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Nobody Likes to Face Rejection: Recent Issues Regarding Executory Contracts

Hosted by the Business Reorganization and Unsecured Trade Creditors Committees

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CONCURRENT SESSION

2017

Nobody Likes to Face Rejection: Recent Issues Regarding Executory Contracts

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EXECUTORY CONTRACTS

I. Executory Contracts Generally

A. Definition. A contract between a debtor and another party under which both sides still have important performance obligations outstanding. A debtor in bankruptcy (or its bankruptcy trustee) may (a) assume, (b) reject, or (c) assume and assign executory contracts. 11 U.S.C. §§365(a)(1) and (f). The business judgment standard governs the choice.

B. Standard for Assumption. To assume an executory contract, a debtor must satisfy the requirements of section 365(b) of the Bankruptcy Code, including curing defaults and providing adequate assurance of future performance. Section 365(b)(1) provides:

1. If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of assumption of such contract or lease, the trustee

a) cures, or provides adequate assurance that the trustee will promptly cure, such default ….

b) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any ancillary pecuniary loss to such party resulting from such default; and

c) provides adequate assurance of future performance under such contract or lease.

C. Assumption and Assignment. If a debtor chooses to assume and assign an executory contract, the proposed assignee must establish it can provide adequate assurance of future performance.

D. Rejection. Alternatively, a debtor or trustee may choose to reject an executory contract. Rejection constitutes a material breach of such contract entitling the non-debtor counterparty to file a claim for rejection damages but without the benefit of specific performance. 11 U.S.C. § 365(g). Rejection does not necessarily terminate the contract, but excuses remaining parties from performing, at least with respect to the debtor.

COLLECTIVE BARGAINING AGREEMENTS

I. Statutory Framework

A. Section 1113. Permits rejection of a collective bargaining agreement, subject to satisfaction of a number of procedural and substantive requirements.

1. Debtor must: a) present a proposal to an authorized representative of employees; b) provide complete and reliable information; c) prove that proposed modifications are necessary to permit reorganization; d) ensure that all creditors, the debtor and other affected parties are treated fairly.

2. Authorized representative must have refused to accept the proposed modifications without good cause.

3. Balance of equities must clearly favor rejection.

4. Nine Factor Test (originating in *In re American Provision Co.*, 44 B.R. 907, 909 (Bankr. D. Minn. 1984)): 1) Debtor makes proposal; 2) proposed must be based on most complete and reliable information available at the time; 3) modifications must be necessary to permit reorganization; 4) proposed modifications must assure all parties are treated fairly and equitably; 5) Debtor must provide the union with relevant information to evaluate the proposal; 6) between the proposal and the hearing, the Debtor must meet at reasonable times with the union; 7) the Debtor must confer in good faith; 8) the union must refuse to accept the proposal without good cause; and 9) the balance of equities must favor rejection.

B. <u>Section 1114</u>. Permits modification of retiree benefits.

1. Courts use the same nine factor test as employed for analysis of section 1113.

II. *In re Alpha Natural Resources, Inc.*, 552 B.R. 314 (Bankr. E.D. Va. 2016)

A. <u>Summary</u>: Liquidating chapter 11, going concern sale pursuant to section 363 of the Bankruptcy Code. Stalking Horse purchaser unwilling to assume union or Coal Act retiree liabilities. Debtor sought to reject collective bargaining agreement under section 1113 and eliminate Coal Act liabilities under section 1114.

B. <u>Issues</u>:

1. Can a liquidating debtor use sections 1113/1114? If liquidating, how can rejection/modification be “necessary to permit reorganization?”

2. Are Coal Act retiree benefits covered by section 1114? Not established by collective bargaining!

3. Was union’s refusal to accept Debtor’s proposal “without good cause?” Can union insist on successor being bound by modified CBA?

C. <u>Necessary to permit reorganization</u>

1. Majority of courts decline to adopt a narrow interpretation of reorganization, which would require a reorganizing chapter 11 plan.

