AMERICAN BANKRUPTCY INSTITUTE

2018 Rocky Mountain Bankruptcy Conference

Real Estate Bankruptcy Issues

David T. Brennan, Moderator
Otten Johnson Robinson Neff + Ragonetti PC; Denver

Matthew Bordwin
Keen-Summit Capital Partners LLC; Melville, N.Y.

Jason S. Brookner
Gray Reed & McGraw LLP; Dallas

Caroline C. Fuller
Fairfield and Woods P.C.; Denver

Hon. Michael E. Romero
U.S. Bankruptcy Court (D. Colo.); Denver

CONCURRENT SESSION

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Real Estate Bankruptcy Issues

THE UNIFORM ASSIGNMENT OF RENTS ACT

David Brennan
Otten, Johnson, Robinson, Neff & Ragonetti, P.C.

The National Conference of Commissioners on Uniform State Laws published the Uniform Assignment of Rents Act ("**UARA**") in 2005. The state of Utah adopted UARA in 2009. Four other states have also adopted the Act. Colorado has not adopted UARA.

This outline summarizes the objectives and key provisions of UARA, and discusses how courts interpret and enforce Assignments of Rents in states that have adopted UARA (like Utah), and those that haven't (like Colorado).

1. **Assignments of Rents, Generally**.

(a) In the majority of states, a mortgage or deed of trust[1] grants the lender only a lien on real property (not title to the property). The Security Instrument does not, by itself, give the lender the right to collect rents generated by the real property.

(b) So, when a mortgage lender's collateral is income-producing property, the lender will require the borrower to execute an "Assignment of Leases and Rents" – either as a separate loan document, as part of the Security Instrument, or both.

(c) An Assignment of Rents helps the lender avoid the risk that, following a default but before foreclosure on the real property, the borrower can collect the rents and use them for purposes other than the operating expenses of the real property and the debt service.

(d) The language in Assignments of Rents typically emphasizes the "absolute" and "present" nature of the assignment. An example:

> "Borrower hereby *absolutely*, *unconditionally and presently* grants, transfers and assigns unto Lender all rents, royalties, issues, profits, income and revenues ("Rents") now or hereafter due or payable for the occupancy or use of the Property." (Emphasis added.)

The Assignment of Rents usually provides that the lender grants the borrower a "license" to collect the rents until an Event of Default occurs, at which point the license is

[1] Following UARA's custom, I will use the term "Security Instrument" to mean a Deed of Trust in states where those are recorded, and a Mortgage in states where those are recorded.

immediately revocable. The Assignment commonly gives the lender broad, self-enforcing remedies upon revocation of the license:

> "Upon or at any time after an Event of Default shall have occurred, Lender may, at its option, without notice, with or without bringing any action or proceeding, (i) enter upon, take possession of, manage and operate the Property, or any part thereof; (ii) *take possession of any and all Rents that may previously have been collected by Borrower*, and which remain in the possession or control of Borrower, together with any bank or similar accounts in which any such Rents may be deposited or held; and (iii) either with or without taking possession of the Property, in its own name sue for or otherwise *collect and receive such Rents*, including those past due and unpaid." (Emphasis added.)

(e) Those "absolute and present" assignments, and the lender's expansive self-help remedies, are virtually never enforced as written.

2. **Assignments of Rents in Non-UARA States: Colorado As An Example**.

(a) Morning Star; the "Inchoate Lien" on Rents, and "Affirmative Steps" to Perfect.

(i) The treatment of assignments of rents in Colorado was summarized by the Bankruptcy Court for the District of Colorado (Matheson, J.) in *In re Morning Star Ranch Resorts*, 64 B.R. 818 (Bankr. D. Colo. 1986).

(ii) In *Morning Star*, the debtor owned a motel in Estes Park, Colorado. The debtor's acquisition of the motel was financed with a loan secured by a deed of trust on the property. The debtor defaulted on the loan. The lender commenced foreclosure and obtained the appointment of a receiver. The debtor then filed Chapter 11, the receivership was terminated, and the property was returned to the debtor. 64 B.R. at 819.

(iii) The Court, citing *Butner v. U.S.*, 99 S. Ct. 914 (1979), explained that "state laws should govern property interests," and that accordingly, "any matter arising in this Bankruptcy Court concerning security interests in rents and profits from Colorado properties must refer to and be limited by the protection granted those interests under Colorado law." 64 B.R. at 821.

(iv) The Court elaborated:

> "In Colorado, a mortgagee or assignee of rents who has been granted the right to collect rents and profits upon default in a security instrument *has only an inchoate lien*. *It is only upon taking affirmative steps to perfect that lien that one secures a right to rents and profits*. The perfection of the lien then dates from when the action is begun. Such affirmative steps include taking

> possession of the property, causing rents to be sequestered, or seeking appointment of a receiver." *Id*. (Emphasis added; citations omitted.)

(v) When the debtor files a bankruptcy petition,

> "[A] notice filed under 11 U.S.C. § 546(b) serves the same purpose as the appointment of a state court receiver absent the advent of bankruptcy. . . [But], upon the filing of a § 546(b) notice, the lender does not become entitled to claim a right to all of the rents collected by the debtor. The lender, instead, is at best entitled to the protection to which he would have been entitled had a receiver been appointed." 64 B.R. at 82, *citing In re Colter*, 46 B.R. 510 (Bankr. D. Colo. 1984).

(vi) The Court went on to explain that a debtor in possession is required to pay the operating expenses of the property, any expenses of preservation of the property and, if appropriate, a management fee out of the rents collected, in the same way that a receiver would. The remaining rents are subject to the lender's security interest (perfected by the filing of the § 546(b) notice), and subject to the Code's restrictions on the use of cash collateral. 64 B.R. at 822-23.

(b) Consequently, lenders who make loans secured by Colorado real estate are accustomed to seeing this type of qualification in the borrower's counsel's opinion letter:

> "Any assignment of rents and leases contained in the Loan Documents is subject to provisions of Colorado law providing that such an assignment is inchoate and does not become enforceable until the assignee takes affirmative, substantial steps in realizing upon the related property as security (normally, the appointment of a receiver)."

3. **UARA's Purpose**. In the Prefatory Note to UARA, the Uniform Law Commissioners note that:

> "the creation and enforcement of security interests in rents tends to be governed by the common law of real property . . . [which] has produced undesirable variation in the rules . . .
>
> * * *
>
> . . . disagreements regarding security interests in rents *tend to be resolved in federal bankruptcy courts*, after the owner of mortgaged real property has resorted to bankruptcy to obtain a stay from creditor collection efforts. *Bankruptcy courts have proven exceptionally adept at creatively interpreting (or misinterpreting) state law principles* – in some cases to disencumber a lender's security interest in rents altogether, or in other cases to exclude

> post-bankruptcy rents from the bankruptcy estate." (Emphasis added.) [UARA Prefatory Note at 1-2.]

(The Commissioners' sentiments, not mine. Judges, please don't shoot the messenger.)

In any event, the Commissioners state that UARA "provides basic rules that establish the 'security interest' of the creditor, the rights of tenants to notice and the effect of notice, and the priority of the security interest against other creditors."

4. **What UARA Does**. Among the principal provisions of UARA are the following:

(a) Assignment of Rents Is Automatic. UARA provides that every enforceable Security Instrument:

> "creates an assignment of rents arising from the real property . . ., unless [the Security Instrument] provides otherwise." [UARA §4(a)]

So in theory, the Security Instrument needn't include any assignment of rents language, although I doubt that any lender would elect not to include its own preferred language.

(b) An Assignment of Rents Creates a Security Interest in Rents; Rents Are Distinct From the Real Property.

> "An assignment of rents creates a presently effective security interest in all accrued and unaccrued rents arising from the real property described in the document creating the assignment, *regardless of whether the document is in the form of an absolute assignment, an absolute assignment conditioned upon default, an assignment as additional security, or any other form*. The security interest in rents is separate and distinct from any security interest held by the assignee in real property." [UARA §4(b)] (Emphasis added.)

Thus, even if the Security Instrument says that the assignment of rents is "absolute and present," it simply creates a security interest in the rents.

(c) Perfection of Security Interests in Rents.

> "Upon recording, the security interest in rents created by an assignment of rents is fully perfected, *even if a provision of the document creating the assignment or law of this state other than this Act would preclude or defer enforcement of the security interest until the occurrence of a subsequent event*, including a subsequent default of the assignor, the assignee's obtaining possession of the real property, or the appointment of a receiver." [UARA §5(b)] (Emphasis added.)

This does away with the "inchoate assignment" concept (as expressed in *Morning Star*), even if that concept is otherwise embodied in state case law.

It also means that a trustee or debtor in possession may not assert the "inchoate" (i.e., unperfected) nature of the assignment of rents in an attempt to avoid that assignment under Section 544(a) of the Bankruptcy Code.

(d) Priority of Security Interest in Rents Against Competing Claims.

> "[A] perfected security interest in rents takes priority over the rights of a person that, after the security interest is perfected:
>
> (1) acquires a judicial lien against the rents or the real property from which the rents arise; or
>
> (2) purchases an interest in the rents or the real property from which the rents arise." [UARA §5(c)]

(e) Rents Are Broadly Defined. Rents are defined as, among other things, all:

> "(A) sums payable for the right to possess and occupy, or for the actual possession or occupation of, real property of another person . . ." [UARA §2(12)]

That broad definition is intended to capture not only commonly understood "rents" – office lease rents, apartment rents, and the like – but other payments which have sometimes been treated as "accounts" under the UCC, such as hotel room revenues and parking garage charges. (That same issue prompted the amendment of Section 552(b) of the Bankruptcy Code in 1994, to include hotel room revenues.)

(f) Three Ways to Enforce A Security Interest in Rents. A lender can enforce a security interest in rents in any of the three ways listed below. From the date of enforcement, the lender (or the receiver, if the security interest is enforced by appointing one) is entitled to collect all rents that have accrued but remain unpaid on that date, and all rents that accrue on or after that date, as those rents accrue. [UARA §6]

(i) ***Enforcement by Appointment of Receiver***. The lender may obtain the appointment of a receiver to collect the rents in much the same manner, and for the same reasons, as it can in a non-UARA state. [UARA §7]

(ii) ***Enforcement by Notice to Borrower/Landlord***. The lender may also enforce its security interest in rents by giving notice to the borrower "demanding that the [borrower] pay over the proceeds of any rents." [UARA §8]

(iii) ***Enforcement by Notice to Tenant***. In the alternative, the lender may enforce its security interest in rents by giving notice to the tenants. Once a tenant receives notice, the tenant is obligated to pay rent to the lender. If the tenant nonetheless continues to pay rent to the borrower/landlord, the tenant is not

discharged from its obligation to pay those rents to the lender (i.e., it may, in effect, be double-charged). But if the tenant pays rent to the lender as specified in the notice, its rent obligation to the borrower under the lease is satisfied. The obligation to pay rent to the lender survives until the tenant receives a written notice from the lender, or a court order, to the contrary. [UARA §9; a form of notice to a tenant is included in UARA section 10.]

Method (iii) above is a pretty effective device (prompt access to the rents, without the appointment of a receiver or other resort to a court) that I suspect lenders would love. Borrowers, not so much.

(g) Payment of Operating Expenses.

