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U.S. Energy Sector: Annus Horribilis, Part II

Investors Face Heightened Risk, Uncertainty in Troubled Oil & Gas Industry

Options for Bankruptcy Trade Claim Investing Fit Varying Risk Appetites

CRITICAL CONSIDERATIONS FOR ASSESSING, INTEGRATING DISTRESSED COMPANIES

2016 Holds Opportunities for Resourceful Distressed Investors

BY BRADFORD J. SANDLER, JANUARY/FEBRUARY GUEST EDITOR

Bradford J. Sandler is co-chair of Pachulski Stang Ziehl & Jones' national Committee Practice Group and maintains a national practice representing debtors, committees, acquirers, and other significant parties in complex reorganizations and financially distressed situations, both in and out of court. He is listed among both "The Best Lawyers in America" and "Delaware Super Lawyers" in bankruptcy and creditor-debtor rights; is ranked among the top bankruptcy attorneys by *The Deal*; holds an AV Preeminent Peer Rating from Martindale-Hubbell; and is ranked among Bankruptcy/Restructuring attorneys by *Chambers USA*.

Challenges present opportunities, and there will be many challenges in 2016 providing for creative distressed investment opportunities. The challenges range from rising interest rates and lower commodity prices to geopolitical risks and a global economic slowdown. Some of these challenges will have a greater impact on specific industries, like oil and gas, mining, and retail. For distressed investors with liquidity, creative and strategic guidance, and perhaps a strong constitution, there will be opportunities to generate enviable returns on investment. Our focus in this edition of the *JCR* is on distressed investing, and we present a broad range of articles that provide a glimpse of what we may see in 2016.

Our issue begins with Dave MacGreevey and Eric Koza at Zolfo Cooper discussing the critical considerations for assessing investment in distressed companies. They take the reader through the process of due diligence, operational integration, and post-closing issues.

We then turn to two related, but separate, articles on the oil and gas industry, which is expected to continue to be a source of opportunities for distressed investors. The first article is by Steve Simms and Albert Conly at FTI Consulting and focuses on the economic state of the oil and gas industry and the impact on the leverage loan market for energy companies. They conclude by predicting the macroeconomic outlook for global energy for 2016.

From this macroeconomic perspective on global energy, we then turn to the microeconomic impact on investors of troubled E&P companies in particular. I am a firm believer that liquidity challenges for companies can lead to significant returns for creative and opportunistic distressed investors. In an article by yours truly, I discuss that while there will be opportunities for distressed investors in E&P companies, those investors must analyze potential risks and uncertainties that can arise in a bankruptcy scenario to help protect their investment.

We next turn to an article on claims trading. Rob Axenrod of CRG Financial focuses on the risks and rewards of bankruptcy claims trading with concrete examples of strategic investment strategies. He shows that the old adage holds true that increased risk leads to potentially increased rewards in this sophisticated arena.

Finally, we conclude with Jay Goffman of Skadden analyzing the high-profile decisions focusing on the Trust Indenture Act issued by the U.S. District Court for the Southern District of New York. He also discusses potential legislative changes and the impact these cases could have for distressed investors.

We concisely cover some timely areas of distressed investing, and on behalf of all of us at the TMA, I hope that you enjoy and find useful this edition of the *JCR*.

Investors Face HEIGHTENED RISK, Uncertainty in Troubled Oil & Gas Industry

BY BRADFORD J. SANDLER,
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The U.S. oil and gas industry has continued to suffer substantial distress this year, with oil prices falling below $35 per barrel. Since late 2014, the industry has grappled with both severely depressed oil prices and burdensome debt levels. Global oil prices began trending lower in summer 2014 as a result of a confluence of slowing global economic growth and excess supply, but prices plummeted in late 2014. During the fourth quarter of 2014, the price per barrel of crude oil declined 40 percent; the West Texas Intermediate (WTI) dropped from approximately $92 per barrel to approximately $55 per barrel. The following year brought no relief as oil prices continued their downward slide, causing the energy sector to account for approximately 30 percent of rated corporate debt defaults as of September 2015.[1]

The declining oil prices have caused many oil and gas exploration and production (E&P) companies to become overlevered and face liquidity

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challenges. E&P companies naturally have taken some measures in response. Many of them scaled back planned exploration activity. Further, E&P companies largely rely on third-party service providers and suppliers to carry out certain critical activities, and some E&P companies have been successful in reducing operating expenses.

However, an increasing number of E&P companies have filed for bankruptcy protection, and others experiencing operational and financial distress may soon follow suit. While operational and financial turnarounds can help E&P companies, real relief will come from higher oil prices. Some analysts believe that, in the longer term, crude oil prices will stabilize at substantially higher than current prices, but few analysts expect a quick reversal.[2] This author believes that absent a geopolitical event, there is no reason to believe that oil prices will materially increase in the short term.

