Chapter 7

Common Issues in Oil and Gas Bankruptcy

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Synopsis

§ 7.01. Operating Agreements (OA) Are Executory Contracts.................242
[1] — Contractual Lien Rights ............................................................243
[2] — The Twilight Zone .................................................................243
[3] — Where the Debtor Is a Non-operator ....................................243
[5] — Where the Debtor Later Rejects the Operating Agreement (OA).................................245
[6] — Where the Debtor Seeks to Sell the Property ...........................246
[7] — Operator’s Liens ........................................................................246
[8] — Practice Tip ................................................................................247

§ 7.02. Oil and Gas Leases May or May Not Be “Executory Contracts” or “Unexpired Leases” ..................................................248

§ 7.03. Reclamation Rights ............................................................................249
[1] — Practice Tip ................................................................................250
[3] — Practice Tip ................................................................................253

§ 7.04. Royalty Claims Do Not Come First — or If They Do, Only to a Limited Extent .................................................................253

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SYNOPSIS

[2] — The Royalty Owner Typically Is Owed a Contractual Obligation Only ................................................................. 253
[3] — The “Termination for Non-payment” Clause in Bankruptcy ................................................................. 254
  [a] — In the Case of Private Parties, § 9.343 of the Texas UCC Creates a Lien in Favor of Royalty Owners and Working Interest Owners .......... 256
  [b] — Royalty Liens Are Statutory and May Be Avoided Under § 545 of the Code ........................................ 257
  [c] — Proceeds of Production .......................................................................................................................... 260
  [d] — Conflict Between Royalty Owners’ Lien and Accounts Receivable Financing Institution ........................................................................... 260
  [e] — Royalty Liens Are Not in Competition with Mineral Contractor Liens on the Same Property ................................................................. 261
  [f] — The Mineral Contractor Liens and Royalty Liens Attach to Different Collateral .................................. 262
  [g] — Texas Statute Creates a Lien in Favor of the State to Secured Unpaid Royalty Owed to the State of Texas ................................................................. 264
  [h] — Louisiana Statute Gives Unpaid Royalty Owners the Right to Cancel a Lease ........................................ 264
  [i] — Minerals Management Service (MMS) Regulations Give the MMS the Right to Cancel a Lease for Unpaid Royalty ................................................................. 265

§ 7.05. The Conflict Between Avoiding Powers (§ 544(a)(3)) and Equitable Title (§ 541(d)), or the Issue of Recorded Versus Unrecorded Title ................................................................. 266

§ 7.06. The § 541(b)(4) Safe Harbor for Recipients of Farmouts from Debtors in Bankruptcy ................................................................. 269
  [1] — When the Debtor Is the Farmor ................................................................. 270
  [2] — The Problem with the “Fat Farmout Agreement” ................................................................. 273

§ 7.07. The § 541(b)(4)(B) Safe Harbor for Recipients of Production Payments ........................................................................... 273

§ 7.08. In Texas, the Priority of a Mineral Contractor’s Lien Is Determined by the Date of First Work, All Lien Claimants Share Pro Rata, and the Lien Attaches to the Greater of the Customer’s Legal or Equitable Title ................................................................. 275
[1] — Date of Inception for Purposes of Priority ................................. 276
[2] — Where to File the Lien Affidavit ............................................... 276
[3] — Where to File a Mineral Contractor’s or Subcontractor’s Lien Against an Outer Continental Shelf (OCS) Lease ..................... 277
[4] — The Reach and Extent of a Mineral Contractor’s Lien .............................. 277
[5] — How to Foreclose a Mineral Contractor’s and Subcontractor’s Lien ................. 278
[6] — Practice Tip ..................................................................... 278
[8] — Texas Mineral Subcontractor’s Liens ............................................. 280
[10] — What and Whose Interest Is Attached when the Mineral Lien Claimant Files His Lien? .............................................. 282

§ 7.09. Whether the Mineral Lien Contractor Has an Interest in the Proceeds of Production as Cash Collateral ................................. 284
[3] — The Resolution ........................................................................... 286

§ 7.10. The Automatic Stay of § 362 Does Not Prohibit Perfecting a Contractor’s Lien If, Under State Law, a Bona Fide Purchaser for Value Does Not Cut Off the Rights of the Lien Claimant ...................................................... 287
[1] — Whether It Is Necessary to File Suit Post-petition to Avoid the Lien Being Lost .................................................. 287

§ 7.11. Whether a Mineral Contractor’s Lien Rights Will Act as a Defense to a Preference Action ............................................. 288

§ 7.12. Plugging and Abandonment Obligations and Environmental and Site Restoration Obligations May (or May Not) Be Administrative Claims .............................................................. 292

§ 7.13. Defenses to Avoidance Actions Found in §§ 546(e), (f) and (g) ................................................................. 295
[1] — The Basic Immunization of § 546(e) ........................................... 296
[3] — The Blurred Distinction Between Future and Forward Contracts ......................... 297
Bankruptcy law gives a debtor numerous tools for wriggling free of burdensome obligations while retaining valuable property rights. The issues that can arise when a debtor owns mineral interests or is a party to oil and gas contracts, including operating agreements, are complex. While the underlying property rights are defined by state law, bankruptcy law allows certain modifications to those rights. A debtor’s actions thus can interfere with other parties’ expectations. A creditor or party to a contract with a potential debtor in an oil and gas bankruptcy should be prepared for—and protect against — some of the harsher potential outcomes. The following is a summary of the issues in a typical oil and gas bankruptcy case, along with practice pointers for parties dealing with debtors or potential debtors.

§ 7.01. Operating Agreements Are Executory Contracts.

The Bankruptcy Code allows a debtor to assume or reject an executory contract.\(^2\) An executory contract is generally defined as a contract under which both sides still have material obligations to perform.\(^3\) If a contract is executory and the debtor decides that it is burdensome, bankruptcy law allows the debtor to get out of its obligations. If the contract is profitable, on the other hand, the debtor has the option to assume it.

Courts have uniformly held that an operating agreement (OA) is an executory contract.\(^4\) Because an OA is almost always an executory contract, the debtor may generally choose either to assume or reject an OA. The other

\(^3\) E.g., Wilson v. TXO Production Corp. (In re Wilson), 69 B.R. 960, 962 (Bankr. N.D. Tex. 1987) (citing In re Sunbelt Elec. Constructors, Inc., 56 B.R. 686, 688 (Bankr. N.D. Ga. 1986)) (“An executory contract is one under which the parties’ obligations to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”).
\(^4\) E.g., Wilson, 69 B.R. at 963 (joint operating agreement is an executory contract).
party to an OA must therefore be prepared for a substantial interference with its expectations.


Operators and non-operators often have contractual lien rights found in the OA, which operate independently of whether the OA is assumed or rejected. A contractual lien under an OA may, however, be avoided if it is not perfected by recording. Therefore, the OA should be recorded promptly upon execution (and well in advance of the bankruptcy filing) in order to perfect its contractual liens.


When a debtor files for bankruptcy, the debtor has either 60 days (in a Chapter 7 case), until the confirmation of a plan (in a case under Chapter 9, 11, 12, or 13), or until the time specified by the court to assume or reject executory contracts. This time period is called the “Twilight Zone.” A difficult issue is what happens to these rights, duties and obligations under the OA during the Twilight Zone before assumption or rejection.


When the debtor is a non-operator under an OA and has not yet decided to assume or reject the OA, it is unclear whether the operator can enforce the OA against the debtor. For example, can the operator enforce provisions such as the consent or non-consent election during the Twilight Zone?

After a debtor commences a chapter 11 proceeding, but before executory contracts are assumed or rejected such contracts remain in existence, enforceable by the debtor but not against the debtor. This seems onerous and unfair, but the debtor cannot simply take the benefits without paying a price:

7 Id.
If the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, . . . which, depending on the circumstances of a particular contract, may be what is specified in the contract . . . . 9

The Wilson court held that the OA does not govern the rights of the parties during the Twilight Zone.10 This is a harsh and, we argue, improper result. If, as Bildisco tells us, the debtor can enforce the OA during the Twilight Zone, the logical corollary should be that the debtor has to pay the fair price of taking the benefit of the OA. That price is allowing the other parties to also enforce the OA during that same period, notwithstanding language to the contrary in Bildisco.

We suggest that the OA continues to be enforceable during the Twilight Zone because the consideration paid (“reasonable value of those services” as described in Bildisco,11) for continuing to own and accept the benefits of the property is measured by the rights granted by each owner to the other in the form of the terms of the OA. Owning, developing and operating an oil and gas property is an expensive proposition. It is not for the faint of heart. Decisions have to be made expeditiously, often in hours, and the rights of the parties must be readily ascertainable while important decisions are being made. The consideration given, each owner to the other, is found in the terms of the OA.

It may be, as the Wilson court held, that the non-debtors may not affirmatively enforce the OA during the Twilight Zone on a passive debtor. But if the debtor is affirmatively taking the benefit of operations, then the price of such benefit ought to be the enforceability of those obligations by all parties during that same period.

9 Bildisco, 465 U.S. at 531.
10 Wilson, 69 B.R. at 966 (“When there is no operating agreement between them, the law of co-tenancy governs their relationship. This law also governs their relationship during the Twilight Zone.”).
11 Bildisco, 465 U.S. at 531.
An important point to remember is that, at some point, the JOA will be assumed or rejected. If it is assumed (e.g., if the debtor sells the property and assigns its rights under the JOA), then all the acts of the debtor during the Twilight Zone must be measured by the fact that the parties now know, looking back, that the contract was in effect during the Twilight Zone, notwithstanding Bildisco and Wilson. The fact that most properties are sold with the JOA intact may be the most important consideration to the debtor in deciding whether to comply with the JOA during the Twilight Zone period.


Likewise, if the debtor is the operator of the property, can the debtor enforce the terms of the OA before assuming the contract? Again, the answer is likely “yes.” During the “run-up” to assumption or rejection, the debtor can enforce the OA as to the other non-operating owners but the consideration for doing so is the debtor’s being bound by the same terms of the OA during the same period.12

[5] — Where the Debtor Later Rejects the OA.

What happens to the rights of the parties if the debtor has continued to operate the property under the OA for 30, 60 or 90 days into the chapter 11 proceeding and then determines to reject the OA? The answer is uncertain but presumably the rights of the parties as they have accrued during the interim period would be fixed, and the rights of the non-debtor parties after the date of rejection would be treated as a prepetition unsecured claim. But, for example, if a party proposed an operation, the debtor elected non-consent and the debtor’s interest had gone into non-consent status on the 30th day of the proceeding, the fact that the debtor rejected the OA on the 60th day of the proceeding ought not take the interest out of non-consent status, it having been fixed as consideration for accepting the benefits of ownership during the interim period.

12 See Wilson, 69 B.R. at 966, quoted above.
Again, however, the answer to this question is uncertain.\textsuperscript{13} In a typical OA, if a party goes non-consent, the OA provides that the non-consenting party’s interest is relinquished until the contractual amounts due are recouped from production. Those relinquished interests would be interests in real property. If interests go into non-consent status during the Twilight Zone, we suggest that the interests ought not to be exempt from that status if the debtor later rejects the OA. Section 365(a) does not grant bankruptcy courts the power to repudiate, terminate, or cancel property interests.\textsuperscript{14} Thus, the rejection of the OA should have no effect on the continuing vitality of the relinquished interests. However, pre-petition non-consent relinquished interests are not part of the debtor’s bankruptcy estate.\textsuperscript{15}

\textbf{[6] — Where the Debtor Seeks to Sell the Property.}

Section 363 of the Bankruptcy Code governs sales of assets of a bankruptcy estate.\textsuperscript{16} When these sales involve oil and gas properties, the acquiring party will want the applicable OA to remain in place. Since the OA is unquestionably an executory contract, a sale under § 363 will require the OA to be assumed or rejected. Given these options, most purchasers choose assumption and assignment of the OA along with processing rights and other contract documents that govern the operation of the property. There are a number of difficult issues that often arise in the assumption and transfer of an OA in connection with the sale of an interest in an oil and gas lease, such as, \textit{e.g.}, how to cure non-monetary breaches, or how to reconcile two inconsistent area of mutual interest clauses.

\textbf{[7] — Operator’s Liens.}

The operating agreement often grants the operator a contractual, consensual lien on the non-operator’s interest in the minerals to secure the

\begin{flushleft}
\textsuperscript{13} Id.
\end{flushleft}
non-operator’s obligations under the OA. Such a contractual operator’s lien is not binding on third parties unless (i) the OA or a memorandum of it, with a sufficient description of the lien rights, is filed of record, (ii) constructive notice to the world is given in some other context such as possession, or (iii) the lien claimant is in possession of the collateral.17 Clearly the better course of action is to record the OA or a memorandum of the OA with reference to its operator’s lien. This operates to perfect the lien. In the absence of recording, the operator’s lien may not be enforceable against a debtor in chapter 11.

The Wilson court held that an operator in possession of the oil and gas property is not in possession as agent of the non-operator sufficient to put the world on notice of the lien contained in the operating agreement.18 However, the Wilson court noted, if the operator is holding funds belonging to the debtor and is owed money by the debtor, then the operator is free to offset, provided only that the other requirements of offset are met, i.e., mutuality and a lifting of the stay.19


Make sure your company has procedures in place to record its operator or non-operator’s lien when it acquires properties by filing a memorandum of the OA with reference to the lien. This memorandum is an exhibit to the AAPL Form Operating Agreement.

If the debtor is a non-operator, the operator has multiple rights that may be enforced, including (i) an operator’s lien, whether perfected or not; (ii) a right of recoupment or offset, with respect to unpaid amounts owing under the OA; and (iii) the right to force a cure of the OA, if the debtor wishes to assume that contract. The most powerful of these tools is, without doubt, the right of recoupment or offset. At least two courts have sustained the operator’s claim of recoupment.20

17 Wilson, 69 B.R. at 964.
18 Id.
19 Id. at 964-65.
20 Security Pacific Nat’l Bank v. Enstar Petroleum Co. (In re Buttes Res. Co.), 89 B.R. 613, 617 (S.D. Tex. 1988) (operator’s claim to production runs is characterized as recoupment and the stay is lifted to allow effectuation of setoff); Farmers Union Central Exch., Inc. v.

The automatic stay applies to the effectuation of an offset, but an “administrative freeze” is available pending relief from the stay. Because recoupment does not involve any action against property of the estate, but rather a determination of the proper amount of the estate’s claim against the party seeking recoupment, it is not barred by the automatic stay.

Significantly, the recoupment rights of the operator may be superior to a bank mortgage encumbering the debtor’s interest. In the Buttes Resources case, the banks intervened in the motion to lift the stay and unsuccessfully argued that their mortgage was prior to the operator’s right of recovery. The court noted that the claim of the debtor was “subject ab initio to reduction for the very expenses that were required to produce the oil.”

