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A "Plug" for Priority Claims in Oil and Gas Cases

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As the price per barrel of oil remains 50 percent below where prices were just two years ago, it is no surprise that bankruptcies related to oil and gas companies are on the rise. According to one industry publication, 42 oil and gas companies filed for bankruptcy protection in 2015, with those cases having a combined debt load of $17.85 billion and roughly half of the debt being unsecured.[1] As of the writing of this article, at least 21 oil and gas producers have filed for bankruptcy in 2016 alone.[2] Some sources in the industry think that the increased trend of oil-and-gas-related companies seeking bankruptcy protection will continue for the foreseeable future.

The production and exploration of oil and gas is highly regulated. When highly regulated companies seek bankruptcy protection, the courts and litigants are required to not only grapple with the requirements of the Bankruptcy Code, but with state and federal regulations as well. These state and federal regulations can disrupt the "routine" priorities of creditors within the bankruptcy case and tilt the dynamic of the debtor's obligations to make payments to certain creditors.

Many chapter 11 debtors seek bankruptcy protection in order to shed burdensome obligations and valueless assets. Modern chapter 11 cases generally include a § 363 sale of valuable assets, followed by a liquidation of what remains through a chapter 7 case, or more recently, through a "structured dismissal."[3] Oil and gas exploration and production debtors face limitations on what can be done with some of their major assets, primarily productive and non-productive wells.

Unlike most assets in a typical bankruptcy case, oil and gas wells cannot simply be abandoned without the debtor complying with environmental obligations to state and federal regulators. Oil and/or gas wells that are unproductive or no longer being used must be plugged, which can be costly and burdensome to the estate. The state regulator often takes the initiative to plug the well on its own and then seeks to recoup the costs from the debtor. When the state regulators undertake the burden of plugging a well, where do these claims belong in the Bankruptcy Code's priority scheme?

State Administrative Laws

Most, if not all, states have an administrative agency that is charged with regulating the production of oil and gas within its borders. For example, Texas has the Texas Railroad Commission, Alabama has the Oil and Gas Board, and Louisiana has the Commissioner of Conservation. At the federal level, many federal agencies have regulatory authority over oil and gas production, including the Department of the Interior, Bureau of Land Management, Mineral Management Service, Bureau of Indian Affairs, Environmental Protection Agency, Bureau of Ocean Energy Management and Bureau of Safety and Environmental Enforcement, just to name a few.

Both state and federal regulations require that at the end of a well's operation, or within a certain specified time frame, the well must be plugged.[4] According to figures from the Texas Railroad Commission, the average cost of plugging a defunct well in 2015 ranged from $4.92 to $17.17 per linear

1 "$17.85 Billion in Oil and Gas Bankruptcies in 2015," *Oil & Gas 360*, Jan. 8, 2016, *available at* oilandgas360.com/17-85-billion-in-oil-and-gas-bankruptcies-in-2015 (unless otherwise indicated, all links in this article were last visited on April 29, 2016).

2 *Oil Patch Bankruptcy Monitor*, Haynes and Boone LLP, April 15, 2016, at 2, *available at* haynesboone.com/~/media/files/attorney%20publications/2016/energy_bankruptcy_monitor/oil_patch_bankruptcy_20160106.ashx.

3 *See, e.g., In re Jevic Holding Corp.*, 787 F.3d. 173 (3d Cir. 2013).

4 *See generally* 30 C.F.R. § 250.173; 16 Tex. Admin. Code § 3.14. The federal government and some states have bonding or financial security requirements to cover the cost of the plugging. *See* 30 C.F.R. § 256.52; 3 Tex. Nat. Res. Code 91.104.

foot of well depth.[5] With the average depth of a crude oil developmental well being around 5,000 feet, the cost to plug a well can become a significant expense, particularly when dealing with multiple wells.[6]

In addition, if a debtor is obligated to plug the well, state and federal governments — through their police powers and regulations — have the ability to bring enforcement actions both in and out of bankruptcy court in order to force the debtor to plug the well. Governments also have the ability to assess daily penalties for a party's failure to timely plug a defunct well.

Administrative Expenses and Priority

Under 11 U.S.C. § 503, certain claims are entitled to be characterized as administrative expenses. Specifically, § 503(b)(1)(A) provides a nonexhaustive list of "actual, necessary costs and expenses" related to "preserving" the bankruptcy estate that are entitled to be administrative expenses. The U.S. Supreme Court has expansive views of what can be considered an "actual, necessary" cost of preserving the bankruptcy estate.[7] In *Reading*, the Court held that damages resulting from the negligence of a receiver appointed under chapter XI of the Bankruptcy Act were the "actual and necessary costs of a Chapter XI arrangement."[8]

