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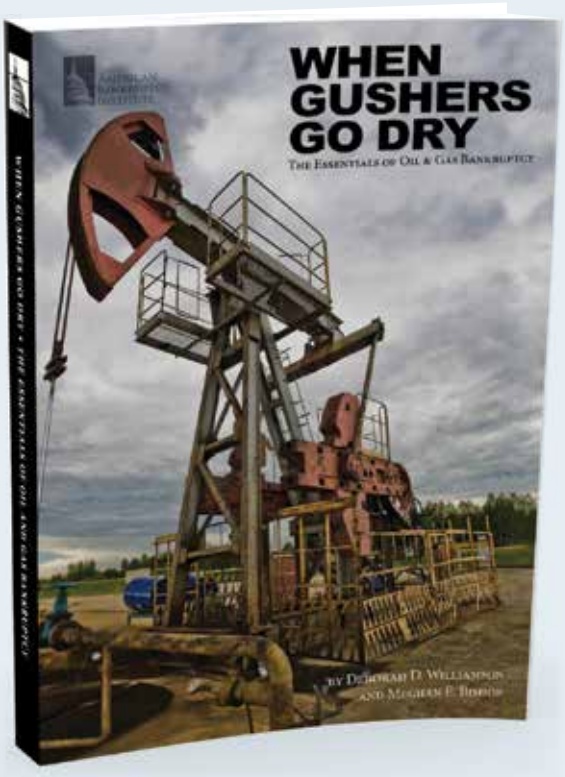

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CRITICAL LEGAL MATTERS IN BANKRUPTCY CASES INVOLVING OIL AND GAS INTERESTS

BANKRUPTCY TREATMENT OF (I) LEASES, (II) JOINT OPERATING AGREEMENTS ("JOAS") AND (III) FARMOUT/FARMIN AGREEMENTS

By

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I. Leases

A. Introduction. Oil and gas leases are the asset base on which an E&P company is valued. E&P valuation (and, therefore, lending) is almost exclusively reserve-based. There are two primary categories of reserves, under which several subcategories are secondarily categorized based on the relative level of risk associated with such assets and, therefore, the value.

1. Proved

   a. Proved Developed Producing (PDP) – least risky, most valuable

   b. Proved Developed Non-Producing (PDNP) – moderately risky, more valuable

   c. Proved Undeveloped (PUD) – more risky, less valuable

2. Non-proved

   a. Probable Reserves (PROB or 2P) – more risky, some value

   b. Possible Reserves (POSS or 3P) – most risky, little (if any) value

B. Property Law Characterization of Leases.[1] The nature of an oil and gas lease is determined by the nature of oil, gas, and minerals under state law,[2] and the language of the granting clause as interpreted under state law.

There are two primary theories governing the property law characterization of unsevered oil, gas, and other minerals – (i) the oil and gas in place theory, and (ii) the non-ownership theory. The primary difference between the ownership in place theory and non-ownership theory, from a real property law standpoint, is the present right of possession. The present right of possession is the defining factor between a corporeal interest (carries with it the right of possession and cannot be abandoned) and an incorporeal interest (does not have a right of possession, but rather a right of use which can be abandoned).[3] Thus, oil and gas

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[1] For a thorough discussion of the legal significance of an oil and gas lease, *see* 2 & 3 E. Kuntz, *A Treatise on the Law of Oil and Gas* (1989)(hereinafter cited as "Kuntz").

[2] For a more thorough discussion of the real vs. personal property nature of oil and gas, see Patrick H. Martin and Bruce M. Kramer, WILLIAMS AND MEYERS, OIL AND GAS LAW (Lexis Nexis, Matthew Bender 2011) (hereinafter Williams and Meyers).

[3] *See*, 2 Kuntz § 2.4.

rights in the states following the non-ownership theory are subject to loss by abandonment or, in the case of Louisiana, codified prescription for non-use. [4]

1. Ownership in place theory.

   a. In "ownership in place" states (the majority rule), the oil and gas under the ground is most often a fee simple absolute estate in land, giving the holder of such rights ownership of the oil and gas in place, subject to the right of others to divestiture.

   b. Under the ownership theory, the entire real property "bundle of sticks" is bestowed upon the owner.

      (1) This "bundle of sticks" includes, (i) the right to present possession of the oil and gas in place; (ii) the right to search for, develop and produce minerals; (iii) the right to profits; (iv) the obligation for costs; (v) the right to lease or sell the mineral interest; and (vi) the right to enjoy benefits under an oil and gas lease.

      (2) These rights include an implied right to reasonable use of the surface to realize the benefits of the mineral estate.

      (3) States that ascribe to the ownership theory are, for example, are Texas, New Mexico, Pennsylvania, Colorado, and Kansas.

2. Non-ownership theory.

   a. Under the non-ownership theory, a landowner does not own the oil and gas in place, and thus there is no "mineral estate" from which to carve a leasehold interest. Instead, a mineral servitude (as it is called in Louisiana) or a license, or a profit à prendre (as it is sometimes known in California) is imposed upon land giving its holder the right to explore for, develop and produce oil and gas. The mineral lease creates a real right, but is not subject to prescription of non-use. The lease is a real property interest allowing the holder to remove a part of the substance of the land.

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[4] *See* Cmt. La. R.S. § 31:114 and La. R.S. § 31:115. Under Louisiana's Civil Law regime, the strong policy in favor of beneficial usage of land results in a codified prescriptive period for non-use, which is 10 years. Good faith operations for the exploration, development and production of oil and gas will prevent the prescriptive period from running. La. R.S. § 31:149. A caveat to this rule is that mineral servitudes in favor of the United States, the State of Louisiana, or any of their respective agencies or subdivisions, are imprescriptible while owned by the government. La. R.S. § 31:29.

b. There is no conveyance of a fee interest. The mineral estate is still dominant in non-ownership states, meaning that there is an implied right to reasonable use of the surface.

c. States such as Oklahoma, Louisiana, California, and Wyoming, are non-ownership theory states.

C. Treatment of Leases under the Bankruptcy Code. 11 U.S.C. § 365 deals with bankruptcy treatment of executory contracts and unexpired leases. Although the determination of whether an oil and gas lease is an executory contract is a question of federal law, the classification of the real property interest is determined by state law.[5] Thus, the analysis of whether an oil and gas lease is subject to § 365 depends on the character of the estate conveyed or created in the particular state in which the property is located.

On one end of the spectrum is the characterization of oil and gas leases as real property interests in oil and gas in-place states that are therefore not subject to 11 U.S.C. § 365.[6] In the middle, are the cases in which courts have recognized a mineral lease as an "incorporeal immovable," such as in Louisiana, and though most courts note these are not of the type of "contracts" contemplated by § 365, the case law is conflicting both as to executory contract status and whether an oil and gas lease is an unexpired lease.[7] Also in

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[5] *See, e.g., Terry Oilfield Supply Co. v. American Security Bank, N.A.,* 195 B.R. 66, 73 (S.D. Tex. 1996).

[6] *River Prod. Co., Inc. v. Webb* (*In re Topco, Inc*.), 894 F.2d 727, 739 n. 17 (5th Cir. 1990); *Terry Oilfield Supply Co., Inc. v. Am. Security Bank, N.A*., 195 B.R. 66, 70 (S.D. Tex. 1996); *see also, In re TXCO Res., Inc.,* 2009 Bankr. LEXIS 5379, 4-5 (Bankr. W.D. Tex. Dec. 15, 2009) (holding that oil and gas leases covering mineral interests in the states of Texas [including any Texas offshore leases], Oklahoma, Mississippi, North Dakota, South Dakota, Colorado and Montana are not "unexpired leases" subject to the provisions of 11 U.S.C. §365, however no Colorado Bankruptcy Court has similarly ruled and the Texas court order does not cite to any authority for its holding as to Colorado leases); *In re Clark Resources*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986) (holding that Oklahoma oil and gas leases are neither executory contracts because the lessee's only remaining obligation is the payment of money and the lessor's only to defend title to the leased land and not to interfere with the lessee's drilling operation - the breach of either not excusing performance by the party not in breach, but merely abating the obligation of the non-breaching party for as long as the breaching party was in breach, nor an unexpired leases of non-residential real property because the interest created by an oil and gas lease is "merely a license to explore, not an interest in real property"); *In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (holding that an Oklahoma oil and gas lease was not an executory contract because the lessor's "only obligations under the contract is to defend her title to the leased land and not to interfere with the lessees' drilling operation. Breach of these duties would not excuse performance by [the lessee], but would merely abate [the lessee's] obligation for so long as [the lessor] was in breach.").

[7] Cases holding that Louisiana oil and gas leases are not executory contacts are: *In re WRT Entergy Corp*., 202 B.R. 579, 583-84 (W.D. La. 1996) (applying the Countryman definition of executory contract in holding that Louisiana oil and gas leases are non-executory because "the lessor's failure to perform would constitute material breach so as to excuse the lessee from its obligations under the lease. . . ."). Cases holding that Louisiana oil and gas leases are executory contracts are: *Texaco, Inc. v. Louisiana Land & Exploration Co*., 136 B.R. 658, 668 (M.D. La. 1992) (applying a broader standard than the Countryman definition in determining that a Louisiana mineral lease is executor because it is not "fully performed," with virtually all performance is by the lessee throughout the entire term of the contract); *In re Ham Consulting Company/William Lagnion/JV*, 143 Bankr. 71 (Bankr. W.D. La. 1992)(relying on *Delta Energy Res., Inc. v. Damson Oil Corp.* [*infra.*], Texaco, Inc. [*supra*.] and *In the Matter of Topco* [*infra*.] to determine that Louisiana oil and gas leases are executory and subject to the requirements of § 365). Cases holding that Louisiana oil and gas leases are not unexpired leases are: *In re WRT Entergy Corp*., 202 B.R. at 583-84 (holding

the middle is the treatment of Outer Continental Shelf ("OCS") leases, the status of which likewise is ambiguous.[8] On the other extreme of the spectrum are those states where oil and gas leases are not considered interests in real property and, as personal property, are treated as executory contracts.[9]

The significance of an oil and gas lease being subject to § 365 is 1) the ability to accept or reject, and the timing therefor, 2) the necessity of curing pre-petition defaults if assumed, and 3) the requirement to pay damages if rejected.

1. Leases that are not subject to § 365.

   a. Fee simple determinable - The characterization of the rights created by an oil and gas lease in ownership in place states begins with the lease granting clause and almost always conveys a fee simple determinable. This is because the typical language creates an interest to continue indefinitely (the "fee simple") subject to the occurrence (or lack of an occurrence) of a specified event (the "determinable"), which is usually the lack of production, failure to pay delay rentals or, in some cases, the failure to pay royalties or continuously drill.

      These leases treated as real property assets, subject to termination under the terms of the leases, but not pursuant to § 365.

   b. Profit à prendre or license (to explore for oil and gas)

      Although these leases often found to have aspects of contracts, they are not necessarily subject to § 365 because such "contracts" are not executory

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that Louisiana oil and gas leases are not unexpired leases because looking at "the interplay between the Mineral Code, the Civil Code, and the jurisprudence of the State of Louisiana, the OG&ML vests the lessee with real rights whereas a lease of real property creates only personal rights."); *In re Ham Consulting Company/William Lagnion/JV*, 143 Bankr. 71 (Bankr. W.D. La. 1992) (holding that though a LA oil and gas lease is an executory contract, it is not an unexpired lease – or at least not the type of unexpired lease contemplated by § 365); *see also*, *Delta Energy Resources, Inc., v. Damson Oil Corp*., 72 B.R. 7, 11 (W.D. La. 1985) (stating that a Louisiana oil and gas lease "is not the conventional lease contemplated by Section 365, but is in fact a real right in favor of another); *In re Topco, Inc*., 894 F.2d at 739 n. 17 (noting in a footnote that Louisiana oil and gas leases are not unexpired leases). The authors know of no cases specifically holding that Louisiana oil and gas leases are unexpired leases for purposes of § 365.

[8] The Bureau of Ocean Energy Management Regulation and Enforcement ("BOERME" [formerly MMS]) has argued that an OCS lease is an unexpired lease of non-residential real property or an executory contract due to the unique nature because OCS leases "convey neither title nor any unencumbered estate in the land or the minerals" and are more akin to a profit-à-prendre in that they simply afford the right, subject to revocation, to go upon land and extract the minerals, the MMS has argued that this definition of "lease" should also apply to §365 on the belief that Congress intended the use of the same word to mean the same thing. There is case law that OCS leases are or should be considered "true leases" although the settlement of the question remains subject to dispute.

[9] *In re J. H. Land & Cattle Co*., 8 B.R. 237 (Bankr. W.D. Okla. 1981) (holding that under Kansas law an oil and gas lease created a license to enter which is an intangible personal property right and, therefore, was an unexpired lease of real property under 11 U.S.C. § 365(h)(1)).

under the Countryman definition because the lessee's only remaining obligation is the payment of money and the lessor's is only to defend title to the leased land and not to interfere with the lessee's drilling operation. The breach by either of these of their obligations would not excuse performance by the party not in breach, but would merely abate the obligation of the non-breaching party for as long as the breaching party was in breach. Further, oil and gas leases that are characterized as licenses are not unexpired leases of non-residential real property because the interest created by an oil and gas lease is "merely a license to explore, not an interest in real property"). *See, In re Heston Oil Co.*, *infra.*

2. Leases that are subject to § 365.

If the oil and gas lease is subject to § 365 then, depending on whether the lease is assumed or rejected, the debtor may be obligated to pay cure costs or the rejected counterparty may have a rejection damage claim.

a. Assumption.

The debtor must (i) cure, or provide adequate assurance that it will promptly cure, all defaults relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, (ii) compensate, or provides adequate assurance that the debtor will promptly compensate, a counterparty to an assumed contract of lease, for any actual pecuniary loss to such party resulting from such default, and (iii) provide adequate assurance of future performance under such contract or lease.

Assuming an oil and gas lease for which there are multiple defaults, including failure to property pay royalty, breach of the covenant to develop or violations of surface use provisions, can be extremely costly and, at times, an impediment to assuming the lease.

b. Rejection.

The Code treats this as a breach of contract claim, with damages calculated as if the debtor had breached the lease on the petition date.[10] The lessor is entitled to damages, which claim receives the priority of an unsecured claim.[11] Rejected leases that had significant defaults often result in lessors comprising a large part of the unsecured creditor pool.

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[10] *Id*. § 365.

[11] *Id*.

c. Timing of assumption or rejection. An unexpired "true" lease must be assumed within 120 days from the petition date or it will be deemed rejected.[12] A one-time extension of 90 days is permitted on motion of the Debtor or lessor, for cause and any subsequent extension may be had only by prior written consent of the lessor.[13] An executory contract does not have to be assumed or rejected until confirmation of a plan.[14] For leases in states with "true" leases, the time frame is short for a determination of whether to assume or reject, and this can have major implications for the ultimate success of a plan of reorganization.