In this challenging climate, creative distressed investors will find a multitude of opportunities to provide solutions to distressed E&P companies, but they must be mindful of a myriad of financial, operational, and legal concerns to maximize their returns. Often investors in a distressed E&P company can strategically work in concert to preserve value by forcing an operational improvement, an accommodation, a deleveraging, or some combination of them.

Out-of-Court Considerations

A distressed E&P company could try to obtain various accommodations, which might include an extension of its debt maturity timetables, reduction of interest expenses, and obtaining more flexibility with regard to debt/interest payment schedules, potentially by offering better terms or new/additional security. However, there are various difficulties and problems with such options. For instance, in respect to existing credit facilities, any such modifications will generally require 100 percent or substantial majority lender consent and payment of substantial lender fees.

In many cases, lenders may not be willing to consider potential material modifications. E&P companies typically rely on reserve-based credit facilities for their working capital needs and to fund their exploration and development projects. Availability under such facilities is allowed up to a borrowing base set by lenders considering, among other things, the value of the borrower's "proved" oil and gas reserves. Generally, proved reserves have at least some level of certainty of recoverability, while unproved reserves are too speculative to form the basis for reserve-based lending.[3]

Reserve-based facilities typically require scheduled redeterminations, as well as special redeterminations, of the borrowing base. In times of steep price declines, like the current environment, most E&P companies' availability for additional borrowings under their credit facility will be reduced as the value of proven reserves shrinks, and there even may be a borrowing base deficiency that could trigger a requirement that the borrower pledge additional collateral, which it may not have, or pay down the debt, causing a liquidity crisis.

To the disadvantage of the borrower, the value of oil and gas reserves is far more subjective and variable than the value of traditional asset-based credit facility inventory like consumer goods and raw material, the value of which can be estimated within a relatively narrow range. Lenders under a reserve-based facility usually exert more control over the process that determines the borrowing base.[4]

It remains to be seen how lenders will continue to respond to the financial difficulties facing E&P companies, whether they will aggressively reduce borrowing bases that will further tighten borrower liquidity or will be willing to waive or suspend financial covenant violations and be more flexible in trying to ride out this period of depressed energy prices.

Potentially, other and more-creative alternatives can be analyzed and recommended to E&P companies, such as refinancings (new bank debt and/or securities), junior lien debt, asset sales, and exchange offers. But the availability, prospects, and net benefits of such alternatives may be limited in many cases, given the largely pessimistic outlook for the oil & energy industry.[5]

Involuntary, Premature Bankruptcy Filings

A never-ending risk for distressed E&P companies is that their creditors may force a premature insolvency proceeding by bringing an involuntary bankruptcy proceeding. For example, in August 2015, creditors filed an involuntary Chapter 11 petition in U.S. Bankruptcy Court for the District of Alaska against Cook Inlet Energy, an Alaska-based oil and natural gas production company; the company later consented to the bankruptcy and various affiliates also filed for bankruptcy protection.

In addition, in November 2015 certain creditors filed in U.S. Bankruptcy Court for the Northern District of Texas an involuntary petition against one of the operating subsidiaries of Energy & Exploration Partners Inc., an oil and natural gas exploration and production company with total estimated proved reserves of 43,420 thousand barrels of oil equivalent. There, too, the company ultimately consented to the bankruptcy filing.

On the reverse side of an involuntary bankruptcy case, it is conceivable that the E&P company itself may voluntarily file for bankruptcy protection, even though, for example, the company may have substantial cash holdings or its notes may not mature for several years. Unless the bankruptcy filing was prenegotiated with investors, investors may believe that any such filing is premature and unwarranted. In such a case, unless there are requirements in the company's corporate charter or other governing documents for lender/investor consent, investors may have little recourse against the company and its board.

A potential remedy for investors with respect to a premature bankruptcy, aside from a good old-fashioned valuation or challenge or the like, is filing a derivative action against the company's board.[6] However, asserting that the board violated its fiduciary duties would likely be a challenging argument unless the board patently shirked its responsibilities and cursorily directed a bankruptcy filing without meaningful input from the company's insolvency counsel and other advisors (an unlikely occurrence in the case of a large E&P company with generally competent management and advisors) or the board is unable to articulate any reasonable financial, business, or operational need for bankruptcy protection (also an unlikely situation in most cases).