2. Chapter 11 plans expressly permit liquidation.

3. Courts considering the issue have unanimously held that section 1113 relief is available in a Chapter 11 liquidation.

4. Held: sections 1113 and 1114 are available to a liquidating debtor.

D. <u>Coal Act Retiree Benefits</u>

1. 3 components of "Retiree Benefits:"

a) Benefit payments to retirees

b) Made under any plan

c) Maintained in whole or part by a debtor

2. Issue: Coal Act benefits are created by congress, not by a debtor. Not product of collective bargaining.

3. Two prior courts, in Kentucky (*Horizon*) and Alabama (*Walter*) both said that Coal Act covered by section 1114. Funds may be *established* by statute, but are *maintained* by a debtor.

4. Held: 1114 applies to Coal Act retiree benefits. Also concluded that the union was the "Authorized Representative" for the retiree benefits because the retirees were all union members, even though the benefits were not created by the CBA.

E. <u>Good Cause for Refusal</u>:

1. Union counteroffer to Debtor's proposal included terms, including requirement that CBA be binding on successors, that were impossible, because Stalking Horse unwilling to purchase if required to assume CBA.

2. Debtor unable to find another buyer willing to purchase and assume the CBA.

3. Union counteroffer provided that successor obligation was an absolute, non-negotiable requirement.

4. Court found that insistence on impossible term would be treated as rejection without good cause.

III. *In re Walter Energy, Inc.* Case No. 15-02741, Bankr. N.D. Ala., December 28, 2015

A. Summary: Going concern sale to Stalking Horse owned by first lien creditors. APA required sale free and clear of legacy union liabilities, including elimination of successorship clauses. No buyer willing to purchase subject to the CBAs.

B. Issues:

1. Is section 1113/1114 relief appropriate in connection with a sale which will be followed by a liquidation? Must debtors demonstrate ability to confirm a plan?

2. May Coal Act obligations be modified under section 1114?

3. Necessary to permit reorganization?

C. Sections 1113 & 1114 apply in Liquidating Chapter 11 Cases, even without plan.

1. Chapter 11 expressly provides for liquidating plans.

2. No requirement that debtor establish feasibility of a liquidating Chapter 11 plan as a condition precedent to relief.

3. Courts interpret "reorganization" to include all types of debt adjustment, including going-concern asset sales. Using sections 1113/1114 to consummate such a sale serves a rehabilitative purpose.

4. "Sections 1113/1114 apply in a liquidating Chapter 11 case regardless of the debtor's ability to confirm a liquidating Chapter 11 plan" (i.e., even if Debtor will be unable to pay administrative expenses.

D. Coal Act – Section 1114.

1. Modification of Coal Act retiree benefits permissible if necessary to facilitate a going-concern sale, rather than piecemeal liquidation.

E. Satisfaction of Procedural and Substantive Requirements of Section 1113.

1. Debtor's "take it or leave it" final proposal, necessitated by stalking horse purchaser, not improper. Provisions were necessary to consummate the APA.

2. "In the context of a liquidation sale . . ., the phrase 'necessary to an effective reorganization' means . . . necessary to the Debtor's liquidation."

3. Distinction between (a) rejection being a necessity to sell (satisfies section 1113) and rejection merely to increase market value of assets to be sold (does not satisfy section 1113). \

IV. *In re Patriot Coal Corp.*, 493 B.R. 65 (Bankr. E.D. Mo. 2013)

A. Summary: Reorganization of coal companies, costs associated with collective bargaining agreement and retiree benefits among key factors leading to pre-bankruptcy financial distress.

B. Issues.

1. Whether Debtors provided sufficient information to evaluate proposals.

2. Necessary for reorganization.

3. Modifications treat parties fairly and equitably.

C. Sufficient Information to Evaluate Proposals.

1. Business plan must serve as basis for concessions debtors deem to be "necessary." Debtors must provide the information upon which its business plan is built to demonstrate underlying factual support for projections.

2. Where analysis and projections are required for evaluation, debtor must provide union with a dynamic model which union can use to change inputs and evaluate diverging data.

3. Business plan based on complex model utilizing proprietary forecasting software. Unions were given access to the business model and offered access to physical office to access the software to manipulate scenarios.

