Annual Institute on Mineral Law

Volume 57 *The 57th Annual Institute on Mineral Law* Article 17

3-25-2010

Managing and Mitigating Bankruptcy Risk in the Oil and Gas World

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Introduction

Inherent in the oil-and-gas business and in contractual relationships in general is the risk that the counterparty may become insolvent or file for bankruptcy protection. Consider the array of commercial and business relationships present in the E&P world. In each case, there is a discrete set of bankruptcy risks to manage:

Contract	Risk of Bankruptcy
Joint Operating Agreement	Any joint interest owner
Sale Contracts	Buyer or seller
Production Payment	Grantor
Service Contract	Contract counterparty
Purchase and Sale Agreement	Buyer or seller, even after closing has occurred
Farmout Agreement	Farmor or farmee

There are three general categories of risk that a contract counterparty faces: (i) credit risk; (ii) avoidance risk; and (iii) business risks. When thought of as a timeline of risks, those categories loosely represent: risk to current transactions (by the risk of nonpayment); risk arising from past transactions (by the risk of avoidance); and risk to transactions in the future (by the risk of loss of future value). These risks can be managed and mitigated inside and outside of the bankruptcy arena through various means, including obtaining security interests, thoughtful structuring of business and contractual relationships, and taking advantage of various rights within the bankruptcy process. If recent history has taught us anything, it is that no enterprise (regardless of size or market share) is immune from bankruptcy risk. Thus, it is important to identify the risks and have a plan for mitigating and managing those risks both before and after they manifest.

I. Bankruptcy Risks: Credit Risk, Avoidance Risk, and Business Risk.

A. Risk of Nonpayment.

There is no requirement in the United States Bankruptcy Code that a person or entity that files bankruptcy must demonstrate that it is insolvent. 11 U.S.C. §109; *In re Integrated Telecom Express, Inc.*, 384 F.3d 108, 121 (3d Cir. 2004) (no insolvency prerequisite to file bankruptcy – petition only must be filed in good faith). However, bankruptcy most often is a response to severe financial distress and usually is a last resort because of the high cost and risk to the enterprise of seeking bankruptcy protection.[1] Thus, in filing bankruptcy, the debtor[2] is frequently expressly or tacitly acknowledging that it is not able to pay its debts and/or meet its contractual obligations as they become due.

Whether in a bankruptcy proceeding under Chapter 7 or Chapter 11 of the Bankruptcy Code, counterparties with pre-bankruptcy claims against the debtor, particularly counterparties to open-account debts, are often paid either pennies on the dollar or not at all. Given this present-tense risk of non-payment or non-performance by the counterparty, a contract creditor must consider and manage the risk that the counterparty will become bankrupt and fail to pay its obligations when due under the applicable contract.

B. Avoidance Risk.

Bankruptcy risk for the contract counterparty encompasses more than the risk of nonpayment by the debtor—there is also the risk of affirmative liability arising from transactions that precede the bankruptcy case. In particular, once a counterparty files bankruptcy, the non-debtor counterparty faces the risk that a contract debtor will invoke applicable provisions of the Bankruptcy Code and/or state law to impose liability on the non-debtor counterparty in connection with pre-bankruptcy transactions (*i.e.*, invoke its "avoidance powers").

1. Preferential Payments/Liability

One of the most seemingly unfair risks that a contract counterparty faces is the possibility of having to repay amounts received from the debtor within ninety days of the bankruptcy case. *See* 11 U.S.C. §547(b); *In re Micro Innovations Corp.*, 185 F.3d 329, 332 (5th Cir. 1999). In general, a debtor may avoid any transfer of an interest in property made to it:

- to or for the benefit of a creditor;

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1 In fact, bankruptcy comes with high costs of administration and the need for transparency in business practices and structure. And there is no guarantee that a company that goes into bankruptcy will come out on the other side. Rasmussen, Robert K., *The Efficiency of Chapter 11*, 8 Bankr. Dev. J. 319 (1991) (only 30% of Chapter 11 cases filed confirm plans).

2 Entities that file Chapter 11 generally are operated by pre-bankruptcy management, *i.e.*, as a "debtor-in-possession." 11 U.S.C. §1104. Much of the discussion herein refers to "debtors" but that would also apply to any trustee appointed to act on behalf of the debtor in a Chapter 11 case or the trustee that is appointed on filing in a Chapter 7 case.

- for or on account of an antecedent debt owed by the debtor before such transfer was made;
- made while the debtor was insolvent;
- if to a non-insider, made on or within 90 days before the date of the filing of the petition; or
- if to an insider, made between ninety days and one year before the date of the filing of the petition; and
- that enables such creditor to receive more than such creditor would receive if the case were a case under Chapter 7 and the transfer had not been made.

11 U.S.C. §547(b).

As a result, if a creditor sells to a debtor on an open account, any payment the creditor receives within ninety days prior to the bankruptcy case is susceptible to the risk that it may have to be repaid to the bankrupt party. Thus, once a bankruptcy case is filed, the contract counterparty faces, not only the risk of inability to collect claims that are due and owing as of the petition date, but also the risk that it may have to repay amounts which were received prior to the bankruptcy case. However, there are defenses to preference liability that, if taken into account in advance, will help mitigate the risk of avoidance once a bankruptcy is filed.

2. Fraudulent Conveyance

The risk of exposure to fraudulent conveyance liability comes in two forms. The first involves transfers wherein actual fraud is committed. If the non-debtor counterparty has committed actual fraud, that party will, of course, be subject to the risk of liability to the debtor. *See* 11 U.S.C. §548; *see also In re Roco Corp.*, 701 F.2d 978, 981 (1st Cir. 1983). Beyond the issue of actual fraud, however, even an innocent, non-insider party can be the subject of an avoidance action. 11 U.S.C. §548(a); *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535 (1994). For instance, where one company (Company "A") has entered into a transaction with a party (Company "B") that later becomes bankrupt, Company A is subject to the risk that, once Company B enters bankruptcy, it will contend that any pre-bankruptcy transfer to Company A was for "less than reasonably equivalent value" in an attempt to avoid the transfer of the property in question. Accordingly, a party that purchases assets from a seller that later goes bankrupt may find itself the victim of its own success such that, if the value of the property is enhanced by the buyer after the sale closes (through, for example, drilling or other developmental activity), the debtor later may contend that the buyer failed to pay reasonably equivalent value in an attempt to unwind the transaction.

C. Prospective Business Risks.

The filing of bankruptcy creates business risks that can have a domino effect that reaches beyond the filing of the bankruptcy case to have a detrimental and long-term impact on the value of oil and gas assets, especially assets that are in the process of being developed. For instance, if a party with outstanding obligations to perform work—such as constructing pipelines or performing work under a day-work contract at a drilling site—files for bankruptcy, the project may stall or halt completely, which may affect the go-forward value of the project. Similarly, an operator's bankruptcy might cause a decline in the value of the underlying property on account of the operator's failure to pay royalties or to meet obligations to develop the properties resulting in the loss of a leasehold interest. The prospective business risks arising from a debtor's bankruptcy case often defy short-term quantification, but may ultimately have the greatest monetary impact on a contract counterparty.

