363 Sales: The Frequent *Sine Quo Non* of Chapter 11 Cases

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I. INTRODUCTION

More and more, the Section 363 sale has become a centerpiece of Chapter 11 cases. The primary reason Section 363 sales are popular is because there are distinct business advantages for all constituencies – investors, debtors, debtors-in-possession, creditors, trade vendors, and professionals. The advantages to investors (buyers) are clear: The assets are conveyed free and clear of liens and encumbrances, relieving fears of lingering liabilities and causes of action, etc. By investing in this way, they can, in rudimentary terms, keep the good stuff and get rid of the bad stuff. Furthermore, investors rest easy knowing, at the close of a competition, they paid no more than the fair market price for the assets, a certainty they do not have if they negotiate with a creditor rather than participate in a process.

While bankruptcy estate property is generally sold, subject to certain requirements, "free and clear of any interest in such property," the actual level of protection that purchasers can obtain "free and clear" depends on the scope of the phrase "interest in property," which is not defined in the Bankruptcy Code. Whether the category of "interests" extends to potential successor liability claims has been the subject of considerable debate.

With the above as the backdrop, the panel discussion (and these materials, which are designed to supplement the panel discussion) will focus on some of the recent trends with respect to Section 363 sales, including the "free and clear" status of Section 363 sales, the sufficiency of notice, the impact on creditors and interested parties on the failure to object to sales, sub rosa plan objections, and the ability of creditors to collaterally attack a Section 363 sale order.

II. PURCHASE OF ASSETS BY MOTION UNDER BANKRUTPCY CODE § 363

The Bankruptcy Code provides two general options for acquiring property from a debtor. First, Section 363(b) permits a debtor in bankruptcy to sell assets upon court approval after notice and a hearing.[1] Second, Section 1123(a)(5) permits a debtor to sell assets, or swap equity, or merge with another entity under a plan of reorganization.[2]

A. General Concepts and Sale of Substantially All Assets

A sale of assets under Section 363(b) has long been a preferred method for acquiring assets because it is generally faster and subject to less a rigorous process than a plan of reorganization. Section 363(b) provides, in relevant part:

> (1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . .[3]

Thus, a trustee or debtor in possession may sell assets in the ordinary course of business without court approval, and may sell assets outside the ordinary course of business with court approval.

[1] 11 U.S.C. § 363(b).

[2] 11 U.S.C. § 1123(a)(5).

[3] 11 U.S.C. § 363(b).

[4] 3 Collier on Bankruptcy ¶ 363.02[4], at 363-18 (Alan N. Resnick & Henry Sommer eds., 16th ed. 2015) ("courts

A debtor's decision to sell assets pursuant to Section 363(b) is reviewed under the business judgment standard.[4] As applied in the bankruptcy context, the business judgment standard permits the bankruptcy court to determine whether the debtor's decision to sell assets is reasonable, but the court "should not substitute its judgment" for the debtor's.[5] Courts are in general agreement that bankruptcy courts should provide substantial deference to a debtor's decision to sell assets, provided that the debtor articulates a legitimate business reason.[6]

B. Sale Free and Clear of Liens, Claims, and Encumbrances (363(f))

One of the key advantages to a sale of assets under Section 363 is that Bankruptcy Code Section 363(f) authorizes a debtor to sell assets that are a part of the bankruptcy estate free and clear of liens, claims and encumbrances under certain circumstances.[7] Section 363(f) provides as follows:

The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Thus, a free and clear sale is permitted in a variety of circumstances, including upon consent and in any situation—including in a bankruptcy plan—where the lienholder could be compelled to accept cash in exchange for its lien. However, there is dispute among courts

[4] 3 Collier on Bankruptcy ¶ 363.02[4], at 363-18 (Alan N. Resnick & Henry Sommer eds., 16th ed. 2015) ("courts generally apply standards that, although stated various ways, represent essentially a business judgment test"); *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.*), 722 F.2d 1063, 1070 (2d Cir. 1983); *In re Integrated Resources, Inc.*, 147 B.R. 650, 656 (S.D.N.Y. 1992) (the presumption is that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the best interests of the company).

[5] 3 Collier on Bankruptcy ¶ 363.02[4], at 363-19.

[6] *In re Lionel Corp.*, 722 F.2d at 1066-1070 (holding that debtor must establish an "articulated business justification, other than appeasement of major creditors"); *In re Abott Dairies*, 788 F.2d 143, 149 (3d Cir. 1986) (adopting the "sound business purpose" test in the Third Circuit); *In re GSC, Inc*., 453 B.R. 132, 174 (S.D.N.Y. 2011) (courts give deference to the debtor as long as there is a "reasonable basis for its business decision") (internal quotations omitted). At least one court has held that it would not approve a Section 363 sale if only secured creditors would benefit. *In re Silver*, 338 B.R. 277 (Bankr. E.D. Va. 2004).

[7] *See* 11 U.S.C. § 363(f).

regarding the scope of Section 363(f). In *Clear Channel Outdoor, Inc. v. Knupfer et al. (In re PW, LLC)*,[8] the Ninth Circuit Bankruptcy Appellate Panel issued a controversial decision narrowly reading the "free and clear" provisions of Section 363(f). The *Clear Channel* court reasoned that: (1) the finality rule set forth in Section 363(m) (discussed below) does not apply to lien stripping under Section 363(f); (2) "aggregate value," as set forth in Section 363(f)(3), refers to a lien's face value, and thus, Section 363(f) lien stripping can only occur when the aggregate face value of all liens secured by the collateral is satisfied; and (3) bankruptcy court cramdown procedures are inapplicable for purposes of Section 363(f)(5).

Several courts, including other courts in the Ninth Circuit, have subsequently authorized free and clear sales under Section 363(f) despite *Clear Channel's* narrow interpretation of the Section.[9] Most courts have declined to confront *Clear Channel's* substantive holdings because the panel resolved the controversy on a procedural basis.[10]

Several non-statutory exceptions also limit the debtor's ability to sell property free and clear under Section 363(f). For example, if any party disputes the estate's ownership of property to be sold free and clear, the court must determine who owns the property before it may authorize the sale.[11] Additionally, a court may not authorize a sale free and clear after confirmation of a plan (discussed below) because the property revests in the reorganized debtor upon confirmation and is no longer property of the estate.[12]

Additionally, the free and clear sale provision of Section 363(f) does not apply in the following circumstances: (1) if the sale transaction constitutes a merger or consolidation; (2) if the buyer is a mere extension or continuation of the seller; (3) if the transfer of assets to the purchaser amounts to a fraudulent or collusive attempt to avoid the seller's liabilities; and (4) if the purchaser made an express assumption of the seller's liabilities.[13]

C. Failure to Object

Section 363(f)(2) requires consent of the affected party. There is a split in authority regarding whether a lienholder's failure to object constitutes an implied consent to a sale free and clear under § 363(f).[14] For instance, some courts hold that factual circumstances may exist that

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[8] 391 B.R. 25 (B.A.P. 9th Cir. 2008).

[9] *See, e.g., In re Jolan Inc*., 403 B.R. 866, 870 (Bankr. W.D. Wash. 2009) (allowing a sale of assets under §363(f)(5) for an amount less than enough to satisfy all liens because applicable state law provided for the foreclosure of junior liens); *see also In re Boston Generating*, 440 B.R. 302, 332 (Bankr. S.D.N.Y. 2010) (declining to follow *Clear Channel*'s interpretation of "value" in section 363(f)(3) to refer to the face amount of the liens).

[10] *See* C. Luckey McDowell, *Buyer's Guide to Section 363 Sales*, 32nd Annual Jay L. Westbrook Bankruptcy Conference, Nov. 21-22, 2013, at 14-15.

[11] *See, e.g., Darby v. Zimmerman (In re Popp)*, 323 B.R. 260, 273 (B.A.P. 9th Cir. 2005).

[12] *In re Golf, LLC*, 322 B.R. 874, 877 (Bankr. D. Neb. 2005).

[13] *In re Savage Indus., Inc.* 43 F.3d 714, 717 n.4 (1st Cir. 1994).

[14] *See In re GSC, Inc.*, 453 B.R. 132, 183 (Bankr. S.D.N.Y. 2011) (holding that failure to object constitutes an implied consent); *In re Borders Grp., Inc.*, 453 B.R. 477, 483-84 (Bankr. S.D.N.Y. 2011) (same); *In re Arena Media Networks, LLC*, No. 10–10667(BRL), 2010 WL 2881346 (Bankr. S.D.N.Y. Mar. 22, 2010) (same); *cf. In re Arch Hospitality, Inc.*, 530 B.R. 588, 591 (Bankr. W.D.N.Y. 2015) ("Consent and failure to object are not synonymous.")

provide grounds to find implied consent.[15] In such cases, the failure to respond may be taken as an admission that there is a bona fide dispute and the collateral may be sold under Section 363(f)(4) or that the creditor actually consented to the sale. Other courts, however, provide that silence may imply the absence of consent and that "consent and failure to object are not synonymous."[16]

D. Section 363 Sale Are Insulated from Challenge on Appeal by Section 363(m)

Bankruptcy Code Section 363(m) prevents the overturning of a completed sale to a good-faith purchaser in the absence of the stay in bankruptcy appeals.[17] Section 363(m) helps maximize the sale proceeds for the estate by giving asset purchasers more confidence in the finality of their purchases. Section 363(m) provides as follows:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Section 363(m) limits the appealability of a Section 363 sale order that has been consummated to the issue of the purchaser's good faith.[18] Courts have strictly enforced Section 363(m), holding that "appellate jurisdiction over an unstayed sale order issued by a bankruptcy court is statutorily limited to the narrow issue of whether the property was sold to a good faith purchaser."[19] "[R]egardless of the merit of an appellant's challenge," an appellate court "may neither reverse nor modify the judicially-authorized sale if the entity that purchased or leased the property did so in good faith and if no stay was granted."[20]

Every sale has different facts and circumstances and Section 363(m) is not always going to provide the buyer protection or render an appeal moot. As discussed above, the court in *Clear Channel* held that Section 363(m) does not apply to Section 363(f) where a sale attempts to strip liens and eliminate the rights of third parties in assets sold by a debtor.

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[15] *See FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281, 285 (7th Cir. 2002) (finding that the circumstances warranted for a lack of objection after notice to constitute consent where the affected interest was a license to use intellectual property).

[16] *In re Arch Hosp., Inc.*, 530 B.R. 588, 591 (Bankr. W.D.N.Y. 2015) ("a failure to oppose . . . differs fundamentally from an affirmation of acquiescence."); *In re Decelis*, 349 B.R. 465, 467–74 (Bankr. E.D. Va. 2006) (finding that a failure to oppose a motion to sell free and clear does not equate to consent pursuant to § 363(f)(2) and distinguishing cases that find otherwise).

[17] 11 U.S.C. § 363(m); *see also Nieters v. Sevcik (in re Rodriguez)*, 258 F. 3d 757, 759 (8th Cir. 2001).

[18] *See* 11 U.S.C. § 363(m).

[19] *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 105 F.3d 837, 839 (2d Cir.1997) (emphasis in original); see also In re Colony Hill Assocs., 111 F.3d 269, 273 (2d Cir.1997) (similar).