(i) UARA provides that a lender that "collects rents following enforcement [by notice to the borrower/landlord, or by notice to the tenants] *need not apply them to the payment of expenses of protecting or maintaining the real property* subject to the assignment." (Emphasis added.) [UARA §13(a)] If the lender does elect to pay operating expenses, the rents can be applied to reimburse the lender for those expenses, along with the lender's expenses of enforcing the assignment of rents. [UARA §12]

(ii) If the lender enforces the assignment of rents with the appointment of a receiver, that receiver will still pay the expenses of operating and maintaining the property, as required by other applicable state law. [UARA §13(c)]

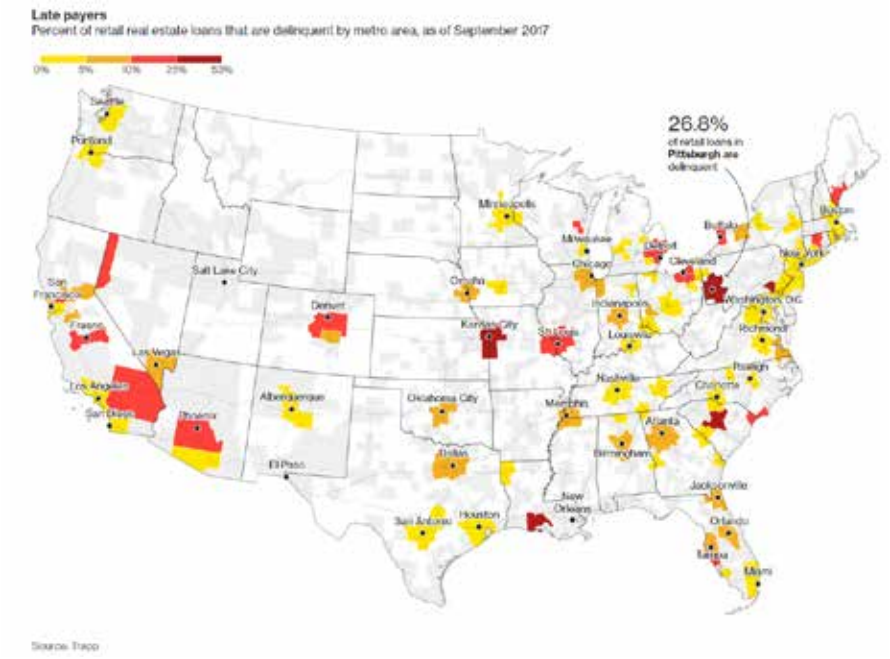
(iii) If the lender enforces the assignment of rents by notice, and then fails to pay taxes, insurance and other operating expenses, the lender's right to collect rent is subject to the claims and defenses of any tenants of the property who are damaged by that failure. [UARA §13(b)] Any of those tenants can seek the appointment of a receiver, or other relief. [UARA §13(c)] This is an analog to Section 365(h) of the Bankruptcy Code, although it does not give the tenant a unilateral right to offset its damages against the rent due.

State of the Retail Market

- With the momentum behind e-commerce and many long-standing chains overloaded with debt (often from leveraged buyouts led by private equity firms), stories of the demise of retailers are more prevalent
- Traditional brick and mortar stores are dropping like flies
- 2017 has seen more than 19 bankruptcy filings, with many smaller retailers organizing liquidations and wind downs, including Toys "R" Us, Vitamin World, Alfred Angelo, Gymboree, Aerosoles, Perfumania, True Religion, rue21, Payless Shoe Source, Gander Mountain, Gordmans and RadioShack.
- Review of credit-rating companies' risk ratings and those on Fitch Ratings' "bonds of concern" and "loans of concern" watch lists are considered to have a significant risk of default over the next 12 months. They have big debt loads and face factors that could complicate their ability to repay them in the days to come.
- Portfolio review will help determine a business' course of action

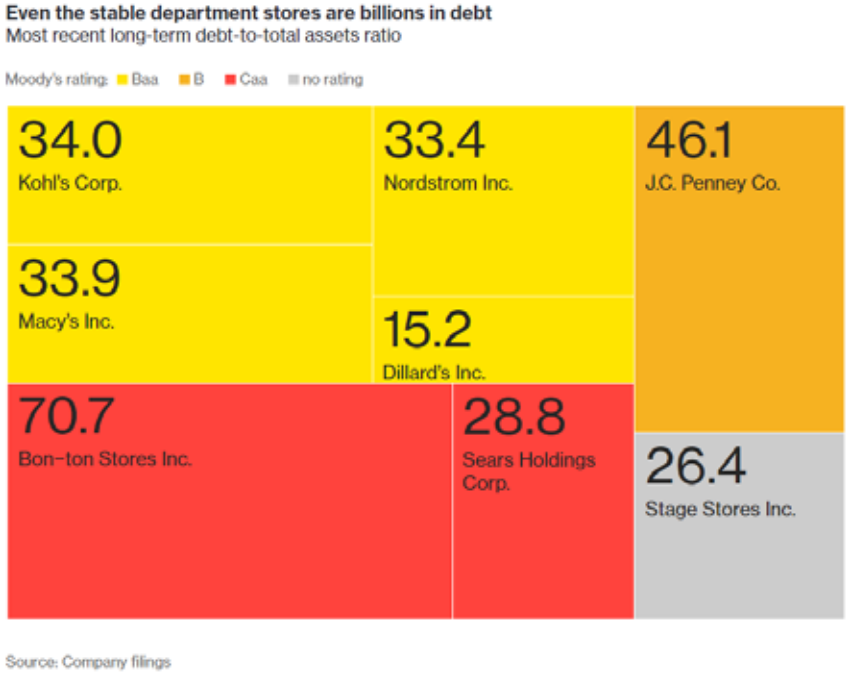
Source: CNBC.com "Here are the retailers that have filed for bankruptcy protection in 2017" 9/23/2017

State of the Retail Market



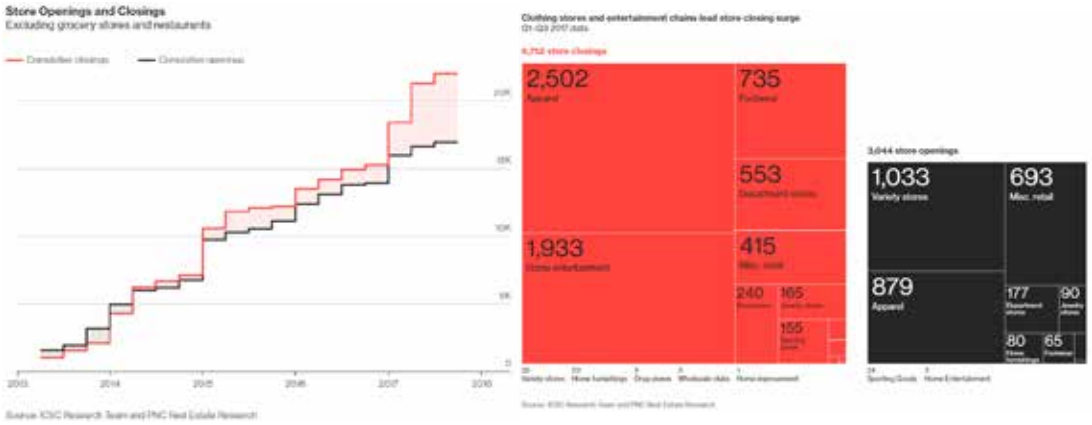
Source: Bloomberg: "America's 'Retail Apocalypse' Is Really Just Beginning" 11/8/2017

State of the Retail Market



Source: Bloomberg: "America's 'Retail Apocalypse' Is Really Just Beginning" 11/8/2017

State of the Retail Market



Source: ICSC Research Team; Bloomberg: "America's 'Retail Apocalypse' Is Really Just Beginning" 11/8/2017

Quadrants of Tenant Lease Restructures

One of four primary approaches should be identified by a tenant, its counsel and consultants prior to commencing any negotiations:

Short Term Relief

- Typically involves a location that has previously been profitable for a period in excess of 12 months with a good strategic and economic investment looking forward
- To be effective, more than eighteen (18) months should remain in lease term

Long Term Relief

- The location has not been profitable, but the tenant continues to believe location is a good strategic and economic investment looking forward
- Other tenants in community are paying much less rental for similar space and/or vacancy is high in the center
- Less than eighteen (18) months remain in lease term

Negotiated Lease Terminations

- The tenant has determined that the location is not financially viable moving forward
- The tenant has money in coffer to offer for settlement
- The tenant wants to preserve long-term relationship with Landlord
- The tenant is an ongoing, viable business with other interests in the marketplace and does not want the negative market perception associated with litigation over a failed lease

"Ostrich Approach" – duck and hide

- The tenant has determined that location is not financially viable moving forward
- No personal guarantees/loan obligations exist, or alternatively, personal guarantors (and underlying tenant entity) are insolvent and/or bankrupt
- The tenant is not interested in a future relationship with its Landlord
- The premises is not likely to be relet at any time in the immediately foreseeable future and/or is unique to the failed tenant

Affect of Code Changes on Lease Sales/Designation Rights

Before Reform and Recession

- Debtor had 60-days after filing, the court could extend this period "for cause," which occurred regularly
- Result was unlimited time to make decisions about lease assumption/ rejection
- Retailers had the opportunity to extend their restructuring period through a holiday season to make decisions

After Reform and Before Recession

- Debtor has 120-days to determine assume/reject an unexpired lease; one time 90-day extension available.
- Result is 210-day limited to make decisions about lease assumption/ rejection
- Retailer might not have the opportunity to use a holiday season to determine if they could be a stronger company,
  The economy was still strong so retailers could utilized store history and sale trends as a predictor.
- Chance for restructuring and recovery

After Reform and Current Market

- Limited time to make decisions about lease assumption/rejection
- Retailer might not have the opportunity to use a holiday season to determine if they could be a stronger company.
- Retailers can't rely on history with the decline of foot traffic and change of purchasing habits via mobile devices, websites and discount online retailers
- Higher chance of liquidation vs. recovery

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Designation Rights

- Sale of designation rights are an alternative option for realizing a leases' value. Debtors decide to sell their lease and transfer the lease terms to a third party. Through the sale of designation rights in bankruptcy, landlords are forced to accept lease assignments, which would otherwise be prevented by lease anti-assignment provisions.
- The estate can attempt to capture value from those leases, as well as manage any pre-rejection liability such as administrative expenses, by selling the "designation rights" of those unexpired leases.
- Designations rights were big business in the late 90s and early 00s with Best Products, Bradlees, Caldor, Ernst Home Centers, Grand Union, Hechinger, Jumbo-sports, Kmart, Montgomery Ward, Service Merchandise and Sun TV.
- The change to the bankruptcy code in 2005 limited the amount of time debtors could assume, reject or assign leases through designation rights to 210 days. The change to the bankruptcy code coincided with sharp downturn of the real estate market 2007. As a result, value in lease assignments were cut dramatically.
- Lease disposition projects have become less successful in recent years as,
  - Fewer retailers are expanding
  - More locations are closing
  - No competition for new space so a retailer wanting new locations could negotiate great deals with landlords directly without needing to take advantage of the bankruptcy process.

Source: ICSC Research Team; Bloomberg: "America's 'Retail Apocalypse' Is Really Just Beginning" 11/8/2017
ABI Journal "Smooth Sailing for Designation Rights Sales" February 2003

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AÉROPOSTALE INC. TRANSACTION

- Aéropostale filed for bankruptcy in May 2016, surrendering to competition from big-box stores, online merchants and "fast fashion" rivals.
- In September 2016, a group of investors that included mall developers, Simon Property Group Inc., General Growth Properties Inc., and Authentic Brands Group, and liquidators, Hilco and Gordon Brothers, won an auction for the assets of Aéropostale Inc. with a $243 million bid.
- While Wall Street analysts speculated that the reason was related to the large number of stores in malls, Simon CEO, David Simon, has stated that the main reason for the transaction was the belief that they could make money. The investment was mostly motivated by the prospect of a hefty profit thanks to the low price paid at auction.
- Only time will tell if the transaction worked and if other landlords will undertake this challenge.
- There have been 25 retail bankruptcies in 2017, but there has not been a similar transaction.

Source: Bloomberg: "Mall Group Wins Aeropostale Auction with $243.3 Million Bid" 9/6/2016
Debtwire "Aeropostale rescue teaches some lessons, but retail industry has much bigger problems at hand – Conference Coverage" 9/14/17
Fortune.com: "Top U.S. Mall Developer Says Aéropostale Could Grow Back to 500 Stores" October 31, 2016

Matthew Bordwin

Matthew Bordwin
Principal & Managing Director

Direct (646) 381-9202
Cell (917) 929-1436
Email mbordwin@Keen-Summit.com
Web www.Keen-Summit.com

Matt specializes in the marketing and sale of businesses along with the valuation, marketing, and disposition of real estate portfolios for healthy and distressed companies. Matt is the recipient of the 2016 Transaction of the Year Award by the TMA.