D. Managing the Risks.

As deals are made and business relationships managed, contract counterparties should take care, when possible, to adopt practices that will mitigate the risk of bankruptcy. Strategies to mitigate bankruptcy risk include obtaining security interests or liens; requiring prepayment; exercising recoupment rights; receiving a corporate guaranty; being strict in application of payment terms; or applying other techniques, the goal of which is to elevate the treatment of the contract creditor's claim, improve the creditor's defenses, and/or maintain the value of the contract creditor's business despite the bankruptcy of a counterparty.

Moreover, contract counterparties must take care to protect their rights once bankruptcy is filed, not only by filing a claim against the debtor but also by taking advantage of ways in which their claims might be entitled to receive an improved priority in the bankruptcy case. Claims against a bankrupt counterparty get sorted into a kind of priority waterfall. General unsecured creditors—for example, parties that sold goods to the debtor on an open account—are generally at the bottom of the bankruptcy priority scale ahead of only equity owners. Prepetition, unsecured creditors are paid behind administrative claims, priority claims, secured claims and rights of offset. 11 U.S.C. §507(a); *In re Jack/Wade Drilling, Inc.*, 258 F.3d 385, 387 (5th Cir. 2001). Therefore, a key to mitigating and managing bankruptcy risk is to identify a strategy to elevate resulting claims ahead of general unsecured creditors.

II. Risk Management Strategies: Liens and Security Interests.

A. Bankruptcy Treatment.

A classic strategy for a creditor managing the risk of the bankruptcy of a contract counterparty is to obtain a lien or security interest to secure the contract claim.

In bankruptcy, however, the lien or security interest will provide protection only if there is value in the underlying collateral that reaches the contract claim. 11 U.S.C. §506(a)(1); *see, e.g., Matter of Senior-G & A Operating Co., Inc.*, 957 F.2d 1290, 1301 (5th Cir. 1992). Thus, if a creditor has a security interest in property, but that property is only worth a fraction of the creditor's claim, there is little protection to the creditor. If there is no value underlying the lien or security agreement, the holder of the lien or security interest will be treated as a general unsecured creditor and, for purposes of bankruptcy distributions, will be in no better position than a wholly-unsecured creditor. 11 U.S.C. §506(a)(1); *Matter of Senior-G & A Operating Co., Inc.*, 957 F.2d 1290, 1301 (5th Cir. 1992). If, on the other hand, there is at least some value underlying the security interest or lien, the claim will be treated as a secured claim to the extent of the value of the collateral and is entitled to elevated priority in the bankruptcy (if not payment in full). *See* 11 U.S.C. §506(a)(1); *In re Hanna*, 912 F.2d 945, 949 (8th Cir. 1990). Any deficiency claim (the difference between the value of the secured claim and the creditor's total claim) is an unsecured claim in the bankruptcy case. *See* 11 U.S.C. §506(a)(1); *In re Hanna*, 912 F.2d 945, 949 (8th Cir. 1990).

Regardless of the risk of deficiencies, security interests are significant in the bankruptcy context because of the priority that having even a partially-secured claim affords a creditor. Accordingly, when considering risk-management tools, in the event of a default by a counterparty, the creditor should seek to ensure that as much of its claim as possible is treated as a secured claim in bankruptcy.

B. Enforceability In Bankruptcy.

To receive recognition as a secured claim in bankruptcy (and therefore more favorable bankruptcy treatment), a contract counterparty's consensual lien or security interest must (i) be perfected and (ii) be from the correct counterparty.

1. Perfection

Outside of the bankruptcy context, a principle that is often expressed in an attempt to mitigate a failure of perfection of the creditor's interest is that an unperfected lien or security agreement is enforceable as between the holder of the lien and the debtor. *In re E.M. Williams & Sons, Inc.*, No. 08-3055-KRH, 2009 WL 2211727 at *2,n.6 (Bankr. E.D. Va. 2009); *In re Kwan Hun Baek*, 240 B.R. 633, 635 (Bankr. M.D. Fla. 1999). In bankruptcy, however, this adage does not offer *any* protection to the holder of an unperfected lien or security interest. An unperfected lien or security interest, for the most part, is worthless as against a counterparty in bankruptcy because the debtor has sweeping "strong arm" powers that, under Bankruptcy Code Section 544, permit the trustee to avoid unperfected liens or security interests.

Knotsman v. West Loop Savings Association (In re Newman), 993 F.2d 90 (5th Cir. 1993).

In practice, to be of value in bankruptcy, the lien or security interest should be perfected contemporaneously with the attachment of the lien or security interest. Perfection of the lien or security interest after the fact will result in a preference or avoidance risk to the counterparty if the debtor files bankruptcy within ninety days of perfection. *In re P.A. Bergner & Co. Holding Co.*, 187 B.R. 964, 983 (Bankr. E.D. Wis. 1995).

In addition, the filing of the bankruptcy results in the imposition of an automatic stay pursuant to Section 362 of the Bankruptcy Code that prevents, in general, creditors from taking action to advance their rights against the debtor once a bankruptcy case is filed. *See* 11 U.S.C. §362; *In re Chesnut*, 422 F.3d 298, 300 (5th Cir. 2005); *Reliant Energy Services, Inc. v. Enron Canada Corp.*, 349 F.3d. 816, 825 (5th Cir. 2003); *Arnold v. Garlock*, 278 F.3d 426, 436 (5th Cir. 2001); *Hunt v. Baker's Trust Co.*, 799 F.2d 1060, 1069 (5th Cir. 1986). The automatic stay prevents a holder of an unperfected lien from perfecting its contractual security interest in the debtor. 11 U.S.C. §362(a)(4) (staying any act to create, perfect, or enforce any lien). Accordingly, once a bankruptcy case is filed, it is too late for the unperfected security interest holder to obtain perfection and, generally, the holder will be treated as a general unsecured creditor.

2. Correct Counterparty

It is not uncommon for counterparties to receive a lien or a security agreement only to find that, upon the bankruptcy of its counterparty, the record owner of the property is an affiliate of the mortgagor. Corporate formalities are recognized in bankruptcy, which typically means that each affiliated debtor will file its own bankruptcy case with each debtor being treated as separate for purposes of, among other things, distributions to creditors. *In re Fernandes*, 346 B.R. 521, 522 (Bankr. D. Nev. 2006).