4. Challenges to document production: standard is "not that Debtors must make sure every scintilla of its records that may directly or tangentially respond to a request for information be proffered." Instead, "question is whether there is *sufficient information* for the [union] to evaluate the Proposals."

D. Modifications are Necessary.

1. Proposed modifications are necessary if they have a significant impact on the debtor's operations and are required to successfully reorganize and compete in the marketplace upon emergency from Chapter 11. Must be justified either by business plan or industry practice.

2. "Snap-back" provisions, where CBA concessions are only temporary to return to viability, are viewed more favorably than permanent concessions.

3. Permissible to base concessions on covenants in DIP financing agreement.

E. Fair and Equitable Treatment.

1. Purpose: "to spread the burden of saving the company to every constituency while ensuring that all sacrifice to a similar degree."

2. Debtor must show that it has not placed a disproportionate share of the financial burden of avoiding liquidation upon the union or retirees.

3. Disparate treatment permitted so long as can be justified. For example, if union employees paid at levels in excess of industry standard, court may allow cuts only to union employee pay/benefits.

V. *In re Trump Entertainment Resorts Inc.*, 810 F.3d 161 (3d Cir. 2016)

A. Summary: Debtor casino sought to reject expired collective barganing agreement.

B. Issue:

1. May a debt reject an expired CBA, or its statutory continuing obligations as defined by the expired CBA?

C. Rejection of expired CBA.

1. CBA expired after bankruptcy filing, but before filing of rejection motion. Under National Labor Relations Act ("NLRA"), debtor-employer required to maintain status quo of the expired CBA post-expiration.

2. Congressional purpose behind section 1113 was to ensure that, when the NLRA yields to the Bankruptcy Code (by permitting rejection of labor obligations), it does so only for reasons that will permit the debtor to stay in business.

3. Relief from the CBA a necessity to avoid closing the casino and liquidation. Plan of reorganization contingent on rejection and cash infusion from first lien secured creditor, who made it clear that it will perform only if the CBA is rejected because the business cannot succeed without the relief.

4. When the employer's statutory obligations to maintain the status quo under an expired CBA will undermine the debtor's ability to reorganize, the bankruptcy concerns are elevated above those of the NLRA.

INTELLECTUAL PROPERTY CONTRACTS

I. Background

A. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985): Prior to enactment of Section 365(n) of the Bankruptcy Code, 11 U.S.C. § 365(n), licensees whose intellectual property licenses were rejected as executory contracts lost their rights under the license. The Fourth Circuit held that Lubrizol, a nonexclusive patent licensee whose patent license was rejected as an executory contract in the bankruptcy case of Lubrizol's licensor, debtor Richmond Metal Finishers, could not "rely on provisions within its agreement with [the debtor] for continued use of the technology." According to Lubrizol, when Congress enacted Section 365(g) of the Bankruptcy Code, governing the effect of rejection of an executory contract, "the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party," and no specific performance remedy. The Fourth Circuit held that, as a result, when the debtor rejected the contract, Lubrizol, as patent licensee, lost its rights under the license.

B. Section 365(n): In reaction to Lubrizol and concerns about the decision's potential impact on patent and other technology licensees, Congress enacted the Intellectual Property Bankruptcy Act of 1988, adding Section 365(n) to the Bankruptcy Code to give licensees special protections. However, the definition of "intellectual property" added to the Bankruptcy Code in Section 101(35A) did not include trademarks.

II. Trademarks

A. *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010):

1. A series of agreements, determined to constitute one integrated agreement, pursuant to which Exide Technologies sold an industrial battery business, and licensed certain trademark rights.

2. The bankruptcy court granted Exide's rejection motion, and district court affirmed.

3. The Third Circuit reversed, holding under New York law, which governed the agreement, once a party substantially performed, a later breach by that party does not excuse performance. Thus, the contract was not executory.

B. *In re Crumbs Bake Shop, Inc.*, No. 14-24287-MBK (Bankr. D. N.J., Oct. 31, 2014)

1. During Chapter 11 case, Crumbs entered into an asset purchase agreement to sell substantially all of its assets, approved by the Bankruptcy Court pursuant to section 363 of the Bankruptcy Code.