Professional and Industry Experience

- Matt's negotiations and sales technique have resulted in multi-million dollar transactions with clients such as Blockbuster Video, Huffman Koos, Arthur Andersen, Fruit of the Loom, and Montgomery Ward.
- Matt's previous clients include Movie Gallery-Hollywood Video, Cable & Wireless, Spiegel/Eddie Bauer, Tommy Hilfiger, New World Pasta, Pillowtex, Edison Brothers, Penthouse/General Media, Coda/Jeans West, Stage Stores, Pic 'N Pay, Service Merchandise and Family Golf Centers.
- Matt handled lease restructuring/termination negotiations on a leasehold obligation in excess of $110 million enabling a successful law firm merger. Matt has also recently worked on one of the largest lease restructuring projects in retail history.
- Matt has also had success in the golf industry, where he sold The Club at Cordillera for $14.2 million, and Long Island National Golf Club, which sold for $6 million.
- Matt is a frequent speaker on industry topics, has written an article published in Real Estate Weekly, has been featured in articles in Fortune magazine and National Real Estate Investor magazine, and has been quoted numerous times as an expert in the real estate industry by

Education, Licenses & Certifications

- BA, Tufts University
- JD, Fordham University School of Law
- Licensed Real Estate Broker
- General Securities Representative (Series 7)
- Registered Principal (Series 24)
- Securities Agent (Series 63)
- Investment Banking Representative (Series 79)

Representative Clients

Financial Clients:	Corporate Clients:	Retail Clients:
• Angelo Gordon	• Arthur Anderson	• Blockbuster
• Bank of America	• Cable & Wireless	• Casual Male
• Citibank	• Family Golf Centers	• Dollar General
• JP Morgan Chase	• Fleming	• Foot Locker
• Silverpoint	• Spiegel	• Tommy Hilfiger
• Wachovia	• Warnaco	• U-Haul Bondholders

REAL ESTATE BANKRUPTCY ISSUES:
Classification and Abandonment of Oil and Gas Interests

By:
Jason S. Brookner
Amber M. Carson
Gray Reed & McGraw LLP

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Classification of Oil and Gas Leases for Purposes of 11 U.S.C. § 365

Whether mineral leases are considered to be "unexpired leases" or "executory contracts" under § 365 of the Bankruptcy Code is a matter of state law. *See Butner v. United States*, 440 US. 48, 54-55 (1979). States, however, do not uniformly agree on whether oil and gas leases are true leases—that can be assumed or rejected in bankruptcy—or interests in real property. Additionally, not all states have considered this question, leaving much uncertainty for bankruptcy practitioners.

Interests in Real Property

Kentucky, Pennsylvania, Texas, California, and Oklahoma hold that oil and gas leases are not subject to assumption or rejection under 11 U.S.C. § 365. *See* **Kentucky** *K & D Energy v. KY USA Energy, Inc. (In re KY USA Energy, Inc.)*, 444 B.R. 734, 737 (Bankr. W.D. Ky. 2011)("It is well settled by many courts that an oil and gas lease is not an executory contract because the rights conveyed are an interest in real estate and not truly a lease…*Kentucky follows the rationale that an oil and gas lease constitutes a conveyance of an interest in realty. . . not executory contracts or unexpired leases.* Accordingly, they are not subject to the dictates of 11 U.S.C. § 365, as a matter of law." (internal citations omitted, emphasis added)); **Pennsylvania** *Chesapeake Appalachia, LLC v. Powell (In re Powell)*, No. 3:13-CV-00035, 2015 WL 6964549, at *6 (M.D. Pa. Nov. 10, 2015)("[O]ur law has evolved to unequivocally establish that *rights to oil and gas are to be treated as transfers of estates in property and not leaseholds*." (citing *Nolt v. TS Calkins & Assocs., LP*, 2014 PA Super 141, 96 A.3d 1042, 1047 n. 3 (2014)(emphasis added)); **Texas** *River Prod. Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990)(in Texas, oil and gas leases do not constitute unexpired leases for purposes of section 365); *Terry Oilfield Supply Co., v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70 (S.D. Tex. 1996) ("A mineral lease in Texas is a *determinable fee. It is not a lease or other form of executory contract that a debtor may accept or reject*.")(emphasis added); **California** *Laugharn v. Bank of Am. Nat'l. Tr. & Sav. Ass'n*, 88 F.2d 551, 553 (9th Cir. 1937)(stating that under California law, assignments of mineral interests are interests in real property and not executory contracts); **Oklahoma** *In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986)("an oil and gas lease is not an unexpired lease or executory contract within the purview of Bankruptcy Code § 365, but is more akin to…an estate in real property having the nature of a fee"); *In re Clark Res*., 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986)(an oil and gas lease is not within the scope of 11 U.S.C. § 365).

Contracts or Leases

Some states, including Michigan, Minnesota, Wisconsin, and Kansas, hold that an oil and gas lease constitutes an unexpired lease of non-residential real property subject to the restrictions of 11 U.S.C. § 365(h). *See* **Michigan** *Frontier Energy LLC v. Aurora Energy Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 678-80 (Bankr. W.D. Mich. 2010)("Michigan treats a lessee's interest as a leasehold…but not a freehold estate…oil and gas leases…are…'leases' within the meaning of Section 365"); *In re P.I.N.E., Inc.*, 52 B.R. 463, 465-68 (Bankr. W.D. Mich. 1985)(suggesting, in dicta, that an oil and gas lease was a lease contemplated by 365); **Minnesota** *In re Huff*, 81 B.R. 531, 537 (Bankr. D. Minn. 1988)(finding that a mining lease was a true lease subject to section 365(h)); **Wisconsin** *In re Myklebust*, 26 B.R. 582, 584 (Bankr. W.D. Wis. 1983)(treating an oil and gas lease as an unexpired lease pursuant to 365(a)); **Kansas** *In re J. H. Land & Cattle Co*., 8

B.R. 237, 239 (W.D. Okla. 1981)(under Kansas law, "[a]n oil and gas lease is within the purview of [Bankruptcy Code] § 365 and may be rejected by a debtor with court approval.").

Undecided

Still other states have not reached a definitive conclusion on this issue. For example, courts in **Louisiana** seem to agree that mineral leases are not true leases, but are split on whether mineral leases simply fall outside of § 365, or whether they constitute executory contracts. *Compare In re WRT Energy Corp.*, 202 B.R. 579, 583 (W.D. La. 1996)(holding that mineral leases were neither executory contracts nor unexpired leases) *with Texaco, Inc. v. La. Land & Expl. Co.*, 136 B.R. 658, 668 (M.D. La. 1992)(holding that a Louisiana mineral lease is an executory contract under § 365) *and In re Ham Consulting Co./William Lagnion/JV*, 143 B.R. 71, 73-75 (Bankr. W.D. La. 1992)(holding that a Louisiana mineral lease is not an unexpired lease but is an executory contract under § 365). In **Ohio**, courts are split regarding whether oil and gas leases qualify as unexpired leases under section 365. *Compare In re Frederick Petroleum Corp.*, 98 B.R. 762, 766 (S.D. Ohio 1989)("[T]he oil and gas leases in this case are not leases of nonresidential real property within the meaning of § 365(d)(4) and § 365(m)") *with In re Gasoil, Inc.*, 59 Bankr. 804 (Bankr. N.D. Ohio 1986)(allowing an oil and gas lease to be rejected as an unexpired lease of nonresidential real property pursuant to section 356(d)(4)) *and In re Integrated Petroleum Co., Inc*., 44 B.R. 210, 214 (Bankr. N.D. Ohio 1984) (deciding, without discussion, that an oil and gas lease was an unexpired lease under 365). **Kansas** courts have pointed out that mineral leases may sometimes qualify as either a real property interest *or* a personal property interest. *See Ingram v. Ingram*, 214 Kan. 415, 420, 521 P.2d 254, 258 (1974) ("[I]n this state an oil and gas lease is a hybrid property interest. For some purposes an oil and gas leasehold interest is considered to be personal property and for other purposes it is treated as real property.").

At least one court in **Illinois** has stated that oil and gas leases are not true leases for purposes of 365, but did not discuss whether such leases can be construed as executory contracts. *In re Hanson Oil Co., Inc.*, 97 B.R. 468, 470-71 (Bankr. S.D. Ill. 1989)(finding that oil and gas leases that convey freehold interests are not true leases contemplated by 365(d)(4)).

Unsettled

In Alabama, Arkansas, and the Outer Continental Shelf, determination of the interest conveyed by mineral leases is even more unsettled. **Alabama** does not have a hard and fast rule for the determination of interests. Instead, the nature of interests created by an oil and gas lease must be determined by the terms of the lease itself. *See Moorer v. Bethlehem Baptist Church*, 272 Ala. 259, 130 So. 2d 367 (1961). **Arkansas** courts have not definitively stated whether section 365 applies to oil and gas leases. However, they have classified the property interest conveyed under such leases as an "an interest and easement in land itself" which makes it probable that Arkansas courts would find § 365 applies. *See Pasteur v. Niswanger*, 290 S.W.2d 852, 854 (Ark. 1956).

Offshore oil and gas leases on the Outer Continental Shelf are governed by federal law and such leases are not real property conveyances. *Union Oil Co. of Cal. v. Morton*, 512 F.2d 743, 747 (9th Cir. 1975) (a lease granted under the Outer Continental Shelf Lands Act "does not convey title in

the land, nor does it convey an unencumbered estate in the oil and gas."). However, no court has yet weighed in on whether such leases are true leases or executory contracts for purposes of 365.

Classification of Royalty Interests

Louisiana, Michigan, New Mexico, North Dakota, Oklahoma, Texas, Colorado, Utah, Wyoming, Montana, and California hold that royalty interests are real property. **Louisiana** *See Terry v. Terry,* 565 So. 2d 997 (La. App.-1st Cir. 1990)(overriding royalties are classified as real rights and incorporeal immovables in Louisiana); **Michigan** *Mark v. Bradford*, 315 Mich. 50 (Mich. 1946)(noting that certain royalty interests take the form of real property interests); **New Mexico** *Team Bank v. Meridian Oil Inc.*, 118 N.M. 147, 149 (1994) ("[A]n overriding interest is an interest in real property"); *Duval v. Stone*, 213 P. 2d 212 (N.M. 1949)("Where royalties are not limited to the product removed from the land under a particular lease, they are perpetual interests in oil and gas to be produced thereafter at any time"); **North Dakota** *ANR W. Coal Dev. Co. v. Basin Elec. Power Coop*., 276 F.3d 957, 965 (8th Cir. 2002)(recognizing that "[o]verriding royalty holders have an interest that is a form of real property under North Dakota law"); **Oklahoma** *De Mik v. Cargill*, 485 P.2d 229, 231 (Okla. 1971)(noting that "[a]n overriding royalty interest generally is held to be an interest in real property" under Oklahoma law); **Texas** *Alamo Nat. Bank of San Antonio v. Hurd*, 485 S.W.2d 335, 338–39 (Tex. Civ. App. 1972)("[T]here can be no doubt in Texas but that an overriding royalty, whether payable in money or by the delivery of oil, is an interest in land"); *Tennant v. Dunn*, 110 S.W.2d 53, 56 (Tex. 1937)(holding under Texas law that conveyances made pursuant to the creation of an oil and gas lease convey a vested real property right at the time of the conveyance); **Colorado** Minerals-Royalty Interests, 1991 Colo. Legis. Serv. S.B. 91-34 ("Any conveyance, reservation, or devise of a royalty interest in minerals or geothermal resources, whether of a perpetual or limited duration, contained in any instrument executed on or after July 1, 1991, creates a real property interest which vests in the holder or holders of such interest the right to receive the designated royalty share of the specified minerals or geothermal resources or the proceeds therefrom in accordance with the terms of the instrument."); **Utah** *Flying Diamond Oil Corp. v. Newton Sheep Co.*, 776 P.2d 618, 629 (Utah 1989)("An oil and gas royalty is an interest in land."); **Wyoming** *Johnson v. Anderson*, 768 P.2d 18, 23 (Wyo. 1989)(an overriding royalty interest is a nonpossessory interest in real property); **Montana** *Edward v. Prince*, 719 P.2d 422, 424 (Mont. 1986)(interpreting a royalty interest under Montana law using a state law provision for real property); **California** *Universal Consol. Oil Co. v. City of Los Angeles,* 202 Cal. App. 2d 771, 784 (Ct. App. 1962)(a "royalty interest, in an oil lease, reserved by a landowner is an interest in real property").

Conversely, Kansas, Idaho, and Arizona classify royalty interests as personal property. *See* **Idaho** *Kopp v. Baird*, 313 P.2d 319, 325 (Idaho 1957)(classifying royalty interests as "an incorporeal right…intangible personal property" in the context of its taxation statutes); **Kansas** *Caney Valley Nat'l Bank v. Alexander (In re Wolfe)*, 181 B.R. 90, 92 (Bankr. D. Kan. 1995)("[A] landowner's royalty is classified as personal property under Kansas law.").