The OA may grant the non-operator a reciprocal lien on the operator’s interest to secure amounts owed by the operator. The non-operator’s lien is less meaningful, however, since the non-operator seldom is called upon to pay the operator’s obligations.

§ 7.02. Oil and Gas Leases May or May Not Be “Executory Contracts” or “Unexpired Leases.”

Section 365 of the Bankruptcy Code, as discussed above, allows a debtor to assume or reject an executory contract or unexpired lease. Whether an oil
and gas lease falls within the definition of “executory contract” or “unexpired lease” is determined under applicable non-bankruptcy law.\textsuperscript{25} The nature of the property right created by an oil and gas “lease” varies from state to state. In Texas, an oil and gas lease is a determinable fee, not a lease or other form of executory contract that a debtor may assume or reject.\textsuperscript{26}

Under Kansas law, on the other hand, a lease is essentially a license to go upon the land in search of oil, and it is subject to assumption or rejection under § 365.\textsuperscript{27}

In Pennsylvania, as in Texas, oil and gas leaseholds are classified as real estate.\textsuperscript{28} Whether a lease under federal non-bankruptcy law (offshore Louisiana) is an “executory contract” or “unexpired lease” is currently being litigated in \textit{In re ATP Oil & Gas Corp.}, Case No. 12-36187 in the Bankruptcy Court for the Southern District of Texas.

If, under the applicable state law, an oil and gas lease qualifies as an unexpired lease of nonresidential real property under § 365, be aware of the time frame for assumption under § 365(d)(4). Section 365(d)(4) requires that a lease for nonresidential real property be assumed by the earlier of 120 days after the order for relief (typically the date the bankruptcy was filed) or date of an entry confirming a plan, unless the court extends the time period. If the lease is not assumed within this time period, it is deemed rejected. Frequently a debtor will file a prophylactic motion assuming oil and gas leases out of an abundance of caution.

\section*{§ 7.03. Reclamation Rights.}

Hydrocarbons are “goods” under the Uniform Commercial Code (UCC), and thus the seller of oil and gas has reclamation rights under both the UCC and the Bankruptcy Code. In addition, many states have granted

statutory liens to protect sellers so that the seller will have a secured claim for hydrocarbons sold but not paid as of the filing. Some states require filings with the county clerk to perfect a producers’ lien; in others, including Texas, producers’ liens are “automatically” perfected.


When considering the alternatives available to a seller of hydrocarbons sold to a counterparty in bankruptcy, the first two action items are to (i) send a reclamation demand and (ii) take steps as necessary to perfect any applicable producer’s lien. The goal is to have both a secured claim and an administrative claim.


The Tex. Bus. & Com. Code § 2.702 provides:

(b) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer’s fraudulent or innocent misrepresentation of solvency or of intent to pay.

(c) The seller’s right to reclaim under Subsection (b) is subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor under this chapter (Section 2.403). Successful reclamation of goods excludes all other remedies with respect to them.

Outside of bankruptcy, the seller can reclaim goods for a 10-day period after delivery. That time limit does not apply if a misrepresentation of solvency has been made by the seller in writing. One example of a solvency representation that may be included in a sales contract or purchase order is as follows:

Buyer hereby represents that it is solvent and that on each delivery this representation shall be deemed renewed unless notice to the contrary is given in writing by the buyer to the seller at or before delivery of the goods.\(^{30}\)

Since the seller (and seller’s counsel) generally will not know on the date of filing whether or not a written misrepresentation has been made, better practice may be to send a notice reclaiming all unpaid goods. The UCC form letter states as follows:

To: [Name of Buyer]

I hereby reclaim from you the following goods sold to you on credit and received by you on [date of receipt]: [description of goods]. I reclaim the goods because of your insolvency.

______________________________
[Name of Seller]\(^{31}\)

It is simplest to attach the invoices to the reclamation demand. The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) expanded the time period during which sellers can exercise their reclamation rights. Section 546(c)(1) provides:

(1) Except as provided in subsection (d) of this section and in section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544(a), 545, 547, and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller’s business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but such a seller may not reclaim such goods unless such seller demands in writing reclamation of goods—


\(^{31}\) Id.
(A) not later than 45 days after the date of receipt of such goods by the debtor; or

(B) not later than 20 days after the date of commencement if the case, if the 45-day period expires after the commencement of the case.\(^\text{32}\)

Prior to the BAPCPA amendments, reclamation rights were only granted to sellers that demanded reclamation of the goods in writing within 10 days of delivery. The BAPCPA amendments expanded this time period from 10 to 45 days (or 20 days after commencement of the case, if the 45 day period expires after the commencement of the case, whichever is later.) Further, the rights granted under BAPCPA are generally better than the rights granted under the UCC because the UCC limits the demand for reclamation to 10 days in most circumstances. Importantly, BAPCPA expanded the right of a seller to recover an administrative claim. Section 503(b)(9) provides:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including —

* * * *

(9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.\(^\text{33}\)

Section 503(b)(9) entitles a seller to an administrative expense claim for goods that were received by the debtor within 20 days of the commencement of the case and sold in the ordinary course of the debtor’s business. The seller need not demand reclamation under § 546(c)(1) to be entitled to an administrative expense under § 503(b)(9). Further, since administrative expense claims are entitled to priority over unsecured claimants, § 503(b)(9) often serves to increase the priority of trade creditors.

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Since there is some uncertainty as to whether bankruptcy reclamation is for goods delivered for the 20 days or 45 days prior to filing bankruptcy, and the seller may or may not know whether a written misrepresentation has been made, the better practice is to make a reclamation demand for all unpaid goods. Typically in larger cases there will be a procedures order put in place on how and where to file these 20-day claims.

§ 7.04. Royalty Claims Do Not Come First — or If They Do, Only to a Limited Extent.

[1] — Are Unpaid Royalty Owners Unsecured Creditors?

It is rare for a debtor who operates oil and gas wells and who files bankruptcy to be current on royalty. Royalty owners occasionally believe their entitlements are special, that they are secured creditors, or that operators hold their money in trust. Generally speaking, none of that is true.

In the ordinary case, prepetition royalty is an unsecured claim. The royalty owner may claim the money is his and is not property of debtor’s estate (though typically it is gone by the time bankruptcy is filed) but that is not the law in the state of Texas. Louisiana gives royalty owners the right to cancel a lease for non-payment of royalty after notice and continued failure to pay. The guiding principal is that the nature of the property right owned by an owner of royalty is defined by applicable non-bankruptcy law.34


In a traditional private-party transaction, the obligation to pay royalty is a contract right and, though it is recognized as an interest in realty, the unpaid royalty owner is, in the ordinary case, an unsecured creditor.35

Contrary to popular opinion among royalty owners, the duty owed by an operator to the royalty owner is not a fiduciary duty and the relationship is

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34 Butner, 440 U.S. at 5455; Patterson, 504 U.S. at 758.
almost entirely contractual.\textsuperscript{36} Other than obligations found in the contract, royalty owners are owed no special duty by lessees.\textsuperscript{37}

In the usual situation, therefore, a royalty owner is simply an unsecured creditor with respect to unpaid prepetition royalty.\textsuperscript{38}

\[3\] — The “Termination for Non-payment” Clause in Bankruptcy.

Occasionally leases contain a clause that allows the lessor (typically the original landowner but sometimes the intervening assignor) to terminate the lease for non-payment of royalty. A typical clause would read something like this:

If Lessee fails to timely pay when due the royalty owed hereunder, after ten days notice and an opportunity to cure, the Lease shall be canceled at the option of Lessor.

In Texas, such clauses are enforceable and give the lessor the right to declare the lease terminated for non-payment of royalty. However, would sending the notice letter be a violation of the automatic stay? Arguably so and would require a motion for relief from stay. In the case of a fee simple determinable, the failure of the condition causes the lease to automatically

\textsuperscript{36} Pickens v. Hope, 764 S.W.2d 256, 270 (Tex. Ct. App. 1988); Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 567-68 (Tex. 1981) (“The standard of care in testing the performance of implied covenants by lessees is that of a reasonably prudent operator under the same or similar facts and circumstances . . . . Every claim of improper operation by a lessor against a lessee should be tested against the general duty of the lessee to conduct operations as a reasonably prudent operator in order to carry out the purposes of the oil and gas lease.”); see Hurd Enter., Ltd. v. Bruni, 828 S.W.2d 101, 108-11 (Tex. Ct. App. 1992) (surveying Texas case law and holding that no special relationship exists in the context of an oil and gas lease); Cambridge Oil Co. v. Huggins, 765 S.W.2d 540, 540-45 (Tex. Ct. App. 1989) (the relationship between lessor and lessee is purely contractual absent some special dealings between the parties outside of the lease context).

\textsuperscript{37} Shelton v. Exxon Corp., 921 F.2d 595, 599 (5th Cir. 1991).

\textsuperscript{38} Some things a practitioner might look for in order to enhance the royalty owner’s position would be special language in the lease, a special relationship outside the lease, or some other consensual or statutory entitlement that might give the royalty owner more rights than a normal lease.
terminate.\textsuperscript{39} Because leases in Texas are a fee simple determinable, bankruptcy practitioners have long believed that clauses such as those quoted above give the royalty owner the right to terminate the lease for non-payment, notwithstanding the \textit{ipso facto} clause of 11 U.S.C. § 365(e), which prevents termination or modification of a lease on the basis of insolvency or a bankruptcy filing, and the automatic stay of 11 U.S.C. § 362(a).

The logical remedy would be to simply pay amounts due post-petition and preserve the asset. Of course, there is a strong bankruptcy policy opposing payment of prepetition unsecured claims outside of confirmation of a plan of reorganization.\textsuperscript{40}

If such clauses are, in fact, enforceable in bankruptcy, there is no statutory mechanism by which such assets can be preserved other than 11 U.S.C. §

\textsuperscript{39} Trigg v. United States, 630 F.2d 1370, 1374 (10th Cir. 1980) (failure to pay delay rental timely caused termination of the lease and bankruptcy court has no remedy); In re MSB Energy, Inc., 438 B.R. 571, 596-97 (Bankr. S.D. Tex. 2010); see also Good Hope Refineries, Inc. v. Benavides, 602 F.2d 998, 1003 (1st Cir.), \textit{cert. denied}, 444 U.S. 992 (1979) (“[T]he law is settled, . . . that ‘unless’ leases are true option contracts in the sense that failure to drill or pay does not work a forfeiture.”).

\textsuperscript{40} Chiasson v. J. Louis Matherne and Assocs. (\textit{In re} Oxford Mgmt., Inc.), 4 F.3d 1329 (5th Cir. 1993) (“But, the powers granted by that statute must be exercised in a manner that is consistent with the Bankruptcy Code. . . . We find that the bankruptcy court was in error when it used its equity powers to command the payment of the appellees’ commissions.” \textit{Id.} at 1334); Official Committee of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987) (“The Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved.” Emergency treatment fund was disallowed.); \textit{In re} Structurlite Plastics Corp., 86 B.R. 922, 93233 (Bankr. S.D. Ohio 1988 (denying payments generally but allowing payments under § 507(a)(4) to an employee benefit plan); \textit{In re FCX}, Inc., 60 B.R. 405, 41011 (E.D.N.C. 1986) (“This court finds that by authorizing the payment of prepetition indebtedness arising from unpaid payroll expenses, unpaid payroll taxes, and unpaid purchases of grain, the Bankruptcy Court effectively subordinated the claims of the remaining unsecured creditors. Such subordination is not authorized under the law absent inequitable conduct on the part of these remaining unsecured creditors. . . . Sec. 105(a), . . . certainly confers equity powers upon the bankruptcy court but it does not authorize it to create rights not otherwise available under applicable law.”). \textit{But see In re} Chateaugay Corp., 80 B.R. 279 (S.D.N.Y. 1987) (approving Judge Lifland’s order authorizing LTV to continue payment of prepetition wages, salaries, employee reimbursement expenses and benefits, including payments on workers’ compensation claims accruing prior to petition date).
105(a). The common resolution of this problem is for the debtor to present a list of leases that it believes are (a) valuable and (b) in danger of being lost due to non-payment of royalty based upon clauses providing for unilateral termination. Upon motion and notice, the bankruptcy court will often approve payment of prepetition royalties to the royalty owners of such leases in order to preserve assets that all parties agree to be valuable. However, the weight of authority suggests that over proper objection, such payment would be an improper payment of a prepetition claim without a plan. There may be other reasons to pay royalty if the Debtor needs royalty owner consent for certain operations or new wells.


Over the years, the various states have taken efforts to protect the rights of royalty owners and to ensure that they are paid.

[a] — In the Case of Private Parties, § 9.343 of the Texas UCC Creates a Lien in Favor of Royalty Owners and Working Interest Owners.

Section 9.343, Tex. Bus. & Com. Code provides, in pertinent part, as follows:

(a) This section provides a security interest in favor of interest owners (as secured parties) to secure the obligations of the first purchaser of oil and gas production (as debtor) to pay the purchase price. . . .

The statute, § 9.343, provides a “security interest in favor of interest owners . . . “ It may be questioned whether the term “interest owner” is intended to include “royalty owner,” though the statutory definition seems sufficiently broad.

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42 Id.
43 Id. at § 9.343(r)(2).

The next question to consider is whether the statutory lien of § 9.343, insofar as it relates to hydrocarbons produced, may be avoidable by the trustee (or debtor-in-possession) in bankruptcy. Liens created by § 9.343 are statutory liens. Statutory liens are avoidable under 11 U.S.C. § 545(2) to the extent that such liens are not enforceable against a bona fide purchaser (BFP) of production. It is clear from the express language of § 9.343 that such liens are not valid against a BFP of production. The only exception is that the lien, once cut off by a BFP, continues as to proceeds as established in § 9.343(c), a provision which is broader than the traditional UCC proceeds provision, i.e. § 9.315.

As stated, avoidance under § 545(2) requires two elements: (a) there must be a statutory lien and (b) the collateral to which the statutory lien is affixed must be incapable of being sold to a BFP for value. Is a § 9.343 lien a statutory lien? The court in *SemCrude* considered the issue, albeit in another context, and concluded that § 9.343 creates “consensual security interests that arise by contract, not statutory liens or similar statutory interests, . . .”

This seems wrong. The Bankruptcy Code defines a statutory lien as one arising solely by force of a statute on specific circumstances or conditions, . . . whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.

The legislative history indicates that “[a] statutory lien is only one that arises automatically, and is not based on an agreement to give a lien or on

44 *See id.* at § 9.343(c)(1)(A) (“sale of such proceeds by a first purchaser to a buyer in the ordinary course of business . . . will cut off the security interest . . .”); and § 9.343(e) (“The security interests . . . are cut off by the sale to a buyer from the first purchaser who is in the ordinary course of the first purchaser’s business . . .”).


judicial action.” It is true that the lien created by § 9.343 is found in Article 9 of the UCC, that it utilizes many of the characteristics of a consensual security interest, and that § 9.343(a) specifically states that “[t]his section provides a security interest” and not a statutory lien. Yet a lien created by § 9.343 seems more analogous to a mechanic’s and materialman’s lien than a consensual lien. While entering into the transaction is consensual, there is nothing consensual about the giving of the lien, which is entirely a creation of statute.

