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Impact of Bankruptcy of an Operator under a Joint Operating Agreement on Non-Operators

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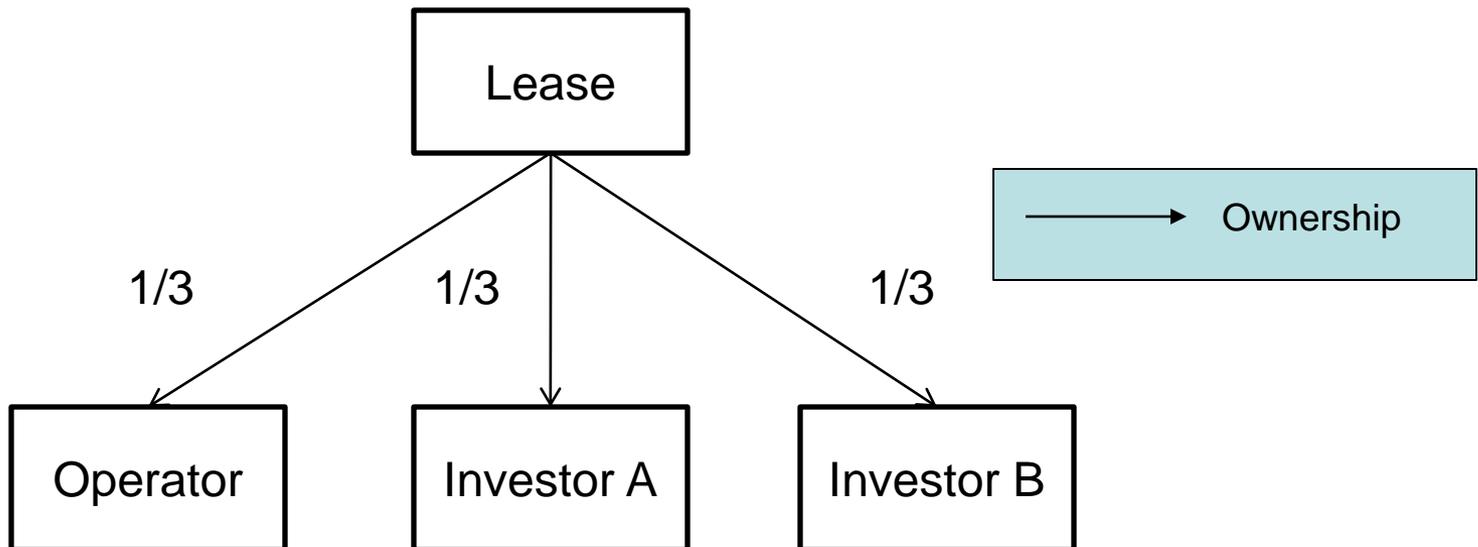
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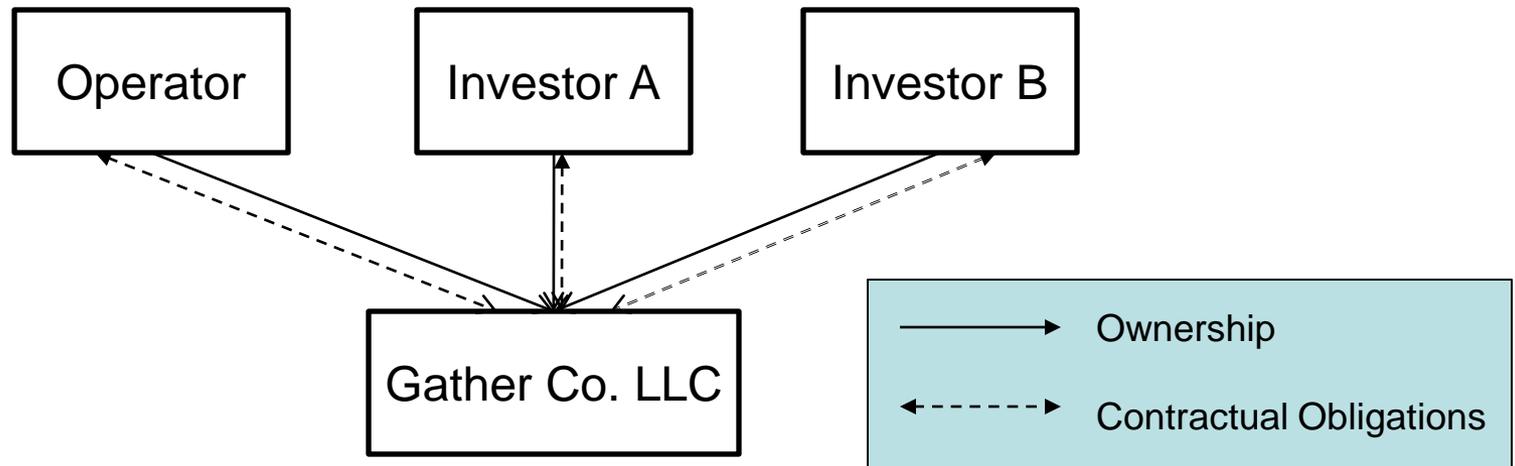
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Hypothetical Deal Structure: The XYZ Shale Project