While affiliated debtors may frequently be jointly administered in bankruptcy by a single bankruptcy judge, substantive consolidation—treating separate debtors as a single distributive pool—is the exception, rather than the rule. *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.)*, 250 F.3d 955, 958 (5th Cir. 2001); *In re Las Torres Develop. LLC*, 413 B.R. 687, 693 (Bankr. S.D. Tex. 2009). In the absence of substantive consolidation of all the debtors, a pledge that was originally given by an entity that did not actually hold an interest in the property will typically mean that the purported security interest is treated as a nullity and that the holder of the security agreement is a general unsecured creditor at or near the bottom of the bankruptcy distribution scale. Thus, in obtaining a lien or security interest, it is crucial for the counterparty to ensure that, at a minimum, the record owner of the property in question enters into the security agreement that will give rise to the attendant lien or security interest.

3. Interests in JOAs

Frequently, joint general operating agreements ("JOAs") contain embedded reciprocal liens and security agreements in which each party to the JOA pledges its interest in the subject property to secure its obligations to the other parties to the agreement. Unfortunately, it is also common for these liens and security interests to be left unperfected. Waiting until the eve of a bankruptcy filing to record the JOA will result, at a minimum, in avoidance risks to the counterparty, and, if a bankruptcy is filed in advance of recordation, the non-bankrupt counterparty will be wholly unsecured. Therefore, the recordation of a JOA at the time that the parties enter into it is a necessary and appropriate means of protecting each party to the operating agreement against the bankruptcy of the other parties.

The parties are protected because, whether an operator or non-operator, a party to a JOA often takes on the credit risk of the counterparty. For instance, operators frequently make advances on behalf of non-operators for both capital expenditures and lease operating expenses. Upon the bankruptcy of the non-operator, claims for both capital expenditure amounts and for unpaid lease operating expenses will be prepetition claims against the non-operator. Operators, on the other hand, often market hydrocarbons for the non-operators, in which case the non-operator takes on the credit risk of the operator. In that circumstance, the bankruptcy of the operator will result in the non-operators being left with claims for hydrocarbons that have been produced and sold prior to the bankruptcy case. Thus, regardless of which party, operator or non-operator, files for bankruptcy protection, a perfected, reciprocal pledge by each party of its working interest share of the property will provide significant credit protection for the JOA contract creditor.

4. The Challenges of Modern Finance

In an age of highly-leveraged companies and mezzanine lending, it is important to consider the impact of modern financing practices on the availability and value of contractual liens for contract counterparties. It is not uncommon for lending restrictions to prohibit an upstream or midstream company from granting liens or security interests without the consent of its financing sources. In practice, such a consent frequently is difficult to obtain. In addition, in bankruptcy, the lien or security interest only has value to the extent that the value of the underlying property exceeds the amount of any senior-secured claim against the same property. *United States v. Ron Pair Enterp., Inc.*, 489 U.S. 235, 241 (1989); *Matter of T-H New Orleans Ltd. P'ship*, 116 F.3d 790 (5th Cir. 1997) (junior lienholders only have a secured claim if value of collateral exceeds senior liens). If, for example, the lien of the financier is recorded in advance of the recordation of the joint operating agreement, upon the filing of a bankruptcy case, the senior-secured debt may consume all the available value and leave the contractual mortgagee with an unsecured claim. This reality of modern finance highlights the need to record the joint operating agreement at the time it is consummated and, to the extent possible, to monitor the balance sheet condition of contract counterparties.

C. Statutory Lien Rights.

In lieu of contractual liens or security interests, underlying applicable state law may grant liens to secure discrete classes of claims. These statutory liens include mechanic's and materialman's liens which, in general, are statutory liens intended to ensure that the property owner does not receive added value from the contractor's work without paying for it. Both Texas and Louisiana have elaborate statutes that create, by statutory fiat, liens to secure the claims of mechanics and materialmen. There are many technical requirements that are necessary in order to perfect a mechanic's and materialman's lien. La. Rev. Stat. Ann. §9:4802; Tex. Prop. Code Ann. §§56.001-56.045 (Vernon 2010).[3] In appropriate circumstances, the beneficiary of a statutory lien may receive elevated bankruptcy treatment. Unlike contractual liens, the perfection of a statutory lien is not subject to the automatic stay. 11 U.S.C. §§362(b)(3), 546(b)(1); *Meek Lumber Yard v. Houts (In re Houts),* 23 B.R. 705, 706 (Bankr. W.D. Mo. 1983). While the requirements of perfection of those interests are beyond the scope of this paper, it is important to note that if the prerequisites are not met, the holder typically will be an unsecured creditor.

Upon learning of the bankruptcy of a contract counterparty, a party that may be eligible to file a statutory lien should immediately consult the applicable statute for requirements of perfection of its mechanic's and materialman's liens. However, in an age of mezzanine financing, obtaining or asserting a statutory lien often will fail to elevate the claim of a counterparty unless it can be shown that the work in question began (or has a deemed inception date) prior to the date of the relevant contractual mortgage. 11 U.S.C. §545(1); *In re Waller Creek, Ltd.*, 867 F.2d 228, 233-34 (5th Cir. 1999); *In re Showplace Square Loft, Co., LLC,* 289 B.R. 403, 407 (Bankr. N.D. CA. 2003).

In any event, merely perfecting a mechanic's and materialman's lien may not be enough to ensure improved bankruptcy treatment. It is often

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[3] Texas Property Code section 56.021 provides: (a) Not later than six months after the day the indebtedness accrues, a person claiming the lien must file an affidavit with the county clerk of the county in which the property is located. (b) Not later than the 10th day before the day the affidavit is filed, a mineral subcontractor claiming the lien must serve on the property owner written notice that the lien is claimed.

necessary for holders of statutory liens to take an active role in the bankruptcy case in order to secure their rights in any underlying collateral and to gain an elevated treatment in the bankruptcy case.

III. Risk Management Strategies: Offset versus Recoupment.

A. The Right to Offset.

A variation of a security interest is the right of offset.[4] The right to offset arises where counterparties have reciprocal debts and obligations, which, in some circumstances, may be set off against each other. In general, to be enforceable in bankruptcy, debts and obligations must be "mutual," which means it must be the same right between the same parties standing in the same capacity and must have arisen before the commencement of the bankruptcy case. *See* 11 U.S.C. §553(a); *Braniff Airways Inc. v. Exxon Co., USA,* 814 F.2d 1030, 1036 (5th Cir. 1987) (mutuality requirement for setoff was met because the debt was incurred prepetition); *Matter of United Sciences of America,* 893 F.2d 720, 723 (5th Cir. 1990)(bank's setoff was not in violation of the Bankruptcy Code since the bank's agreement created the mutuality of the debts between the parties); *In re Bevill, Breler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 59 (3d Cir. 1990)(bank's possession of interest payments does not constitute a mutual debt for purposes of setoff because bank was merely a trustee); *In re Davidovich*, 901 F.2d 1533, 1538 (10th Cir. 1990)(former partner was not entitled to offset for amount allegedly owed to him pursuant to debtor's post-petition default because did not meet "mutuality" requirement).