2. After entry of sale order, Crumbs moved to reject certain executory contracts and unexpired leases, including trademark license agreements with various operators of the Crumbs' locations. A counterparty asserted that, as a licensee, it could elect, under Section 365(n) of the Bankruptcy Code, to retain its rights under its license agreement. The debtors eventually withdrew motion to reject the license agreements, leaving the court to determine whether the "free and clear" provisions of the sale order negatively impacted the licensees' rights with respect to the purchaser, who asserted it had purchased the name and intellectual property free and clear of the licensees' rights.

3. The court observed similarities between Section 365(h) and Section 365(n) as Section 365(h) grants clearly stated rights to lessors of rejected leases similar to rights of intellectual property licenses under 365(n). The bankruptcy court relied on concurring opinion in *Exide* to conclude that section 365(n) could be equitably extended to trademarks. Additionally, court found that trademark licensees' rights were not vitiated by "free and clear" sale order because licensees did not consent.

C. *In re Interstate Bakeries Corp.*, 690 F.3d 1069 (8th Cir. 2012): Eighth Circuit treats a trademark license as executory.

1. In case factually similar to *Exide*, the United States Court of Appeals for the Eighth Circuit examined whether a perpetual, royalty-free, assignable, transferable, and exclusive license to use brands and trademarks belonging to Interstate Brands Corporation (IBC), which subsequently filed for bankruptcy, was an executory contract that could be rejected. Although the relevant aspects of the license agreement appeared to be, at first blush, nearly identical to those in *Exide*, the Eighth Circuit found the agreement in *Interstate Bakeries* to be materially different from the one in *Exide* and held that the agreement was executory.

D. <u>Sunbeam Products, Inc. v. Chicago Am. Mfg. LLC</u>, 686 F.3d 372 (7th Cir. 2012): 7th Circuit Rejects *Lubrizol*

1. In *Sunbeam*, the Seventh Circuit focused on the text of Section 365(g) and addressed the statutory protections granted to licensees of trademarks as similar to real estate lessees whose leases are rejected by debtor/lessors.

2. The court noted that "a lessor that enters bankruptcy could not, by rejecting the lease, end the tenant's right to possession and thus re-acquire premises that might be rented out for a higher price," before holding that the licensee of a trademark should be entitled to similar protections for their license rights.

E. Conclusion. With no Section 365(n) protection, and in the face of the *Lubrizol* decision, trademark licensees have long faced the serious risk of losing all license rights to a trademark if the licensor files for bankruptcy and rejects the trademark license as an executory contract. If the trademark owner considers the license unfavorable and a better deal can be had under a new license agreement with someone else, the trademark owner likely will reject the existing trademark license agreement. Even the enforceability of phase-out provisions, allowing a licensee to continue to use a mark for a limited time period after the license is terminated, is unclear.

SUPPLY CONTRACTS

I. § 556 Safe Harbor May Limit Debtor's Ability to Assume or Reject?

A. Section 556 provides an exception to section 365's prohibition on *ipso facto* clauses, for certain classes of commodity contracts, including forward contracts entered into by "forward contract merchants."

B. A forward contract potentially could include any contract for delivery of a good, if that good (or similar good) is the subject of dealing in the forward contract trade, and if the contract contemplates delivery/payment more than two days after execution of the contract.

C. Elements of a forward contract (*In re National Gas Distributors, LLC*, 556 F.3d 247 (4th Cir. 2009):

1. Subject of the contract is a commodity with substantially all of the expected costs of performance attributable to the expected costs of the underlying commodity;

2. Contract has a maturity date more than two days after contracting date;

3. Price, quantity, and time elements of the contract are fixed at the time of contracting; and

4. The contract has a relationship to the financial markets.

D. Applying Cases

1. *In re Louisiana Pellets, Inc.*, 2016 WL 4011318 (Bankr. W.D. La. July 22, 2016) – Supplier of wood pellets sought to terminate contract based section 556, but contract did not contain *ipso facto clause.* Section 556 only grants authority to terminate based on *ipso facto* clauses. Other contractual provisions which might authorize termination (such as non-performance) still covered only by section 365.