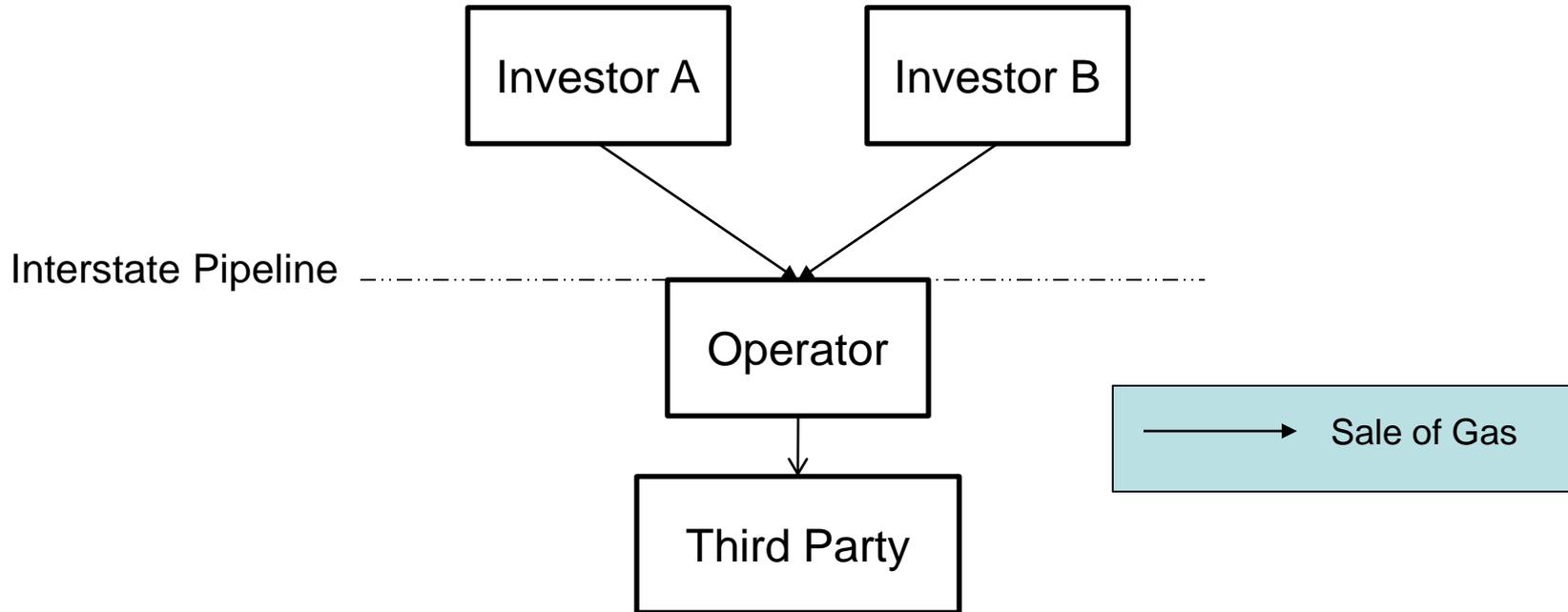
Operator sells 1/3 of its interest in the Lease to each of Investor A and Investor B, and they enter into a joint venture agreement and a joint operating agreement (collectively, the “Joint Venture”). Under the Joint Venture, Investor A and Investor B make monthly advances to Operator their shares of expenses, plus a portion of Operator’s expenses (the carry). Also under the terms of the Joint Venture, if one of the parties wants to sell its interest, the other two have a right of first refusal.

