Texas Wesleyan Law Review

Volume 16 | Issue 1 Article 10

10-1-2009

Introduction to Bankruptcy Considerations for Oil and Gas Lawyers

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INTRODUCTION TO BANKRUPTCY CONSIDERATIONS FOR OIL AND GAS LAWYERS

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I. SUMMARY

The following paper is meant as a general introduction to bankruptcy considerations for non-bankruptcy attorneys in Texas. It is common for non-bankruptcy attorneys (and sometimes bankruptcy attorneys) to comment on the perceived counterintuitive nature of bankruptcy cases and the Bankruptcy Code. This may be due to the shifted responsibilities of the debtor as debtor-in-possession and the overall goal of *pro rata* distribution to creditors. Regardless, entry into the world of bankruptcy can be somewhat complicated and should be approached with care. This is especially true in the context of an oil and gas bankruptcy where the intersection of state property law and federal bankruptcy law is combined with multiple layers of creditor constituencies and interests.

This paper will focus on considerations within a chapter 11 corporate restructuring oil and gas case. These types of cases tend to be quite complex and any actions taken within such a case should be carefully considered. This is distinguished from a chapter 7 liquidation which, while not dissimilar, will have numerous material differences.

It should be reiterated that this is a small sample of issues that may arise in a chapter 11 corporate oil and gas case and factors to consider when weighing a client's legal options will vary substantially from case to case and even from time to time within a bankruptcy case and related proceedings.

II. IMMEDIATE CONSIDERATIONS AT THE TIME OF THE PETITION

A. *Brief Summary of Filing a Bankruptcy Petition*

When dealing with business entities, the two most common forms for bankruptcy protection sought are chapter 7 and 11 of the United States Bankruptcy Code (the Code).[1] A petition for relief under the Code (commonly called a "petition") is effective the moment of filing.[2] Among other effects of filing a petition, the bankruptcy estate is immediately created. This estate encompasses all property of the

1. *See generally* 11 U.S.C. § 101 (2006).

2. To initiate a bankruptcy case the only document necessary is the petition, however, to remain in bankruptcy the Code and Federal Rules of Bankruptcy Procedure (the "Rules") require the filing of various other documents and pleadings at various deadlines keyed, in some cases, from the date the petition was filed.

DOI: https://doi.org/10.37419/TWLR.V16.I1.8

debtor prior to bankruptcy and can be thought to function like a trust.[3] A trustee will administer the estate for the benefit of creditors. In the case of a chapter 11 filing, the pre-petition debtor will serve as trustee and in that capacity is known as the debtor-in-possession.[4]

Shortly after the petition is filed, the various forms of notice will begin to be provided to creditors.[5] Notice in bankruptcy is extremely important because substantive rights can be taken away in bankruptcy that might not otherwise be possible outside of bankruptcy so long as proper notice is provided.[6] Notice also plays a very important role in the context of creditor's claims, as discussed below.

B. *Property of the Estate*

Upon the entry of the order for relief under the Code, the debtor's property instantly becomes property of the estate.[7] Property of the estate is defined extremely broadly pursuant to section 541. Section 541 states that "[s]uch estate is comprised of all of the property, wherever located and by whomever held: (1) . . . all legal or equitable interests of the debtor in property as of the commencement of the case."[8] It is black letter law that section 541 is to be viewed extremely

3. In the case of an individual filing, such individual may claim certain assets as exempt and thus those assets will not be administered by the estate. This paper focuses on corporate entities so further discussion of individuals will not be undertaken.

4. It is very common for non-bankruptcy attorneys to confuse the various types of "trustees" in a bankruptcy case. In a chapter 7 filing, the debtor immediately loses control upon the filing and the estate is administered by a third party chapter 7 trustee. In a chapter 13, the standing chapter 13 trustee provides oversight and various other functions for all chapter 13 cases pending in the division. In chapter 11, if the debtor-in-possession is removed and the case is not converted to chapter 7 (or dismissed), then a third party chapter 11 trustee will be appointed to continue the business as a going concern or to facilitate a sale as a going concern. Finally, the Department of Justice appears regularly in bankruptcy court by way of the office of the United States Trustee, who could be said to police all bankruptcy cases filed in their respective jurisdictions.

5. All bankruptcy cases dockets are available on-line and most jurisdictions have a mandatory electronic filing order and automatic electronic notice. These facts combined with the fact that most mid to large size bankruptcies will, in the opening days, have hundreds of filings requiring notice. The non-bankruptcy attorney should be aware of the potential costs to clients when reviewing the filings.

6. *See* FED. R. BANKR. P. 2002.

7. 11 U.S.C. § 541 (2006). Not relevant to this discussion is the distinction between the filing of the petition and the entry of an order for relief which arises in the context of an involuntary bankruptcy. *See generally id.* § 303.