[20] *Gucci*, 105 F.3d at 840; *see In re Sax*, 796 F.2d 994, 997 (7th Cir.1986) ("Section 363(m) does not say that the sale must be proper under § 363(b); it says the sale must be authorized under § 363(b)." (emphasis in original)).

E. Typical Section 363 Sale Process

In many cases, the debtor will engage an investment banker and begin marketing its assets before filing a bankruptcy petition. This approach is generally preferred because it can help streamline the bankruptcy case and reduce the amount of time the debtor spends in bankruptcy. The marketing process typically involves creating an electronic data room with key documents and contracts, contacting potentially interested parties (both strategic and financial), and engaging in discussions with serious potential purchasers.

Traditionally, debtors have preferred to negotiate an asset purchase agreement (or similar transaction agreement) with a stalking horse bidder prior to filing a bankruptcy petition. A stalking horse bidder is a proposed purchaser that agrees to submit a binding bid, typically in the form of an executed asset purchase agreement, in exchange for certain protections. These protections safeguard the stalking horse bidder if the debtor ultimately sells its assets to another party, and is triggered if that occurs. The most common stalking horse protections include:

(1) **Expense Reimbursement –** Expense reimbursement can be provided for in the asset purchase agreement between the buyer and the debtor and is subject to court approval. The purpose of expense reimbursement is to protect the buyer from the out of pocket costs associated with due diligence (that may be relied upon by the parties), and negotiating and documenting the transaction, i.e. legal fees, appraisal fees, and diligence fees.

(2) **Break-Up Fees**[21] **–** Break-up fees compensate the stalking horse for the value that its bid provided to the debtor's estate. Many courts approve a fee up to approximately 3% of the bid value.

(3) **Non-Solicitation and Exclusivity Rights –** Buyers have been increasingly negotiating for such rights in purchase agreements. These rights comprise a list of covenants by the debtor in an effort to prevent the emergence of a competing alternative transaction.[22] While such rights limit the debtor's right to "window shop" for new offers, they often allow the debtor flexibility in responding to unsolicited proposals.

(4) **Limiting the Scope of the "Fiduciary Out" –** Traditionally, the "fiduciary out" allows the debtor to terminate the purchase agreement with the buyer and pursue

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[21] The standards for approval of break- up fees and other bid protections, depending on the jurisdiction, are (1) the business judgment standard, (2) the administrative expense test and (3) the "best interest of the estate" test. *See In re Integrated Res., Inc.*, 147 B.R. 650, 660 (S.D.N.Y. 1992) (adopting the business judgment standard); *In re ASARCO, L.L.C.*, 650 F.3d 593, 601 (5th Cir. 2011) (affirming that the business judgment standard was the correct legal standard to apply to certain bid protections); *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 435 (3d Cir. 1999) (applying the administrative expense standard to bid protections); *In S.N.A. Nut Co.*, 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) (applying the best interest of the estate standard). In many cases, the court's analysis may combine or overlap elements of these standards. *See* John D. Bittner, *Introduction to Credit Bidding and Bankruptcy Acquisition Strategies*, 32nd Annual Advanced Business Bankruptcy, February 19-20, 2015.

[22] Additionally, where there are limited go-shop periods, the non-solicitation provisions of the sale agreement may also include covenants to shut down and extinguish such process at the end of the go-shop period).

an alternative proposal when doing so is required to satisfy the debtor's fiduciary duty to maximize value. Limitations on the "fiduciary out" include contractual specifications regarding what the debtor must consider in determining whether an offer triggers the fiduciary out.

(5) **Increasing the Buyer's Information Rights –** Increased information rights are designed to provide the buyer more information regarding competing proposals made to the debtor.

(6) **Match Rights –** This is a less common form of bidder protection. Match rights require the debtor to give the buyer notice before the debtor may terminate the purchase agreement in favor of a competing proposal. Additionally, match rights may require the debtor to negotiate with the buyer before termination to determine whether the buyer can provide a more appealing offer than the competitor.

A debtor who has negotiated an asset purchase agreement with a stalking horse bidder prior to filing for bankruptcy will typically file a prompt motion to sell assets pursuant to Section 363 and to approve procedures to govern a bidding and sale process.[23] To maximize value, courts often approve procedures that permit competing bidders to submit offers and participate in an auction for the debtor's assets. It is common for disputes to arise in connection with bidding procedures, as creditors' committees and competing bidders often seek additional time for submitting competing bids, relaxed standards for becoming bidders qualified to participate in the auction, reduction of the overbid amount, and related items.

After bidding procedures are established, qualified bidders submit competing bids, which are typically made in the form of an asset purchase agreement and marked against the stalking horse bidder's asset purchase agreement or the debtor's form. The debtor will review the bids and typically will select a lead bid to open the auction. The auction often takes place at the offices of the debtor's counsel, but some judges require auctions to occur in the courtroom or other places within the courthouse. It is not uncommon for auctions to be protracted affairs, with numerous negotiations between bidders, the debtor and committees.

Secured lenders often play an important role in Section 363 sales. Section 363(k) allows lenders to credit bit at a Section 363 sale unless the court finds cause to disallow it. *See* 11 U.S.C. § 363(k). The ability to credit bid gives secured lenders a great deal of influence in the bidding process. A common dynamic involves the secured lender bidding against a cash bidder, where the issue becomes how much is the cash bidder willing to bid against what is often a much larger amount of secured debt.

At the conclusion of the auction, the bankruptcy court will hold a hearing to approve the auction results and the sale of assets. After the sale closes the bankruptcy case typically concludes with the approval of a liquidating plan or conversion to Chapter 7 to distribute the sale proceeds.

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[23] In jurisdictions the request to sell assets and the request to establish bidding procedures may be asserted in the same motion.

F. Credit Bidding

Section 363 of the Bankruptcy Code permits a debtor to sell all or substantially all of its assets free and clear of all liens. In many cases, either due to a lack of stalking horse bidders stepping up, personal preference of the secured creditors, or sometimes due to a lack of time to run a stalking horse selection process (which often takes longer than the main marketing and auction process), we will see a credit bid by the secured creditors serving as the stalking horse bid. This often works well, as the secured creditors are very well aware of what the collateral is and is debating internally whether they want to own and operate the collateral. By serving as a stalking horse, they are given the ability to see a true market test before ultimately deciding whether to exercise their credit bid rights or not. They are also able to negotiate the asset purchase agreement to their own specifications and include various bells and whistles in both the asset purchase agreement as well as the bidding procedures order, thus being able to control the process.

Section 363 permits a holder of an allowed secured claim against a debtor to credit bid its loans in a Section 363 sale, unless a court, for "cause," orders otherwise.[24] Prior to 2014, the bankruptcy courts had generally limited "cause" to situations in which a secured creditor had engaged in egregious misconduct (i.e., such as collusion) and were largely unsympathetic to arguments that credit bidding should be precluded because it would chill the bidding process.

In 2014, there were two bankruptcy court decisions from the District of Delaware and the Eastern District of Virginia—*In re Free Lance-Star Publishing Co. of Fredericksburg, Va.*[25] and *In re Fisker Automotive Holdings, Inc.*[26]—that had raised serious concerns for secured lenders and purchasers of secured loans in the secondary market. In *Free Lance-Star and Fisker Automotive*, the respective bankruptcy courts severely limited the ability of the secured creditors in question to credit bid their secured claims. Specifically, in *Free Lance-Star*, the secured creditor had purchased an existing $50.8 million loan to the debtor. The debtor commenced a Section 363 sale process, and the secured creditor attempted to credit bid its $38 million secured claim against the debtor.

Upon objection by the debtor and the unsecured creditors committee, the bankruptcy court entered an order limiting the secured creditor's right to credit bid to $13.9 million, and concluded that: [t]he confluence of (i) [the secured creditor's] less than fully secured lien status;; (ii) [the secured creditor's] overly zealous loan to own strategy; and (iii) the negative impact of [the secured creditor's] misconduct has had on the auction process has created the perfect storm, requiring curtailment of [the secured creditor's] credit bid rights.

Similarly, in *Fisker Automotive*, the bankruptcy court limited a secured creditor's right to credit bid its $169 million secured claim to the $25 million that the secured creditor paid for its claim. The bankruptcy court found that cause existed to limit the secured creditor's rights due to (1) the desire not to chill bidding at the Section 363 sale and (2) concerns raised by unsecured

[24] 11 U.S.C. § 363(k).

[25] 512 B.R. 798 (Bankr. E.D. Va. 2014)

[26] 510 B.R. 55 (Bankr. D. Del. 2014).

creditors regarding the extent and validity of the secured creditor's liens on certain assets being sold.

The *Free Lance-Star* and *Fisker Automotive* cases broke new ground by expansively interpreting "cause" under Section 363(k) of the Bankruptcy Code to include situations where a court has determined that capping a credit bid would foster a "robust," "competitive" and "open" sale process and found a "loan to own" investment strategy by a secured creditor suspect. Courts had previously limited "cause" to clearly egregious conduct by a lender and not just the fact that credit bidding could chill bidding in the Section 363 sale process.

A recent bankruptcy court decision in *In re Aéropostale, Inc.*[27] may provide some comfort to secured creditors seeking to credit bid in a sale process commenced by a debtor pursuant to Section 363. The court addressed the debtors' arguments, relying on the *Free Lance-Star* and *Fisker Automotive cases*, that permitting the creditor to credit bid would impermissibly chill bidding at the Section 363 sale. With respect to the *Fisker Automotive* decision, the *Aéropostale* court noted that the chilling of bidding, alone, was not sufficient to justify prohibiting credit bidding and minimized *Fisker Automotive* by noting that the *Fisker Automotive* court had been concerned by "other problematic conduct" in that the secured creditor in *Fisker Automotive* had "insisted on an unfair process."[28]

G. Sub Rosa Plans

While the business judgment standard is deferential and rarely results in Bankruptcy Court denial of a sale motion, whether or not a debtor may sell substantially all of its assets under Section 363(b) has been the subject of extensive debate, particularly within the Fifth Circuit. Even the most thoroughly prepared and objectively supported Section 363(b) sale cannot be approved if the transactions attempts to structure the rights and claims of interested parties. The concept that a Section 363(f) sale might be an objectionable "*sub rosa*" plan of reorganization originated in *In re Braniff Airways, Inc.*[29] where the court concluded that "any future attempts to specify the terms whereby a reorganization is to be adopted, the parties and the district court must scale the hurdles erected in chapter 11" and not through a Section 363 sale. While sales of all or substantially all the debtor's assets prior to administration of a Chapter 11 plan have been approved in a variety of circumstances, a sales transaction that purports to accomplish a de facto reorganization exceeds the limitations of Section 363.

In *Braniff* we recognized that a debtor in Chapter 11 cannot use § 363(b) to sidestep the protection creditors have when it comes time to confirm a plan of reorganization [I]f a debtor were allowed to reorganize the estate in some fundamental fashion pursuant to § 363(b), creditor's rights under, [plan of reorganization sections] might become meaningless. Undertaking reorganization piecemeal pursuant to § 363(b) should not deny creditors the protection they would receive if the proposals were first raised in the reorganization plan. At the same time, we fully appreciate that post-petition, pre-confirmation transactions outside the ordinary course of

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[27] 555 B.R. 369 (S.D.N.Y. 2016).

[28] *Id.* at 417.