Arizona gives the parties some flexibility—royalty interests can be interests in real property if "the parties so intend." *Paloma Inv. Ltd. P'ship v. Jenkins*, 978 P.2d 110, 115 (Ariz. Ct. App. 1998).

Abandonment of Property and the Survival of Associated Environmental Liabilities

A trustee or debtor in possession may be obligated to clean up contaminated real estate or property pursuant to prepetition contracts, court orders, or federal or state law. And, a trustee or debtor in possession is obligated to "manage and operate the property in his possession ... according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof." 28 U.S.C. § 959(b). In bankruptcy, however, a trustee or debtor in possession may abandon property that is "burdensome to the estate" or of "inconsequential value and benefit to the estate." 11 U.S.C. § 554.

When property is abandoned, it is to the person having a possessory interest in the property. S.Rep. No. 95–989, p. 92 (1978); *Ohio v. Kovac*s, 469 U.S. 274, 285 n. 12 (1985). If the property is worth more than the cost required to bring the property into compliance with environmental laws, the trustee will likely try to sell the property, leaving the purchaser to the task of ensuring compliance with environmental laws. In this case, the debtor's obligation to clean up the property would be extinguished. If the property is not worth more than the cost of cleanup, however, the property is likely to be abandoned back to the debtor, who then must comply with environmental laws. This latter situation, when trying to reconcile the three rules listed above, can be subject to debate, even after guidance from the Supreme Court.

In 1985, the Supreme Court held in *Ohio v. Kovacs* that an injunction ordering cleanup of environmental liabilities qualified as a "debt" or "liability on a claim" subject to discharge when such an obligation was converted into an obligation to pay money. 469 U.S. 274, 274-75 (1985). However, the Court was careful to clarify that notwithstanding the discharge, "anyone in possession of the site…must comply with the environmental laws of the State… that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions." *Id.* at 285. Thus, environmental laws and their respective obligations attached to current ownership of land survive bankruptcy.

A year later, in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, the Supreme Court identified a "narrow" exception to the trustee's abandonment powers, and held that property cannot be abandoned if doing so would contravene state law or regulations that are "reasonably designed to protect the public health or safety from identified hazards," unless a court first formulates conditions to "adequately protect the public's health and safety." 474 U.S. 494, 507 (1986). The trustee in *Midlantic* sought, unsuccessfully, to abandon property that contained toxic waste oil stored in unguarded and deteriorating containers. *Id.* at 498. In denying the trustee's request, the Court emphasized that "[n]either the Court nor Congress has granted a trustee in bankruptcy powers that would lend support to a right to abandon property in contravention of state or local laws designed to protect public health or safety," and that "the efforts of the trustee to marshal and distribute the assets of the estate must yield to governmental interest in public health and safety." *Id.* at 502.

In a "famed" footnote in the opinion, *In re Shore Co.*, 134 B.R. 572, 578 (Bankr. E.D. Tex. 1991), the Court explained further that the exception to the trustee's abandonment power "does not encompass a speculative or indeterminate future violation" of environmental laws. *Midlantic*, 474

U.S. 507 n. 9. This language has prompted disagreement among courts regarding the application of environmental laws prior to abandonment.

Some courts interpret *Midlantic* as requiring strict compliance, before abandonment, with environmental laws. Relying on *Midlantic*, the Fifth Circuit held that a trustee is required to plug wells prior to abandonment if he is obligated to plug the well under a state law reasonably designed to protect public health or safety. *See Texas v. Lowe (In re H.L.S. Energy Co.)*, 151 F.3d 434, 439 (5th Cir. 1998). In other words, a trustee cannot abandon the associated obligation to plug an unproductive well along with the well. *Id.* Other courts have followed similar reasoning. *See In re Peerless Plating Co.*, 70 B.R. 943 , 947-48 (Bankr. W.D. Mich. 1987)("[T]he Trustee cannot abandon the property under *Midlantic* without complying with [federal law]."); *In re Am. Coastal Energy Inc.*, 399 B.R. 805, 810 (Bankr. S.D. Tex. 2009)(citing *Midlantic* and *H.L.S. Energy* to hold that a trustee cannot abandon property without first addressing environmental concerns); *Lancaster v. State of Tenn. (In re Wall Tube & Metal Prods. Co), 831 F.2d 118, 119 (6th Cir. 1987)*, 831 F.2d 118 (6th Cir.1987).

However, the majority of courts follow the arguably more logical rule that the *Midlantic* exception only applies where there is an imminent and identifiable harm or danger to the public. *See, e.g. In re Unidigtal, Inc*., 262 B.R. 283, 286-87 (Bankr. D. Del. 2001)(listing cases); *N.M. Env't Dep't v. Foulston (In re L.F. Jennings Oil Co.)*, 4 F.3d 887, 890 (10th Cir. 1993)(abandonment allowed where there was no immediate threat at the time of the abandonment); *Commonwealth Oil Ref. Co. v. E.P.A. (In re Commonwealth Oil Ref. Co.)*, 805 F.2d 1175, 1185 (5th Cir. 1986)("[T]he question before the Court in *Midlantic* was the scope of the abandonment power, and it is *that* power that the Court found to be limited by the 'imminent and identifiable harm' standard.")(emphasis in original); *In re FCX, Inc*., 96 B.R. 49, 54 (Bankr. E.D.N.C. 1989)("Full compliance with all environmental laws is not required prior to abandonment, but abandonment is not authorized when there is an immediate threat to the public health and safety and an imminent danger of death or illness."); *White v. Coon (In re Purco, Inc.)*, 76 B.R. 523, 533 (Bankr. W.D. Pa. 1987)(permitting abandonment when there was no showing that hazardous waste would cause a threat to public safety or health); *In re Franklin Signal Corp.*, 65 B.R. 268, 272 (Bankr. D. Minn. 1986)("The trustee only needs to take adequate precautionary measures to ensure that there is no imminent danger to the public as a result of abandonment."); *Shore Co.*, 134 B.R. at 578 ("[A] trustee's right to abandon environmentally impacted estate property is limited only by the precondition that the trustee remediate any imminent and identifiable danger present on the property proposed to be abandoned.").

A few other cases cannot be separated into one of the two groups above. For example, the Fourth Circuit has followed the lead of the majority, but also held that the value of unencumbered assets of the estate should impact whether compliance with environmental laws is required. *Borden, Inc. v Wells-Fargo Bus. Credit (In re Smith-Douglass, Inc.)*, 856 F.2d 12, 17 (4th Cir. 1988); *see also In re Microfab, Inc.*, 105 B.R. 161 (Bankr. D. Mass. 1989). In *In re Globe Bldg. Materials, Inc.*, the bankruptcy court held that 28 U.S.C. § 959(b) did not apply to a case where the trustee was merely liquidating the debtor's property, which contained storage tanks that gave rise to an "immediate and identifiable harm to the public health and safety," and that the trustee would only be required to abate environmental hazards if the trustee retained ownership and control over the tanks but *if and only if* any sale of the property did not contemplate that the purchaser was

responsible for abatement and if the trustee had access to the property. 345 B.R. 619, 636 (Bankr. N.D. Ind. 2006).

The most logical conclusion, based on *Midlantic* and its progeny, is that the *Midlantic* exception applies if the following conditions have been demonstrated:

> (1) an identified hazard exists that poses a risk of imminent and identifiable harm to the public health and safety;
>
> (2) abandonment of the property will violate a state statute or regulation;
>
> (3) the statute or regulation being violated is reasonably designed to protect the public health and safety from imminent and identifiable harm caused by identified hazards; and
>
> (4) compliance with the statute or regulation would not be so onerous as to interfere with the bankruptcy administration itself.

N.J. Dept. of Envtl. Prot. v. Atkinson (In re St. Lawrence Corp.), 248 B.R. 734, 739 (D.N.J. 2000).

Even if the *Midlantic* exception applies, the costs of complying with environmental laws can constitute an administrative expense under section 503(b)(1)(A) when such costs benefit the estate. *See Burlington N. R.R. Co. v. Dant & Russell, Inc. (In re Dant & Russell, Inc.)*, 853 F.2d 700, 709 (9th Cir. 1988)(listing cases); *H.L.S. Energy Co.*, 151 F.3d at 437; *Com. of Pa. Dep't of Envtl. Res. v. Conroy*, 24 F.3d 568, 569 (3d Cir. 1994); *United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997, 999 (2d Cir. 1991); *Wall Tube*, 831 F.2d at 119.

REAL ESTATE BANKRUPTCY ISSUES: Oil and Gas Primer

23rd Annual Rocky Mountain Bankruptcy Conference
January 25-26, 2018
Denver, Colorado

Jason S. Brookner
Gray Reed & McGraw LLP; Dallas

INDUSTRY BASICS

Sectors and Terminology

Sectors

UPSTREAM

Exploration
Field Development
Production Operations

Upstream mainly focuses on the exploration of crude oil and natural gas fields, as well as production & recovery. The upstream sector is also commonly known as the Exploration and Production ("E&P") sector.

MIDSTREAM

Transportation
Processing
Storage & Distribution

Midstream primarily involves the storage and transport of upstream oil & gas through a network of pipelines, trucks, rail, ships, tankers, and barges to the downstream sector.

DOWNSTREAM

Manufacturing
Refining and Petro-Chemicals
Wholesale & Marketing

Downstream focuses on the refining of crude oil & purifying natural gas. In addition, this is where the sales, marketing, product distribution and retail takes place. This sector provides the closest connection to consumers.

3

THE UPSTREAM SECTOR

Upstream is the Exploration and Production segment of the industry, also called "E&P." These are the companies who find it and get it out of the ground

Support:

- Drilling Contractors and Production Services
- Geophysical Services
- Equipment Providers
- Well Services

Companies such as:

- Conoco Phillips
- Pemex
- Anadarko Petroleum
- Apache
- Chevron
- Shell
- Occidental
- Marathon Oil
- Chesapeake
- Sandrirdge Energy (Debtor)
- Energy XXI (Debtor)
- Sabine Oil & Gas (Debtor)
- Linn Energy (Debtor)
- Samson Resources (Debtor)
- Miller Energy (Debtor)
- Magnum Hunter (Debtor)
- Goodrich Petroleum (Debtor)
- Quicksilver Resources (Debtor)

4

THE MIDSTREAM SECTOR

Midstream is the transportation sector of the industry – getting your hydrocarbons from "here to there"

- Pipelines, Gathering, Marine Transportation

Support:

- Pipeline Construction & Services
- Transportation Scheduling
- Marine Vessel Construction

Companies such as:

- Energy Transfer Partners
- Williams
- Enterprise Product Partners
- Spectra Energy Partners
- Magellan Midstream
- Murphy Energy Corp (Debtor)
- Peregrine Midstream (Debtor)
- Hovensa (Debtor)
- Beaver Creek Pipeline (Debtor)
- Tristream East Texas (Debtor)
- Ryckman Creek Resources (Debtor)

5

THE DOWNSTREAM SECTOR

Downstream is the refining, processing, storage and retail sales segment of the industry

Companies such as:

- Sunoco L.P. (fuel distribution, convenience stores)
- Valero Energy (refineries, convenience stores, ethanol plants)
- Alon USA (refineries, convenience stores)
- Tesoro Corp (refineries, convenience stores, wholesales)
- Phillips 66 (refineries, chemical manufacturing, marketing, midstream)
- Par Petroleum (refineries, marketing)
- Western Refining (refineries, marketing, convenience stores)

6

CASE PLAYERS

CASE PLAYERS

1. **Debtor**
2. **Lenders** (banks as well as Wall Street funds)
3. **Trade vendors**
4. **Contract counterparties**
5. **Derivative (hedge) counterparties**
6. **Lessors (royalty owners)**
7. **Joint Operating Agreement parties**
8. **Working interest owners**
9. **Regulatory agencies** (state and federal, including EPA and state env't)
10. **Equity holders**

8

WHAT TYPE OF INTEREST DO YOU HOLD?

WHAT TYPE OF INTEREST DO YOU HOLD?

- Mineral Interest: typically a property interest for what is in the ground, created by an instrument filed in the real property records office – grant, assignment, reservation, transfer
- Royalty Interest: a property interest held by the lessor in an oil and gas lease, which entitles the lessor to a share of the production revenues (if there is production) – free of costs of production
- Working Interest (op or non-op): synonymous with "cost bearing interest." A percentage ownership interest in a lease that grants the owner the exclusive right to explore for and extract hydrocarbons
- Overriding Royalty Interest (ORRI): a non-operating interest carved out of the working interest, which gives the holder an entitlement to a percent of the proceeds of production, free of capital costs
- Net Revenue Interest (NRI): property interest in the proceeds of production held by the lessee under an oil and gas lease, free of production costs, after ORRIs and royalties are paid

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WHAT TYPE OF INTEREST DO YOU HOLD?