In *Tri-Union Development Corporation*, the Creditors’ Committee opposed the payment of royalty owners, asserting that such liens as existed under then-§ 9.319 could be avoided as statutory liens under 11 U.S.C. § 545(2) of the Bankruptcy Code. The court rejected that argument for two reasons: First, the court noted that § 545(2) is not mandatory but is optional. In *Tri-Union*, the debtor had elected not to avoid the liens and sought to pay its royalty owners.

The debtor has prudently chosen not to attempt to avoid these royalty liens — it is seeking to adequately protect not only the collateral interests of the royalty owners, but also its own image by filing this motion to pay.

Second, the court noted that the § 9.343 lien continues in proceeds that are traceable to accounts or cash for an indefinite period of time, *i.e.*, forever. “When, however, the proceeds are either accounts or cash proceeds, the security interest exists ‘for an unlimited period of time.’”

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48 U.C.C. § 9.343(a) (emphasis added).
50 *Id.* at 813.
51 *Id.*
52 *Id.*
53 *Id.* at 813-14.
54 *Id.* at 813.
The first basis for the court’s ruling is correct and is, standing alone, probably sufficient to sustain the court’s decision. We respectfully submit that the second alternative basis is wrong. Section 545(b) of the Bankruptcy Code allows a debtor-in-possession and/or trustee in bankruptcy to avoid a statutory lien if, and only if, a BFP under state law could take title to the property free of the lien. By way of example, a mechanic’s and materialman’s lien is entirely statutory. Because a BFP (in Texas at least) cannot take free of that lien, § 545(b) does not allow the trustee to avoid it. The issue is not how long the lien continues while the collateral (and proceeds) are in the possession of the debtor. The issue is whether the debtor could convey good title to the collateral (and the proceeds) to a BFP free and clear of the lien. In our case, there are two issues: the collateral and the proceeds. The statute expressly states that the debtor could convey good title to the collateral to a BFP free of the lien. It is true that the lien continues in the proceeds (so long as it is accounts and cash) for an unlimited time — but that is true only while in the hands of the debtor. The real question is whether the debtor can transfer the cash proceeds to a BFP free of the lien of § 9.343(a)? Clearly the debtor could do so. Thus, we submit, the requisites for a § 545(b) avoidance action are satisfied. If a literal reading of § 9.343(c)(1)(C) were true, i.e. that the lien continued in the cash for “an unlimited time,” then the lien would follow the cash into the hands of employees, the light company or the landlord — clearly an improper and untenable result. We suggest that § 9.343(c)(1)(C)’s meaning is that the 20-day requirement of § 9.315 is eliminated by § 9.319(c)(1)(C) and the lien continues for an “unlimited time” so long as the proceeds are in the hands of the debtor or the first purchaser, but not thereafter. In sum, the § 9.343 liens are akin to floating liens against inventory and accounts receivable and do not follow the production (or the proceeds) into the hands of subsequent purchasers in the ordinary course of business.

The only exception occurs when a sale of production has occurred within 20 days of the date of filing. Then the lien would be saved (to a limited extent)

by § 9.343(c)(1)(A). But the benefit is then lost if the amounts received are commingled. The statute, § 9.315(d)(3), limits a lien claim to amounts paid within 20 days prior to bankruptcy (if commingled).

[c] — Proceeds of Production.

The outcome is different with respect to proceeds of production that can be traced. It is typically the case that the operator will dissipate (some months before the date of filing) the proceeds of production that were in the bank account used by the operator to pay royalty and working interest owners. It often happens that, after dissipating the proceeds, the operator will then replace some or all of the funds with other funds during the months leading up to bankruptcy. Those funds are then commingled with other funds admittedly belonging to the operator. This dissipation and commingling eliminates any tracing that might otherwise enable the royalty lien claims to be effective.

The common exception is the proceeds of production due for the sale of hydrocarbons produced in the period (either a month or a portion of a month) just prior to filing of bankruptcy. For that period, the purchaser of production typically will have not yet paid the operator. It is conceivable and perhaps likely that the royalty owners’ lien under § 9.343 will attach to the proceeds of production in the hands of the first purchaser prior to payment to the operator. Could the Debtor assign the account receivable from the first purchaser to a BFP free of the royalty owners’ lien? If so, it is avoidable under § 545. If not, then not.


In the scenario just discussed, there is often a conflict between the royalty owners and the collateral assignee of the debtor’s accounts receivable. Because the sale of hydrocarbons generates an account receivable, a

collateral assignee of accounts receivable will assert its entitlement to a lien on the proceeds of production ahead of any lien of the royalty owners and working interest owners. The analysis and resolution of this conflict turns on the inception date of the lien for purposes of priority and the outcome is uncertain. First, note that the collateral assignee of accounts receivable has a lien only against the debtor’s interest in the proceeds, \textit{i.e.}, no lien against the portion attributable to the interests of non-operators and royalty owners who are taking in kind. Second, note that the collateral assignment of receivables is a consensual lien governed by Article 9 of the Uniform Commercial Code, whereas the rights of royalty owners who are not taking in kind is a statutory lien (albeit arising under Article 9 also) that attaches to the funds (really a portion of the funds, being the amount necessary to pay royalty) in the hands of a third party. Third, note that the documents giving rise to the royalty owners’ lien under § 9.343 almost always exist \textbf{prior} to the attachment of the lien of the financing institution, but the statutory lien cannot exist until the hydrocarbons are produced. Prior to that date, there is no debt. Since there typically is no perfection of the § 9.343 lien, the royalty owners’ lien does not exist and there is no notice or attachment of the lien until the obligation arises, almost always \textbf{after} the attachment of the lien of the financing institution. The outcome of the priority fight between the financing institution and the royalty lien claimants was recently decided by the Delaware bankruptcy court in \textit{SemCrude Arrow Oil & Gas Inc. v. SemCrude L.P.}\textsuperscript{58} The court held the banks trumped the producer lien claimants.\textsuperscript{59} The Bankruptcy Court certified the case for immediate appeal to the Third Circuit, but the case settled.

\begin{center}
\textbf{[e] — Royalty Liens Are Not in Competition with Mineral Contractor Liens on the Same Property.}
\end{center}

Occasionally royalty claimants assert that their § 9.343 lien (if any) attaches to the debtor’s interest in the leasehold estate and is prior to mineral

\begin{footnotesize}
\textsuperscript{59} \textit{Id.} at 139.
\end{footnotesize}
contractor liens. The significance of such argument is that the mineral contractor liens (with exceptions noted above) are often paid (albeit usually at a discount) out of the proceeds of the sale of leases out of the bankruptcy estate. Royalty claimants have occasionally argued that the royalty liens (if any) might be ahead of the mineral contractor liens so that such payment might prejudice the rights of the royalty claimants. We believe this argument has no merit. Mineral contractor liens and royalty liens under § 9.343 attach to fundamentally different things, i.e., the former to the property and the latter to the production once severed. As a result, payment of one out of collateral cannot prejudice the other. In any event, the rule of priority is first in time is first in right (i.e., § 9.322(a)(1) provides that the first lien in time to both attach and be perfected is prior to another lien that is later in time).

In our view, the royalty lien under § 9.343 cannot both attach and be perfected (as required under § 9.309) until after the date of production, so that mineral contractor liens will often be prior in time to the royalty claims. If it is found that the royalty lien under § 9.343 arises, attaches and is perfected when the lease is signed, the well drilled, and production begins, then it may be a close question as to which lien is prior in time.

[f] — The Mineral Contractor Liens and Royalty Liens Attach to Different Collateral.

It is a fundamental principle that liens arising under § 9.343 attach only to production (and proceeds of production). Mineral contractor liens, on the other hand, attach only to the lands and leases as to which services and materials were provided, but do not attach to production. The court stated in *Hess v. Bank of Oklahoma (In re Hess)*:

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60 Tex. Bus. & Com. Code § 9.343(c) (“security interest exists in oil and gas production”), and § 9.343(r)(1) (definition of “Oil and gas production”); see also § 9.343(p) and § 9.343(r)(3).

61 United States v. Texas Eastern Transmission Corp., 254 F. Supp. 114 (W.D. La. 1965) (courts have consistently held that since the proceeds of an oil and gas well were not explicitly listed in Art. 5473 (predecessor of § 56.003), they were not subject to the mechanic’s and materialman’s lien); Wilkins v. Fecht, 356 S.W.2d 855 (Tex. Civ. App. 1962); see Abella v. Knight Oil Tools, 945 S.W.2d 847, 850-51 (Tex. Ct. App. 1997).

In Texas, Minerals are considered real estate and governed by real estate law while Production is considered personalty and is governed by the law of personal property. . . . It is settled under Texas law that the holder of a lien on the real estate (including the Minerals) does not have a lien on the Production because it is personal property. . . . This is true even where the lien on the real property is a mechanic’s lien for work performed on an oil and gas well. . . . [W]hen oil and gas are produced, they become personal property and the lien of the Bank [as mortgagee] on real estate is subject to being lost unless the Bank’s security documents cover production and are properly perfected as to personal property. . . .

Because in Texas the two liens attach to quite different aspects of the oil and gas estate, they are mutually exclusive and the payment of one (mineral contractor liens) from the proceeds of the sale of the leases cannot affect the rights of § 9.343 claimants, whose rights extend only to production.

If the liens were conflicting, then by statute the first in time prevails. There is nothing in the statute, § 9.343, which states that liens under that provision are prior to statutory liens of mineral contractors. Sections 9.343(f), (g) establish and define the priorities of § 9.343 with regard to conflicting liens. They do not explicitly address the issue of a mineral contractor lien arising by statute. Thus the latter lien’s priority would be established in accordance with the ordinary rule found in § 9.322(a)(1), that is, the first lien in time to both attach and be perfected is prior to another lien that is later in time. In a typical case, the royalty claimants’ lien under § 9.343 cannot arise prior to production of hydrocarbons, whereas the lien of mineral contractors arises and is perfected on the date of first service, a date often substantially in advance of first production.

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63 Id. at 978; see also Crowley v. Adams Bros. & Prince, 262 S.W. 883, 885 (Tex. Civ. App. 1924).
[g] — Texas Statute Creates a Lien in Favor of the State to Secured Unpaid Royalty Owed to the State of Texas.

With respect to lands leased from the State of Texas, the state has a lien to secure payment of royalty and other amounts due. Sec. 52.136 of the Texas Natural Resources Code provides that “The state has a statutory first lien on all oil and gas produced on any lease area to secure payment of unpaid royalty and other amounts due.” There have been no reported decisions interpreting this provision. It is not clear from the statute or from case law whether such a lien could be defeated by a BFP. In support of the argument that a BFP would be bound, the legislature in 1997 added the following language:

(c) The statutory and contractual liens and security interests described in this section may be foreclosed with or without court proceedings in the manner provided under Chapter 9, Business & Commerce Code.64

This sentence makes one think that the state may be free to seize and foreclose upon the collateral without regard to where it is found. On the other hand, the legislature also added the following language, indicating that a BFP would not be bound:

The state may require the lessee to execute and record instruments reasonably necessary to acknowledge, attach, or perfect the liens.65

If the last sentence serves any purpose, it could only be to provide notice effective against third parties who are otherwise not bound. If a BFP is not bound (there is no reason why it would not be) such statutory liens are avoidable under § 545(2) of the Bankruptcy Code.

[h] — Louisiana Statute Gives Unpaid Royalty Owners the Right to Cancel a Lease.

Louisiana law provides that if a lessee fails to pay royalty, the court may award as damages double the amount of royalty due, interest, and attorney’s
fees. The court may also dissolve the lease in its discretion.\textsuperscript{66} However, dissolution is not a favored remedy and dissolution should be granted only if the conduct of the lessee “is such that the remedy of damages is inadequate to do justice.”\textsuperscript{67} This usually requires evidence of fraudulent conduct.\textsuperscript{68} As a result, leases are seldom canceled. The provision is typically pleaded for its \textit{in terrorem} effect.

\begin{verse}
[i] — Minerals Management Service (MMS) Regulations Give the MMS the Right to Cancel a Lease for Unpaid Royalty.
\end{verse}

The Outer Continental Shelf Land Act provides:

\begin{verse}
(d) Cancellation of producing lease

Whenever the owner of any producing lease fails to comply with any of the provisions of this subchapter [Subchapter 3 - Outer Continental Shelf Lands] or of the lease or the regulations issued under this subchapter, such lease may be forfeited and canceled by an appropriate proceeding in any United States district court having jurisdiction under the provisions of this subchapter.\textsuperscript{69}

Further,

A lease issued under this Act, . . . does not convey title in the land, nor does it convey an unencumbered estate in the oil and gas.\textsuperscript{70}

The MMS regulations provide:

Producing leases issued under the Act may be canceled by the Secretary whenever the lessee fails to comply with any provision
\end{verse}

\begin{itemize}
\item[68] Wegman \textit{v.} Central Transmission, 499 So. 2d 436, 453 (La. Ct. App. 1986); \textit{see} Slattery Co., Inc. \textit{v.} Chesapeake La. Co., 2013 WL 1152718, at *3 (W.D. La. 2013) (lease dissolution available only if lessee fails to provide a reasonable explanation for nonpayment within 30 days).
\item[69] 43 U.S.C. § 1334(d) (1986).
\item[70] Union Oil Co. \textit{v.} Morton, 512 F.2d 743, 747 (9th Cir. 1975).
\end{itemize}
of the Act, applicable regulations or the lease only after judicial proceedings as prescribed by section 5(d) of the Act.\textsuperscript{71}

This provision would require the debtor to bring past-due royalties current, if the debtor wishes to assume the lease and avoid cancellation of the lease. Presumably the debtor and creditors would only permit such an assumption if the value of the producing lease exceeded the amount of the past-due royalties.