For example, if an operator files bankruptcy and, at the time of the filing, a non-operator has obligations to the operator for joint interest billings but is also owed amounts by the operator for production that the operator was marketing on behalf of the non-operator prior to the bankruptcy case, the non-operator may have offset rights in the payable for joint interest billings to deduct its receivable for unpaid hydrocarbon sales. *See, e.g., Matter of Kosadnar*, 157 F.3d 1011, 14 (5th Cir. 1998). Receivables and payables that are not "mutual" debts are not subject to the right of offset. For instance, a debt owing by a creditor to a subsidiary or affiliate of the debtor generally cannot be set off against a debt owed by the debtor to the creditor. *Braniff Airways Inc. v. Exxon Co., USA,* 814 F.2d 1030, 1034 (5th Cir. 1987).

Parties frequently seek to expand the offset right by entering into agreements that purport to expand the definition of what constitutes a mutual debt. Under those agreements (often called "master netting agreements"), parties are permitted to offset debts owed to affiliates against amounts owed by another affiliate. Accordingly, a master netting

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[4] The right to offset is termed the right to "setoff" in the Bankruptcy Code. 11 U.S.C. §553(a); *In re Supreme Beef Processors, Inc.*, 391 F.3d 629 (5th Cir. 2004).

agreement purports to expand by contract the right of offset beyond the common and statutory law. A question has existed and continues to exist regarding whether parties can contractually expand the right of offset (through master netting agreements or otherwise) by expanding the definition of mutuality to include affiliates. In at least one recent case, a court has held that expansion of the right of mutuality by contract to include so-called triangular offset is not enforceable in bankruptcy. *In re SemCrude*, 399 B.R. 388 (Bankr. D. Del. 2009) (referred to herein as "*SemCrude* I").[5]

SemCrude I stands out for two reasons. First, it highlights the possibility that a court may disregard a master netting agreement and limit the right of offset to receivables and payables among the same corporate entities. *See id.* at 399. But the fact that a court may disregard the contractual expansion of the definition of mutuality is not a reason to discontinue using netting agreements. There are jurisdictions in which those rights may be enforced. *See, e.g., Wooten v. Vicksburg Refining, Inc.* (*In re Hill Petroleum Co.*), 95 B.R. 404, 411-412 (Bankr. W.D. La. 1988)(purchaser of petroleum products that tried to offset debt owed to seller against amounts owed another corporation under common control by seller was invalid because there had been no formal agreement by seller that the two entities could aggregate debts to and from it. Had there been such an agreement, the court impliedly would have allowed it.); *Bloor v. Shapiro*, 32 B.R. 993, 1001-1002 (Bankr. S.D.N.Y. 1983) (where guarantor assumed third party's obligations to bankrupt, and bankrupt had agreed that guarantor was entitled to assert bankrupt's liabilities to third party, liabilities became debts owed by bankrupt to guarantor; thus, such debts could be asserted by guarantor as setoff against bankrupt's claims notwithstanding section of Bankruptcy Act that provided mutual debts or credits could be setoff only as to claims to/from same creditor in same capacity). The decision should instead remind contracting parties not to overemphasize a master netting agreement in risk management and underwriting practices.

Second, *SemCrude I* is instructive of the principle that parties may have (and often end up having) their contract rights determined by bankruptcy courts outside of their own jurisdictions. Debtors have a very broad venue choice in filing bankruptcy that includes principal place of business, principal assets and place of organization of the debtor or its

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5 "[S]ection 553 of the [Bankruptcy] Code prohibits a triangular setoff of debts against one or more debtors in bankruptcy as a matter of law due to lack of mutuality." *SemCrude* I at 392-93. "...mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff. Unlike a guarantee of debt ... an agreement to setoff funds does not create an indebtedness from one party to another. Sem-Crude does not owe anything to Chevron, thus there are no debts in this dispute owed between the 'same persons in the same capacity.'" *Id.* at 397.

affiliates. *See* 11 U.S.C. §1408. Accordingly, both New York and Delaware are frequent venue choices in Chapter 11 cases because of the frequency with which those jurisdictions are used for entity organization purposes (even for companies with principal assets in more traditional hydrocarbon-producing states).[6]

Even if mutuality and other setoff prerequisites are met, the correct and appropriate means for asserting an offset right against a counterparty in bankruptcy is to withhold amounts due and owing to the debtor, subject to the right of offset. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 289 (1995). The automatic stay prevents a contract counterparty from offsetting an account payable against an account receivable in the absence of modification of the automatic stay. *In re Szymanski,* 413 B.R. 232, 240 (Bankr. E.D. Pa. 2009). Thus, once bankruptcy is filed, the party asserting the right of offset should withhold payment of the payable (which is a variation of the so-called "administrative freeze"). However, if the contract creditor's claim against the debtor exceeds the amount due and owing by the contract creditor to the debtor, then it may be possible for the creditor to obtain modification of the automatic stay pursuant to Section 362(d)(2) to assert the right of offset in the payable. 11 U.S.C. §553(a); *In re Moore*, 376 B.R. 704, 707 (Bankr. W.D. Ark. 2007). If the stay is lifted and offset is achieved, the contract creditor will be in the preferred position of having collected the amount of the payable with only its deficiency claim (the unsatisfied amount of its claim) left for treatment as an unsecured claim.

B. Recoupment.

A related contractual risk-mitigation principle is recoupment. In general, recoupment is netting of obligations within or among the same agreement. *In re Holford,* 896 F.2d 176, 178 (5th Cir. 1990); *In re Brown*, 325 B.R. 169, 175-76 (Bankr. E.D. La. 2005). While a more narrow principle (which is probably not susceptible to contractual expansion), recoupment has the added advantage of not being subject to the automatic stay. *In re Holford*, 896 F.2d 176, 179 (5th Cir. 1990); *In re McWilliams*, 384 B.R. 728, 729 (Bankr. D.N.J. 2008). Thus, a contract counterparty should consider whether the netting of amounts owed to and owed by a debtor are so closely tied together contractually that recoupment, not setoff, may be applicable.

Frequently, the line between recoupment and setoff is a blurry one and counterparties are not willing to risk being accused of violating the automatic stay by exercising, post-petition, a purported right of

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[6] The parties in the *SemCrude* case, for example, submitted expert reports and affidavits on oil and gas-specific concepts, and the court noted in one of its decisions that, "The parties to this litigation have expended significant time and effort in educating the Court as to the history and particulars of oil and gas ownership and production in Kansas..." *SemCrude II* at 90.

recoupment. It is common for parties, such as non-operators who have amounts owed to and owed by a bankrupt operator, to seek modification of the automatic stay in order to setoff (or recoup) obligations that arise under the same agreement. By seeking court approval, those counterparties mitigate the risk that a debtor or trustee, with the benefit of hindsight, will accuse them of having violated the automatic stay by offsetting a payable owed by the debtor against a receivable owed to the debtor.