8. *Id.* § 541(a)(1). Property enters the estate "only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." *Id.* § 541(d). While this section is intended to remove property held in trust for the benefit of another from the estate, this section is often invoked by bankruptcy lawyers seeking to impose a constructive trust thereby removing that property from the estate. *See* Haber Oil Co. v. Swinehart (*In re* Haber Oil Co.), 12 F.3d 426, 431 (5th Cir. 1994) ("Just as medieval alchemists bent all their energies to discovering a formula that would transmute dross into gold, so too do modern creditors' lawyers spend prodigious amounts of time and effort seeking to convert their clients' general unsecured claims against a bankrupt debtor into some-

broadly. As a practical matter, one should err on the side of caution when considering whether property is property of a bankruptcy estate. In the absence of controlling federal bankruptcy law, the substantive nature of the property rights held by a bankrupt debtor and that property's relationship to the debtor's creditors is defined by state law.[9]

C. *Automatic Stay*

One of the various effects of filing a bankruptcy petition is the automatic stay.[10] This stay operates as an automatic injunction against a number of activities, not the least of them is any action to collect pre-petition debt or recover property of the estate from the debtor.[11] It cannot be overstressed how seriously bankruptcy courts view the automatic stay or any violation of the automatic stay. Once a creditor has notice of the bankruptcy, filing an action in contravention of section 362 will almost certainly be viewed as a violation of the automatic stay and expose that creditor (and his or her attorney) to stiff sanctions and other remedies including punitive damages.[12]

The automatic stay is in place to give the debtor "breathing room" and aid in its reorganization. However, simply because the debtor has filed for bankruptcy does not mean that the creditor will never see any return on its claim. A brief discussion of claims and the bankruptcy priority scheme will be helpful, and then the discussion will turn to asserting pre-petition claims against the debtor.

D. *Priority Scheme*

In bankruptcy pre-petition claims are generally separated into secured and unsecured claims. Determination of secured status is governed by section 506.[13] It is often helpful to think of bankruptcy priority as a waterfall scheme.[14] In that sense, unsecured creditors will

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thing more substantial."); *In re* Tex. Standard Oil Co., No. 08-34031-HDH-11, 2008 WL 5479114, at *5 (Bankr. N.D. Tex. Nov. 12, 2008).

9. It should be noted that "state law defining property rights may not, of course, go so far as to manipulate bankruptcy priorities." *Haber Oil Co.*, 12 F.3d at 435 (quoting Vineyard v. McKenzie (*In re* Quality Holstein Leasing), 752 F.2d 1009, 1014 n.10 (5th Cir. 1985)).

10. 11 U.S.C. § 362(a) (2006).

11. Wilson v. TXO Prod. Corp. (*In re Wilson*), 69 B.R. 960, 966 (Bankr. N.D. Tex. 1987) ("Postpetition operating expenses can be charged against postpetition production *only*."). Post petition operating expenses are generally given administrative expense priority. *See id.* One effect of this is the way operating expenses can be post petition. *See id.*

12. Gen. Homes Corp. v. Am. Sav. & Loan Ass'n of Fla. (*In re* Gen. Homes Corp.), 181 B.R. 870, 880 (Bankr. S.D. Tex. 1994). Also, even without notice of the stay, actions against a debtor's property based on a pre-petition claim are very likely voidable, but less likely to be sanctionable. *See id.*

13. 11 U.S.C. § 506 (2006).

14. *See id.* § 507.

not receive payment until secured creditors are addressed.[15] Several other layers of priorities are also part of the bankruptcy priority scheme. Those include pre-petition priority claims[16] as well as post petition administrative expenses.[17]

In terms of potential for payment, the best position a creditor can be in is that of the secured creditor. Assuming the interest is properly secured, such interest will not usually be disturbed in bankruptcy.[18] As a general rule, the property rights afforded by the state in which the bankruptcy was filed will govern within the bankruptcy case and any proceedings.[19]

On the other hand, a general unsecured creditor will find it very difficult to raise itself from its position at the bottom of the priority scheme. These debts are generally trade debt, but also can be certain types of employee compensation which may be granted priority status. In recent cases in the Fort Worth division, the court has held that "critical vendors" and certain employee wages and benefits arising pre-petition may be paid at the onset of the case notwithstanding the priority scheme and automatic stay.[20] Creditor attorneys should stay apprised of any new case because these "critical vendor motions" and "pre-petition employee wage motions" are often filed as "first day" motions.[21] Obviously, most unsecured trade creditors would like to be considered "critical vendors" and those creditors who are not a part of the critical vendor motion will want to ensure that all the estate money is not exhausted paying pre-petition claims.

E. *Filing Claims*

As a predicate matter, a claim in bankruptcy is defined very broadly.[22] Creditors with pre-petition claims will be entitled to assert

15. Pre-petition equity holders are below the unsecured creditors in the priority scheme. It is very common that pre-petition equity is wiped out at plan confirmation because unsecured claims would need to be paid in full (or consent) prior to any distribution to equity.

16. *See* 11 U.S.C. § 503(b)(9) (2006).

17. At times certain claims are granted "super priority" status, but that is beyond the scope of this paper.

18. 11 U.S.C. § 552 (2006).

19. Sandoz v. Bennett (*In re* Emerald Oil Co.), 807 F.2d 1234, 1237–38 (5th Cir. 1987); Wilson v. Parson (*In re* Jones), 77 B.R. 541, 544 (Bankr. N.D. Tex. 1987).

20. *In re* Tusa-Expo Holdings, Inc., No. 08-45057-DML-11, 2008 WL 4857954, at *1 (Bankr. N.D. Tex. Nov. 7, 2008).

21. *See infra* Part III.B.1–2.