\section*{§ 7.05. The Conflict Between Avoiding Powers (§ 544(a) (3)) and Equitable Title (§ 541(d)), or the Issue of Recorded Versus Unrecorded Title.}

In most jurisdictions (including Texas and Louisiana), it often does not matter whether the debtor has made assignments that are “recorded” or not. What matters is whether the purported assignee can satisfy the statute of frauds and has paid the contractual purchase price. The bankruptcy estate is comprised of the debtor’s “true title,” which is the equivalent of “equitable title.”\textsuperscript{72} Whether an assignment has been recorded or not is a mechanism for giving notice to the world of the transfer of title. In most jurisdictions, recording is effective to cut off the rights of a bona fide purchaser for value (“BFP”) who is unrecorded. Although the BFP test is critically important in the context of a fraudulent transfer under bankruptcy law and most state laws, \textit{e.g.}, 11 U.S.C. § 544(a)(3), the debtor’s and trustee’s (and hence the creditors’) ability to benefit from a failure to record is undercut by the Code’s safe harbor for “equitable title,” found in 11 U.S.C. § 541(d). In short, § 541(d) often trumps § 544(a)(3). The Fifth, Tenth and Eleventh circuits hold that § 541(d) prevails over a competing § 544(a)(3) avoidance claim.\textsuperscript{73}

\begin{itemize}
  \item \textsuperscript{71} 30 C.F.R. § 256.77(b) (1997).
  \item \textsuperscript{72} 11 U.S.C. § 541(a).
  \item \textsuperscript{73} Haber Oil Co. v. Swinehart (\textit{In re} Haber Oil Co.), 12 F.3d 426, 436 (5th Cir. 1994); City Nat’l Bank of Miami v. General Coffee Corp. (\textit{In re} General Coffee Corp.), 828 F.2d 699, 704-07 (11th Cir. 1987), \textit{cert. denied}, 485 U.S. 1007 (1988); Turley v. Mahan & Rowsey, Inc. (\textit{In re} Mahan & Rowsey, Inc.), 817 F.2d 682, 684 (10th Cir. 1987); Sandoz v. Bennett (\textit{In re} Emerald Oil Co.), 807 F.2d 1234, 1238 (5th Cir. 1987); Vineyard v. McKenzie (\textit{In re} Quality Holstein Leasing), 752 F.2d 1009 (5th Cir. 1985) (dictum); \textit{see also In re} Cutter, 398 B.R. 6, 22 n.20 (B.A.P. 9th Cir. 2008).
\end{itemize}
Even in those jurisdictions which resolve the conflict in favor of § 541(d), however, a prerequisite for § 541(d) to prevail is that the unrecorded interest owner establish his ownership under applicable non-bankruptcy law. In most reported opinions, this has taken the form of litigating whether a constructive trust is found to exist, entitling the unrecorded assignee to be recognized as an owner.\textsuperscript{74}

But establishing a constructive trust can be difficult. In Texas, a constructive trust requires (1) breach of informal relationship of special trust or confidence arising prior to and apart from the transaction in question or actual fraud; (2) unjust enrichment of the wrongdoer; and (3) tracing to an identifiable \textit{res}.\textsuperscript{75} In the typical oil and gas case, the unrecorded interest owner has found it extremely difficult to establish an entitlement to constructive trust.\textsuperscript{76} As a result, it has been rare for the unrecorded assignees to prevail in Texas on a constructive trust theory.\textsuperscript{77}

It is occasionally argued that \textit{Wilson v. Parson (In re Jones)}\textsuperscript{78} supports the argument that § 544(a)(3) prevails over § 541(d). This argument and the precise holding in the \textit{Jones} case are directly contrary to Fifth Circuit precedent. The court in \textit{Jones} incorrectly assumed the debtor is a BFP and is entitled to treat the unrecorded assignment as void, per the Texas recording statute. “Section 544 gives the Trustee the rights of a bona fide purchaser and an attaching lien creditor (the strong-arm powers). These rights cut off most unrecorded interests and unperfected security interests.”\textsuperscript{79} The court in \textit{Jones} acknowledged that § 541(d) prevails over § 544,\textsuperscript{80} and even acknowledged that § 541(d)’s application was much broader than the mortgage servicing

\textsuperscript{74} \textit{E.g., Boyd v. Martin Exploration Co.}, 56 B.R. 776, 781 (E.D. La. 1986).
\textsuperscript{75} American Cancer Society v. Cook, 675 F.3d 524, 529 (5th Cir. 2012); Monnig’s Dep’t Stores, Inc. v. Azad Oriental Rugs, Inc. (\textit{In re Monnig’s Dep’t Stores, Inc.}), 929 F.2d 197, 201 (5th Cir. 1991); Meadows v. Bierschwale, 516 S.W.2d 125, 128 (Tex. 1974); Thigpen v. Locke, 363 S.W.2d 247, 250-53 (Tex. 1962).
\textsuperscript{76} \textit{Haber Oil Co.}, 12 F.3d at 43537.
\textsuperscript{77} \textit{E.g.}, Wilson v. Parson (\textit{In re Jones}), 77 B.R. 541 (Bankr. N.D. Tex. 1987); \textit{but see} Todd v. Pettit (\textit{In re Elliott}), 108 F.2d 139 (5th Cir. 1939).
\textsuperscript{78} \textit{In re Jones}, 77 B.R. 541 (Bankr. N.D. Tex. 1987).
\textsuperscript{79} \textit{Id.} at 548.
\textsuperscript{80} \textit{Id.}
industry. The Jones court then concluded that the unrecorded assignees had not pleaded “constructive trust;” and denied them relief based on the trustee’s BFP status. The reasoning in Jones ignores the obvious fact that the debtor in Jones was not a BFP except insofar as the statute grants such status to a trustee for the limited purpose of pursuing a § 544(a)(3) action. And of course, § 541(d) prevails over § 544, as the Jones court acknowledged.

In Jones, the flaw in the reasoning was to assume that the assignments are void under state law (they are not — except as to BFPs), that the trustee is a BFP (he is not, except for § 544 purposes), and to fail to realize that the trustee’s BFP status under § 544 is of no import because § 541(d) prevails over § 544. To state the obvious, a trustee cannot obtain the benefits of BFP status without first bringing an adversary proceeding to plead and adjudicate all of the elements of an avoidance action, which must result in a final judgment setting forth the rights and remedies, if any, to which the trustee is entitled. And, of course, § 541(d) prevails over § 544, so the trustee would fail in such an action. We therefore suggest that the holding in Jones is incorrect and is directly contrary to both the statute and controlling Fifth Circuit precedent.

Further, the Jones court incorrectly analogized a person who holds an unrecorded assignment in an oil and gas property to a person who is a “secured” party in property but who did not perfect his security interest. In drawing the comparison, the court failed to recognize a critical difference between a creditor and an owner. Under Texas law, the party who has paid the consideration and holds the unrecorded assignment owns legal and equitable title to the property. Because the debtor does not have equitable title, the interest is not property of the bankruptcy estate. On the other hand,

81 Id.
82 Id. at 549.
83 Id. at 550.
84 In re Jones, 77 B.R. at 548.
85 Id.
the unperfected “secured” party is a creditor with an unperfected security interest in property of the bankruptcy estate. Accordingly, the circumstances facing the respective parties are very different — one is an owner and one is a creditor — and, as a result, the interrelation and application of §§ 541(a), 541(d), and 544(a) lead to different results. “[T]his Court reads section 541(d) in conjunction with section 541(a)(1) rather than as two distinct, inconsistent provisions.”

There is substantial authority that Louisiana does not recognize equitable title and thus rejects notions of constructive trust.

Regardless of whether the assignee has paid the purchase price or not, the statute of frauds still applies. Thus, the test for equitable title is whether (i) there is a writing that adequately describes the interest and (ii) the assignee has paid the purchase price in connection with a transaction evidencing an intent to presently pass title. An alternative to a constructive trust is the resulting trust, in which the purported assignee has paid the consideration and owns equitable but not legal title.

It must be recognized, however, that the Fifth Circuit has not squarely faced the § 544(a)(3) versus § 541(d) issue since the 1984 amendments adding the limiting language in § 541(d) (“under subsection (a)(1) or (2)”) which, by implication, take § 544(a)(3) out from the § 541(d) safe harbor. Thus, these issues remain, to some extent, a work in progress.

§ 7.06. The § 541(b)(4) Safe Harbor for Recipients of Farmouts from Debtors in Bankruptcy.

In the oil & gas industry, a “farmout” is a contractual arrangement by which one party (the farmee) earns all or a portion of the interest in a property owned by another (the farmor) in exchange for the performance

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88 In re Ramba, 437 F.3d at 461 n.4 (citing In re Maple Mortg., 81 F.3d 592, 595 (5th Cir. 1996)).
of certain tasks, such as drilling or completing certain wells. In a typical farmout, the farmee drills a well and, upon satisfactory completion, earns a percentage of the acreage and additional rights going forward. Significantly for our purposes, title remains in the name of the farmor pending the farmee’s completion of the contractual obligations. Also significantly, an incomplete farmout agreement is almost certainly an executory contract. Section 541(b)(4) of the Bankruptcy Code provides that mineral leases covered by certain types of “farmout” agreements (as defined in the Code) are not property of the debtor’s estate. Also note that the debtor can be either the farmor or the farmee and that the resulting legal issues are quite different.

[1] — When the Debtor Is the Farmor.
If the debtor is the farmor and the farmee has drilled a successful well, it may be the case that rejection of the farmout agreement will create more value for the estate than a recognition of the farmee’s interest. From the non-debtor farmee’s point of view, this is particularly difficult when the farmee has sold interests in the “to be acquired” property to third parties. This has happened often enough and achieved a sufficiently infamous result that Congress enacted § 541(b)(4) of the Bankruptcy Code to prohibit what is perceived as a windfall to the debtor-farmor. However, as with much legislation that has general language aimed at a specific problem, it may be that the amendments have overshot the mark. Thus, the Bankruptcy Code now contains a definition of *farmout* that is much more broad than that typically thought of in the oil and gas industry. Section 101(21A) of the Code provides:

Farmout agreement means a written agreement in which —

(A) the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and

(B) such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property; . . . .

The significance is that any agreement for the assignment of an interest in an oil and gas lease that includes, as consideration, the defined operations upon the property will be a farmout under § 101(21A). This encompasses many more agreements and transactions than parties in the industry would normally think of as being a farmout. If your client is an unrecorded interest owner through a debtor, if the property interest can be defined as a “farmout” under § 101(21A), and if your client provided part of the capital that enabled the debtor to perform operations, then § 541(b)(4)(A)(i) may give relief. If so, there are two substantial benefits to the unrecorded interest owner: (i) the unrecorded interest owner’s share is not property of the estate and (ii) the owner can successfully defend against an avoidance action.

As stated, what is created by § 541(a) (defining property of the estate) is then limited by § 541(b)(4), which provides:

(b) Property of the estate does not include —

. . . .

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

(A)(i) the debtor has transferred or has agreed to transfer such interest pursuant to a farmout agreement; and

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

(B)(i) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from which such production payment is transferred; and

(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 542 of this title; . . . .

Clearly, § 541(b)(4)(A) is intended to apply to farmouts, primarily those in which the debtor is the farmor. By the operation of § 541(b)(4)(A), the debtor-farmor is not able to withhold from its farmee an assignment of an interest if it is otherwise earned. The reference to § 365 is intended to negate the debtor’s ability to reject an otherwise earned farmout as an executory contract. A farmout that is incomplete on the date the debtor files bankruptcy is probably an executory contract capable of rejection, though § 541(b)(4)(A) prevents that rejection from having the effect of terminating the farmee’s right to receive an assignment of its interest. The reference to § 544(a)(3) declares that the farmee’s right to an assignment (if it is otherwise properly earned) may not be defeated by the fact that the farmee’s interest is not of record. Section 544(a)(3) probably would otherwise have this effect because that section enables a debtor to avoid an assignment of property to another if a bona fide purchaser for value could take title superior to the assignee.

A more difficult question arises from the fact situation where the debtor is the farmee and promised to sell, or actually sold, interests to the debtor’s assignees but such assignments are not of record. In that case, does § 541(b)(4)(A)(i) provide any solace to the unrecorded interest owner? A first reading of the statute will demonstrate that it does not really address the issue because it is couched in terms of the debtor being the farmor. As a result, the analysis may fall back on the issue of whether the farmout is an executory contract capable of being assumed under 11 U.S.C. § 365.

If the farmout is assumed, then what about the undivided interests that the farmee (in this example, the debtor) contracted to assign to others? Some benefit may be gleaned from the words “pursuant to a farmout agreement” in § 541(b)(4)(A)(i). If the debtor acquired a leasehold interest through being a farmee of a farmout, promised to assign an interest in the earned farmout acreage to a third party, and if such farmout can be assumed under § 365, does such a “transfer” of an interest fall within the phrase “pursuant to a farmout agreement or any written agreement directly related to a farmout agreement . . .”? One possible resolution is that if the debtor’s farmout agreement has no

reference to third parties, then the obligation to transfer to such third parties is probably not “pursuant to” the farmout agreement. On the other hand, if the debtor’s ability to perform under the farmout (through cash or other capital infusion) arises in part from the assignment to third parties (which is commonly the case), then such assignment may (and perhaps should) be “directly related to” the farmout agreement. Other constructions of the statutory language are, of course, possible.

If the debtor is a farmer under a farmout, the property interest that is (or will be) earned by the farmee is not property of the estate except to the extent of the contract rights of the farmer under the farmout agreement. That is, the debtor/farmor cannot “reject” the farmout and take away the farmee’s right to earn title.

[2] — The Problem with the “Fat Farmout Agreement.”

What about a situation where the Debtor has been paid two million dollars to farmout an area in which 10 wells can be drilled and 10 separate assignments will be made for the acreage surrounding the wells. At the time of filing of the petition, three wells have been drilled. Clearly the farmee has earned that acreage. But what about the rights to earn the acreage for the other seven wells? The answer is not clear but we submit the farmee should be entitled to drill and earn the remaining acreage.


Section 541(b)(4)(B) of the Bankruptcy Code protects the assignees of production payments and makes clear what has generally been considered to be the law by practitioners, that is, that the assignee of a production payment takes title to property and, as a result, such production payment ceases to be property of the estate. Section 541(b)(4) of the Bankruptcy Code provides:

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95 E.g., Terry Oilfield Supply, 195 B.R. at 74 (production payment is ownership of real property interest and not property of estate).
(b) Property of the estate does not include—

. . . .

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

(A)(i) the debtor has transferred or has agreed to transfer such interest pursuant to a farmout agreement; and

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

(B)(i) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from which such production payment is transferred; and

(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 542 of this title; . . . 96

The limiting language ‘to an entity that does not participate in the operation of the property’ is apparently intended to apply to entities who provide financing only and who do not participate in operations.97 This is unfortunate language because it is not uncommon for one party to take a production payment as compensation while providing services on the property, sometimes even conducting operations.98 By negative implication, § 541(b)(4)(B)(i) may cause someone to believe that “property of the estate” under § 541(a) picks up an assignment of a production payment to an entity that participates in operations. If so, this would be an unfortunate and probably unintended result — certainly contrary to preexisting law.

When the debtor is the farmee, the farmout agreement is an executory contract and the debtor must cure prepetition defaults and provide adequate assurance of future performance.

98 E.g., Terry Oilfield Supply, 195 B.R. at 70.
Certain types of production payments are not property of the estate.\textsuperscript{99} Most practitioners never believed that production payments were property of the estate.\textsuperscript{100} Because of the § 541(b)(4)(B) safe harbor, we know that one specific type of production payment is not. What about the others?