The XYZ Shale Project



The three parties have also formed a gathering company, Gather Co. LLC, which has constructed a gathering system to take gas from their leases to an interstate pipeline. Each of Operator, Investor A and Investor B has entered into a gathering agreement with Gather Co. which commits their gas to delivery into the gathering system for an extended period (e.g. 15 years).

The XYZ Shale Project



At the interconnection between the gathering system and the interstate pipeline, Operator purchases all of Investor B's and Investor C's gas pursuant to a gas purchase agreement (the "Purchase Agreement"), transports it to the point of sale to a third party, and pays A and B their share of the net proceeds after deducting transportation costs and a marketing fee.

Overview of Certain Chapter 11 Concepts Affecting the XYZ Shale Project

- Chapter 11 generally favors reorganization of the debtor's business over liquidation and, accordingly, provides the debtor with certain tools to achieve such an end.
- “Debtor-in-Possession”
 - In most chapter 11 cases, the debtor's pre-bankruptcy management remains in control of the debtor's affairs and continues to operate the debtor's business.
- Automatic Stay
 - Section 362 of the Bankruptcy Code provides for a broad stay of actions, judicial or otherwise, to enforce or collect prepetition claims. It also stays actions that would affect or interfere with property of the debtor's estate.

Overview of Certain Chapter 11 Concepts - Executory Contracts and Unexpired Leases

- Executory contract defined:
 - “A contract under which the obligation of both the bankrupt and the other party 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.”
- A joint operating agreement is likely an executory contract for purposes of a bankruptcy case. Assuming the parties have not already substantially performed their obligations, a joint venture agreement is also likely an executory contract.
- The debtor has four options with respect to its executory contracts and unexpired leases:
 - Reject
 - Assume
 - Assume and assign to a third-party
 - Do nothing

Overview of Certain Chapter 11 Concepts - Executory Contracts and Unexpired Leases

- A debtor may assume or reject a contract or lease if it has determined in its “business judgment” that doing so would be beneficial to the estate. This is a very low standard.
- Rejection
 - Rejection of a contract or lease constitutes a breach of such contract or lease immediately before the filing of the bankruptcy petition and generally entitles the counterparty to a prepetition unsecured claim for damages.
- Assumption
 - Assumption means that the debtor agrees to remain bound by the contract or lease.
 - In order to assume a contract or lease, a debtor must:
 - (i) cure, or provide adequate assurance that it will promptly cure, any existing defaults, and
 - (ii) provide adequate assurance of future performance under such contract or lease.

Overview of Certain Chapter 11 Concepts - Executory Contracts and Unexpired Leases

- Assumption and assignment to a third-party
 - A debtor generally may assign a contract or lease to a third-party, notwithstanding a provision in such contract or lease, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease (such as consent or preferential right requirements).
 - The debtor may assign a contract or lease only if:
 - (i) the debtor assumes such contract or lease in accordance with the Bankruptcy Code, and
 - (ii) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

Overview of Certain Chapter 11 Concepts - Executory Contracts and Unexpired Leases

- Time for assumption
 - A debtor may assume an executory contract or unexpired lease of personal property at any time before confirmation of a plan.
 - Additional rules apply to leases of real property.
 - The Court may, on motion of a party to a contract or lease, shorten the time within which the debtor may assume or reject based upon a showing of “cause.”
 - If the debtor does not assume a contract or lease within these deadlines, such contract or lease is deemed rejected.