In scrutinizing whether a particular claim is an "actual and necessary cost" that is entitled to priority status, courts look to determine whether the actions behind the claim were a benefit to the estate and its creditors.[9] The concept of whether a claim provided "benefit" to the estate is not independently found in the Bankruptcy Code; however, it is a *litmus* test to determine whether such a claim was necessary to the estate. If a party seeking the administrative status of a claim did not provide a benefit to the estate, then that party did not provide anything "necessary" to the estate; therefore, its claim cannot be characterized as an administrative claim under § 503(b)(1)(A).[10] Whether a creditor provided a benefit to the estate harkens back to the very root of why administrative expenses are given priority: The Code seeks to compensate creditors for "those expenses [that were] necessary to produce the distribution to which they are entitled."[11]

Once a claim is deemed to be an administrative expense, that claim is entitled to be given priority under 11 U.S.C. § 507(a)(2) and to be paid before all other unsecured claims with the exception of certain domestic-support obligations. In a chapter 7 case, the trustee must comply with the priority order as specified under § 507 in distributing the assets of the estate, which entitles an administrative expense to be paid after any domestic-support obligations.

In a chapter 11 case, on the other hand, an administrative expense, absent an agreement to the contrary, must generally be paid by the debtor on the plan's effective date.[12] Therefore, if the debtor does not have the ability to pay an administrative claim on the effective date and does not reach an agreement with the priority creditor to pay the claim after the effective date, the chapter 11 plan cannot be confirmed.[13]

Are Expenses for Plugging a Well Entitled to Priority?

Certain courts have determined that when a state regulator undertakes the debtor's pre- or post-petition obligation to plug an oil and/or gas well, the regulator is entitled to recoup its costs as an administrative expense of the bankruptcy case.[14]

Post-Petition Claims

In *Texas v. Lowe*,[15] the debtor filed for chapter 11 protection, and after the debtor sold off all its valuable assets, the case was converted to chapter 7.[16] During the chapter 11 case, the Texas Railroad Commission brought an informal action against the bankruptcy estate in order to secure compliance with the debtor's obligation to plug the unproductive wells.[17] The Texas Railroad Commission and the chapter 11 debtor entered into a settlement of the state's claims prior to converting the case to chapter 7.[18] As part of this settlement, the state would plug the wells and charge the cost of plugging to the bankruptcy estate.[19] Once the case was converted, the Texas Railroad Commission asserted that its costs for plugging the well were entitled to priority.[20]

In determining whether the Texas Railroad Commission's claim was entitled to priority, the Fifth Circuit Court of Appeals held that because the trustee was under a legal duty to plug the wells and the bankruptcy estate could be subject to further liability and fines if the wells were not plugged, the costs that the state incurred in plugging the wells was a "benefit" to the estate and therefore entitled to priority.[21] In arriving at this conclusion, the court found that under 28 U.S.C. § 959(b), a bankruptcy trustee is obligated to comply with state law.[22] Moreover, the trustee cannot merely "abandon property in contravention of a state law reasonably designed to protect public health or safety."[23] Thus, since the trustee in this case could not abandon the unproductive wells and was under state and federal obligations to plug them, the fulfillment of this obligation by the Texas Railroad Commission was seen as a benefit to the estate and therefore entitled to priority.[24] In its opinion in *Lowe*, the Fifth Circuit specifically declined to rule on whether post-petition expenses for the cleanup of pre-petition plugging obligations could also be deemed an administrative expense.[25] More than a decade later, the

5 *See* "Cost of Calculation: Plugging Cost Estimates," Railroad Commission of Texas, *available at* rrc.state.tx.us/oil-gas/compliance-enforcement/hb2259hb3134-inactive-well-requirements/cost-calculation.
6 "Average Depth of Crude Oil and Natural Gas Wells," U.S. Energy Info. Admin., July 31. 2015, *available at* eia.gov/dnav/ng/ng_enr_welldep_s1_a.htm.
7 *Reading Co. v. Brown*, 391 U.S. 471, 485 (1968).
8 *Id.* (internal quotations omitted).
9 *Texas v. Lowe*, 151 F.3d 434, 437 (5th Cir. 1998).
10 *Id.*
11 *Id.*
12 11 U.S.C. § 1129(a)(9)(A).
13 *Id.*
14 *See, e.g., Lowe*, 151 F.3d at 439; *In re Am. Coastal Energy*, 399 B.R. 805, 817 (Bankr. S.D. Tex. 2009).
15 *Texas v. Lowe*, 151 F.3d 434 (5th Cir. 1998).
16 *Id.* at 436.
17 *Id.*; *see also* 16 Tex. Admin. Code § 3.9.
18 *Lowe*, 151 F.3d at 436.
19 *Id.*
20 *Id.*
21 *Id.* at 438.
22 "[A] trustee ... shall manage and operate the property in his possession as such trustee ... according to the requirements of the valid laws of the State in which such property is situated...."
23 *Id.* at 438 (citing *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot.*, 474 U.S. 494, 507 (1986) ("[W]e hold that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards.")).
24 *Id.*
25 *Id.* at 439.

U.S. Bankruptcy Court for the Southern District of Texas addressed this issue using much of the same analysis as found in *Lowe*.