Furthermore, so-called “production payments” may be recharacterized as loans and thus not subject to the safe harbor under § 541(b)(4)(B).\textsuperscript{101}

\section{§ 7.08. In Texas, the Priority of a Mineral Contractor’s Lien Is Determined by the Date of First Work, All Lien Claimants Share Pro Rata, and the Lien Attaches to the Greater of the Customer’s Legal or Equitable Title.}

Oil & gas contractors’ lien claims come into existence on the date of first work but do not have to be evidenced by a recorded lien affidavit until a statutory period after the date of last work (so long as there is continuous intervening work). For priority purposes, the contractors’ lien claims incept back to the date of first work. In Texas such lien claimants normally have the right to share and share alike upon foreclosure by any single lien claimant (other states such as Mississippi go by first-filed lien). Contractors’ liens (with certain exceptions) attach only to the leases upon which services or materials were provided.

Texas has statutorily provided lien rights to mineral contractors and subcontractors.\textsuperscript{102} Texas mineral contractors, § 56.001(2), receive a lien to secure payment for labor or services related to mineral activities.\textsuperscript{103} The property subject to the lien is the leasehold (but not the fee, § 56.003(b)) and related property and equipment. Tex. Prop. Code § 56.002. The amount secured is no more than the amount contracted for. Tex. Prop. Code § 56.006.

\textsuperscript{100} \textit{Terry Oilfield Supply}, 195 B.R. at 70.
\textsuperscript{101} \textit{See PSI, Inc. of Mo. v. Aguillard (In re Senior-G&A Operating Co.),} 957 F.2d 1290, 1296 (5th Cir. 1992) (looking to the substance of “Production Payment Loan Agreement” and determining that the transaction was a loan rather than the transfer of a mineral interest).
\textsuperscript{102} Tex. Prop. Code § 56.001 \textit{et seq.} (Vernon 1995).
\textsuperscript{103} \textit{Id.} § 56.002.
For purposes of enforcement, mineral liens incorporate the provisions of mechanic’s, contractor’s or materialman’s liens from Chapter 53 of the Tex. Prop. Code § 56.041(a).

[1] — Date of Inception for Purposes of Priority.

Under Texas law, a mineral contractor has six months from the date of accrual of indebtedness in which to file the lien affidavit.104 The contractor must provide a notice of intent to file a lien at least 10 days before filing the lien affidavit.105

For purposes of priority, the mineral contractor’s lien (and subcontractor’s lien if otherwise valid) incepts back to the date of first work, provided that the lien is otherwise timely filed.106 The date of “priority” seems to be the date of first work regardless of whether that work was paid for or not.107 All mineral lien claimants share pro rata in recoveries from the collateral.108 Because they share pro rata, it is unclear whether the priority of the earliest mineral contractor will be sufficient to prime an intervening mortgage for the benefit of all lien claimants.


Under Texas law, a mineral contractor or subcontractor must file the lien affidavit with the county clerk of the county in which the property is located.109 The statute does not address the perfection of a lien on leases outside any county, as in the case of Outer Continental Shelf (OCS) leases.

104 Id. § 56.021(a).
105 Id. § 56.021.
106 Id. § 53.124(a) (commencement of construction of improvements or delivery of materials) as incorporated by § 56.041(a).
108 Tex. Prop. Code § 53.122(a), as incorporated by § 56.041(a). LaneWells Co. v. Continental EMSCO Co., 397 S.W.2d 217, 219-20 (1965); In re MEG Petroleum Corp., 61 B.R. 14, 21 (Bankr. N.D. Tex. 1986) (“But since holders of competing mechanic’s and materialmen’s liens have equal priority, AWS and Halliburton must share Net Production Income payments attributable to the Lopez Creek lease on a pro rata basis.”).
[a] — Where to File a Mineral Contractor’s or Subcontractor’s Lien Against an OCS Lease.

The federal system does not establish a mechanism for filing or perfecting oil and gas contractor and subcontractor liens against OCS leases. As a result, early cases recognized some uncertainty as to where to file liens against OCS leases.110 O’Kane and Bolack appear to recognize the existence of a “void or gap” in federal law applicable to the perfection of oil and gas contractor’s liens against onshore federal oil and gas leases.111 More recent cases confirmed what appears intuitive, i.e., that in the absence of any express federal or state law, the lien affidavit should and must be filed with the county clerk of the adjacent parish or county.112

[b] — The Reach and Extent of a Mineral Contractor’s Lien.

A mineral contractor’s lien in Texas reaches only to the leasehold interest of the party contracting with the contractor, as well as improvements.113 It is

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110 E.g., O’Kane v. Walker, 561 F.2d 207 (10th Cir. 1977); Bolack v. Underwood, 340 F.2d 816 (10th Cir. 1965).
111 Id.
112 Union Texas Petroleum Corp. v. PLT Eng’g, Inc., 895 F.2d 1043 (5th Cir. 1990) (holding that contractors were entitled to Louisiana liens even though the leases were not located within a parish; also holding that filing of lien notice within the parish records of the parish adjacent to the OCS lease was proper); World Hospitality, Ltd. v. Shell Offshore, Inc., 699 F. Supp. 111, 113-14 (S.D. Tex. 1988) (offshore catering service was held to have a lien under Texas statute against an OCS lease; liens filed with MMS found ineffective but liens filed in two Texas coastal counties adjacent to leases held to perfect liens). But see St. Mary Iron Works, Inc. v. McMoRan Exploration Co., 802 F.2d 809 (5th Cir. 1986), op. withdrawn, 809 F.2d 1130 (5th Cir. 1987) (Louisiana law required filings in the parish where the property was located to perfect a valid lien; there is no statutory means of filing when property is on the OCS and thus, court held, plaintiff has no lien. Opinion was withdrawn because of a later case holding that no lien filing is required to perfect a lien.)
well established in Texas that a mineral lien does not extend to the production from the lease but only to the leasehold interest itself.\footnote{114}

It is settled under Texas law that the holder of a lien on the real estate (including the Minerals) does not have a lien on the Production because it is personal property. . . . This is true even where the lien on the real property is a mechanic’s lien for work performed on an oil and gas well.\footnote{115}

The astute practitioner will immediately note that the mineral lien claimant, because he has no lien on production, is subject to being depleted during the pendency of the bankruptcy unless he either proceeds to foreclose or is granted a substitute lien to protect against depletion. The latter is normally the proper result.

[c] — How to Foreclose a Mineral Contractor’s and Subcontractor’s Lien.

A mineral lien is foreclosed in the same manner as a mechanic’s and materialman’s lien, pursuant to Chapter 53.\footnote{116} A mechanic’s and materialman’s lien may be foreclosed only by a judicial foreclosure.\footnote{117}

[d] — Practice Tip.

A judicial foreclosure may take some time and, in the meantime, the well is being depleted. The solution is to have a receiver appointed to collect

\footnotesize

\footnote{114} United States v. Texas Eastern Transmission Corp., 254 F. Supp. 114 (W.D. La. 1965) (courts have consistently held that since the proceeds of an oil and gas well were not explicitly listed in Art. 5473 (predecessor of Tex. Prop. Code § 56.003), they were not subject to the mechanic’s and materialman’s lien); Hess v. Bank of Oklahoma (In re Hess), 61 B.R. 977, 979 (Bankr. N.D. Tex. 1986).


\footnote{116} Tex. Prop. Code § 56.041(a).

\footnote{117} Id. § 53.154.
and hold the proceeds of production until the court adjudicates the lien foreclosure. 118


It is common for a service company to provide services only to a well, lease, or series of wells and leases, but not uniformly on all of the debtor’s properties. Indeed, it would be unusual for the service company to have provided the identical services to all properties owned by a particular customer. A bank, on the other hand, commonly secures its debt with a blanket mortgage on all properties of the debtor, wherever located. The mineral liens and the bank’s mortgage commonly compete in bankruptcy for the equity in the debtor’s properties. The threshold issue is that of priority. The bank’s priority as to the debtor’s properties in a given county or parish will be determined by the date of filing the mortgage in that jurisdiction. The same is true for mineral liens except that those statutorily get the benefit of a six-month reach back before the date of filing the lien, and then incept back through all work to the date of first work. 119

Once the threshold issue of priority is determined, usually on a county by county or parish by parish basis, the next question is one of allocation. Consider the following illustration: Assume the bank is owed $10 million and has a first lien against all assets of debtor, which consist of four properties worth $5 million, $3 million, $2 million, and $1 million, respectively, for an aggregate value of $11 million. Theoretically there is $1 million of equity for mineral contractors’ liens — but from which property does the $1 million in equity come? The mineral contractors’ liens only attach to specific properties. If there are $6 million in mineral contractors’ liens against the $5 million property, then how can we say there is equity in that property if it is worth only $5 million and has $10 million of bank debt against it? This raises the issue of marshaling, an equitable concept that is not well defined in Texas, Louisiana, or in bankruptcy.

119 Id. at § 53.154.
Marshaling is beyond the scope of this paper but, briefly, is the doctrine by which a junior creditor may require a senior creditor to look to a specific item of collateral first if it makes no difference to the senior creditor but makes a great deal of difference to the junior.\textsuperscript{120}

In our example (and in most oil and gas bankruptcies), no matter which way the bank allocates its debt, some mineral lien claimant will suffer injury. In the vast majority of cases, the resolution has been a negotiated one in which the bank debt is spread over all the properties pro rata in accordance with some known measure of value. The absolute values of the properties constituting the bank’s collateral need not be known but the relative values are critical. For example, if one property is worth twice as much as another, it ought to bear twice as much of the bank’s debt. Note, however, that there is no clear authority for accomplishing this other than inherent fairness. Also note that these issues are not unique to bank mortgages — the same principles would apply to any case in which the senior lien covers more collateral than the junior lien.

\textbf{[a] — Texas Mineral Subcontractor’s Liens.}

The Texas mineral subcontractor’s lien statute appears to create a lien on the leasehold and the improvements, § 56.003(a), but it is unclear to what extent this really occurs. Section 56.006 provides that the owner is never liable for more than the amount contracted for, and § 56.043 states that the owner may withhold payment to the contractor once the subcontractor’s notice is served. The owner is not liable to the subcontractor for more than

\textsuperscript{120} \textit{E.g.}, \textit{In re} Jack Green’s Fashions for Men – Big and Tall, Inc., 597 F.2d 130 132-33 (8th Cir. 1979) (junior lienholder wanted the first lienholder to pursue guarantor’s collateral prior to pursuit of debtor’s collateral; court granted the request and ordered marshalling). \textit{But see} \textit{In re} Mesa Intercontinental, Inc., 79 B.R. 669, 672 n.1 (Bankr. S.D.Tex. 1987) (describing Jack Green’s as unclearly reasoned departure from majority rule). \textit{In re} San Jacinto Glass Industries, Inc., 93 B.R. 934, 938 (Bankr. S.D. Tex. 1988) (“The hallmark of the marshaling doctrine is contained in the requirement that one creditor alone have access to more than one of the debtor’s assets by which to realize its claim. In equity, the paramount creditor’s power to make discretionary choices regarding sources of repayment should be tempered but only to the extent necessary to insure that other deserving creditors be spared needless adverse effects.”).
the amount that the owner owes the original contractor when the notice is received by him.121

The result is that the Texas mineral subcontractor’s lien is, in essence, nothing more than a trapping statute similar to Tex. Prop. Code § 53.082, part of the Mechanic’s, Contractor’s, or Materialman’s Lien Statute.122 The basic principle is that the service company who contracts through the operator and perfects a subcontractor’s lien is entitled to a lien on all amounts due from non-operators to the operator.123

The characteristics of contractor and subcontractor can become blurred. In the typical transaction, the operator contracts directly with vendors but the non-operators do not. A service company contracting with the operator is a contractor as to the operator (if the operator owns an interest in the lease) but a subcontractor as to non-operators.124 In that example, the service company would need to perfect its lien both ways, first as a subcontractor and second as a contractor.

The subcontractor, as a condition of perfecting the subcontractor’s lien, must serve on the owner a notice of claim of lien not later than 10 days prior to filing the affidavit.125 Do not fall into the trap of serving the notice on the operator only, because the operator is not the agent of the non-operators (owners) for purpose of the statutory notice.126

122 First Nat’l Bank in Graham v. Sledge, 653 S.W.2d 283, 286 (Tex. 1983) (“Article 5463 is a ‘trapping’ statute. It provides the subcontractors can trap, in the owner’s hands, funds payable to the general contractor if the owner receives notice from the subcontractors that they are not being paid.”).

In Texas, the mineral contractor or subcontractor is not entitled to a constitutional lien. Ordinary mechanics and materialmen can obtain a lien on a construction project pursuant to the Texas Constitution:

Sec. 37. Mechanic’s, artisans and materialmen, of every class, shall have a lien upon the buildings and articles made or repaired by them for the value of their labor done thereon, or material furnished therefor; and the Legislature shall provide by law for the speedy and efficient enforcement of said liens.127

However, this does not apply to oil and gas contractors and subcontractors.128

[c] — What and Whose Interest Is Attached when the Mineral Lien Claimant Files His Lien?

It is common for a promoter/operator to contract with service companies for work on leases at a time when record title is in a state of flux. At a time when farmouts and letter agreements are ubiquitous and record title tends to play catch-up at a later date, there is a substantial question as to what a mineral lien attaches, depending upon the state of title. As a basic rule of thumb, the mineral lien claimant who properly files and perfects its lien is entitled to a lien against the greater of the recorded interest or the equitable interest of its customer.129 The possible permutations on the state of title are extensive.

127 Tex. Const art. XVI, § 37.
128 MidAmerica Petroleum Inc. v. Adkins Supply, Inc. (In re MidAmerica Petroleum, Inc.), 83 B.R. 937, 943 (Bankr. N.D. Tex. 1988) (oil and gas lien claimants are generally not entitled to assert the benefits of the constitutional lien contained in Art. XVI, § 37 of the Texas Constitution); Oil Field Salvage Co. v. Simon, 168 S.W.2d 848, 851 (Tex. 1943) (confirmed the holding of Ball as to unavailability of a constitutional lien for laborers and materialmen in the oil and gas industry); Ball v. Davis, 18 S.W.2d 1063, 1066-67 (Tex. 1929).

For the sake of completeness, it is worth noting that a contractor in the construction industry who receives funds intended for the payment of subcontractors is the trustee of a statutory trust created for the benefit of the subcontractors.\textsuperscript{130} The statutory requirements for the creation of such a trust are that:

(a) Construction payments are trust funds . . . if the payments are made . . . under a construction contract for the improvement of specific real property in this state.

(b) Loan receipts are trust funds . . . if the funds are borrowed . . . for the purpose of improving specific real property in this state, and the loan is secured in whole or in part by a lien on the property.\textsuperscript{131}

The beneficiaries of the trust are, broadly speaking, the workers and subcontractors who provide labor, materials and services for the “construction or repair of an improvement on specific real property in this state . . . .”\textsuperscript{132}

The trustee who misapplies such trust funds by failing to pay the beneficiaries commits a Class A misdemeanor or a third degree felony, depending on the amount of money involved.\textsuperscript{133} Misapplication occurs when:

(a) A trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds.\textsuperscript{134}

There are certain affirmative defenses to an action for misapplication of fiduciary funds.