- Farmout: an agreement pursuant to which the owner of a mineral lease (the "farmor") agrees with another (the "farmee") that the the farmee will drill a well. At the time the well is completed (or at the time the well reaches a certain depth), the farmee becomes entitled to the farmor's working interest in the lease. The farmor usually retains an ORRI, which may or may not be convertible to a working interest after payout.
- Farm-in: basically the same thing, but from the viewpoint of the farmee.

Why do a farmout?

- For the farmor, because she may not want to spend any money drilling and exploring.
- For the farmee, reasons include obtaining production, and obtaining geological information (which is also a benefit for the farmor).

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GENERAL NATURE OF HOW THE PRODUCTION PROCEEDS FLOW

Mineral owner (lessor) signs lease with Acme Oil (E&P) and retains a royalty interest ("R")

Acme Oil, as lessee, holds a 100% working interest in the lease (real property interest) and must bear all costs of drilling and production

Acme Oil carves out of its working interest a non-cost bearing override ("ORRI") in favor of, *e.g.*, Geophysical Company, which entitles Geo to a percentage of Production Proceeds ("PP")

Acme Oil's net revenue interest ("NRI") is its rights to the proceeds of production, net of all royalties and ORRIs.

So, math for lawyers:

$$NRI = PP - (Rs + ORRIs)$$

[yes, there can be more than one royalty interest holder and more than one ORRI; there can also be more than one working interest]

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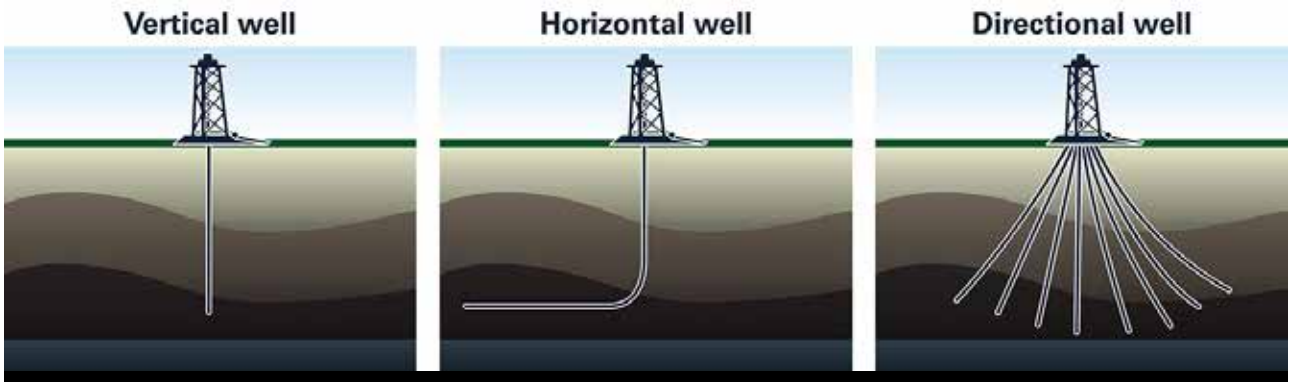
DRILLING

TYPES OF DRILLING

Vertical, Horizontal, and Directional



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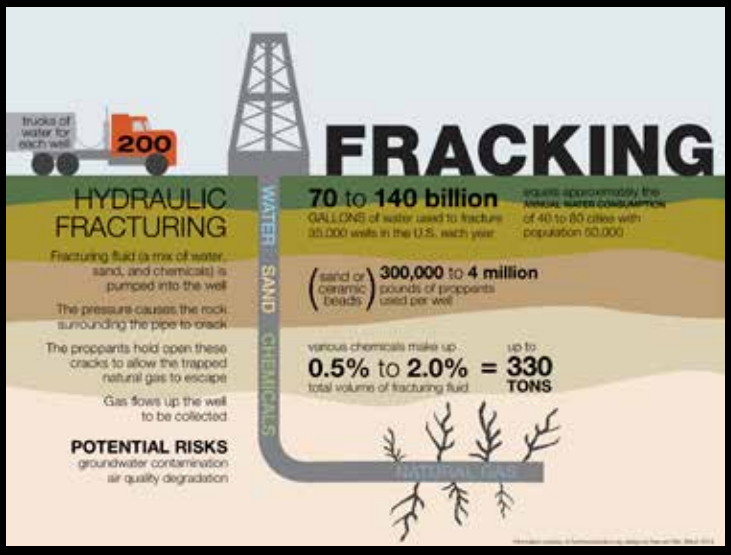
HYDRAULIC FRACTURING

Known in the industry as "fracking," it is not a drilling technique as such (like directional, vertical or horizontal) but instead, is a means by which to increase the permeability of rock to increase the amount of oil or gas produced.

Fluids (water and chemicals) and a "propping agent" (usually sand) are injected into the pipe under high pressure. The effect is to widen natural fissures in the rock formation, which are held open by the sand after the pressure is released. As the sand holds the fissures open, the hydrocarbons flow into the pipe and up through the well.



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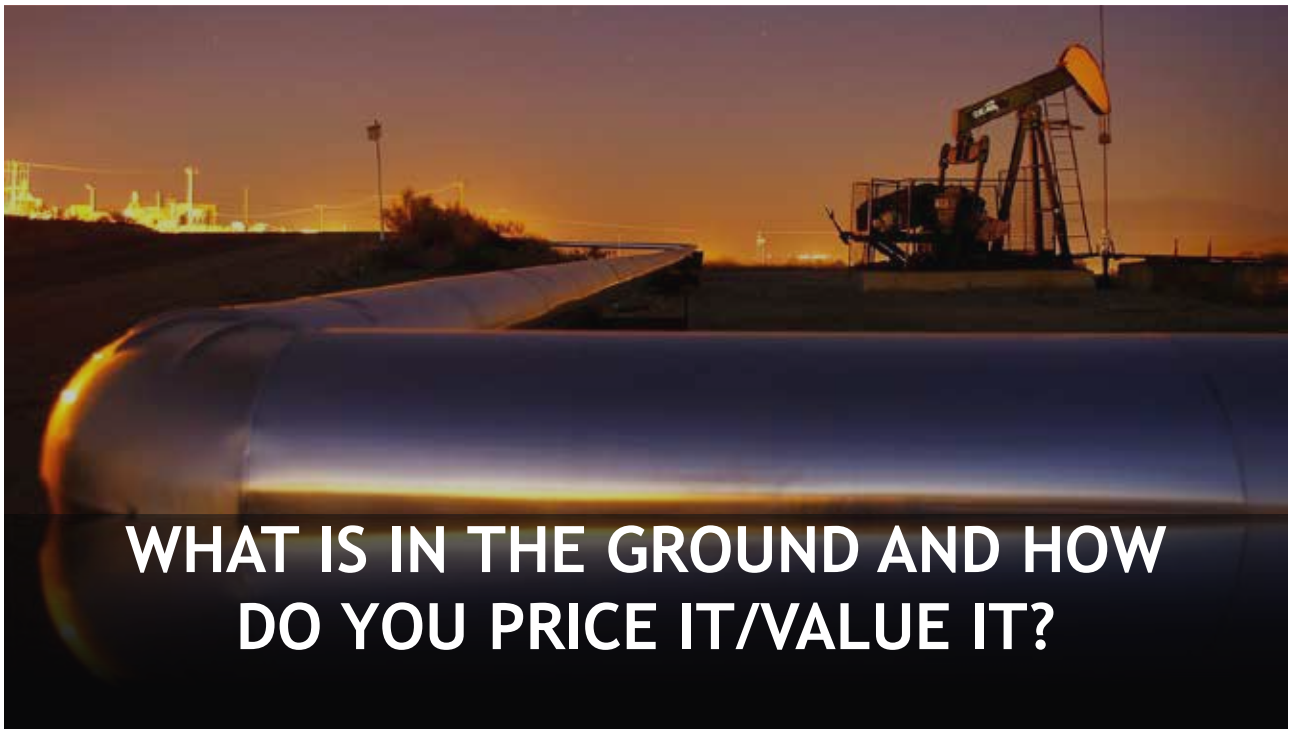

CATEGORIES OF RESERVES

Proved: 90% certainty of commercial extraction. The Society of Petroleum Engineers defines proven reserves as "those quantities of petroleum which, by analysis of geological and engineering data, can be estimated with reasonable certainty to be commercially recoverable, from a given date forward, from known reservoirs and under current economic conditions, operating methods, and government regulations. Proved reserves can be categorized as developed or undeveloped"

- **PDP = Proved Developed Producing:** proved reserves that can be produced with existing wells and perforations, or from additional reservoirs where minimal additional investment (operating expense) is required
- **PDNP = Proved Developed Non-Producing:** proved reserves that are developed behind pipe or shut-in or that can be recovered through improved recovery only after the necessary equipment has been installed, or when the costs to do so are relatively minor
- **PUD = Proven Un-Developed:** proved reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.

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CATEGORIES OF RESERVES

Unproved: "Unproved reserves are based on geologic and/or engineering data similar to that used in estimates of proved reserves; but technical, contractual, economic, or regulatory uncertainties preclude such reserves being classified as proved. Unproved reserves may be further classified as probable reserves and possible reserves" (SPE definition)

Probable: "Probable reserves are those unproved reserves which analysis of geological and engineering data suggests are more likely than not to be recoverable. In this context, when probabilistic methods are used, there should be at least a 50% probability that the quantities actually recovered will equal or exceed the sum of estimated proved plus probable reserves" (SPE definition)

Possible: "Possible reserves are those unproved reserves which analysis of geological and engineering data suggests are less likely to be recoverable than probable reserves. In this context, when probabilistic methods are used, there should be at least a 10% probability that the quantities actually recovered will equal or exceed the sum of estimated proved plus probable plus possible reserves" (SPE definition)

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VALUING RESERVES

PV-10: Present value of the estimated future oil and gas revenues, reduced by direct expense and discounted at an annual rate of 10%. This is the valuation metric used in public company reporting filed with the SEC, and is referred to as the "SEC reported value." The PV-10 SEC reported value is *NOT* necessarily an indicator of fair market value.

SEC Final Rule: The 12-month average price, calculated as the unweighted arithmetic average of the first-day-of-the-month price for each month within the 12-month period prior to the end of the reporting period (historical). SEC Final Rule does not always reflect market prices at a particular point in time.

Forward Pricing (a/k/a Strip Pricing): A forward view of pricing based on publicly available values based on future estimates. For example, NYMEX has a 5-year forward curve of average future prices.

Fair Market Value: A reserve report is prepared by a petroleum engineering firm that estimates the remaining quantities of oil and gas expected to be recovered from existing properties. Often based on the NYMEX future pricing in effect as of the valuation date. Reserves are classified into one of the "Ps" – proved, probable or possible – and then discounted based on the relative riskiness of each category (which includes an analysis of "how much it will cost to get it out of the ground.") For example, PDP is often valued at PV-10; PUDs may be valued at PV-15; and probables valued at PV-20 or even PV-25.

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LEGAL ISSUES PRESENTED IN OIL AND GAS CASES

LEGAL ISSUES PRESENTED IN OIL AND GAS CASES

Covenant running with the land or executory contract?

