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Minimizing Counterparty Bankruptcy Risk

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Mitchell E. Ayer[*]

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INTRODUCTION[1]

In 2014, price shocks sent waves of financial distress throughout the oil and gas industry, as the price of crude oil plummeted from a high of $100.36/bbl in June to a low of $31.62/bbl by the beginning of February.[2] This drop in prices hit many American producers especially hard because a growing share of production in the United States has been sourced from "unconventional" deposits with limited permeability, which involve higher production costs relative to traditional sources of petroleum.[3] Consequently, there is growing concern over bankruptcy in the industry, with prices continuing to be suppressed over a year after their initial fall.[4]

[1] This Article is based on a presentation by our firm at the 2014 Texas Bench Bar Conference titled "Today's Oil and Gas Market: Managing and Mitigating Bankruptcy Risk." David M. Bennett, Today's Oil and Gas Market: Managing and Mitigating Bankruptcy Risks (2014) (unpublished manuscript), *available at* http://www.tklaw.com/files/Publication/6bd977c5-ad04-4a0a-a4a3-575e4dd4b242/Presentation/PublicationAttachment/ab5898d2-0fca-455f-a285-5ab58228cd3e/Today's%20Oil%20and%20Gas%20Market%3B%20Managing%20and%20Mitigating%20Bankruptcy%20Risks.pdf.

[2] *Crude Oil*, NASDAQ, http://www.nasdaq.com/markets/crude-oil.aspx (last visited Feb. 2, 2016).

[3] Ed Crooks, *US Shale Industry Braced for Bankruptcy*, FIN. TIMES (Sept. 6, 2015, 1:37 PM), www.ft.com/cms/s/0/5974a3ce-52e0-11e5-b029-b9d50a74fd14.html#axzz3wSuE689J; *see also* Jennifer Cruz, Peter W. Smith & Sara Stanely, *The Marcellus Shale Gas Boom in Pennsylvania: Employment and Wage Trends* (U.S. Bureau of Statistics Monthly Labor Report, Feb. 2014); U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-12-732, OIL AND GAS: INFORMATION ON SHALE RESOURCES, DEVELOPMENT, AND ENVIRONMENTAL AND PUBLIC HEALTH RISKS (2012).

[4] Crooks, *supra* note 3.

The recent price shock illustrates just one of the many threats to parties in an industry characterized by pervasive risk.[5] From natural disasters to human error, risk events may cause firms in the oil and gas industry to incur debilitating costs that render them insolvent. As a result, the threat of counterparty insolvency is always looming for parties to oil and gas contracts.

Due to the omnipresent threat of counterparty insolvency, parties should actively manage counterparty credit risk. Long-term credit risk management in oil and gas contracts is challenging because production in some fields lasts many decades and a contract counterparty may change completely or suffer financial reverses. Accordingly, such long-term contracts should be written with the view that one's counterparty will evade its debts and will be the subject of bankruptcy proceedings.

Although the institution of bankruptcy proceedings normally suggests that many creditors will not be satisfied in full, there are a number of strategies that a party to an oil and gas contract can employ to increase its chances of satisfaction. These strategies should be considered before a potential party enters into an agreement. That party may consider a range of factors before determining whether to employ a particular strategy, especially the type of contractual relationship under consideration.

This Article addresses five major contract relationships and furnishes advice to protect clients or companies in the event of bankruptcy. These relatively simple and inexpensive steps can save millions of dollars and protect clients and companies from the draconian "strong arm" powers given to a trustee or debtor-in-possession in bankruptcy.[6]

Part I of this Article discusses the treatment of claims in bankruptcy proceedings generally as well as the significance of a creditor's unsecured claims in particular, providing background information for discussions of the consequences of bankruptcy for specific contractual relationships. Parts II through VI discuss the consequences of bankruptcy for parties to sales contracts for oil and gas production, joint operating agreements, oil and gas leases, purchase and sale agreements, and farmout agreements, respectively, as well as furnish relevant, practical strategies. Part VII discusses a final strategy that can be applied to various types of relationships—"Bad Boy" guaranties. This Article concludes with a summary of advice for protecting a party to oil and gas contracts from the consequences of counterparty credit risk.

[5] *See generally* ROBERTA BIGLIANI, REDUCING RISKS IN OIL AND GAS OPERATIONS (2013), *available at* http://www.emc.com/collateral/analyst-reports/minimizing-operational-risk-in-oil-gas-industry.pdf.

[6] *See* 11 U.S.C. § 544 (2014).

I. PRIORITY OF "CLAIMS" IN BANKRUPTCY

The practical advice presented in this Article are responses to the treatment of "claims" in bankruptcy proceedings. Under the Bankruptcy Code, a "claim" is essentially defined as a "right to payment" or a "right to an equitable remedy for breach of performance if such breach gives rise to a right to payment."[7] A claim is treated differently depending on its classification under the Bankruptcy Code, including whether it is, among other things, secured or unsecured.[8]

The treatment of an unsecured claim in bankruptcy proceedings shows the importance of obtaining adequate security from a potential bankruptcy debtor. A claim is unsecured to the extent that the creditor has failed to obtain a valid lien or security interest to secure the value of the debtor's obligation to the creditor.[9] In most cases, such claims will be practically worthless because there will be few assets of the debtor remaining after all higher priority claims are satisfied.[10]

Claims are satisfied in accordance with a priority scheme provided by the Bankruptcy Code as supplemented by relevant state law.[11] The goal is to be at the top of the food chain, which is basically delineated as follows:

1. Owners are at the top because an ownership interest passes through bankruptcy.[12] It is best to own mineral interests or real property interests such as production payment, relinquished interest, working interest, or farmout interest.
2. Covenants running with the land are next. If the obligations can be characterized as covenant running with the land, the majority view is the counterparty cannot the reject contract in bankruptcy.
3. Generally, secured creditors (lien creditors) are entitled to the value of their collateral.
4. Administrative Claims (super-priority or general administrative) (20 day claims) are fourth.
5. Unsecured Claims (priority or general unsecured) fall into the fifth position.
6. Equity Interests (preferred or common) come last.

[7] *Id.* § 101(5).
[8] *Id.* § 507.
[9] *See id.* § 506(a)(1).
[10] DAVID G. EPSTEIN, BANKRUPTCY AND RELATED LAW IN A NUTSHELL 186 (8th ed. 2013).
[11] 11 U.S.C. § 507.
[12] *See id.* § 507.

As this list makes clear, a secured creditor is in a more advantageous position than an unsecured creditor and, thus, is more likely to have its claims satisfied. Consequently, one way to manage counterparty credit risk is by securing the obligations of potential debtors on the front end. However, the mechanics of and issues surrounding securing a claim varies depending on the type of contractual relationship under consideration.