[29] 700 F.2d 935 (5th Cir. 1983).

business may be required and that each hearing on a § 363(b) transaction cannot become a mini-hearing on plan confirmation. Balancing these considerations, we hold that when an objector to a proposed transaction under § 363(b) claims that it is being denied certain protection because approval is sought pursuant to § 363(b) instead of as part of a reorganization plan, the objector must specify exactly what protection is being denied. If the court concludes that there has in actuality been such a denial, it may then consider fashioning appropriate protective measures modeled on those which would attend a reorganization plan.[30]

More recently, in *In re Gulf Coast Oil Corp.*[31] a now-retired bankruptcy judge in the Southern District of Texas created a multi-factor test for evaluating whether a sale under Section 363(b) should be approved, or whether the sale should be rejected as a clandestine plan of reorganization. While not binding authority, certain judges in the Southern District of Texas continue to follow the *Gulf Coast Oil* approach. The *Gulf Coast Oil* court set forth the following factors to consider in this determination:

(1) whether there is evidence of a need for speed, e.g., based on the perishable nature of assets or looming, adverse market conditions;

(2) whether there is business justification for sale and sale process, as well as for having sale process proceed apart from confirmation process;

(3) whether the case is sufficiently mature that parties in interest have received adequate notice, have obtained appropriate information, and have been able to participate;

(4) whether the proposed sales process is sufficiently straightforward to facilitate competitive bids;

(5) whether the assets have been aggressively marketed in active market;

(6) whether the fiduciaries that control the debtor are truly disinterested, so that the court can have faith in their business judgment;

(7) whether the proposed sale includes all of the debtor's assets or the "crown jewel" of such assets;

(8) whether the purchaser will receive any extraordinary protections;

(9) burdens of proposing sale as part of plan confirmation process;

(10) who will benefit from the sale;

(11) whether any special adequate protection measures are necessary or possible; and

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[30] *Id.* at 1227.

[31] 404 B.R. 407, 422-27 (Bankr. S.D. Tex. 2009).

(12) whether the hearing on proposed sale was true adversary presentation.[32]

While this standard is somewhat rigorous, sales of substantially all assets have become fairly routine in many cases.

In other jurisdictions, including popular venues like the District of Delaware and the Southern District of New York, the sale of all assets under Section 363 is less controversial.[33] As a leading bankruptcy treatise concludes: "It is now generally accepted that section 363 allows such sales in chapter 11, even where there is no emergency requiring immediate action."[34]

Two of the most notable Section 363 sales of the past decade occurred in the sales of substantially all of the assets of Chrysler LLC and General Motors Corporation.[35] In *Chrysler*, the Bankruptcy Court for the Southern District of New York authorized a Section 363 sale of "Old Chrysler's" assets to "New Chrysler."[36] The court reasoned that the sale was permissible under Section 363(b) because Old Chrysler would receive more than fair value in return for the sale of assets to New Chrysler, and all the sale proceeds would be distributed according to the Chapter 11 priority scheme.[37] It also noted that New Chrysler was the only entity willing to help Old Chrysler, and that Old Chrysler would be forced into a total liquidation if the court nullified the transaction.[38] The court's central theme in justifying its holding was that the transaction in no way affected the Chapter 11 priority scheme.[39]

On appeal, the Second Circuit approved the district court's authorization of the sale free and clear of any existing tort liability (the significance of "free and clear" sales under Section 363 is discussed below).[40] Although the appeal was dismissed and vacated as moot, the reasoning set forth by the Southern District of New York and the Second Circuit could serve as a model for debtors in possession who wish to sell substantially all of their assets at the beginning of bankruptcy.

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[32] *Id.*

[33] *See In re Abbots Dairies*, 788 F.2d 143, 150, 14 C.B.C.2d 811, 819 (3d Cir. 1986); *Florida Dep't. of Revenue v. Picadilly Cafeterias, Inc.*, 128 S. Ct. 2326, 2330 n.2 (2008) ("Chapter 11 bankruptcy proceedings ordinarily culminate in the confirmation of a reorganization plan. But in some cases, as here, a debtor sells all or substantially all of its assets under § 363(b)(1) before seeking or receiving plan confirmation").

[34] 3 Collier on Bankruptcy, ¶ 363.02[3].

[35] *See In re Chrysler LLC*, 576 F.3d 108 (2d Cir.), *judgment vacated as moot*, 175 L.Ed. 2d 61 (2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010); *In re General Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

[36] *In re Chrysler*, 405 B.R. 84, 97-98 (Bankr. S.D.N.Y. 2009).

[37] *Id*. at 97-98.

[38] *Id.* at 98.

[39] *Id.*

[40] *Chrysler, LLC,* 576 F.3d at 126-27.

H. Structured Dismissal

The idea that a "structured dismissal" could be used as a means to conclude a Chapter 11 case after a sale of substantially all assets has made its way into case law. A structured dismissal is a dismissal pursuant to either Section 1112(b) or Section 305(a)(1) that occurs following a sale of substantially all of the debtor's assets. Usually a bankruptcy case can only be resolved in one of three ways: confirmation of a Chapter 11 plan of reorganization by a bankruptcy judge, a Chapter 7 conversion to liquidate a debtor's assets or outright dismissal of a bankruptcy case, leaving individual creditors seeking a recovery to fend for themselves. A structured dismissal, therefore, is a hybrid approach to reorganization that provides an alternative for an administratively insolvent debtor that has support from various creditor groups.

On December 7, 2016, the U.S. Supreme Court heard argument with respect to a Third Circuit-affirmed settlement and dismissal of the Chapter 11 cases of *Jevic Transportation, Inc.* and certain of its affiliates.[41] Specifically, the Supreme Court will determine whether a settlement *Jevic* made with its secured lenders and the official committee of unsecured creditors, which included a "structured dismissal" of *Jevic's* bankruptcy cases, runs afoul of the payment priority scheme set forth in the Bankruptcy Code.

In affirming the appeal of the settlement and dismissal, the Third Circuit reinforced a circuit split with the Fifth Circuit, which held in *U.S. v. Aweco Inc. (In re Aweco, Inc.)*,[42] that a bankruptcy court cannot approve a settlement agreement between a debtor and a junior creditor if the objections of senior creditors regarding priority are not respected. The Third Circuit "admit[ted] that it [was] a close call," but stated that approval of the settlement agreement and structured dismissal "remained the least bad alternative since there was 'no prospect' of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate . . . ."[43]

III. HOW FAR DOES FREE AND CLEAR GO? SUCCESSOR LIABILITY ISSUES

Section 363(b) of the Bankruptcy Code provides that a trustee or DIP may use, sell, or lease estate property outside the ordinary course of the debtor's business with bankruptcy court approval. In addition, under Section 363(f), the sale may be "free and clear of any interest in such property of an entity other than the estate," provided it satisfies any one of certain specified conditions. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the amount of all liens encumbering the property, and if the interest is in bona fide dispute.

A bankruptcy court's power to order sales free and clear of a competing interest without the consent of the party asserting the interest has been recognized for more than a century. It promotes the expeditious liquidation of estate assets by avoiding delay attendant upon sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in

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[41] *See Official Comm. of Unsecured Creditors v. CIT Grp./Bus. Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. 2015), *cert. granted Cyzewski v. Jevic Holding Corp.*, No. 15-649, 2016 WL 3496769 (U.S. 2016).

[42] 725 F.2d 293 (5th Cir. 1984).

[43] *Jevic*, 787 F.3d at 175.

a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset.

Meanwhile, holders of competing interests are also provided with protections by the Bankruptcy Code. Pending the bankruptcy court's resolution of any disputes, the interest holder is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

A. "Any Interest" Broadly Construed

Section 363(f) has been applied to a wide range of "interests," but courts have sometimes struggled to grasp the scope of the term, which is defined nowhere in the Bankruptcy Code or its accompanying legislative history. For example, courts have disagreed as to whether a successor liability claim constitutes an "interest" in property that can be extinguished by means of a sale free and clear. Some courts have narrowly construed the term "interest" to include only in rem interests (e.g., liens and security interests that attach to specific property). These courts typically have ruled that product liability claims and tort actions against the seller are unaffected by a bankruptcy sale and can be asserted against the buyer. Other courts have construed the term broadly to hold that certain liabilities (e.g., certain environmental remediation costs and employment discrimination claims) do not follow assets sold free and clear under Section 363(f).

Special circumstances have led to the development of case-specific rules. For example, some bankruptcy courts have expanded the scope of traditional successor liability where there is an overriding need to protect federal rights or effectuate federal policies. These courts have allowed actions against a purchaser of a debtor's business if the successor had notice of the claim before the acquisition and there is substantial continuity in the operation of the business before and after the sale.

Courts have also struggled to develop an appropriate way to deal with "future claims" (i.e., claims that do not arise until after the bankruptcy proceedings have concluded). Some have adopted a blanket rule that future claims cannot be discharged in a debtor's bankruptcy case. Other courts have adopted a more practical approach in dealing with future claims. Instead of denying discharge of all future claims, these courts have examined whether the debtor notified as many potential claimants as possible of the sale, whether the debtor sought court approval to preclude successor liability, and whether the debtor made arrangements for future claimants so that they are able to look to some source for recovery.

B. Chrysler and GM

i. *In re Chrysler LLC*[44]

In *Chrysler*, the Southern District of New York Bankruptcy Court held that all liens and successor liability claims were extinguished by the sale of substantially all of Chrysler's assets pursuant to Section 363(f)(5). The court found that, through their collateral trustee, the first-

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[44] 405 B.R. 84 (Bankr. S.D.N.Y. 2009), cited *supra*.

priority secured lienholders consented to the free and clear sale. The court then followed Third Circuit precedent to reject the objections to the sale by current and future tort claimants because such claims are "interests in property" under Section 363(f). Furthermore, the court held that Section 363(f) encompasses both in personam and in rem claims. Accordingly, Chrysler's assets were taken free and clear of all tort claims. On appeal, the Second Circuit confirmed the bankruptcy court ruling for "the reasons stated in the opinions [below]."[45] However, the Second Circuit left open the possibility that future tort claims against the purchaser—"New Chrysler"—might be actionable. The court declined to "delineate the scope of the bankruptcy court's authority to extinguish future claims, until such time as we are presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the Sale, and that is cognizable under state successor liability law."

ii. *In re General Motors Corp.*[46]

A little over month after the *Chrysler* decision, the Bankruptcy Court for the Southern District of New York permitted a similar sale in General Motors. The court relied on *Chrysler* and the Second Circuit's subsequent affirmation to conclude that the sale of substantially all of General Motors' assets pursuant to Section 363(f) was free and clear of all liens and tort claims. On appeal, the district court held that, because the sale was not stayed on appeal, it could not be modified to strike the provision selling the assets free and clear of any successor liability. Once the sale closed, any appeal was moot under both Section 363(m) and the doctrine of equitable mootness.[47] However, the district court did interpret Section 363(f) as allowing bankruptcy courts to authorize the sale of an asset free of successor liability.

