled the operations on leases upon which the debtor held interests[25] in certain oil and gas wells.[26] Pursuant to these agreements, TXO would bill non-operators, including the debtor, for their proportionate share of costs and expenses each month.[27] Prior to the debtor filing for bankruptcy protection, when Wilson would fail to pay his share of costs, TXO would apply funds attributable to Wilson's interests in the wells to cover these expenses.[28] After Wilson filed for bankruptcy, TXO continued to set aside the proceeds attributable to Wilson's interests, claiming that it had liens on the funds pursuant to the operating agreements between the parties, which TXO contended constituted executory contracts that Wilson had to either assume or reject.[29] In response, Wilson argued that, irrespective of whether or not the operating agreements constituted executory contracts, the seizure of proceeds relating to Wilson's interests in the wells constituted "illegal transfers before the [bankruptcy] petition was filed and violations of the automatic stay after the petition was filed."[30]

In addressing the issues raised by the parties, the court in *In re Wilson* began by analyzing the issue of whether or not the operating agreements in question constituted executory contracts under the Bankruptcy Code.[31] With limited discussion, the court concluded that because "both Wilson and TXO [had] continuing obligations under the operating agreements so long as oil and gas [were being] produced from the wells in question . . . the operating agreements [were] executory contracts" and subject to assumption or rejection, pursuant to the provisions of section 365 of the Bankruptcy Code.[32] Having made the determination that the operating

[24] *Id.*

[25] These interests consisted of royalty interests, which consist of payments free of any costs of producing oil and/or gas, and a number of non-operating working interests, which bear their proportionate share of costs associated with operating the well(s) to which they relate. *Id.* at 962.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* at 962-63.

[32] *Id.* at 963.

agreements in question were executory contracts, the court, after a discussion regarding the nature of TXO's liens and setoff rights, proceeded to address the status of the relevant "operating agreements/executory contracts between the date of the [filing of the Wilson's bankruptcy] petition . . . and the date Wilson accepts or rejects them (the Twilight Zone)."[33]

Relying on the Supreme Court's holding in *NLRB v. Bildisco & Bildisco*,[34] the court in *In re Wilson* concluded that, during the twilight zone, the parties' relationship was not governed by the terms of their operating agreements, pending the debtor's decision of whether to assume or reject the relevant agreement(s).[35] Specifically, the court held as follows:

> An executory contract is unenforceable against a Debtor-in-Possession who has not yet assumed the contract. . . .[T]he filing of the petition in bankruptcy means that the executory agreement is no longer immediately enforceable and may never be enforceable again. Further, . . . since it is unenforceable, the Debtor-in-Possession need not comply with the terms of the contract prior to seeking the Bankruptcy Court's permission to either assume or reject.[36]

Based upon this statement of law, the court concluded that, during the twilight zone, the relationship of Wilson and TXO would be governed, not by their operating agreements, but rather the law applicable to their relationship in the absence of any agreement (i.e., the law of cotenancy).[37] While this holding, on its face, may not seem to be an unreasonable result, the concepts presented in *In re Wilson*, if followed, could have far-reaching effects. Moreover, the concepts presented in *In re 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.

[c] Analysis of *In re Wilson*

In analyzing *In re 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 than [the debtor] had outside of bankruptcy."[38] Indeed, the filing of bankruptcy, as noted above, does not even prevent the termination of a contract pursuant

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[33] *Id.* at 965.

[34] 465 U.S 513 (1984).

[35] *In re Wilson*, 69 B.R. at 965-66.

[36] *Id.* (internal citations omitted).

[37] *Id.* at 966.

[38] 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)).

to its own terms.[39] In this regard, the holding of *In re Wilson* presents problems in cases where, absent the application of the twilight zone, a contract would otherwise terminate and not be subject to assumption or rejection, pursuant to section 365 of the Bankruptcy Code.

It is well settled that once a contract terminates pursuant to its own terms, a debtor may not assume or reject such contract. While the Bankruptcy Code, via the provisions of section 365, grants the debtor the ability to assume or reject executory contracts, this right is limited by the terms of the agreement governing its termination or expiration. Indeed, because the Bankruptcy Code does not grant the debtor greater rights and powers under a contract than it had outside of bankruptcy, section 365 cannot operate to "prevent[ ] the termination of [a] contract on its own terms. . . ."[40]

[d] *In re Wilson* Could Allow a Debtor to "Back In" to Deals

Typically, when multiple parties hold title to an oil and gas lease, their operations are governed by the terms of a joint operating agreement. As a matter of industry standard, the party designated as the operator of an oil and gas lease is obligated to give working interest owners notice of operations on the lease that exceed a certain monetary threshold. If the working interest owners consent to such operations, then they are obligated to pay their share of the expenses associated with the operations in question. Conversely, if a party does not consent to such operations, it is not eligible to receive any production or revenues from the proposed operations until each of the participating parties receive production revenues equal to a multiple of the costs associated with the operations to which the nonparticipating party did not consent. If, however, the operations in question are necessary in order to maintain the joint owners' interest in the oil and gas lease, certain joint operating agreements provide for a nonparticipating party to automatically relinquish its interest in the lease upon non-consent of the "lease saving operations." It is in a factual scenario such as this where the *In re Wilson* holding becomes particularly problematic.