Overview of Certain Chapter 11 Concepts – *Ipso Facto Clauses*

- Notwithstanding a provision in a contract or lease, or in applicable law, a contract or lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
 - (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
 - (B) the commencement of a case under the Bankruptcy Code; or
 - (C) the appointment of or taking possession by a trustee in a case under the Bankruptcy Code or a custodian before such commencement.

Bankruptcy: Issues in the XYZ Shale Project

- What happens to prepetition payments made by Investor A and Investor B to the Operator?
 - Payments are property of the Operator's bankruptcy estate, and the Operator may not be required to apply the payments as provided under Joint Venture, even if the payments are kept in a segregated account.
- Is the Operator required to perform its obligations under the Joint Venture while it decides whether to assume or reject?
 - No; the Operator may chose to (i) perform its obligations, (ii) not perform its obligations, or (iii) partially perform its obligations.
- Can the Operator be removed for its non-performance?
 - Probably not, if the operatorship is viewed as an asset of the estate. "*Ipsa facto*" clauses allowing removal upon bankruptcy are clearly unenforceable.

Bankruptcy: Issues in the XYZ Shale Project

- What, if any, options do Investor A and Investor B have during this limbo period?
 - Withhold performance until the Operator performs or provides assurance of performance.
 - Seek an order compelling the Operator to determine within a specified period of time whether to assume or reject the Joint Venture.
 - Seek relief from the automatic stay to enforce rights and remove the Operator.
- What happens if the joint venture agreement and operating agreement are rejected?
 - The Operator and Investors are co-owners under common law, without a designated operator.
 - The parties lose the right to enforce terms of the rejected agreements, such as outstanding non-consent premiums that are owed, against the Operator.

Executory Contracts and Unexpired Leases: Issues in the XYZ Shale Project

- Can the Operator assign its interest in the Joint Venture, Gathering Agreement and/or Purchase Agreement to a third-party?
 - Yes, provided the Operator:
 - (i) cures, or provides adequate assurance that it will promptly cure, any existing defaults, and
 - (ii) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.
- Can the Investors enforce their consent right under their joint venture agreement and their right of first refusal under their operating agreement against the proposed assignment?
 - Generally, these restrictions are not enforceable in the case of an assignment in bankruptcy.

Executory Contracts and Unexpired Leases: Issues in the XYZ Shale Project

- What happens to the operation of Gather Co. LLC, in which Operator holds a 1/3 interest?
 - Nothing will happen as a direct results Operator's bankruptcy filing, except that Operator may cease performing as manager of Gather Co. because it lacks the resources or it doesn't view Gather Co. as profitable and plans to reject the operating agreement of Gather Co.

Avoidance Powers

- A debtor has broad authority to avoid certain types of prepetition transactions.
- Of particular relevance, a debtor may avoid an unperfected security interest and unperfected transfers of real property.
- In certain circumstances, the debtor may also avoid the transfer of property and the grant of liens in its property.

Avoidance Powers: Issues in the XYZ Shale Project

- Do the liens and security interests created by the Joint Venture protect Investor A and Investor B?
 - Only if such liens and security interests were perfected prepetition, which may not be a feasible option. For example, liens on real property must be perfected by recording in the relevant real property records, and liens on cash must be perfected by acquiring control of the cash. Security interests in bank accounts are perfected through account control agreements.
 - But statutory liens provided by state law may survive if they are not based upon the bankruptcy or insolvency of the operator.
 - Recording a memorandum of operating agreement in the public records may at least protect the Investors as to matters covered by the lien by perfecting their security in the leases, fixtures and oil and gas “as-extracted collateral” (UCC 9-501).