22. *See* 11 U.S.C. § 101(5) (2006) ("The term 'claim' means—(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.").

that pre-petition claim in the form of a "Proof of Claim."[23] It is typical that a creditor will first see a proof of claim form contained along with the form "Notice of Bankruptcy and 341 Meeting" that is mailed to creditors.[24] A proof of claim, once properly filed, constitutes *prima facie* evidence of that claim's amount, priority, and secured/unsecured status.[25] However, the filing of a proof of claim also acts of consent to the jurisdiction of the bankruptcy court.[26]

The schedules filed by the debtor may reflect the claim of the creditor. Inclusion of a claim on the schedules may preserve the claim of that creditor but it is very common and a good idea to file an independent proof of claim.[27] This is true of all classes of creditors, including secured and unsecured creditors. The filing of a proof of claim will shift the burden back to the debtor to show that the claim is not valid as filed.[28] In the context of a secured creditor the proof of claim also serves to assert a value of the encumbered collateral.[29] This will become important in the context of valuation and cram down of the collateral. These considerations are beyond the scope of this paper; however, the portion of debt above the value of the collateral will generally be viewed as unsecured, with the remaining portion secured.[30] In an instance in which the secured creditor wants to retrieve its collateral or exercise state court remedies but is otherwise frustrated by the automatic stay, he will need to seek leave of the court to lift, condition, or modify the automatic stay.[31] These actions are commonly called "Lift Stay" motions.

F. *Lift Stay*

Section 362(d) provides a mechanism by which the secured creditor may lift, condition, or modify the stay injunction as to a particular

23. *Id.* § 501.

24. The "341 Meeting" gets its name from 11 U.S.C. § 341 which provides for a meeting between the debtor and the creditors of the estate–this meeting provides creditors an opportunity for the pre-petition creditors to face the debtor and ask questions of it regarding the bankruptcy and their claims. *See id.* § 341; *see also id.* § 343.

25. *See id.* § 502(a).

26. *See* Granfinanciera, S.A. v. Nordberg (*In re* Estate of Chase & Sanborn Corp.), 492 U.S. 33, 57–59 (1989); *but see* Mirant Corp. v. S. Co., 337 B.R. 107, 114–15 (N.D. Tex. 2006). The scope of a bankruptcy court's jurisdiction is somewhat technical, but to over simplify it, any actions arising under the Code or arising in or relating to a bankruptcy case or proceeding can be said to be within the jurisdiction of a bankruptcy court. *See* 28 U.S.C. §§ 157, 1334 (2006).

27. Even if a claim is included on the schedules it may be deemed contingent, disputed, and unliquidated by the debtor.

28. 11 U.S.C. § 502(a).

29. *See id.*

30. *Cf. id.* § 1111(b).

31. *See id.* § 362(d).

piece of collateral and seek remedies beyond that of a bankruptcy court.[32] Section 362(d) reads in part:

> (d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
>
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
>
> (2) with respect to a stay of an act against property under subsection (a) of this section, if—
>
> (A) the debtor does not have an equity in such property; and
>
> (B) such property is not necessary to an effective reorganization.[33]

In the context of an oil and gas bankruptcy, if any secured lender, operator asserting a lien, or lessor sought to take action against the debtor based on its secured status they would need to lift the stay to proceed.[34]

III. THE "FIRST DAY" MOTIONS

The term "First Day Motion" is a generic term used in bankruptcy cases to refer to pleadings that are generally filed at or very near the time the petition is filed. The relief requested in a First Day Motion is almost always sought on an expedited basis and courts will usually hear the motions on very little notice.[35]

The types of pleadings that may be filed as First Day Motions vary widely based on the type of company that is seeking relief as well as the financial situation of the debtor. Below is a general sampling of the type of pleadings that are filed as first day motions as well as a brief description of their purposes and other considerations.

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32. *Id.* § 362(d)(1)–(2). Any action enjoined by the automatic stay may be subject to a lift stay motion. *See id.*

33. *Id.*

34. It is typical that a form of operating agreement will contain a provision allowing a working interest owner to take his portion of gas "in kind." An argument could likely be made in good faith that the gas under the ground and removed at all times is the sole property of the non-bankruptcy working interest owner however, because the potential impact on a bankrupt working interest owner's bankruptcy case a motion to lift stay should be filed out of an abundance of caution if the non-bankrupt working interest owner seeks to take in kind.

35. The court in *Mirant Corporation* held a hearing on the First Day Motions the same day they were filed. *See In re* Mirant Corp., No. 03-46590-DML-11, 2003 WL 25574685, ¶ 4 (Bankr. N.D. Tex. Aug. 22, 2003). More recently, the court in *Pilgrim's Pride* held a hearing on the First Day Motions the day after filing. *See In re* Pilgrim's Pride Corp., No. 08-45664-DML-11, 2008 WL 5340224 (Bankr. N.D. Tex. Dec. 1, 2009) (see docket 38 for Dec. 2, 2008 order). These types of time frames for hearings on First Day Motions are not uncommon.

A. *Cash Collateral and DIP Financing*

The debtor's request to use cash collateral and to incur post-petition financing ("DIP Financing") is generally combined into one motion. Both of these types of relief are distinct under the Code, but because of their interrelationship in effect, they are often combined. These types of motions, and the relief requested tend to be very complicated so I will provide a brief overview.[36]

1. Cash Collateral

Immediately upon the filing of the bankruptcy petition the debtor may no longer use cash collateral (to the extent that cash collateral exists).[37] Under the Code pre-petition lenders are entitled, pursuant to section 361 and 363(e), to "adequate protection" before a debtor may use cash collateral.[38] Often adequate protection is replacement liens; however, this is a negotiated point and may vary from case to case.