2. *In re Clear Peak Energy, Inc.*, 488 B.R. 647 (Bankr. D. Arizona 2013) – renewable power purchase and sales agreement between electric power company and debtor, for sale of electricity, qualified as a forward contract under section 566, permitting power company to terminate contract based on *ipso facto* clause.

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MIDSTREAM CONTRACT ISSUES

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Introduction to Midstream Contract Issues in Bankruptcy

- This presentation will examine whether midstream contracts, such as the typical oil and gas gathering and processing agreements are executory contracts that are subject to rejection by a bankrupt producer, or instead create real property-like interests "owned" by the midstream company (outside of the debtor's estate) such that the rights of the midstream company cannot be avoided via a rejection action.

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Gathering Agreements – Main Features

- Seller commits to deliver gas from specified wells, leases, or areas at agreed delivery points to gatherer, and gatherer agrees to transport the gas to agreed redelivery/sales points. Issues like quality, pressure, and methods of measurement are specified.
- Sometimes seller agrees to ship a minimum quantity over agreed time periods in order to assure gatherer of sufficient cash flow to amortize the construction costs of the pipelines and other facilities. If there is a shortfall in such minimum quantity, the seller pays the deficiency and sometimes is allowed to recoup that via 'over deliveries' in the future.

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Marketing Contracts

- Oil - Generally sold on short-term contracts. Can be marketed by trucking oil from tanks installed at or near the well or field, or via pipelines where there are significant quantities involved. Price is usually Platts with location and quality differentials.
- Gas - Generally sold on longer-term contracts, often to the end user or public utilities. Can be sold at any location around the United States, with the delivery to the buyer via intrastate or interstate pipeline systems. Even if contracts are longer term, price fluctuates based on spot (e.g. Henry Hub plus or minus X).
- Processing - Gas often contains natural gas liquids ("NGLs"), which, if removed from the gas stream by processing and sold separately, result in greater realization to the producer (i.e., the value of the NGLs plus the residue gas stream is greater than just the value of the "wet" gas, even adjusted for heating (BTU) value adjustments).
- Marketing contracts are often entered into by the "operator" of the well or field on behalf of the other working interest owners. The operator then collects the sales proceeds and distributes them to the other working interest owners, royalty owners, etc., after deducting taxes and sales expenses. [Note: There are significant hotly contested legal issues regarding what marketing expenses, if any, can be deducted from the royalty share of sales proceeds.]

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Purpose and Extent of Dedication

- Historically, the primary purpose of the “dedication” was to ensure that anyone who succeeded to the producer’s wells or leases would be burdened by the gathering agreement and would continue to perform under it.
- Sometimes this “dedication” was reflected in a document filed in the real property records of the relevant county or parish in order to put any possible successor on notice of the dedication.
- In some cases, this dedication language was said to be a “covenant running with the land.” In legal terms, a covenant running with the land is said to be a right and obligation that passes automatically when title to the land passes to a third party (i.e., it is not personal to only the party who originally was bound by it).

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Commitment/Dedication

- Seller’s commitment can be expressed in a number of ways:
  - From specified wells
  - From all wells on specified leases
  - From all wells on specified leases, plus any other, or new, leases within a specified area
  - With a promise not to transport gas from such wells or areas to anyone else
- The language around this commitment is sometimes called a “dedication.”

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Relevant Features of Midstream Contracts

- Midstream contracts often contain one or more of the following provisions
  - Acreage, lease, or production dedications
  - Statements that they create "covenants running with the land"
  - Provisions for execution and recordation of a memorandum of the agreement (assuming that they contain legally sufficient descriptions of the land covered)
  - Minimum volume commitments (i.e., ship or pay)
  - Provisions that they are binding on successors
  - Obligations of the producer to grant the midstream company easements on or across its oil and gas leases to facilitate laying of gathering pipelines or construction of other facilities
- Historically, one principal purpose of the "dedication" was to ensure that any successor to the producer's wells or leases would be burdened by the midstream contract and would continue to perform under it.

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Why Is There Uncertainty on This Issue?