II. Sales Contracts For Oil and Gas Production

One type of contractual relationship that may be threatened by bankruptcy proceedings is a sales contract for oil and gas production. When oil and gas production is sold on credit without a security agreement to secure the purchase price, the seller will bear significant risk of nonpayment if the purchaser declares bankruptcy, as the seller will have a mere unsecured claim.[13] As a result, it is important for the seller to obtain an attached and perfected security interest—or some other right—in collateral to guarantee payment by purchasers. This observation is important for both producers selling to first purchasers and first purchasers selling to downstream purchasers.

In practice, oil and gas production is frequently bought and sold by various parties before it reaches the end consumer. After producers extract the oil or gas, first purchasers typically buy the oil or gas at the wellhead from local tanks located on the leased premises, or at nearby market centers. First purchasers often—particularly in the case of oil—transport the products for temporary storage before reselling to downstream purchasers, such as refiners or commodities traders. Consequently, each party involved in the various transactions is paid on a different timeline, resulting in open balances between parties at different points of the process.

The timeline for payment under oil and gas sales contracts depends on the nature of the interests involved. Producers are customarily paid by first purchasers on either the 20th day or 25th day of each month for oil or gas produced in the previous calendar month. Thus, producers have essentially extended credit for 50 to 56 days of production.[14] First purchasers are then paid by downstream purchasers pursuant to the terms of their respective agreements. The multiple parties involved with the production and shipment of oil or gas results in competing interests.

Due to competing interests, sellers and lenders should timely perfect security interests or liens in the oil and gas sold to outrank other creditors

[13] *See id.* § 506(a)(1).

[14] For example, SemCrude filed bankruptcy on the 20th day of the month to maximize its cash, which resulted in maximum losses to its sellers.

who may have interests in the same collateral. Although some of these interests are brought about by specific clauses in the contract, others may arise by operation of law.

Following bankruptcies of Basin, Inc., Brio Petroleum, Inc., Compton Petroleum Corp., and Gratex Corp. in 1982, several states enacted statutory producers' liens.[15] Texas,[16] Oklahoma,[17] New Mexico,[18] Kansas,[19] and North Dakota[20] have enacted statutes that grant royalty owners, producers, and other oil and gas interest owners a statutory security lien to secure payment of the purchase price for that production.[21] Importantly, certain states allow these security interests to be treated as purchase money security interests ("PMSI").[22] A PMSI is a security interest or claim on property that enables a lender or provider of goods on credit who provides financing for the acquisition of goods or equipment to obtain priority ranking ahead of other secured creditors.[23] Because the producer is the one actually furnishing the goods—in this case the oil or gas—it is logical that a producer have a PMSI-like lien in such goods and the proceeds of their sale. Before a party may take advantage of the super priority of such producers' liens, however, those liens must be made effective against third parties.

Some states provide for producers' liens that are not automatically perfected and involve certain temporal limitations. For example, to perfect and maintain the New Mexico producers' lien, the interest owners must file a Notice of Lien (similar to notices that are needed to perfect statutory

[15] *See generally* Terry I. Cross, *Oil and Gas Product Liens—Statutory Security Interests for Producers and Royalty Owners Under the Statutes of Kansas, New Mexico, Oklahoma, Texas and Wyoming*, 50 CONSUMER FIN. L. Q. REP. 418 (1996).

[16] TEX. BUS. & COM. CODE ANN. § 9.343 (West 2011).

[17] OKLA. STAT. ANN. tit. 52, §§ 549.1, 549.3 (West 2011).

[18] N.M. STAT. ANN. §§ 48-9-1, 48-9-3 (West 2003).

[19] KAN. STAT. ANN. § 84-9-339a (West 2008). Interest owners in Kansas are required to file an "affidavit of production" in the register of deeds of the county where the oil and gas is produced to perfect the security interest. *Id.* § 84-9-339a(b). Like Texas, the security interest in and lien on produced oil and gas is treated as a PMSI for purposes of determining priority relative to other Article 9 security interests. *Id.* § 84-9-339a(h).

[20] N.D. CENT. CODE ANN. § 35-37-02 (West 2008).

[21] Mississippi grants a lien to royalty owners to secure the payment of the royalty proceeds. *See* MISS. CODE ANN. § 53-3-41 (West 2014). Unlike the other liens, however, a producer who is not also a royalty owner would not be protected. *Id.*

[22] *See supra* notes 16, 19.

[23] TEX. BUS. & COM. CODE ANN. § 9.103 (West 2011).

mechanics liens) "after fifteen days and within forty-five days after payment is due by terms of agreement."[24] The lien terminates if the notice is not timely filed, and if timely filed, the lien expires one year after the date of the filing of the notice unless an action to enforce the lien is begun.[25] North Dakota's Oil and Gas Owner's Lien Act[26] is similar to New Mexico's. North Dakota's Oil and Gas Owner's Lien Act grants interest owners a continuing security interest in and lien on unpaid oil or gas until the purchase price has been paid to the interest owner.[27] To perfect the security interest on oil and gas, producers are required to file a UCC-1A in North Dakota's central indexing system, record the lien in the real estate records in the county in which the well is located, and provide other interest owners with a copy of the notice of the lien by registered mail.[28] The security interest must be perfected within 90 days from the date of production; otherwise the security interest will not have priority over other security interests in the same oil or gas.[29]

Other states provide for producers' liens that are "automatically" perfected.[30] For example, under the Texas producers' lien statute, a security interest "is perfected automatically without the filing of a financing statement."[31] Specifically, the statute provides that "[i]f the interest of the secured party is evidenced by a deed, mineral deed, reservation in either, oil or gas lease, assignment, or any other such record recorded in the real property records of a county clerk, that record is effective as a filed financing statement."[32]

Even in states that allow automatic perfection, producers may receive better treatment if they also file a UCC-1. For example, while the Texas producers' lien is automatically perfected under the Texas statute,[33] the bankruptcy court for the District of Delaware held that a producers' lien was subordinate to a contractual secured lender's lien because the Texas producer had not filed a UCC-1 in the state of incorporation of the purchaser of the production before the contractual secured lender's lien.[34]

[24] N.M. STAT. ANN. § 48-9-5 (West 2003).

[25] *Id.*

[26] N.D. CENT. CODE ANN. §§ 35-37-01 to 06 (West 2008 & Supp. 2015).

[27] *Id.* § 35-37-02.

[28] *Id.* § 35-37-04.

[29] *Id.*

[30] *See* TEX. BUS. & COM. CODE ANN. § 9.343 (West 2011); OKLA. STAT. ANN. tit. 52, § 549.1 (West 2011).

[31] TEX. BUS. & COM. CODE ANN. § 9.343(b).

[32] *Id.*

[33] *Id.*

[34] Samson Res. Co. v. SemCrude, L.P. (*In re* SemCrude, L.P.), 407 B.R. 140, 158 (Bankr. D. Del. 2009).