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[39] *Id.*

[40] *Id.* (quoting *Nashville White Trucks, Inc.*, 5 B.R. 117); *see also In re* B&K Hydraulic Co., 106 B.R. 131 (E.D. Mich. 1989) (holding that the life insurance policy at issue terminated pursuant to its own terms, by virtue of the debtor failing to pay post-petition premiums prior to assumption or rejection of the policy); *In re* J.E. Adams Industries, Ltd., 269 B.R. 808, 814 (N.D. Iowa 2001) (holding that automatic stay does not affect expiration of a contract); Valley Forge Plaza Associates v. Schwartz, 114 B.R. 60, 62 (E.D. Penn. 1990) (citations omitted) ("A debtor in bankruptcy has no greater rights or powers under a contract than the debtor would have outside of bankruptcy. . . . The ability to terminate a contract on its terms survives bankruptcy.").

[3] Triangular Setoff

[a] Definition

Setoff is the ability of entities that owe each other money to apply their debts against each other, thereby avoiding "the absurdity of making A pay B when B owes A."[41] While the Bankruptcy Code does not create a right to setoff, it preserves non-bankruptcy rights to setoff pursuant to section 553. Specifically, section 553 permits setoff if there is an applicable non-bankruptcy right, the debts arose pre-petition, and the debts are mutual.[42] Mutuality is a complex and oft-litigated concept. In short, mutuality is present only when the debts "are due to and from the same persons in the same capacity."[43]

Triangular setoff is when a creditor offsets a debt it owes to a corporation against funds owed to it by a third corporation. Strictly speaking, of course, this violates the mutuality requirement of section 553 because the debts are not due and from the same person in the same capacity. Some bankruptcy courts, however, allowed triangular setoffs when two of the entities were related—for example, a wholly owned subsidiary—and the parties agreed to triangular setoffs in a valid and enforceable pre-petition contract. Numerous cases suggest that an explicit agreement providing for triangular setoff between related entities could satisfy the mutuality requirement of section 553.[44]

Many derivatives contracts, including those documented on the International Swaps and Derivative Association, Inc.'s forms, often provide that setoff of debts and claims is to occur between counterparties and their affiliates, essentially treating affiliates as one entity for the purpose of setoff.[45] This practice of triangular setoff, however, appears to have been laid to rest by the Delaware Bankruptcy Court in *In re SemCrude, L.P.*

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[41] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995) (quoting Studley v. Boylston Nat. Bank, 229 U.S. 523, 528 (1913)).

[42] There are other elements required by section 553 which are not applicable to this discussion.

[43] *See* Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 149 (2d Cir. 2002) (quoting Beecher v. Peter A. Vogt Mfg., 125 N.E. 831, 833 (N.Y. Ct. App. 1920)).

[44] *See, e.g., In re* Berger Steel Co., 327 F.2d 401 (7th Cir. 1964); *In re* Hill Petroleum Co., 95 B.R. 404, 411–412 (Bankr. W.D. La. 1988).

[45] Shmeul Vasser & Iva Uroic, "Triangular Setoffs May Be Unenforceable in Bankruptcy," New York Law Journal, Vol. 241, No. 70, at 4 (Apr. 14, 2009).

[b] *In re SemCrude, L.P.*[46]

In *In re SemCrude, L.P.*, three debtors that were indirect subsidiaries of each other had a contract with a third party. The contracts provided that in the event any party failed to make a timely payment, the other party may offset any payments due under any agreement between the parties and their affiliates. The third-party creditor was owed $13.5 million by two of the debtors and was indebted to the other debtor in the amount of $1.4 million. The creditor sought to offset its debt to one of the debtors with the $13.5 million it was owed by the other two debtors.[46.1] Due to the netting agreement in the contracts with all three debtors, the creditor argued that the debtors agreed to mutuality in the contract, and if not, that there was an exception to the mutuality requirement when there is an agreement.

The Delaware bankruptcy court held that private agreements cannot confer mutuality to debts that otherwise fail the mutuality test under section 553, and that there is no exception to the mutuality requirement. First, in holding that private agreements cannot confer mutuality on non-mutual debts, the court looked at the definition of mutual debts adopted by most courts and the fact that mutuality is strictly construed against the party seeking setoff. The court determined that the creditor only owed a debt to one debtor, and that debtor did not owe anything to the creditor. Thus there was no mutuality. Then the court noted that there was no exception to the mutuality requirement. The court focused on the fact that the statute does not provide for an exception based on the parties' agreement and that it would be improper to create an exception not found in the Bankruptcy Code. Thus, the Delaware bankruptcy court invalidated the use of triangular setoff, even when all parties have agreed to its use in a valid contract. In so holding, the Delaware bankruptcy court further limited the rights of creditors within the bankruptcy context.[47]

[4] Section 363 Sales

[a] Background

Section 363 of the Bankruptcy Code has been an instrumental tool for corporate debtors looking to reorganize by selling certain assets and by purchasers looking for assurance that purchased assets will come with a

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[46] Jointly administered Case No. 08-11525 in the U.S. Bankruptcy Court for the District of Delaware. The author is counsel for one of the parties in this matter.

[46.1] *In re* SemCrude L.P., 399 B.R. 388, 392 (D. Del. 2009).