C. Other Successor Liability Cases in the Wake of Chrysler and GM

i. *In re Grumman Olson Indus., Inc.*[48]

In *Grumman Olson*, the bankruptcy court held that: (a) a bankruptcy court has continuing jurisdiction to interpret its prior sales order in a dispute between two non-debtor parties; and (b) while Section 363(f) sales can shield purchasers from in personam successor liability, the products liability tort claimants in this case could proceed against the purchaser in state court. The court validated the products liability claims because the accidents occurred after the Section 363(f) sale. Accordingly, (a) there was no "claim" under Section 101(5)(A)'s definition of "claim" at the time of the sale even though the defective products were manufactured before the sale and (b) due process notice requirements were not met.

ii. *In re Polyurethan Foam Antitrust Litigation*[49]

At issue was whether a Section 363(f) sale precludes successor liability for antitrust

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[45] *Chrysler LLC*, 576 F.3d at 111.

[46] 407 B.R. 463 (Bankr. S.D.N.Y. 2009), cited *supra*.

[47] *In re Motors Liquidation Co.*, 428 B.R. 43 (S.D.N.Y. 2010).

[48] 445 B.R. 243 (Bankr. S.D.N.Y. 2011).

[49] 799 F. Supp. 2d 777 (W.D. Ohio 2011).

claims. The court left this issue open because it held that the purchaser may be liable under other legal theories, such as co-conspirator joint liability for activities after the sale. However, the court explained that if the plaintiff was unable to produce evidence to support an alternative theory, the court would revisit the topic.

iii. *In re Skyline's Woods Country Club*[50]

The court declined to enjoin a state court decision that held restrictive land-use covenants on the purchased property were valid against the Section 363(f) sale purchaser. The purchaser attempted to reopen the bankruptcy case to enjoin enforcement of the state court judgment, but the circuit court affirmed the bankruptcy court's decision not to do so. The court reasoned that the state court had, at the very least, concurrent jurisdiction over the post-bankruptcy dispute, and thus, the state court judgment would be entitled to full faith and credit in a reopened bankruptcy case.

iv. *Teed v. Thomas & Betts Power Solutions, L.L.C.*[51]

In this decision, the court found a Section 363 purchaser liable for Fair Labor Standards Act ("FLSA") violations, related to the debtor-seller's nonpayment of overtime, on the basis of successor liability as a matter of the federal FLSA statute. Applying a federal common-law standard for successor liability in a case arising under a federal statute, the court found that the federal standard is more permissive towards successor liability than most state-law standards. The court's standard was whether "good reasons" existed to withhold successor liability, and it found that they did not. The court implied that lack of notice of the claims to the purchaser, or a lower price offered by the purchaser if successor liability claims were not to be released, may have been "good reasons."

v. *Molla v. Adamar of New Jersey, Inc.*[52]

The plaintiff alleged a tort that happened at the Tropicana Casino after bankruptcy but before the Section 363 sale closed. The court added that the sale order relieved the purchaser of liability and that the sale order could be enforced against the plaintiff. In doing so, the court stated that notice was required before claims are discharged against a debtor, but not before a court eliminates claims that might otherwise exist against a non-debtor purchaser. This is a surprising statement. Due process protects against deprivations of any "property," and it is not clear why less notice should be required to divest a claimant of a claim against the debtor, but not to divest the same claimant of a (probably more valuable) claim against a non-debtor.

vi. *In re NE Opco*[53]

The court barred former seller employee claims against the buyer related to the pre-closing period, even though the buyer's pre-closing conduct was included in the allegations of those claims. But, the court did not bar former seller employee claims against the buyer related to the post-closing period, citing *Grumman*, even though the employee's work for the seller was

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[50] 636 F.3d 46 (8th Cir. 2011).

[51] 711 F.3d 763 (7th Cir. 2013).

part of the factual predicate for the employee's post-closing claims against the buyer**.**

vii. *Elliott v. General Motors, LLC (In re Motors Liquidation Co.)*[54]

Shortly after General Motors Corporation's ("Old GM") bankruptcy in 2009, Old GM's assets were sold to General Motors LLC ("New GM") pursuant to Section 363 of the Bankruptcy Code. The sale order, among other things, authorized the sale of such assets free and clear of successor liability claims and enjoined all parties from making any such claims against New GM. Despite such protections in the sale order, class action lawsuits were filed against New GM asserting successor liability claims related to faulty ignition switches in vehicles produced by Old GM. The problems with the faulty ignition switches were known to Old GM before such switches were even placed into vehicles, yet Old GM did not work to fix the problems. The bankruptcy court decided that the claimants had insufficient notice of the Sale Motion but held that their interests had been adequately addressed in the 850 other objections to the Sale Motion considered prior to entry of the Sale Order. Accordingly, the bankruptcy court determined that the claimants were not prejudiced by insufficient notice of the Sale Motion.

The Second Circuit agreed with the bankruptcy court that notice by publication was insufficient to apprise the claimants of the sale motion and that the debtor "should have provided direct mail notice to . . . [known] owners" of defective vehicles." However, the Second Circuit disagreed with the bankruptcy court that the defect was harmless. The insufficient notice prejudiced the holders of pre-closing claims because it was not clear that the key players (Old GM, New GM, and the United States Department of Treasury) would not have made some type of payment to those claimants to push the sale through, particularly given the focus on consumer confidence throughout the bankruptcy case, the involvement of the Department of Treasury, and the significant financial and business associated with the sale.

The Second Circuit's decision provides a clear indication that successor liability claims can be barred by Section 363 sale orders; however, due process must be afforded to creditors for parties to obtain Section 363's protections.

D. Environmental Claims

Potential purchasers should be aware of the unique limitations placed on the dischargeability of environmental claims held by the U.S. Government. Courts have held that injunctions obtained under environmental statutes to abate ongoing pollution are not within the ambit of "claims"[55] under the Bankruptcy Code and, accordingly, are not dischargeable under a

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[52] No. 11-6470, 2014 WL 2114848 (Bankr. D.N.J. May 20, 2014).

[53] 513 B.R. 871 (Bankr. D. Del. 2014).

[54] 829 F.3d 135 (2d Cir. 2016).

[55] *See* 11 U.S.C. § 101(5) (a "claim" includes a "right to an equitable remedy for breach of performance if such performance gives rise to a right to payment…"); *In re Davis*, 3 F.3d 113, 116-17 (5th Cir. 1993) (equitable remedies that do not fall within the Bankruptcy Code's definition of claim cannot be discharged).

Chapter 11 plan.[56] The U.S. Department of Justice ("DOJ"), on behalf of the U.S. Environmental Protection Agency ("EPA"), recently expressed concerns about the proposed plan of reorganization in the *Milagro* bankruptcy based on its concerns regarding a perceived discharge of non-dischargeable environmental claims. Environmental agencies regularly insist that special measures be taken by the parties to provide funding for the remediation of assets on which there is ongoing pollution generated by the debtor, often by establishing trust funds.[57] Moreover, when a purchaser acquires assets on which contamination created by the seller remains, the purchaser will have liability to address the contamination as the current owner or operator of the property without regard to the doctrine of successor liability.[58]

There are currently a number of pending coal company bankruptcies that may give rise to successor liability issues. In a coal company bankruptcy, an asset purchaser will likely confront the risk of being bound by the "successorship" provisions of collective bargaining agreements as well as potential statutory successor liability for retiree health care benefits premiums imposed under the federal Coal Industry Retiree Health Benefit Act.[59] A federal district court in the Northern District of Alabama recently affirmed the holdings of a bankruptcy court that the debtors' liabilities for premiums under the Coal Act were "interests in property" under Section 363(f) of the Bankruptcy Code and that the debtors' assets could be sold to a purchaser free and clear of such interests under Section 363.[60] The bankruptcy court also held that the debtors' collective bargaining agreements could be rejected under Section 1113 of the Bankruptcy Code, the debtors' obligations to their retirees could be terminated under Section 1114, and the purchaser could acquire the debtors' assets free and clear of any successor employer obligations to the debtors' employees and retirees under the debtors' collective bargaining agreements.[61]

E. Pension Liability

In *In re Ormet Corp.*,[62] the Delaware Bankruptcy Court held that Section 363(f) sales are free and clear of successor liability for withdrawal from a multi-employer pension plan or an ERISA-qualified plan. First, the court discussed the Third and Fourth Circuit cases cited by the debtors, in which assets were sold free and clear of successor liability claims for employment and sex discrimination *(In re Trans World Airlines, Inc*., 322 F.3d 283 (3d. Cir. 2003)) and for future medical benefits under the Coal Industry and Retiree Health Benefit Act *(Mine Workers 1992 Benefit Plan v. Leckie Smokeless Coal Co.*, 99 F.3d 573 (4th Cir. 1996)). The Court

[56] *See In re Chateaugay Corp.*, 944 F.2d 997, 1008 (2d Cir. 1991); *In re Torwico Elecs., Inc.*, 8 F.3d 146, 150 (3d Cir. 1993), cert. denied, 511 U.S. 1046 (1994); *United States v. Apex Oil Co.*, 579 F.3d 734, 738 (7th Cir. 2009), cert. denied, 562 U.S. 827 (2010).

[57] *See, e.g.*, environmental trust established in *In re Tronox Inc.*, No. 09-10156 (ALG) (S.D.N.Y.).

[58] *See Ohio v. Kovacs*, 459 U.S. 274, 285 (1985) (liability for ongoing environmental contamination "runs with the land").

[59] 26 U.S.C. §§ 9701-9722.

[60] *UMW Combined Ben. Fund v. Walter Energy Inc.*, 2016 U.S. District LEXIS 29097, at **19-25 (N.D. Ala. Mar. 8, 2016). The court followed the Fourth Circuit's similar 1996 holding in *Leckie Smokeless*, cited *infra*.

[61] *In re Walter Energy Inc.*, 542 B.R. 859 (Bankr. N.D. Ala. 2015), aff'd, 2016 U.S. Dist. LEXIS 65166 (N.D. Ala. May 18, 2016); *see also In re Alpha Natural Res. Inc.*, 2016 Bankr. LEXIS 2154 (Bankr. E.D. Va. May 24, 2016).

[62] No. 13-10334, 2014 WL 3542133 (Bankr. D. Del. July 17, 2014).

explained that while strong policy interests were also at stake in the cases, the Third and Fourth Circuits held that these claims could be extinguished by a sale of assets under Section 363. In addition, the court expressed concern that making an exception to free and clear asset sales under Section 363(f) for successor liability claims may depress the prices that parties bid for a debtor's assets. Finally, the court rejected the following cases noting that none of them involved a sale of assets free and clear of claims under Section 363(f):

- *Einhorn v. M.L. Ruberton Const. Co.*[63]

In *Einhorn*, the Third Circuit created concern that a purchaser of the debtor's assets may be liable for the debtor's pre-petition obligations under ERISA where (1) the buyer had notice of the liabilities prior to the sale; and (2) there is sufficient evidence of continuity of operations between the buyer and seller. The court stated that the "inquiry should be effectuated on a case by case basis balancing the equities presently before the court." The court explained that the substantial continuity test requires courts to consider: continuity of the workforce, management, equipment and location; completion of work orders begun by the predecessor; and constancy of customers. Commonality of ownership is not required.