The lower priority resulted in the loss of approximately $57 million to the Texas owner's interest in the oil and gas proceeds.[35] Thus, to ensure the best priority for the Texas producers' lien, producers who are selling on credit should file a UCC-1 in the state of incorporation of the first purchaser of the production rather than rely solely on automatic perfection.[36] A recent check of UCC records shows this advice is not being followed. But the lessons learned from bankruptcies of large purchasers such as Enron and Semcrude show that it needs to be done regardless of the size or reputation of the purchaser of production. A protective UCC preserving possibly millions of dollars in liens can be filed at a relatively nominal cost.[37]

Assuming that the security interest is timely perfected, then the security interest and lien takes priority over the rights of persons whose rights or claims arise afterwards, but may not take priority over the security interest and liens previously created and perfected.[38]

The Oklahoma legislature amended the producers' lien statute in an attempt to ensure both automatic perfection and first priority to producer lienholders following the *Semcrude* decision.[39] The Oklahoma statute purports to grant producers an automatically perfected lien that has first priority over other competing Article 9 security interests even if the competing interests are first-in-time.[40] The sole exception to this grant of

[35] *Id.*; Victor Chiu & Penelope Christophorou, Presentation, *Joint Meeting of the UCC Committee and the Commercial Finance Committee* (Aug. 1, 2009), *available at* https://apps.americanbar.org/buslaw/committees/CL710000pub/materials/2009/annual/semgroup-bankruptcy.pdf.

[36] Note that filing a protective UCC might not guarantee the producer is senior to a lender. Because the producers' lien was a non-standard UCC provision and no UCC-1 was filed, the court did not need to address the issue of priority based on date of filing, which might give the bank another argument if it filed first. If a producer does not file a UCC, however, the secured lender will win. As of January 2016, the producers are still appealing their treatment to the Second Circuit. As long as there is any question, the better practice is to file a protective UCC.

[37] For example, in Delaware, Capitol Services charges $125 to file a UCC-1, plus cost of any paralegal time, and a state charge of $2 per page in excess of four pages. If the same purchaser is in multiple states with statutory liens, it can file one UCC for multiple states.

[38] N.D. CENT. CODE ANN. § 35-37-01 (West 2008).

[39] *See* Sahar Jooshani, *There's a New Act in Town: How the Oklahoma Oil and Gas Owners' Lien Act of 2010 Strengthens the Position of Oklahoma Interest Owners*, 63 OKLA. L. REV. 133, 142 (2012). The Texas legislature did not address the *Sumcrude* problem.

[40] OKLA. STAT. ANN. tit. 52, § 549.7 (West 2011).

priority is a permitted lien.[41] A "permitted lien" under the Oklahoma statute is a "validly perfected and enforceable lien created by statute or by rule or regulation of a governmental agency for storage or transportation charges . . . owed by a first purchaser in relation to oil or gas originally purchased under an agreement to sell."[42] Thus, a permitted lien is a narrow exception to the otherwise broad superior priority granted in favor of first sellers of production by the Oklahoma producers' lien statute. Although the Oklahoma legislature purportedly addressed the *Semcrude* problem, until courts decide the legislative fix worked, the better practice is to file a protective UCC-1.

In summary, perfecting producers' liens should be on a marketing checklist because when in bankruptcy, the failure to properly perfect producers' liens in accordance with the specific jurisdiction's statute poses a risk of significant loss to producers as a result of lower priority.[43] A producer's inability to recover amounts owed because of lower priority and the ensuring lower recovery as an unsecured creditor is a real threat to an otherwise sound contractual relationship is one of many risks that unprepared parties face as a result of a bankruptcy proceeding.

III. JOINT OPERATING AGREEMENTS

A second type of contractual relationship that may be threatened by bankruptcy proceedings is a joint operating agreement ("JOA"). A JOA is an "agreement between or among interested parties for the operation of a tract or leasehold for oil, gas and other minerals," by which "[t]he parties to the agreement share in the expenses of the operations and in the proceeds of development."[44] It is important to note that "the agreement normally is not intended to affect the ownership of the minerals or the rights to produce," and, thus, the JOA does not create a separate entity distinct from the working interest owners who are parties to the agreement.[45] Consequently, working interest owners must include provisions in the JOA that allocate drilling and production risks among themselves. This allocation of risks may be disturbed if one of the working interest owners is the subject of bankruptcy proceedings. Accordingly, as this Part will show, a party to a JOA should

[41] *Id.*

[42] *Id.* § 549.2(11)(b).

[43] For the importance of checklists in every business endeavor, this Author recommends the very interesting, best-selling book, ATUL GAWANDE, THE CHECKLIST MANIFESTO (2011).

[44] PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS, OIL AND GAS LAW, § 8-J (LexisNexis 2014).

[45] *Id.*

protect against working interest owner credit risk by obtaining and perfecting a security interest or a party to the JOA may also have protection through setoff and recoupment.

A. Mitigating Credit Risk by Obtaining and Perfecting a Security Interest or Lien

One way to mitigate working interest owner credit risk under a JOA is by obtaining and perfecting a lien or security interest in oil and gas leases, personal property, or fixtures, as are specifically set forth in the Model Form Operating Agreement. Without a perfected lien or security interest, a party to the JOA will have a mere unsecured claim for another working interest owner's share of production and drilling costs under the agreement.[46] Thus, to protect itself to the greatest extent possible, a party to the JOA should make sure its interest is both adequately perfected and of maximum value.

1. Avoiding Common Pitfalls When Perfecting a Security Interest or Lien

The importance of an adequately perfected security interest or lien for securing a counterparty's obligations under a JOA should not be underestimated. Remember that no matter how stellar the counterparty is today, documents should be drafted and security interests perfected under the assumption that the interest will either be assigned to a persistent debt evader or the counterparty's new management will worsen. 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.[47] Due to the limited resources available to repay creditors, pre-bankruptcy general unsecured claims and open-account debts often are paid either pennies on the dollar or not at all. Given this present-tense risk of non-payment or non-performance by the counterparty, the risk that the counterparty will become bankrupt should be considered from the beginning of the contractual relationship. Obtaining a lien or security interest to secure a claim under a contract is a first line of defense. The steps required to

[46] 11 U.S.C. §507(3) (2014).

[47] 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. *See* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 636 (2008) (approximately 30% to 50% of Chapter 11 cases filed confirm plans).

perfect the liens and security interests available to secure different oil and gas contracts, however, will vary with the nature of the contract, and a party must seek to avoid common pitfalls to ensure its security interest or lien is effective against third persons and trustees in bankruptcy.

a. Failure to Perfect a Security Interest or Lien

A common pitfall associated with obtaining a security interest or lien is failing to perfect that interest before the institution of bankruptcy proceedings. A lien or security interest only provides protection in bankruptcy if it is timely and properly perfected.[48] Although—in the absence of bankruptcy—properly attached security interests and lien rights are enforceable by the creditor or the lienholder against the debtor,[49] once bankruptcy is filed, in most cases, an unperfected lien or security interest is of little or no value.