Under section 363(c)(2) of the Code, a debtor may not use cash collateral unless "(A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use in accordance with the provisions of this section."[39]

2. DIP Financing

It is very common for chapter 11 debtors to seek post-petition financing either from its pre-petition lender or from another source. Incurring debt post-petition is governed by section 364.[40] Section 364(c) of the Code provides, among other things, that if a debtor is unable to obtain unsecured credit allowable as an administrative expense under 503(b)(1) of the Code, the court may authorize the debtor to obtain credit or incur debt (a) with priority over any and all

36. A recent addition to the Federal Rules of Bankruptcy Procedure limits the ability of a debtor to file certain types of first day motions less than 20 days from the filing of the petition. FED. R. BANKR. P. 6003. A review of Rule 6003 immediately reveals that the phrase "immediate and irreparable harm" takes on a key role. *Id.* Rule 6003 reads:

> "Except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding the following:
> (a) an application under Rule 2014;
> (b) a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition, but not a motion under Rule 4001; and
> (c) a motion to assume or assign an executory contract or unexpired lease in accordance with § 365." *Id.*

37. 11 U.S.C. § 363(c)(2) (2006).
38. *Id.* §§ 361, 363(e).
39. *Id.* § 363(c)(2).
40. *Id.* § 364.

administrative expenses as specified in section 503(b) or 507(b) of the Code, (b) secured by a lien on property of the estate that is not otherwise subject to a lien, or (c) secured by a junior lien on property of the estate that is subject to a lien.[41]

If the debtor is not able to obtain credit on an unsecured or junior secured basis (or secured as to a non-encumbered asset) the debtor may then seek to prime liens. Section 364(d) of the Code allows a debtor to obtain credit secured by a senior or equal lien on property of the estate that is subject to a prior existing lien, provided that (a) the debtor is unable to obtain such credit otherwise, and (b) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.[42] It is not uncommon for a debtor to seek, and a court to enter, an interim order on cash collateral and DIP Financing and contemporaneously to schedule a hearing on a final hearing.

B. *Critical Vendor Motion / Employee Wages*

Another type of First Day Motion that often combines relief or at least has related relief is the request by the debtor to pay pre-petition claims of unsecured trade creditors because they are "critical vendors" to the debtor and the debtor's request to pay outstanding pre-petition employee wages.

1. Critical Vendor Motion

The general rule in chapter 11 bankruptcy is that unsecured pre-petition claims cannot be paid prior to plan confirmation and distribution.[43] Based on a "doctrine of necessity" bankruptcy courts have created a carve-out from this rule to pay some of the debtor's vendors who are considered "critical" to the ongoing operations and thus must be paid so that the "critical vendor" will continue providing goods or services to the debtor post-petition.[44]

The underlying consideration with a critical vendor motion is that the debtor will need these critical vendors to maintain the ongoing value of the debtor. This same consideration is present in motions to pay pre-petition wages.

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41. *Id.* § 364(c).

42. *Id.* § 364(d).

43. *Id.* §§ 507, 549(a).

44. *In re* CEI Roofing, Inc., 315 B.R. 50, 59 (Bankr. N.D. Tex. 2004); *In re* CoServ, L.L.C., 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002); *In re* Mirant Corp., 296 B.R. 427, 429–30 (Bankr. N.D. Tex. 2003).

2. Employee Wage Motion

As an outgrowth of critical vendor motions, debtors will usually also seek to pay priority pre-petition wages of employees.[45] Simply put, courts recognize that employees who are not paid will often not remain at work and thus employees should be paid unpaid priority pre-petition wages in order to maintain business operations of the debtor.[46] Recently, in the Northern District of Texas, a court has issued an opinion regarding employee pre-petition wages holding that it would be an abuse of discretion to deny payment of unpaid pre-petition wages otherwise entitled to priority.[47]

C. *Applications to Employ*

Professionals to be employed at the expense of the estate must be approved by the bankruptcy court.[48] Such professionals include, *inter alia*, the debtor's counsel and other professionals, a committee's counsel and other professionals, and an ombudsman. For the purposes of a first day motion it is common to see an application to employ counsel for the debtor. Rule 6003 has created additional considerations with respect to retention of counsel.[49]

D. *Maintain Utility Service Motion*

Section 366 of the Code addresses utility service provided to the debtor. Section 366 prevents utility companies from altering, refusing, or discontinuing service to a debtor during the first 30 days for a chapter 11 case.[50] Pursuant to section 366(c)(2) of the Code, a utility may alter, refuse, or discontinue a chapter 11 debtor's utility service "if during the 30-day period beginning on the date of filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment of utility service that is satisfactory to the utility."[51] Chapter 11 debtors will often file a motion to maintain utility service and seek to impose a process to ensure that the utility receives satisfactory adequate assurance. Courts will deal with such a request in varying ways. In the Fort Worth Division, Judge Lynn has

45. *See* § 507(a)(4)–(5). The Code provides for limits on the amount of pre-petition wages which may be claimed as priority. *Id.*

46. *In re* Tusa-Expo Holdings, Inc., No. 08-45057-DML-11, 2008 WL 4857954, at *3 (Bankr. N.D. Tex. Nov. 7, 2008).