The case law precedents dealing with bad faith bankruptcy filings may be relevant to a possible attack on an allegedly premature bankruptcy filing. Although the analysis is

highly dependent on the particular circumstances at hand, various cases suggest in the context of Bankruptcy Code Section 1112 dismissal motions that a relatively stable company with only speculative, future concerns should not file a Chapter 11 petition.[7] On the other hand, substantial case law exists supporting the argument that potential future difficulties may justify a Chapter 11 filing by a solvent, ostensibly stable company, depending on all of the circumstances.[8]

Even if no bad faith filing motion is filed in the E&P company's bankruptcy case, any fiduciary breach action would have to surmount the application of the highly deferential business judgment rule.[9] The company's board could be further shielded by exculpatory provisions in the corporate charter, unless there is evidence of self-dealing, conflicts of interest, or the like.[10] In short, subject to the particular case's circumstances, it is very possible that the E&P company's board would (absent self-dealing or director conflicts) be protected from liability in a fiduciary breach action, assuming that the board undertook a reasonable decision-making process and can proffer reasonable financial and business justifications for the Chapter 11 filing.

The Bankruptcy Process

Depending on the E&P debtor's particular circumstances, while there certainly may be some significant benefits that may be obtained through an in-court insolvency proceeding, there are also some areas of uncertainty in the law and other risks that may hinder the debtor's reorganization efforts.

Automatic Stay. Upon the filing of a voluntary petition, the debtor and its operations are generally protected by imposition of the automatic stay under Bankruptcy Code Section 362; however, some creditors (depending on their circumstances and the action at issue) may be exempt from the automatic stay. For example, some oil and gas leases provide for automatic termination for unpaid royalties. When the conditions for termination are triggered pre- or post-bankruptcy, a royalty owner may seek relief from the stay or possibly a comfort order finding the applicable lease terminated.

Further, royalty owners in some jurisdictions, like Texas, are protected by state statute as automatically perfected secured creditors. Other creditors of an E&P debtor may also have statutory or contractual lien rights (for example, lien rights may arise under some joint operating agreements). Exceptions to the automatic stay and a debtor's lien avoidance powers (*e.g.*, Sections 362(b)(3) and 546(b)) also may potentially allow post-petition perfection of such rights under applicable non-bankruptcy law.

Moreover, the automatic stay generally does not apply to creditors' rights of recoupment. Recoupment—the netting of obligations within the same transaction—does not require relief from the stay. Many courts, however, take a restrictive view of recoupment, especially in requiring a single integrated transaction or single operative set of facts.

In contrast, a creditor will need relief from the stay to exercise rights of setoff, which is an equitable right of a creditor (under common, state, or

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non-bankruptcy federal law) to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction, provided that the offsetting debts are "mutual" (*i.e.*, debts between the same parties standing in the same capacity) and both arose prepetition (or post-petition).

However, typically bankruptcy courts will not allow triangular setoffs involving the creditor and more than one debtor, a situation that often arises under master netting agreements in oil and gas cases. Within the oil and gas industry, parties frequently negotiate for the right to offset debts owed to corporate affiliates with debts owed by different corporate affiliates through such agreements. Because of the lack of mutuality, setoffs under master netting agreements will likely not be permitted in the E&P debtor's case.[11]

Additionally, the automatic stay does not prevent creditors of the E&P debtor from demanding reclamation of goods provided to the debtor within 45 days of the bankruptcy filing, subject to the requirements set forth in code Section 546(c). Relatedly, such creditors will also be able to file administrative claims on account of goods received by the debtor within 20 days of the bankruptcy filing pursuant to Section 503(b)(9), which is another factor that must be considered carefully and analyzed by investors to understand the cost and impact of a bankruptcy filing.

Exclusion from the Bankruptcy Estate. The impact of Section 541(b)(4) may also be salient and affect the E&P debtor's bankruptcy efforts. That statute excludes from property of the bankruptcy estate any interest of the debtor in oil and gas that the debtor has transferred, or agreed to transfer, pursuant to a "farmout" agreement.

The Bankruptcy Code defines farmout agreements as those in which the owner of a right to drill, produce, or operate liquid and gaseous hydrocarbons on property (often referred to as the "farmor") agrees to transfer or assign all or a part of such right to another party (the "farmee"). The other party, as consideration, agrees to perform the drilling, reworking, recompleting, testing, or similar or related operations to develop or produce liquid or gaseous hydrocarbons on the property. Moreover, a production payment that meets the code's definition is not a part of the bankruptcy estate.

In a common farmout arrangement in the oil and gas industry, the farmee drills a well and upon completion earns a percentage of the acreage and additional rights; title remains in the name of the farmor pending the farmee's completion of the contractual obligations. The Bankruptcy Code thus prevents a debtor-farmor from withholding from a non-debtor farmee an assignment of an interest in the property that has otherwise been earned by the farmee under the farmout agreement.