[47] *Id.* at 399. *But see In re* Garden Ridge Co., 338 B.R. 627, 635–636 (Bankr. D.Del. 2006) (stating in dicta that triangular setoff is allowed based upon an agreement between the related entities).

clean title. Section 363(f) provides that a debtor may sell assets free and clear of liens and interests and such liens or interests will attach to the proceeds of the sale, not the property sold. By authorizing debtors to sell property free and clear, section 363 created a method by which debtors could obtain top dollar for their nonessential assets. Purchasers were willing to pay top dollar because potential fraudulent transfer claims were reduced by a court order finding that the sale was for the highest and best offer; there was no commercial reasonableness standard to worry about, like in many Uniform Commercial Code sales; and, even better, a section 363 purchaser was further protected by 11 U.S.C. § 363(m), which protects the validity of the sale even if the authorization is later overturned on appeal. Thus, the chance of future complications for a purchaser was very remote in the context of a section 363 sale, at least until the *Clear Channel* case.

[b] *Clear Channel v. Knupfer*[48]

In *Clear Channel v. Knupfer (In re PW, LLC)*, a Chapter 11 trustee sought authority from the bankruptcy court to sell real property of the debtor to the debtor's senior secured lender. The senior secured lender credit bid its interest because it was worth more than the value of the property. Credit bidding is allowed pursuant to section 363(k), which authorizes a secured creditor to set off its claim against the purchase price of the asset that secured its lien. For example, if a secured creditor has a security interest or claim worth $150, and the property securing such interest is sold to the secured creditor for $150, the transaction is a wash and the secured creditor need not actually pay any money to the estate. Rather, it takes possession of the asset and its secured claim is satisfied.

Pursuant to the authority of section 363(k), the senior secured lender in *Clear Channel* credit bid its interest in certain of the debtor's real property. The junior lienholder—whose interest was completely undersecured and could be classified as an unsecured claim—objected, but the sale was approved over the junior lienholder's objection. The junior lienholder appealed to the Bankruptcy Appellate Panel (BAP), which reattached the junior lienholder's lien to the property. As a result, the once completely undersecured junior lienholder, whose claim was worth nothing more than general unsecured status, was given a lien on the property that was bought by the senior lienholder. The senior lienholder has essentially paid for property that still has a lien attached, and now the senior lender must pay the junior lienholder in order to remove the lien. In essence, the junior lienholder skipped over the senior lienholder.

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[48] 391 B.R. 25 (B.A.P. 9th Cir. 2008).

The BAP's decision, while controversial, was premised on the language of section 363(f). That subsection states that a trustee may sell assets free and clear if one of five elements are satisfied. The bankruptcy court indicated that the last element, section 363(f)(5), was satisfied. That subsection states that a sale may be free and clear of an entity's interest if such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. The BAP held that "cramdown," section 1129(b)(2)'s procedure by which secured creditors can be forced to take less than their interest in property through the plan confirmation process, does not satisfy section 363(f)(5).[48.1] The BAP did not consider whether another legal or equitable proceeding would satisfy section 363(f)(5). Many commentators have noted that judicial foreclosure would have satisfied section 363(f)(5).

[c] The Aftermath of *Clear Channel*

In the year since the *Clear Channel* decision many commentators have attacked the decision as impractical and legally flawed. The case, however, has only been examined by a couple of courts. The U.S. Bankruptcy Court for the Western District of Washington examined the *Clear Channel* case in *In re Jolan, Inc.*,[49] and held that section 363(f)(5) permits a trustee to sell property free and clear of liens, even when the proceeds of the sale may be insufficient to pay all lienholders. In disagreeing with *Clear Channel*, the *Jolan* court specifically noted that there are legal and equitable proceedings in Washington by which a lienholder can be compelled to accept a money satisfaction of their interest. The *Jolan* court identified one reason why the *Clear Channel* court may have missed the mark: "the appellees defending the sale free and clear did not even argue that there were any qualifying legal or equitable proceedings beyond cramdown under § 1129. . . . [The *Clear Channel* court] exercised its prerogative to limit its ruling to the arguments presented by the parties."[50]

The other court to mention the *Clear Channel* case was the U.S. Bankruptcy Court for the Southern District of Texas.[50.1] In what has been described as "an able and comprehensive discussion of the propriety of section 363 sales,"[51] the court noted the holding in *Clear Channel*—that a credit bid by a secured creditor does not convey title free and clear of

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[48.1] *Id.* at 46.

[49] 403 B.R. 866 (Bankr. W.D. Wash. 2009).

[50] *Id.* at 869.

[50.1] *In re* Gulf Coast Corp., 404 B.R. 407, 421 n. 38 (S.D. Tex. 2009).

[51] *In re* Jolan, at 869.

junior liens—although purely in dicta. The Bankruptcy Court did not approve or disapprove of the *Clear Channel* holding.

Until more courts review *Clear Channel* and come to some consensus, debtors and purchasers must beware of the possibility that junior liens will remain attached to the property and not the proceeds. The best way to proceed in this uncertain environment is to argue—and properly document in briefs and at any hearing on the matter—that multiple legal or equitable proceedings could compel the junior lienholder to accept a money satisfaction of its interest. This will provide the court with multiple options to find that section 363(f)(5) is satisfied.

[5] Plugging and Abandonment Liabilities in Bankruptcy[52]

[a] Background

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, bondholders, and trade creditors, but also as a way of avoiding or subordinating environmental liabilities, including decommissioning obligations. In the exploration and production industry, debtors use bankruptcy to reject oil and gas leases and related agreements in an effort to avoid plugging and abandonment or decommissioning obligations or as a means of abandoning altogether properties burdened by such liabilities. If, however, a bankrupt exploration and production company is successful in avoiding its decommissioning obligations through bankruptcy, the mineral lessor will seek performance of this obligation from the operator, co-lessees, or predecessors in interest.

