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# Understanding rights, opportunities as a creditor or asset purchaser in bankruptcy proceedings

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In 2015, 42 North American oil and gas exploration and production companies filed for bankruptcy protection. At least another 29 have filed in 2016, and continuing price pressure may result in more bankruptcy filings. Given this state of affairs, companies operating in the oil and gas sector should understand how their rights and obligations are affected when their contractual counterparties become bankruptcy debtors, and how to take advantage of business opportunities presented through the bankruptcy process.

**Assumption or Rejection of Contracts**

One of the main purposes of the Bankruptcy Code is to afford a commercial debtor the opportunity to rehabilitate and reenter the stream of commerce as a productive enterprise. One tool afforded to debtors is the right under Section 365 of the Bankruptcy Code to determine which of its "executory contracts" dating from prior to the bankruptcy filing are beneficial, and which are burdensome, and to reject those that are burdensome, thereby relieving the debtor of the obligation to perform burdensome contracts going forward. The Bankruptcy Code does not define the term "executory contract," but the term is generally understood to encompass those contracts where the obligations of both parties are unperformed to the degree that the failure of either party to complete performance would constitute a material breach. Section 365 also permits a debtor to reject its unexpired leases.

The question of whether a debtor can reject particular sorts of contracts can hinge on issues determined under state law. More specifically, the treatment of oil and gas leases, gathering agreements and transportation agreements can vary, depending on the treatment of those agreements under the state law governing those agreements.

Major developments in this area occurred in late 2015, and are continuing to develop this year.

**Oil and Gas Leases**

Under the law of certain states, including Pennsylvania and West Virginia, an oil or gas lease is not a true lease, but instead is the conveyance to the lessee of a real property interest in the oil or gas in place for its extraction and development. Upon termination of the lease, the interest reverts to the lessor. The interest conveyed to the lessee is referred to as a fee simple determinable with right of reversion. Prior to November 2015, cases interpreting Pennsylvania law generally held that, regardless of the language of the lease, an oil or gas lease was a conveyance of legal title to the oil or gas in place that vested when the property was brought into production. Those cases also held that, prior to production, an oil or gas lease was subject to rejection under Section 365 of the Bankruptcy Code because the conveyance of legal title to the oil or gas in place had not yet vested.

In November, 2015, the U.S. District Court for the Middle District of Pennsylvania, in the case of *In re Mark Powell and Powell Development Company, Inc.*, determined on appeal that the underlying Bankruptcy Court, and indeed most courts that had examined the issue under Pennsylvania law to date, misinterpreted Pennsylvania law to the extent they based their rulings on the principle that an oil and gas lease, as a matter of law, conveys title that is inchoate and vests only when oil or gas is produced (and, therefore, is subject to rejection prior to when oil or gas is produced), regardless of the language used in the lease. Instead, the District Court ruled that the language of the specific oil or gas lease must be examined to determine if it grants a fee simple determinable. If that language is in the traditional form (that is, "the lessor hereby grants and conveys to the lessee…"), the court held that the lease constitutes the conveyance of a fee simple determinable that is not subject to

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rejection, even before oil or gas is produced.

This decision in the *Powell* case binds lower federal courts in the Middle District of Pennsylvania, including the Bankruptcy Court in that District. It remains to be seen how other courts will respond to this decision, but if it is followed by other courts (which certainly is likely), it represents a potentially significant change in law concerning Pennsylvania oil and gas leases.

**Gathering and Transportation Agreements**

The rejection of gathering and transportation agreements has taken center stage in several major bankruptcy cases involving debtor exploration and production companies. The agreements sought to be rejected generally provide for lengthy fixed terms and have minimum throughput-or-pay provisions that, when viewed in a depressed price and decreased production environment, present onerous burdens on the debtor producer.

Whether a debtor producer may avoid the burdens of a gathering or transportation agreement through rejection has come to turn on whether the agreement "runs with the land." Non-debtor gatherer/transporters have argued, historically and in recent cases, that their contracts, which include provisions that say the contract "runs with the land," are not susceptible to rejection, or, if they may be rejected, create property rights on the part of the non-debtor gatherer/transporter that survive rejection because they amount to an interest in real property that has been conveyed to the non-debtor counterparty rather than a mere contract right. Non-debtor gather/transporters also have argued that the language in their contracts dedicating acreage, or the production from specified acreage, to the contract also prevents them from being rejected or also creates property rights that survive rejection. Debtor producers have argued that the mere inclusion of running with the land or dedication language is not dispositive, and more specific requirements to be determined under state law must be satisfied.