IV. Risk Management Strategies: Corporate Guaranty.

Another strategy for mitigating bankruptcy risk is to obtain a guaranty at the time the initial agreement is entered into from either a corporate parent or another solvent affiliate. The value of a corporate guaranty should not be underestimated. At a minimum, in most cases, obtaining a guaranty will arm the contract creditor with additional leverage against the bankrupt debtor.

If the guarantor is not in bankruptcy, the filing of a bankruptcy case by the guarantor's affiliate and the attendant automatic stay applicable to that affiliate will not prevent the contract creditor from pursuing its guaranty claim against the guarantor. 11 U.S.C. §362; *Browning Seed Inc. v. Bayles*, 812 F.2d 999, 1004 (5th Cir. 1987); *NCNB Texas Nat'l Bank v. Johnson*, 11 F.3d 1260, 1266 (5th Cir. 1990); *In re Guy C. Long Inc.*, 74 B.R. 939, 943-944 (E.D. Pa. 1987). In fact, in most cases, claims against a non-bankrupt guarantor cannot be discharged in bankruptcy, absent the consent of the contract creditor. 11 U.S.C. §524(e); *In re Applewood Chair Co.*, 203 F.3d 914, 918 (5th Cir. 2000); *NCNB Texas Nat'l Bank v. Johnson*, 11 F.3d 1260, 1266 (5th Cir. 1990).

In addition, in most cases, even if the guarantor files its own bankruptcy case, the existence of the corporate guaranty will have value to the contract creditor. Since the general rule is that bankruptcy cases are not substantively consolidated, the existence of a guaranty will mean that the contract creditor has not only a claim in the bankruptcy case of the contract counterparty but also a claim in the bankruptcy case of the guarantor. 11 U.S.C. §524(e); *see, e.g., In re Pacific Lumber Co.*, 584 F.3d 229, 249 (5th Cir. 2009); *McNulty v. McDonald*, 631 F. Supp. 2d 115, 119 (D. Me. 2009). In that situation, the contract creditor would then be eligible to receive a distribution from both bankruptcy estates.

In practice, particularly in some of the recent so-called "mega" (*i.e.*, large) bankruptcy cases, the existence of a corporate guaranty has meant not only a greater distribution from the bankruptcy case under a confirmed plan of reorganization, but a higher market value for the claims in the secondary markets. For example, claims in the Lehman Brothers bankruptcy that were backed by a guaranty given by Lehman Brothers Holding, Inc. are trading at substantially higher rates than claims without a guaranty. *See The Case for Auctioning Lehman*

Brothers Unsecured Claims Now, Mission Capital Advisors, www.missioncap.com/download.php?f=uploaded_files/cs/lehman.pdf (last visited March 9, 2010) ("claims with an LBHI guarantee typically trade as though they have two (2) claims, one against the subsidiary debtor and one against the holding company, which is why they are pricing at a substantially higher price than the senior unsecured bonds").

It should be noted that there is a material difference between the risk of obtaining a guaranty from a corporate parent of a contract counterparty and receiving the guaranty of a subsidiary or an affiliate. A "downstream" guaranty by a corporate parent typically is held to be both supported by consideration and insulated from avoidance in bankruptcy because of the benefit to the corporate parent via the enhancement of the value of its ownership interest in the subsidiary. *In re Image Worldwide, Ltd.*, 139 F.3d 574 (7th Cir. 1998). In contrast, an "upstream" or "sidestream" guaranty by a subsidiary or affiliate that is not a direct or indirect owner of the contract debtor may be vulnerable to attack. The vulnerability is based on an argument that there is a failure of consideration received by the guarantor —that is, because the guarantor did not receive "reasonably equivalent value" and, hence, is avoidable as a fraudulent conveyance. *Id.*; *see also* 11 U.S.C. §548.

For these reasons, particularly with respect to significant credit relationships, consideration should be given to press for a guaranty from a parent or an affiliate, particularly the guaranty of a corporate parent.

V. Risk Management Strategies: Elevation of Claims.

A. Business Relationship Leverage.

Even in the absence of an enforceable lien, security agreement or recoupment right, the contract creditor may have leverage to improve its treatment in bankruptcy because of the importance of the contract in the debtor's business or to maintaining the value of the debtor's assets.

In bankruptcy, a debtor may assume or reject contracts that, as of the petition date, were "executory" in nature. 11 U.S.C. §365. An executory contract is a contract for which material performance is due and owing on both sides of the contract, the non-performance of which would result in a material breach of the agreement. *NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (U.S. 1984); *In re Murexco Petroleum, Inc.*, 15 F.3d 60, 63 (5th Cir. 1994). If a contract is not necessary for the debtor's continued operations, or for the debtor to realize value from its assets in connection with a sale, the contract may be rejected and the claim of the contract counterparty will be treated as a claim in the debtor's bankruptcy case (although it may be treated as a secured claim if there is a valid, perfected lien to secure damage claims arising from the subject contract). *In re Continental Airlines*, 981 F.2d 1450, 1459 (5th Cir. 1993). However, a contract that is necessary to the debtor's operations or for the debtor to maintain the value of its property in a sale, may be assumed by the debtor and, in appropriate circumstances, assigned to a third party. *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1309 (5th Cir. 1985) ("business judgment" test for decisions to accept or reject executory contracts).

In most instances, a debtor may, subject to court approval, assume and assign an executory contract (notwithstanding a provision in the contract that requires counterparty consent to the assignment). 11 U.S.C. §365(f). Bankruptcy, therefore, interposes the risk that a debtor will assume and assign a contract without needing the consent of the contract counterparty. For example, a debtor could assume and assign an operating agreement over the objection of the non-operating joint interest owners, even if, in the absence of bankruptcy, consent of the non-operator would have been a necessary condition to such assignment.

The prerequisites for the debtor's assumption of an executory contract is that the debtor (i) cure defaults pursuant to the agreement and (ii) demonstrate that there is "adequate assurance" that the counterparty will be able to perform the obligations under the contract once the contract has been assumed. 11 U.S.C. §§365(b)(1)(B) and (C); *In re Rare Earth Minerals*, 445 F.3d 359, 362 (4th Cir. 2006). As a result, even in the absence of a perfected security interest or other priority-elevating prepetition right, a contract creditor may press for payment in full out of a bankruptcy estate by advancing a cure claim in the event that the contract is sought to be assumed by the debtor. In fact, in appropriate circumstances, a contract creditor may seek to shorten the time period for a debtor to assume or reject an agreement. 11 U.S.C. §365(d)(2); *Texas Importing Co. v. Banco Popular de Puerto Rico*, 360 F.2d 582, 583 (5th Cir. 1966).[7]

Acceleration of the debtor's time period to assume or reject an agreement may force a debtor to assume a contract that is necessary to the debtor's operations. However, most bankruptcy courts will be reluctant to force a debtor to prematurely assume an executory contract (and pay the attendant cure claims) if the value of the contract to the debtor's estate or the outcome of the case is uncertain. For instance, if a motion by a contract counterparty to force the debtor to assume or reject the contract comes so early in the case that not even the debtor knows whether it is likely to confirm a plan, effect a sale, or possibly even have to convert to a Chapter 7 case, the bankruptcy court is not likely to require the debtor to make an accelerated decision regarding contract assumption or rejection.