Recoupment and Setoff

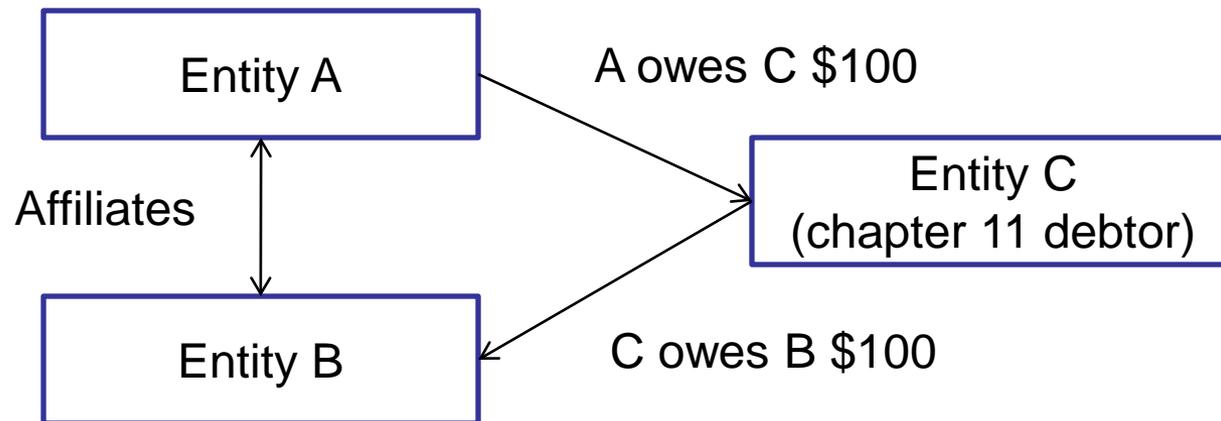
- **Recoupment**
 - Recoupment allows a creditor to offset amounts it owes to the debtor against amounts the debtor owes to the creditor *under the same agreement*.
 - Under recoupment, a creditor may offset amounts regardless of whether they arise out of prepetition obligations or postpetition obligations.
 - The automatic stay does not bar a creditor from applying recoupment.

Recoupment and Setoff

- **Setoff**
 - Setoff allows a creditor to offset amounts it owes to the debtor against amounts the debtor owes *under different agreements*.
 - Setoff rights are not created by the Bankruptcy Code and must, instead, arise under non-bankruptcy law or contract.
 - Under setoff, a creditor may only offset mutual debts and credits—*e.g.* a prepetition claim against the debtor may be setoff against a prepetition debt owed to the debtor but not against a postpetition debt.
 - Although the Bankruptcy Code explicitly preserves a creditor's setoff right, the automatic stay prohibits the creditor from effectuating the setoff, without court permission.

Recoupment and Setoff

- Triangular setoff, which is not permitted in bankruptcy, arises when Entity A seeks to offset the claims of its affiliate Entity B against the debts owed to Entity C by Entity A.



- Even if Entity A has a contractual right to setoff Entity B's claims against Entity A's debts to Entity C, such setoff is prohibited under the Bankruptcy Code.

Recoupment and Setoff: Issue in the XYZ Shale Project

- May Investor A and Investor B setoff amounts they are owed under the Purchase Agreement, such as indemnity claims, against amounts they owe under the Joint Venture?
 - Yes, however only if Investor A and Investor B are the actual parties to both agreements—*i.e.* they may not setoff if their affiliates are parties to one but not both of the agreements.

Payments under the Joint Venture before the Operator's Chapter 11 Filing

- What could Investor A and Investor B have done to protect their interests in the XYZ Shale Project if they believed the Operator would soon commence a chapter 11 case?
 - Attempt to perfect any liens provided under the Joint Venture.
 - May be subject to avoidance in a chapter 11 case if accomplished too close to bankruptcy.
 - Make payments under the Joint Venture into escrow.
 - May not be practical from a business perspective.
 - Withhold performance.
 - May create exposure to breach of contract claims.
 - Revise the joint venture agreement to provide for the Operator to bill after the month of expenditure rather than cash-calling in advance
 - Operator will resist at a time of cash flow problems, and may be subject to avoidance in a chapter 11 case if accomplished too close to bankruptcy.

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