These issues were presented in several recent bankruptcy cases, including *In re Sabine Oil Gas Corporation*, *In re Quicksilver Resources, Inc.* and *In re Magnum Hunter Resources Corporation*. *[Editor's note: An accompanying article explores the issue in more depth.]*

**Farmout Agreements**

The characterization of farmout agreements under the Bankruptcy Code is also an important issue in the context of an oil and gas exploration and production company bankruptcy. Farmout agreements may be considered executory contracts subject to acceptance or rejection under Section 365; however, an analysis of the specific terms of the farmout agreement and what, if any, obligations remain to be performed by the parties at the time of the bankruptcy filing must be performed. Depending on the status of the specific farmout, it may be considered a performed agreement establishing interests in real property, which interests are not subject to assumption or rejection. Additionally, Section 541(b)(4) of the Bankruptcy Code contains a safe harbor protection for non-debtor farmees where the debtor-farmor seeks to reject a farmout agreement after the farmee has performed its contractual obligations, but before the required conveyance of the working interest has been recorded. If the Section's criteria are met, rejection does not impact the rights of the farmee with respect to any interest it earned prior to the petition date. Such interests are generally considered to be the non-debtor farmee's separate property, as opposed to a claim against the debtor farmor. While there are very few cases interpreting this Section of the Bankruptcy Code, it is available in the proper circumstances.

**Master Agreements**

Section 365 of the Bankruptcy Code requires the assumption or rejection of a contract in its entirety. A debtor may not pick and choose which elements of a contract to assume and which to reject. Sometimes, multiple contracts comprise a single, integrated agreement. For example, a master agreement may contain the general terms and conditions that govern a series of similar transactions to be entered into overtime. Where a debtor seeks to reject some, but not all, of the related agreements, the non-debtor counterparty will argue that the agreements are so interrelated as to form an integrated whole, and therefore all of the interrelated contracts must be assumed or rejected together.

This fact pattern is present in the *Magnum Hunter* case, where the debtor has agreements with a gatherer and is seeking to reject some, but not all, of its agreements with the counterparty. Specifically, the debtor and the gatherer are parties to a master agreement and several subsidiary agreements, or confirmations, that support a pipeline network of multiple lateral segments and transportation lines. The gatherer argues that these segments are not individually viable, and are instead maintained as components of an integrated system. As with so many critical issues in bankruptcy, the counterparties argue that the question of whether the related agreements constitute an integrated whole must be determined under state law. The issue remains to be decided in the *Magnum Hunter* case.

**Mineral Interests**

Investors in the energy sector make their investments in a variety of ways, including purchasing overriding royalty interests, net profits interests, working interests, production payments and other interests. The nature of the interest purchased can have a dramatic effect on the investor's recovery in a bankruptcy case.

Generally, an overriding royalty interest is an interest in oil or gas flowing from an underlying oil and gas lease that is free of the costs of production, similar to the usual landowner's royalty. A net profits interest is a share of the gross production of a property measured by net profits from operations. In either case, these interests are often conveyed through documentation reflecting the parties' intent to transfer an interest in real property. One reason that an investor would want to structure its investment as an interest in real property is that, under bankruptcy law, such an interest would be excluded from the debtor's estate, and therefore not subject to divestment in the bankruptcy case. The Bankruptcy Code specifically excludes from property of the estate "any interest of the debtor in liquid or gaseous hydrocarbons to the extent that . . . the debtor has transferred such interest pursuant to a written conveyance of a production payment [as defined in Section 101(42A)] to an entity that does not participate in the operation of the property from which such production payment is transferred. . . ." This language may be read to mean that the exclusion from property of the estate is only available to assignees that provide


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financing, as opposed to assignees that receive production payments as compensation for services rendered in the operation of the property. There is little case law on this issue, though the recent spate of oil and gas bankruptcy cases may change that.

By the time a bankruptcy case begins, a debtor production company may owe substantial royalty payments to lessors. Generally, a lessor's pre-petition royalty claim may be treated as a general unsecured claim. However, a lessor may challenge this treatment based on specific language in its lease, or based on specific state law peculiarities. Leases may include language that allows the lessor to terminate a lease for non-payment of royalties. The Bankruptcy Code's automatic stay notwithstanding, such provisions can be enforced in some states, including Texas. To prevent termination, debtors may seek court approval to pay prepetition royalty payments in order to preserve the value of the lease.

**Purchase of Assets in a Section 363 Sale**

**Use, sale or lease of property of the estate**. Section 363 of the Bankruptcy Code sets forth the rights and powers of debtors with respect to the use, sale or lease of property of the estate other than in the ordinary course of business. Generally, a bankruptcy debtor may enter into transactions, including the sale, use or lease or property of the estate, without involvement by the Bankruptcy Court, so long as such transactions are within the ordinary course of the debtor's business. The use, sale or lease of property of the estate other than in the ordinary course of business requires notice, a hearing and an order of the Bankruptcy Court approving such use, sale or lease.