II. Joint Operating Agreements ("JOAs") and Joint Exploration Agreements ("JEAs")

A. Description. The JOA is an agreement between co-owners of the rights to explore for and develop the oil and gas in a certain described lands, usually called the "contract area." While the co-owners usually own undivided fractional oil and gas leasehold interests, the JOA can also cover owners of the fee oil and gas estate who would rather participate in the cost and risk of exploration and development than execute an oil and gas lease and participate only as a royalty owner. The JEA generally describes an agreement in which at least one party "drills to earn" acreage, expending the costs of drilling to earn an assignment of a working interest in the acreage.

B. Bankruptcy Treatment under § 365. Applying the Countryman definition to JOAs and joint exploration agreements, most of the time these agreements will be executory because exploration and development (*i.e.* drilling) is ongoing on the properties and there always remain unperformed duties, the lack of performance of which would constitute a material breach. However, there are arguments as to why certain of these agreements, should not simply be assumed to be executory and therefore subject to § 365 without further analysis. For example, there may be an argument that provisions in a JOA actually are separate contracts and, therefore, depending on the status of fulfilled obligations may or may not be executory, even if other provisions remain executory.[15] In addition, some joint exploration agreements contain various "phases" under each of which are distinct responsibilities and benefits. Such a JEA may be ripe for argument that each "phase" is its own contract or the JEA may be so fully consummated at the time § 365 becomes an issue that it is no longer executory. Notwithstanding these arguments, most of the time, JOAs and JEAs are executory and must be assumed or rejected within the time frames specified by § 365.

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[12] 11 U.S.C. § 365(d)(4)(A).

[13] *Id*. § 365(d)(4)(B).

[14] *Id*. § 365.

[15] *See, e.g. Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co*., 83 F.3d 735, 742 (5th Cir. Tex. 1996) (holding that where a trustee rejects a severable contract containing both an executed and an executory agreement, such rejection is not equivalent to the breach or rescission of the executed agreement nor does it require the undoing or reversal of already executed portions of the contract).

III. Farmouts and Farmins

A. Description. A very common form of agreement between operators, whereby a lease owner not desirous of drilling at the time agrees to assign the lease, or some portion of it (in common or in severalty) to another operator who wants to drill on the tract. The assignor in such a deal may or may not retain an overriding royalty or production payment. The primary characteristic of the farmout is the obligation of the assignee to drill one or more wells on the assigned acreage as a prerequisite to completion of the transfer to him.

B. Safe Harbor Provisions. The farmout safe harbor" is spelled out in § 541(b)(4). This Code section was designed to give protection for those entities that have spent time, effort and capital farming-in to a particular lease (the "farmee") but who have not yet received an assignment of the farmed-in property from the farmor when the farmor files for bankruptcy protection.

Section 541(b)(4)(A) states that:

(b) "Property of the estate does not include - . . .

(4) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that –

(A)(i) the debtor has transferred or has agreed to transfer such interests pursuant to a farmout agreement or any written agreement directly related to a farmout agreement;

and

(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 544(a)(3) of this title[.]"

As can be gleaned from the statutory language, this section of the Code provides that interests of the debtor covered by certain types of farmout arrangements are not property of the estate, either by negating the debtor's ability to reject as an executory contract an otherwise earned farmout (§ 365) or declaring that the farmee's right to an earned assignment cannot be defeated due to lack of recordation (§ 544(a)(3)). Despite clearly being drafted with the assumption that the debtor is the farmor, this section is nonetheless applicable both with the debtor is the farmor and the farmee, leading to a distinct set of legal issues depending on which is the case.

1. The Debtor as Farmee. When the debtor has agreed to "drill to earn" and has therefore contracted with a third-party leasehold owner to drill (and likely, also complete) wells to earn acreage, such debtor usually must meet drill to certain specifications (successfully completing the "earning event") before it is entitled to an assignment of acreage or working interest in acreage. Record title, therefore,

remains with the farmor until the earning event (and, often, in practice, even until much later). When the debtor is the farmee, and only in cases where the earning event has been met, the argument is simply that the debtor owns the equitable interest in the lease (that which was earned) and, therefore, such is property of the estate, regardless of the status of assignment or recordation of assignment. However, the situation becomes more complicated if the debtor/farmee has contracted to assign farm-in interests to third-parties (for example, an overriding royalty interest to the debtor/farmee's chief geologist). The assignee's best argument likely would be that the assignment is a "written agreement directly related to a farmout agreement" and, therefore, the estate does not include the assignee's interest under §541(b)(4)(A)(ii). There is an especially compelling case where the assignee's performance contributed to the farmee's ability to successfully meet its earning event obligations in the first place. Note that the protections afforded by this section require that "the estate could include the interest . . . only by virtue of section 365 or 544(a)(3)" thus likely necessitating that the farmout is an executory contract under § 365. Otherwise the Debtor could avoid the assignment because it is not of record.

2. The Debtor as Farmor. The scenario of the debtor/farmor more squarely fits within the statutory language. Where the debtor is the farmor, the farmee's earned interest is not part of the estate, other than to include the rights of the farmor under the particular farmout agreement. Where the farmee has already earned interests under the farmout on the date of filing, the "safe harbor" provision kicks-in and protects the farmee's right to interests already earned. However, it is uncertain what the effect of this provision is on the unearned rights under the farmout. Depending on the benefit to the estate of the farmout, some practitioners have argued that the unperformed part of the farmout (that which is executory) cannot be rejected because of § 541(b)(4). The argument focuses on the language that the debtor has "agreed to transfer" and would include even unperformed farmout provisions as part of an "agree[ment[to transfer." There are no cases, reported or unreported, addressing this argument and, to these authors it seems a stretch that § 541(b)(4)'s language would trump the plain language of most farmout agreements (the agreement to transfer not being absolute in any sense, but subject at all times to the successful completion of certain conditions) or the long history of farmouts falling under the rubric of § 365.

C. Penalty Provisions. Another issue dealt with separately by the Code that is applicable to JOAs or JEAs is § 365(b)(2)(D) exception for requiring cure of all defaults, when such relates to a penalty rate or a penalty provision. For example, where the debtor is the operator under a JEA, and must drill a certain number of wells meeting certain specifications and within a certain time frame or pay a penalty (usually a set price/net

mineral acre), there is an argument that such a provision constitutes an unenforceable penalty provision under § 365(b)(2)(D).[16]

D. Lien Issues. The method for perfecting a lien on an oil and gas lease depends upon the characterization of oil and gas leases. For example, where the oil and gas lease is a fee simple determinable, the method for perfecting a lien is by deed of trust. The deed of trust often will reference the lease, rather than provide a metes and bounds property description.

There are myriad issues regarding the extent and validity of liens in an E&P bankruptcy as it relates to farmouts. An E&P company may have an interest in a lease as to certain depths and, subsequent to a loan, acquire interests in other depths (which may or may not be covered by an after acquired property clause); a borrower may enter into a JEA either before or after a loan and "earn" acreage from the primary working interest owner by drilling; a lease may expire as to certain acreage not held by production, but not other acreage; a lease may be unitized or pooled only as to certain depths; or the mortgage itself may be limited only as to certain depths in a given lease.

1. Lien Avoidance. In theory, a lien should attach to the equitable but unassigned interest that may be owned by a debtor/farmee under the safe harbor provisions. However, § 544(a)(3) of the Bankruptcy Code creates the fiction that the debtor is in the same position as a bona fide purchaser for value, as of the filing date, and as if the debtor had recorded the interest. Because a bona fide purchaser can generally avoid unrecorded title, this section of the Bankruptcy Code has been argued successfully to allow the debtor to avoid transfers of oil and gas interests that are not recorded.

2. After acquired property. A security agreement and deed of trust often will state that after acquired property is covered by the holder of the security interest's lien. These documents also must provide a property description covered by the lien which, often, is a reference to the leases and/or wells covered. However, it is common that these documents reference the property description by lease or well, and the lease or well itself is depth severed. If acreage is earned by the borrower/farmee owner in other depths at a later date, such property will not necessarily be covered by the lien due to the security agreement and deed of trust's limiting property description in the referenced leases.

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[16] *In re DSBC Invs*., 2009 Bankr. LEXIS 2954, 5-6 (Bankr. D. Ariz. Sept. 11, 2009) (holding that a default interest rate provision was either a "penalty rate" or "penalty provision" within the meaning of § 365(b)(2)(D)).

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January 22-23, 2015

CRITICAL LEGAL MATTERS IN BANKRUPTCY CASES INVOLVING OIL AND GAS INTERESTS

PART 2

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Scope and Administration of Oil and Gas "Safe Harbor" Contracts in Bankruptcy

I. Introduction

A. Transactions involving interests in oil and gas are frequent subjects of "safe harbor" contracts.

B. What types of contracts are subject to special treatment under the Code? Listed in § 561(a)[1]:

1. Securities contracts (defined in § 741(7)).

2. Commodity contracts (defined in § 761(4)).

3. Forward contracts (defined in § 101(25)).

4. Repurchase agreements (defined in § 101(47)).

5. Swap agreements (defined in § 101(53B)).

6. Master netting agreements (defined in § 101(38A)).

7. This discussion will focus on forward contracts—used for purchase and sale of oil and gas in the future—and swap agreements—used by entities involved in oil and gas transactions to hedge their positions in the market.

C. Why are these agreements called "safe harbor contracts"? Congress has provided parties to these contracts with exemptions from significant and otherwise generally-applicable provisions of the Code.

1. "As new financial instruments have been developed, Congress has recognized the need to amend certain aspects of the Bankruptcy Code in order to continue to provide the necessary speed and certainty in complex financial transactions. In 1982 and again in 1984 Congress amended section 362 to exempt the termination and setoff of mutual debts and claims arising under securities contracts, forward contracts, commodity contracts and repurchase agreements. The 1982 amendments were 'intended to minimize the displacement caused in the commodities and securities markets in the event of a bankruptcy affecting these industries,' recognizing the 'potential volatile nature of the markets.' 128 Cong. Rec. H261 (daily ed. Feb. 9, 1982). The same rationale supported the 1984 amendments. These

[1] Unless otherwise specified, all references to statutory section numbers refer to the Bankruptcy Code.

protections should be extended to the swap and forward foreign exchange agreements for the same reasons . . . .

As Congress recognized at the time of the 1982 and 1984 amendments, counterparties could be faced with substantial losses if forced to await bankruptcy court decision on assumption or rejection of financial transaction agreements. Unlike ordinary leases or executory contracts, where the markets change only gradually, the financial markets can move significantly in a manner of minutes. The markets will not wait for a court decision . . . . There is a clear need for Congress to assure counterparties that they will be able to terminate these agreements and exercise contractual liquidation and netting rights if a party to the agreement files for bankruptcy relief." [2]

2. Congress favored these financial contracts in three key areas:

   a. Allowing parties to enforce *ipso facto* bankruptcy termination provisions.

      (1) The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract, as defined in section 761 of this title, or forward contract because of a condition of the kind specified in section 365(e)(1) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title.[3]

   b. Exempting from the automatic stay parties' actions to liquidate, terminate or accelerate contracts, or realize on collateral.

   c. Exempting debtors' transfers of property or obligations under these contracts, and counterparties' rights in and to collateral, from

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[2] 135 Cong. Record S1414-1416 (daily ed. Feb. 9, 1989) (statement of Sen. DeConcini).
[3] § 556.

avoidance and recovery as preferences or fraudulent transfers, or under "strong arm powers."[4]

(1) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.[5]

(2) Note that this exemption still allows claims for intentional fraudulent transfers to go forward.

II. Critical definitions.

A. Forward contract, § 101(25):

1. The term "forward contract" means—

(A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date of the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;

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[4] *See* S. Vasser, *Derivatives in Bankruptcy*, 60 The Business Lawyer 1507, 1509 (Aug. 2005).
[5] §546(e)

(B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);

(C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);

(D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or

(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.

2. Note that a "commodity contract," which is excluded from the definition of a forward contract, is defined in § 761(4).

B. Swap agreement, § 101(53B):

The term "swap agreement"—

(A) means—

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is—

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;

(III) a currency swap, option, future, or forward agreement;
(IV) an equity index or equity swap, option, future, or forward agreement;
(V) a debt index or debt swap, option, future, or forward agreement;
(VI) a total return, credit spread or credit swap, option, future, or forward agreement;
(VII) a commodity index or a commodity swap, option, future, or forward agreement;
(VIII) a weather swap, option, future, or forward agreement;
(IX) an emissions swap, option, future, or forward agreement; or
(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that—
(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and
(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value:

(iii) any combination of agreements or transaction referred to in this subparagraph;
(iv)any option to enter into an agreement or transaction referred to in this subparagraph;
(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap

agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.; and

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Gramm-Leach-Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(45) of the Securities Exchange Act of 1934) and the Commodity Exchange Act.

2. In a less technical practical definition, a swap agreement is:

   a. "[A] contract between two parties . . . to exchange ("swap") cash flows at specified intervals, calculated by reference to an index. Parties can swap payments based on a number of indices including interest rates, currency rates and security or commodity prices."[6]

3. The definition is "extremely broad,"[7] and is intended to encompass future investment products that haven't yet been invented, and creative variations on existing products.

   a. The definition covers "any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph."

   b. The definition covers "several dozen enumerated contracts and transactions, as well as combinations of them, options on them, and similar contracts or transactions."[8]

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[6] *Michigan State Housing Development Authority v. Lehman Bros. Derivative Prods Inc. (In re Lehman Bros. Holdings Inc.)*, 502 B.R. 383, 391 (Bankr. S.D.N.Y. 2013) ("*Lehman-MSHDA*") (quoting *Thrifty Oil Co. v. Bank of Am. Nat'l Trust & Sav. Assn.*, 322 F.3d 1039, 1042 (9th Cir. 2003)).
[7] *In re National Gas Distributors, LLC*, 556 F.3d 247, 253 (4th Cir. 2009).
[8] *Sher v. JP Morgan Chase Funding, Inc. (In re TMST, Inc.)*, 2014 WL 4823829, *11 (Bankr. D. Md., Sept. 25, 2014).

C. Master netting agreement, § 101(38A):

1. The term "master netting agreement"—

(A) means an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts that are described in any one or more of paragraphs (1) through 5) of section 561(a), or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing, including any guarantee or reimbursement obligation related to 1 or more of the foregoing; and

(B) if the agreement contains provisions related to agreements or transactions that are not contracts described in paragraphs (1) through (5) of section 451(a), shall be deemed to be a master netting agreement only with respect to those agreements or transactions that are described in any one or more of paragraphs (1) through (5) of section 561(a).

2. This provides for a "netting" of multiple transactions involving a single type of safe harbor contract, or multiple types of safe harbor contracts.