As a general proposition, the goal of bankruptcy is to allow a debtor to rehabilitate financially by allowing it to restructure or discharge certain pre-petition debts, reject burdensome contracts, and abandon property, under certain circumstances.[53] The purpose of environmental laws, and more specifically regulations dealing with plugging and abandonment or decommissioning liabilities, however, is to protect the public health,

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[52]This section contains an analysis of some recent caselaw and a summary of an article previously co-written by the author with Mark A. Chavez & Omer F. Koebel III, "Decommissioning/Plugging and Abandonment Liabilities in Bankruptcy: What Priority Should They Be Afforded?" published in conjunction with the Center for American and International Law's 57th Annual Conference on Oil and Gas Law (Spring 2005).

[53]Deborah E. Parker, "Environmental Claims in Bankruptcy: It's a Question of Priorities," 32 San Diego L. Rev. 221, 222 (1995).

safety, and welfare.[54] 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 least true where the party seeking such relief is the sovereign. Where, however, the party seeking that finding is a party with whom the debtor is co-liable for such environmental obligations, the issue takes on a new shape.

[b] Assumption/Rejection and Plugging and Abandonment Liabilities

The problem assumption/rejection poses with respect to plugging and abandonment liabilities is two-fold. First, assuming a debtor assumes the operating agreements or leases that give rise to the plugging and abandonment liability, section 365 of the Bankruptcy Code, 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 obligations as impossible to perform or as "nonmonetary" obligations, the ultimate interpretation of this provision remains an open question. Second, 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.[55]

[c] Abandonment Power

Bankruptcy Code section 554 provides, in relevant part: "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

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[54] *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).

[55] 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 Minerals Management Service, however, has taken the position that federal oil and gas leases are executory contracts subject to assumption or rejection.

[56] Reserved.

by environmental liabilities, including, for example, decommissioning obligations.[57]

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

28 U.S.C. § 959(b) provides that:

> a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in 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 section 959 of title 28 of the United States Code as a limited exception to the broad power of a bankruptcy trustee to abandon property that is burdensome to the estate. More specifically, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*,[58] the U.S. Supreme Court held "that a 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."[58.1] Although the *Midlantic* decision was not based on section 959, the court relied upon section 959(b) to show "that Congress did not intend for the Bankruptcy Code to preempt all state laws."[59] Since *Midlantic*, courts have interpreted section 959 as a "public interest" statute. In enacting it, Congress intended to limit a trustee's ability to 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 environmental regulations, which would include decommissioning/plugging and abandonment liabilities.[60]

In *In re H.L.S. Energy Co., Inc.*,[61] the Fifth Circuit concluded: "Under federal law, bankruptcy trustees *must* comply with state law. Furthermore,

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[57] 4 Norton Bankr. L. & Prac. 3d § 74:6.

[58] Midlantic National Bank v. New Jersey Department of Environmental Protection, 474 U.S. 494 (1986).

[58.1] *Id.* at 507.

[59] *Id.* at 505.

[60] *In re* Wall Tube & Metal Products Co., 831 F.2d 118, 124 (6th Cir. 1987) (holding that a state's emergency cleanup 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, 552 (N.D. Ind. 1991) (holding a debtor in possession must comply with environmental cleanup plans ordered by state and federal agencies, notwithstanding the debtor's claim of insufficient funds).

[61] 151 F.3d 434 (5th Cir. 1998).

a bankruptcy trustee *may not* abandon property in contravention of a state law reasonably designed to protect public health or safety. . . . [A] combination of Texas and federal law place[] on the trustee an *inescapable obligation* to plug the unproductive wells. . . ."[62] 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."[64] "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[] well operators to plug their wells. . . ."[65] 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.

[e] Administrative Priority for Environmental Liabilities

In *In re Environmental Waste Control, Inc.*,[66] 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 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 U.S. Environmental Protection Agency (EPA) from forcing it to meet certain environmental obligations arising out of EWC's contamination of groundwater beneath its landfill.[67] Applying *Midlantic* and *Ohio v. Kovacs*,[67.1] 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. . . . [A]nyone in possession of a site, whether a bankruptcy trustee or anyone

[62] *Id.* at 438 (internal citations omitted; emphasis added).

[63] Reserved.

[64] H.L.S. Energy Co. Inc., 151 F.3d at 438.

[65] *Id.* at 439.

[66] 125 B.R. 546 (N.D. Ind. 1991).

[67] *Id.* at 549.

[67.1] 469 U.S. 274 (1985).

> else, may not maintain a nuisance. . . or refuse to remove the source of such conditions.[69]

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."[70] Such is the case even where claims by secured creditors exist. Where environmental cleanup is required, a secured creditor's "position regarding its priority over the estate's assets must yield in light of the competing environmental harms."[71] 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."[72] Such "reality does not divorce EWC from its legal duties."[73]

[f] Pitfalls for Predecessors in Interest

[i] Plugging and Abandonment Liabilities as "Imminent Harms"

In *In re McCrory*,[74] 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.[75] The *McCrory* court, however, applying *Midlantic*, found that the *Midlantic* analysis was not satisfied where (1) "required clean-up could be deferred"; (2) the site at issue was being leased to "another tenant who conducted substantially the same

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[68] Reserved.

[69] 125 B.R. at 550 (internal citations and quotations omitted).

[70] *Id.* at 552.

[71] *Id.* at 552.

[72] *Id.* (emphasis added).

[73] *Id.* Similarly, in *In re* Wall Tube & Metal Products Co., 831 F.2d 118, 121–122 (6th Cir. 1987) (emphasis in original), the Sixth Circuit recognized that

> [n]either the [Supreme] 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 health and safety.*

[74] 188 B.R. 763 (S.D.N.Y. 1995).