Unperfected liens and security interests are of little or no value because a debtor in bankruptcy has sweeping "strong arm" powers that permit the trustee to avoid unperfected liens or security interests.[50] Once an unperfected lien or security interest is avoided, the creditor will be left as a general unsecured creditor down the bankruptcy payment waterfall with a reduced recovery, if any.[51] This result cannot be cured after the institution of bankruptcy proceedings. Upon the filing of a bankruptcy case, the automatic stay prevents a holder of an unperfected lien or security interest from perfecting such interest.[52] Thus, after the petition date, the holder of an unperfected contractual lien or security interest holder in most cases will have little recourse other than its rights as an unsecured creditor.

b. Perfecting a Security Interest or Lien Against the Wrong Counterparty

Another all-too-common mistake, particularly with oil and gas assets for which record title may be a complex issue, is to obtain and perfect a lien or a security interest against the wrong entity. Corporate formalities

[48] 11 U.S.C. § 544.

[49] First Cmty. Bank v. E.M. Williams & Sons, Inc. (*In re* E.M. Williams & Sons, Inc.), No. 08-3055-KRH, 2009 WL 2211727, at *2 n.6 (Bankr. E.D. Va. July 17, 2009); *In re* Kwan Hun Baek, 240 B.R. 633, 635 (Bankr. M.D. Fla. 1999).

[50] *See, e.g.*, Knostman v. W. Loop Sav. Ass'n (*In re* Newman), 993 F.2d 90 (5th Cir. 1993).

[51] *See* 11 U.S.C. § 507.

[52] *Id.* § 362(a)(4) (staying any act to create, perfect, or enforce any lien). But it should be noted that holders of inchoate mechanics liens that incept before bankruptcy may file an affidavit or other such filing to perfect such interest.

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.[53]

While affiliated debtors may frequently be jointly administered in bankruptcy, substantive consolidation—treating separate debtors as a single distributive pool—is the exception rather than the rule.[54] In the absence of substantive consolidation of all the debtors, an undertaking that was originally given by an entity that did not actually hold an interest in the property will typically mean that the purported lien or security interest is treated as a nullity and that the holder of the security agreement is a general unsecured creditor in the bankruptcy case. Thus, it is crucial for the counterparty seeking to establish secured status in a bankruptcy case to ensure that the lien or security interest is obtained from, and perfected against, the record owner of the property.

A financing statement that fails to sufficiently provide the debtor's name could be "seriously misleading," and therefore not effective to perfect a security interest. For example, in *In re Tyringham Holdings, Inc. v. Suna Brothers, Inc.*, a relatively minor error voided the security interest.[55] Suna filed a UCC-1 financing statement to perfect its security interest in consigned goods under Article 9.[56] The debtor's name, as contained in Virginia's records, was "Tyringham Holdings, Inc.," but Suna's financing statement listed the debtor's name only as "Tyringham Holdings."[57] The bankruptcy court held that the financing statement was seriously misleading because the search logic used by the state of incorporation considered "Inc." a significant and necessary word.[58] Therefore, it is imperative to name the proper entity when perfecting a security interest or lien against a counterparty.

c. Failure to Perfect a Security Interest or Lien as Soon as Possible

A final common pitfall associated with obtaining security interests or liens concerns the timing of the perfection of that interest. 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 for

[53] *In re* Fernandes, 346 B.R. 521, 522 (Bankr. D. Nev. 2006).

[54] Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (*In re* Babcock & Wilcox Co.), 250 F.3d 955, 958 (5th Cir. 2001); *In re* Las Torres Dev., L.L.C., 413 B.R. 687, 693 (Bankr. S.D. Tex. 2009).

[55] Tyringham Holdings, Inc. v. Suna Bros., Inc. (*In re* Tyringham Holdings, Inc.), 354 B.R. 363, 365 (Bankr. E.D. Va. 2006).

[56] *Id.*

[57] *Id.* at 366.

[58] *Id.* at 368.

two reasons. First, 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 90 days of perfection.[59] Second, the lien or security interest only has value to the extent that the value of the underlying property exceeds the amount of any prior liens against the same property.[60] Because the priority of a lien or security interest often is based upon first to file, value that otherwise could be captured in a bankruptcy case often is lost by a delay in perfection and resultant loss of priority to intervening liens.[61]

In an age of highly-leveraged companies and mezzanine lending, it is important to consider the impact of modern financing practices on the value of contractual liens for junior secured creditors. If, for example, the lien of the secured financier is recorded in advance of the recordation of a JOA, which has an imbedded reciprocal lien among the parties to the JOA upon the filing of a bankruptcy case, the lien in favor of the secured financier may consume all the available value and leave the counterparty to the JOA with a wholly unsecured claim. This reality of modern finance highlights the need to record and perfect a lien or security interest as soon as possible to ensure the highest priority possible upon the filing of a bankruptcy case.

In short, to maximize value to a secured creditor once bankruptcy is filed, a lien or security interest should be perfected against the correct counterparty contemporaneously with the attachment of the security interest or lien. But the manner of attachment and perfection will vary with the type of lien and applicable state law.

2. Perfecting Oil and Gas Liens

JOAs give rise to credit risk for all of the working interest owners that are parties to the agreements, both operators and non-operators. 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

[59] Bergner v. Bank One, Milwaukee N.A. (*In re* P.A. Bergner & Co. Holding Co.), 187 B.R. 964, 983 (Bankr. E.D. Wis. 1995).

[60] United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989); Fin. Sec. Assurance Inc. v. T-H New Orleans L.P. (*In re* T-H New Orleans L.P.), 116 F.3d 790, 800 (5th Cir. 1997) (holding junior lienholders only have a secured claim if value of collateral exceeds senior liens).

[61] *See* TEX. BUS. & COM. CODE ANN. § 9.322(a)(1) (West 2011); U.C.C. § 9-322 (2010).

the non-operator. Operators, on the other hand, typically market hydrocarbons on behalf of non-operators before paying the non-operators. As a result, the non-operators often take 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.

To reduce this risk, the terms of JOAs often include reciprocal contractual liens to secure the performance of a counterparty. For example, Section VII.B of the A.A.P.L. Form 610-1989 Model Form Operating Agreement, which is one of the most commonly used forms of operating agreements, includes a reciprocal contractual lien and security interest in both current and future acquired real property located within the "Contract Area," and a security interest in the currently-owned and after-acquired personal property and fixtures related to the real property.

The manner of perfecting the lien and security interest in a JOA will vary with applicable state law. To ensure the enforceability and priority of such liens and security interests in the underlying oil and gas interests, the parties must perfect these interests by executing, acknowledging, and recording a memorandum of the operating agreement in the appropriate land records of the county or counties where the lands are located.[62] If a Contract Area under an operating agreement is located in two or more counties, parties should record the memorandum in all applicable counties.