3. However, even though a master netting agreement may encompass a range of transactions among two parties that includes both safe harbor and non-safe harbor contracts, only actions under the master netting agreement pertaining to safe harbor contracts will be entitled to safe harbor treatment.

III. Is your oil and gas purchase and sale or supply agreement a forward contract?

A. The contract must involve the sale of a commodity, but it cannot be a "commodity contract" under § 761(4).[9]

a. The key criterion for a commodity contract is generally whether the transaction is effectuated through a commodity exchange or board of trade ("on-exchange") or merely through private party action ("off-exchange"). Only on-exchange transactions qualify as

[9] *Buchwald v. Williams Energy Marketing & Trading Co. (In re Magnesium Corp. of America)*, 460 B.R. 360, 370 (Bankr. S.D.N.Y. 2011).

"commodity contracts."[10] "Congress apparently intended that 'forward contracts' need not be traded on any exchange or in any financial market." [11]Thus, most oil and gas supply contracts among private parties will qualify as forward contracts.

b. Oil and gas is a commodity.[12] For these purposes, so is electricity.[13]

B. Courts have established a four-element test to determine whether an agreement is a forward contract.[14]

1. The subject of the contract must be a commodity with substantially all of the expected costs of performance attributable to the expected costs of the underlying commodity.

a. The benefits of the contract must depend primarily on future fluctuations in commodity prices, rather than costs attributable to packaging, marketing, transportation, or construction of power generating or oil and gas collection facilities.

2. The contract must have a maturity date more than two days after the contracting date.

a. This element is usually satisfied easily, as most oil and gas supply contracts provide for purchases, sales and deliveries covering at least a week, month or year in the future.

b. The absence of specific delivery dates for each particular delivery of a commodity will not prevent the agreement from being a forward contract, as long as the general term extends into the future.[15]

3. The quantity and time elements must be fixed at the time of contracting.

a. Generally, a supply or requirements contract is valid under § 2-306 of the UCC and will supply the necessary "quantity" element.[16]

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[10] *Matter of Olympic Natural Gas Co.*, 294 F.3d 737, 741 (5th Cir. 2002); *BCP Liquidating LLC v. Bridgeline Gas Mktg., LLC (In re Borden Chemicals and Plastics)*, 336 B.R. 214, 218 (Bankr. D. Del. 2006).
[11] *National Gas*, 556 F.3d at 256-57.
[12] *Olympic Natural Gas Co.*, 294 F.3d at 741; *Borden Chemicals,* 336 B.R. at 218.
[13] *Lightfoot v. MX Energy Electric, Inc. (Matter of MBS Mgmt. Services, Inc.)*, 690 F.3d 352, 355 (5th Cir. 2012); *Clear Peak Energy, Inc. v. Southern Calif. Edison Co. (In re Clear Peak Energy, Inc.)*, 488 B.R. 647, 658 (Bankr. D. Ariz. 2013).
[14] *See National Gas*, 556 F.3d at 259; *Clear Peak Energy*, 488 B.R. at 657.
[15] *MBS Mgmt.*, 690 F.3d at 356; *Clear Peak Energy*, 488 B.R. at 658.
[16] *MBS Mgmt.*, 690 F.3d at 356 n. 3.

b. An extended term will be a sufficiently specific time period for the contract, and any deliveries of product more than two days following the date of contracting will satisfy this requirement.

4. The contract must have a relationship to the financial markets.

a. This element involves a fine line: Although a forward contract will provide for the purchase, sale and delivery of goods on an ongoing basis over an extended period of time, such a contract cannot be merely "an ordinary supply contract," a "normal purchase and sale agreement," "ordinary supply-of-goods contracts," or a "simple supply contract."[17]

b. Thus, there must be evidence that a principal purpose or effect of the agreement was to protect against the uncertainty of future price fluctuations and to hedge against possible changes in the price of a commodity.[18]

c. A forward contract may involve the actual physical delivery of goods on an ongoing basis, and such physical delivery will not vitiate the "financial" character of the agreement.[19]

C. To qualify for the Code's exemption, at least one of the parties to the transaction must be a "forward contract merchant."

1. "Forward contract merchant" is defined in § 101(26).

a. The term "forward contract merchant" means a Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.

2. What this means generally is that the contract will qualify unless both parties are entering into a forward contract for the first time.[20]

3. Nevertheless, the parties cannot ignore this requirement, and must adduce evidence that at least one of the parties had a regular business practice of entering into forward contracts.[21]

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[17] *National Gas*, 556 F.3d at 256; *Clear Peak Energy*, 488 B.R. at 659; *Borden Chemicals*, 336 B.R. at 219-20.
[18] *Clear Peak*, 488 B.R. at 659-60; *Borden Chemicals*, 336 B.R. at 220-22.
[19] *National Gas*, 556 F.3d at 258; *Olympic Natural Gas*, 294 F.3d at 741.
[20] *Clear Peak*, 488 B.R. at 660-61; *Borden Chemical*, 336 B.R. at 225.

IV. Critical issues in administering safe harbor contracts during bankruptcy.

A. Setoff limitations.

1. The general rule is that a nondebtor counterparty to a safe harbor contract may exercise setoff rights permitted under contract documents and applicable law, without regard to the automatic stay. Section 362(b)(6) provides that the automatic stay does not apply:

> [U]nder subsection (a) of this section, of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts.

2. But, the above statute affects only the *ability* to effectuate a setoff. The counterparty must still have a *right* to setoff under both applicable non-bankruptcy law (state law and contract principles) and the limitations on setoff imposed under § 553.[22]

3. The strict mutuality requirements for setoff in § 553 of the Code remain applicable to setoffs involving safe harbor contracts and are not overridden by provisions in safe harbor contracts allowing non-mutual setoffs.

4. No "triangular" or multi-party setoffs are permitted.

a. Many swap agreements provide that a non-defaulting party may setoff, against any amounts owed to it or its affiliates, any amounts owed by the defaulting party or its affiliates.

b. Courts have repeatedly held that there is no "contract exception" to the mutuality requirement for a setoff under Code § 553.

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[21] *Magnesium Corp.*, 460 B.R. at 376.
[22] *In re SemCrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010); *In re Lehman Bros. Holdings, Inc.*, 433 B.R. 101, 109 (Bankr. S.D.N.Y. 2010) ("*Lehman-Swedbank*"), *aff'd*, 445 B.R. 130 (S.D.N.Y. 2011).

(1) In *SemCrude*, the court rejected Chevron's attempt to setoff, against amounts that it owed SemCrude, amounts that SemFuel and SemStream owed to Chevron.[23]

(2) In *Lehman-UBS*, the court rejected UBS's attempt to setoff, against amounts that it owed Lehman Brothers, Inc., amounts that LBI owed to UBS Securities and UBS Financial Services.[24]

c. This applies to the Code's temporal mutuality requirement also: The Code's safe harbor provisions will not trump § 553 to allow setoff of a post-petition debt against a pre-petition debt.[25]

B. The Code's "safe harbor" to liquidate, terminate or accelerate a covered contract will be strictly construed.

1. A creditor's right, under a safe harbor contract, to alter or "flip" a right of payment to favor the creditor due to the debtor's bankruptcy filing will be prohibited.[26]

2. Similarly, a creditor cannot use the debtor's bankruptcy filing to alter the priority of the debtor's right to payment under the safe harbor contract, as that modification will be deemed an unenforceable *ipso facto* provision.[27]

3. Nevertheless, a contractual provision for calculating the amount owing following a party's bankruptcy default will be given effect.[28] "Referring to the ordinary meaning of 'liquidation' leads to the conclusion that the right to cause the liquidation of a swap agreement must mean the right to determine the exact amount due and payable under the swap agreement."[29]

4. The *Lehman* court emphasized the textual distinction between "the insolvency or financial condition *of the debtor*" in §365(e)(1)(A) and "the commencement of a case [*by anyone*]" in § 365 (e)(1)(B) and held that a counterparty's termination of a swap and exercise of bankruptcy-related rights against LBSF, prior to LBSF's bankruptcy filing and based on LBHI's (the guarantor's) insolvency and bankruptcy filing, was void in LBSF's later bankruptcy filing as an invalid act under an *ipso facto*

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[23] *SemCrude*, 399 B.R. at 396-97.
[24] *In re Lehman Bros. Inc.*, 458 B.R. 134, 143 (Bankr. S.D.N.Y. 2011 ("*Lehman-UBS*").
[25] *Lehman-Swedbank*, 433 B.R. at 109-110.
[26] *Lehman Bros. Special Fin. Inc. v. BNY Corporate Transaction Svcs. (In re Lehman Bros. Holdings Inc.)* ("*Lehman-BNY*"), 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010).
[27] *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Limited (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31, 39-40 (Bankr. S.D.N.Y. 2011) ("*Lehman-Ballyrock*").
[28] *Lehman-MSHDA*, 502 B.R. at 395 ("The very act of liquidating and the method for doing so are tightly intertwined to the point that liquidation without a defining methodology is impossible to perform.").
[29] *Id*. at 393.

clause.[30] [Query: What if termination occurred based on contractual provisions relating to the "insolvency or financial condition" of LBHI, which was not "the debtor" in LBSF's case?]

a. The court found that the bankruptcy filings of the many Lehman affiliates constituted a single integrated act, even in the absence of any veil-piercing or substantive consolidation.

b. This prevented any counterparty, retroactively, from claiming the benefits of prompt protective action during the short interim period between LBHI's bankruptcy filing and those of other Lehman affiliates, including LBSF, which was Lehman's principal swaps arm. Effectively, LBSF's contracts were protected from a bankruptcy default even before LBSF filed for bankruptcy.

c. Thus, Ballyrock could not use LBHI's bankruptcy default to avoid paying LBSF, which was "in the money" at the time of LBHI's bankruptcy filing and Ballyrock's attempted termination.

5. The Code changes the normal rules when calculating damages based on rejection of a safe harbor contract.

a. Normally, §§ 365(g) and 502(g) of the Code provide that damages for rejection of an executory contract relate back to the petition date, meaning that the amount of a debtor's liability is generally fixed as of the date of the bankruptcy filing.[31]

b. Section 562(a) fixes damages arising from the rejection of a safe harbor contract as of the earlier of the rejection date or the termination date of the contract.

(1) Termination of the contract may occur due to the nonbankrupt counterparty's exercise of a bankruptcy termination right under the agreement, consistent with the Code's "safe harbor" rights, or due to a termination date under the agreement.

(2) Rejection will be based on the debtor's exercise of rights under § 365.

(a) Consistent with the principle that an executory contract is enforceable by, but not against, the debtor during bankruptcy prior to assumption or rejection, a debtor may "play the market" during the bankruptcy and reject

[30] *Lehman-Ballyrock*, 452 B.R. at 39 n. 25 (citing *Lehman-BNY,* 422 B.R. at 420).
[31] *See generally* L. Barefoot and D. Levine, *When to Pull the Trigger*, ABI Journal (March, 2014) at 18.

when the market is in the debtor's favor, to minimize the amount of a counterparty's claim. Of course, if the debtor bets wrong, it can also increase the creditor's claim.

(b) A counterparty must act quickly to terminate if it wishes to take advantage of a bankruptcy termination clause and preclude the debtor from playing the market to the counterparty's disadvantage, and has much less latitude to "play the market" than does the debtor.

6. The little-known unpublished *Metavante* decision in the Lehman Brothers case has significantly affected practice with safe harbor contracts.[32]

   a. Metavante had a swap agreement with LBSF, guaranteed by LBHI. The agreement required the out-of-the-money party to pay true-up amounts quarterly under the agreement.

   b. At the time of LBHI's bankruptcy, Metavante was out of the money and, thus, was obligated to pay LBSF.

   c. Shortly after LBHI's bankruptcy Metavante notified LBSF that, due to the default of LBHI (as the credit support party under the swap) based on financial tests not relating to LBHI's bankruptcy filing, Metavante was exercising its express right as the non-defaulting party to suspend performance (*i.e.*, paying LBSF) under the swap.

   d. LBSF then filed for bankruptcy. Metavante continued to suspend performance and not pay LBSF post-bankruptcy, while playing the market and hoping that its situation under the swap would improve.

   e. LBSF neither assumed nor rejected the swap for nearly a year.

   f. LBSF did, however, sue Metavante for violating the automatic stay by not paying under the swap.

   g. The court held that, because LBHI's and LBSF's bankruptcy filings were unified acts, Metavante's reliance on LBHI's financial condition to take action against LBSF was essentially based on LBSF's financial condition as a debtor, and therefore a void exercise of rights under an *ipso facto* clause.

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[32] *In re Lehman Bros. Holdings Inc.*, Case No. 08-13555 [Dkt No. 5261] (Bankr. S.D.N.Y., Sept. 15, 2009) ("*Metavante*").

h. Although a counterparty has the right to terminate a safe harbor agreement following a debtor's bankruptcy, free from hindrance by the automatic stay, that right is of brief duration and prevents the counterparty from playing the market. The court ruled that a counterparty's "window to act promptly under the safe harbor provisions has passed, and while it [might] not have had the obligation to terminate immediately upon the filing of [LBSF's bankruptcy case], its failure to do so, at this juncture, constitutes a waiver of that right at this point."[33]

i. Although the safe harbor provisions of the Code protect liquidation, termination and acceleration, they do not include suspension of performance as one of a counterparty's protected activities. The counterparty must either terminate or perform.

j. The court gave no indication on how long the "termination window" will remain open for a swap counterparty. In Metavante's case, eleven months was too long.

Nonstandard Preference Defenses Applicable to Oil and Gas Bankruptcy Cases

I. "Inchoate lien defense" under § 547(b)(5).

A. The inchoate lien defense attacks the preference element, under § 547(b)(5), of showing that, absent the preferential transfer, the creditor-transferee would have received more than it would have received in the debtor's hypothetical liquidation under Chapter 7 of the Code.

B. The basic theory behind this defense is that, if the preferential payment had not been made, the creditor would have perfected and enforced statutory lien rights—here, oil and gas mechanic's and materialmen's liens—against the debtor's property, and that lien would have been paid in full during any liquidation of the debtor's property.