Applicability of Section 365. Additional risks exist with respect to the potential treatment of oil and gas leases in a bankruptcy case. For example, the law is not settled as to whether oil and gas leases are true leases or executory contracts under the Bankruptcy Code.[12] Oil and gas leases are the asset base on which an E&P company is valued.[13] Generally, the classification of a specific oil and gas lease depends on state law property rights and on what interests are being conveyed under the particular agreement as interpreted under state law, as well as potentially what the parties' ongoing obligations are under the agreement.

Some courts applying state law have held that oil and gas leases are unexpired leases or executory contracts subject to Section 365.[14] Other courts applying state law have held that a mineral interest lease is neither a lease nor an executory contract.[15] Some commentators have remarked that in most oil and gas producing states, an oil, gas, and/or mineral lease conveys a real property interest to the lessee, and thus, such a lease creates a presently vested interest in real property that is not subject to Section 365.

In contrast, the U.S. government has taken the position in some cases that federal oil and gas leases are subject to Section 365.[16] This critical issue is one that any distressed investor must understand and analyze thoroughly so that a proper risk profile can be assigned to the E&P investment.

As to an E&P company's joint operating agreement, in most cases (subject to the specific contract at issue) such agreements likely will be determined to be executory contracts subject to Section 365. A joint operating agreement is an agreement that splits the working interests among multiple E&P companies either as "operators" or non-operators in respect to oil and gas operations in certain specified lands. Because typically exploration, development, and/or production is ongoing on the properties and unperformed duties remain (the lack of performance of which would constitute a material breach), such agreements would likely fall within the ambit of Section 365.

Classification of an oil and gas agreement as falling within the scope of Section 365 affects, among other things, whether (i) the agreement may be assumed or rejected as a general matter; (ii) the timing of assumption or rejection (*e.g.*, if the agreement is a true lease of real property, there is a 210-day maximum time limit; if it is an executory contract, it must be assumed/rejected by plan confirmation); (iii) the necessity of curing prepetition defaults if assumed by the debtor; (iv) the requirement to pay unsecured rejection claims, if rejected; and (v) the requirement of providing adequate assurance of future performance to the non-debtor party if the agreement is assumed.

Finally, even if a particular oil and gas agreement is subject to Section 365 and can be rejected or assumed, it is important to note that, depending on the specific contract and situation at issue, the effects of such rejection or assumption may not be as sweeping as desired by the debtor and its stakeholders. For instance, some operating agreements may create contractual lien rights, and such rights may be preserved notwithstanding the rejection of the operating agreement by a non-operator debtor. However, such liens will not be binding on third parties unless certain steps are taken under applicable non-bankruptcy law (*e.g.*, recording of the operating agreement or memorandum thereof).

Abandonment, Plugging, Compliance with Non-Bankruptcy Laws/Regulations. Another potentially significant concern in bankruptcy proceedings may be the E&P company's ability (or inability) to abandon unproductive or unnecessary oilfields and other facilities. Plugging and abandonment (P&A) claims are common in oil and gas bankruptcy cases. Generally, under federal and state laws, E&P companies are required to plug and abandon a well after drilling or production ceases. Under federal law, oil and gas companies operating

offshore on the Outer Continental Shelf (OCS) are required to plug and remove all structures on a lease within certain time periods after the end of production.

Conceivably, rather than undertaking P&A measures, a debtor oil and gas company could try to abandon the well, site, or other facility pursuant to Bankruptcy Code Section 554. Some courts have allowed abandonment, regardless of non-bankruptcy environmental laws and regulations, when no "imminent" or "immediate" identifiable threat was posed to public health and safety, especially if the debtor lacks sufficient unencumbered funds to do the remediation itself.[17]

However, there is substantial authority to the contrary, which is in line with the general requirement that Chapter 11 debtors continue to operate and manage their assets, requiring compliance with environmental obligations under applicable federal, state, and local laws and regulations.[18] Moreover, depending on the circumstances of the particular oil well, site, or other facility, substantial or nearly substantial compliance with applicable non-bankruptcy laws may be required in any event to eliminate an imminent or immediate risk to public safety.[19]

In all likelihood, as a practical matter, if the debtor lacks sufficient resources to do so or otherwise fails to do so, some party (including, for instance, governmental authorities or other parties in the chain of title) will undertake to plug a debtor's oil wells or otherwise remediate the debtor's oil and gas facilities as a matter of public health and safety, and may assert administrative priority claims against the estate on account of such actions.[20] Whether a particular P&A claim is entitled to administrative priority may depend on applicable non-bankruptcy law and when the liability arose thereunder.[21]