[7] In a Chapter 11 case, a debtor has until confirmation of a plan (which, in some cases, may take a year or longer) to assume or reject an executory contract in the absence of a court order shortening that time period. 11 U.S.C. §365(d)(2).

In addition, as more and more Chapter 11 cases culminate it sales of the debtor's assets, it has become common for debtors to link the sale of assets under Bankruptcy Code section 363 to assumption and assignment of a contract pursuant to Bankruptcy Code section 365. Assumption and assignment of a contract as part of a 363 sale of assets requires notice to the contract counterparties and an opportunity for the contract counterparties to demonstrate the amount of the cure claims that must be paid as a condition to the assignment of the executory contracts. *River Production Co. v. Webb (In the Matter of Topco, Inc.)*, 894 F.2d 727, 730 (5th Cir. 1990). As 363 sales gain more popularity as the bankruptcy exit strategy of choice for Chapter 11 debtors, contract counterparties must take care to follow pending bankruptcy proceedings for notice of a sale that could affect that contract counterparty's claims against, and contracts with, the debtor. *See* 11 U.S.C. §365(b)(1)(B) & (C).

B. Right of Reclamation.

In connection with a contract for the sale of goods, including hydrocarbons, a contract creditor has at least two statutory tools at its disposal that should be considered in elevating the rights of a contract creditor in bankruptcy. First, reclamation rights, which are principally creatures of state law, give a contract creditor the right, upon notice of a counterparty's insolvency or bankruptcy, to reclaim goods sold within a pre-specified time period. Tex. Bus. & Comm. Code Ann. §2-702 (Vernon 2009); The Louisiana statute creates a vendor's lien that has been held to be analogous to a right of reclamation. La. Civ. Code Ann. arts. 3217(7) & 3227; *In re Hughes*, 9 B.R. 251, 255 (Bankr. W.D. La. 1981). Under the Bankruptcy Code, a reclamation creditor has twenty days after the bankruptcy case to give notice which, if given timely and properly, will afford the creditor a right to "reclaim" goods sold up to forty-five days prior to the bankruptcy case. 11 U.S.C. §546(c)(1). Sending notice of reclamation is not subject to the automatic stay, and, at a minimum, reclamation notice may give a creditor that has sold hydrocarbons to the debtor on an open account an ability to elevate its claim above general unsecured to administrative status, at least for goods delivered within the reclamation period. *In re Ames Dep't Stores, Inc.*, 582 F.3d 422, 424 (2d Cir. 2009); 11 U.S.C. §503(b)(9).

There is an issue regarding whether the Bankruptcy Code creates an independent right of reclamation for the reclamation claimant. *In re Dana Corp.*, 367 B.R. 409, 414 (Bankr. S.D.N.Y. 2007); *In re Tucker*, 329 B.R. 291, 298 n.8 (Bankr. D. AZ. 2005). However, in circumstances in which, for example, a seller has delivered hydrocarbons to a debtor within 45 days of the filing of a bankruptcy case, a reclamation notice is a relatively inexpensive strategy for potentially elevating the priority of the seller's claim in the buyer's bankruptcy case.

C. Twenty-Day Administrative Claims.

The so-called "twenty-day claim" is a right that is similar to the right of reclamation but arises exclusively out of the Bankruptcy Code for goods sold within twenty days of the bankruptcy case. 11 U.S.C. §546(c)(1)(B). The right to twenty-day claims was enacted as part of the recent 2005 Bankruptcy Code amendments ("BAPCPA"). A contract creditor is entitled to a twenty-day claim for goods delivered to the debtor within twenty days prior to bankruptcy. *Id.* In midstream cases in particular, twenty-day claims may become a very significant constituency because a prerequisite to confirmation of a plan of reorganization is to pay all administrative creditors in full on the effective date of any plan. 11 U.S.C. §1129(a)(9)(A).

For example, a producer that sold hydrocarbons to the debtor in the period leading up to the bankruptcy case will have an administrative claim with elevated priority for all hydrocarbons delivered in the twenty days prior to bankruptcy. If the buyer, now bankrupt, is to confirm a Chapter 11 plan, the buyer will have to demonstrate that it can pay the hydrocarbon seller's twenty-day administrative claim as of the effective date. 11 U.S.C. §1129(a)(9)(A).

As a condition to allowance of its twenty-day claim, the seller will have to prove that the debtor was in fact the transferee of the hydrocarbons sold and that the hydrocarbons were delivered within the twenty days prior to the bankruptcy case. 11 U.S.C. §1129(a)(9)(A). In addition, in some cases, an unintended consequence of the elevation of the twenty day claim to priority status is that the liquidity problem caused by the need to pay twenty-day claims on the effective date may, in fact, cause the Chapter 11 debtor to have problems emerging from bankruptcy. Thus, it is not out of the question that a twenty-day claimant may be asked to take a reduced distribution or an extended payout rather than face conversion of the bankruptcy case to a case under Chapter 7 of the Bankruptcy Code (which may result in an even greater discount in the distributions on account of even administrative creditors).

Nevertheless, there is no question that holding a twenty-day claim is a significant increase in leverage for a seller of hydrocarbons or other goods and a significant benefit to the contract counterparty in appropriate circumstances.

D. First Purchaser Statute.

Another possible strategy for elevating the claim of a seller of hydrocarbons is found in the so-called "first purchaser" statutes. Texas, for example, has implemented statutory schemes designed to protect sellers of hydrocarbons at the wellhead. Tex. Bus. & Com. Code Ann. §9.343 (Vernon 2009). In addition, hydrocarbon sellers have an array of trust funds and related theories to argue that they should have special rights or priorities in inventory, receivables or the proceeds of both upon the bankruptcy of a buyer and resulting default in the seller's obligations to pay for the goods in question. *Boyd v. Martin Exploration Co.* 56 B.R. 776 (Bankr. E.D. La. 1986); *In re Jones*, 77 B.R. 541, 549 (Bankr. N.D. Tex. 1987).

While these applicable state statutes often offer some protection for the seller of hydrocarbons, it should be noted that, in a recent case, when faced with weighing the relative rights of secured lenders with perfected security interests against the rights of parties that had sold hydrocarbons to the debtor prior to bankruptcy case, a Delaware bankruptcy court found in favor of the debtor's senior lender and, in the end, for the most part, the hydrocarbon sellers were treated as wholly unsecured creditors. *In re SemCrude, L.P.* (*Mull Drilling Co. v. SemCrude, L.P.*), 407 B.R. 82, 110 (Bankr. D. Del. 2009) (referred to herein as "*SemCrude* II").[8]

VI. Risk Management Strategies: Special Considerations.

A. Purchase and Sale Agreements.

While trading, operating agreements, and vendor contracts are most often impacted by bankruptcy, there are other agreements also impacted upon the bankruptcy of the counterparty in ways that should be taken into account up front. Purchase and sale agreements are one obvious example.