C. The modern concept of this defense arose from the 360 Networks bankruptcy case in 2005, where the court stated:

"[P]ayments made to the holder of an inchoate statutory lien during the preference period are not avoidable where, at the time of the payment, the lienholder: i) remained eligible to perfect the lien pursuant to relevant state

[33] *Id*., slip op. at 111-12.

law, and ii) such perfection would not otherwise have been avoidable under the Bankruptcy Code."[34]

The 360 Networks court further held that a preference claim should not exist for payments to obviate the filing of a statutory lien, because otherwise,

"Holders of an inchoate statutory lien will be faced with an unreasonable Hobson's choice between accepting payment or taking the commercially unreasonable step of declining payment in order to perfect an inchoate statutory lien."[35]

D. The inchoate lien defense has been recognized by courts throughout the country, including the Tenth Circuit B.A.P.[36]

E. Colorado law affords specific lien rights securing amounts owed to contractors or laborers that are hired to perform labor, or to furnish materials or supplies, for the "altering or operating" of any gas or oil wells by virtue of an express or implied contract.[37] The lien attaches to the property or interests owned or held by the contracting party (including any leasehold interest), and the improvements themselves. The lien arises, or is fixed, upon the first providing of labor or materials.[38] To preserve a lien on oil and gas property, the lien must be recorded within six months after the last labor or material was provided under the contract.[39] Colorado's oil and gas lien statute treats an open running account as a single contract: in other words, as long as some work was provided during the six month period, the right to recover for unpaid amounts accruing prior to the six month period on an open account between the parties will still be secured by the lien.[40]

F. The inchoate lien defense requires proof that:

1. At the date of payment, the creditor could have perfected its statutory lien; and

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[34] *The Official Committee of Unsecured Creditors of 360 Networks (USA), Inc. v. AAF-McQuay, Inc. (In re 360 Networks (USA), Inc.)*, 327 B.R. 187, 193 (Bankr. S.D.N.Y. 2005.
[35] *Id.* at 192.
[36] *Bryant v. JCOR Mechanical, Inc. (In re The Electronic Corp.)*, 336 B.R. 809, 813 (10th Cir. B.A.P. 2006); *Betty's Homes, Inc. v. Cooper Homes, Inc.*, 411 B.R. 626, 632 (Bankr. W.D. Ark. 2009); *Snittjer v. Pippert (In re Carney)*, 396 B.R. 22, 27 (Bankr. N.D. Iowa 2008); *Hopkins v. Merlins Insulation, LLC (In re Larsen*), 2008 WL 4498890 at **4-5 (Bankr. D. Idaho. Aug. 14, 2008).
[37] *C.R.S. § 38-24-101.*
[38] *Id.*; *Electron Corp.*, 336 B.R. at 811 (interpreting identical "at the time . . . commenced" language of Colorado's general mechanic's and materialmen's lien statute).
[39] *C.R.S. § 38-24-104(1).*
[40] *C.R.S. § 38-24-104(2).*

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2. The value of the debtor's property subject to the lien would have, in light of other liens on the property and the amount and priority of the creditor's lien, supported payment in full of the creditor.[41]

3. Thus, a creditor must compare the dates of perfection for all other liens against the relevant property, and the date of perfection of the hypothetical statutory lien under applicable state law, which will likely date from the first date of performing services at the property.

II. Contract assumption defense.

A. This defense is also based primarily on a failure to satisfy § 547(b)(5). It is axiomatic that, before a trustee or debtor in possession may assume a contract under § 365 of the Code, it must "cure all defaults, assure future performance, and make the other contracting party whole."[42] Thus, because a contract creditor whose contract is assumed would be paid in full pursuant to § 365, a plaintiff seeking to avoid as preferential pre-petition payments made under the assumed contract cannot satisfy the hypothetical liquidation test under § 547(b)(5).[43]

B. Other courts have held, primarily as a matter of policy and Congressional intent, that §§ 365 and 547 are mutually exclusive remedies, and that permitting a preference suit after assumption of an executory contract would undermine the intent and purpose of § 365.[44]

C. The Contract Assumption Defense can arise in oil and gas supply agreements, oilfield services agreements, and agreements for the purchase, sale and distribution of other commodities in the energy industry.

D. A potential preference defendant should investigate whether (1) its contract was assumed, either separately or in bulk under a plan or omnibus assumption order and (2) the challenged payments were received under the assumed contract, or some other transaction involving the debtor.

III. Interplay between § 503(b)(9) claims and new value defense to preference claims under § 547(c)(4).

A. Oil and gas can be the subject matter of a § 503(b)(9) claim.

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[41] *Electron Corp.*, 336 B.R. at 813.
[42] *Kimmelman v. Port Auth. of New York & New Jersey (in re Kiwi Int'l Air Lines, Inc.)*, 344 F.3d 311, 318 (3rd Cir. 2003).
[43] *Id*. at 318-19. *Accord In re Newpage Corp.*, Adv. Pro. No. 13-52196 (KG), slip op. at 10 (Bankr. D. Del., Oct. 1, 2014); *Weinman v. Allison Payment Systems, LLC (In re Centrix Fin'l, LLC)*, Adv. Pro. No. 08-01576 EEB, slip op. at 7-8 (Bankr. D. Colo., June 15, 2010)..
[44] *In re Superior Toy & Mfg. Co., Inc.*, 78 F.3d 1169, 1174 (7th Cir. 1996); *Centrix Fin'l*, slip op. at 6-7 (and authorities cited therein).

1. § 503(b)(9) applies to the sale of "goods," which bankruptcy courts will interpret using the UCC's definition of "goods."[45]

2. The definition of "goods" in UCC § 2-105 includes "other identified things attached to realty as described in [UCC § 2-107, defining the scope of "sales of goods"]."

3. UCC § 2-107 provides, "A contract for the sale of minerals or the like (including oil and gas) . . . is a contract for the sale of goods within this Article . . . ."

4. Thus, oil and gas fall within the scope of "goods" that may form the basis of a claim under §503(b)(9) of the Code.[46]

B. The elements of a defense to a preference claim under § 547(c)(4) are well-settled:

1. A creditor must have received a transfer that is otherwise avoidable as a preference;

2. After receiving the preferential transfer, the preferred creditor must advance "new value" to the debtor on an unsecured basis; and

3. The debtor must not have fully compensated the creditor for the "new value" as of the date that it filed its bankruptcy petition.[47]

4. Delaware characterizes the "new value" defense as a "subsequent advance approach."

a. "Creditors are entitled to set off the amount of 'new value' which remains unpaid on the date of the petition against the amount which the creditor is required to return to the trustee on account of the preferential transfer it received. In making an analysis of payments, however, one need not link specific invoices to specific payments . . . rather, one need only track the debits and credits generally. One should only look at the net result—the extent to which the creditor was preferred,

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[45] *In re NE Opco, Inc.*, 501 B.R. 233, 240 (Bankr. D. Del. 2013); *In re Pilgrim's Pride Corp.*, 421 B.R. 231, 237 (Bankr. N.D. Tex. 2009); *In re Plastech Engineered Prods.*, 397 B.R. 828, 836 (Bankr. E.D. Mich. 2008).
[46] *Id. See also In re SemCrude, L.P.*, 416 B.R. 399, 405 (Bankr. D. Del. 2009).
[47] *In re Friedman's, Inc.*, 738 F.3d 547, 552 (3rd Cir. 2013); *In re Winstar Communications, Inc.*, 554 F.3d 382, 402 (3rd Cir. 2009).

taking account of the new value the creditor extended to the debtor after repayment on old loans."[48]

b. The only limitation on what would otherwise be a "net result" approach is that one cannot apply the test to give a credit for new value in excess of the creditor's preference exposure at any time during the preference period.[49] This means that Delaware courts cannot be making a true "net result" calculation and will be applying preferential payments and new value sequentially, in a debits and credits format, throughout the preference period.

5. Courts in the Seventh and Eleventh Circuits take the "remains unpaid approach" and conduct an invoice-by-invoice analysis to determine whether a particular transfer of new value by the creditor remained unpaid as of the petition date—if the particular new value was paid, then the creditor cannot claim a defense to the extent of that value.[50]

6. The Southern District of New York also appears to follow a more surgical approach to the "remains unpaid approach." New York courts properly read the Code literally by holding that a new value defense is available, even for new value that is paid, as long as the payment is itself an avoidable transfer.[51] This approach also contemplates a rigorous matching of invoices to payments.

7. Although the Tenth Circuit B.A.P. has stated the elements of § 547(c)(4) as conforming to the strict "remains unpaid approach,"[52] the District of Colorado follows the Delaware "subsequent advance approach," whereby each transfer is avoidable until exceeded by subsequent advances of new value, and surplus new value cannot be applied as a credit against later preferential payments.[53]

C. In Delaware, the status of the new value defense is frozen as of the petition date; thus, unavoidable post-petition payments to the creditor (e.g., under a

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[48] *Miller v. JNJ Logistics LLC (In re Proliance Int'l, Inc.)*, 514 B.R. 426, 436 n. 41 (Bankr. D. Del. 2014); *Burtch v. Masiz (In re Vaso Active Pharm., Inc.)*, 500 B.R. 384, 396 (Bankr. D. Del. 2013); *In re Sierra Concrete Design, Inc.*, 463 B.R. 302, 305-06 (Bankr. D. Del. 2012).
[49] *Proliance*, 514 B.R. at 436; *Sierra Concrete*, 436 B.R. at 307-08.
[50] *See authorities cited in Proliance*, 514 B.R. at 431 n. 22.
[51] *In re Musicland Holding corp.*, 462 B.R. 66, 71 (Bankr. S.D.N.Y. 2011); *In re Maxwell Newspapers*, 192 B.R. 633, 639 (Bankr. S.D.N.Y. 1996).
[52] *Rushton v. E&S Int'l Enterprises, Inc. (In re Eleva, Inc.)*, 235 B.R. 486, 488-89 (10th Cir. B.A.P. 1999).
[53] *Jobin v. Lalan (In re M&L business Machine Co.)*, 160 B.R. 851, 855 (Bankr. D. Colo. 1993), *aff'd*, 167 B.R. 219 (D. Colo. 1994); *Clark v. Frank B. Hall & Co. of Colorado (In re Sharoff Food Service, Inc.)*, 179 B.R. 669, 677 (Bankr. D. Colo. 1995).

critical vendor order or an order to pay pre-petition wages in favor of a staffing agency) won't reduce the creditor's defense.[54]

1. Delaware has two potential exceptions to the general rule that post-petition payments to the creditor are irrelevant to a new value defense:

    a. Post-petition assumption of an executory contract will be relevant to extinguish the preference claim generally.

    b. The Third Circuit has indicated that a creditor's valid reclamation claim may have retroactively prevented the reclaimed goods from ever adding value pre-petition to the debtor's estate and may reduce the new value defense.[55]

2. The Colorado Bankruptcy Court has ruled only that post-petition advances by a creditor cannot factor into the new value analysis, and has not yet ruled on the effect of unavoidable post-petition payments to a creditor.

3. The New Mexico Bankruptcy Court held that unavoidable post-petition payments to a creditor under a critical vendor order will reduce the creditor's new value defense, and that post-petition value supplied by the creditor will not factor into the defense.[56]

D. Based on their invocation of particular tests for the new value defense, courts are split on whether the amount of a creditor's valid § 503(b)(9) claim will reduce that creditor's new value defense.

1. Two courts have held that a § 503(b)(9) claim that is allowed and paid cannot be part of a new value defense, because to hold otherwise would allow "double dipping" by a creditor and deplete the estate to the detriment of all creditors.[57]

    a. The *Circuit City* court held that the plain language of § 547(c)(4) prevents the defense from being applied where new value has been paid through an "otherwise unavoidable" payment.

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[54] *Friedman's*, 738 F.3d at 562; *Stanziale v. Car-Ber Testing, Inc. (In re Conex Holdings, LLC)*, Adv. Pro. No. 12-51132 (CSS), slip op. at 2-3 (Bankr. D. Del., Dec. 27, 2013).
[55] *Id*.
[56] *Gonzales v. Sun Life Ins. Co. (In re Furr's Supermarkets, Inc.)*, 485 B.R. 672, 734 (Bankr. D. N.M. 2012).
[57] *Siegel v. Sony Electronics, Inc. (In re Circuit City Stores, Inc.)*, 515 B.R. 302, 313 (Bankr. E.D. Va. 2014); *TI Acquisition, LLC v. Southern Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 385 (Bankr. N.D. Ga. 2009).

b. The *TI Acquisitions* court noted that the Eleventh Circuit follows the "remains unpaid" test. Thus, when new value has been paid through a post-petition payment, a creditor cannot use that new value to defend against a preference claim.

2. One court held that deliveries of new value entitled to § 503(b)(9) claim status are not disqualified from constituting new value for purposes of § 547(c)(4).[58]

a. The "plain language of § 547 closes the preference window at the petition, limiting the § 547(c)(4) defense to new value supplied and payments made before the debtor crosses over into bankruptcy."[59]

b. The *TI Acquisitions* court noted that there was no indication in the *Commissary Operations* opinion that the creditor's § 503(b)(9) claim had been paid, while the creditor's priority claim in *TI Acquisitions* had been paid, so that might be a valid point of distinction between the cases.

c. Based on the Third Circuit's drawing of a hard line at the petition date for the new value defense in *Friedman's*, and disagreeing with the *TI Acquisitions* court's consideration of post-petition payments, it is reasonable to expect Delaware to follow *Commissary Operations*.

d. Based on New York's application of the "remains unpaid approach," it is reasonable to expect New York to follow *TI Acquisitions*.

Walking Through an Asset Sale in an Oil and Gas Bankruptcy Case

I. Will credit bidding preclude at the outset a competitive sale process generating cash for the estate?

A. Section 363(k) preserves the right of secured creditors to credit bid the full amount of their allowed claim, not limited to the value of collateral or any bifurcation of a claim into secured and unsecured components.[60]

B. But § 363(k) also provides that the right to credit bid exists "unless the court for cause orders otherwise." Recent cases have established a potential trend of limiting secured creditors' credit-bidding rights.[61]

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[58] *Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 878 (Bankr. M.D. Tenn. 2010).
[59] *Id.*(quoting *Phoenix Rest. Group, Inc. v. Ajilon Prof'l Staffing LLC (In re Phoenix Rest. Group, Inc.)*, 317 B.R. 491, 496 (Bankr. M.D. Tenn. 2004)).
[60] *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 2070 (2012); *Cohen v. KB Mezz Fund II (In re Submicron Systems Corp.)*, 432 F.3d 448, 459-60 (3rd Cir. 2008).

1. In *Fisker*, the secured creditor bought $168.5 million in secured debt for $25 million, and sought to buy all of the debtor's assets through a $75 million credit bid. The only competing (cash) bidder testified that it would not participate unless the secured creditor's credit bid was capped at $25 million. The court capped the credit bid, finding that a material portion of the debtor's assets were not covered by perfected liens of the secured creditor, the scope of the secured creditor's lien on other assets was disputed, and that "cause" for a cap existed, due to the need to facilitate a competitive cash auction.

2. In *In re Free Lance-Star*, the court reduced the secured creditor's credit bid from around $38 million to $13.9 million, finding that the secured creditor didn't have perfected liens on portions of the debtor's property and that it had engaged in inequitable conduct.[62] The inequitable conduct included (a) pressuring the debtor into a hasty bankruptcy filing; (b) filing UCC financing statements shortly before bankruptcy when it realized that it was unperfected; (c) not disclosing those belated filings during the cash collateral hearing; (d) shortening the marketing period for the sale; and (e) requesting the debtor to put language in the marketing materials conspicuously noting the secured creditor's credit bidding rights.