\textsuperscript{130} Id. at § 162.002.
\textsuperscript{131} Id. at § 162.001(a)-(b).
\textsuperscript{132} Id. at § 162.003.
\textsuperscript{133} Id. at § 162.032.
\textsuperscript{134} Id. at § 162.031(a).
The statute was written with the real estate construction industry in mind; however, it would seem that a producing oil and gas well is or could be an improvement to real property. An older case held the identical statute, before codification, to be applicable to the oil and gas industry.\textsuperscript{135} A more recent case has held that the statute does \textit{not} apply to funds paid to operators for the purpose of drilling oil and gas wells.

The drilling of an oil well does not involve construction, in the sense of assembling materials to make a permanent whole. The drilling rig, itself, is not a permanent fixture, but rather is removed from the wellsite after drilling is completed. Drilling a hole in the ground does not involve the assembly of various materials into a permanent structure. The only permanent construction involved in drilling an oil well is the casing pipe which is put into the hole in order to preserve the hole and prevent the earth from collapsing into it. In sum, this Court concludes as a matter of law that drilling an oil and gas well is not the construction of an improvement on real property within the meaning of Chapter 162 of the Property Code.\textsuperscript{136}

We observe that whether a particular well is an “improvement” would appear to be a question of fact for the jury.

\textbf{§ 7.09. Whether the Mineral Lien Contractor Has an Interest in the Proceeds of Production as Cash Collateral.}

Whether a creditor has an interest in cash collateral is often critically important in the first days of any bankruptcy case. A mineral lien contractor in Texas probably can have an interest in cash collateral if his lien claim is properly perfected, though this is not certain.

\textsuperscript{135} Triton Oil & Gas Corp. v. E. W. Moran Drilling Co., 509 S.W.2d 678, 687 (Tex. Civ. App. 1974).

\textsuperscript{136} Holley v. NL Indus./NL Acme Tool Co., 718 S.W.2d 813, 815 (Tex. Ct. App. 1986).

The problem for the mineral lien contractor is that Texas law clearly gives the lien claimant a lien against the minerals but not against the proceeds. Thus, if the analysis ended here, the mineral lien claimant in Texas would have no interest in cash collateral.

From a practical perspective, this is a serious problem for the lien claimant because the collateral (the producing wells) are depleting the reserves, and thus depleting the value of the collateral. In most bankruptcies, the proceeds of production go to pay the costs of administration of the bankruptcy estate and, absent special relief, the mineral lien claimant gets no substitute lien or enhancement of collateral elsewhere to compensate for the loss of value through production. Thus, the mineral lien claimant, from an economic point of view, needs either adequate protection, an interest in cash collateral, or a substitute lien to replace depletion.


Notwithstanding state law, the Bankruptcy Code gives a lien claimant an interest in cash collateral if it is the “proceeds” of property in which the claimant has a security interest. Section 363(a) states:

(a) . . . [“C]ash collateral” means cash, . . . or other cash equivalents whenever acquired . . . and includes the proceeds, products, offspring, rents, or profits of property . . . subject to a security interest as provided in section 552(b) of this title, . . .

At first blush, this appears to give to mineral lien claimants an interest in cash collateral as “proceeds, products, . . .” of property subject to the mineral claimants’ lien. However, on closer review, § 552(b) is limited to consensual security interests whereas the mineral lien claimants’ rights arise by statute. It is hard to imagine that the Bankruptcy Code recognizes

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137 United States v. Texas Eastern Transmission Corp., 254 F. Supp. 114 (W.D. La. 1965) (courts have consistently held that since the proceeds of an oil and gas well were not explicitly listed in Art. 5473 (predecessor of Sec. 56.003), they were not subject to the mechanic’s and materialman’s lien); Wilkins, 356 S.W.2d 855 (citing Crowley, 262 S.W. 883).
a secured creditor’s interest in cash collateral created by a consensual lien but denies it to a claimant whose lien arises by statute only. But that may be the outcome if § 363(a) is read literally and in conjunction with § 552(b).


Fortunately for the lien claimant, Texas law gives that party the opportunity to seize the proceeds of a well pending a judicial foreclosure of the lien, and the appointment of a receiver for such purpose is expressly recognized in § 64.092, Tex. Civ. Prac. & Rem. Code. The Bankruptcy Code gives a lien claimant the right to effectuate the equivalent of such a seizure under § 546(b)(1) and § 362(b)(3) by giving notice to the debtor and the court of the claimant’s assertion of such a right.

We conclude, therefore, that a mineral lien claimant who takes the proper steps and gives such notice has an interest in cash collateral.


Because the mineral lien claimant unquestionably has an interest in the underlying mineral estate owned by his customer, the lien claimant is entitled to adequate protection. Since production depletes the collateral during the pendency of the case, the mineral lien claimant could file a motion under § 362 to compel the giving of adequate protection. Depending upon the relative values, such a motion may achieve the same outcome as an interest in cash collateral, depending upon whether there is an adequate equity cushion or other alternative protection for the lien claimant’s economic interest.

Under either theory, whether an interest in cash collateral or via motion for adequate protection, we suggest that mineral lien claimants are entitled to a substitute lien in other assets of the estate to secure the amount of

diminution in value of their economic interest in the collateral, if any, during the pendency of the case.


The automatic stay of 11 U.S.C. § 362(a) does not prevent the filing of notices or affidavits that are a prerequisite to perfecting a statutory oil and gas contractor’s lien.\(^{141}\) The statutory basis for this rule is found in 11 U.S.C. § 362(b)(3) and § 546(b)(1). However, in order for the claimant to be able to file notice of perfection of the lien post-petition, it is necessary that state law provide that a bona fide purchaser for value be subject to such liens. The Mississippi lien statute, for example, provides that a BFP cuts off the rights of lien claimants until the lien affidavit is filed.\(^{142}\) For a lien filed against a Mississippi mineral property, therefore, § 362(a) of the Bankruptcy Code would likely prohibit the perfection of such a lien post-petition.


The time within which to file an action to foreclose a mineral contractor’s lien is tolled by 11 U.S.C. § 108(c).\(^{143}\)

\(^{141}\) *In re* Houts, 23 B.R. 705 (Bankr. W.D. Mo. 1982) (court holds that filing of mechanic’s lien statement was allowable in spite of the stay, though further enforcement of the lien was stayed.) See also *In re* Yobe Elec., Inc., 30 B.R. 114, 11618 (Bankr. W.D. Pa. 1983).

\(^{142}\) Mississippi Code Ann. § 85-7-131, 85-7-133 (1972).

\(^{143}\) Miner Corp. v. Hunters Run Ltd. P’ship (*In re* Hunters Run Ltd. Part’ship), 875 F.2d 1425 (9th Cir. 1989) (state law required claimant to file an action in state court to foreclose a lien or else lose it; the court holds that § 362(a) stayed any action to enforce a mechanic’s and materialman’s lien, and that 11 U.S.C. § 108(c) tolled the state law statute requiring suit to enforce same, so that the lien claim is still good); *In re* Morton, 866 F.2d 561, 566 (2d Cir. 1989) (holding that § 108(c) tolls New York’s 10-year period governing judgment liens on real property); *In re* Phillips Constr. Co., 579 F.2d 431, 4323 (7th Cir. 1978) (noting that *In re* Warren [cited below] is arguably distinguishable); Nash Phillips/Copus, Inc. v. El Paso Floor, Inc. (*In re* Nash Phillips/Copus, Inc.), 78 B.R. 798, 802 (Bankr. W.D. Tex. 1987) (defendant filed suit in Colorado to enforce a mechanic’s and materialman’s lien against property of debtor; found not permitted by § 546(b), and a violation of automatic
The time within which to file an action to foreclose a lien is not tolled by the predecessor to § 108(c), if the statute being proceeded under is one of duration rather than limitation.\textsuperscript{144} \textit{Warren} holds that a failure to file suit during bankruptcy causes the lien to be lost.

In the case of a unit in a jurisdiction that treats a unit as a cross conveyance, the lien would attach to the customer’s proportionate share of the unit that benefited from the services or materials. In some cases, a lien can attach to a “project” rather than a lease or a unit.\textsuperscript{145} “Where different lots or tracts of land are contiguous, and are treated as a single tract, the lien statutes do not require the affidavit and account to stipulate on which tract the material was delivered or used.”\textsuperscript{146} This exception has seldom been applied.

\textbf{§ 7.11. Whether a Mineral Contractor’s Lien Rights Will Act as a Defense to a Preference Action.}

It is common for a service company to receive payment for services and materials rendered during the period in which a lien affidavit could be filed and, as a result of payment, to forego the filing of the lien affidavit. In fact, it would be impermissible for the service company to state in an affidavit stay; defendant was protected by § 108(e) of Code and need not have filed suit to perfect its lien); \textit{In re} Cantrup, 38 B.R. 148 (Bankr. D. Colo. 1984) (filing notice of perfection of mechanic’s lien is all that is necessary. Filing suit is not necessary to perfect the lien); \textit{In re} Victoria Grain Co. of Minneapolis, 45 B.R. 2, 6 (Bankr. D. Minn. 1984) (“... filing of mechanics lien statement is perfection of a lien as that term is used in 11 U.S.C. § 546(b). However, clearly the commencement of foreclosure proceedings is something other than perfection of a lien . . . .”); \textit{In re} New England Carpets Co., 26 B.R. 934, 939 (Bankr. D. Vt. 1983). (§ 546(b) applies to perfection of lien only; enforcement is stayed by § 362); \textit{In re} Houts, 23 B.R. 705, 707 (Bankr. W.D. Mo. 1982) (§ 108(c) applies and § 546(b) does not because “[t]he courts distinguish, and properly so, between the act of perfecting the lien and the act of attempting to enforce it.”); \textit{In re} Design Builders, Inc., 18 B.R. 392, 39495 (Bankr. D. Idaho 1981); Garbe Iron Works, Inc. v. Priester, 99 Ill.2d 84, 75 Ill. Dec. 428, 431, 457 N.E.2d 422, 425 (1983) (§ 108(c) tolls Illinois mechanic’s lien enforcement period even though statute involved ‘not an ordinary statute of limitations since it conditions the right to enforce a mechanic’s lien and not just the remedy.’)

\textsuperscript{144} \textit{In re Warren}, 192 F. Supp. 801 (W.D. Wash. 1961) (applying § 11(f) of Act, which applied only to statutes of limitation); \textit{see} Miner Corp. v. Hunters Run Ltd. Partnership (\textit{In re} Hunters Run Ltd. Partnership), 875 F.2d 1425, 1426 and especially n.3 (9th Cir. 1989).

\textsuperscript{145} Oil Field Salvage Co. v. Simon, 168 S.W.2d 848, 853 (Tex. 1943).

\textsuperscript{146} \textit{Id.} at 853.
that the amount stated is due and unpaid (which is a prerequisite for such a lien) at a time when such statement would be false. Sadly, it also happens that the owner/operator may file bankruptcy within 90 days and create the issue of whether such payment is recoverable under 11 U.S.C. § 547(b)(4)(A) as a preference. Most practitioners will immediately note that if the service company was fully secured at the time of payment, then no preference can have been received because one of the elements of § 547 requires, in essence, that the payment be on an unsecured claim. (This is another way of viewing the requirement that the payment must have allowed the payee to have received more than he would have received in a chapter 7 liquidation. This is so because a secured creditor who receives a payment will always fail to satisfy the “more than he would have received” requirement.)

The problem arises because a service company, in order to be secured, has to file the lien affidavit. By not filing it, the service company arguably was never secured. Does the fact that the service company received payment within the period during which it had the statutory right to file the lien affidavit (and thus become secured) operate to shield the company from liability for receiving a preference under § 547? One reported decision held that payment in lieu of a lien right where the lien would have been against the debtor’s property is not a preference.147

In Cimmaron, certain consultants provided field service geological services to Cameron on two of Cameron’s wells. The court held that § 547(c)(6) prohibits the trustee from avoiding the perfection of a true statutory lien. The “fixing” that may not be avoided includes “transfers in satisfaction of liens.” “This interpretation of 547(c)(6), while faithful to congressional intent, obviates the commercially unreasonable consequences that could result if the trustee were permitted to pay for a lienor’s services, thereby precluding the perfecting of the lien, and later avoid the payments as preferences. It is also consonant with the Code’s intent in granting avoidance power to the trustee.”148

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148 Id.
Section 547(c)(6), as interpreted by the court today, does not permit the lien creditor to obtain from the debtor any greater interest than the creditor would otherwise have realized.\(^{149}\)

In *Baker Hughes Oilfield Operations, Inc. v. Cage (In re Ramba, Inc.)*, however, the Fifth Circuit rejected *Cimmaron*’s analysis as being contrary to the statute.\(^ {150}\) However, the court’s statement in *Baker Hughes Oilfield* may well be dicta. Other reported decisions have held such payments to be recoverable as preferences.\(^ {151}\)

Obviously, where the lien would be against property of a third party (that is, not property of the debtor), then the payment is not a preference.\(^ {152}\)

\(^{149}\) *Id.; see also* Rand Energy Co. v. Strata Directional Tech., Inc. (*In re* Rand Energy Co.), 259 B.R. 274 (Bankr. N.D. Tex. 2001) (preferential transfer could not be avoided by debtor where, if debtor had not paid creditor’s invoices, creditor could have perfected a statutory lien under state law); Weill v. Evans Lumber Co. (*In re Johnson*), 25 B.R. 889, 89294 (Bankr. E.D. Tenn. 1982) (payment of creditor who had a good lien claim was held not to be a preference); Ricotta v. Burns Coal & Building Supply Co., 264 F.2d 749, 75051 (2d Cir. 1959) (“Surely receipt of payment itself should not be less secure than the lien which could have secured it.”); interpreting Sec. 67(b) of the Bankruptcy Act; it is not clear from the decision who owned the property as to which the inchoate lien would have attached. However, the court does say: “Had the liens been filed, payment merely discharging them, without improving the creditor’s position as against the general creditors of the bankrupt, would likewise have been immune from attack.”); *Greenblatt v. Utley*, 240 F.2d 243, 247 n.10 (9th Cir. 1956) (credit which discharged unperfected mechanic’s lien on debtor’s property could not be avoided as a preference).

\(^{150}\) *Baker Hughes Oilfield Operations, Inc. v. Cage (In re Ramba, Inc.)*, 416 F.3d 394, 401 (5th Cir. 2005); *see also* St. Paul Travellers Ins. Co. v. Century Asphalt Materials, LLC. (*In re* Contractor Technology, Ltd.), 529 F.3d 313 (5th Cir. 2008) (Inchoate lien rights are not a defense and failure to comply with the lien statute timely is not excused by being paid. If lien claimant is sued for a preference and pays the preference back, the time to give notice and file a lien is not reinstated. There is no equitable tolling.).