- *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc.*[64]

In *Tasemkin*, the Seventh Circuit Court of Appeals reversed the district court's dismissal of a complaint brought by a pension fund against a Chapter 7 debtor's successor seeking payment on account of the debtor's pre-petition obligation for delinquent pension funds and ERISA withdrawal liability, finding that a blanket rule precluding all successor liability claims following a bankruptcy was unsound. The court explained that a distinct purchaser of a business can be liable for the obligations of its predecessor if "(1) the successor had notice of the claim before the acquisition; and (2) there was "substantial continuity in the operation of the business before and after the sale." Nevertheless, the case involved a post-bankruptcy claim as a result of a foreclosure sale during or after the closed Chapter 7 case, but it did not involve a court-supervised Section 363 sale.

IV. BASIC PRINCIPLES APPLICABLE TO TREATMENT OF EXECUTORY CONTRACTS IN SECTION 363 SALES

Section 365 of the Bankruptcy Code gives a debtor-in-possession/trustee the ability to assume, assume and assign, or reject an executory contract, notwithstanding any contractual prohibitions on assignment.[65]

[63] 632 F.3d 89 (3d Cir. 2011).

[64] 59 F.3d 48 (7th Cir. 1995).

[65] *See* 11 U.S.C. § 365(a) ("the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor"); 11 U.S.C. § 365(f)(1) (subject to certain exceptions, the trustee may assign contracts and leases "notwithstanding a provision in an executory contract or unexpired lease of the debtor . . . that prohibits, restricts or conditions the assignment" thereof).

A. Section 365 Only Applies to Contracts that Remain Executory as of the Petition Date

Section 365 only applies if the contract qualifies as "executory" as of the petition date. This term is not defined in the Bankruptcy Code. Under the most commonly accepted test, "executory" means that the "obligations 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."[66] Conversely, a contract is generally not considered executory if one party to the contract has completed all material performance.[67]

B. Intellectual Property/Licensees

Intellectual property ("IP") licenses are usually considered to be executory contracts and thus may be assumed and assigned to a buyer under Sections 365 and 363 in a bankruptcy sale.[68] However, case law has created confusion, exceptions and conflicts among the circuit courts.

i. *Debtor is the Owner*

The debtor/trustee in bankruptcy is free to sell such IP at a Section 363 sale to the same extent as any other asset where the debtor is the owner of IP and has not licensed the rights to such IP to a third party.

ii. *Debtor Owns the IP But Has Licensed the Use of the IP to Third Party*

Here, the debtor/trustee may sell the IP and the existing license (and thus the revenue stream) to a third party, either as a "stand-alone" sale or as part of a sale of a going concern business under Sections 363 and 365. In short, where both the IP and the license are being sold together to a single buyer, the sale will generally be allowed, especially where the sole impact on the nondebtor licensee is merely a change in the address of the party to whom royalty checks will be sent in the future. However, practitioners should be aware of potential objections from nondebtor licensees in situations where the debtor/licensor serves a role beyond that of mere

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[66] *Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 2033 (4th Cir. 1984) (quoting Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 (1973)). *See also, e.g.*, *Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985) ("[t]his court has recently adopted Professor Countryman's more specific test for determining whether a contract is 'executory' in the required sense"); *In re Norquist*, 43 B.R. 224, 228 (Bankr. E.D. Wash. 1984) (stating that "the Supreme Court in citing the legislative history appears to have agreed with the expression of Congress that a precise definition of an executory contract is inadvisable," but applying the Countryman definition).

[67] *See, e.g.*, *In re Spectrum Info. Tech., Inc.*, 190 B.R. 741, 750 (Bankr. E.D.N.Y. 1996) (holding that separation agreements were not executory because they lacked "the requisite material future obligations on both sides"); *see also In re Monument Record Corp.*, 61 B.R. 866, 868 (Bankr. M.D. Tenn. 1986) (holding that recording contract was not executory because it did not "contain the continuing mutual obligations necessary to constitute an 'executory' contract").

[68] *Lubrizol Enters. Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985) (nonexclusive agreement to use patented technology found to be "executory" under Section 365); *In re Kmart Corp.*, 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy Code."); *In re Aerobox Composite Structures LLC*, 373 B.R. 135, 139 (Bankr. D.N.M. 2007).

recipient of periodic IP royalties. For example, if the debtor/licensor also provides raw materials, source code, maintenance or other needed services to the licensee, then care must be taken to ensure that the licensee's needs are "adequately protected" by the buyer of the IP (and as assignee of the IP license) going forward. [69]

There is a statutory prohibition on rejecting IP licenses to the detriment of licensees. Thus, a debtor/licensor may not reject an existing license of its IP and then sell such IP "free and clear" of the rejected IP licensee's rights Specifically, Section 365(n) provides that a licensee of IP may elect, after a rejection of the IP license, to (a) treat such contract as terminated (i.e., the licensee can walk away with no further obligations but with no further right to use the IP), or (b) alternatively, can elect to retain all rights, including rights to enforce any exclusivity provisions in the license and related or ancillary agreements, for the duration of the license contract and any extensions thereof permitted by law or by the license.[70] If the licensee elects to retain its rights, then it must make all required royalty payments and must waive any administrative claim for nonperformance by the debtor/trustee. Accordingly, Sections 365(n) and 363(e) effectively prevent a debtor/trustee from stripping a licensee's rights and selling the IP "free and clear" as an unfettered asset.[71]

iii. *Debtor is a Licensee*

Where a licensee of IP is in bankruptcy, the ability of the debtor or trustee to assume and assign (i.e., to sell the IP) to a third party under Section 365 will vary greatly depending upon (a) the kind of IP to be assigned, (b) the exclusivity of the IP rights held by the debtor/licensee, and (c) the jurisdiction in which the bankruptcy case is located.

Courts have generally held that nonexclusive patent licenses are not assignable unless the patent owner consents since: "[i]t is well settled that a nonexclusive licensee of a patent has only a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment."[72] Although an exclusive patent license does provide broader rights to the licensee (including the right to sue for patent infringement), many courts nevertheless hold that exclusive patent licenses are also generally nonassignable without the patent owner's consent (or where the patent owner

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[69] *See* 11 U.S.C. § 363(e) (court may prohibit or condition the "use, sale or lease [of property] as is necessary to provide adequate protection" of a party's "interest").

[70] 11 U.S.C. § 365(n).

[71] *See, e.g., In re Dynamic Tooling Sys. Inc.*, 349 B.R. 847, 855-56 (Bankr. D. Kan. 2006) (court holds that a "[licensee's] interests can be protected by this court's express order that to the extent [debtor's] intellectual property is included in the asset transfer, that property is subject to whatever license rights [licensee] may have under the agreement."); *In re Qimonda AG*, 462 B.R. 165, 184 (Bankr. E.D. Va. 2011) (where the Bankruptcy Code prevented the debtors from unilaterally terminating the rights of licensees of their intellectual property by rejecting licensing agreements so as to allow the foreign representative to reject licenses for the debtor's United States patents and to compel licenses to negotiate new licensing agreements at more favorable rates).

[72] *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986); *In re Catapult Entm't*, 165 F.3d 747, 750 (9th Cir. 1999) (nonexclusive patent licenses do not give rise to ownership rights and thus cannot be assigned).

has manifested a clear "pre-consent" in the license itself).[73] Similarly, nonexclusive copyright licenses are generally not assignable by a licensee in bankruptcy.[74] This is because nonexclusive copyright licenses do not transfer any rights of "ownership" to the licensee and thus, the license is "personal" to the transferee who cannot assign it to a third party absent the copyright owner's consent.[75] However, unlike exclusive patent licenses (where assignment is generally prohibited absent consent), some courts allow assignments of exclusive copyright licenses since, under applicable copyright law, an exclusive copyright license conveys an "ownership" interest.[76]

Finally, with respect to trademarks, courts generally hold that trademarks are "personal" and thus not assignable under trademark law (or, as a result, in bankruptcy) without the consent of the trademark owner/licensor.[77]

C. Oil and Gas Leases

Section 365(d)(4) provides that an unexpired lease of non-residential property will be deemed rejected and surrendered to the lessor unless the debtor, within 120 days of the bankruptcy petition date, assumes, assumes and assigns, rejects, or gets an extension of the deadline. This provision raises the question whether an oil and gas lease is an executory contract.

The question of whether an oil and gas lease constitutes an executory contract is highly dependent on whether applicable state law classifies the type of interest created by an oil and gas lease as a real property ownership interest or something else, like a license. If, under state law, the grant of an oil and gas lease is treated as a transfer of real property to the debtor lessee, then the oil and gas lease is not likely to be classified as an executory contract. Not surprisingly, this issue has been addressed by courts considering oil and gas leases from traditional oil producing states like Texas and Louisiana. Unfortunately, the law from other states is less developed. Below is a summary of certain jurisdictions.

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[73] *See, e.g.*, *In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002) (licensor's consent required to assign exclusive patent license since, to hold otherwise would render an exclusive license the equivalent of an outright assignment of the patent in contravention of federal case law, which carefully distinguishes between the two); *Proteo Tech Inc. v. Unicity Int'l Inc.*, 542 F. Supp. 2d 1216, 1219 (W.D. Wash. 2008) (same).

[74] *See, e.g.*, *In re Patient Educ. Media*, 210 B.R. 237, 240-43 (Bankr. S.D.N.Y. 1997); *In re Golden Books Family Entm't. Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001); *ITOFCA Inc. v. MegaTrans Logistics Inc.*, 322 F.3d 928, 941 (7th Cir. 2003).

[75] *MacLean Assoc. Inc. v. William Mercer-Meidinger-Hansen Inc.*, 952 F.2d 769, 778-79 (3d Cir. 1991); *In re Patient Education Media, Inc.*, 210 B.R. at 237, 240 (Bankr. S.D.N.Y. 1997); *In re Golden Books Family Entm't. Inc.*, 269 B.R. at 311.

[76] *See, e.g.*, *Golden Books Family Entm't. Inc.*, 269 B.R. at 319 *but see Gardner v. Nike Inc.*, 110 F. Supp. 2d 1282, 1287 (C.D. Cal. 2000) (holding that exclusive copyright licensees do not have the right to assign absent copyright owner's consent).

[77] *In re N.C.P. Mktg. Grp. Inc.*, 337 B.R. 230, 237 (D. Nev. 2005), *aff'd*, 279 Fed. Appx. 561 (9th Cir. 2008); *In re XMH Corp.*, 647 F.3d 690, 695 (7th Cir. 2011).

- ***Texas***

An oil and gas lease is not an executory contract under Texas law because the lease constitutes a conveyance of an ownership interest in real property.[78]

- ***Louisiana***

In Louisiana, whether oil and gas leases are considered executory contracts for the purposes of Section 365 remains a controversial and undecided issue. Where the debtor wanted to assume leases and clearly had the ability to perform, some Louisiana courts have ruled oil and gas leases to be executory contracts.[79] Other Louisiana judges have rejected this analysis and held that oil, gas and mineral leases in Louisiana are not executory contracts under Section 365.[80]

- ***Oklahoma and New Mexico***

Oklahoma and New Mexico also characterize oil and gas leases as conveyances of real property, and thus, the leases are not considered executory contracts.[81]

- ***Kansas and Ohio***

In Kansas and Ohio, oil and gas leases are considered executory contracts.[82]

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[78] *Cherokee Water Co. v Forderhause*, 641 S.W.2d 522, 525 (Tex. 1982); *see also Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002) ("A Texas mineral lease grants a fee simple determinable to the lessee."). The law in Texas is well developed and makes clear that Section 365 of the Bankruptcy Code is inapplicable. *See River Prod. Co. v. Webb (In re Topco., Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990); *see also Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70 (Bankr. S.D. Tex. 1996) ("A mineral lease in Texas is a determinable fee. It is not a lease or other form of executory contract that a debtor may assume or reject.").