3. In *In re RML Development, Inc.*, the court found "cause" to limit a secured creditor's credit bid to the principal amount of its debt, excluding interest, after an objection was filed to the interest component and the priority of the secured creditor's lien was disputed, and further required the secured creditor to post a letter of credit or surety bond in the amount of the principal credit bid.[63]

II. The bid procedures order plays a critical role in determining the extent of competition for assets.

A. In oil and gas cases, a stalking horse can have an even greater advantage than in other cases by slanting the bid procedures order in its favor. Most oil and gas cases will present complex title, geologic, valuation and environmental issues that must be analyzed. The stalking horse will have had all the time it desired to study these issues, while competitors must address the same issues in a compressed time-frame. Also, the stalking horse will have been able to line up its financing, while competitors must move quickly to obtain the substantial financing that will likely be required.

B. Generally, a 30-day period for the submission of competing bids is the middle range for a sale of oil and gas assets.

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[61] *See In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 315-16 (3rd Cir. 2010) (and authorities cited therein); *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55, 59-60 (Bankr. D. Del. 2014).
[62] 512 B.R. 798, 805-06 (Bankr. E.D. Va. 2014).
[63] *In re RML Development, Inc.*, 2014 WL 3378578 at ** 3-6 (Bankr. W.D. Tenn. July 10, 2014).

C. A bid procedures order must walk a difficult line between promoting competition and incentivizing the stalking horse to continue pursuing the purchase. Battleground items will include:

1. Qualification of competing bidders, and proof of financial wherewithal.
2. Amount of earnest money or deposit.
3. Increments for overbids.
4. Conditions on due diligence.
5. Who will have input into the determination of whether an entity is a "Qualified Bidder," and what information on bidders is shared with the stalking horse.

III. Due diligence issues.

A. Work immediately to negotiate and execute a confidentiality agreement that will allow access to information by counsel, client personnel and outside consultants.

B. Counsel must work closely with a client's personnel or outside landmen and valuation experts to evaluate the title, production, and valuation information affecting the property.

C. It is especially important to summarize the debtor's executory contracts, and note all termination conditions, necessary consents for assignments, potential defaults, and cost-benefit information. The client's personnel will be invaluable in this step.

D. Other due diligence will involve title searches on the debtor's property to determine all entities with claims or liens against, or interests in, the debtor's property. The list of these entities will be important for providing notice of a sale free and clear of those liens, claims and interests under § 363(f). Numerous cases hold that a free and clear bankruptcy sale is void or voidable on due process grounds as to the holder of a lien or interest who didn't receive formal notice of the free and clear sale.[64] One court held that, because of potential due process violations, a bankruptcy sale conducted without proper notice to a holder of a claim, lien or interest is "caveat emptor" to the purchaser.[65]

E. Although due diligence will primarily be conducted through a virtual data room, oil and gas cases typically involve an actual hard copy data room, and on-site inspection and other work at the producing property.

IV. Sale through § 363 or a plan?

A. The structure of the purchase and the debtor's financial position will often dictate whether the sale may or should be conducted through a stand-alone § 363 sale, or through a confirmed plan.

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[64] *In re F.A. Potts & Co.*, 86 B.R. 853 (Bankr. E.D. Pa. 1988), *aff'd*, 891 F.2d 280 (3rd Cir. 1989); *In re MMH Automotive Group, LLC*, 385 B.R. 347 (Bankr. S.D. Fla. 2008); *In re Metzger*, 346 B.R. 806 (Bankr. N.D. Cal. 2006); *In re Rounds*, 229 B.R. 758 (Bankr. W.D. Ark. 1999).
[65] *In re Parrish*, 171 B.R. 138 (Bankr. M.D. Fla. 1994).

B. Generally, courts have overcome earlier "sub rosa plan" concerns, and are more willing to authorize the sale of all assets for cash through a § 363 sale. This may be desirable in the interests of speed, and where the debtor may not have time or financing to last through a longer plan process, with a resulting loss of value for the estate.

C. However, if the sale structure is more complex, and if creditors will have an ongoing interest in the operation of the assets through issuance of equity in the buyer entity that will encompass the purchased assets, then the sale will probably require the disclosure and protective requirements of a plan confirmation.

D. Also, a plan may be necessary to wipe out junior liens or interests in the assets.

1. Courts have held that property may not be sold free and clear of junior liens under § 363(f), ruling that a state law foreclosure sale is not the type of applicable law that permits sale of property free and clear.[66] Thus, in those jurisdictions, a confirmed plan may be necessary to extinguish junior liens on the property.

2. Other courts have held that junior liens may be extinguished through a state law foreclosure sale and, thus, may be stripped from the property in a sale under § 363(f).[67]

V. Break-up fee issues.

A. Although the buyer will seek broader conditions for the payment of a break-up fee, the condition for a fee will be based upon the seller's termination of a stalking horse agreement in order to pursue an offer promising greater economic value for the estate.

B. A break-up fee will follow, and often be a condition of, a signed stalking-horse purchase agreement. Thus, the stalking-horse must usually invest resources into drafting and negotiating a stalking-horse purchase agreement without any guaranty that it will be provided a break-up fee.

C. To award a break-up fee, courts require a showing that the proposed buyer would not have entered into the stalking-horse agreement or agreed to subject its purchase to the risk of potential overbids without a break-up fee.[68] The stalking horse agreement should contain a condition precedent of a break-up fee, a representation that the buyer would not have entered into the stalking-horse agreement without the incentive of a break-up fee, and a right of termination if the break-up fee is not awarded.

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[66] *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25, 40 (9th Cir. B.A.P. 2008); *In re Jaussi*, 488 B.R. 456, 459 (Bankr. D. Colo. 2013).
[67] *In re WK Lang Holdings, LLC*, 2013 Bankr. LEXIS 5224 at **27-28 (Bankr. D. Kan. Dec. 11, 2013); *In re Jolan, Inc.*, 403 B.R. 866, 869 (Bankr. W.D. Wash. 2009).
[68] *In re Reliant Energy Channelview LP*, 594 F.3d 200, 208 (3rd Cir. 2010).

D. A break-up fee of around 3% of the proposed sale price is the typical magnitude that courts will view as reasonable, but the amount is dependent on numerous case-specific factors.[69]

E. The break-up fee order should provide that the fee has priority over all other administrative expenses, and may be paid without further motion to or order from the Court upon the occurrence of one of the specified conditions for the fee.

VI. Key components of the purchase and sale agreement.

A. There must be a clear delineation of which assets and liabilities are being included/assumed or excluded/rejected. This includes both the nature of assets and liabilities and cutoff dates. The agreement must provide for an exclusion of any successor liability claims, as a prelude for including this protection in the sale order.

1. There will be a schedule of all contracts designated for assumption and assignment, and a representation of any cure amounts. Responsibility for paying any cure amounts will be negotiated and will be a key element of deal economics.

2. Generally, excluded assets will include tax refunds, pre-sale accounts receivable, and avoidance claims.

B. Title and environmental issues.

1. There will be a due diligence period for title and environmental issues, before the agreement goes "hard," usually around 30 days. Before that deadline, the agreement can be terminated without liability, after that date, a deposit may be forfeited, or liquidated damages can be awarded.

2. Often there is a "basket" or a deductible for any claimed title or environmental defects, before any adjustment to the purchase price may exist. Standards for evaluating these claims will be closely negotiated.

3. Seller must provide access to all relevant records, including drilling and production records.

4. There must be reasonable access to the actual properties for on-site inspection and at least a Phase I environmental assessment. The parties should enter into, and submit for court approval, an agreement for indemnification and insurance during on-site due diligence and inspections by buyer's and seller's personnel.

5. The agreement may provide for termination without penalty if total title or environmental claims exceed a certain threshold.

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[69] *See generally In re Integrated Resources, Inc.*, 147 B.R. 650, 662 (Bankr. S.D.N.Y. 1992); D. Kleiman, *Alternatives for Awarding Break-Up Fees to Stalking Horse Bidders*, Am. Bankr. Inst. J. 26 (Oct. 2010).

C. Representations regarding seller's assets.

1. The accuracy of the title, drilling, production and revenue information provided to buyer.

2. All royalties, rentals and payments under material leases have been paid and no defaults exist.

3. All gathering systems and other key facilities are located on properties where seller has surface rights.

4. Every well owned and operated by seller or under a contract with seller has been drilled, completed and operated in accordance with applicable law.

5. Every well has been operated in accordance with reasonable and prudent oil field practice and in compliance with applicable leases.

D. No surface or access agreement exists that would materially interfere with the use of any oil and gas assets, and all such assets are subject to valid agreements that provide reasonable access to the oil and gas assets.

E. The agreement should provide that the buyer would not enter into the agreement without a break-up fee (see above), that an order authorizing the break-up fee is a condition precedent to closing, and that failure to obtain a break-up fee order by a date certain constitutes grounds for the buyer to terminate the agreement without penalty.

F. Normal bankruptcy conditions.

1. The sale order must be entered by the court on or before a certain date in a form acceptable to buyer.

2. The court must find that the buyer is a good faith purchaser, under § 363(m).

3. There is no conversion to Chapter 7, relief from stay with respect to any material assets, or default under any post-petition financing order.

4. The sale order must provide that the sale is free and clear of claims, liens and interests under § 363(f), the free and clear order includes any claims of successor liability, the purchase price constitutes reasonably equivalent value for purposes of all state and federal fraudulent transfer laws, and buyer shall not be deemed a successor of seller for purposes of any successor liability laws or claims.

VII. Assumption, assignment, and rejection of contracts.

A. Extensive due diligence will be necessary regarding all of the debtor's executory contracts, so that the buyer and seller can make knowledgeable decisions about which contracts to assume, assign or reject, whether it is possible to assume and assign certain contracts, and the economics involved in the decision.

1. Buyer's and seller's personnel must work together closely, and in conjunction with counsel, during due diligence to assemble information

and prepare necessary documents for filing with the court and notice to parties.

2. Because of the uncertainty whether an oil and gas lease is a lease of nonresidential real property, any motion to assume/assign an oil and gas lease should be made within 120 days after filing, or an extended period of up to 210 days, under § 365(d)(4)(A).

3. A debtor's assumption or rejection of contracts is evaluated under the business judgment rule.[70] To assume or assign a contract, the debtor must (a) cure, or provide adequate assurance that it will promptly cure, any default in the contract and (b) provide adequate assurance of the future performance of all obligations under the contract.[71]

4. The list of all contracts to be assumed and assigned will have to include a proposed amount to cure any defaults (usually listed at $0.00), and the motion should state conspicuously that all contracts not listed as assumed/assigned will be rejected, along with a deadline for any parties to rejected contracts to file a proof of claim for any rejection damages.

5. The parties should prepare a notice list for all contracts, so that proper notice of the assumption, assignment or rejection can be sent to all contract counterparties. As a matter of due process, a counterparty is entitled to actual, written notice of a debtor's motion to assume or reject its contract. Failure to give notice of rejection will cause the contract to "ride through" bankruptcy without being discharged, and subject to the counterparty asserting a postconfirmation claim against the reorganized debtor.[72] Failure to give notice of assumption and cure will cause the purported assumption to be void.[73] A counterparty to the debtor's contract is entitled to individualized, formal notice of assumption or rejection of a contract, and failure to provide such notice makes the assumption or rejection invalid, based on a lack due process.[74]

B. Under § 365(c), restrictions on assignment that would be valid under generally-applicable nonbankruptcy law will be given effect in bankruptcy. These valid restrictions can include limitations on transfers of interests in closely-held companies, transfers of intellectual property licenses, and transfers of personal

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[70] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523 (1984); *Sharon Steel Corp. v. National Fuel Gas Distrib. Corp. (In re Sharon Steel Corp.)*, 872 F.2d 36, 40 (3rd Cir. 1989).
[71] *Lakeside at Pole Creek, LLC v. Tabernash Meadows, LLC (In re Tabernash Meadows, LLC)*, 2005 WL 375660 at *9 (Bankr. D. Colo. Feb. 15, 2005) (quoting *Eastern Airlines, Inc. v. Ins. Co. of Penn. (In re Ionosphere Clubs, Inc.)*, 85 F.3d 992, 999 (2nd Cir. 1996).
[72] *Century Indemnity Co. v. Nat'l Gypsum Co. Settlement Trust (Matter of National Gypsum Co.)*, 208 F.3d 498, 504-05 (5th Cir. 2000).
[73] *Id.*
[74] *Dataprose, Inc. v. Amerivsion Communications, Inc. (In re Amerivision Communications, Inc.)*, 349 B.R. 718, 722-23 (10th Cir. B.A.P. 2006); *Gray v. Western Env'l Services & Testing, Inc. (In re Dehon, Inc.)*, 352 B.R. 546, 559 (Bankr. D. Mass. 2006).

service contracts or other contracts where the identity of the counterparty is an essential feature of the agreement.[75]

C. But, even where a creditor's interest is not subject to a free and clear sale, or a counterparty has a valid cure claim or a non-assignable contract right, or any party has a right to adequate protection, those rights and objections can be waived if the creditor or counterparty fails to object after receiving proper notice of the debtor's motion.[76]

1. Many counterparties will fail to object to a $0.00 cure amount stated in a voluminous omnibus assumption motion.

2. If a counterparty to a real estate agreement raises an objection that the assumption violates a transfer restriction or covenant, then the buyer and seller will likely have to negotiate in an effort to resolve the objection.

3. Many easements, covenants, and other restrictions running with the land are enforceable in equity, not subject to a free and clear sale under §363(f), and—despite the fact that they may have many of the characteristics of executory contract rights—not subject to assignment or abrogation under §365.[77]

D. Again, because of the uncertainty over the characterization of oil and gas leases as executory contracts or vested interests in real property, all oil and gas leases should be listed as both executory contracts to be assumed and assigned under § 365, and as property to be sold under § 363.

E. The purchaser/assignee must be able to demonstrate "adequate assurance of future performance" under all assigned contracts.