[75] *Id.* at 768 (quoting *Midlantic*, 474 U.S. at 499, 506–507).

operations" at the site; (3) there was not an "imminent harm to public health or safety"; and (4) "there [was] no indication that any state agency threatened to close operation or required immediate clean-up."[76]

[ii] "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.

[iii] 11 U.S.C. § 502(e)

Section 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 section 502(e)(1)(B), it must be demonstrated that a creditor's claim is a claim: (1) on which the creditor is co-liable with the debtor; (2) contingent in nature; and (3) for reimbursement or contribution.

In *In re Tri-Union Development Corp.*,[77] the court was presented with a scenario in which several of the debtors' predecessors in interest had filed proofs of claims based upon their co-liability on the debtors' plugging and abandonment (P&A) obligations arising under various agreements with the debtors and applicable Minerals Management Service (MMS)

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[76] *Id.* at 769 (internal quotes omitted).

[77] 314 B.R. 611 (Bankr. S.D. Tex. 2004).

regulations.[78] Also filing a proof of claim on these obligations was MMS.[79] Based upon these seemingly competing claims, the debtors moved to have the predecessors' claims disallowed pursuant to section 502(e). The court analyzed each of the required factors and disallowed the claims of the debtors' predecessors in interest.[80]

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

[g] Recent Cases

While the court in *Tri-Union* did not address the question of whether P&A liabilities constitute an administrative expense of the estate,[81] this issue was addressed in *In re Texas Standard Oil Company*[82] regarding the administrative expense of P&A liabilities.[83] In its order, the court estimated the administrative claim of an operator for P&A liabilities. Importantly, the order only estimates the value of the administrative claims and does not determine whether the claims should be administrative or pre-petition claims. The debtor advanced two relevant arguments against the administrative claim and in favor of a finding that the estimated amount of

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[78] *Id.* at 615 n.4

[79] *Id.* at 616.

[80] *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 622.

[81] 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.

Id. at 627.

[82] Case No. 08-34031, pending in the U.S. Bankruptcy Court for the Southern District of Texas.

[83] Finding of Fact and Conclusions of Law Regarding Estimation of the Following Claims: (1) Pre-Petition Claim of Forest Oil Corporation; (2) Pre-Petition Claim of Mariner Energy, Inc. and Mariner Energy Resources; and (3) Administrative Claim of Mariner Energy, Inc. and Mariner Energy Resources (docket no. 177, Mar. 18, 2009 (*In re* Texas Standard Oil Co.)).

the claim should be zero: (1) the claims were pre-petition claims incapable of being administrative; and (2) the debtor was not the operator and the government did not pay the P&A liabilities.

Addressing the first argument, that the claims are pre-petition claims that cannot be classified as administrative because the contract arose pre-petition, the *Texas Standard* court relied on the case of *In re American Coastal Energy, Inc.*[84] In *American Coastal*, the court analyzed a similar argument and found that "[b]ecause the debtor-in-possession is required to operate the estate in accordance with state law, post-petition expenditures necessary to bring the estate into compliance with the law are necessary for the debtor's rehabilitation."[84.1] Thus, the *Texas Standard* court found that the Fifth Circuit is likely to rule that P&A expenses constitute an administrative claim, notwithstanding the fact that they arose pre-petition.[84.2]

Similarly, the *Texas Standard* court found that the debtor's second argument did not prevent the operator from obtaining an administrative claim.[84.3] Because non-operators can be held liable for P&A liabilities, and both state and federal authorities have the right to seek reimbursement from non-operators, even non-operators who file for Chapter 11 have exposure to liability in the event the operator fails to undertake P&A.[84.4] Thus, the mere fact that the debtor was not the operator does not shield it from paying administrative expense claims based on P&A. The court went on to estimate the operator's administrative claim at $471,094.85.[84.5]

The *Texas Standard* court, however, limited its ruling to the dispute at issue, namely the estimation of the operator's administrative expense claim, and not whether the operator was actually due an administrative expense claim. The order explicitly stated that "[b]ecause there are sound arguments going both ways, this Court concludes that if and when the Fifth Circuit ever rules on this specific issue, there is a fifty percent chance that the Fifth Circuit would hold Mariner has an administrative claim,

[84] 399 B.R. 805 (Bankr. S.D. Tex. 2009).

[84.1] *Id.* at 816.

[84.2] *In re* Texas Standard Oil Co. at 16 (Docket No. 177, Mar. 18, 2009) (see note 83).

[84.3] *Id.* at 17-18.

[84.4] *Id.* at 18.

[84.5] *Id.* at 24.

and there is a fifty percent chance that the Fifth Circuit would hold that Mariner has solely a pre-petition claim."[84.6]

[6] Hidden Liens

[a] *In re SemCrude, L.P.*

Most companies understand that they should check the credit of customers to whom credit will be extended. But few, if any, companies check the creditworthiness of their suppliers. That may all change if a group of producers in the *SemCrude* bankruptcy cases[85] have their way. The producers in those cases have requested a ruling that could potentially impact every person who buys oil, gasoline, or other petroleum-based products.

The producers filed adversary proceedings in the bankruptcy court seeking a finding that they have a statutory lien in the debtor's oil and gas and all proceeds therefrom and also a constructive trust on proceeds under the laws of various states including Kansas, Oklahoma, and Texas. The producers claim that their statutory lien is superior to the article 9 lien held by a consortium of lenders that, by all accounts, properly perfected their security interests in all of the debtor's assets, including all of the debtor's inventory and accounts.