[62] *See, e.g.*, Amarex, Inc. v. El Paso Natural Gas Co., 772 P.2d 905, 906 (Okla. 1987) ("The operator's lien created by the A.A.P.L. Form 610–1977 Model Form Operating Agreement is a contractual lien. In order to perfect such a contractual lien against a working interest owner's real property rights, an operator must file an operating agreement in the land records of the county or counties where the lands are located. Such an instrument must be executed, attested and acknowledged in accordance with the statutory formalities found in Title 16 of the Oklahoma Statutes."); Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 908 (Tex. 1982) (reference to an operating agreement in the chain of title placed competing interests on notice of the operating agreement); LA. REV. STAT. ANN. § 31:217 (Supp. 2015) ("In lieu of filing an [operating] agreement as provided in R.S. 31:216, the parties thereto may file a declaration signed by them, or signed by any person designated in the agreement as the general operator or agent of the parties, describing the lands affected by the mineral rights that are the subject of the agreement, stating in general terms the nature or import of the agreement, and stating where the agreement may be found. The recording officer of the parish in which the declaration is filed may copy into his records only the declaration, without the exhibit attached thereto. The declaration when so filed shall serve as full and complete notice of the agreement to the same extent as if the original agreement had been filed and recorded.").

To perfect in personality, parties must file a UCC-1 with the Secretary of State of the operating agreement counterparty's state of incorporation.[63]

In some states such as North Dakota, the working interest owners rely upon the forced pooling order to allocate expenses and risk penalties and often do not enter into an operating agreement. If the working interest owners do enter into an operating agreement, the agreement merely supplements the forced pooling order. Any liens granted in forced pooling orders need to be perfected in accordance with state law. For example, in addition to any contractual lien, Oklahoma grants operators of pooled units a statutory lien on participating interests in the unit to secure the costs of operation.[64] These liens may be perfected by filing a land-record filing that shows the unit approval and the participation of particular leases or interests.[65]

B. Mitigating Risk Through Setoff and Recoupment

Another way to mitigate working interest owner credit risk under a JOA is through setoff and recoupment. In many cases, counterparties to oil and gas agreements will have reciprocal payables and receivables owed and owing to each other. For example, a producer that has entered into a gathering agreement—in which hydrocarbons produced at the well head are physically sold to the gatherer—may simultaneously have both an obligation to pay for ongoing gathering services (an account payable) and a right to be paid for hydrocarbons that are being continuously purchased by the gatherer (an account receivable). This scenario may create a right of setoff in the context of bankruptcy proceedings.[66]

A right of setoff is analogous to a security interest[67] and arises where counterparties have reciprocal debts and obligations.[68] In some circumstances,

[63] Arrow Oil & Gas, Inc. v. SemCrude, L.P. (*In re* SemCrude, L.P.), 407 B.R. 112, 136 (Bankr. D. Del. 2009).

[64] *See* OKLA. STAT. ANN. tit. 52, § 287.8 (2011) (voluntary pooled unit liens); *Id.* § 87.1(e) (2011 & Supp. 2015) (forced pooled unit liens).

[65] *See* TCINA, Inc. v. NOCO Inv. Co., 95 P.3d 193, 195 (Okla. Civ. App. 2004) (interpreting operator's liens that arise under Oklahoma Statutes title 52, section 287.8); *see also* GasRock Capital, L.L.C. v. EnDevCo Eureka, L.L.C., 313 P.3d 1028, 1034–35 (Okla. Civ. App. 2013) (holding that an operator's lien subject to Oklahoma Statutes title 52, section 287.8 was perfected by the land-record filing of a notice of approval of the unit and that it was "inconsequential" when drilling services were performed).

[66] *See* 11 U.S.C. § 553 (2014).

[67] The right to offset is termed the right to "setoff" in the Bankruptcy Code. *See* 11 U.S.C. § 553(a); *In re* Supreme Beef Processors, Inc., 391 F.3d 629, 636 (5th Cir. 2004).

[68] *See* 11 U.S.C. § 553.

accounts payable and accounts receivable may be set off against each other.[69] In bankruptcy, parties can offset "mutual" debts—debts between the same parties standing in the same capacity—that arose prior to the commencement of the bankruptcy case.[70] The Bankruptcy Code does not create this right of setoff; it merely preserves setoff rights created under applicable non-bankruptcy law and then only to the extent that the conditions of section 553 have been satisfied.[71]

The threshold determination in every case involving section 553 is the source of the alleged setoff right. Recognizing the right of setoff in bankruptcy often allows the creditor holding the right to recover a greater percentage of its claim than other creditors who have no setoff entitlement.[72] The automatic stay, however, prevents a contract counterparty from offsetting an account payable against an account receivable without modification of the automatic stay.[73]

A related contractual risk-mitigation principle is recoupment. Setoff applies to mutual debts between the same parties standing in the same capacity but does not require that the debts arise out of the same agreement. Recoupment, on the other hand, is the netting of obligations within or among the same agreement.[74] Thus, recoupment is more narrowly applied.[75] But

[69] *See id.*

[70] *See id.* § 553(a); Braniff Airways, Inc. v. Exxon Co., U.S.A, 814 F.2d 1030, 1036 (5th Cir. 1987) (mutuality requirement for setoff was met because the debt was incurred prepetition); Sherman v. First City Bank of Dall. (*In re* United Sciences of Am., Inc.), 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); Cohen v. Sav. Building & Loan Co. (*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); Davidovich v. Welton (*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 he did not meet the "mutuality" requirement).

[71] Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 18–19 (1995); N.Y. State Elec. & Gas Co. v. McMahon (*In re* McMahon), 129 F.3d 93, 96 (2d Cir. 1997); Stephenson v. Salisbury (*In re* Coreland Corp.), 967 F.2d 1069, 1076 (5th Cir. 1992).

[72] *See* Cumberland Glass Mfg. Co. v. De Witt, 237 U.S. 447, 455 (1915).

[73] Szymanski v. Wachovia Bank, N.A. (*In re* Szymanski), 413 B.R. 232, 240 (Bankr. E.D. Pa. 2009).

[74] Holford v. Powers (*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).

[75] Recently, some courts have applied recoupment even more narrowly. *See, e.g.*, Sacramento Mun. Util. Dist. v. Mirant Ams. Energy Mktg., LP (*In re* Mirant Corp.), 318 B.R. 377, 381 (Bankr. N.D. Tex. 2004) (holding that recoupment

recoupment is not subject to the automatic stay.[76] Several courts have applied the doctrine of recoupment and lifted the automatic stay, to the extent necessary, to allow an operator to exercise its rights against a non-operator pursuant to a JOA.[77] Therefore, 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.