1. "Adequate assurance" depends on the facts and circumstances of each case, but should be given a "practical, pragmatic construction."[78]

2. The primary focus of adequate assurance concerns the assignee's ability to fulfill the financial obligations under the contract.[79]

3. Thus, the assignee should provide financials showing sufficient liquidity and cash flow from present and projected future operations to satisfy its obligations under the assigned contracts.[80]

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[75] *In re Headquarters Dodge, Inc.*, 13 F.3d 674, 682 (3rd Cir. 1993); *In re West Electronics, Inc.*, 852 F.2d 79, 83 (3rd Cir. 1988); *In re The IT Group, Inc.*, 302 B.R. 483-488-89 (Bankr. D. Del. 2003).
[76] *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537, 547-48 (7th Cir. 2003).
[77] *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994); *In re Lonesome Pine Holdings, LLC*, Case No. 10-34560 HRT, slip op. at 5 (Bankr. D. Colo. Sept. 1, 2011).
[78] *In re Sanshoe Worldwide Corp.*, 139 B.R. 585, 592 (Bankr. S.D.N.Y. 1992) (*quoting In re Bygaph, Inc.*, 56 B.R. 596, 605 (Bankr. S.D.N.Y. 1986). *Accord In re Fleming Companies, Inc.*, 499 F.3d 300, 307 (3rd Cir. 2007); *Carlisle Homes, Inc. v. Azzari (In re Carlisle Homes, Inc.)*, 103 B.R. 524, 528 (Bankr. D. N.J. 1989).
[79] *In re Martin Paint Stores*, 199 B.R. 258, 263 (Bankr. S.D.N.Y. 1996); *In re Fifth Ave. Originals*, 32 B.R. 648, 653 (Bankr. S.D.N.Y. 1983).

4. The assignee should also provide evidence of the qualifications and experience of its management team, and of its solid track record of performance under similar agreements.

F. Federal lands issues.

1. Federal leases, unit operating agreements, communitization agreements, rights-of-way and other agreements will likely have transfer restrictions that would be given effect in bankruptcy.

2. Buyer and seller must negotiate with the relevant agency of the Department of Interior early in the process.

3. Provided that the Department is satisfied with the proposed buyer/assignee, the Department is likely to give its conditional consent to transfer.

4. Typical conditions include:

a. Payment of all amounts owed by the debtor, following a post-sale audit by the Department.

b. Assumption of all decommissioning obligations and financial assurance/wherewithal requirements.

c. Allowing the Department to perform continuing audits and compliance review.

VIII. Maintaining the seller's operations during the sale process.

A. The seller may have vital operations that it is unable to continue while the sale is pending. Alternatively, various leases or contracts of the debtor may have provisions that require the commencement or completion of drilling, unitization or other activities by a certain date in order to preserve valuable rights under those contracts or leases—and that date might happen to occur during the sale process.

B. First analysis involves whether availability exists under the debtor's DIP loan to undertake the required efforts.

C. Second, determine whether the buyer (with consent of senior lenders) can extend supplemental post-petition financing to enable the debtor to pursue the necessary activity.

D. Third, and most practically, perhaps the buyer can perform the work for the debtor under a services agreement.

1. All provisions of the services agreement, and all costs and payments by debtor thereunder, must be approved by key constituencies in the bankruptcy case: DIP lenders, Committee, UST, Court.

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[80] *Matter of Texas Health Enterprises, Inc.*, 72 Fed. Appx. 122, 126 (5th Cir. 2003).

2. It is reasonable for the buyer to require advance payment for the bulk of the services and equipment, subject to approval by the DIP Lenders and the Committee.

3. The parties will need to balance termination rights, in order to keep buyer engaged to finish the project even if buyer is overbid for the debtor's assets.

4. The court must enter an order approving the services agreement and authorizing the debtor to make any payments thereunder.

5. Indemnification of the buyer/servicer for extraordinary loss or damage under the agreement may require further motion to and order from the court.

IX. Important provisions of the sale order.

A. Standard provisions not to be overlooked.

1. Court has jurisdiction as a core matter.

2. Notice to all parties in interest was sufficient.

3. Marketing was reasonable to expose assets to the relevant market and maximize value realized in the sale.

4. Debtor is authorized to sell assets, and to execute and perform the asset purchase agreement.

5. Sale is free and clear of liens, claims and interests, and all creditors are enjoined from pursuing the buyer on account of claims against the debtor.

6. Sale price constitutes "reasonably equivalent value" under state and federal fraudulent transfer laws.

7. Bankruptcy court retains jurisdictions over any disputes related to the purchase, and to enforce provisions of the sale order.

B. Importance of good faith finding under § 363(m).

1. § 363(m) provides that reversal or modification of an order authorizing a sale of assets does not affect the validity of a sale to an entity that purchases such property in good faith, unless the sale was stayed pending appeal.

2. Sale in good faith can't be overturned on appeal unless objector gets a stay of the sale order.

3. Sale in good faith, completed while an appeal is pending, generally renders the appeal moot and subject to dismissal.

4. "The requirement that a purchaser act in good faith . . . speaks to the integrity of his conduct in the course of the sale proceedings. Typically, the misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other

bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders."[81]

5. Generally, good faith is established through declarations from representatives of the buyer and seller. However, counsel should research the particular bankruptcy court to determine whether live testimony will be required to support a good faith finding in the sale order.

C. Successor liability issues.

1. The buyer will generally include as part of the APA a condition requiring the sale order to provide that the buyer will not be subject to any claims of successor liability under any statutory or common law theory arising from claims against the seller, and that the buyer shall not be deemed to be a successor to the seller under any such theory or body of law.

2. Generally, there is a carve-out from this successor liability exemption for potential environmental claims by the EPA or other federal agencies. Because the federal environmental laws have equal preemptive scope with the Bankruptcy Code, objections by the EPA can derail or delay a bankruptcy sale; consequently, in oil and gas cases it is important to engage with federal and state environmental authorities early in the process to negotiate a mutually acceptable environmental carve-out from the free and clear provisions.

3. Key bankruptcy courts generally hold that a free and clear sale order will extinguish successor liability claims against the buyer relating to its use of the purchased assets.[82]

4. However, because of due process concerns, a free and clear sale order will bar only those successor liability claims based on damage or injury occurring prior to the sale closing, and cannot bar successor liability claims arising from pre-sale conduct that does not result in any injury, manifestation of damage, or realization of a claim until after the sale, known as "future claims."[83]

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[81] *In re Abbotts Dairies of Pennsylvania, Inc.*, 788 F.2d 143, 147 (3rd Cir. 1986).
[82] *In re Chrysler LLC*, 576 F.3d 108, 126 (2nd Cir. 2009), *vacated as moot on other grounds sub. nom. Ind. State Police Pension Trust v. Chrysler LLC*, 130 S.Ct. 1015 (2009); *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3rd Cir. 2003).
[83] *Morgan Olson L.L.C. v. Frederico (In re Grumman Olson Industries, Inc.)*, 467 B.R. 694, 707-08 (S.D.N.Y. 2012); *Schwinn Cycling & Fitness Inc. v. Benonis*, 217 B.R. 790, 797 (N.D. Ill. 1997).

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American Bankruptcy Institute

Rocky Mountain Bankruptcy Conference

January 22-23, 2015

Restructuring Distressed Coal Companies

By

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Restructuring Distressed Coal Companies

I. Introduction

There are a number of areas of nuance in Chapter 11 cases of coal companies including:

1. Labor
2. Environmental/Regulatory
3. Contractual

II. Labor-Related Issues

A. Collective Bargaining Agreements (CBAs): Sections 1113/1114

1. United Mine Workers of America (UMWA) represents certain active and retired coal miners.
    a) Less than 12% of all miners currently employed in the U.S. coal industry are represented by the UMWA.
    b) More than two-thirds of the UMWA's members are retirees.
2. Obligations to UMWA-represented employees and retirees are governed by a form of industry CBA (the NBCWA), which provides for, among other things, lifetime healthcare.
3. Current obligations to employees and retirees under the CBA may be adjusted under sections 1113 and 1114 of the Bankruptcy Code, which impose procedural and substantive rules for modification and rejection.
    a) **Section 1113** requires that a debtor first make a proposal to the union before modifying or rejecting a CBA. If the union rejects the proposal, a bankruptcy court will look to whether the proposed modifications were in fact "necessary to permit reorganization of the debtor," whether they were "fair and equitable" to all affected parties, whether the proposal was rejected "without good cause" and whether the "balance of the equities" favors rejection.
    b) **Section 1114**, which is virtually identical to section 1113, governs the modification and rejection of retiree health

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benefits, and courts routinely apply the same factors to analyze the sufficiency of requests under both sections.

4. Unless and until the bankruptcy court approves the modifications, a company must honor the terms of the CBA.

5. The NBCWA has a strong successorship clause prohibiting a signatory coal company from selling its assets absent assumption of the CBA by the purchaser.

B. Multiemployer Pension Plan Obligations / Withdrawal

1. Contributions to the United Mine Workers of America 1974 Pension Plan (the 1974 Plan) may be required by the CBA.

   a) The 1974 Plan provides pension benefits to approximately 93,000 retirees and their surviving spouses.

   b) The 1974 Plan is governed by the UMWA and the Bituminous Coal Operators' Association (BCOA), which is the coal industry bargaining representative. Murray Energy, as purchaser of Consol's union mines, controls the BCOA.

2. Generally, a debtor may withdraw from a multiemployer pension plan with union consent or section 1113 relief; however, the 1974 Plan has taken the position that the union and individual employers do not have the authority to negotiate a modification or termination of this obligation to contribute.

   a) The 1974 Plan trust agreement contains an "Evergreen Clause," which provides that participating employers are bound to make continuing contributions to the 1974 Plan so long as:

      (1) the employer remains in the coal industry, and

      (2) that the amounts of contribution will be as specified in future agreements.

3. A debtor may be subject to joint and several withdrawal liability and be required to pay such liability in a lump sum vs. annual installments.

   a) Generally, outside of bankruptcy, an employer is entitled under ERISA to pay withdrawal liability in equal annual installments over a period of time; however, the 1974 Plan has taken the position that, by filing a chapter 11 petition, among other things, a debtor loses this option and must pay the liability as a lump sum, thereby creating a large general unsecured claim for withdrawal liability.

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b) Similarly, when calculating the amount of the lump sum claim, the 1974 Plan has asserted that the amount should equal the nominal amount of the debtor's proportionate share of unfunded pension liabilities, rather than the effective present value of the annual installment payments.

4. The 1974 Plan is in "Seriously Endangered" status, which may terminate and trigger mass withdrawal liability as early as 2017. Upon a mass withdrawal, each contributing employer will be charged with annual withdrawal liability payments.

5. UMWA signatory companies may also contribute to a single employer plan for their non-union employees.

    a) The two primary types of "qualified" single employer pension plans are defined benefit plans and defined contribution plans.

    b) In order to terminate these plans, the debtor or PBGC must institute termination proceedings, and, if terminated, PBGC will have a claim for the difference between the present value of its liabilities and the value of the plan's assets (the "unfunded benefit liabilities" claim), which is generally a nonpriority general unsecured claim except to the extent that PBGC can establish that a portion of the claim is attributable to services rendered post-petition or within 180 days prior to bankruptcy (in which case, such portion may be entitled to administrative expense priority or priority unsecured claim status).

    c) PBGC may also have a claim for termination premiums calculated at $1,250 per participant, per year, for 3 years, which claim would be an administrative expense claim.

    d) Subsequent to plan termination, there is often litigation over both the size and priority of PBGC claims; these issues are complex and vary greatly by circuit.

        (1) One common dispute centers on whether PBGC is allowed to use its regulatory (very conservative) present value methodology as opposed to the "prudent investor rate" generally used by bankruptcy courts in calculating creditor claims.

        (2) PBGC has also made different arguments in support of its request to be treated as a secured, priority tax, other priority or administrative claimant.

C. Coal Act

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1. The Coal Act is a statutory obligation that requires each current and former coal industry employer that was a signatory to a CBA as of July 20, 1992 to maintain the benefit plan that was in place for retirees who retired prior to October 1, 1994, and to pay annual premiums to share in the cost of health care for "orphaned" retirees whose employers have gone out of business.

2. The Coal Act was enacted in 1992 in order to provide for continued financing for retiree benefits for miners who had legitimate expectations of lifetime healthcare benefits.

3. The act imposes joint and several liability on entities that were under common control as of July 20, 1992.

4. Coal Act claims are treated as administrative expense claims in the bankruptcy and, therefore, must be paid in the ordinary course.

5. Case law is unclear on whether certain of these obligations can be modified by section 1114.

    a) One case has held that section 1114 can be used to modify only voluntary retiree benefits, not retiree benefits required by statutes such as the Coal Act. Buckner v. Westmoreland Coal Co. (In re Westmoreland Coal Co.), 213 B.R. 1 (Bankr. D. Colo. 1997).

    b) Another case has held that, although a debtor cannot modify its obligation to pay annual or monthly premiums to the Coal Act statutory orphan funds, it can use 1114 to modify the retiree benefits it administers pursuant to the Coal Act. The case, In re Horizon Natural Resources Co., 316 B.R. 268 (Bankr. E.D. Ky. 2004), was decided in the context of a liquidation, and the court found that no buyer would purchase the debtors' assets absent termination of the retiree benefits.

6. "Safe Harbor" – assets can be sold free and clear of Coal Act liability if the purchaser is "unrelated to the seller", and the sale is a bona fide, arm's length sale for fair market value.

    a) In such a case, Coal Act liability will revert back to the "last signatory operator" (i.e., the most recent coal industry employer of the retiree as of July 20, 1992). If there is no more recent employer, the miner will be provided benefits from the statutory Coal Act funds administered by the UMWA.

D. Federal Black Lung Act

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1. The Black Lung Act provides for monthly payments to coal miners totally disabled from pneumoconiosis (black lung disease).

2. The system is administered similar to workers' compensation; virtually all debtors seek and are granted authority to continue to pay claims during the case.

3. Coal companies are usually required to post collateral to the Department of Labor to secure obligations, and, in a bankruptcy, the Department of Labor will have a general unsecured claim against a company for any deficiency; however, an argument can be made that at least a portion of the claim (for the prior three years) may be afforded priority status as an excise tax under section 507(a)(8)(E) of the Bankruptcy Code.

4. Directors and officers may incur personal civil liability if an operating company fails to maintain approved insurance or qualify as a self-insurer.

5. A bankruptcy estate can likely sell assets "free and clear" of Black Lung liabilities, and liability will revert back to the most recent employer of the miner. If there is no more recent employer, the miner will be provided benefits from a statutory fund administered by the Department of Labor.

6. There is an open question, however, as to whether directors and officers may still be liable under these circumstances if they are found to be "prior operators" of the mine. While there is no case law on point, the statute appears broad enough to cover this scenario.

E. Workers' Compensation Obligations

1. Virtually all debtors seek and are granted authority to pay claims and continue their workers' compensation programs (including state black lung claims).

2. Debtors are usually required to have the programs in place under mining permits.

3. Various states require collateral to be posted to secure obligations, and, in a bankruptcy, the insurance company or state insurance fund will have general unsecured claims against a company for any deficiency.

III. Environmental/Regulatory Issues

A. Federal and state regulatory authorities impose obligations on the coal mining industry in a wide range of areas:

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1. Employee health and safety

2. Permitting and licensing requirements

3. Environmental protection

4. Reclamation and restoration of mining properties after mining has been completed, and

5. Surface subsidence from underground mining and the effect of mining on surface and groundwater quality and availability.