Closing Thoughts

This article only skims the surface of the litany of legal, business, and operational concerns that investors in E&P companies must consider to understand the risk profile of their investment. Given the current economic conditions and the short-term outlook for the oil and gas

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industry, there likely will be continued distress in the industry that will present both opportunities and challenges for investors. The substantial uncertainties at play (economic, financial, business, and legal) require investors to become familiar with the potential salient issues to best protect their investments as more E&P companies file for or are thrust into bankruptcy. ■

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[1] As observed by some commentators, much of the prior oil and gas boom was debt-financed (often in the form of junior lien and unsecured bonds). See, *e.g.*, Carroll & Yozzo, "The New Energy Crisis: Too Much of a Good Thing (Debt, That Is)," 34-3 ABIJ 14, 15 (March 2015) ("Total debt associated with these E&Ps currently tops $285 billion, compared to $125 billion in 2007. More broadly, the U.S. energy sector constitutes just 8 percent of the S&P Composite 1500 Index, yet accounts for nearly 20 percent of all U.S. high-yield debt.").

[2] The World Bank and IMF in their respective October 2015 reports anticipated further, relatively slight, crude oil price declines in 2016.

[3] See J. Tracy, "E&P Restructurings Turn on State Law Property Rights, Collateral Documentation and Lien Perfection," Debtwire (Nov. 19, 2015), p. 2 (describing three categories of proved reserves).

[4] See "The New Energy Crisis," pp. 82-83.

[5] One 2015 analysis (based on SEC filings, press releases, management presentations, and other sources) identified out-of-court transactions (primarily debt or equity exchanges or repurchases consummated through October 2015) involving only approximately 10 E&P companies (although some such companies engaged in multiple transactions). See E&P Restructurings, Annex B. In respect to asset sales (another way to expeditiously raise funding), the net benefits thereof may be limited in many cases. See, *e.g.*, C. Poole, "How Many More Oil & Gas Companies Will File for Bankruptcy?" available at www.thestreet.com, Sept. 25, 2015 (noting E&P companies EnCana, W&T Offshore, and Alta Mesa Holdings sold hundreds of millions of dollars of assets in 2015; "the spread between how much a company wants to sell assets for and what the buyer is willing to pay is still wide"; quoting analysts as opining "The name of the game today is extending liquidity" and "We don't see asset sales solving some capital structures, making bankruptcy likely.").

[6] Any action by shareholders or creditors alleging breach of fiduciary duty would be a derivative action. See, *e.g.*, *Kramer v. Western Pacific Industries, Inc.*, 546 A.2d 348, 353 (Del. 1998). If the E&P company were to file a bankruptcy petition, any such claims would become property of the bankruptcy estate and would have to be prosecuted by the debtor in possession (or trustee, if one was appointed) or other special party (like a creditors' committee) that receives court authority and standing to bring such action on behalf of the estate. See, *e.g.*, *In re The 1031 Tax Group, LLC*, 397 B.R. 670, 680-81 (Bankr. S.D.N.Y. 2006); *Unsecured Creditors Comm. v. Noyes (In re STN Enterprises, Inc.)*, 779 F. 2d 901, 905 (2d Cir. 1985) (creditors' committee can initiate actions on behalf of estate where, among other things, debtor unjustifiably refuses to bring suit and claim for relief is colorable). We note that various organizational forms and vehicles are used in the energy sector aside from corporations, which forms could be subject to different standards of liability and court review. For instance, generally, Delaware limited partnerships are contractually permitted to expand, restrict, or eliminate fiduciary duties in their partnership agreements, and thus the viability of any investor's action for a premature bankruptcy filing would depend on, among other factors, the applicable provisions of the operative governance documents.

[7] See, *e.g., In re Liberate Technologies*, 314 B.R. 206 (Bankr. N.D. Cal. 2004) (while solvent debtor had unsuccessful business, large losses, and several pending lawsuits, it had a large amount of unrestricted cash sufficient to pay its liabilities; the case was dismissed as bad faith filing; an apparently attractive sale option, outside of bankruptcy, was available to debtor as well; the alleged risk of potential continuing business losses in the future was not an adequate basis for filing); *In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3d Cir. 2004) (Chapter 11 case of solvent debtor with substantial cash holdings, even though it was losing money, was dismissed as bad faith filing; "the collapse of [debtor]'s business model" did not change the analysis).