47. *Id.* at *1 ("[B]ecause there is no objection, the court believes it would be an abuse of discretion not to grant the payment of the priority prepetition wages within the statutory limit as described in the Motion.").

48. 11 U.S.C. §§ 327–28, 330 (2006).

49. *See* FED. R. BANKR. P. 6003.

50. 11 U.S.C. § 366(c)(2) (2006).

51. *Id.*

dealt with this issue recently in *In re Pilgrims Pride Corporation* and *In re Renaissance Hospital Grand Prairie, Inc.*[52]

E. *Reclamation Claims*

Section 546(c)(1) provides a right in some circumstance for a creditor to seek reclamation.[53] In addition, section 503(b)(9) has similar import.[54] Often debtors will file a motion to set up procedures to deal with reclamation claims. Creditors who may be subject to such a motion should consider the motion carefully as it will likely be specific to the case, as are most chapter 11 pleadings.

F. *Maintain Cash Management System*

A debtor's motion to maintain a cash management system is a debtor's attempt to continue operations of what may be a complex interrelationship of accounts. The debtor typically seeks this relief in order to be exempt from various requirements of the United States Trustee regarding accounts. It is not uncommon for such a motion to be granted, but that is not to say that a motion of this type will be granted as a matter of course.

IV. THE WORKING INTEREST OWNER RELATIONSHIP IN BANKRUPTCY

In terms of an oil and gas industry bankruptcy, those bankruptcies involving working interest owners tend to be the most complicated. This is due to the large amounts in question and the often complicated relationships between working interest owners—either operators or non-operators.

A. *Effect on Operations*

In a chapter 11 bankruptcy, the debtor-in-possession is authorized to operate its business in the ordinary course.[55] In a chapter 7 bankruptcy, the trustee is not permitted to operate the business except in certain limited situations and only after court permission.[56]

Another consideration when dealing with oil and gas is that the Code specifically carves out from the automatic stay governmental actions dealing with hazardous waste and a ". . . governmental unit's or organization's police and regulatory power . . . ."[57] The practical im-

52. *See* Mem. Order to Docket 51 at 1–2, *In re* Pilgrim's Pride Corp., 407 B.R. 211 (Bankr. N.D. Tex. 2009); Court Order I, *In re* Renaissance Hosp.-Grand Prairie, Inc., No. 08-43775-11, 2008 WL 5746904 (Bankr. N.D. Tex. Dec. 31, 2008).
53. 11 U.S.C. § 546(c)(1) (2006).
54. *Id.* § 503(b)(9).
55. *Id.* §§ 363(c)(1), 1108.
56. *Id.* § 721.
57. *See id.* § 362(b)(4).

pact of this provision is that, as a general rule, the Texas Railroad Commission may continue to police oil and gas wells in Texas and take related action. This would likely include shutting wells down for violations of, *inter alia*, Title 16 Part 1 of the Texas Administrative Code. An ancillary point to this is that the debtor must operate in conformity with the law.[58]

B. *The Operating Agreement*

Working interest owners among themselves and without another contractual relationship are simply co-tenants.[59] The common use of operating agreements gives rise to the necessity to discuss the treatment of executory contracts in bankruptcy. "An executory contract is one under which the parties' obligations to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[60]

In bankruptcy, an operating agreement is an executory contract subject to section 365.[61] Pursuant to section 365 the ". . . trustee [or debtor-in-possession as trustee], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[62] Until such time as the debtor-in-possession assumes or rejects an executory contract the non-debtor counter-party must continue to perform under the executory contract (*i.e.* the operating agreement) but the counter-party may not enforce the executory contract against the debtor-in-possession.[63]

An operating agreement is no different. An operating agreement is not enforceable against the debtor-in-possession until assumed, if

58. 28 U.S.C. § 959(b) (2006) ("(b) Except as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.").

59. Wilson v. Parson (*In re* Jones), 77 B.R. 541, 547 (Bankr. N.D. Tex. 1987) (citing Shaw & Estes v. Tex. Consol. Oils, 299 S.W.2d 307 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.) ("Under Texas law, the Debtor and the Investors, as owners of working interests, are co-tenants in the leases.")); Wilson v. TXO Prod. Corp. (*In re* Wilson), 69 B.R. 960, 964 (Bankr. N.D. Tex. 1987).

60. *Wilson*, 69 B.R. at 962 (Bankr. N.D. Tex 1987) (citing *In re* Sun Belt Elec. Constructors, Inc., 56 B.R. 686, 688 (Bankr. N.D Ga. 1986); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L.REV. 439, 458–62 (1973)).

61. *Wilson*, 69 B.R. at 963 ("As executory contracts, the operating agreements between [operator] and [debtor non-operating WIO] are subject to the provisions of 11 U.S.C. § 365 which govern the time for curing defaults.").

62. 11 U.S.C. § 365(a) (2006).