- Cutting edge, key and very recent issues, coming up in E&P cases, which affects midstream providers
- Is the "dedication language" in a midstream transportation contract sufficient to create a property interest (*i.e.*, a covenant that runs with the land) that cannot be rejected, or is the relationship purely contractual and thus subject to rejection?
- The issue came up in *Quicksilver* but was not litigated – consensual resolution
- Other cases have also had consensual resolutions
- Only case to date that has decided the issue (under Texas law) is *In re Sabine Oil & Gas*, 551 B.R. 132 (Bankr. S.D.N.Y. June 15, 2016). Judge Chapman issued an initial decision in March 2016 on a motion to reject, informed the parties an adversary was required, and issued a final decision in the adversary context cited above in June.
- Because it is the determination of an interest in property, summary proceeding of a rejection motion doesn't work. Must file an adversary proceeding. *See* Bankruptcy Rule 7001(2), (9)

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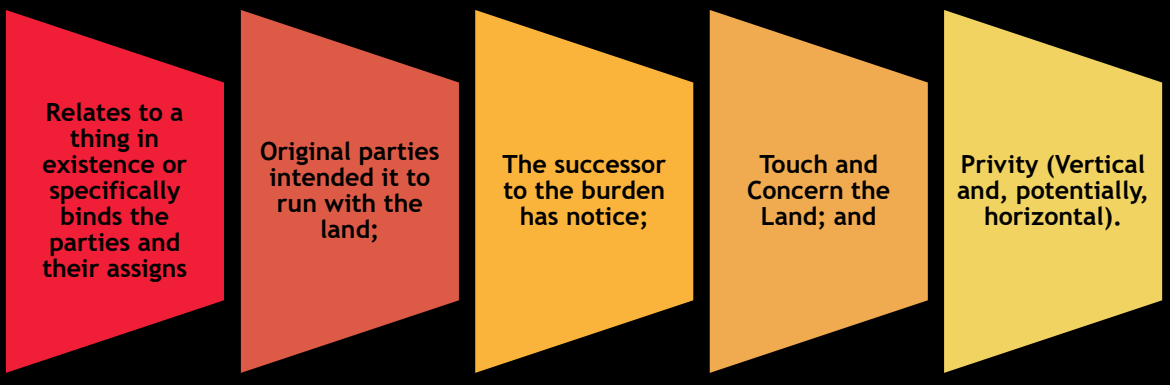
LEGAL ISSUES PRESENTED IN OIL AND GAS CASES

Elements of Covenants that Run with the Land under Texas law



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LEGAL ISSUES PRESENTED IN OIL AND GAS CASES

Touch and Concern the Land: Something that affects the "nature, quality or value of the thing demised, independently of collateral circumstances, or if it affect[s] the mode of enjoying it." *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

Things that have been held to "touch and concern" real property:

- **Area of Mutual Interest Agreement**. *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).
- **Water Purchase Contract**. *Wimberly v. Lone Star Gas Co.* 818 S.W.2d 868, 870 (Tex. App.—Fort Worth 1991, writ denied).
- **Gas Sales Contract**. *Prochemco, Inc. v. Clajon Gas Co.*, 555 S.W.2d 189, 190 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.).
- **Transportation Fee in Gathering Contract**. *Newco Energy v. Energytec, Inc.*, 739 F.3d 215 (5th Cir. 2013).

Does not "touch and concern": **Contractual Provision Relating to Indemnity for Environmental Clean Up Costs**. *In re El Paso Refinery, LP*, 302 F.3d 343, 356 (5th Cir. 2002).

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LEGAL ISSUES PRESENTED IN OIL AND GAS CASES

Vertical Privity: involves a mutual or successive relationship to the same rights in the property. The classic example of vertical privity is of a producer that sells its leasehold interest to another producer.

Horizontal Privity: Requires a simultaneous existing interest between the original parties as either landlord and tenant or grantor and grantee. *Energytec*, 739 F.3d at 222.

- No definitive pronouncement on whether this is required, or not, from the Texas Supreme Court
- Restatement 3rd has abandoned the horizontal privity requirement
- Texas cases requiring horizontal privity:
  - *Wayne Harwell Prop. v. Pan Am. Logistics Ctr., Inc.*, 945 S.W.2d 216, 218 (Tex. App.—San Antonio 1997, writ denied));
  - *Clear Lake Apartments, Inc. v. Clear Lake Utilities Co.*, 537 S.W.2d 48, 51 (Tex. App. 1976)
- Texas cases that neither require nor discuss horizontal privity:
  - *Wimberly v. Lone Star Gas, 818 S.W.2d 868, 870 (Tex. App.—Fort Worth 1991, writ denied);*
  - *Prochemco, Inc. v. Clajon Gas Co., 555 S.W.2d 189 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.)*
  - *Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 911 (Tex. 1982)*

Practice Tip: Hire a landman! Privity requires an analysis of (a/k/a deep dive into) state (local) property records

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LEGAL ISSUES PRESENTED IN OIL AND GAS CASES

***Sabine* court requires horizontal privity:** "In light of the fact that numerous Texas courts have expressly included horizontal privity in their analyses, *the Court is not persuaded that the requirement of horizontal privity has been abandoned under Texas law*, and therefore … the Court shall consider the issue of horizontal privity."

Under Texas law, minerals *in the ground* are real property interests; but once they come out of the ground, it's personal property. Key to the decision in *Sabine* was the dedication, or granting, language in the applicable agreements, which related to what was *produced* by Sabine rather than what was in the earth.

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THANK YOU

QUESTIONS?

Jason S. Brookner
Gray Reed & McGraw LLP; Dallas
jbrookner@grayreed.com

23rd Annual Rocky Mountain Bankruptcy Conference
Real Estate Bankruptcy Issues
-
Do I Stay or Do I Go Now?
"The Clash" between Sections 363 and 365 and its impact on lessee rights

Caroline C. Fuller

Sarah Millard Wright

Fairfield and Woods, P.C.

Denver, Colorado

Does a lessee's possessory interest in real property survive a "free and clear" sale of the property pursuant to Section 363 of the Bankruptcy Code? The resolution of this issue revolves around the intersection of two statutory provisions: 11 U.S.C. §363(f) and §365(h). Most recently, the United States Court of Appeals for the Ninth Circuit has addressed this issue and, joining the Seventh Circuit, rejected the majority view of federal courts on this issue, holding that a sale can be free of the lessee's possessory interest.

Precision Industries v. Qualitech Steel SBQ, LLC

In *Precision Indus. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the Court was tasked with reconciling 11 U.S.C. §363(f) and 11 U.S.C. §365(h). *Id.* at 540. Section 363 authorizes the sale of a debtor's property free of any "interest" other than that of the estate. Section 365(h) protects the rights of the lessee when the debtor landlord rejects a lease of estate property. *Id.*

In *Qualitech*, the debtors in the bankruptcy proceeding ("Qualitech") owned and operated a steel mill on a 138-acre tract of land. *Id.* Qualitech entered into two agreements with another party ("Precision"), which provided that Precision would build, and subsequently operate, a

warehouse on Qualitech's property for ten years and that Qualitech would lease to Precision the land underlying the warehouse for ten years. *Id.* Qualitech thereafter filed for bankruptcy and its assets were sold at auction. *Id.* The bankruptcy court entered an order approving the sale "free and clear" of any "interests." *Id.* at 541. All persons and entities holding interests other than those expressly preserved in the sale order were barred from asserting those interests against the purchaser. *Id.* Precision's lease interest was not expressly mentioned in the sale order. *Id.* The sale closed without the assumption of the lease by the purchaser, but negotiations toward that end continued. *Id.* Ultimately, these negotiations were not successful and the purchaser did not assume the lease. *Id.* Precision then vacated and padlocked the warehouse. *Id.* The purchaser entered onto the property and changed the locks without Precision's knowledge or consent, which Precision argued violated its possessory rights. *Id.* Thus, the question arose whether a sale order issued under Section 363(f), which purports to authorize the transfer of a debtor's property "free and clear of all liens, claims, encumbrances, and interests," operates to extinguish a lessee's possessory interest in the property, or whether the terms of Section 365(h) operate to preserve that interest. *See id.* at 543.

The Court recognized the long-standing tenet of statutory interpretation that, if possible, the Court must construe the relevant statutory provisions in such a way as to avoid conflicts between them. *Id.* With this in mind, the Court then turned to the statutes themselves. Focusing first on Section 363, the Court noted that this section generally provides for the use, sale, or lease of property belonging to the bankruptcy estate. *Id.* at 544-45. Relevant to this analysis, subsection (f) of Section 363 sets forth the conditions under which estate property may be sold unencumbered of interests held by others. Concluding that the possessory interest of a lessee was "an interest" under Section 363(f), the Court reasoned that the statute, on its face, authorized

the sale of the property at issue free and clear of that interest. *Id.* at 545. Notably, however, 363(e) provides some protection to the lessee because "on request of an entity that has an interest in the property . . . proposed to be sold . . . by the trustee [or the debtor-in-possession], the court, with or without a hearing, shall prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest." *Id.*

The Court then turned to Section 365, which generally provides the trustee or debtor-in-possession with the right to reject executory contracts that are unduly burdensome. *Id.* at 546. However, where leases of the estate's property are concerned, the power of rejection is limited so as to preclude eviction of the lessee. *Id.* In short, Section 365(h) allows a lessee to remain in possession of estate property notwithstanding the debtor-in-possession's decision to reject the lease. *Id.*

The Court's analysis turned on three points. First, the Court concluded that the statutory provisions themselves do not suggest that one supersedes or limits the other. *Id.* at 547. Second, Section 365(h)(1)(A) applies only where the trustee [or debtor-in-possession] rejects an unexpired lease of real property. *Id.* It does not apply to any and all events that threaten the lessee's possessory rights, such as a sale. *Id.* Third, Section 363 itself provides a mechanism to protect the rights of parties whose interests may be adversely affected by the sale of estate property. *Id.* at 547-48. Namely, Section 363(e) requires that the bankruptcy court, on the request of any entity with an interest in the property to be sold, "prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest." *Id.* at 548. Thus, the Court reasoned, a lessee of property being sold pursuant to subsection (f) would have the right to insist that its interest be protected. *Id.*

The Court concluded that where estate property under lease is to be sold, Section 363 permits the sale to occur free and clear of a lessee's possessory interest – provided that the lessee (upon request) is granted adequate protection for its interest. *Id.* Where the property is not sold, and the debtor remains in possession of the property but chooses to reject the lease, Section 365(h) is triggered and the lessee retains the right to possess the property. *Id.* In this way, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees. *Id.*

Applying this holding to the facts of the case, the bankruptcy court's sale of Qualitech's property free and clear of Precision's possessory interest as a lessee was upheld. *Id.* Because Precision neither objection to the sale nor sought the protection that was available under Section 363(e), its possessory interest was extinguished by the sale. *Id.*

Pinnacle Restaurant at Big Sky, LLC v. CHSP Acquisitions

The Ninth Circuit is the second circuit court to address the same issue. *Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions (In re Spanish Peaks Holdings II, LLC)*, 872 F.3d 892 (9th Cir. 2017). Spanish Peaks was a resort in Big Sky, Montana, which was financed by a $130 million loan and was owned and operated by a collection of interrelated entities. *Id.* As relevant here, Spanish Peaks Holdings, LLC ("SPH") leased out two commercial properties at the resort to two different companies ("Pinnacle" and "Opticom"). *Id.* Notably, the "brainchild" of the Spanish Peaks resort was an officer of both SPH and Pinnacle and executed the lease as both lessor and lessee. *Id.* In addition, the same individual was also the sole member of lessee Opticom. *Id.*

Facing mounting operational losses and a down real-estate market, SPH began defaulting on its $130 million dollar loan and petitioned for bankruptcy. *Id.* at 895. The trustee and the estate's largest creditor, holding a valid claim of more than $122 million, agreed to a plan for liquidating the debtor's real and personal property. *Id.* This plan contemplated an auction with a minimum bid of $20 million and the sale of all real and personal property would be "free and clear of all liens." *Id.* The trustee moved the bankruptcy court for an order authorizing and approving the sale. *Id.* The trustee represented that the proposed sale would be "free and clear of any and all liens, claims, encumbrances and interests," except for certain specified encumbrances, and that other specified liens would be paid out of the proceeds of the sale or otherwise protected. *Id.* The Pinnacle and Opticom leases were not mentioned in either the list of encumbrances that would survive the sale or the list of liens for which protection would be provided. *Id.* Both Pinnacle and Opticom objected to any effort to sell the debtor's assets free and clear of Pinnacle and Opticom's leasehold interests. *Id.*

The real property was sold and both Opticom and Pinnacle claimed that they were entitled to retain possession pursuant to their leases. *Id.* The bankruptcy court, noting that it was applying a "case-by-case, fact-intensive, totality of the circumstances approach," held that the sale of the real property was free and clear of the Pinnacle and Opticom leases. *Id.* at 896. The district court affirmed and an appeal to the Ninth Circuit followed. *Id.*

The Ninth Circuit noted that the issue presented in this case brings two sections of the Bankruptcy Code into apparent conflict. *Id.* at 897. Section 363 authorizes the trustee to sell property of the estate, both within the ordinary course of business and outside it. *Id.* And, given certain qualifications set forth in the statute, sales may be "free and clear of any interest in such property." *Id.* However, upon the request of a party with an interest in the property, the

bankruptcy court "shall prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest." *Id.* Meanwhile, Section 365 of the Code authorizes the trustee, "subject to the court's approval," to "assume or reject any executory contract or unexpired lease of the debtor." *Id.* However, the rejection of an unexpired lease leaves a lessee in possession with two options: treat the lease as terminated (and make a claim against the estate for breach), or retain any rights – including a right of continued possession – to the extent those rights are enforceable outside of bankruptcy. *Id.* at 898.