[8] See, *e.g., In re The Bible Speaks*, 65 B.R. 415 (Bankr. D.Mass. 1986) (while debtor (which was solvent on balance-sheet basis excluding disputed litigation claim) also apparently had a short-term (approximately six-month) liquidity problem in timely paying all its debts, court focused on potential adverse result in prepetition litigation, which could possibly result in sizeable claim beyond debtor's assets, jeopardizing ongoing operation; such possibility, coupled with short-term liquidity issue, constituted adequate financial distress); *In re Cent. Jersey Airport Servs.*, 282 B.R. 176 (Bankr. D. N.J. 2002) ("[I]t must be pointed out that the airline industry as a whole is experiencing financial difficulties and there is no reason that a [highly solvent] debtor airport which seeks the protection of the bankruptcy court to prevent further financial distress should not be permitted to reorganize...."); *In re Mirant Corp.*, 2005 Bankr. LEXIS 1686 (Bankr. N.D. Tex. Jan. 26, 2005) (debtor's case was filed in good faith for purposes of 1112 where debtor, although it was balance sheet solvent and had no problem in paying debts, was part of distressed corporate family of debtors and the other affiliates' filings could affect debtor; there was no evidence of any nefarious purpose for filing, such as trying to gain tactical advantage in litigation or negotiations; "MirMA [debtor] faced [cross] defaults in various contracts, complications in their interaction with chapter 11 debtor affiliates and other potential consequences from the filings of those affiliates"; "[the board's] purpose was valid; to protect MirMA's ability to continue as a going concern as part of the corporate family enterprise"; in board's view "chapter 11 was an appropriate way to address possible tough times ahead"); *In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D. N.Y. 2009) (while some debtors' key debts would not mature for a while, court should consider financial difficulties of entire interrelated corporate group; "Faced with the unprecedented collapse of the real estate markets, and serious uncertainty as to when or if they would be able to refinance the project-level debt, the Debtors' management had to reorganize the Group's capital structure.... [A] judgment on an issue as sensitive and fact-specific as whether to file a Chapter 11 petition can be based in good faith on consideration of the interests of the group as well as the interests of the individual debtor."). See generally *In re Johns-Manville Corp.*, 36 B.R. 727 (Bankr. S.D. N.Y. 1984) (debtor "must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization").

[9] Generally, putting aside the exculpatory provision issue (discussed below), a board's decision whether to authorize a bankruptcy filing or not is subject to the deferential business judgment rule. See, *e.g., In re Fedders North America, Inc.*, 405 B.R. 527 (Bankr. D. Del. 2009). The business judgment rule under Delaware law is that courts ordinarily will not "second guess" a business decision by a board or impose liability on its directors, there being a "presumption 'that in making a business decision, the directors of a corporation acted on an informed basis (i.e., with due care), in good faith and in the honest belief that the action taken was in the best interest of the company.'" See *End of the Road Trust v. Terex Corp. (In re Fruehauf Trailer Corp.)*, 250 B.R. 168, 197 (D. Del. 2000). When the rule is in effect, the existence of any rational business purpose for the decision will protect the decision from being disturbed. Put a different way, deficiencies in the directors' decision-making process will become actionable only if the directors' actions are grossly negligent, and a plaintiff typically must show gross negligence to demonstrate that the duty of care was violated. *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 749 (Del Ch. 2005) (internal quotations omitted). If the business judgment rule presumption were to be somehow rebutted by the plaintiffs, then the issue becomes whether the bankruptcy filing was "entirely fair" to the corporation and its stakeholders, and the burden shifts to the defendant directors to demonstrate that this standard was met. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1287 (Del. 1989).

[10] Section 102(b)(7) of the Delaware General Corporate Law allows a Delaware corporation to include a provision in its certificate of incorporation that prospectively exculpates its directors from monetary liability for a breach of the duty of care asserted by the corporation or its shareholders, other than for (a) conduct that constitutes a failure to act in good faith, (b) a breach of the duty of loyalty, or (c) an act or omission of the director that involves "intentional misconduct" or a "knowing violation of the law." 8 Del. C. sec. 102(b)(7). Because most large Delaware corporations have such exculpatory provisions, "litigation concerning the duty of care is rare today." *Fedders North America, Inc.*, 405 B.R. at 540. See also *Nelson v. Emerson,* 2008 Del. Ch. LEXIS 56 (Del. Ch. May 6, 2008) (102(b)(7) exculpatory provision in the debtor's charter cut off any potential claim of the defendants having violated their duty of care when filing the bankruptcy petition and engaging in the recharacterization action).

[11] See, *e.g., In re Semcrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), aff'd, 428 B.R. 590 (D. Del. 2010).

[12] See, *e.g., In re Wilson*, 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987).