- In prior downturns, the midstream space was largely owned and run by the producers.
- There were long-term gas sales agreements, but largely at market prices.
  - But, there were a few rejections in some take-or-pay settings.
- The rise of the MLP structure, along with the relatively cheap capital available for development of midstream assets, created opportunities for producers.
- Midstream assets were developed by the producers where long-term volume commitments drove significant value creation for spinoff opportunities.
- Thus, we now have a well-developed midstream sector that did not exist in prior downturns.
- The foregoing factors and the significant drop in commodity prices created the perfect storm.

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Texas Law on Covenants Running with the Land

- In Texas, there are several requirements of a "covenant running with the land" that have been set down in case law.
  - The covenant must "touch and concern" the land.
  - The covenant must be intended by the original parties to run with the land.
  - The covenant must relate to something in existence or must specifically bind the parties and their assigns.
  - The successor to property burdened by the covenant must have notice of the covenant.
- Although there is some debate on the issue, generally there must be privity of estate between the parties to the agreement at the time the covenant is made – sometimes referred to as "vertical privity."
- Note: Some states follow the Texas rule; others do not require that all of the above factors be present.

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Circumstances Affecting the Analysis – Examination of the exact language in the midstream contract is required

- What is dedicated—acreage, leases, land, wells, gas, or other rights? This is important because, for example, "gas," after it is brought to the surface, is "severed" from the ground and is capable of delivery at a delivery point. Therefore, it is generally considered personal property, not real property. So, a mere dedication of gas or wells might not be sufficient to create a real property interest. In some states (including Texas), acreage or rights in oil and gas leases are considered real property if properly described.
- Does the language say that the dedication is intended to be a "covenant running with the land"? While not determinative alone, an affirmative statement on the point may assist the midstream company's argument, while its absence may lead to an inference that the parties did not intend to create an interest in real property. Even if the statement is present, courts have examined several features of the issue to determine whether such a clause in a contractual setting does indeed create a covenant running with the land.
- Is the midstream contract, or a short form/memorandum thereof, recorded in the real property records of the relevant county or counties?
- Does the contract contain a legally sufficient description of the land "dedicated" under applicable state law in order to provide a valid property right?
- Is there any language in the contract indicating an intent to "convey," "grant," or "transfer" any property right, given that, to create a property right, words indicating the presence of a grant are generally necessary?

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The State of the Law Before *Sabine*

- Normally, in the case of a midstream contract without a "dedication" and with no overt transfer of property rights, the contract would be executory in nature and could be rejected by the debtor in bankruptcy.
- However, if a midstream company can successfully argue that its contract creates a dedication that qualifies as a covenant running with the land, what is the basis on which it can argue that its contract cannot be rejected?
  - Prior Bankruptcy Cases: Midstream companies have relied on bankruptcy cases where restrictive covenants (or deed restrictions) covering real estate were held to be rights in real property that were not subject to rejection in bankruptcy. The bankruptcy courts characterized the restrictive covenants as "covenants running with the land," but that does not appear to be the sole basis on which the courts made their rulings—rather, they found that the restrictions were created at the time of, and as part of, a conveyance of real property and therefore were in the nature of real property interests.
  - Therefore, the question is: Are the "dedications" in midstream agreements considered property rights of the midstream company, which are not part of the debtor's estate and therefore not capable of being rejected in bankruptcy?