[79] *Texaco Inc. v. Louisiana Land Expl. Co.*, 136 B.R. 658, 668 (Bankr. M.D. La. 1992); *see also In re Ham Consulting Co./William Lagnion/JV*, 143 B.R. 71, 73-75 (Bankr. W.D. La. 1992) (finding Louisiana mineral lease not an unexpired lease but is executory contract under Section 365).

[80] *See, e.g., In re WRT Energy Corp.*, 202 B.R. 579, 583-84 (Bankr. W.D. La. 1996) (lease was not an executory contract because the lessors' failure to perform under the lease would not constitute a material breach excusing the lessee's performance, but would only delay performance); *see also Delta Energy Res., Inc. v. Damson Oil Corp.*, 72 B.R. 7, 11 (Bankr. W.D. La. 1985) (finding Louisiana mineral leases to be rights to incorporeal immovables and not "conventional leases" contemplated by Section 365).

[81] *See In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (determining oil and gas lease is fee estate in real property and therefore not within purview of Section 365); *In re Clark Res.*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986) (finding that, under Oklahoma law, oil and gas lease is not executory contract or unexpired lease under Section 365); *In re Antweil*, 91 B.R. 65 (Bankr. N.M. 1989) (holding that oil and gas leases are not executory contracts).

[82] *See, e.g. In re J.H. Land & Cattle Co., Inc.*, 8 B.R. 237, 239 (Bankr. W.D. Ok. 1981) (holding oil and gas leases to be executory contracts in Kansas because Kansas law considers them personal property and a *profit a prendre*); *In re Integrated Petroleum Co., Inc.*, 44 B.R. 210, 214 (Bankr. N.D. Ohio 1984) (holding oil and gas leases treated as executory contracts under Ohio law).

- ***North Dakota, Mississippi, and Wyoming***

Courts in North Dakota, Mississippi, and Wyoming have not expressly addressed whether an oil and gas lease is considered an executory contract in bankruptcy; however, they have addressed whether an oil and gas lease is considered a real property interest or a true lease.

In North Dakota, an oil and gas lease is considered a real property interest rather than a true lease.[83] Because the lessee holds a real property interest and not a "lease" interest, it appears that Section 365 is not applicable. The North Dakota bankruptcy court recently affirmed in *Great Plains Royalty Corp. v. Earl Schwartz Co.*[84] that oil and gas leases are interests in real property in North Dakota, although it made no Section 365 determinations.

Likewise, under Mississippi law an oil and gas lease appears to transfer an interest in real property.[85]

Under Wyoming law, however, it appears that an oil and gas lease does not convey an ownership right.[86]

- ***Outer Continental Shelf Leases and Section 365***

For offshore oil and gas leases, a prospective purchaser first must determine whether state or federal law applies to the lease, which depends on where the leased interests are located. Generally, state law applies to the area extending up to three geographical miles from the state's coast.[87] Federal law governs the area extending from the offshore state boundary to at least 200 nautical miles from the shore. This offshore area is known as the Outer Continental Shelf ("OCS").[88] Leases located in the OCS are governed by federal law.

The United States typically will argue that an OCS lease is a true lease under Section 365, rather than an interest in real property.[89] Moreover, the typical federal lease merely provides rights to extract minerals, and expressly states that no ownership rights in a mineral

[83] *See, e.g.*, *Messersmith v. Smith*, 60 N.W.2d 276, 280 (N.D. 1953) (referring to and treating a mineral lease as a deed of real property); *Petroleum Exch. v. Poynter*, 64 N.W.2d 718, 726 (N.D. 1954) (oil, gas and mineral leases are transfers of interests in real property).

[84] No. 68-00039, 2015 Bankr. LEXIS 883, at *52-54 (Bankr. N.D. Mar. 18, 2015).

[85] *See Chevron U.S.A., Inc. v. State*, 578 So.2d 644, 654 (Miss. 1991) ("As to the minerals, an oil and gas lease is a deed as such term is usually employed. It may be described in real property terms as a conveyance of an estate in fee simple defeasible" absent a contract modifying the nature of the conveyance) (internal quotations omitted).

[86] *Shepperd v. Boettcher & Co., Inc.*, 756 P.2d 182, 185 (Wyo. 1988) (reasoning that a fractional working interest owner with no right to control the surface "has certain contractual rights and obligations by contract, but not by property ownership").

[87] *See* 43 U.S.C. § 1312.

[88] *See* 43 U.S.C. § 1331(a).

[89] *See, e.g., NGP Capital Res. Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014); *see also* 43 U.S.C. § 1331-1356a (2006) (using the term "lease" to characterize the property interested granted by the United States to OCS lessees).

interest are being conveyed. However, some authors have suggested that "an OCS lease is clearly a form of property right, created by statute."[90]

In *ATP*, the United States argued that OCS leases were unexpired leases subject to Section 365 of the Bankruptcy Code and that the instrument conveying an OCS lease is also an executory contract subject to Section 365. Many practitioners were hopeful that the *ATP* court would evaluate the government's argument and resolve the issue of whether an OCS lease is an executory contract and/or an unexpired lease; however, the court declined to provide clear answers. Thus, the question of whether an OCS lease is a true lease or an executory contract under Section 365 remains an undecided issue.

i. *Joint Operating Accounts ("JOAs") and Farmout Agreements Often Are Executory Contracts.*

11 U.S.C. § 101(21A) defines a farmout agreement as 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.

Farmout agreements that have not been fully performed usually are treated as executory contracts under the Bankruptcy Code and are subject to all applicable executory contract provisions, including Section 365 assumption or rejection.[91] Applying the provisions of Section 365(i) to farmout agreements can create many different consequences, depending on whether the debtor is the farmor or the farmee.[92]

It is not entirely clear whether JOAs are treated as executory contracts subject to assumption or rejection under Section 365. If the non-operator has continuing obligations under a JOA, the agreement could be classified as an executory contract.[93] Importantly, though, the *Wilson* decision does not support labeling all JOAs as executory contracts because JOAs are often highly complex and may contain both executory and non-executory provisions.[94] For example, operators and non-operators often have contractual lien rights, which operate

[90] Rhett Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, Texas Journal of Oil, Gas, and Energy Law Symposium, Jan. 21-22, 2010, at 5.

[91] Charles Beckham, *et al.*, *Oil and Gas Leases: They're Not Just in Texas Anymore; They're Fracking Everywhere!*, 32nd Annual Jay L. Westbrook Bankruptcy Conference, Nov. 21-22, 2013 ("Beckham, *et al.*"), at 4-5.

[92] *See id.*

[93] *See Wilson v. TXO Prod. Corp. (In re Wilson)*, 69 B.R. 960, 962-63 (Bankr. N.D. Tex. 1987).

[94] Beckham, *et al.*, *supra* at 6-8.

independently of whether the agreement is assumed or rejected, but the lien may be avoided if it is not perfected by recording.[95]

When a JOA is an executory contract, disputes may arise in the time period before the debtor assumes or rejects the agreement.[96] In *NLRB*, the Supreme Court held that after a debtor commences a Chapter 11 proceeding, but before it assumes or rejects executory contracts, the contracts remain enforceable by the debtor but not against the debtor.[97] In *Wilson*, the court held that the JOA does not govern the rights of either party during the Twilight Zone, but rather, the laws of co-tenancy govern.[98] Regardless, eventually the operating agreement will be either assumed or rejected. If the operating agreement is assumed, the debtor's acts prior to assumption or rejection will be measured as though the contract was actually in effect for the entire time period.[99]

ii. *Are Production Payments and Overriding Royalty Interests Executory Contracts?*

In Texas, an overriding royalty interest generally is an interest in real property.[100] Because royalty interests are considered real property interests of the production payment owner, the interest should be excluded from property of the production payment seller's bankruptcy estate generally under Section 541(a), and specifically under Section 541(b)(4)(B).[101]

Despite this general rule, In *NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*,[102] Judge Marvin Isgur of the Southern District of Texas found that issues of material fact existed regarding whether certain prepetition term overriding royalty transactions ("ORRIs") were properly characterized as real property transactions, or whether they were more accurately characterized as debt financings.

In *ATP*, the debtor indicated to its ORRI holders that it planned to recharacterize a number of ORRIs as debt financings. The Judge examined the "economic substance" of the purported ORRIs to determine whether they were actually more like debt instruments than real property conveyances. The Judge reasoned that the instruments at issue contained characteristics of both real property conveyances and financing transactions, and thus, summary judgment was inappropriate. This finding introduces the possibility that a bankruptcy trustee may be able to

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[95] *See* Rhett G. Campbell, *The 10 Things You Ought to Know About Oil & Gas Bankruptcy (And Probably Didn't Know to Ask)*, 26th Annual Advanced Business Bankruptcy Course, 2008, at 4.

[96] *See, e.g.*, *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984); *see also Wilson*, 69 B.R. at 965.

[97] 465 U.S. at 532.

[98] 69 B.R. at 966.

[99] Rhett Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, Texas Journal of Oil, Gas, and Energy Law Symposium, Jan. 21-22, 2010, at 28.

[100] *See, e.g.*, *Sheffield v. Hogg*, 124 Tex. 290 (1934).

[101] *See* Jeffrey S. Munoz, Financing of Oil and Gas Transactions, 4 TEX. J. OIL GAS & ENERGY L. 223, 234 (2009).

[102] No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014).

recharacterize such transactions as loans, which would disadvantage the royalty owners. In *ATP* and more generally, this determination is a fact specific and summary judgment appears unlikely.

iii. *Requirements for Assumption: Cure of Existing Defaults and Adequate Assurance of Future Performance Going Forward*

Section 365(b) sets forth the requirements a trustee must satisfy before it may assume an executory contract. Section 365(b) provides as follows:

(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

iv. *Strategy Regarding Assuming and Rejecting Contracts*

In the process of conducting due diligence, the buyer will identify desired assets. Some of the assets are likely to be executory contracts and unexpired leases that are necessary for operating the business going forward. While some buyers seek a blanket assignment of "all executory contracts," it is preferable to develop a schedule of contacts that the buyer has determined are necessary or beneficial. The bankruptcy plan or sale documents would then provide for assumption and assignment of only those contracts and a rejection of the rest.

Plan or sale transactions that include the assumption and assignment of "all contracts" are risky because the buyer could be acquiring unknown and potentially significant liabilities. For example, in the recent case of *Noble Energy vs. Conoco-Phillips*,[103] the predecessor of Noble Energy purchased assets and obtained assignment of contracts from a predecessor of Conoco-

[103] 462 S.W.3d 255 (Tex. App. 2015).

Phillips in a bankruptcy case. The plan of reorganization in that case provided that unless a contract was listed on a schedule of rejected contracts, the contract "shall be assumed by the Debtors and assigned to the [Buyer]." In other words, the plan accomplished the opposite of what the authors recommend herein—it contained an assumption and assignment of all contracts, subject to the specific exclusion of listed contracts to be rejected.

In the *Noble* case, the contract that later became an issue was not listed on the rejection schedule, and thus, Noble arguably obtained an assignment of that contract. That contract included an indemnity obligation and Conoco later made an indemnity demand after an environmental lawsuit was filed in Louisiana.