\(^{152}\) 4 Collier on Bankruptcy, para. 67.22 n.17a p. 266267 (14th ed. 1978); Lang v. Heieck Supply (*In re Anderson Plumbing Co.*), 71 B.R. 19, 20 (Bankr. E.D. Cal. 1986) (“the payment by the contractor to the supplier holding a lien on third party’s property is not preferential and the release of the lien by accepting such payment constitutes a contemporaneous exchange of new value, giving rise to an affirmative defense as provided for in Section 547(c)(1).”);
A troubling case, finding an analogous payment to be a preference, is *Gulf Oil Corp. v. Banque de Paris et des PaysBas (In re Fuel Oil Supply and Terminaling, Inc.)*.\(^{153}\) *Fuel Oil Supply* is not specifically a mechanic’s and materialman’s lien case but letter of credit; however the reasoning is analogous because the letter of credit is similar to having a lien on property of a third party. *Fuel Oil Supply* specifically rejects *Henley* and *Advanced Contractors*.

The seminal case holding such payments to be a preference seems to be *San Mateo Feed & Fuel Co. v. Hayward*,\(^ {154}\) although that case is not truly a mechanics’ and materialmen’s lien case. In *San Mateo Feed*, the bankrupt was a plaster contractor who had received checks payable jointly to himself and materialmen who had furnished the bankrupt plastering materials for use in a building.\(^ {155}\) Within four months of bankruptcy the checks were delivered to the materialmen, thereby reducing the bankrupt’s indebtedness for the materials but also reducing by a like amount the materialmen’s acknowledged liens on the building of the writer of the checks.\(^ {156}\) Nevertheless, the court held the delivery of the checks to be preferential and recovery was

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\(^{153}\) *Gulf Oil Corp. v. Banque de Paris et des PaysBas (In re Fuel Oil Supply and Terminaling, Inc.)*, 72 B.R. 752, 757 (S.D. Tex. 1987), on appeal, 837 F.2d 224 (5th Cir. 1988).

\(^{154}\) *San Mateo Feed & Fuel Co. v. Hayward*, 149 F.2d 875 (9th Cir. 1945).

\(^{155}\) *Id.* at 875.

\(^{156}\) *Id.* at 876.
allowed.\textsuperscript{157} Greenblatt involved property of the bankrupt. The decision is written by Judge Afee, the author of the \textit{San Mateo Feed & Fuel} decision and distinguishes that case on the grounds that payment here did not come from property of the bankrupt.\textsuperscript{158}

\section*{§ 7.12. Plugging and Abandonment Obligations and Environmental and Site Restoration Obligations May (or May Not) Be Administrative Claims.}

So-called “end of life” liabilities associated with oil & gas properties have become a major issue in connection with energy cases. Offshore abandonment liability cases run into the tens of millions of dollars. The issue of who is the proper claimant and whether the “P&A” claim is entitled to administrative priority have become increasingly important.

In Texas, plugging and abandonment operations must be commenced on a well within one year from the date that drilling or operations cease.\textsuperscript{159} Although initially contingent, the obligation to plug and abandon a well comes into play when drilling operations are commenced. The parties obligated to pay the P&A and restoration costs are, at the first level, the operator, then the co-owners, and ultimately any predecessor owner. If one party pays the P&A cost, that party may or may not be entitled to indemnity or contribution from other parties who either are or were owners of undivided interests. The Texas Supreme Court decision in \textit{Seagull Energy E&P, Inc. v. Eland Energy, Inc.}\textsuperscript{160} raised a number of difficult issues by holding, in essence, that a party to an OA who had sold its interest to a third party may yet be liable for plugging & abandonment costs as to operations performed many years after its ownership terminated.

The Fifth Circuit, interpreting Texas law, has held that P&A liabilities are entitled to administrative claim priority if the liability accrued under

\begin{itemize}
\item\textsuperscript{157} \textit{Id.}, But see Greenblatt v. Utley, 240 F.2d 243, 247 n.10 (9th Cir. 1956) (credit which discharged unperfected mechanic’s lien on debtor’s property could not be avoided as a preference).
\item\textsuperscript{158} \textit{Greenblatt}, 240 F.2d at 247.
\item\textsuperscript{159} 16 Tex. Admin. Code § 3.14(b)(1) (2007).
\end{itemize}
state law (that is, if operations ceased either after the date of filing or less than one year prior to the date of filing). Applying the test of Reading Co. v. Brown, the court held that the plugging and abandonment was actual, necessary, and also “benefited” the estate. The court reasoned that a debtor (and trustee) must comply with state law and may not abandon property in contravention of a state law reasonably designed to protect public health and safety. Significantly, for our purposes, the trustee argued that the obligation to P&A a well arises as soon as it becomes unproductive, but this argument was rejected by the court based on a reading of the Texas statute. Rather, the court held as a matter of law that the obligation does not accrue until the passage of one year. The trustee also argued that the chapter 11 trustee never “operated” the wells, so that costs associated with the wells were of no benefit and were not necessary to his management of the estate. The court rejected this argument as well, saying “Again, Texas law directly dictates otherwise. . . . It matters not whether the bankrupt estate produced any oil or received any revenues from the wells. As the operator, it was required to plug them.”

One commentator has gone behind the opinion in H.L.S. Energy and found, from the briefs in the Fifth Circuit, that the Texas Railroad Commission had apparently entered a finding that the unplugged wells constituted an imminent danger to the groundwater and thus, the state used its own funds to plug the wells rather than wait for the debtor. The claim at issue was for reimbursement for costs the state had already incurred.

163 In re Transamerican Natural Gas Corp., 978 F.2d 1409, 1416 (5th Cir. 1992) (must benefit the estate).
166 In re H.L.S. Energy, 151 D.3d at 438 n.3.
167 Id. at 439.
168 Id. at 439.
Using the Rooker-Feldman doctrine, *D.C. Court of Appeals v. Feldman*\(^{170}\) and *Rooker v. Fidelity Trust Co.*\(^{171}\) that author believes the Fifth Circuit was bound by the Railroad Commission’s analysis and that the *H.L.S. Energy* decision thus follows the *Midlantic* line of cases “which finds that burdensome property may be abandoned by the debtor unless such property is in violation of laws or regulations designed to protect the public health and safety from imminent and identifiable hard and, in fact, imminent and identifiable harm is present.”\(^{172}\) While the background and findings of the Texas Railroad Commission may help explain the court’s decision, it must be noted that the Fifth Circuit decision did not mention those facts as being significant to its holding.

That said, it is significant that the *H.L.S. Energy* decision does not deal with the issue of whether a P&A claim arising prepetition would be accorded an administrative expense.

In the case of *In re American Coastal Energy Inc.*\(^{173}\) the court faced a claim for administrative expense filed by the Texas Railroad Commission for remediation of “environmental risks for which American Coastal had ongoing responsibility.”\(^{174}\) American Coastal’s obligation to plug and abandon the wells arose prepetition and the Railroad Commission expenditure occurred postpetition. In allowing an administrative expense, the bankruptcy court held:

> Because the debtor-in-possession is required to operate the estate in accordance with state law, post-petition expenditures necessary to bring the estate into compliance with the law are necessary for the debtor’s rehabilitation. The need to bring the estate into compliance with state environmental and safety laws is not less significant than the need to maintain commercial relations with trade creditors that

\(^{171}\) Rooker v. Fidelity Trust Co., 263 U.S. 413 (1923).  
\(^{172}\) *Residual Liabilities at the End of the Oil & Gas Lease: Who’s to Pay? (You Can Run, but You Can’t Hide)* (last viewed October 14, 2007).  
\(^{174}\) *Id.* at 807.
provide the raw materials of the debtor’s business. A debtor cannot operate an estate in violation of environmental and safety laws.175

Generally speaking, each owner in the chain of title is statutorily obligated to fulfill the plugging, abandonment, and site restoration obligations, regardless of current ownership and without regard to indemnities and releases granted at the time of a prior assignment. Bonds supporting the obligation to P&A the properties have value in that liabilities are reduced but they are not available for the payment of other types of claims.

A related issue is whether a debtor may abandon wells that are subject to P&A obligations. Judge Isgur of the Bankruptcy Court for the Southern District of Texas recently held in In re ATP Oil & Gas Corp.,176 that where the debtor had no funds to pay for the expensive abandonment of offshore wells but a predecessor in interest did, and the government supported abandonment, the debtor could abandon. The court noted that Midlantic is intended to protect the public’s health and safety, and “it would potentially violate Midlantic by requiring ATP to retain the [properties] when the United States has chosen an alternate course of action to protect the public health and safety.”177 That decision is on appeal.

§ 7.13. Defenses to Avoidance Actions Found in §§ 546(e), (f) and (g).

Sections 546(e), (f) and (g) of the Code immunize from avoidance actions all payments received from certain parties in connection with certain types of “protected” contracts.178 Many contracts for sale of oil or gas, for example, fall into the statutory definition of a “forward contract,” so that all “settlement payments” (another defined term) cannot be recovered, either as a preference or as a fraudulent transfer.

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175 Id. at 816.
176 In re ATP Oil & Gas Corp. (Bankr. S.D. Tex. 2013).
177 Id. at *3.
[1] — The Basic Immunization of § 546(e).

Section 546(e) provides that, subject to certain exceptions, the trustee may not avoid a transfer that is a margin payment or settlement payment made by or to, e.g., a forward contract merchant prior to the commencement of a bankruptcy case. Section 546(e) does not require that the subject margin payment or settlement payment be made “in connection with” a forward contract in order to obtain the benefit of its avoidance exemption.179 Rather, the key is whether the recipient is one of the protected categories including, inter alia, a “forward contract merchant,” and whether the payment or other transfer at issue is a margin payment or settlement payment.180 Additionally, the breadth of the § 546(e) exemption has been enhanced by the broad scope accorded the term “settlement payment” by the courts. The language of § 546(e) allows the margin payment or settlement payment to be made by the protected party (forward contract merchant, stockbroker, financial participant, financial institution, or securities clearing agency) to a third party, or by a third party to the protected party. The protected parties are exempted from the automatic stay and may offset the debtor’s margin payments against the losses of derivatives contracts.181


The Code defines “forward contract” as:

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

179 Id.
180 Id.
deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;

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

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

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

(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, . . . . 182


A “forward contract is a legal agreement to make or take delivery in the future,” usually involving fungible goods such as currencies and commodities.183 Parties use physical contracts, whether future or forward, to ensure delivery of a commodity they need at a certain price; actual delivery is the key. Early in the process, parties used future and forward contracts to protect against price fluctuation without intending to take actual delivery of the commodity. Financial contracts, whether future or forward, are used to protect against price fluctuation — a sort of insurance policy.

There is no “bright-line” distinction between forward and commodities contracts.\textsuperscript{184} Courts have, however, developed guidelines for characterizing a contract as a futures contract. A futures contract (\textit{i.e.}, a commodity contract for future delivery traded on a national or regional exchange) has four distinct traits: (i) it is standardized as to all terms other than price, (ii) it is freely transferable, usually on the same exchange, (iii) the market has a fixed location, and (iv) the conclusion of the contract seldom involves physical delivery.\textsuperscript{185} A forward contract is non-standard, may or may not be freely transferable, is traded over the counter (not on a fixed exchange) and may or may not require physical delivery.

There is also a difference in regulation of the forward contracts market and the futures market. The forward contracts market is largely unregulated. Its rules of construction and enforcement are drawn from the common law of contracts. In the United States, most regulatory provisions regarding commodities futures contracts are found in the Commodity Exchange Act, which is administered and enforced by the Commodities Futures Trading Commission.\textsuperscript{186} The futures market is also subject to self-regulation by the National Futures Association, an industrywide self-regulating entity authorized by Congress.\textsuperscript{187}

\section*{[4] — The Parenthetical Exception “Other than a Commodity Contract.”}

One problem in interpreting the legal definition of “forward contract” lies in the exception contained in the parenthetical “(other than a commodity contract).” The problem arises, in part, because the Code lacks a general definition of “commodity contract” and because, within the industry, the term “commodity contract” can mean a lot of things, including “on-exchange

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\textsuperscript{184} Commodity Futures Trading Comm’n v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982).
\textsuperscript{185} See generally Abrams v. Oppenheimer Gov’t Sec., Inc., 737 F.2d 582, 590-92 (7th Cir. 1984); and Shmuel Vasser, “Derivatives in Bankruptcy,” 60 Bus. Law. 1507, 1523-24 (2005).
\textsuperscript{186} 7 U.S.C. § 1 et seq.
\textsuperscript{187} Kline at 10; see Nat’l Futures Ass’n, http://www.nfa.futures.org (last visited October 5, 2013).
futures contract,” “off-exchange futures contract,” “forward contract,” or “contract for the purchase of a commodity (without regard to time).” The general definitions section, § 101 of the Code, has no definition of “commodity contract,” though there is a definition of “commodity contract” found in Chapter 7, Subchapter IV of the Code at § 761(4).