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The *Energytec* Case

- The case of Newco Energy v. Energytec Incorporated (2013) concluded that a sale of a pipeline system and processing plant out of bankruptcy by the debtor, Energytec, was not free and clear of a transportation fee to be paid to a predecessor owner of the pipeline system because the right to the transportation fee was a covenant running with the land. The 5th Circuit Court of Appeals (applying Texas law) found that:
  - The agreement to pay the fee satisfied the five-part test of a covenant running with the land, partly because it affected the value of the land sold as part of the pipeline system.
  - Requisite privity was found to exist between the buyer and the holding of the right to the transportation fee (i.e., the agreement to pay the fee was **not personal** to the original owner) due, in part, to the fact that the agreements creating the fee had all been recorded in the real property records.
- However:
  - The case involved the creation of the right at the time of the sale of a pipeline system itself, which is, in part, made up of right-of-way and real property interests.
  - Although not mentioned in the opinion, the holder of the right to the fee also had recorded a lien and security interest to secure the payment of the fee.
  - The payment obligation relating to the fee for transportation burdened the pipeline owner, and the payment obligation was as partial consideration given for, and at the time of, the conveyance of the pipeline system, which included real property, from the payee to the pipeline owner/payor.
  - Energytec was not faced with a "rejection" situation, but rather a "sale free and clear" situation under Section 363 of the Bankruptcy Code.
  - It did not involve an upstream acreage "dedication" situation, so it is not directly on point.
  - Finally, the 5th Circuit remanded the case to determine whether the right to the transportation fee could be extinguished in a qualifying proceeding where a determination would need to be made of the value required to extinguish the holder of the right to the fee under Section 363(f)(5) of the Bankruptcy Code.

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The *Sabine* Case

- In early 2016, the debtors in *Sabine* sought to reject midstream contracts with HPIP Gonzales Holdings LLC and Nordheim Eagle Ford Gathering LLC.
- In March 2016, Judge Shelley Chapman entered an order rejecting the *Sabine* midstream agreements. However, she declined to opine as to whether the midstream agreements created a covenant running with the land, noting that applicable 2nd Circuit law required an adversary proceeding for such declaratory relief.
- This left the debtor in a quagmire regarding future production—with the current midstream contracts rejected, but no ruling on whether the dedications contained in the agreements continue or were terminated along with the rejection, it was impossible to enter into new midstream contracts with a third party. Recognizing this, Judge Chapman provided a preliminary or advisory opinion indicating that the debtors were not in horizontal privity with the midstream companies. Additionally, Judge Chapman found that, because the agreements provided that the midstream companies would receive the gas at certain points located away from the wells and that the fee for their services would be triggered at these receipt points, the subjects of the agreements were minerals that had already been severed from the ground (i.e., personal property). As a result, she held that the agreements did not touch and concern the land and did not create real property interests. In May 2016, Judge Chapman issued a final ruling in the *Sabine* proceedings consistent with her preliminary ruling.
- The midstream providers appealed Judge Chapman's final ruling and sought a stay of the decision and certification to appeal directly to the 2nd Circuit, arguing that these are unsettled issues of state law with the potential for significant repercussions in the oil and gas industry. Judge Chapman disagreed. With respect to certification, she reasoned that her rulings were limited to the particular facts of the case and the application of well-settled bankruptcy law. Judge Chapman declined to stay her decision because there was no risk of no irreparable harm. The appeal remains pending.

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Forthcoming Decisions

- *Sabine* (S.D.N.Y.)
  - The appeal is pending before Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York.
  - Briefing was completed on September 20, 2016 and oral arguments were held on October 26, 2016.
- *Triangle USA Petroleum Corporation* (N.D. Dist. Ct.)
  - Midstream provider's declaratory judgement action in North Dakota state court was pending when Triangle filed for chapter 11 bankruptcy.
  - The bankruptcy court dismissed Triangle's subsequently filed adversary proceeding and modified the stay to allow the declaratory judgement action to continue in North Dakota federal or state court.
  - On December 30, 2016, the case was remanded from federal district court to the District Court for the Northwest Judicial District, Williams County, North Dakota.

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Rejection Risks

- To the extent that a producer successfully rejects a midstream contract, the producer may find itself in a dangerous situation vis-à-vis its ability to continue to hold its oil and gas leases. For example, even if the producer can access another market, doing so may take time, during which it may be shut-in.
- Most leases provide that, once production is obtained, it must continue without interruption with certain limited exceptions, usually for only events beyond the control of the producer.
- Therefore, a rejection that results in a loss of a market for the producer's gas, even for a short period of time, creates a substantial risk that the producer may forfeit its oil and gas leases where its reserves are located.
- The automatic stay, which prevents counterparties from terminating agreements pre-emptively, does not apply to the typical oil and gas lease that terminates by operation of law (i.e., automatically, without any action by the oil and gas lessor).