A Houston state district court held that Noble did not receive an assignment of the relevant contract, but the 14th Court of Appeals reversed and rendered on that point, holding that Noble assumed the contractual obligations. The court held that, consistent with well-accepted bankruptcy law, assumption of a contract also comes with the burden of all contractual obligations. In other words, the court held that a buyer cannot choose to assume only the benefits of a contract—a limitation on the general rule that a buyer of assets in bankruptcy can choose assets is wants and leave liabilities behind.

Porter Hedges filed an amicus brief in support of a petition for review to the Texas Supreme Court on behalf of Plains All American Pipeline—which was not involved in the case but buys assets out of bankruptcy from time to time. The brief argued that the court of appeals misapplied the language of the plan and that the contract at issue was not assumed. The brief also argued, on the basis of Third Circuit authority, that assumption of a contract and assignment of a contract are two separate powers under Section 365 of the Bankruptcy Code. And even though a debtor must assume an entire contract, the debtor may assign only certain provisions. This view is consistent with both the language and policy of the Bankruptcy Code—which is intended to maximize interest in a debtor's assets, and thus, value for the estate. The petition for review remains pending in Texas Supreme Court. Regardless of the outcome, the safer approach for a buyer is to only assume those contracts that it has identified as being beneficial.

v. *Executory Contracts Can Be Assumed and Assigned as Part of An Asset Sale under Section 365 or a Plan Transaction.*

Section 365(f) provides that a trustee may assign an executory contract to a third party if it assumes the contract as required by Section 365(b) and provides adequate assurance that the assignee will continue performing under the contract—even in most situations where the contents contains anti-assignment language.

The full text of Section 365(f) is as follows:

(1) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

(2) The trustee may assign an executory contract or unexpired lease of the debtor only if—

(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B) 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.

(3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

V. ANOTHER EXCEPTION TO SECTION 363(F): COVENANTS RUNNING WITH THE LAND

Real property being sold in a Section 363 sale may also be subject to other types of contract-based interests and restrictive covenants that cannot be eliminated with a "free and clear" sale order. The issues closely resemble those with respect to IP licenses: the contractual covenant restrictions are either treated as no longer executory or as limitations on the estate's ownership interest in the real property, rather than as mere contract obligations that can be rejected.

Negative easements and covenants do not create reciprocal obligations that may be excused by failure of performance and, as such, agreements that create them generally will not be subject to rejection pursuant to Section 365. Covenants that are said to "run with the land" are treated as being so intrinsically linked to a particular parcel of land that the benefits and burdens arising from the covenant will apply to any owner of the given parcel and will not be treated as constituting mere contract rights between the original covenanting parties

A. Recent and Current Cases

i. *In re Energytec, Inc.*[104]

This case has been relied on by exploration and production ("E&P") debtors to support their argument that a dedication is a covenant running with the land. In this case, Energytec, Inc., the debtor, owned a pipeline system that it acquired from Producers Pipeline Corporation ("PPC") several years prior to filing for bankruptcy. PPC originally acquired the pipeline system from Newco Energy, Inc. ("Newco") subject to a transportation fee based on throughput and a consent right in favor of an affiliate of Newco. The transportation fee and consent right were agreed to in a letter agreement executed simultaneously with execution of the sale from Newco

[104] 739 F.3d 215 (5th Cir. 2013).

to PPC. Additionally, the assignment and bill of sale for the pipeline expressly stated that the conveyance was "subject to the Transportation Fee and other terms and provisions" in the letter agreement. As security for payment of the transportation fee, Newco also held a perfected lien in the pipeline system.

The issue presented to the court was whether Energytec, Inc. could sell the pipeline system it acquired from PPC/Newco in a Section 363 sale "free and clear" of any liens, claims or encumbrances, including both the transportation fee and consent right held by Newco's affiliate. The bankruptcy court initially concluded that the transportation fee was not a covenant running with the land and the obligation was dischargeable through the Section 363 sale process. The district court affirmed the bankruptcy court decision.

Upon appeal, the Fifth Circuit reversed and held that a covenant runs with the land when it touches and concerns the land, relates to a thing in existence or specifically binds the parties and their assigns, is intended to run with the land, and when the successor to the burden has notice. However, the Fifth Circuit noted that *Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987), which contains the elements the Fifth Circuit relied on, "referred to a requirement of privity but did not detail it." Notwithstanding the lack of clarity on the horizontal privity element in Texas opinions, the court concluded that because the other elements were met and horizontal privity was present if it was required by Texas law, the transportation fee and consent right ran with the land.

Having held that the transportation fee and consent right ran with the land, the Fifth Circuit remanded the case to the lower courts to determine whether Newco, the party benefitting from the transportation fee and consent right, could be forced to accept monetary satisfaction under Section 363(f)(5) for these interests in exchange for selling the pipeline system "free and clear" in the Section 363 sale process. This issue was not decided by the lower courts as a result of a settlement between the parties, but remains an important consideration because even if a midstream contract is (or contains) a covenant running with the land, a Section 363 free and clear sale of assets may still be available to the E&P debtor pursuant to Section 363(f)(5).

Several midstream producers have cited *Energytec* for the propositions that (a) dedications contained in midstream contracts constitute burdens running with the land and (b) the privity element is not necessarily required by Texas courts. The E&P debtors have urged the court to distinguish *Energytec* because it involved a fee payment and consent right that were created at the time the pipeline system was sold and the conveyancing document referenced the burdens. In *Sabine*, Judge Chapman agreed with the E&P debtors and distinguished *Energytec.*

ii. *In re Sabine Oil & Gas Corp.*[105]

In *Sabine*, the E&P debtor, Sabine Oil & Gas Corp. ("Sabine"), requested approval of the bankruptcy court to reject certain midstream contracts for the gathering of gas and condensate entered into with each of Nordheim Eagle Ford Gathering LLC ("Nordheim") and HPIP Gonzales Holdings, LLC ("HPIP"). The Nordheim and HPIP midstream contracts both contained

[105] No. 15-11835 (Bankr. S.D.N.Y.).

dedications that give Nordheim and HPIP the exclusive right to gather gas and condensate in certain agreed to areas.

On March 8, 2016, Judge Chapman of the United States Bankruptcy Court for the Southern District of New York granted Sabine's motion to reject the Nordheim and HPIP midstream contracts notwithstanding "dedication" language in the contracts purportedly creating covenants running with the land. Judge Chapman issued a bench decision explaining her reasoning. In the bench decision, Judge Chapman first explained that, under applicable Second Circuit law, she could not fully and finally determine issues of Texas property law in the context of a motion to assume or reject a contract, which is a summary proceeding. Thus, the discussion in the bench decision of covenants running with the land under Texas law is not binding and will have no precedential value in other cases. However, due to the lack of clarity on these issues, other courts are certain to at least consider Judge Chapman's analysis.

In the non-binding portion of the bench decision, Judge Chapman explained that the Nordheim and HPIP midstream contracts did not contain covenants running with the land because (a) horizontal privity did not exist between the Debtors and Nordheim, and the Debtors and HPIP; and (b) the Nordheim and HPIP midstream contracts did not "touch and concern" the debtor's land (*i.e.* leases of mineral estate).

First, Judge Chapman concluded that Texas law requires horizontal privity, and in this case there was no horizontal privity between the debtors and Nordheim or HPIP, because there was no conveyance of a property interest from the debtor to Nordheim or HPIP. Specifically, the debtor did not transfer any real property rights in its oil and gas leases, which rights under Texas law are limited to the right to develop, right of ingress/egress, right to receive bonus payments, right to receive delay rentals, and the right to receive royalties. While Nordheim argued that horizontal privity is not required under Texas law, no party identified any cases rejecting horizontal privity as a requirement.[106]

Second, Judge Chapman found that the dedications in the midstream contracts did not touch and concern the land because the midstream contracts in which the dedications are contained were personal undertakings to perform services related to extracted minerals, and extracted minerals are not real property.

On March 18, 2016, Sabine filed two declaratory judgment actions against Nordheim and HPIP as adversary proceedings seeking a binding ruling on the subject. In Judge Chapman's bench decision she indicated that she would not be changing her mind if the issue were presented to her in an adversary proceeding. If that is the case, she will likely find for Sabine on the issue, which would be a binding decision and subject to appeal by the midstream producers.

The bankruptcy decision is on appeal to the district court, direct certification to the Second Circuit having been declined. The appeal process will likely take many months.

[106] Note that the bench decision does not cite which Texas cases were identified that required horizontal privity.

iii. *In re Quicksilver Res. Inc.*[107]

In *Quicksilver*, Quicksilver Resources Inc., the E&P debtor, put its Barnett Shale oil and gas assets up for sale in a Section 363 sale process. The winning bidder, Bluestone Natural Resources II ("Bluestone"), bid approximately $240 million. Importantly, the bid was conditioned on the Debtor's rejection of its midstream contracts with Crestwood Midstream Partners LP ("CMLP"). The next highest bidder for the assets bid was a $157 million credit bid with an additional $93 million cash component. The next highest bid does not contain the condition precedent regarding rejection of the midstream contracts contained in the Bluestone bid.

Quicksilver differs from *Sabine* because the dedications contained in the *Quicksilver* midstream contracts do not contain express language stating that the dedications are intended to be covenants running with the land. Furthermore, CMLP's objection to Quicksilver's motion to reject the midstream contracts occurred after a "free and clear" order had already been signed by Judge Silverstein. While the order contained reservation of rights language, which permitted CMLP to object to rejection, the judge in oral hearings questioned Crestwood's failure to object to the sale and whether such failure may amount to a waiver of its reservation of rights. If such rights were waived, it is possible that a Section 363(f) sale could be consummated notwithstanding CMLP's objection.

Specifically, Section 363(f) of the Bankruptcy Code permits an E&P debtor to sell its oil and gas leasehold and mineral interests "free and clear" of "interests" in such property of the estate. Such a sale will be "free and clear" only if: (a) non-bankruptcy law permits the sale free and clear of the interests, (b) the interest holder consents to the "free and clear" sale, (c) the interest is a lien and the price at which the property will be sold is greater than the aggregate value of all liens on the property, (d) the interest is in bona fide dispute, or (e) the interest holder could be compelled, in a legal or equitable proceeding, to accept a money judgment in satisfaction of selling "free and clear" of such interest.

After a battle that delayed the sale closing by approximately two and a half months, Quicksilver, Bluestone, and CMLP reached a practical solution that allowed the sale to proceed with CMLP retaining its role with an altered minimum volume commitments.

iv. *In re Magnum Hunter Res. Corp.*[108]

In *Magnum Hunter*, the E&P debtors filed motions to reject a transaction confirmation under a midstream contract with Eureka Hunter Pipeline LLC under which gathering services would be provided. This motion raised an additional nuance not yet raised in either *Sabine* or *Quicksilver* the issue of contract severability and whether E&P debtors may be able to reject a specific transaction under a midstream contract, if the contract is so structured, or if the

[107] No. 15-10585 (Bankr. D. Del.).