[13] Given the decline in prices, it is conceivable that an E&P company's valuable oil and gas leases are terminated prior to the bankruptcy filing. Typically, an oil and gas lease requires production in "paying quantities." See, *e.g.,*

Andarko Petroleum Corp. v. Thompson, 94 S.W.3d 550 (Tex. 2002); *Clifton v. Koontz*, 325 S.W.2d 684, 690-91 (Tex. 1959) (generally describing "production in paying quantities" as producing a profit, but setting forth other factors and nuances as well; "The term paying quantities involves not only the amount of production, but also the ability to market the product (gas) at a profit."). Some landowners and mineral estate owners have used the production-in-paying-quantities requirement as a basis to terminate the lease. See *In re Nueces Petroleum Corp.*, 2007 WL 418889 (Bankr. S.D. Tex. Feb. 2, 2007) (oil and gas lease terminated by its own terms due to debtor-lessee's failure to produce in paying quantities); *In re Energytec Inc.*, 2009 WL 5101765 (Bankr. E.D. Tex. Dec. 17, 2009) (similar); see also *T.W. Phillips Gas and Oil Co. v. Jedlicka*, 42 A.3d 261, 268 (Pa. 2012) ("Typically, as herein, the habendum clause in an oil and gas lease provides that a lease will remain in effect for as long as oil or gas is produced 'in paying quantities.' [footnote omitted] Traditionally, use of the term 'in paying quantities' ... was regarded as for the benefit of the lessee, as a lessee would not want to be obligated to pay rent for premises which have ceased to be productive, or for which the operating expenses exceed the income.... More recently, however, and as demonstrated by the instant case, these clauses are relied on by landowners to terminate a lease.").

[14] See, *e.g.*, *In re J.H. Land & Cattle Co.*, 8 B.R. 237 (Bankr. W.D. Okla. 1981) (applying Kansas law; oil and gas lease is within purview of Section 365); *In re Ham Consulting Company/ William Lagnion/JV,* 143 B.R. 71 (Bankr. W.D. La. 1992) (Louisiana oil and gas lease was executory contract and not unexpired lease of real property for purposes of 365(d)(4)); *Texaco Inc. v. Louisiana Land and Exploration Co.,* 136 B.R. 658 (Bankr. M.D. La. 1992) (despite acknowledging mostly passive nature of lessor's obligations, Louisiana mineral lease was determined to be executory contract); *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.,* 439 B.R. 674 (Bankr. W.D. Mich. 2010) (Michigan oil and gas lease was true lease; "Michigan treats a lessee's interest as a leasehold or *profit á prendre*, but not a freehold estate. In this significant respect, Michigan departs from the law of Texas and several other oil and gas states that apparently regard a lessee's interest under an oil and gas lease as a freehold or fee.").

[15] See, *e.g., In re Topco, Inc.,* 894 F.2d 727, 739 n. 17 (5th Cir. 1990) (under Texas law, oil and gas lease is not unexpired lease; "the so-called leaseholds at issue in this case actually constitute determinable fee interests"; opining that Oklahoma law and Louisiana law are similar); *Terry Oilfield Supply Co., Inc. v. Am. Security Bank, N.A.,* 195 B.R. 66, 73 (S.D. Tex. 1996) ("Bankruptcy courts routinely treat oil and gas leases as falling under the trustee's power to reject executory contracts and unexpired leases. In Texas, an oil and gas lease is a fee interest, not a lease, regardless of what bankruptcy lawyers may think. Although 'lease' is in the heading of the instrument, and 'lease' is in the bankruptcy code, the code provision on executory contracts does not apply to Texas mineral leases."); *In re WRT Energy Corp.,* 202 B.R. 579 (Bankr. W.D. La. 1996) (Louisiana oil and gas lease was neither lease nor executory contract); *In re Clark Resources, Inc.,* 68 B.R. 358 (Bankr. N.D. Okla. 1986) (applying Oklahoma law).

[16] See, *e.g., NGP Capital Resources Co. v. ATP Oil & Gas Corp., Inc. (In re ATP Oil & Gas Corp., Inc.)*, Case No. 12-36187, Adv. No. 12-03443 (Bankr. S.D. Tex. 2012) (docket no. 13).