IV. TREATMENT OF EXECUTORY CONTRACTS AND OIL AND GAS LEASES

A third type of contractual relationship that could be threatened by bankruptcy proceedings is a mineral lease. Because a mineral lease involves ongoing rights and obligations, there may be a concern that the lease might be held to be an "executory contract" or "unexpired lease" under the Bankruptcy Code. Counterparty credit risk may be drastically different depending on whether a contract qualifies as an "executory contract" or an "unexpired lease" under the Bankruptcy Code. In particular, debtors may reject executory contracts and unexpired "true" leases, in which case the other party may be left with a mere unsecured claim for damages.[78]

A. Characterization of Oil and Gas Leases

The nature of the rights created or conveyed by an agreement is a matter of non-bankruptcy law.[79] Although the majority of oil and gas contracts—for example, operating agreements, participation agreements, area of mutual interest agreements, development agreements, take-or-pay contracts, etc.—are executory contracts governed by section 365 of the

should be narrowly applied and that an "overpayment or something like it" such as "harm to a creditor or benefit to a debtor in excess of that contemplated by the Code" must be shown to justify recoupment).

[76] *In re Holford*, 896 F.2d at 179; *In re* McWilliams, 384 B.R. 728, 729 (Bankr. D.N.J. 2008).

[77] *See, e.g.*, Sec. Pac. Nat'l Bank v. Enstar Petroleum Co. (*In re* Buttes Res. Co.), 89 B.R. 613, 617 (Bankr. S.D. Tex. 1988) (holding that an operator could recoup production costs advanced before the petition from pre- and post-petition proceeds payments owed to the non-operator debtor); Garmers Union Cent. Exch., Inc. v. Sec. Pac. Nat'l Bank (*In re* Buttes Gas & Oil), 72 B.R. 236 (Bankr. S.D. Tex. 1987) (holding that the doctrine of recoupment applied where the operator's right to reimbursement for costs and the non-operator's right to proceeds arose from a JOA).

[78] 11 U.S.C. § 365 (2014).

[79] Butner v. United States, 440 U.S. 48 (1979) (the Bankruptcy Code does not create or define property interests but leaves that for state law or for applicable non-bankruptcy law).

Bankruptcy Code,[80] the nature of a mineral lease varies among different jurisdictions.

In almost all hydrocarbon producing states, an oil, gas, or mineral lease conveys a real property interest to the lessee.[81] Thus, for the most part, an oil and gas lease creates a presently vested interest in real property that is not subject to section 365 of the Bankruptcy Code.[82] Even if a debtor–lessor were able to reject an oil and gas lease in bankruptcy, section 365 of the Bankruptcy Code allows the lessee to retain its rights under the lease for the term of the lease and any extensions.[83]

The Bureau of Ocean Energy Management ("BOEM") and the Bureau of Safety and Environmental Enforcement ("BSEE") of the Department of Interior ("DOI"), however, have stated that the apparent position of the United States government is that a federal lease is subject to rejection under section 365.[84] The DOI reasons that federal leases are governed by federal, rather than state, law and are subject to disposition under sections 365 and 541 of the Bankruptcy Code based on the plain language of the Outer Continental Shelf Lands Act ("OCSLA"), which includes the statement that OCS leases are "rental agreements to use real property."[85]

[80] *See, e.g.*, *In re* Wilson, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987).

[81] *See, e.g.*, Foothills Tex., Inc., v. MTGLQ Investors, L.P. (*In re:* Foothills Tex., Inc.), 476 B.R. 143 (Bankr. D. Del. 2012); *In re* WRT Energy Corp., 202 B.R. 579 (Bankr. W.D. La. 1996); *In re* Frederick Petroleum Corp., 98 B.R. 762 (S.D. Ohio 1989); *In re* Hanson Oil Co., 97 B.R. 468 (Bankr. S.D. Ill. 1989).

[82] Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A., 195 B.R. 66, 70–73 (S.D. Tex. 1966); *In re WRT Energy Corp.*, 202 B.R. at 583; *In re Frederick Petroleum*, 98 B.R. at 767; *In re* Clark Res., 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986).

[83] 11 U.S.C. § 365(h)(1)(A)(ii).

[84] *See, e.g.*, United States' Motion to Intervene, NGP Capital Res. Co. v. ATP Oil & Gas Corp., No. 12-36187, Adv. No. 12-03443 (Bankr. S.D. Tex. 2012) [Dkt No. 13] ("[A] Federal Lease is, pursuant to its enabling statutes, a 'rental agreement to use real property' subject to section 365 of the Bankruptcy Code."). "On October 1, 2011, the Bureau of Ocean Energy Management, Regulation and Enforcement (BOEMRE), formerly the Minerals Management Service (MMS), was replaced by the Bureau of Ocean Energy Management (BOEM) and the Bureau of Safety and Environmental Enforcement (BSEE) as part of a major reorganization." *Reorganization of the Bureau of Ocean Energy Management, Regulation and Enforcement*, BUREAU OF OCEAN ENERGY MGMT., REG. & ENFORCEMENT, http://www.boemre.gov/ (last visited Jan. 6, 2015).

[85] *See* Frontier Energy, LLC v. Aurora Energy, Ltd. (*In re* Aurora Oil & Gas Corp.), 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010) (quoting 11 U.S.C. § 365(m)).

Although many cases have addressed the issue of whether a mineral lease is a true lease or an executory contract under section 365,[86] none have considered this issue with respect to a federal OCS lease. Nonetheless, it is typical for the OCS and other governmental agencies to take the position that government oil and gas leases are not conveyances of an interest in real property and are, in fact, subject to section 365 of the Bankruptcy Code.[87]

B. Assumption and Assignment of Oil and Gas Leases

A debtor may, subject to court approval, assume and assign executor contracts and unexpired leases. Anti-alienation provisions that limit or prohibit the assignment of a contract or lease, however, are unenforceable in bankruptcy.[88] Therefore, a debtor for the most part has the power to assign a contract or lease without the consent of contract counterparties, which would be required in the absence of bankruptcy. 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.[89]

While a debtor decides whether to assume or reject an executory contract or unexpired lease, the non-debtor party must continue to perform under the contract.[90] During this "gap period," the non-debtor party will bear the risk and uncertainty that results from not knowing whether the contract will be rejected, assumed, or assumed and assigned.[91] Particularly with "core contracts" that are central to a producer's business, the uncertainty surrounding whether such an agreement will be assumed or rejected and whether the counterparty will have sufficient capital to meet its ongoing obligations thereunder can layer on enormous additional risks for capital-intensive projects. In certain circumstances, a creditor may seek

[86] *See, e.g.*, Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A., 195 B.R. 66, 70 (Bankr. S.D. Tex. 1996) (showing that Texas has determined that mineral lease is not an executor contract under section 365).

[87] United States' Motion to Intervene, *supra* note 84; Response of the United States to Trustee's Motion for Determination, Sonoma Energy Corp., No. 08-34430-H4-7 (Bankr. S.D. Tex.) [Dkt. No. 116].