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Commercial Considerations

- Given the unique nature of many of these gathering and processing systems, it is likely that the counterparties will still be incentivized to work together due to the critical need for cash flow on both sides.
- Contract renegotiations will turn on the leverage of the parties involved, particularly whether the producer can survive a shut-in (harming cash flow and potentially putting its oil and gas leases at risk) or has another way to move or process its hydrocarbons.
- Practically speaking, it is important to analyze what alternative a producer has to continue its production if the midstream contracts are rejected and how likely is it that another midstream company could offer midstream services at a more competitive rate for a new build system vs. existing (sunk cost) infrastructure.
- Finally, it is likely that midstream companies and their financing partners will start to think about ways to mitigate this rejection risk on a going-forward basis via security requirements and contract structuring.

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Trade Creditors and the Extension of Postpetition Credit to a Debtor

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Trade Creditor: Supply Agreements

- A Supply Agreement may be viewed as an Executory Contract under the Bankruptcy Code
- How?

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Trade Creditor: Supply Agreements

- Many supply contracts require the vendor to fulfill orders throughout the entire contract period.
- Not all of these contracts, however, impose a mutual obligation on the debtor to place orders.
- Accordingly, despite the contractual period extending beyond the petition date, the contract might not be executory because both parties may not have material unperformed obligations on the petition date.
  - *See, e.g., In re Exide Techs*, 607 F.3d 957, 962 (3d Cir. 2010); *see also In re Riodizio, Inc.,* 204 B.R. 417, 421 (Bankr. S.D.N.Y. 1997)

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Trade Creditor: Supply Agreements

- Of note are individual orders or releases under a supply contract:
- Such releases may impose independent executory contractual obligations because they provide mutual obligations to both sides.
  - *See e.g. In re Dana Corp.*, 2007 Bankr. LEXIS 3927, *7-8 (Bankr. S.D.N.Y. 2007).

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Trade Creditor: Supply Agreements

- Not all supply contracts define the length of the contractual relationship
- Where no duration is set, the general rule is that such agreements are terminable at will
  - *See Ketcham v. Hall Syndicate, Inc.*, 37 Misc. 2d 693, 699 (Sup. Co. N.Y. City 1962)
- Termination of this type of supply contract is not generally viewed as a breach.
  - *See In re Dana Corp.*, 2007 Bankr. LEXIS 3927, *13 (Bankr. S.D.N.Y. 2007)

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Trade Creditor: Supply Agreements

- So, assuming your contract is "executory," and your customer is already in default and then files for bankruptcy, are you required to continue doing business with them post-petition according to the terms of the contract?
- For example, if your contract is executory and requires you to supply goods on credit, does that obligation persist post-petition?

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Trade Creditor: Supply Agreements

- There are no reported decisions from any Circuit Court of Appeals that has held that a vendor that refuses to extend credit to a bankrupt customer, without taking any other action, has violated the automatic stay.
- There is an important distinction, however, between post-petition cancellation of an executory contract (not allowed) versus a demand for adequate assurances of payment (which is ok).
  - *See e.g. In re Coast Trading Co.,* 26 B.R. 737 (Bankr. D. Or. 1982)

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Trade Creditor: Supply Agreements

- Indeed, at least three courts have found that trade creditors are entitled to varying degrees of post-petition protection:
  - *In re Pacific Gas And Elec. Co.,* 2004 U.S. Dist. LEXIS 22023 (N.D. Cal. 2004)
  - *In re Continental Energy Assocs. Ltd. Pshp.,* 178 B.R. 405 (Bankr. M.D. Pa. 1995)
  - *In re Lucre, Inc.*, 339 B.R. 648, 650 (Bankr. W.D. Mich. 2006)

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Trade Creditor: Credit Agreements

- In *In re Lucre Inc.*, the U.S. Bankruptcy Court for the Western District of Michigan suggested that Chapter 11 debtors cannot compel non-debtor parties to continue performance where the debtor was in breach of the contract prior to the petition date.
- The question is: Does *In re Lucre* provide an "out" to suspend credit-extension obligations under an executory contract after the customer's Chapter 11 filing?

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