[17] See, *e.g., In re L.F. Jennings Oil Co.,* 4 F.3d 887, 890 (10th Cir. 1993) (abandonment proper where debtor-owned property posed no immediate threat to public health); *In re Smith-Douglass, Inc.*, 856 F.2d 12, 16 (4th Cir. 1988) (lower court properly determined "no threat of immediate harm" where state agency had not taken any enforcement action, thus abandonment of debtor-owned fertilizer plant was permissible); *In re Better-Brite Plating,* 105 B.R. 912, 917 (Bankr. E.D. Wis. 1989), *vacated on other grounds,* 136 B.R. 526 (Bankr. E.D. Wis. 1990) ("The unencumbered assets in this case are far short of the estimated ... cost of cleanup, and there is no evidence that there is any imminent harm or danger to the public"); *In re Guterl Special Steel Corp.,* 316 B.R. 843 (Bankr. W.D. Pa. 2004) ("If there is no imminent threat to public or safety, abandonment pursuant to section 554(a) may be permitted even though state laws or regulations designed to protect public health or safety will be violated as a consequence."; Chapter 7 trustee allowed to abandon radioactively contaminated real property owned by debtor); *In re MCI, Inc.,* 151 B.R. 103 (E.D. Mich. 1992) (abandonment of property to EPA and other agency authorized where there was no imminent harm to public); *In re Shore Co., Inc.,* 134 B.R. 572 (Bankr. E.D. Tex. 1991) (trustee could abandon debtor-owned contaminated refinery real and personal property where agencies failed to demonstrate imminent, identifiable harm; "a trustee's right to abandon environmentally impacted estate property is limited only by the precondition that the trustee remediate any imminent and identifiable danger present on the property"; "[V]iolation of state and federal environmental laws is not enough to limit the trustee's powers of abandonment nor, is the recognition that a former oil refinery site probably contains some hazardous substances sufficient.").

[18] See, *e.g., In re H.L.S. Energy Co., Inc.,* 151 F.3d 434 (5th Cir. 1998) (state's expenses in plugging debtor's inactive oil wells were administrative expenses; under *Midlantic Nat'l Bank v. N.J. Dep't of Environmental Protection,* 474 U.S. 494 (1986), debtor could not abandon property in contravention of state law reasonably designed to protect public health; no discussion of immediate harm); *In re Am. Coastal Energy, Inc.,* 399 B.R. 805, 813 (Bankr. S.D. Tex. 2009) (dealing with plugging of inactive oil/gas wells; reading *Midlantic* "to require the Court to determine whether the debtor is violating a statute 'reasonably designed to protect the public health or safety from identified hazards,' not the extent to which particular conduct imposes actual and imminent threats"); *In re Appalachian Fuels, LLC,* 521 B.R. 779 (Bankr. E.D. Ky. 2014) (debtor could not abandon coal mining properties without adhering to federal and state remediation statutes).

[19] See *Leavell v. Karnes,* 143 B.R. 212 (S.D. Ill. 1990) (before abandonment of contaminated oil well, at a minimum, immediate and identifiable health risks must be addressed); *In re Eagle-Picher Holdings, Inc.,* 345 B.R. 860 (Bankr. S.D. Ohio 2006) ("One line of cases holds that abandonment is appropriate unless there is a showing of an imminent danger to public health and safety while the other line of cases holds that abandonment is appropriate only upon a showing of full compliance with the applicable environmental laws."; in this case "the two standards create a distinction without a difference" but court expressly adopted tougher full compliance standard).

[20] See, *e.g., H.L.S. Energy Co., Inc.,* 151 F.3d 434 (state's expenses in plugging debtor's inactive oil wells were administrative expenses); *In re Wall Tube & Metal Products, Inc.,* 831 F.2d 118, 122 (6th Cir. 1987) (trustee could not abandon property (which contained drums of hazardous substances) under *Midlantic*, and was also prohibited from maintaining property in continuous violation of state environmental laws; the state, in remediating the property, was performing a service already obligatory on the part of the trustee, and state was entitled to administrative claim; "It is undisputed that the hazardous wastes still within the debtor's estate ... presented a danger to the public's health and safety."); *In re Peerless Plating Co.,* 70 B.R. 943, 946-47 (Bankr. W.D. Mich. 1987) (trustee could not abandon property in violation of CERCLA, and EPA was entitled to administrative claim); *In re Stevens,* 68 B.R. 774, 783-84 (Bankr. D. Me. 1987) (unlawful and improper storage of hazardous substances constitutes an imminent and identifiable danger and costs of protecting public from that danger are entitled to administrative claim priority; "The court finds that conditions that will adequately protect the public's health and safety are conditions that will provide for compliance with the relevant state and local laws.").

[21] See, *e.g., H.L.S. Energy Co., Inc.,* 151 F.3d 434; *Leavell v. Karnes,* 143 B.R. 212; see also *In re ATP Oil & Gas Corp.,* 2014 Bankr. LEXIS 1050 (Bankr. S.D. Tex. 2014) (oil and gas debtor had *Midlantic* duty to make abandoned platform safe under state law, and thus third party service provider who provided postpetition "safe out work" to make the platform safe was entitled to administrative claim).