In resolving this apparent "conflict," like the Seventh Circuit, the Ninth Circuit found that there was no conflict at all. *Id.* at 899. Section 363 governs the sale of estate property, while Section 365 governs the formal rejection of a lease. *Id.* The court reasoned that a "rejection" is universally understood as an affirmative declaration by the trustee that the estate will not take on the obligations of a lease or contract made by the debtor. *Id.* A sale of property free and clear of a lease may be an effective rejection of the lease in an everyday sense, but it is not the same thing as the "rejection" contemplated by Section 365. *Id.*

The Court noted that while this result may seem harsh, the mandatory language of Section 363(e) provides the lessee with "adequate protection." *Id.* at 899-900. This could include any relief – other than compensation as an administrative expense – that will result in the realization of the indubitable equivalent of the terminated interest. *Id.* Some courts have even found that "adequate protection" could take the form of continued possession. *Id.* at 900. The Court noted that, in this case, Pinnacle and Opticom failed to request "adequate protection" until after the sale had taken place. *Id.*

The Court further noted that the bankruptcy proceeding proceeded very much like a foreclosure sale, as the largest creditor of the estate was the holder of the note and mortgage on

the property. *Id.* Under Montana law, a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property. *Id.* The Court noted that Section 363(f)(1) permits free-and-clear sales only in certain circumstances, such as where "applicable nonbankruptcy law permits sale of such property free and clear of such interest." *Id.* To bolster its opinion, the Ninth Circuit reasoned that Montana's foreclosure laws (i.e. an applicable nonbankruptcy law) would have led to the same result – the sale of property free and clear of the leasehold interest. *Id.* Applying this rationale to the facts of the case, the Court held that Section 363(f)(1) authorized the sale of the property free and clear of the Pinnacle and Opticom leases. As the trustee did not reject the lease, Section 365 was not implicated. *Id.* at 901.

Post*-Pinnacle *Decisions

Since the Ninth Circuit's decision in *Pinnacle*, it appears that only one case has revisited the interplay between Sections 363 and 365. In *IDEA Boardwalk, LLC v. Polo North Country Club, Inc.*, Civil Action No. 16-8683 (MAS), 2017 U.S. Dist. LEXIS 180076 (Oct. 31, 2017), as part of its plan to open a now-defunct casino located in Atlantic City, Revel entered into a 10-year term lease, which was ultimately assigned to IDEA, to operate two night clubs and a beach club. *Id.* at *1-*2. Approximately two years later, Revel filed its second voluntary Chapter 11 petition and informed all tenants, including IDEA, of its intention to close the casino. *Id.* at *2. Revel subsequently filed a motion with the Bankruptcy Court to reject the lease *nunc pro tunc* to the date Revel closed its doors. *Id.* at *3. After various proceedings, Revel executed an Amended and Restated Asset Purchase Agreement ("APA") with Polo. *Id.* The APA provided that Polo would purchase "certain claims" Revel may have against IDEA with respect to the lease, and Polo agreed to assume Revel's liability to IDEA for an administrative expense claim of a maximum of $133,872.31. *Id.* Simultaneously, Revel filed a motion to sell its assets to Polo free

and clear of liens, claims, encumbrances, and interests, including the lease. *Id.* at *4. IDEA, along with other tenants, opposed the motion; however, the Bankruptcy Court entered an order granting the motion and approving the APA, but subject to IDEA's rights under the lease. *Id.*

IDEA then filed a response to Revel's motion to reject the lease (filed 8 months prior) seeking clarification of its rights under Section 365(h). *Id.* at *4-*5. The Bankruptcy Court subsequently entered an order granting Revel's motion to reject the lease dating back to the day the casino closed. *Id.* at *5. IDEA then filed a Notice of Election to retain its rights under the lease pursuant to Section 365(h). *Id.* In light of Polo's purchase of Revel, the Bankruptcy Court entered an Order granting Revel's Motion to Substitute Polo as defendant in the underlying bankruptcy adversary proceeding. *Id.* The Bankruptcy Court further ruled that Polo was enjoined from interfering with IDEA's rights under the lease, finding that Polo "is now treated as the landlord with the both the benefits and burdens of Section 365(h)." *Id.*

In its analysis, the Court grappled with the interplay between Sections 363(f) and 365(h) and acknowledged a split between various courts regarding whether a debtor-lessor may sell real property free and clear under Section 363(f) and strip a lessee of its rights under 365(h). The Court noted that: "[t]he facts of this case involve a further complication in the application of Section 365(h) – this is not a dispute between the original landlord and the tenant." *Id.* at *15-*16. Ultimately, however, the Court agreed that where Revel, the debtor-lessor, rejected the Lease and then sold its assets to Polo subject to the lease, as set forth in the Court's sale order, Polo "stepped into the shoes of the Debtors" and Polo is "treated as the landlord, with both the benefits and burdens of Seciton 365." *Id.* at *16. The Court agreed with the Bankruptcy Court's conclusion that Polo was excused from performing all duties under the lease, except for allowing

IDEA's continued possession, use and quite enjoyment of the premises, and its rights appurtenant to the real property. *Id.*

This case is distinct from the fact pattern in *Pinnacle* or *Qualitech* in that the lease was rejected prior to the sale of the property and the sale order provided that the sale was subject to IDEA's rights under the lease. While not rejecting the rationale put forward by the Circuit Courts in *Qualitech* or *Pinnacle*, the *IDEA* decision highlights that the analysis of the interplay between Sections 363(f) and 35(h) continues to evolve, and the resolution of the issue often depends upon the specific facts and procedural background of the case.

Relevant Cases in the Tenth Circuit

In *In re Dynamic Tooling Sys., Inc.*, 349 B.R. 847 (Bankr. D. Kan. 2006), the Debtor, which manufactured knives and knife blades for sale to the meat packing industry, filed for chapter 11 bankruptcy. *Id.* at 849. Prior to filing for bankruptcy, Debtor entered into an agreement with a distributor who would also receive a perpetual and irrevocable license to manufacture the Debtor's products utilizing the Debtor's intellectual property ("Licensee"). *Id.* at 849-50. Entering the bankruptcy fray, Debtor's direct competitor ("Competitor") started to acquire the unsecured claims of Debtor's creditors. *Id.* at 850. Competitor thereafter entered the case as a creditor and party in interest and eventually filed its own plan and disclosure statement. *Id.* As relevant here, the Competitor submitted a plan wherein all of Debtor's assets would be transferred to Competitor's subsidiary ("Subsidiary"). *Id.*

The Licensee objected to Competitor's plan because it provided that all of Debtor's assets would be transferred to Subsidiary "free and clear of all Liens, Claims, and Interests." *Id.* at 854. Thus, the Court was tasked with deciding whether Section 365(n) would protect the Licensee's

rights in Debtor's intellectual property such that the Licensee's rights would survive a Section 363(f) sale "free and clear" of all interests. *Id.* at 855.

The court analogized the situation to sales pursuant to Section 363(f) wherein there exists a lease interest that is protected under 365(h). *Id.* at 855-56. Ultimately, the court concluded that the issue was "easily resolved" by the use of the Court's Section 363(e) powers to limit or prohibit a sale free and clear of interests in order to protect those interests. *Id.* at 856. The Court reasoned that the licensee's interests can be protected by the Court's express order that to the extent the intellectual property is included in the asset transfer to Subsidiary, that property is subject to whatever license rights the Licensee has in the IP. *Id.* The analysis concluded:

> In short, while some case law suggests that estate property may be sold free and clear of a licensee interest, the Court can ameliorate what little harm such a sale would work here by ordering that the transfer [of the IP] be subject to whatever licensee rights [the licensee] has in the [debtor's] intellectual property.

Id.

Thus, it appears that the Court relied on Section 363(e) to provide protection to the interest holder in the context of the Section 363(f) sale, as did the *Pinnacle* and *Qualitech* decisions.

The Takeaway

As noted in *Pinnacle*, the majority of bankruptcy courts addressing this issue have held that Sections 363 and 365 conflict when they overlap because each provision seems to provide an exclusive right that, when invoked, would override the interest of the other. These courts looked at the legislative history of the two provisions and further reasoned that the more specific

mandates of Section 365 trump the more general provisions of Section 363, and thus, estate property cannot be sold free and clear of a leasehold interest. *In re Crumbs Banke Shop, Inc.*, 522 B.R. 766, 778-79 (Bankr. D.N.J. 2014); *In re Zota Petroleums, LLC*, 482 B.R. 154, 163 (Bankr. E.D. Va. 2012); *In re Samaritan Alliance, LLC*, 2007 Bankr. LEXIS 3896, 2007 WL 4162918, at *4-5 (Bankr. E.D. Ky. Nov. 21, 2007); *In re Haskell, L.P.*, 321 B.R. 1, 8-9 (Bankr. D. Mass. 2005); *In re Churchill Props.*, 197 B.R. 283, 286 (Bankr. N.D. Ill. 1996); *In re Taylor*, 198 B.R. 142, 164-66 (Bankr. D.S.C. 1996).

The Seventh and Ninth Circuit have now rejected the majority analysis, ruling that, unless the tenant takes appropriate action to protect its interests in the context of a free and clear sale, the sale may be ordered free and clear of its possessory rights. The Ninth Circuit further analogized the sale to a foreclosure sale, where the mortgage holder rights were superior to the tenant's; presumably no subordination and non-disturbance agreement was in place.

The takeaway message to lessees is, where estate property is sold pursuant to Section 363, if you want to retain your possessory interest, or at least be protected for your loss, you must participate and request protection under Section 363(e). The passive lessee is not protected. Further, in connection with negotiation of leases that are of significant value to the tenant, the tenant should insist on execution of a subordination and non-disturbance agreement which might provide even further ammunition to contend that its possessory rights should survive any sale.

23rd Annual Rocky Mountain Bankruptcy Conference
Real Estate Bankruptcy Issues
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Landlord's Right to Recover Attorneys' Fees for Assumed Lease

Caroline C. Fuller
Fairfield and Woods, P.C.
Denver, Colorado

Section 365(b)(1) provides that the trustee may not assume an unexpired lease that is in default without curing, or providing adequate assurance of curing, defaults (other than non-monetary defaults which are impossible to cure), including compensation for actual pecuniary losses. Sections 365(b)(2) and 365(e) clarify that the obligation to cure also does not apply to a default that is a breach of any lease provision related to the pre-petition insolvency or financial condition of the tenant debtor, the bankruptcy filing itself, or appointment of a trustee or taking possession of a custodian. While such provisions are common, the Code renders them unenforceable. *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608 (1st Cir. 1995) (section 365(e) invalidates contractual *ipso facto* provisions and preempts state partnership laws to the same effect); *Allentown Ambassadors, Inc. v. Northeast Am. Baseball, LLC In re Allentown Ambassadors, Inc.)*, 361 BR 422, 445 (Bankr. E.D. Pa. 2007).

Caselaw is clear that Section 365(b) does not create a statutory right for the landlord's recovery of attorneys' fees; thus the right must be derived from either applicable state law or the terms of the lease itself. *Three Sisters Pship, L.L.C. v. Harden (In re Shangra-La, Inc.)*, 167 F.3d 843, 849 (4th Cir. 1989); *In re M. Fine Lumber Co.*, 383 BR 565, 569 (Bankr. E.D.N.Y. 2006); *In re Crown Books Corp.* 269 BR 12, 15. (Bankr. D. Del. 2001), *Lacey v. Westside Print Works (In re Westside Print Works)*, 180 BR 557, 564 (9th Cir. BAP 1995). Courts have

generally recognized that the following criteria must be satisfied before the nondebtor counterparty is entitled to its attorney's fees: (1) a default must have occurred; (2) the agreement must specifically entitle the nondebtor party to reimbursement of attorney's fees; (3) applicable nonbankruptcy law must recognize a right to attorney's fees; and (4) the attorney's fees must be reasonable. *In re Shangra-La,* 167 F.3d 12 849-50.