The debtor's secured lenders are leading the fight against the imposition of the statutory lien and constructive trust in connection with cross motions for summary judgment filed on what has become known in the *SemCrude* case as Phase 1 of the Threshold Issues. According to the lenders, if the court finds that the producers do in fact have a statutory lien, it would create "a perpetual trust of unlimited geographic scope, extending endlessly down the stream of commerce, wherever and to whomever oil . . . is subsequently sold."[86] It would reach "every person, everywhere, who comes in contact with the proceeds of any sale of oil."[87] The lenders also point out, among other things, that constructive and resulting trusts are

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[84.6] *Id.* at 20.

[85] Jointly administered as case no. 08-11525 in the U.S. Bankruptcy Court for the District of Deleware.

[86] J. Aron & Company's Consolidated Answering Memorandum in Opposition to the Producers' Motions for Summary Judgment, at 1.

[87] *Id.*

judicial remedies that only arise between specific parties before the court, not from a legislative body.[88]

[b] Potential Aftermath of *SemCrude*

The potential ramifications of the dispute between the producers and lenders and other purchasers of commingled product down the line in *SemCrude* are serious and bear watching. The result could impact the manner in which crude oil and gas trading and sales occur. The author is counsel for one of the parties in this matter and does not advocate a position in this article, simply noting the pending issue for further consideration.

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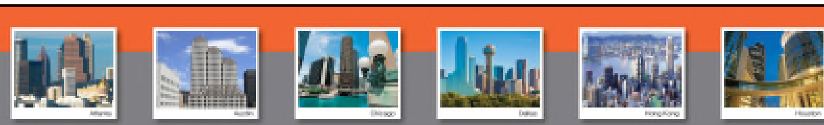
[88] After completion of this chapter, on June 19, 2009, the Delaware Bankruptcy Court entered opinions on Phase 1 of the Threshold Issues. The court held that: (1) the interests claimed by the producers in Texas were security interests that arise by contract, not statutory liens; and (2) unless the producers can show in Phase II that they have properly filed financing statements in Delaware or Oklahoma, as applicable, they do not have perfected security interests. The court also held that Oklahoma law does not impose a resulting implied or constructive trust in favor of the Oklahoma producers and that any liens the producers might have under the Oklahoma Oil and Gas Owners Lien Act are subject to the rights, priorities, or remedies of any person under the applicable provisions of the Uniform Commercial Code (UCC). *See In re* SemCrude, L.P., 407 B.R. 112, *and* 407 B.R. 140 (D. Del. 2009). The bankruptcy court certified the opinions for appeal, and as of the date of this writing they were on appeal with the Third Circuit. *See* Arrow Oil & Gas, LLC, et al. v. SemCrude, L.P., et al., App. No. 09-3023 (3d Cir.), Arrow Oil & Gas, LLC, et al. v. SemCrude, L.P., et al., App. No. 09-3228 (3d Cir.), and Samson Resources Co. et al., v. SemCrude, L.P., App. No. 09-3009 (3d Cir.).



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CAUTION TO THE UNWARY: THE FALLOUT TO THE DRILLING INDUSTRY FROM THE ATP BANKRUPTCY

Phil Eisenberg
Omer F. (Rick) Kuebel, III

October 15, 2014

INTRODUCTION

This presentation will include a discussion of:

a) how ATP arrived at the brink of bankruptcy;
b) the industry conditions that existed at the time;
c) the domino effect of the ATP Bankruptcy filing; and
d) where industry will go from here

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FINANCIAL RISKS

- No Payment or Delayed Payment for pre-petition and post-petition services
- Loss or Impairment of Security Rights
  a) Priming Liens
  b) Loss of collateral and/or value on liens
  c) Re-characterize ORRIs

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FINANCIAL RISKS

- Litigation Expense/Exposure
  a) Preference payments
  b) Work or services provided
  c) Inclusion in collateral litigation
- Critical Vendor Status
  a) Service providers forced to work based on automatic stay

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BACKGROUND

- ATP acquired and developed properties with proven undeveloped reserves in the Gulf of Mexico, North Sea and Eastern Mediterranean Sea
- As of December 31, 2009, ATP had leasehold and other interests in 62 offshore blocks and 104 wells of which ATP was then operating a total of 93
- As of March 16, 2010, ATP owned an interest in 36 platforms, including two floating production facilities: the ATP Innovator, located in the Gulf of Mexico at ATP's Gomez Hub, and the ATP Titan, also in the Gulf of Mexico at ATP's Telemark Hub

BACKGROUND

- On April 19, 2010, ATP raised $1.5 Billion by selling unregistered private notes to institutional investors
- The next day, April 20, 2010, the drilling rig Deepwater Horizon exploded and sank in the Gulf of Mexico fracturing the drill pipe and creating the largest oil spill in U.S. history

BACKGROUND

- In response, the U.S. Department of Interior issued two moratoria that halted all drilling at depths greater than 500 feet between May 6, 2010 and October 12, 2010 and then instituted new rules and regulations conditioned on additional testing, training and compliance
- The moratoria and new rules effectively halted all of ATP's exploration and development operations in the Gulf of Mexico in 2010 and the six wells scheduled to be drilled were postponed