[108] No. 15-12533 (KG) (Bankr. D. Del.)

midstream contract must be rejected or assumed in its entirety. The motion was eventually resolved by stipulation.[109]

Also on March 17, 2016, Magnum Hunter Resources filed a motion, and a separate adversary proceeding, seeking to reject a gas purchase agreement with Oneok Rockies Midstream LLC, based on the non-binding bench decision in *Sabine*. The motion came days after Magnum Hunter entered into a settlement agreement to terminate contracts with midstream pipeline partner, Texas Gas Transmission Inc., while stipulating that Texas Gas Transmission's damages were qualified rejection damages in the amount of $15,000,000. The issue of whether the damages were recoverable as rejection damages arose because Texas Gas Transmission had not yet completed construction of the midstream facilities.[110] The court ultimately entered an order granting the motion.[111]

v. *In re Emerald Oil*[112]

In *Emerald Oil*, the debtor sought to reject its midstream contracts as part of its asset sale, seeking declaratory relief under North Dakota law. The midstream obtained a TRO in Delaware bankruptcy court after several days of evidentiary hearings, depositions, and hundreds of pages of briefing on bankruptcy and North Dakota law. The court found that the midstream "stood the likelihood of prevailing on the merits . . . that the dedication agreements do not run with the land." Months later, Emerald and its midstream reached a resolution that permitted the asset sale, with the midstream retaining its service contracts (with altered minimum volume commitments) and earning equity in the reorganized debtor and a board seat.

vi. *In re Triangle USA Petroleum Corp.*[113]

On November 22, 2016, the U.S. Bankruptcy Court for the District of Delaware took a notably different tack than *Sabine* and lifted the automatic stay to allow a North Dakota court to determine whether a gas-gathering agreement constitutes covenants that run with the land under North Dakota law. As for Triangle USA's Chapter 11 plan, it left the issue of contract rejection in the state court's hands, meaning that the fate of the gathering agreements will follow the debtor out of bankruptcy if not resolved as part of the plan's confirmation.

vii. *In re Tristream East Texas*[114]

In *Tristream*, the midstream-debtor reached an agreement with the Official Committee of Unsecured Creditors culminating in their submission, and the court's entry, of an agreed order

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[109] *In re Magnum Hunter Res. Corp*., No. 15-12533 (KG), Docket No. 1214 (Bankr. D. Del. Apr. 29, 2016).

[110] In another dispute in the *Magnum Hunter* case, a contract counterparty faced with rejection has argued that the issue of whether the contact is severable—which would permit rejection of the contact in part—is an issue that cannot be decided by the bankruptcy court.

[111] *In re Magnum Hunter Res. Corp*., No. 15-12533 (KG), Docket No. 1131 (Bankr. D. Del. Apr. 14, 2016).

[112] No. 16-10704(KG) (Bankr. D. Del.).

[113] No. 16-11566(MFW) (Bankr. D. Del.).

[114] No. 16-31521(DRJ) (Bankr. S.D. Tex. Mar. 30, 2016).

granting in part the debtor's motion to reject its midstream service contracts. The agreed order, however, did not make a finding "of any kind with respect to whether any provision of the [midstream agreement] constitutes a covenant running with the land, equitable servitude, or any other legal interest in real property . . . ." The Official Committee of Unsecured Creditors opposed the rejection and brought an adversary proceeding seeking declaratory relief under Texas law to clarify that the dedications embedded in the agreements could not be rejected in bankruptcy.[115] Tristream's E&P joined the fight, arguing that its gathering agreements were non-executory covenants running with the land, continuing the role reversal that this bankruptcy proceeding presents. The parties eventually entered into a joint stipulation resolving all matters in the adversary proceeding.[116]

B. Practical Implications: Negotiating and Renegotiating Midstream Agreements.

i. *Strategic Considerations.*

Dedication language in existing contracts should be closely examined to determine the relative strength of the dedication. In the event new midstream contracts are being executed, the midstream providers should take certain precautions that will put their contracts, and the dedications contained therein, in the best position to be characterized as covenants running with the land.

- ***Record a Memorandum of Agreement.***

One element for a covenant to run with the land that can be easily satisfied through actions of the covenanting parties is the requirement that a subsequent purchaser of the oil and gas interests of the E&P debtor be put on notice of the purported burden running with the land. To accomplish this, the parties to the midstream contract should record a memorandum of their midstream contract in the real property records where the dedicated interests are located describing, at a minimum, the scope of the dedication, a legally sufficient description of the oil and gas leases and lands burdened by the dedication and the term of the midstream contract.[117]

- ***Object of Dedication: Leasehold, Reserves in Place and Produced Gas.***

Based on Judge Chapman's bench decision in *Sabine*, it is important that the scope of the dedication be as broad as possible. It appears that dedications that solely dedicate produced gas may be at risk of failing to satisfy the condition that the covenant "touch and concerns" the land.

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[115] *In re Tristream East Texas*, No. 16-03234 (DRJ) (Bankr. S.D. Tex.).

[116] *In re Tristream East Texas*, No. 16-03234, Docket No. 17 (DRJ) (Bankr. S.D. Tex. Dec. 27, 2016).

[117] Tex. Prop. Code Ann. § 12.001(a) (2014) ("An instrument concerning real or personal property may be recorded if it is has been acknowledged . . ."); Tex. Prop. Code Ann. § 13.002 (2014) ("An instrument that is properly recorded in the proper county is . . . (1) notice to all persons of the existence of the instrument and (2) subject to inspection by the public."); To constitute a legally sufficient description, a description of real property in a deed or other instrument must furnish, either within the instrument or by reference to another existing writing, the means by which the property can be identified with reasonable certainty. *See e.g.*, *Broaddus v. Grout*, 258 S.W.2d 308 (Tex. 1953).

Therefore, the dedication should be a dedication of all produced gas (both owned and controlled), reserves in place, and the specific leases owned within a certain area.

- ***Clarify Intent to Run with Land.***

Another element of the burden running with the land that can be easily satisfied by actions of the parties to a midstream contract is the intent element. Ideally, the midstream contract will provide that "it shall constitute a covenant running with the land"' and that the dedication and midstream contract "binds and inures to the benefit of each parties' successors and assigns."

- ***Include Granting Language.***

The most problematic element required to characterize a covenant as one that runs with the land is horizontal privity. Because horizontal privity requires a conveyance in the estate burdened by the covenant running with the land, if this element is ultimately determined to be a requirement under Texas law, the parties cannot merely contract around this requirement. For example, Judge Chapman in *Sabine* noted that the dedication did not constitute a conveyance of a portion of the E&P debtor's leasehold interests where (a) lenders have been granted liens on the leases and (b) there are restrictions on the debtor's right to sell such interests under Texas law because the real property rights under an oil and gas lease are limited, and the right to gather and process is not one of them.

However, midstream providers may find it prudent to include granting language in future dedications notwithstanding Judge Chapman's non-binding decision. It is possible that other courts could hold differently. An example of language to consider is the following:

> The Dedication by Producer of the Produced Gas, Reserves in Place and Dedicated Leases shall be a covenant running with the land, such land being the Dedicated Leases, and Producer does hereby grant, bargain, sell, convey, transfer, assign and deliver unto Midstream Provider such real property interest in the Dedicated Leases necessary to create a covenant running with land.

While this provision includes granting language and purports to convey unspecified rights in the Dedicated Leases, it may still fall short of granting a real property right out of the mineral estate's "bundle of sticks" required to achieve horizontal privity.[118] Obtaining such rights in and to the leases could ultimately involve a grant of an interest in the lease from the producer and require midstream producers to obtain consent or subordination from the lenders who have liens on the leases.

[118] The "bundle of sticks" includes the right to develop, right of ingress/egress, right to receive bonus payments, right to receive delay rentals and the right to receive royalties.

ii. *Factors to Consider with Respect to Requests for Fee and Minimum Volume Relief.*

Because of the recent bench decision in *Sabine* and the generally unsettled nature of these issues, producers for the moment believe they have gained leverage when it comes to requesting fee or minimum volume commitment relief. This leverage increases as a producer's financial situation becomes more precarious and bankruptcy appears more likely. Midstream providers should review and monitor its producer counterparties' financial situations and the possibility that they may face bankruptcy. If the producer does not face the threat of bankruptcy, there may be no legal reason for amending the terms of the midstream contract (although there may certainly be commercial reasons to do so). Additionally, midstream providers should evaluate the cost to the requesting producer of obtaining alternative midstream services, such as gathering and processing, in its area of operation. If no alternative exists or existing alternatives are prohibitively expensive, then midstream providers should be especially wary of such requests. Absent a looming bankruptcy filing, midstream providers may not find any compelling reason to grant fee and volume commitment relief. Furthermore, midstream providers should not be the only party granting concessions to the producer prior to the bankruptcy filing. Rather, they should be a part of the bankruptcy process (pre-arranged or pre-packaged) where equity and debt stakeholders of the E&P debtor are also making concessions.

The decisions that have provided the momentum to producers are fact specific, state specific, and to date are non-binding. Forthcoming decisions may reach different conclusions and appeals of existing decisions could also alter the current views of the midstream contracts as executory contracts.

With regard to requests from E&P debtors currently in bankruptcy, a midstream provider's approach to fee and volume commitment relief is different because of the immediate threat of rejection. The midstream provider should evaluate the specific facts and circumstances surrounding the parties' relationship and the availability of midstream alternatives in the E&P debtor's area of operation, in which state and court the bankruptcy is filed, in which state the applicable midstream system and oil and gas properties are located, and the actual language of the underlying midstream contract.

VI. SPECIAL CONSIDERATIONS INVOLVING THE PURCHASE OF OIL AND GAS ASSETS

A. Assumption of Executory Contracts and Payment of Contract Cure Costs

As discussed above, many contracts common in oil and gas businesses may be executory contracts under the Bankruptcy Code. For example, joint operating agreements, farmout agreements, and vendor contracts may qualify as executory contracts. It is important for the buyer to identify those contracts that may be executory and clearly communicate to the debtor which ones will be the subject of assumption and assignment.

Another key negotiating issue with respect to contracts is responsibility for "cure costs" that must be paid for the debtor to assume contracts. If the debtor has not been keeping trade creditors current, there may be significant cure costs. In many situations, the debtor lacks the funds to pay cure costs and can negotiate for the buyer to pay them as part of the transaction.

B. Allocation of Plugging and Abandonment Liabilities

The issue of a whether a plugging and abandonment ("P&A") claim is entitled to administrative priority and who is a responsible party for P&A liabilities is a prominent issue. In Texas, the obligation to P&A a well arises when drilling operations are commenced, and P&A operations must be commenced on a well within one year from the date that drilling or operations cease.[119] If one party pays the P&A cost, that party may be entitled to indemnity or contribution from other parties who either are or were owners of undivided interests.

The Fifth Circuit, interpreting Texas law, has held that P&A liabilities are entitled to administrative claim priority if the debtor's liability to P&A accrued under state law (as opposed to contract) and a failure to comply with state law would result in further liability under state law.[120] The Supreme Court also has reasoned that a debtor must comply with state law as well as 28 U.S.C. § 959(b) and may not abandon property in violation of a state law reasonably designed to protect the public health and safety.[121]

[119] 16 Tex. Admin. Code § 3.14(b).

[120] *State v. Lowe (In re HLS Energy Co., Inc.)*, 151 F.3d 434. 438-39 (5th Cir. 1998).

[121] *Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Protection*, 474 U.S. 494, 503-05 (1986).