Pre-Petition Claims

In *In re Am. Coastal Energy*,[26] the U.S. Bankruptcy Court for the Southern District of Texas found that post-petition expenses related to pre-petition well-plugging claims were entitled to priority as an administrative expense of the estate.[27] Prior to filing bankruptcy, the debtor had eight wells that were subject to Texas's plugging requirement.[28] The Texas Railroad Commission plugged four of the eight wells post-petition and sought $421,952.35 for its efforts.[29] The debtor's chapter 11 plan listed the Texas Railroad Commission's claim as being unsecured, and the Texas Railroad Commission objected.[30]

In arriving at its opinion, the bankruptcy court reviewed the Supreme Court's *Midlantic* decision and several neighboring circuit court opinions. The court noted that *Midlantic* stands for the proposition that a bankruptcy trustee cannot abandon property in violation of a law or regulation that is designed to protect the public's health and safety.[31] The bankruptcy court found that *Midlantic*'s analysis was not based on the Bankruptcy Code's statutory language, but more from "historic antecedents."[32] Specifically, the Supreme Court found that "historic antecedents" and overall public policy dictated that the bankruptcy trustee's powers are to be "subservient to the state's health and safety concerns."[33] The bankruptcy court then applied that same public policy found in *Midlantic* — the bankruptcy trustee has a duty to comply with state health and safety laws and regulations — to the facts of its case.

The court first held that the debtor's duty to expend funds in order for the estate to be compliant with state health and safety laws was not contingent upon whether the obligation arose pre- or post-petition.[34] As the bankruptcy court stated, "whether the liability arose pre-petition or post-petition produces an analysis that is superficial. The analysis must focus not on just when the obligation arose, but whether the obligation continues to arise anew with the passage of each day."[35]

The bankruptcy court then analyzed several other neighboring circuit court opinions that held that post-petition expenses for pre-petition environmental liabilities were entitled to priority.[36] In all three of these opinions, the courts relied on *Midlantic* in finding that since the trustee could not avoid the environmental claims through abandonment, the cost of remedying the environmental issue was "necessary" to preserve the estate.[37]

The debtor argued, however, that existing Fifth Circuit precedent has held that only post-petition liabilities can qualify as a § 503(b)(1)(A) administrative expense; therefore, the state's claims were not entitled to priority.[38] The bankruptcy court found the existing case law and the debtor's argument unpersuasive. Those opinions, the court stated, were based largely in part on *In re TransAmerican Natural Gas Corp*., which "only held that a claimant *may* establish that its claim qualifies as an administrative expense under § 503(b)(1)(A) by demonstrating that the claim arose from a transaction with the debtor in possession."[39] Moreover, the court stated that previous precedent did not deny administrative-expense characterization based solely upon being a pre-petition liability, but administrative-expense status was denied because the claimant's actions did not benefit the estate.[40] Therefore, the bankruptcy court held that the central concern in determining whether a claim should be entitled to be characterized as an administrative expense is not whether the claim occurred pre- or post-petition, but rather whether the actions supporting the claim provided a benefit to the estate.[41] If a benefit has been provided to the estate, then it follows that the actions were necessary to preserve the estate; therefore, the claim should be entitled to be an administrative expense.

Conclusion

Much like retail debtors who must have a game plan for dealing with § 503(b)(9) claims, oil and gas debtors must assess (prior to filing) the potential for large priority claims arising from regulations that require the plugging of unproductive or inactive wells. Claims related to the plugging of oil and gas wells could potentially prevent the confirmation of the chapter 11 plan or absorb all of the distributable assets in a chapter 7 liquidation. All parties-in-interest should be aware of these risks so that they can promote a resolution with the specific regulatory authority in order to facilitate the confirmation of a plan or the effective distribution of assets to unsecured creditors. abi

Editor's Note: *For more on this topic, purchase* When Gushers Go Dry: The Essentials of Oil & Gas Bankruptcy, Second Edition, *now available in the ABI Bookstore (abi.org/bookstore). Members must log in first to obtain reduced pricing.*

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26 399 B.R. 805 (Bankr. S.D. Tex. 2009).
27 *Id.* at 807.
28 *Id.*
29 *Id.* at 808.
30 *Id.*
31 *Id.* at 810.
32 *Id.* at 811.
33 *Id.* (citing *Midlantic*, 474 U.S. at 500-01, 507-08).
34 *Id.*
35 *Id.*
36 *Id.* at 812-14 (citing *Dep't of Envtl. Res. v. Conroy*, 24 F.3d 568, 569 (3d Cir. 1994); *In re Chateaugay Corp.*, 944 F.2d 997, 999 (2d Cir. 1991); *In re Wall Tube & Metal Prod. Co.*, 831 F.2d 118, 119 (6th Cir. 1987)).
37 *Id.* at 812.
38 *Id.* at 814.
39 *Id.* (citing *In re Transamerican Nat. Gas Corp.*, 978 F.2d at 1416) (emphasis in original).
40 *Id.* at 815-16.
41 *Id.*