63. *See id.* § 365(c). The debtor-in-possession may also assume and assign an executory contract or unexpired lease under section 365. Additional considerations are present in order to be able to assign the executory contract or unexpired lease not discussed herein, but the requirements of assumption must typically first be met prior to assignment. *Id.*

ever.[64] In the context of an oil and gas case, this unique situation is at times referred to the "twilight zone" between assumption or rejection. In cases under chapter 11, there is no time frame (prior to confirmation) in which the debtor-in-possession must assume or reject an executory contract.[65] Even so, the debtor-in-possession may be compelled to assume *or* reject sooner upon motion by a counter-party.[66]

During the "twilight zone" the debtor will likely be treated as cotenant as to the other working interest owners.[67] This will include the time between the filing of the petition and the assumption or rejection of the contract.[68] In light of this situation, it very common to see requests for a "procedure order" in bankruptcy which will in some way define the relationship between the debtor and the other working interest owners if the debtor is the operator. Here again, a procedures order will be unique to each case.

A practical consideration is the effect of a form operating agreement's treatment of bankruptcy and an *ipso facto* clause. The model form operating agreement appears to recognize that *ipso facto* clauses are not enforceable in bankruptcy, but may discuss the effect of bankruptcy as a rejection or resignation as operator.[69] Creditor attorneys should be cautioned that attempting to enforce a provision purporting to reject the operating agreement or resignation by the debtor as operator would very likely be considered action against the estate in violation of the automatic stay.

C. *Interests in the Real Property of the Debtor*

It is well settled that an interest in a mineral lease is an interest in real property.[70] In bankruptcy, an encumbrance of an oil or gas interests will continue to exist subject to the right of the debtor-in-possession to exercise its strong-arm-power.[71] Section 544(a) of the Code provides the debtor-in-possession the ability to avoid certain unperfected pre-petition liens thereby relegating that purported secured claim to an unsecured claim.[72] Section 544(a) reads:

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64. *Wilson*, 69 B.R. at 965.

65. § 365(d)(2).

66. *Id.*

67. *Wilson*, 69 B.R. at 966 ("When there is no operating agreement between them, the law of co-tenancy governs their relationship.").

68. *Id.*

69. An *ipso facto* clause in a lease or contract is one which creates a breach upon the occurrence of, *inter alia,* bankruptcy or insolvency. Such a clause is not enforceable against the trustee or debtor-in-possession. *See* § 365(b)(2).

70. Phillips Petroleum Co. v. Adams, 513 F.2d 355, 363 (5th Cir. 1975); Onyx Ref. Co. v. Evans Prod. Corp., 182 F. Supp. 253, 256 (N.D. Tex. 1959); *Wilson*, 69 B.R. at 965; Jones v. Parson (*In re* Jones), 77 B.R. 541, 544–45 (Bankr. N.D. Tex. 1987).

71. *See* 11 U.S.C. § 544(a) (2006).

72. *Id.*

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
>
> (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or
>
> (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.[73]

The practical effect of this provision is that the debtor-in-possession takes the position of a judgment lien creditor under state law and may avoid most security interests not properly perfected pre-petition. In understanding this concept it is important to remember that the debtor-in-possession is usually considered to be a new entity as if created at the moment of the petition. In this way, the debtor-in-possession is presumed to be without any notice (if not properly filed constructive notice) even if the debtor's management (who are still in control) had actual knowledge of the pre-petition unperfected security interest.[74] Additionally, the bankruptcy court will not infer inquiry notice or equitable notice based on the debtor and non-debtor working interest owners being co-tenants.[75]

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73. *Id.*

74. *See id.*

75. *Jones*, 77 B.R. at 546–47 ("Possession by one co-tenant does not give notice of equitable rights as against another co-tenant."); *see also Wilson*, 69 B.R. at 964 (Bankr. N.D. Tex. 1987) ("In fact, possession consistent with record title does not constitute notice of an unrecorded claims."). In the *Wilson* case the creditors argued that it was customary for operator liens to be granted, and thus, the debtor in possession should be deemed to have notice. *Id.* The court rejected this argument, stating that, "Although, as [operator] asserts, the granting of a lien to an operator in an operating agreement may be customary in the oil industry, such customs do not constitute legally enforceable rights, nor do they give constructive notice to a prospective purchaser or attaching lien creditor." *Id.*

1. The Operator's Lien

Common in the industry are the cross liens between the various working interest owners against each other's interests. These are good examples of interests that must have been properly perfected prior to the petition date otherwise they will be exposed to avoidance pursuant to the strong-arm-provisions of the Code in the event a working interest owner files for bankruptcy.

Here again state law governs with regard to whether or not perfection is proper. It is worth noting that while the hydrocarbons are in the ground they are real property but once removed they will be viewed as personal property.[76] This distinction will have an effect in bankruptcy as a properly perfected interest in the real property hydrocarbons will not necessarily be properly perfected (and thus avoidable) once removed.[77] That being the case, perfection of an operator's lien to the extent seeking to perfect against the oil or gas produced should be perfected not only in the property records, but also in conformity with the UCC.[78]

2. M&M Liens

Mechanic's and materialmen's liens (M&M Liens) are an area of considerable litigation within bankruptcy due in part to the trustee's strong-arm-powers. A full discussion of the issues which arise in bankruptcy is not contained herein; rather an overview of some of the issues of perfection and avoidance will be discussed.

Section 362(b)(3) provides, *inter alia*, that actions taken to perfect a security interest pursuant to section 546(b) are not subject to the automatic stay.[79] Section 546(b)(1)(A), in turn, reads "(b)(1) The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that – (A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection . . . ."[80] The interplay of these two sections allows for an interest to be secured post-petition if the state law allows the lien to be perfected and relate back. In Texas, M&M Liens are permitted to do just that.