BACKGROUND

- In addition to the timing delays from the moratoria, ATP experienced operational difficulties when it began drilling its wells and liquidity constraints from its ongoing capital program, which included an offshore facility called the "Octobuoy" destined for the North Sea and with regard to its Clipper project
- In connection with the liquidity constraints, ATP granted various Overriding Royalty and New Profits Interest on its Gulf of Mexico projects. ATP offered to secure drilling and other services through a grant of ORRIs

BACKGROUND

- On the face of its audited financials for the quarterly period ending March of 2012, ATP total assets scheduled at $3,638,399,000, including $3,221,049,000 in net asset value for oil and gas properties
- At the time, based on its net worth and financial condition, ATP qualified with BOEM as an exempt company with regard to supplemental bonding requirements for offshore decommissioning in the Gulf of Mexico

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BIG PICTURE FINANCIAL STRUCTURE FOR ATP PRIOR TO BANKRUPTCY

- 1st lien debt ($366 million)
- 2nd lien noteholders ($1.5 billion)
- Various overriding royalty and net profits interests (greater than $489 million)
- Exempt status from supplemental bonding for plugging and abandonment (no supplemental bonds)
- Significant producing undeveloped reserves (both approved producing and undeveloped @76 MMBOE in the Gulf of Mexico and 42.9 MMBOE overseas)

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ATP FILES FOR CHAPTER 11 BANKRUPTCY RELIEF

- In late summer 2012, ATP ran out of cash before ATP could complete its Clipper project and generate revenues necessary to remedy its liquidity position and the first lienholders would not advance additional funds without additional protections to do so
- ATP filed for bankruptcy under Chapter 11 on August 17, 2012
- As part of the bankruptcy filing, ATP obtained what is known as Debtor-in-possession financing, or what is colloquially called a DIP loan

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FINAL STRUCTURE AFTER CHAPTER 11 FILING

- DIP Loan with rollup to finance ongoing operations and Clipper project
- BOEM withdrawal of exempt status from supplemental bonding
- Overriding Royalty and Net Profit Interests asserting priority in payment
- Significant liens filed and insufficient cash to fund all payments, including to Critical Vendors

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THREE TO FOUR MONTHS INTO BANKRUPTCY FOR ATP

- Time delay and significant cost overruns in bringing Clipper project online
- Additional BOEM demands for supplemental bonding including reassessment of exposure for deepwater properties raising bonding needs from $80 million to over $500 million
- Delayed sales process with insufficient interest
- Lawsuits filed by ATP to recharacterize ORRI and Net Profits as financings that could be rejected in bankruptcy instead of real rights

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THE ONGOING BANKRUPTCY PROCESS

- The DIP Lender was able to credit bid and cherry picked viable ATP assets and also kept a large deficiency claim
- BOEM allowed ATP to abandon its rights to assets that were not being picked up by the DIP Lender so plugging and abandonment went to co-owners or predecessors in title and ORRI and Net Profit Interests on these properties were wiped out

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THE ONGOING BANKRUPTCY PROCESS

- ATP converted from Chapter 11 reorganization to Chapter 7 liquidation and presently has limited funds
- Administrative Claimants are having increasing difficulty being paid due to limited funds and challenges to administrative status
- Lien claimants are being wiped out to the extent not senior to first lien at time of DIP financing

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CONSIDERATIONS

- Focused financial and legal analysis of counter parties
- Act like a bank in securing your rights and verifying the priority of your security
- Utilize bankruptcy protections such as § 365 executory contract assumption and critical vendor status

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Conclusion/Q&A

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Bankruptcy M&A: Acquiring Assets Through the Bankruptcy Process

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Aaron C. Smith

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- C. Submission of Bids & the Auction
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- F. Post-Sale Hearing Issues

I. Introduction To Bankruptcy Chapters, Terminology And Claim Types

A. Bankruptcy Chapters

1. Chapter 7 – Liquidation
2. Chapter 11 – Reorganization

B. Common Concepts and Terms

1. Automatic Stay
2. Cash Collateral Use
   a) Adequate Protection Requirement
   b) Grant of Liens on Unencumbered Property to Protect Against Diminution in Value of Collateral
3. DIP Financing
   a) Grant of Administrative Claim Status
   b) Lien on Unencumbered Assets
   c) Junior Lien

I. Introduction To Bankruptcy Chapters, Terminology And Claim Types (cont.'d)

C. Absolute Priority Rule: Order of Payment of Claims

1. No Claims in a Class are Paid Until Claims in Superior, Higher Priority Classes are Paid in Full.
2. Classes of Claims
   - Secured
   - Administrative
   - Priority Unsecured
   - General Unsecured
   - Equity

II. Acquiring Assets Out Of Bankruptcy

A. Benefits of Acquiring Assets Out of Bankruptcy

1. Ability to Coordinate with, and Bind, if Necessary, Various Constituents
2. Transparency to the Process
3. Assets are Delivered to Buyer "Free & Clear" Pursuant to a Federal Court Order
4. Ability of Buyer to "Cherry Pick" Favorable Executory Contracts & Unexpired Leases

II. Acquiring Assets Out Of Bankruptcy (cont'd.)

B. Overview of Bankruptcy Sale Process

1. Auction is Typical, But a Bankruptcy Sale May Occur Without an Auction
2. Auction Sales May Be Conducted With or Without a Stalking Horse Purchaser
3. Timeline – Process Usually Requires a Minimum of 60 Days
   a) Bid & Auction Procedures Approval
   b) Due Diligence Period
   c) Auction
   d) Sale Hearing & Court Approval