[88] 11 U.S.C. § 365(f).

[89] *See, e.g.*, *In re* Wilson, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987).

[90] NLRB v. Bildisco & Bildisco, 465 U.S. 513, 532 (1984).

[91] *See* Mitchell E. Ayer, *Common Issues in Oil and Gas Bankruptcy*, 34 ENERGY & MIN. L. INST. 239, 243–46 (2013).

to reduce this uncertainty by seeking to shorten the time period for a debtor to assume or reject an agreement.[92]

In addition, as more Chapter 11 cases culminate in sales of the debtors' assets, debtors—often at the behest of prospective buyers—often link the sale of assets pursuant to section 363 (through a plan of reorganization or otherwise) to assumption and assignment of contracts pursuant to section 365.[93] Assumption and assignment of an executory contract or unexpired lease requires notice to the non-debtor party and a showing, among other things that: (1) any defaults pursuant to the contract sought to be assigned have or will be cured as a condition to such assignment, and (2) there is "adequate assurance of future performance" under the terms of the contract on the part of prospective assignee.[94] As sales of all or a portion of the debtors' assets continue to be a preferred exit strategy for Chapter 11 debtors, contract counterparties must take care to track bankruptcy cases for developments that could impact their rights.[95]

V. PURCHASE AND SALE AGREEMENTS

Another type of contractual relationship that may be threatened by bankruptcy proceedings is a purchase and sale agreement ("PSA"). A PSA typically does not immediately transfer ownership. There is usually a period of time to conduct due diligence between the signing of the PSA and the closing.[96] Prior to consummation, a PSA is almost certainly an executory contract subject to rejection by the bankrupt debtor.[97] But even after a transaction has been consummated, there may be claims—such as

[92] 11 U.S.C. § 365(d)(2); Tex. Importing Co. v. Banco Popular de P.R., 360 F.2d 582, 583 (5th Cir. 1966). 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. *See* 11 U.S.C. § 365(d)(2).

[93] *See, e.g.*, *In re* Cano Petroleum, Inc., No. 12-31549, 2012 Bankr. LEXIS 3281 (Bankr. N.D. Tex. July 18, 2012).

[94] River Prod. Co. v. Webb (*In re* Topco, Inc.), 894 F.2d 727, 730 (5th Cir. 1990).

[95] *See* 11 U.S.C. § 365(b)(1)(B), (C).

[96] If the diligence is done in advance, the parties may have a transaction "sign and close" on the same day.

[97] *See* 11 U.S.C. § 365; Butler v. Resident Care Innovation Corp., 241 B.R. 37, 45–46 (Bankr. D. R.I. 1999) (finding the agreements at issue to be executory because the agreements remained substantially unperformed by both parties).

claims for indemnity—that arise under the agreement that need to be taken into account once the debtor enters bankruptcy.

Creditors arguably must file such contingent claims, which arise under fully consummated agreements, or risk losing them.[98] When a party to a PSA 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 on the part of the buyer—such as for plug and abandonment or other remediation liability—that continue long after consummation of the transaction. Even if these contingent claims have not been liquidated, the Bankruptcy Code in some circumstances permits estimation of these contingent claims in a manner that will permit such claimants to participate in distributions in a bankruptcy case.[99] Accordingly, a proof of claim should be filed under these circumstances or the creditor will risk the loss of the claim (contingent or not) forever.

VI. MITIGATING RISKS RELATED TO FARMOUTS AND PRODUCTION PAYMENTS

A final type of contractual relationship that may be threatened by bankruptcy proceedings is a farmout agreement. A farmout agreement is "a contract to assign oil and gas lease rights in certain acreage upon completion of drilling obligations and the performance of any other covenants and conditions therein contained."[100] Because this arrangement usually arises when a mineral lessee is unable to maintain its lease past the primary term and the lease is nearing expiration, the lessee will "farm out" its lease in exchange for an overriding royalty or carried interest.[101] Although this arrangement is technically an executory contract and would otherwise be subject to avoidance,[102] there are special rules regarding farmout agreements.

The Bankruptcy Code contains a special set of rules—or "safe harbor" provisions—for both the farmee and the holder of a production payment in circumstances spelled out by the Bankruptcy Code.[103] If a farmout falls within the bankruptcy safe harbor, then even a debtor's rejection of the farmout agreement as an executory contract will not impact the rights of the farmee, at least with respect to any interest that had been earned as of

[98] FED. R. BANKR. P. 3002(c).

[99] 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).

[100] PATRICK H. MARTIN & BRUCE M. KRAMER, OIL AND GAS 774 (9th ed. 2011).

[101] *Id.*

[102] *See id.*

[103] 11 U.S.C. § 541(b)(4).

the petition date.[104] Further, a production payment that meets the statutory definition is subject to its own safe harbor and is a property right separate and apart from the bankruptcy estate.[105]

The distinction between the holder of a separate property interest—like a production payee or farmee—and a secured creditor is a crucial distinction in bankruptcy. This is because a creditor's separate property interest, for the most part, is not subject to the jurisdiction of the bankruptcy court and, therefore, is not subject to being stripped or modified in bankruptcy.[106] In contrast, if a counterparty is merely a secured creditor, the counterparty's property interest is subject to the increased risk of impact, including a bankruptcy court: (1) 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), or (2) forcing, through a plan of reorganization pursuant to section 1129(b), a modification of repayment terms on the contract counterparty—for example, 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 "pass through" the bankruptcy case with a reduced risk of impairment.

VII. Include Bad Boy Guaranties in the "Credit Toolkit" When Conducting Oil and Gas Deals

Although some strategies are particular to the contractual relationship under consideration, others may apply more widely. One such example is the "Bad Boy" guaranty.

"Bad Boy" or "Springing Recourse" guaranties[107] have changed the face of real estate lending. In the 1980s, real estate developers would put their single asset properties with non-recourse mortgages into bankruptcy with the hope that keeping it in bankruptcy would allow them a chance to have rents or prices increase. This tactic increased the cost of lenders to foreclose. The mortgage lenders' response was to have the mortgage

[104] *See In re* Res. Tech. Corp., 254 B.R. 215, 222 n.2 (Bankr. N.D. Ill. 2000). The language of section 541(b)(4)(A) could also be read to insulate unearned acreage as of the petition date; however, no court has directly addressed such issue.

[105] 11 U.S.C. § 541(b)(4)(B).

[106] 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).

[107] Such guaranties are sometimes referred to as "non-recourse carveouts."

documents provide that the borrower and one or more guarantors will become liable for the *entire loan balance* if certain prohibited acts occurred. This clause is referred to as a springing recourse provision. Although traditional bad acts have been fraud, misappropriation of funds, willful misconduct, gross negligence, and unauthorized transfer of collateral, "bad acts" can also include the borrower's filing a bankruptcy petition.