Section 56.021(a) of the Texas Property Code allows an M&M Lien to be filed within 6 months of the date the debt accrued and then relate back to the date of inception.[81] Under Texas law the debt will accrue on the last day that material is delivered or service is rendered.[82] If properly perfected, the M&M Lien will relate back to the

76. *Wilson*, 69 B.R. at 963.
77. *See id.* ("[O]nce oil and gas are produced, they become personal property.").
78. *Id.* at 964.
79. 11 U.S.C. §§ 362(b)(3), 546(b) (2006).
80. *Id.* § 546(b)(1)(A).
81. *See* TEX. PROP. CODE ANN. § 56.021(a) (Vernon 2008).
82. *Id.* § 56.005(b).

lien inception date, which is the first day material is delivered or service is rendered.[83]

The perfection of M&M Liens against a bankruptcy debtor are one of the rare occasions in which a creditor may perfect a pre-petition security interest post-petition. In the case of M&M Liens, the perfection could conceivably take place six months after the petition date.[84] However, even with the ability to perfect an M&M interest post-petition they are still subject to the strong-arm-provisions of the bankruptcy code. That being the case, an M&M Lien can be avoided to an unsecured claim if not properly perfected.[85]

3. Assignments of Interests

As mentioned above, an interest in a mineral lease is an interest in real property. As such, an assignment of an interest must be properly recorded in order to be perfected. In a case in which the debtor assigned (or purported to assign) working interests and the "assigned" interest is not filed in the public record and perfected, that interest is subject to avoidance under the strong-arm-provisions.[86] This issue comes up in situations where an operator/landman holds the assignments (maliciously or otherwise) without recording them. Often the assignees are told that the assignments are being held in trust for them. Unfortunately, this will likely be held ineffective to protect the purported transferees from avoidance once in bankruptcy.[87] Another important aspect of the timing of assignments of interest is the exposure to M&M Lien liability. The Texas Property Code provides that an M&M Lien will not encumber an interest perfected prior to the lien inception date, i.e. prior to the first date of work.[88] In a situation

83. *In re* Meg Petroleum Corp., 61 B.R. 14, 18 (Bankr. N.D. Tex. 1986) ("[T]he Court finds that for purposes of Texas law the mechanic's and materialmen's lien filed by a mineral contractor automatically relates back to the date that it first furnishes materials and services to the oil and gas lease so long as the contractor files a lien affidavit in the proper county clerk's office within six months of concluding its activities on the tract.").

84. It is also rare for two security interests to share priority *pari passu* but M&M Liens also hold that distinction. *See Meg Petroleum*, 61 B.R. at 21 (Bankr. N.D. Tex. 1986) ("But since holders of competing mechanic's and materialmen's liens have equal priority, [M&M Lien claimant no. 1] and [M&M Lien claimant no. 2] must share Net Revenue Income payments attributable to the Lopez Creek lease on a pro rata basis.") (citing Lane-Wells Co. v. Cont'l-Emsco Co., 397 S.W.2d 217 (Tex. 1965)).

85. *See* Mid-Am. Petroleum, Inc. v. Adkins Supply, Inc. (*In re* Mid-Am. Petroleum, Inc.), 83 B.R. 937, 940 (Bankr. N.D. Tex. 1988).

86. Jones v. Parson (*In re Jones*), 77 B.R. 541, 548 (Bankr. N.D. Tex. 1987).

87. *Id.* at 551 (discussing that once in bankruptcy, the debtor in possession is charged with the duty to maximize returns for the creditor body as a whole—in this context it is very likely that even if the debtor-in-possession *actually* wanted to view the unperfected assignment as perfected the debtor could not do so absent new consideration).

88. TEX. PROP. CODE. ANN. 56.004(a) (Vernon 2008) ("The lien does not affect an encumbrance that attached to land or a leasehold before the lien's inception.").

in which the bankrupt operator has been incurring liability to future M&M Lien claimants and at the same time not providing or filing assignments to third party working interest owners, those third party working interest owners have a great risk of being exposed to M&M Lien liability. The operator, who holds the unrecorded assignments, may attempt to record some or all of the unrecorded assignments just prior to the bankruptcy filing. Unfortunately for the assignees of these late filed assignments, they will very likely be subject to being pulled back into the estate pursuant to the Code as a preference or fraudulent transfer.[89]

4. Preference/Fraudulent Transfer regarding Transfer of Interests

Keeping in mind that two of the purposes of the Code are to ensure equal treatment among classes and to maximize return to unsecured creditors, the Code provides for asserting a preference claim or fraudulent transfer claim to bring money (or other interests) back into the estate when transferred pre-petition.[90] It is not uncommon for the target of a preference suit to comment on the perceived inequity of the preference laws. Even so, when considering the preference section, remember that it is designed to treat creditors equally and prevent inequity or preferential payment. Section 547 provides for recovery of preferences, it reads in part:

> (b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor;
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or within 90 days before the date of the filing of the petition; or
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
> (5) that enables such creditor to receive more than such creditor would receive if—
> (A) the case were a case under chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[91]

This section allows for recovery of money paid pre-petition by the debtor or interests transferred to creditors by the debtor meeting

89. *See* 11 U.S.C. § 547(b) (2006).
90. *See id.* §§ 547(b), 548(a)(1).
91. *Id.* § 547(b).