**Advantages and Disadvantages of a Section 363 Sale**

Some of the advantages to a buyer in a bankruptcy sale are the opportunity to negotiate a reduced price from a seller whose leverage is impaired, and the opportunity to be selective about the assets to be purchased. Perhaps the most compelling advantage of a 363 sale, however, is the quality of title that may be acquired. The order confirming the sale will provide that the assets are conveyed free and clear of at least the liens identified in the pleadings. The order might alternatively provide that the assets are conveyed free and clear of all liens. Section 363(f) authorizes sales free and clear of "any interest in such property," provided one of five criteria is satisfied. This provision is most commonly understood to enable the assets to be transferred free from liens and other similar encumbrances. Even at this most basic level, this feature is a powerful argument for purchasing assets inside, rather than outside, of a Chapter 11 proceeding. Section 363(f), however, has been construed even more broadly by some courts. In the case of *In Re Trans World Airlines, Inc.*, airline workers' employment discrimination claims against a Chapter 11 debtor airline, as well as flight attendants' rights under a travel voucher program that the debtor airline had established in settlement of sex discrimination actions, both qualified as "interests in property" under Section 363(f). This case established for the Third Circuit that Section 363(f)'s "interest in property" language means more than in rem interests, such as liens.

There may also be disadvantages to a sale under Section 363. Although an auction process is not mandated by the Bankruptcy Code, the prospective purchaser should assume that the transaction will be subject to higher and better offers where the assets to be acquired are material to the debtor. Also, the timing of a Section 363 transaction can be problematic, particularly if the bankruptcy case has not yet been commenced. In either case, the bankruptcy proceeding adds an additional layer of cost to the transaction. An acquired business or business unit may also have impaired relationships with its customers, vendors and employees. Finally, the differing interests among the debtor, the secured creditors and the unsecured creditors' committee can complicate and delay the deal-making process.

**Special Considerations for Section 363 Agreements of Sale**

The negotiation of an agreement of sale where the seller is a Chapter 11 debtor involves some unique considerations, including the following:

Although the preferred goal of Chapter 11 is for the debtor to emerge from bankruptcy as a reorganized, viable business, it is entirely possible that the Chapter 11 debtor/seller will not emerge as a business at all. Accordingly, representations and warranties that serve to shift risk in non-bankruptcy transactions can be meaningless in Chapter 11 transactions. Instead, matters that might typically be addressed in such representations and warranties in non-bankruptcy transactions (e.g., the condition of the assets and required consents) should be viewed merely as conditions to closing.

Assuming the Chapter 11 debtor/seller will not emerge from bankruptcy as a viable business, the buyer might be inclined to negotiate special price concessions, hold backs or escrows to address potential claims. Such mechanisms, however, may not be favored by creditors of the seller who have little interest in waiting for additional payments to be distributed at some point in the distant future, if at all.

The increased likelihood that the prospective buyer will be unsuccessful in a Chapter 11 sale, whether because of competitive bidding or otherwise, suggests that extensive efforts should not be devoted to due diligence while the Chapter 11 sale remains uncertain. The debtor/seller's status, however, puts even more pressure than normal on the due diligence process. One way to address this concern is to include an expense reimbursement feature in the sale procedures, whereby the unsuccessful bidder may recoup at least its out-of-pocket expenses (i.e., attorneys' fees).

The assignment and assumption of significant contracts is an important component of the acquisition of any on-going business. Chapter 11 sales, however, involve a number of additional concerns relating to the assignment and assumption of contracts. Pursuant to Code Section 365(f), the debtor/seller has the right to assign most contracts without the consent of the counterparty, even if the contract being assigned requires such consent. The buyer/assignee, however, must be prepared to provide adequate assurance of future performance. In addition, all monetary defaults must be cured before an executory contract can be assumed and assigned in a Chapter 11 case. The buyer should be prepared to bear those costs where the debtor/seller is liquidating.

In non-bankruptcy transactions, the agreement of sale usually contains various conditions to the parties' respective obligations to close. One of the most common of these is a financing contingency. In bankruptcy sales, however, such conditions can severely hamper the prospective purchaser's prospects for success, either because a competitive bid might not include such


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conditions (and might therefore be a “better” if not “higher” offer), or because the inclusion of such conditions will lose the support of creditors and other parties-in-interest for the proposed transaction.

**Stalking Horse Issues and other Sale Procedures**

The prospective buyer who enters into an agreement of sale with a Chapter 11 debtor/seller where the sale is subject to competitive bidding at a court-ordered auction is referred to as a “stalking horse.” A stalking horse bidder bears the risk of losing the desired assets to a higher or better bid. Accordingly, the first decision any prospective purchaser of assets in a Chapter 11 sale faces is whether to become the stalking horse bidder, or whether to wait to let another prospective purchaser do the initial heavy lifting - getting the deal put together and mustering the support of the various parties-in-interest for a transaction - then bid at the ensuing auction. Based on the theory that the interests of the estate and its creditors are served by encouraging someone to step up and begin the bidding process, bankruptcy law and practice affords some protections for the stalking horse bidder, including the opportunity to establish the procedures by which the sale will be conducted, and the opportunity to collect a fee or be reimbursed for expenses if the stalking horse bidder is not the successful purchaser.

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