Prior to consummation, a purchase and sale agreement is almost certainly an executory contract subject to rejection by the bankrupt debtor. *See* 11 U.S.C. §365; *see, e.g., Butler v. Resident Care Innovation Corp.*, 241 B.R. 37, 45-6 (D. R.I. 1999) (finding the agreements at issue to be executory because the agreements remain substantially unperformed by both parties). But even after a transaction has been consummated, there may be claims that arise under the agreement that need to be taken into account once the debtor files bankruptcy.

In bankruptcy, a bar date for filing claims is typically set. 11 U.S.C. §§501, 502. If the creditor (contract or otherwise) with actual or constructive notice of the bar date does not file a claim by the bar date, the claim is generally lost. Fed. R. Bankr. P. 3002(c). Thus, when a party to a purchase and sale agreement has been given notice of the bankruptcy of a counterparty, consideration should be given to what, if any, ongoing claims may exist against the debtor. For example, there may be outstanding indemnity obligations or property abandonment claims that continue even after consummation of the transaction. Even if these contingent claims have not been liquidated, a counterparty holding such claims pursuant to a purchase and sale agreement should, at a minimum,

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8 The Court held that "a security interest perfected only in Kansas by virtue of [a Kansas statute] will be subordinate to a security interest that was duly perfected against the Debtors [by a mortgage holder] in the appropriate state." *SemCrude* II at 111.

file a claim in the bankruptcy case, even if that claim is contingent in nature. The Bankruptcy Code permits a bankruptcy judge to estimate contingent claims in order that they may participate in distributions in a bankruptcy case. 11 U.S.C. §502(c); *Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 957 (2d Cir. 1993). Accordingly, a proof of claim should be filed under these circumstances or the contract creditor will risk the loss of the claim forever.

B. Farmouts and Production Payments.

In addition, both farmout agreements and production payments are the subject of a special set of rules in bankruptcy. 11 U.S.C. §541(b)(4). The Bankruptcy Code contains a safe harbor for both the farmee and the holder of a production payment in the circumstances spelled out by the Bankruptcy Code. *Id.* If a farmout falls within the bankruptcy safe harbor, then even a rejection of the farmout agreement (as an executory contract) will not impact the rights of the farmee, at least in respect of any interest that had been earned as of the petition date. *See In re Resource Technology Corp.*, 254 B.R. 215, 222 n.2 (Bankr. N.D. Ill. 2000). Moreover, the holder of a production payment, under the circumstances described in the statute, is subject to its own safe harbor and, unlike the holder of a secured claim, cannot be crammed down in the bankruptcy case.

The distinction between the holder of a separate property interest (like a production payee or farmee under a farmout agreement) and a secured creditor is a crucial distinction in bankruptcy. A separate property interest, for the most part, is not subject to the jurisdiction of the bankruptcy court and, therefore, is not subject to being taken away or modified in bankruptcy. 11 U.S.C. §541; *but see* 11 U.S.C. §363(f) (permitting bankruptcy trustee to force a sale of a co-owner's interest along with the debtor's interest in property). In contrast, if a contract counterparty is merely a secured creditor, the counterparty's property interest is subject to the increased risk of impact from the bankruptcy case, including a bankruptcy court: (i) permitting a debtor to use the proceeds or revenues from the collateral over the objection of the secured creditor pursuant to Bankruptcy Code section 363(c)(2) and/or (ii) forcing, through a plan of reorganization, a modification of repayment terms on the contract counterparty. 11 U.S.C. §1129(b) (setting out the statutory requirements to effect a "cramdown").

Thus, if a counterparty is choosing, for example, between a conveyance of a production payment or a claim that is secured by a claim on property of the estate, in many cases, the former is preferable because the production payment should, for the most part, "pass through" the bankruptcy case with a reduced risk of impairment of its pre-bankruptcy contractual rights.

VII. Risk Management Strategies: Affirmative Liability.

In addition to impacting a contract creditor's rights and remedies upon default, as previously discussed, a contract counterparty's bankruptcy case may result in the risk of avoidance liability. There are, however, strategies which a contract creditor may utilize to reduce or mitigate those risks.

A. Preference Exposure.

There are a number of strategies available to mitigate the risk that the contract counterparty will be forced through a preference action to repay amounts received prepetition. One of the latchkey elements of a preference claim is that it is a payment on account of an "antecedent debt". 11 U.S.C. §547(b). Accordingly, a true prepayment, or cash on delivery of goods, should not be susceptible to being avoided as a preference because such amount was not paid on account of an antecedent (*i.e.*, preexisting) debt. *See In re Fritz-Mair Mfg. Co.*, 16 B.R. 417, 420 (Bankr. N.D. Tex. 1982); *see also In re Southmark Corp.*, 62 F.3d 104, 107 (5th Cir. 1995).

However, in managing the credit risk of a counterparty, if a creditor wishes to implement true prepayment or cash-on-delivery credit terms, the creditor should take care to ensure that the amount is received in advance of any obligation arising pursuant to the agreement in question. If the creditor does not take care to implement a strict system to enforce its credit terms, the creditor may be "caught in the middle" if the failing counterparty files for bankruptcy because any payment received after an obligation arises pursuant to the applicable agreement might be subject to recovery as a preference action. 11 U.S.C. §547(b). There is often the temptation to relax credit standards in response to business considerations. However, if that occurs, and a "pre-payment" is received after the obligation is incurred, the contract creditor faces not only the risk of non-payment in the event of a bankruptcy case, but the risk that the contract creditor may have to return some or all of the amounts paid to that creditor during the ninety day run-up to bankruptcy. *See, e.g., In re SGSM Acquisition Co., LLC*, 439 F.3d 233, 239 (5th Cir. 2006); *In re Intercontinental Polymers, Inc.*, 359 B.R. 868, 881-82 (Bankr. E.D. Tenn. 2005).

A second commonly-employed defense to a preference action is the "ordinary course of business defense." Pursuant to section 547(c)(2) of the Bankruptcy Code, a debtor cannot avoid a transfer to the extent that such transfer was

- in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; and

- such transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee; or
- such transfer was made according to ordinary business terms.