these broad criteria and subject to the affirmative defenses contained in section 547(c).[92] In terms of a late recorded working interest owner this will be an immediate concern. An illustrative fact pattern is as

92. *Id.* § 547(c). "The trustee may not avoid under this section a transfer—
(1) to the extent that such transfer was—
(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
(B) in fact a substantially contemporaneous exchange;
(2) 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—
(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
(B) made according to ordinary business terms;
(3) that creates a security interest in property acquired by the debtor—
(A) to the extent such security interest secures new value that was—
(i) given at or after the signing of a security agreement that contains a description of such property as collateral;
(ii) given by or on behalf of the secured party under such agreement;
(iii) given to enable the debtor to acquire such property; and
(iv) in fact used by the debtor to acquire such property; and
(B) that is perfected on or before 30 days after the debtor receives possession of such property;
(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—
(A) not secured by an otherwise unavoidable security interest; and
(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;
(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—
(A)
(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
(ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
(B) the date on which new value was first given under the security agreement creating such security interest;
(6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title;
(7) to the extent such transfer was a bona fide payment of a debt for a domestic support obligation;
(8) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $600; or
(9) if, in a case filed by a debtor whose debts are not primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $5,000."

follows: the unassigned working interest owner enters into a participation agreement, pays for the acreage in full, and then pays all or a portion of drilling and completion costs but never causes an assignment to be filed for a few months. Then, just prior to the bankruptcy the operator (who is holding the assignment) files the assignment at the 11th hour before the bankruptcy filing. The now late filed assignment will have a high likelihood of exposure under section 547(b) and the purported assignee then faces the probability of being unperfected once in bankruptcy.

In a similar vein, the Code allows for recovery of fraudulent transfers pursuant to section 548. Section 548 reads in part:

> 548 (a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (B)
>
> (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii)
>
> (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
>
> (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[93]

This section will look very similar to regular state court fraudulent transfer law, and in fact, the state fraudulent transfer laws may also been invoked by the debtor in possession to recover property.

93. *Id.* § 548(a).

In short, the non-debtor assignee should carefully consider timing and the relevant statutory provisions if an assignment was made at or near the time of the petition date.[94]

V. Relationship with Lessors

As discussed above, the property rights in a bankruptcy case are determined by the state law which will include causes for termination.[95] In Texas, the "term 'oil and gas lease' is a misnomer because the interest created by an oil and gas lease is not the same as an interest created by a lease governed by landlord and tenant law . . . the so-called leaseholds . . . actually constitute determinable fee interests."[96] Whether an oil and gas lease may properly be rejected or abandoned is beyond the scope of this paper, but a brief description of determination of rights as to a lease purported to have terminated by its terms is in order.

If a lessor believes that an oil and gas lease has terminated by its own terms post-petition the lessor should generally initiate an adversary proceeding to assert that position. Rule 7001(2) states that an adversary proceeding is "to determine the validity, priority, or extent of a lien or other interest in property, other than a proceeding under 4003(d)."[97] An oil and gas lessor in bankruptcy seeking to enforce a provision allowing for termination under the oil and gas lease is seeking determination of an interest on the debtor's estate, thus an adversary proceeding is necessary.[98]

VI. Conclusion

The preceding is simply a small example of issues to consider when faced with a bankrupt oil and gas company. A significant consideration which was only generally referred to herein is the jurisdictional grant to bankruptcy courts and the court's jurisdictional limits. Additionally, this paper has not discussed, *inter alia*, the effects of plan confirmation or discharge. While this paper is meant to familiarize non-

94. Section 549 provides a similar mechanism for undoing post-petition transfers in certain circumstances. *Id.* § 549.

95. Primo Res., Inc. v. Balcones Oil Co. (*In re* Balcones Oil Co.), 21 B.R. 36, 39 (Bankr. W.D. Tex. 1981).

96. River Prod., Co. v. Webb (*In re* Topco, Inc.), 894 F.2d 727, 740 (5th Cir. 1990) (internal citation omitted) (citing Cherokee Water Co. v. Forderhause, 741 S.W.2d 377 (Tex. 1987); Howell v. Union Producing Co., 392 F.2d 95, 111 (5th Cir. 1968); Amber Oil & Gas Co. v. Bratton, 711 S.W.2d 741, 743 (Tex. App.—Austin 1986, no writ); Tex. Commerce Bank Nat'l Ass'n v. Interpol '80 Ltd., 703 S.W.2d 765, 769 (Tex. App.—Corpus Christi 1985, no writ)).

97. Fed. R. Bankr. P. 7001(2).

98. *See* Breithaupt v. Nueces Petroleum Corp. (*In re* Nueces Petroleum Corp.), No. 05-44617, 2007 WL 418889, at *1 (Bankr. S.D. Tex. Feb. 2, 2007); 523 N. Belt Assocs. v. GHR Energy Corp. (*In re* GHR Energy Corp.), 66 B.R. 54, 57 (Bankr. S.D. Tex. 1986). Conversely, a lessee seeking to assert that a lease has or has not expired should also use an adversary proceeding to determine his rights.

bankruptcy attorneys with concepts and issues that may be encountered in a bankruptcy case, getting bankruptcy counsel is recommended.

It is the author's hope that the layers of complexity that are created by the filing of an oil and gas bankruptcy petition are in some way conveyed.