B. New Regulatory Burdens

1. Over the past several years, new regulations, new interpretations of existing laws and regulations, and citizen lawsuits brought by non-governmental organizations have resulted in increased compliance costs for coal companies and their customers.

   a) In June 2013, President Obama announced initiatives intended to reduce greenhouse gas emissions globally, including curtailing U.S. government support for public financing of new coal-fired power plants overseas and promoting fuel switching from coal to natural gas or renewable energy sources.

   b) The EPA has proposed a rule that aims to reduce carbon dioxide emissions from existing coal-fired power plants by 30% by 2030 from the 2005 level, which would require the implementation of costly pollution control technology, thereby placing significant additional financial and operational burdens on power plants fueled by coal.

   c) It is difficult to estimate impact as there will likely be years of litigation over these rules, and the EPA is not requiring progress until 2022.

C. Debtors' Ongoing Compliance with Environmental Regulations During Bankruptcy

1. A debtor must continue to comply with its environmental obligations under applicable federal, state and local laws, regulations and permits, as well any obligations under court orders and settlements with regulators or non-governmental organizations.

2. In the event a debtor fails to comply with its obligations, penalties assessed will be granted administrative expense status, which must be paid in full in connection with a reorganization.

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3. Related entities may have joint and several liability.

    a) Under certain federal and state laws, liability for contamination relating to a subsidiary's facility can extend to a parent if the parent is deemed to be an "operator" of the relevant facility.

    b) Relevant environmental permits might impose liability on the parent.

    c) Parent may also have other direct obligations for subsidiary liabilities under agreements with regulators or non-governmental organizations.

D. Reclamation Obligations

1. Coal companies have the legal obligation to close and restore (or reclaim) land disturbed by mining operations.

2. States require that companies post bonds to secure these reclamation obligations.

3. May be joint and several liability to the extent that reclamation bonds contain indemnification provisions rendering related entities liable.

4. Reclamation obligations cannot be discharged in a bankruptcy, and for all practical purposes assets cannot be sold free and clear of reclamation obligations.

    a) A purchaser will have to assume the obligations or negotiate with regulators to develop a solution (e.g., leave behind assets in, or dedicate future revenues to, a trust to fund the obligations); otherwise, regulators may not approve the transfer of the related mining permits to the purchaser.

E. Permit Block Considerations

1. Federal and state agencies can block the issuance or renewal of mining permits (without which a coal company cannot lawfully engage in coal mining) in order to enforce the provisions of its safety, health and environmental laws.

2. The blocking of permits may be used against the coal company, affiliate entities and persons who are deemed to be in control of the permitted entity.

3. Permit blocking can effectively preclude any strategy of reorganizing around "good" assets and leaving the "bad" assets (i.e., those with reclamation obligations) behind.

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4. This provides a powerful incentive for a coal mining company to comply with applicable laws and honor reclamation obligations for all affiliates.

F. Sureties and 365(c)(2) Considerations

1. Before a coal company can obtain mining and related permits, they must provide acceptable financial assurance to the relevant state agencies to secure performance of its obligations.

2. The required amount of financial assurance is supposed to be sufficient to assure the completion of the reclamation if the work has to be performed by the regulatory authority in the event of a default by the company, which would allow the state agencies issuing the permits to draw on the bonds.

3. Sureties require companies to execute an indemnity agreement as a precondition to issuing bonds, pursuant to which the surety may have the right to demand collateral for up to 100% of the value of the bond at any time.

4. Sureties cannot demand more collateral during chapter 11; but the bonds and related indemnity agreements likely cannot be assumed absent consent by the surety.

5. These sureties will generally ride through the bankruptcy unimpaired.

IV. Contractual Issues

A. Liens on Coal Leases

1. Coal leases often have anti-assignment provisions, which may prohibit assigning and/or pledging a lease as collateral without the consent of the lessor.

2. While section 365(f) of the Bankruptcy Code allows debtors to override anti-assignment clauses, and arguably section 364 of the Bankruptcy Code allows debtors to grant a lien on assets in connection with a DIP financing notwithstanding any contractual prohibitions on granting liens, coal companies are often sensitive to relationships with their lessors and do not want to pledge their leases as collateral for financing without lessor consent (which may be difficult and costly to obtain).

a) Courts have held that a pledge does not implicate a pure anti-assignment provision because, unlike assignment, a pledge allows the title to the pledged property to remain with the pledgor.

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b) It can also be argued that section 365 may be used to override anti-pledge provisions on the basis that, since Congress allowed for assignment in the face of a prohibition, then pledging, something less than assignment, should also be allowed.

B. Override Agreements

1. The terms "overriding royalty" or "override" refer to the interest in production retained by a lessee after assigning a lease to a third party, whereby the lessee-assignor receives payments from the assignee (over and above the royalty reserved in the lease payable to the lessor) based on the amount of coal mined from reserves covered by the applicable lease.

2. The arrangement is generally memorialized in two separate instruments, an assignment of the lease and an override payment agreement.

3. In a bankruptcy, the following issues may arise: whether the override agreement is executory (i.e., does a debtor have to assume or reject the agreement) and whether the override agreement is integrated with the assignment or the lease (i.e., if a debtor assumes or rejects the lease, does the override agreement get assumed or rejected therewith).

4. In the Patriot Coal bankruptcy, the court held that an override agreement between a Patriot subsidiary and certain Alpha Natural Resources, Inc. subsidiaries was not an executory contract subject to assumption or rejection because there were no obligations remaining on the part of the assignor. The court also held that, despite the fact that it is likely that the parties would not have entered into the assignment absent the override agreement, the two documents were not integrated with the assignment or the underlying lease because they were all separate contracts serving separate purposes.

American Bankruptcy Institute

Rocky Mountain Bankruptcy Conference

January 22-23, 2015

Myths and Facts about Renewable Energy: Is Bankruptcy Inevitable?

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I. Introduction

In recent years, bankruptcy cases of companies involved in renewable energy have hit the headlines as evidence of what some believe is the complete failure of this country's renewable energy program. The now infamous photograph of President Obama at the Solyndra plant in 2010, expounding on the future of solar energy and the support of the Federal government with a substantial Department of Energy backed loan, has become the poster child of a purportedly failed energy program.

But is renewable energy really a failure? This outline will identify the various forms of renewable energy, the challenges facing the industry and the successes as well as the failures.

II. Currently there are a number of different forms of alternative energy, some viable and productive and others at the leading edge of innovation.

1. Solar Power

    a. Solyndra

    b. Solar Trust

    c. Sun-Tech

    d. Abound Solar

2. Wind Farms

3. Batteries and Battery Storage Systems

    a. 123 Systems LLC

    b. Beacon Power

4. Bio Fuels

    a. Nova Biosources

    b. Aventine Renewable Energy Holdings

    c. KiOR - converts wood chips, logging residue and other biomass into renewable crude oil.

5. Hydro-electricity
6. Geothermal
    a. Nevada Geothermal Power
7. Electric vehicles
        a. Fisker
        b. ECO Totality Company
        c. Vehicle Production Group (VPG)
        d. Vision Industries
        e. Tesla Motors

III. Development and Financing

1. Government grants, tax incentives and loan guarantees – The Department of Energy offers a variety of grants and loan guarantees under the Renewable Energy and Efficient Energy Projects Loan Guarantee Program. For example, a Section 1603 grant allows a developer to recover up to 30 percent of construction costs for renewable-energy projects through cash grants instead of tax credits. Other examples include the $8 billion loan program offered for Advanced Fossil Energy Projects and the $16 billion for the Advanced Technology Vehicle Manufacturing (ATVM) loan program.

2. Project Financing – lenders of conventional financing often see renewable energy as too risky. The research and developmental phases are the most costly aspect of renewable energy. The return on investment is often significantly delayed.

IV. Economic and Environmental Challenges

1. Toxic Waste
        a. Solar-photovoltaic panels
        b. Hydro electricity - Heavy metals
2. Impact on environment – wind farms
3. Unpredictable commodity prices
4. Weather
5. Economic slow downs

6. Competition from foreign companies

V. Foreign Investments –Regulatory Hurdles

1. CFIUS

a. There are certain regulatory challenges that may impose hurdles to foreign investors seeking to invest in the United States. Approval of the Committee on Foreign Investment in the U.S. (CFIUS) is required for certain transactions, particularly with respect to transactions where there are national security concerns.

b. CFIUS is an inter-agency committee tasked with reviewing transactions that could result in control of a U.S. business by a foreign person or entity, to determine the effect of such transactions on the national security of the U.S.

c. CFIUS may, through its executive authority, suspend or prohibit any foreign acquisition, merger or takeover of a U.S. company that might "threaten or impair" the national security of the United States. CFIUS review, though not required prior to the closing of every foreign purchase, is mandatory in cases where acquisitions are made by a foreign person controlled by a foreign government. In addition, foreign direct investors acquiring assets in certain sensitive U.S. industries—for example, energy and natural resources, aerospace and defense, and technology—face special scrutiny, which often leads to extensive substantive review by CFIUS of these transactions.

VI. Uncertainty of Regulations

1. Renewable Fuel Standards (RFS)

a. EPA is responsible for developing and implementing regulations to ensure that transportation fuel sold in the United States contains a minimum volume of renewable fuel. The Renewable Fuel Standard (RFS) program regulations were developed in collaboration with refiners, renewable fuel producers, and many other stakeholders

b. The RFS program was created under the Energy Policy Act of 2005, and established the first renewable fuel volume mandate in the United States.

c. The RFS establishes minimum volumes of various types of renewable fuels that must be included in the United States' supply of fuel for transportation. Those volumes, as defined by the Energy Independence

and Security Act of 2007 (EISA), are intended to grow each year through 2022. In recent years, the requirements of the RFS have been met largely by blending gasoline with ethanol made from cornstarch. In the future, EISA requires the use of increasingly large amounts of "advanced biofuels," which include diesel made from biomass (such as soybean oil or animal fat), ethanol made from sugarcane, and cellulosic biofuels (made from converting the cellulose in plant materials into fuel). Congressional Budget Office, *The Renewable Fuel Standard: Issues for 2014 and Beyond,* June 2014.

d. One of the main goals of the RFS is to reduce U.S. emissions of greenhouse gases, which contribute to climate change. EISA requires that the emissions associated with a gallon of renewable fuel be at least a certain percentage lower than the emissions associated with the gasoline or diesel that the renewable fuel replaces.

e. Policymakers and analysts as well as critics have engaged in a public debate about the RFS, particularly about the feasibility of complying with the standard, whether it will increase prices for food and transportation fuels, and whether it will lead to the intended reductions in greenhouse gas emissions.

f. Failure to enact the RFS as a law leaves many biofuel companies with uncertainty and difficulty raising capital and financing, since they are subject to the EPA promulgating regulations on the applicable annual standards. For example, EPA has announced that the Agency will not be finalizing 2014 applicable percentage standards under the Renewable Fuel Standard program before the end of 2014.

2. FERC - 2011 FERC Order requires U.S. grid operators to implement strategies for installing batteries to help regulate frequencies and peak demands.

3. Biodiesel Tax Credits; Production Tax Credits for wind power.

VII. Intellectual Property Litigation

1. Since many renewable energy companies are based on new and innovative technology, it is not surprising that there are challenges to patent rights. This issue has taken center stage in the biofuels industry.

2. In 2013, GreenShift Corp and its subsidiary, GS CleanTech Corp., sued 15 ethanol plants in Illinois, Indiana, Iowa, Minnesota, Wisconsin and North Dakota for allegedly infringing on its patented corn oil extraction technology.

3. The following quote from GreenShift Corp. highlights the risks faced by companies and their lenders, contract parties, and shareholders when a company is embroiled in contentious patent litigation that lasts years at a steep cost:

> "Ethanol managers, board members, owners, lenders and other stakeholders that have adopted 'wait-and-see' infringement strategies are encouraged to pay careful attention to these events. Licensed producers receive a significant competitive advantage that we have pledged to vigorously defend. We will continue to do so and now look forward to expanding our efforts in the coming months."

4. Two giants in the biofuel arena have been litigating over patent rights for years. Butamax Advanced Biofuels LLC is a joint venture of BP and DuPont, formed to commercialize biobutanol as a transportation fuel using patented technology the two corporations developed collaboratively. Butamax instituted a patent infringement case against Gevo Inc., a leading renewable chemicals and next-generation biofuels company over Gevo's claims to isobutanol and related technology.

VIII. Renewable Energy Companies: Success or Failure

1. Failures in US

   a. Solyndra- Fremont, California manufacturer of an unusual technology - cylindrical solar panels designed to catch solar rays when the sun was anywhere on the horizon. Plummeting silicon prices and competition from China led to the company's being unable to compete with conventional solar panels made of crystalline silicon. The company filed on Sept. 1, 2011 with debt to the DOE of $535 million on a federal loan guarantee.

   b. Abound Solar – received $400 million in federal loan guarantees in 2010, and closed door in 2012 with toxic waste in facilities.

   c. Nevada Geothermal – received $98.5 million loan guarantee to develop geothermal energy

   d. Thompson River Power – received a $6.5 million federal grant to convert Montana coal-fired plant into wood-fired plant.

2. Post-Bankruptcy Successes

   a. Eco-Totality Inc.: Car Charging Group purchased Eco-Totality Inc.'s Blink Network of charging stations.

   b. Ener1: provides energy storage solutions for electric grid, transportation and industrial applications. Emerged from chapter 11 in March, 2012 with new $86M of equity funding.

   c. Vehicle Production Group: exited chapter 11 and sold to GM

d. A123 Systems: pre bankruptcy developed lithium ion cells for electric car batteries. Chapter 11 sale to Chinese company. Remained in US and channeled lithium cells into new use – battery storage for electrical grids and power plants; necessary to comply with FERC requirements for back up storage

e. Beacon Power: developed flywheel technology that absorbs and stores excess energy from the grid and releases when high demand. Purchased out of chapter 11 by PE firm.

f. Aventine Renewable Energy Holdings: ethanol producer successfully restructured its balance sheet, converting prepetition debt to equity, emerging from chapter 11 in fewer than 12 months.

3. Department of Energy Backed Successes

   a. Tesla: The Department of Energy's renewable grant energy loan program's biggest success story has been Tesla Motors Inc. The Elon Musk-backed electric carmaker paid back its $465 million federal loan nine years early. *Bloomberg News, November 12, 2014*

   b. Abengoa SA: Received a $132.4 million DOE guarantee and opened a biofuels plant in Kansas in October 2014. *Bloomberg News, November 12, 2014* Abengoa's new industry-leading biorefinery plant utilizes only "second generation" biomass feedstocks for ethanol production, meaning non-edible agricultural crop residues (such as stalks and leaves) that do not compete with food or feed grain.

   c. SolarReserves - developer of utility-scale solar power projects and advanced solar thermal technology with more than $1.8 billion of projects in construction and operation worldwide including Crescent Dunes Project in Nevada and Jasper in South Africa. Crescent Dunes is the first utility-scale facility in the world to feature advanced molten salt power tower energy storage capabilities, providing energy night or day. SolarReserves received a $737 million loan guarantee from the U.S. Department of Energy in fall 2011.