Accordingly, if the timing and manner of payment to a contract counterparty during the preference period is the same or similar as it has been in the run-up to bankruptcy, it may be possible to deflect any liability to a debtor or trustee in bankruptcy. The availability of this defense underlies the need to closely monitor any attempt to avoid preference liability by implementing prepayment credit terms or obtaining security. For example, if a counterparty that is nearing bankruptcy changes course and begins to prepay invoices (rather than pay on invoice terms), that change in the pattern of payment will likely undermine the availability of the ordinary course of business defense. *See, e.g., In re Hechinger Inv. Co. of Delaware, Inc.*, 489 F.3d 568, 577 (3d Cir. 2007) (changes in credit terms just prior to bankruptcy resulted in a finding that the payments were not made in the ordinary course).

Thus, the contract counterparty should take care to make certain that any prepayments are actually delivered in advance of the incurrence of liability under the agreement. 11 U.S.C. §547(b); *see also In re SGSM Acquisition Co., LLC*, 439 F.3d 233, 239 (5th Cir. 2006). If the contract counterparty does not remain vigilant, and if a prepayment is actually received after liability has been incurred, then the contract counterparty will both undermine the ordinary course of business defense and any ability to contend that such an amount was not paid on account of an antecedent debt.

The bottom line is that careful attention needs to be paid to managing a credit relationship, particularly with a financially troubled counterparty. If credit terms requiring prepayment or cash-on-delivery are imposed on a counterparty, the enforcement of those terms should be closely monitored or the risk to the contract creditor may be increased, not decreased.

In addition, to be a preference, a payment or transfer must enable a recipient to "receive more than in a Chapter 7 liquidation." 11 U.S.C. §547(b)(5). This standard means that if an otherwise unsecured creditor receives payment in full on account of an antecedent debt during the preference period, and, once bankruptcy is filed, unsecured creditors are paid only a percentage of their claims (which is typical), that creditor is at risk of having to pay back the payment amount as a preference. This standard also means that a party which is a secured creditor probably does not have preference exposure, at least to the extent of the value of the collateral at the time the payment is made. *In re El Paso Refinery, LP*, 171 F.3d 249, 253-54 (5th Cir. 1999).

Accordingly, the avoidance of a preference liability is another reason to consider asking for security for the obligations of an insolvent or potentially insolvent counterparty. Not only will such security help ensure that any distribution from a bankruptcy case is greater than it would be if the claim were wholly unsecured, it will also help avoid or minimize preference liability on the part of the contract counterparty. It should be noted, however, that a transfer of security on account of an otherwise unsecured claim during the preference period is a transfer that is subject to being set aside as preferential. *See, e.g.*, *In re Compton Corp.*, 831 F.2d 586, 590-91 (5th Cir. 1987) (extension of letter of credit to preexisting debt was subject to review as potential preferential transfer). So a request for, and receipt of, security may also subject the recipient of the security to preference liability.

Yet, the fact that a payment or transfer of security may later be avoided is not the reason to decline any such offer of payment or transfer of security. The payee or transferee of a security interest is almost certainly better off having received the payment or security interest than it would be otherwise, even if such transferee or payee takes on additional avoidance risks.

B. Fraudulent Conveyance.

The foregoing illustrates that a contract counterparty takes on a built-in risk in dealing with a bankrupt counterparty that can be managed but cannot be entirely avoided. This is true whether or not the contract creditor has a pre-existing claim against a potential debtor or is engaged in a transaction with the debtor. In the latter case, the contract party should consider the risk of entering into and engaging in a transaction with a counterparty that maybe in the vicinity of bankruptcy, even if credit is never extended under the agreement. In particular, a purchase of assets from an entity that is insolvent or nearly insolvent brings with it certain inherent risks which cannot be deflected in the absence of bankruptcy. Under Section 548 of the Bankruptcy Code, a transfer that occurred within two years prior to bankruptcy may be avoided if the debtor received less than "reasonably equivalent value" in exchange for the transfer. 11 U.S.C. §548(a)(1); *In re TransTexas Gas Corp.*, 2010 WL 447323, Nos. 08-20401 & 08-41128, *4 (5th Cir. Feb. 10, 2010). As a result, even after a transaction closes, if the seller later files bankruptcy, the trustee or debtor-in-bankruptcy may seek to set aside the transfer of assets as a fraudulent conveyance. This risk is particularly exacerbated in the oil and gas arena where assets, by their very nature, may have speculative value. Where a buyer has drilling success, it may be easy for the debtor or trustee, with the benefit of hindsight, to contend that the debtor was underpaid for the value of assets purchased from the debtor prior to bankruptcy.

As a result, fraudulent conveyance risk will exist for virtually any transaction with a bankrupt or near bankrupt buyer or seller. Completing a transaction in accordance with the terms of an agreement between the parties will not bind the debtor, trustee or a bankruptcy court to the deal in a subsequent bankruptcy proceeding. 11 U.S.C. §548(a)(1); *see, e.g., In re EBC I, Inc.*, 356 B.R. 631, 640 (Bankr. D. Del. 2006) (citing *In re R.M.L., Inc.*, 92 F.3d 139, 148 (3d Cir. 1996) for the proposition that a transfer may be fraudulent even if it is made in accordance with the terms of a contract between the parties). A third-party appraisal obtained at the time of the transaction, however, may help rebut an assertion that the debtor received less than reasonably equivalent value. *In re WRT Energy Corp.*, 282 B.R. 343 (Bankr. W.D. La. 2001). Nevertheless, the issue of whether the transaction was a fraudulent conveyance may well present a fact question and the risk of a lawsuit in a subsequent bankruptcy case.

For that reason, a buyer considering a transaction with a bankrupt or near- bankrupt business may even condition completion of the transaction on the seller filing bankruptcy and receiving a court order under Section 363 of the Bankruptcy Code approving the transaction. The benefit of such an order is that it will ensure the buyer is not subject to future avoidance risks. The downside, however, of such a condition is that, once the debtor has filed bankruptcy, there is no assurance that the transaction will take place. Once a bankruptcy case is filed, the debtor often will be required to expose the assets to the market and, if a buyer at a higher price emerges, it is likely that the original transaction will not be lost. Fed. R. Bankr. P. 2002(a)(2), (c)(1) and 6004; *see also In re Gulf Coast Oil Corp.*, 404 B.R. 407, 424 (Bankr. S.D. Tex. 2009) ("The principal justification for §363(b) sales is that aggressive marketing in an active market assures that the estate will receive maximum benefit. Established public auction markets provide the best assurance of full value at any given time. The absence of any market is problematic."). Accordingly, a buyer that proposes to buy assets from a bankrupt or near-bankrupt counterparty must weigh the risk of avoidance, if the transaction closes outside of bankruptcy, against the risk that, if the transaction is conditioned upon filing a bankruptcy case and receiving a court order, that the transaction will be lost to a competing buyer that materializes in the bankruptcy case.

Conclusion

The risk of bankruptcy or insolvency by a contract counterparty is ever present. However, by considering those risks and implementing strategies to mitigate and manage those risks (both inside and outside of bankruptcy), contract creditors can better protect themselves, insulate their businesses and minimize the deleterious impact of a contract counterparty's bankruptcy.