The definitional problem was addressed by the Fifth Circuit in In re Olympic Natural Gas Co., where the issue was whether the definition of forward contracts under the Bankruptcy Code encompassed off-exchange contracts for the commercial supply of commodities with a future delivery date (the Fifth Circuit held that it did) and whether Morgan Stanley was a forward contract merchant entitled to the safe harbor benefits (the court concluded it was). Morgan Stanley Capital Group, Inc. (Morgan Stanley) was a party to a Natural Gas Sales and Purchase Agreement (the “Contract”) with Olympic Natural Gas Co. and Olympic Gas Marketing, Inc. (collectively, Olympic). Under the Contract, each month the parties would enter into a series of individual transactions after agreeing on the price, quantity, timing, and delivery point for the natural gas. Because of the numerous transactions conducted each month and because Morgan Stanley and Olympic each would at different times act as buyer or as seller, the contract provided for a single net payment to be made in settlement of each month’s trading. After bankruptcy proceedings involving both Olympic entities were consolidated into a single Chapter 7 proceeding and a trustee was appointed, the trustee filed a complaint against Morgan Stanley seeking to recover $1.8 million in payments made within 90 days of the date of filing by Olympic to Morgan Stanley, arguing that the payments were avoidable as preferential transfers under § 547(b) of the Code. As a defense, Morgan

190 In re Olympic Natural Gas Co., 294 F.3d 737, 740 (5th Cir. 2002).
191 Id. at 739.
192 Id.
193 Id.
194 Id.
Stanley argued that the payments were settlement payments made by a forward contract merchant within the meaning of § 546(e) of the Code.\footnote{Id. at 739-40.}

The trustee argued that forward contracts under § 546(e) are limited to off-exchange \textit{financial} transactions, relying in large part on the legislative history.\footnote{In re Olympic Natural Gas Co., 294 F.3d at 742.} Thus, the trustee argued, because the Contract provided for physical delivery, it was not a § 546 forward (financial) contract but was rather an ordinary commodity (physical) contract that would be exempted from the definition of forward contract by the parenthetical in the first line “other than a commodity contract.”\footnote{Id. at 740.} The trustee argued that there are three types of contracts in the “world of commerce in commodities,” to wit: (1) future contracts (on-exchange financial instruments), (2) forward contracts (off-exchange financial instruments), and (3) ordinary commodity contracts such as the Contract between Morgan Stanley and Olympic.\footnote{Id. at 741.} Morgan Stanley argued that the parenthetical “other than a commodity contract” reinforces the established practice of distinguishing off-exchange forward contracts from on-exchange future commodities contracts.\footnote{Id.} Morgan Stanley also argued that the third category enunciated by the trustee, forward off-exchange financial contracts, does not exist as a distinct legal category, and that the second category, forward contracts, includes both financial and physical transactions.\footnote{Id. (citing 5 Collier § 556.02, 556-5 (providing “[t]hat the terms ‘commodity contract’ and ‘forward contract’, taken together, seamlessly cover the entirety of transactions in the commodity and forward contract markets, whether exchange traded, regulated, over-the-counter, or private.”)) (internal citations omitted).}

The Fifth Circuit agreed with Morgan Stanley and held that “the commodities market is divided into only two categories: (1) on-exchange futures transactions; and (2) off-exchange forward contracts.”\footnote{Id.} The Fifth Circuit further wrote that its interpretation is “in accord with the traditional
definition of ‘forward contract’” and rejected the assertion by the trustee that because the contract contemplated actual delivery, it was not a § 546(e) forward contract. The Fifth Circuit cited cases in other circuits for the proposition that one of the distinguishing characteristics of a forward contract is that the parties expect to make actual delivery.

A “forward contract merchant” is defined by the statute as:

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

Is a party to a forward contract, by definition, a forward contract merchant? In fact, the Fifth Circuit engaged in this precise analysis in In re Olympic Natural Gas Co., where the court seems to have decided that Morgan Stanley was a forward contract merchant with no more analysis than its having entered into a forward contract.

In In re Mirant Corp., the court considered the question more closely and found two relevant subparts to the definition, “business” and “merchant.” The court declined to focus on the nature of the contract but rather the nature of the business or trade being protected.

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202 Olympic, 294 F.3d at 741.
203 See, e.g., Nagel v. ADM Investor Servs., Inc., 217 F.3d 436, 441 (7th Cir. 2000); Commodity Futures Trading Comm’n v. Co Petro Mktg Group, Inc., 680 F.2d 573, 579 (9th Cir. 1982); Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983, 990 (8th Cir. 1999).
206 Olympic, 294 F.3d at 740-42.
207 In re Mirant Corp., 310 B.R. 548, 568 (“a forward contract merchant is a person that, in order to profit, engages in the forward contract trade as a merchant or with merchants.”).
[T]he Congressional purpose behind provisions dealing with forward contracts, . . . was not to affect a class of transactions (i.e., forward contracts), but rather was to protect certain persons (i.e., those engaged in the forward contract trade) and the market in which they were participants.208

Focusing first on “merchant,” the court found that “a merchant is one that is not acting as either an end-user or a producer. Rather, a merchant is one that buys, sells or trades in a market.”209 “Business,” of course, “is something one engages in to generate a profit.” As a result, in order to be a “forward contract merchant” the court concluded that one “must have entered into the Agreements as a participant seeking profit in the forward contract trade.”210

[6] — What Is a Settlement Payment?

The Code defines a “settlement payment,” for the purposes of the forward contract provisions, as

- a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.211

This circular and cryptic definition defies plain meaning.212 The first six examples tell us that a “settlement payment” is a “settlement payment.” The last phrase adopts the usage of the commodities industry in the forward contract trade. Recognizing this, many courts construing “settlement

208 Id. at 567.
209 Id. (The court analogized that Congress probably did not intend for a farmer to be classified as a forward contract merchant, notwithstanding that a farmer may often sell commodities into the forward contract market. Id. at 568 n.31.)
210 Id. at 570.
payment” have recognized that the statutory definition, though circular, is extremely broad.  

Many courts interpreting the meaning of “settlement payment” have analyzed the legislative history and the traditional working of the securities industry. In a simple example, a transfer of purchased securities to the purchaser constitutes a settlement payment, and a purchaser’s payment to the broker for securities purchased also would seem to easily fit the definition of settlement payment.

Most of the reported decisions interpreting “settlement payment” arise in the context of an avoidance action because §§ 546(e) and (f) provide a defense if the transfer sought to be avoided is a settlement payment made by or to a “commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency,” or if made by or to a repo participant. This defense to an avoidance action is commonly known as the “stockbroker defense” and there are numerous reported decisions regarding the extent of its application.

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213 E.g., Bevill Bresler & Shulman Asset Mgmt. Corp. v. Spencer Sav. & Loan Ass’n, 878 F.2d 742, 752 (3d Cir. 1989) (settlement payment includes any transfers that occur during the settlement process); but see Enron Corp. v. Bear Stearns Int’l Ltd. (In re Enron Corp.), 323 B.R. 857, 864, 866, 870 (Bankr. S.D.N.Y. 2005) (focusing on “or any other similar payment commonly used in the securities trade” as a basis for discerning the meaning of “settlement payment”).

214 Bevill Bresler & Shulman Asset Mgmt. Corp., 878 F.2d at 747. (extensive discussion of industry at 745-47 and legislative history at 746-49); Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846. 849 (10th Cir. 1990) (discussion of industry); In re Adler, Coleman Clearing Corp., 263 B.R. at 406, 475-76 (examination of purpose of statute and usages of the industry); Zahn, 218 B.R. at 675 (discussion of industry); Raleigh v. Schottenstein (In re Wieboldt Stores, Inc.), 131 B.R. 655, 664-65 (N.D. III. 1991) (examination of legislative history, and discussion of “clearance and settlement” system; see especially nn. 9-10).

215 Bevill, Bresler & Schulman, 878 F.2d at 751 (“Delivery of the securities was part of the settlement process, and thus constitutes a ‘settlement payment’ for purposes of section 546(f).”). See Cohen v. Sav. Building & Loan Co. (In re Bevill, Bresler & Schulman Asset Mgmt Corp.), 896 F.2d 54, 61 (3d Cir. 1990) (transferring securities to a safekeeping account for a purchaser is a settlement payment); but see Edelsberg v. Thompson v. McKinnon Sec., Inc. (In re Edelsberg), 101 B.R. 386, 389 (Bankr. S.D. Fla. 1989) (execution on judgment arising from a debt for settlement amounts owed is not a settlement payment).


In *Kaiser Steel Corp.*, the Tenth Circuit held that a payment made to a shareholder in connection with a leveraged buy-out (LBO) was a settlement payment and thus received the exemption of the safe harbor.218 In reaching this decision, the court said “[t]he definition in § 741(8), while somewhat circular, is ‘extremely broad,’ . . . in that it clearly includes anything which may be considered a settlement payment.”219 The court also noted that

[I]nterpreting “settlement payment” to include the transfer of consideration in an LBO is consistent with the way “settlement” is defined in the securities industry. Settlement is “the completion of a securities transaction.”220

In the case of *In re Resorts Int’l, Inc.*, the Third Circuit joined the Tenth in holding that payments to tendering shareholders in an LBO are settlement payments.221

Notwithstanding the broad statutory definition of “settlement payment,” some courts, including the Eleventh Circuit, have concluded that exempting payments and transfers to shareholders made in connection with a purely private transaction, such as an LBO, does not implicate the national securities markets or the clearance and settlement system and therefore is not the kind of “settlement payment” intended to be protected by § 546(e).222

218 *Kaiser Steel Corp.*, 913 F.2d at 850; see also *Kaiser Steel Corp. v. Pearl Brewing Co.* (*In re Kaiser Steel Corp.*), 952 F.2d 1230, 1237 (10th Cir. 1991), cert. denied sub nom. *Kaiser Steel Res. Inc. v. Pearl Brewing Co.*, 505 U.S. 1213 (1992) (in holding LBO payments to be settlement payments, the court said: “The clear aim of the definition is to encompass all ‘settlement payments’ commonly used in the securities trade.”); *see also* *Lowenschuss v. Resources Int’l, Inc.* (*In re Resorts Int’l, Inc.*), 181 F.3d 505, 515 (3d Cir. 1999); and *Official Committee of Unsecured Creditors v. Clark* (*In re National Forge Co.*), 344 B.R. 340, 351 (W.D. Pa. 2006).

219 *Kaiser Steel Corp.*, 913 F.2d at 848.


221 *In re Resorts Int’l, Inc.*, 181 F.3d 505, 516 (3d Cir. 1999) (“A payment for shares during an LBO is obviously a common securities transaction, and we therefore hold that it is also a settlement payment for the purposes of section 546(e).”); *see also* *In re National Forge Co.*, 344 B.R. at 351.

Illustrative of the reasoning in these cases is that of the court in *Wieboldt Stores*:

In the instant case, however, requiring the Trump defendants (or other Wieboldt shareholders) [LBO sellers] to return to the Trustee payments they received from WSI [LBO purchaser] through Harris Bank [the clearing agent] poses no significant threat to those in the clearance and settlement chain. Neither Harris nor any other financial intermediary purportedly involved in the clearance and settlement process would be meaningfully affected by such a judicial order.\(^{223}\)

As indicated in the language of the *Wieboldt* court, these cases focus on the involvement of the securities markets or the financial clearing system in order to qualify as a settlement payment. Similarly, several reported decisions have focused on the importance of protecting the national capital markets and financial clearing systems while resolving the tension between Chapter 5 avoidance actions and the safe harbors of § 546(e), (f).\(^{224}\)

In § 546(e), Congress recognized that the unwinding of settled securities transactions could create an environment hostile to capital formation, engendering diminished investor confidence, as well as increased costs and volatility of transactions in capital markets. To that end, strong policy reasons favor a statutory reading of settlement payments that protects participants in the securities markets and

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Dimensions Group v. Munford, Inc., 522 U.S. 1068 (1998) (“Here, the transfers/payments were made by Munford to shareholders. None of the entities listed in section 546(e) . . . made or received a transfer/payment. Thus, section 546(e) is not applicable.”) (emphasis in original); Buckley v. Goldman, Sachs & Co., No. Civ.A.02-CV-11497RGC, 2005 WL 1206865 (D. Mass. 2006) (following *Zahn*, the court does not apply 546(e) to LBOs; finds no implication of public clearing system); *Zahn*, 218 B.R. at 677 (D.R.I. 1998) (“It thus appears highly unlikely that Congress would intend these transfers to be covered as ‘settlement payments.’”); *In re Healthco Int’l*, 195 B.R. at 983 (“The payment to [Defendant] was a one-time distribution in complete liquidation of its stock interest. These circumstances, particularly where there is no showing of a guaranty by a securities clearing agency, are not what Congress had in mind in enacting section 546(e).”).

\(^{223}\) *In re Wieboldt Stores, Inc.*, 131 B.R. at 664-65.

\(^{224}\) *Bevill, Bresler*, 878 F.2d at 751; *Adler, Coleman*, 263 B.R. at 479; *Jewel Recovery, L.P.*, 196 B.R. at 353 (“[A]pplying the plain language of § 546(e) to this private transaction conflicts and is inconsistent with Congress’ statutory scheme in Chapter 5 of the Code.”).
promotes finality of securities transactions, as a counterbalance to safeguarding the interests of creditors. At the same time, the spirit that infuses the whole of SIPA and the Bankruptcy Code is Congress’s determination, reflected in a trustee’s avoidance powers under § 548 as well as SIPC Rule 300.503, that “a few individuals should not be allowed to benefit from transfers by an insolvent entity at the expense of the many. Rather, Congress intended equal shares of the bankruptcy estate for creditors of equal rank.”

One court held that in order for a payment to qualify “as a settlement payment protected by § 546(e)” such payment must be “common within the securities trade.”

In any event, the tension between the trustee’s avoiding powers contained in Chapter 5 of the Code and Congressional policy manifested in § 546(e), (f) (including the extent of the reach of the definition of “settlement payment”) is exemplified by payments to shareholders in a private LBO.

The plain language of § 546(e) would appear to apply to this transaction. . . . [but] [t]he . . . transaction was a private transaction which did not implicate the clearance and settlement process.

In In re Olympic Natural Gas Co., the Fifth Circuit concluded that monthly contract payments constituted “settlement payments” under § 101(51A). In reaching its decision, the court reasoned that “’settlement payment’ should be interpreted very broadly” and rejected the trustee’s argument that in order to be exempt from avoidance, a settlement payment must be made on a financial derivative contract and be cleared through a centralized system.

225 Adler, Coleman, 263 B.R. at 479.
226 Enron Corp. v. J.P. Morgan Sec., Inc. (In re Enron Corp.), 325 B.R. 671, 677 (Bankr. S.D.N.Y. 2005) (with respect to early payment of commercial paper, court found a fact issue as to whether “common within the securities trade,” justifying denial of summary judgment).
228 In re Olympic Natural Gas Co., 294 F.3d at 742.
229 Id. (citing Kaiser Steel Corp., 952 F.2d at 1240). See also In re Resorts Int’l, Inc., 181 F.3d at 515 16 (holding that payment for securities made in conjunction with a leveraged buyout is a settlement payment, regardless of whether a clearing agency was involved).
In summary, the Third, Fourth, Fifth, and Tenth Circuits, as well as the Bankruptcy Court for the Southern District of New York, interpret “settlement payments” broadly and do not require the implication of national securities markets or clearing systems, whereas the Eleventh Circuit utilizes a more restrictive definition and requires the involvement of securities markets and financial clearing systems.\footnote{Hutson v. E.I. du Pont de Nemours and Co. (In re Nat’l Gas Distrib., LLC), 556 F.3d 247, 257 (4th Cir. 2009); In re Resorts Int’l, Inc., 181 F.3d 505 (3d Cir. 1999); Olympic Natural Gas, 294 F.3d 737, cited in Lightfoot v. MXEnergy Elec. (In re MBS Mgmt. Servs., Inc.), 690 F.3d 352, 356 (5th Cir. 2012); In re Kaiser Steel Corp., 952 F.2d 1230 (10th Cir. 1991); Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846 (10th Cir. 1990); In re Munford, Inc., 98 F.3d 604 (11th Cir. 1996); Buchwald v. Williams Energy Mktg. & Trading Co. (In re Magnesium Corp. of Am.), 460 B.R. 360, 374 (Bankr. S.D.N.Y. 2011).} The Ninth Circuit interprets “settlement payment” broadly, but has not addressed the issue of whether securities markets or clearing systems are essential.\footnote{In re Comark, 971 F.2d 322 (9th Cir. 1992).}