4. Fact or Fiction – The DOE renewable energy loan program has been a failure

   a. Overall, the agency has loaned $34.2 billion to a variety of businesses, under a program designed to speed up development of clean-energy technology. Companies have defaulted on $780 million of that — a loss rate of 2.28 percent. The agency also has collected $810 million in interest payments, putting the program $30 million in the black. Jeff Brady, NPR News, November 13, 2014.

b. The DOE's Loan Program Office explains:

> "However, losses are also inherent in any lending portfolio. And because the mission of LPO is to finance innovative technologies that have never been deployed at commercial scale in the U.S., the program was intentionally designed to carry some level of risk -- and Congress specifically set aside funds to cover those losses when the program was established. But today, actual and estimated loan losses to the portfolio are only approximately $780 million, or only a little over 2 percent of the program's loans, loan guarantees and commitments -- and less than the more than $810 million in interest payments the program has earned to date."

Energy.gov, *Energy Department's Loan Portfolio Continues Strong Performance While Deploying Innovation*, Nov. 12, 2014

c. In 2014, DOE began lending money again. They have programs in the works that will support both renewable energy and fossil fuel projects. In February it approved $6.5 billion in loan guarantees to build two nuclear reactors in Georgia, and it issued a conditional $150 million commitment to help build a wind project off the coast of Cape Cod, Massachusetts. Reuters, November 13, 2014 reporting on a recent report by the DOE.

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ELECTRICITY AS "GOODS"

11 U.S.C. § 503(B)(9)

By

Presented by: Mary Grace Diehl, US Bankruptcy Judge, Northern District of Georgia

Materials by: Nathan Juster, Law Clerk

Electricity Under Section 503(b)(9): A Survey of Court Decisions

Introduction

Does electricity constitute "goods" under 11 U.S.C. § 503(b)(9)? The First Circuit Bankruptcy Appellate Panel was the latest court to consider the divisive issue in *In re PMC Marketing Corp.*, 517 B.R. 386 (B.A.P. 1st Cir. 2014). Section 503(b)(9) creates an administrative expense claim, entitled to priority, for "the value of any goods received by the debtor within 20 days" prior to the bankruptcy filing, provided that "the goods have been sold to the debtor in the ordinary course of such debtor's business." 11 U.S.C. § 503(b)(9). The term "goods" is not defined in the bankruptcy code. The question of whether electricity constitutes goods or services is crucial to providers who dealt with the debtor on the eve of bankruptcy—entitlement to priority can mean the difference between payment in full or cents on the dollar, as was the case in *PMC Marketing.*

Puerto Rico Electric Power Authority, or PREPA, sought allowance of an administrative expense of $89,336.42 for electricity provided to the Debtor within 20 days before the bankruptcy case. *PMC Mktg.*, 517 B.R. at 387–88. The bankruptcy court, in considering whether electricity provided by PREPA constituted goods or a service, looked to PREPA's status as a regulated public utility and concluded as a utility it was a service provider. *Id.* at 388–89. Judge Finkle, writing for the First Circuit BAP, vacated the decision. It held that the fundamental inquiry is not the relationship between the provider of electricity and the debtor, but the status of electricity itself. *Id.* at 392. While the court did not determine whether electricity constitutes goods or services, it noted that other courts have considered the definition of "goods" found in UCC Article 2. U.C.C § 2-105(1). *Id.* It did not ultimately hold that the bankruptcy court should have followed the UCC, perhaps in part because Puerto Rico has not actually adopted UCC

Article 2. *Id.* at 390. But Judge Hoffman urged just that, noting in concurrence that it was "irrelevant" that Puerto Rico had not adopted the UCC, and that bankruptcy courts should look to the "model" UCC rather than any specific state enactment. *Id.* at 395, 395 n. 6 (Hoffman, J., concurring). Unfortunately, this solution is hardly a resolution. Courts applying the UCC have sharply divided on whether electricity constitutes goods under its definition.

A. Courts have consistently applied the UCC definition of goods.

The leading case on the subject, *In re Erving Industries, Inc.*, 432 B.R. 354, 365 (Bankr. D. Mass. 2010), rejected a "common" understanding of the term "goods" in section 503, noting that "it is hardly plausible that Congress expected bankruptcy judges to roll up their sleeves and set to work re-inventing the proverbial wheel . . . [i]nstead, this Court concludes (as have most, if not all, courts addressing the issue), that the meaning of *goods* under § 503(b)(9) is primarily informed by the meaning of *goods* under Article 2 of the UCC." (emphasis in original).

Bankruptcy courts will only go so far in following the UCC, however. Most courts have rejected the "predominant factor" test under the UCC, which looks to whether services or goods predominated the transaction overall. *E.g. In re NE Opco, Inc.*, 501 B.R. 233, 257 (Bankr. D. Del. 2013), *appeal dismissed per stipulation,* No. 1:13-cv-02035-GMS (July 1, 2014). Further, bankruptcy courts have not considered themselves bound by state law decisions interpreting the UCC. *In re Pilgrim's Pride Corp.*, 421 B.R. 231, 236 (Bankr. N.D. Tex. 2009); *accord Erving Indus.*, 432 B.R. at 365 n.23.

B. Courts have divided on whether electricity constitutes "goods" under UCC Article 2.

While there is near uniformity that the UCC section 2-105(1) contains the correct standard to apply, courts have differed in their conclusions drawn from that standard. *Compare Erving Indus.*, 432 B.R. at 365 *with NE Opco, Inc.*, 501 B.R. at 250. 'Goods' under Article 2, as noted

by the *Erving Industries* court, are "all things . . . which are movable at the time of identification to the contract for sale." *Erving Indus.*, 432 B.R. at 369 (citing U.C.C. § 2–105(1)). Accordingly, courts have primarily looked to the movability and identifiability of electricity at the time of making the contract.

1. Courts concluding electricity is "goods"

At least three courts have taken the position that electricity does constitute goods. In *Erving Industries*, the bankruptcy court endeavored to answer the question by looking first to "the basic processes of electrical energy generation and its mechanics." *Erving Indus.*, 432 B.R. at 367 (Boroff, J.). The court stated that electricity "easily meets the movability requirement," noting that electricity is transmitted through a wide distribution network to the customer. *Id*. at 369. Likewise, the court noted that electricity is identifiable, because it can be metered. *Id*. at 370 (citing *In re Pac. Gas & Elec. Co.*, 271 B.R. 626, 640 (N.D. Cal. 2002)). It recognized, however, that movability at the time of identification to the contract was a less straightforward question. *Id.* The debtor argued that because electricity is consumed at the time it is metered, it is not moveable at the time of identification. *Id.* However, the court disagreed, noting that electricity passes through the meter and continues moving until it reaches the object to be powered, even if at "speeds so imperceptible that consumption appears to occur simultaneous with identification." *Id.* Thus, it held, electricity is movable at the time of identification for contract, and therefore a good.

The court also rejected the debtor's argument that the meaning of goods in section 503(b)(9) should be construed in accordance with section 546(c), which gives a seller of goods a right to reclaim certain goods from the debtor. *Id.* at 373–74. The debtor asserted that because goods under section 546(c) necessarily must be capable of being stockpiled, and that because

Congress intended 546(c) to be an alternative remedy to a claim under 503(b)(9), goods under section 503(b)(9) must also be capable of stockpiling—something that electricity is not. *Id.* The court disagreed, holding that 546(c) does not limit 503(b)(9).

The second case to adopt the position that electricity constitutes goods was *GFI Wisconsin, Inc. v. Reedsburg Util. Comm'n*, 440 B.R. 791, 795 (W.D. Wis. 2010). The debtor in that case took specific issue with the *Erving Industries* court's findings about the nature of electricity, going so far as to submit the affidavit of an engineer to rebut the conclusion that electricity remains movable after metering. The bankruptcy court disagreed, and the debtor appealed. The district court affirmed, asserting that the inquiry "should not depend on quantum physics, how fast electrons are moving at a particular time or even where a debtor's meter is located on an electrical circuit." *Id.* at 800. Instead, the district court proposed a more "straightforward assessment, taking into consideration the nature and common understanding of the thing, but also considering its similarities to goods that fall undisputedly under the UCC and would receive administrative priority under § 503(b)(9)." *Id.* The court held that electricity satisfies this test, noting that it is "movable, tangible and consumable, that it has physical properties, [and] that it is bought and sold in the marketplace." *Id.*

The court also rejected the argument that the separate treatment of utility providers in section 366, "Utility Service," coupled with the fact that the appellee utility sought protection as a provider of "utility services" under that section led to the conclusion that utilities providers always provide services. *Id.* at 801. The court explained that the two provisions were not mutually exclusive, and that a provider of services can also be a seller of goods.

Finally, the court in *In re S. Montana Elec. Gen. & Transmission Coop., Inc.*, No. 11-62031-11, 2013 WL 85162, 2013 Bankr. LEXIS 62 (Bankr. D. Mt. Jan. 8, 2013) largely adopted the *Erving Industries* rationale as expanded by the court in *GFI Wisconsin*.

2. Courts concluding electricity is not "goods"

Several cases decided before *Erving Industries*, and at least one decided after, took the position that electricity does not constitute goods. The bankruptcy court in *In re Samaritan Alliance, LLC*, No. 07-50735, 2008 WL 2520107, 2008 Bankr. LEXIS 1830 (Bankr. E.D. Ky. June 20, 2008) considered many of the same arguments rejected by *Erving Industries* and *GFI Wisconsin*, including that electricity cannot be stockpiled for reclamation under section 546(c). While it did not specifically adopt this rationale, it agreed with the debtor that "electricity provided is more properly characterized as a 'service.'" *Id.* at *4, 2008 Bankr. LEXIS at *9.

A little over a year later, the bankruptcy court in *In re Pilgrim's Pride Corp.*, 421 B.R. 231 (Bankr. N.D. Tex. 2009) considered the issue. The electricity provider in *Pilgrim's Pride* asserted that because the U.S. Supreme Court held electric energy is "property," it qualifies as goods. *Id* at 238 (citing *Ashwander v. Tenn. Valley Auth.*, 297 U.S. 288, 330 (1936)). The court pointed out that not all "property" is "goods," intellectual property being one example. *Id.* at 238–39. The court was also not convinced by the argument that electricity meets the definition of a product—distributed for use or consumption—noting that television shows would meet that definition but are not goods. *Id.* at 239. Finally, the court rejected the argument that electricity's capacity to be metered rendered it movable at the time of identification for contract. *Id.* It analogized the metering of electricity to that of telecoms and internet—two obvious service providers. *Id.* In finally concluding that electricity is a service, the court noted that provisions of the Code granting priority claims must be strictly construed. *Id.* at 240.

More recently, the divergence of views was addressed in *In re NE Opco, Inc*., 501 B.R. 233 (Bankr. D. Del. 2013), *appeal dismissed per stipulation*, No. 1:13-cv-02035-GMS (July 1, 2014) (Sontchi, J.). In that case, the bankruptcy court agreed with the *Erving Industries* court that goods need not be reclaimable under section 546(c). *Id.* 254–55. It also agreed with the *GFI Wisconsin* court that section 366 was irrelevant to section 503(b)(9). However, the court disagreed with underlying premise of those cases: that electricity is movable at the time of identification because the time between metering and consumption is meaningful. *Id.* at 250. It explained that electricity travels through wires at nearly at the speed of light, and concluded that "[a] difference of approximately 1/60th of 1/60th of 1/60th of a second between identification and consumption renders the separation between the two meaningless. Electricity cannot be shoehorned into the definition of a good based on such an infinitesimal delay." *Id* (footnotes omitted).

The *NE Opco* court also took issue with the "straightforward" test articulated in *GFI Wisconsin*, under which the electricity was considered "comparable" to other goods under the UCC such as water or natural gas. *Id.* at 251. The court noted that water and natural gas can be identified "well before consumption," and can be transported back and forth between providers and consumers. *Id.* at 252. It anticipated the argument that electricity can be stored in a battery, explaining:

> [E]lectricity stored in a battery is no longer electricity. It has become potential energy stored in materials or chemicals that will produce electricity when they react with each other. While the battery itself is a good, the electricity used to charge it and that will flow from it is not.

Id.

3. Neither

A few courts have addressed the issue but have not resolved it. *See, e.g., In re Great Atlantic & Pacific Tea Co., Inc*., 498 B.R. 19 (S.D.N.Y. 2013) (vacating bankruptcy court's holding that electricity is not goods but remanding for evidentiary hearing on whether electricity can be identified prior to consumption); *PMC Mktg.*, 517 B.R. at 386 (summarized above).

Some bankruptcy courts have addressed the issue of whether electricity is considered goods in other contexts, such as breach of contract claims. *See, e.g.*, *Enron Power Mktg., Inc. v. Nevada Power Co.*, No. 01-16034 (AJG), 2004 WL 2290486, at *2, 2004 U.S. Dist. LEXIS 20351 (S.D.N.Y. Oct. 12, 2004) (applying UCC to a breach of contract action against an electricity provider); In re Pac. Gas & Elec. Co., 271 B.R. 626, 638 (N.D. Cal. 2002) (applying UCC to an electricity provider's claim of default for relief from stay). Further, countless state courts and federal courts have addressed the issue of whether electricity is a good under their enacted version of the UCC. *E.g., Cincinnati Gas & Elec. Co. v. Goebel*, 28 Ohio Misc. 2d 4, 5, 502 N.E.2d 713, 715 (Mun. 1986); *United States v. Consol. Edison Co. of New York*, 590 F. Supp. 266, 269 (S.D.N.Y. 1984); *Buckeye Union Fire Ins. Co. v. Detroit Edison Co*., 38 Mich. App. 325, 328, 196 N.W.2d 316, 317 (1972). While the analysis in these cases may be helpful for interpreting 509(b)(9), the difference in context means they have limited applicability to the issue of whether electricity is a good under the bankruptcy code.

Conclusion

The First Circuit BAP decision is not likely to provide much guidance to bankruptcy courts considering whether electricity constitutes goods under section 509(b)(9). Courts have yet to receive guidance from any circuit court of appeals on the issue. In a Chapter 11 case, administrative expenses such section 509(b)(9) expenses must be paid in cash at confirmation.

11 U.S.C. § 1129(a)(9)(A). Consequently, until this issue is authoritatively resolved, it has the potential to cause uncertainty and impact plan feasibility since almost every case will have an electricity supplier with a potential 503(b)(9) claim.