In many cases, however, courts have found a landlord to not be entitled to attorneys' fees, based on the particular dispute at issue and the language of the lease itself. *Crown Books Corp.* , 269 BR at 16 (landlord which did not prevail in its objection to a proposed sale motion was not entitled to recovery of legal fees incurred in opposing the motion, under lease provision that awarded fees to "successful party," but was entitled to legal fees for successfully challenging proposed cure amounts); *In re Best Prods. Co.* 148 BR 413 (Bankr. S.D.N.Y. 1992 (landlord not entitled to recovery of attorneys' fees in connection with its unsuccessful objection to debtor's proposed assumption of lease, when lease limited recovery of attorney's fees to successful actions to enforce its rights under the lease); *M. Fine Lumber Co.*, 383 BR at 569 (landlord not entitled to recover attorneys' fees in unsuccessful opposition to motion to assume and demand for adequate protection, but was entitled to fees incurred with its motion to compel the tenant to perform its obligations under the lease pending assumption or rejection, where lease limited landlord's recovery to actions instituted by the landlord)

But what about a lease that is not in default? First, Section 365(b)(1) applies only to leases in default. If there is no default, there is nothing to cure.

> By its terms, section 365(b) applies only when there has been a default other than a default relating to bankruptcy or financial condition. If there has been no default, the trustee need not comply with the cure, compensation and adequate assurance requirements of section 365(b). Instead, the trustee, subject to court approval, may simply assume a contract or lease, unless such assumption is barred by other provisions of subsection 365, such as section 365(c) or (e).
>
> *Collier on Bankruptcy,* 16th ed., ¶365.06[1].

More fundamentally, however, the ultimate right to recover legal fees is based on the terms of the lease itself. It would be a rare lease that would entitle a landlord to seek recovery of attorneys' fees in the absence of a default. And, it is highly unlikely that a bankruptcy court would enforce a provision purporting to obligate the tenant to pay the landlord's attorneys' fees upon the tenant's bankruptcy filing, if the lease is not otherwise in default. In the only reported decision located by this author, the court in *In re FKA FC, LLC*, 545 BR 567 (Bankr. W.D. Mich. 2016), held that the landlord was not entitled to recover attorneys' fees when, after litigation, the court found that the debtor/tenant was not in default under the lease.

The answer may be different, however, if and when the debtor tenant or trustee seeks to assign the lease to a third party. Section 365(f)(1) permits the assignment of a lease despite a provision that prohibits, restricts, or conditions its assignment, but Section 365(f)((2) provides that a lease may only be assigned if it is assumed, and if the assignee offers adequate assurance of future performance. Section 365(f)(3) provides that a lease containing a provision permitting the landlord to terminate or modify a lease upon its assignment by the tenant may not be terminated simply because the lease is assumed or assigned. Section 365(c) imposes a further limitation on the assumption and assignment of leases if applicable law excuses the landlord from accepting performance from another tenant.

A typical lease provides that its assignment without the landlord's consent is a breach of the lease. While the anti-assignment provision may be rendered unenforceable by the Code, the Code provides that the landlord is entitled to demand adequate assurance of future performance from the proposed assignee and, if applicable, to oppose assignment outright if grounds for objection exist under Section 365(c). It would follow that the landlord would be entitled to recovery of reasonable fees in raising these two issues, if the lease contains a provision for recovery of fees under such circumstances. *But see In re Jamesway Corp.*, 201 BR 73 (Bankr. S.D.N.Y. 1996), invalidating a provision in a lease entitling the landlord to a share of the profits from any assignment of the lease by the debtor/tenant, as unenforceable under Section 365(f)(1). The provision in question also obligated the tenant to reimburse the landlord for its attorneys' fees and costs in connection with the proposed assignment, but the landlord apparently did not seek reimbursement of its attorneys' fees, since the decision is silent on that point.

Takeaway: A landlord will only be able to recover attorneys' fees and costs in connection with the proposed assumption of a lease if the lease is in default, and the lease contains express language for an award of fees under the circumstances. Thus, attorney's fees provisions designed to protect a landlord's interests should be broadly drafted to contemplate an award to the landlord upon an event of default, without tying the award to a specific type of proceeding, requiring that the landlord initiate it, or requiring that the landlord prevail or substantially prevail. A landlord may, however, be entitled to recover attorneys' fees in connection with the proposed assumption and assignment of the lease, given the landlord's statutory right to demand proof of adequate assurance, and possible right to oppose assignment, again assuming the lease contains appropriate fee provisions.

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Pre-Petition Lease Termination as Avoidable Transfer

Caroline C. Fuller
Fairfield and Woods, P.C.
Denver, Colorado

The Seventh Circuit recently held that a pre-petition termination of a lease, in which the debtor was the lessee, is a transfer of an interest of the debtor in property which may, upon proper showing, be avoided as a preferential or fraudulent transfer. *Official Committee of Unsecured Creditors of Great Lakes Quick Lube LP, v. T.D. Invs. I, LLP (In re Great Lakes Quick Lube LP*), 816 F.3d 482 (7th Cir. 2016). In *Great Lakes,* Great Lakes entered into a pre-petition lease termination agreement with two affiliated landlords involving five leases all in default. The landlords agreed to forgive accrued but unpaid rents, taxes and deferred maintenance, and to forgive all future claims arising under the leases. In exchange, Great Lakes agreed to terminate and vacate the five locations, three of which were operating unprofitably, and two of which were profitable.

The Creditors' Committee filed suit against the landlord of the two profitable locations, arguing that Great Lakes did not receive reasonably equivalent value for the termination of those locations, and walked away from potential future income from those locations of over $800,000. The Bankruptcy Court found that the lease termination did not qualify as a transfer of an interest of Great Lakes in property, because (a) Great Lakes was precluded from assuming the terminated leases under 11 USC §363(c)(3), and (b) the Committee had failed to oppose Great Lakes' earlier motion seeking to reject any residual interest the estate might have had in the terminated leases.

On direct appeal to the Seventh Circuit, Judge Posner rejected the Bankruptcy Court's analysis, finding that §363(c)(3) – which precludes the assumption or assignment of leases terminated pre-petition - was irrelevant to the ability of the Committee to recover damages suffered by Great Lakes as the result of the lease termination. Since leasehold interests are property, and the termination of those leases results in a transfer of the debtor's interests to the landlord, the estate had the authority to seek to recover damages (as contrasted with reinstatement of the lease) suffered as a result of the transfer, if grounds for avoidance are found under either the preference or fraudulent transfer provisions of the Bankruptcy Code.

While the Seventh Circuit cited essentially no caselaw in its decision, numerous other lower courts have reached the same conclusion. *See, Pettie v. Ringo (in re White)*, 559 BR 787, 799 (Bankr. N.D. Ga. 2016) (citing *Great Lakes); Thompson v. Doctor's Assoc. (In re Thompson),* 186 B.R 301, 307 (Bankr. N.D. Ga. 1995); *EBC I, Inc. v. America Online, Inc. (In re EBC I, Inc.)*, 356 B.R. 631, 637 (Bankr. D. Del. 2006) (termination of internet service contractis a transfer that is subject to potential avoidance); *Fitzgerald v. Cheverie (In re Edward Harvey Co.*), 68 B.R. 851, 858 (Bankr. D. Mass 1987) (court ordered reinstatement of lease terminated pre-petition); *In re Queen City Grain, Inc*., 51 B.R. 722, 726 (Bankr. S.D. Ohio 1985) (pre-petition grain lease termination is a transfer of an interest of the debtor in property); *In re Indr*i, 126 B.R. 443, 446 (Bankr. D.N.J. 1991) (pre-petition lease termination may be avoidable transfer which must be pursued through adversary proceeding); *Fashion Gallery, Inc. v. Finard (In re Fashion World, Inc.*), 44 B.R. 754, 756 (Bankr. D. Mass. 1984) (pre-petition lease modification giving landlord unilateral right to terminate is potentially avoidable transfer).

Some lower courts have held to the contrary. Several have found that the provisions of §365)(c)(3), which recognize the validity of pre-petition lease terminations, must control over

more general statutes allowing the avoidance of preferences or fraudulent transfers. These courts generally recognize a distinction between "collusive" and "non-collusive" terminations. Collusive ones (presumably premised on agreement between the parties) may be subject to avoidance, but non-collusive ones (presumably based on the unilateral action of the landlord) may not be. *Haines v. Regina C. Dixon Trust (In re Haines),* 178 BR 471, 474 (Bankr. W.D. Mo. 1995) (non-collusive lease termination may not be avoided); *In re Egyption Bros. Doughnut, Inc.*, 190 BR 26, 29 (Bankr. D.N.J. 1995); *In re Jermoo's*, 38 BR 197, 204 (Bankr. W.D. Wis. 1984); *In re 421 Willow Corp.*, 2003 US Dist. LEXIS 18029, 2003 WL 22318022, at *4-6 (E.D. Pa. 2003); *Metro Water & Coffee Servs. V. Rochester Cmty. Baseball (In re Metro Water & Coffee Servs.),* 157 BR 742, 747 (Bankr. W.D.N.Y. 1993) ("a prepetition ordinary course of commercial business, non-collusive termination of an executory contract in accordance with the terms of the contract by reason of a Debtor's material defaults is, as a matter of law, not a transaction or transfer which is actually or constructively fraudulent within the meaning, intent and underlying policy of these fraudulent conveyance laws"); *130/40 Essex St. Dev. Corp. v. City of New York (In re 130/40 Essex St. Dev. Corp.*, Bankr. LEXIS 4017 (Bankr. S.D. NY 2008).

Those courts that have found a pre-petition lease termination to be an avoidable transfer have generally limited the determination of damages to the rent differential between fair market rent and contract rent. They have rejected arguments suggesting the valuation should be some different measure, such as the net income that could have been generated by the debtor at the leased location had the lease not been terminated. Upon remand in *Great Lakes,* the bankruptcy court rejected the Committee's alternative arguments that the estate's damages were either the potential net income that might have been generated from the two locations had the leases not been terminated; or the potential sales price the estate might have realized from a sale of those

locations. 2017 Bankr. LEXIS 1464 (Bankr. E.D. Wis. 2017). The court agreed with the landlord's argument that no "business" was transferred to the landlord. The landlord just got the locations back, empty and subject to deferred maintenance and repairs. Rather, the court found that the only damages suffered by Great Lakes was the fair market value of the lease itself – which was the discounted present value of the difference between the market rent and the actual rent paid by Great Lakes for the remaining term of the lease. In this case, the landlord had re-leased the locations at a higher rent than that paid by Great Lakes, the total differential being $57,000. After deducting the $46,110 in past-due rent and unpaid taxes forgiven in connection with the lease termination, the bankruptcy court found the estate's actual damages to be $10,890.[1] *See also Fashion World*, 44 BR at 757-758 ("reasonably equivalent value" is determined by difference between market and contract rents).

Similarly, *In re Thompson*, 186 BR 301, involved the pre-petition termination of a franchise agreement and sublease. While finding the terminations to be avoidable transfers, the court rejected the debtor's argument that its damages should be quantified by the value realized by the franchisor/lessor from a new franchisee/lessee, which entered into new agreements with the franchisor/landlord containing materially different terms.

[1] Notably, the Court apparently did not factor in its damages calculation either (i) the deferred maintenance and repairs at each location for which Great Lakes had potential liability; or (ii) the forgiveness of accrued rents and taxes, and future claims, related to the three other leases terminated under the same agreement. Had these elements been considered by the Court, the Court would presumably have concluded the estate suffered no damages at all.

> [N]ot every transfer of an allegedly valuable property right is recoverable irrespective of the magnitude of the loss. The fraudulent conveyance provisions were not designed to redress every deprivation of value potentially realizable by a debtor and its creditors, and to allow otherwise would disrupt normal commercial expectations. . . . [V]aluation of the interest at termination and dispossession is difficult because the bundle of rights lose by [the estate] is not the same bundle of rights [the franschisor/lessor] later transferred to [the new franchisee].

Id. at 310.

Takeaway: Even in districts where a court may find a lease termination to be avoidable, reasonably equivalent value will generally not be determined by either the value that might have been realized by the debtor from a going concern sale of the location, or the net operating income the debtor might have realized from continued operations there, because the going concern was not transferred to the landlord. Rather, the measure of damages under 11 U.S.C. §550(a), will be the value received by the landlord – which most typically will be (a) the difference between the contract rent that would have been paid by the debtor, and the fair market rental value of the property, for the remainder of the lease term, discounted to present value, (b) reduced by any forgiveness of accrued and unpaid rent or other obligations due by the debtor under the lease.