II. Acquiring Assets Out Of Bankruptcy (cont'd.)

5. Participating as a Stalking Horse vs. Non-Stalking Horse at Auction
   a) Stalking Horse has More Control Over the Sale Process
      - Seat at the Table From the Beginning to Negotiate APA & Bid Procedures, Including Bid Protections and Time for Others to Conduct Due Diligence
      - More Time to Conduct Due Diligence (subject to Financial Considerations)
      - Receives Updated, Current Reports about Operations

II. Acquiring Assets Out Of Bankruptcy (cont'd.)

b) Downside: Stalking Horse Incurs Additional Costs and Fees of Professionals Because of Its Involvement from the Beginning of the Sale Process

II. Acquiring Assets Out Of Bankruptcy (cont'd.)

C. Submission of Bids & the Auction

Step 1: Bidding & Auction Procedures are Approved

- Bidding & Auction Procedures ("Bidding Procedures") are comprised in a single document.
- Court Approval of the Bidding Procedures is Required, after Notice and a Hearing (such approval is granted by way of what is commonly referred to as the "Bidding Procedures Order").
- Certain Bid Protections & Perks are Offered to the Stalking Horse: Break-Up Fee, Expense Reimbursement, and Automatic Designation of Bid as a "Qualified Bid."

II. Acquiring Assets Out Of Bankruptcy (cont'd.)

Step 2: Competing Bidder Must Meet the Requirements of an "Acceptable Bidder" to Conduct Due Diligence of the Debtor.

- Items Required to Be Deemed an Acceptable Bidder Eligible to Conduct Due Diligence of the Debtor:
  a) Executed Confidentiality Agreement;
  b) Non-Binding Indication of Interest; and
  c) Preliminary Proof of Financial Capacity to Close a Proposed Transaction

II. Acquiring Assets Out Of Bankruptcy (cont'd.)

Step 3: Acceptable Bidders Must Submit a Qualified Bid to Participate at the Auction. A Qualified Bid is:

- Written & Irrevocable: Consists of an APA Executed by the Competing Bidder in a Form Substantially Similar to the APA Executed by the Stalking Horse.
- Good Faith Deposit (typically 10% of the Proposed Purchase Price).
- Demonstrated Financial Capacity.
- Identity & Contact Information of Each Entity Participating in Connection with the Submitted Bid.
- Proof of Corporate Authority to Submit Bid and Close Possible Transaction.
- Consent to Bankruptcy Court Jurisdiction.
- Minimum Cash Component of Qualified Bid Must Be Equal to or Greater Than the Initial Overbid + Break-Up Fee + Expense Reimbursement.

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II. Acquiring Assets Out Of Bankruptcy (cont'd.)

Step 4: Auction Occurs if a Qualified Bid (other than the Stalking Horse Bid) is Received.

- Conduct of Auction & What to Expect
  - When? Where? Who May Attend?
  - How? Bidding Procedures Govern the Conduct of the Auction.
    - a) Determination of Starting, or Floor Bid
    - b) Auction Commences & Subsequent, Higher Bids Meeting the Minimum Bidding Increment Requirement are Submitted
    - c) Selection of Successful Bidder
    - d) Designation of Back-Up Bidder

Step 5: After Auction Concludes, Bankruptcy Court Will Hold a Hearing to Consider the Proposed Sale and, if it is Approved, Enter a Sale Order.

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II. Acquiring Assets Out Of Bankruptcy (cont'd.)

D. Contract Assumption, Rejection, and Assumption and Assignment

1. Only "Executory Contracts" and Unexpired Leases are Eligible for Rejection, Assumption, or Assumption and Assignment
    a) Executory Contract: Contracts where both parties to the contract have unperformed obligations
2. Timeframe for Determining Which Executory Contracts & Unexpired Leases to Assume/Reject
    a) Chapter 7 – Generally, Within 60 Days of Filing of Petition
    b) Chapter 11 –Confirmation of a Plan

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II. Acquiring Assets Out Of Bankruptcy (cont'd.)

3. Non-Debtor Contract Counterparty Must Continue to Perform Under the Executory Contract or Unexpired Lease if No Prepetition Breach
4. Purchaser Input
5. Rejection
    a) Contract Rejection is Treated as a Prepetition Breach of the Contract
    b) Results in "Rejection Damages Claim", an Unsecured Claim against Debtor's Estate
    c) Rejection Damages Claims are Paid with Estate Funds on a Pro Rata Basis with Other General Unsecured Claims

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II. Acquiring Assets Out Of Bankruptcy (cont'd.)

6. Assumption
    a) Must Assume Entire Contract
    b) Must Cure All Defaults ("Cure Costs")
7. Assumption & Assignment to Purchaser
    a) Non-Assignability/Bankruptcy Default Provisions in Contracts Void
    b) Same Rules for Assumption Apply. Negotiation Point: Payment of Cure Costs to be Borne by Debtor or Purchaser
    c) Assignment Requires Adequate Assurance of Future Performance by the Assignee
    d) Opportunity to Negotiate Better Terms

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II. Acquiring Assets Out Of Bankruptcy (cont'd.)

E. Sale Hearing & Entry of Sale Order

1. Sale Hearing
    - Presentation of Case by Debtor's Counsel
    - Business Judgment Test is Applied
    - Availability & Testimony of Fact Witnesses
2. Sale Order
    - Issued by Federal Bankruptcy Court
    - Binding Effect of Sale Order

F. Post-Sale Hearing Issues

- Retention of Bankruptcy Court Jurisdiction Over Sale Transaction.

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QUESTIONS?

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