By imposing personal liability on the guarantor who is usually in charge of the borrower, bad boy guaranties create a financial disincentive for the guarantor to cause or even permit the borrower to impede the lender's collateral enforcement action by filing a bankruptcy petition. The resulting liability for breach depends on negotiated terms. A bad boy guaranty can provide for consequential damages resulting for breach, full recourse liability, or anything in between.[108]

The courts that have looked at these provisions generally find that the lender protections are enforceable[109] and the non-recourse event need not be within the guarantor's control.[110]

Although widely used in real estate, "bad boy" guaranties are generally not seen in connection with oil and gas transactions.[111] But their use could be expanded to cover comparable non-recourse events, such as where the operator converts funds belonging to override owners, converts funds from production payment, or files bankruptcy and seeks to re-characterize

[108] Sebastian F.C. Kaufmann & Arthur J. Steinberg, *New Decisions Offer Lessons on Bad Boy Guaranties*, N.Y.L.J., Mar. 12, 2012, at 1, *available at* http://www.kslaw.com/imageserver/kspublic/library/publication/2012articles/3-12nyljsteinbergkaufman.pdf. Courts have upheld these guaranties.

[109] *See, e.g.*, Heller Fin. Inc. v. Lee, No. 01 C 6798, 2002 WL 1888591 (N.D. Ill., Aug. 16, 2002) (holding that a hotel was encumbered with liens without lender's prior written consent and enforcing the non-recourse carve-out clause for loan obligations for breach of loan covenants); LaSalle Bank N.A. v. Mobile Hotel Props., LLC, 367 F. Supp. 2d 1022 (E.D. La. 2004) (enforcing the non-recourse carve-out clause when the borrower amended its articles of incorporation so that it was no longer a single purpose entity); Blue Hills Office Park LLC v. J.P. Morgan Chase Bank, 477 F. Supp. 2d 366 (D. Mass. 2007) (enforcing a springing guaranty for personal liability for the full amount of indebtedness against two real estate developers that failed to disclose or pay over to the lender a $2 million settlement related to a commercial development dispute); 111 Debt Acquisition Inc. v. Six Ventures, Ltd., No. C2-08-768, 2009 WL 414181 (S.D. Ohio, Feb 18, 2009) (springing guaranty enforced against guarantors when borrower filed for bankruptcy).

[110] Michigan, Non-Recourse Mortgage Loan Act, MICH. COMP. LAWS ANN. §§ 445.1591 to 445.1595 (West Supp. 2015); Ohio, Legacy Trust Act, OHIO REV. CODE ANN. § 5816.01 to 5816.14 (West 2007 & Supp. 2015), have passed laws limiting the use of bad boy guaranties.

[111] This Author has seen individual guaranties when an investor was putting in 100% of funds and the geologist was contributing expertise and leases.

production payments or overrides. This type of conduct was certainly not contemplated by the parties. It is beyond the scope of this Article to delineate the scope of such guaranties or the litany of conduct that could be prevented, but this is something that should be in the credit toolkit.

VIII. MITIGATING REGULATORY RISKS

When a debtor's property includes interests in unproductive oil or gas wells, the debtor may seek to abandon such interest to relieve the estate of burdensome liabilities pursuant to Bankruptcy Code section 554.[112] Therefore, the issue often arises as to whether a debtor may exercise its "abandonment" power to abandon property burdened by regulatory obligations.

There are several state or federal obligations that may arise at the end of an oil or gas well's useful life.[113] Such obligations include the "plugging" of the well and removal of facilities from the site, and are defined as "plugging and abandonment" ("P&A") or "decommissioning activities" pursuant to federal regulations.[114] Further, to protect the United States from incurring a financial loss, the DOI has instituted a bonding program for federal lands. Before the DOI will issue a new lease or approve the assignment of an existing lease, the lessee or designated operator is required to obtain a surety bond guaranteeing performance of all contractual and regulatory obligations under that lease.[115]

Courts have generally held that a debtor's abandonment power does not allow release from such obligations, finding that, under federal law, debtors must comply with state law.[116] Further, the Fifth Circuit Court of

[112] *See* 11 U.S.C. § 554 (allowing a debtor to abandon certain property of the estate that is burdensome to the estate or that is of inconsequential value to the estate).

[113] *See, e.g.*, TEX. NAT. RES. CODE ANN. § 89.011 (West 2010). Texas Natural Resources Code section 89.011 provides: "The operator of a well shall properly plug the well when required and in accordance with the commission's rules that are in effect at the time of the plugging." *Id.* § 89.011(a).

[114] 30 C.F.R. §§ 250.1700 to 250.1754 (2015).

[115] 30 C.F.R. § 556.52. The United States requires supplemental bonds for costs associated with specific oil and gas facilities, abandonment and site clearance. *Id.*

[116] *See, e.g.*, Texas v. Lowe (*In re* H.L.S. Energy Co.), 151 F.3d 434, 437 (5th Cir. 1998) (citing 28 U.S.C. § 959(b); Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Prot., 474 U.S. 494, 507 (1986) (holding that a trustee may not abandon property in contravention of a state law reasonably designed to protect public health or safety)). *But see In re* Shore Co., 134 B.R. 572, 576 (Bankr. E.D. Tex. 1991) (holding that a violation of state and federal environmental laws must be

Appeals has held that P&A liabilities are entitled to administrative claim priority if the plugging obligations accrued post-petition under state law because the debtor cannot avoid such liability. Thus, the expenses are "necessary" and "beneficial" to the estate under an administrative claim analysis.[117]

Because P&A liability can be significant, particularly in the case of offshore wells, a provision for payment of P&A expenses can become a threshold issue in the administration or sale of oil and gas properties in offshore bankruptcy cases. In fact, because a bankrupt operator may seek to either transfer or cease operations on a lease, non-operators in the chain of title may need to intervene to ensure that the P&A liabilities—for which they may otherwise be financially responsible—are satisfied by the operator or assumed by any successor.

CONCLUSION

Oil and gas companies manage all types of risk—price risk, political risk, geological risk, etc. Credit risk, however, is often ignored. Given the large amount of money involved in oil and gas transactions, companies must have systems in place to protect their lien rights in sales and operating agreements. Likewise, when appropriate, transactions should be structured to employ the safe harbors of production payments and farmout agreements. This foresight and diligence will achieve the benefit of its bargain if the counterparty files bankruptcy.

coupled with a showing that the violation constitutes an imminent and identifiable harm to limit the trustee's powers of abandonment). Notably, in finding that the trustee was permitted to abandon the contaminated property, the *Shore* Court "place[d] great weight on the lack of activity on the part of a state agency charged with protecting the health and welfare of the people of the State of Texas." 134 B.R. at 579.

[117] *In re H.L.S. Energy Co.*, 151 F.3d at 437.