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**Intersection of Bankruptcy and Energy Law**

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## Intersection of Bankruptcy and Energy Law<sup>1</sup>

The intersection of oil and gas law and bankruptcy law presents many complex issues for practitioners and courts alike, and courts across the country confronting such issues have addressed the same issues with varying and, at times, disparate results. Consequently, practitioners must be aware of the issues that may arise in an oil and gas bankruptcy and the varying ways in which courts have analyzed and ultimately decided the same issues in different ways.

This paper surveys a selection of the issues that may arise in an oil and gas bankruptcy and the differing ways in which courts have analyzed and decided the issues with the goal of highlighting the need for practitioners to analyze such issues based on the specific facts in the case and the law of the jurisdiction you are in.

### **I. Rejection of Oil and Gas Leases in Bankruptcy**

The Bankruptcy Code<sup>2</sup> is a toolbox for debtors in distress filled with many powerful tools unavailable to entities outside of bankruptcy. One such tool is the ability for debtors to reject certain contracts and leases, enabling a debtor to shed themselves of burdensome agreements and, generally, to treat any damages arising from such rejection as prepetition unsecured claims subject to impaired treatment pursuant to a debtor's plan of reorganization.

#### *A. Assumption and Rejection of Executory Contracts and Unexpired Leases Generally*

Section 365 of the Bankruptcy Code permits a debtor, with bankruptcy court authorization, to assume, reject, or assume and assign executory contracts and unexpired leases.<sup>3</sup> Generally, to reject an executory contract or unexpired lease while in bankruptcy, the debtor must file a motion seeking an order of the bankruptcy court authorizing such rejection, demonstrating, among other things, that (i) the contract or lease at issue is an "executory contract" or "unexpired lease," as those terms are used in the Bankruptcy Code and (ii) rejection of such contract or lease satisfies the business judgment rule.<sup>4</sup>

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<sup>2</sup> The Bankruptcy Code is codified in title 11 of the United States Code.

<sup>3</sup> See 11 U.S.C. § 365(a) ("[T]he [debtor], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.").

<sup>4</sup> See *Matter of Falcon V, L.L.C.*, 44 F.4th 348, 352 (5th Cir. 2022). The business judgment rule requires that the debtor "show that the proposed course of action will be advantageous to the estate and the decision is based on sound business judgment." *In re TM Vill., Ltd.*, 598 B.R. 851, 859–60 (Bankr. N.D. Tex. 2019). However, when applying the business judgment rule, courts show great deference to a debtor's business decisions and are "loath to interfere with corporate decisions

## 1. Determination of Executory Contract or Unexpired Lease Generally

Although the Bankruptcy Code does not define the terms “executory contract” or “unexpired lease,” courts have developed various tests to determine whether a contract or lease at issue constitutes an executory contract or unexpired lease.

To determine whether a contract constitutes an executory contract, bankruptcy courts generally apply the “Countryman” test.<sup>5</sup> Pursuant to the Countryman test, a contract constitutes an executory contract only if (i) performance remains due to some extent on both sides and (ii) at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract, thereby excusing performance of the other party.<sup>6</sup> Both prongs of the test must be satisfied for a contract to constitute an executory contract.<sup>7</sup>

To determine whether a lease constitutes an unexpired lease, bankruptcy courts look to underlying state law and the substance (rather than form) of the lease to determine whether it is a true lease.<sup>8</sup>

## 2. Determination of Whether an Oil and Gas Lease is an Unexpired Lease<sup>9</sup>

As applied to oil and gas leases, to determine whether an oil and gas lease constitutes an unexpired lease subject to assumption or rejection, bankruptcy courts will disregard the

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absent a showing of bad faith, self-interest, or gross negligence.” *Official Comm. Of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.)*, 147 B.R. 650, 656 (S.D.N.Y. 1992); *see also Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985). Thus, “[w]here the debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), courts will generally not entertain objections to the debtor’s conduct.” *Comm. of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986) (citation omitted); *see also Stanziale v. Nachtomi (In re Tower Air, Inc.)*, 416 F.3d 229, 238 (3d Cir. 2005) (“Overcoming the presumptions of the business judgment rule on the merits is a near-Herculean task.”).

<sup>5</sup> The test was first proposed by Professor Vern Countryman in a law review article and has been widely adopted by courts across the country. *See Matter of Falcon V, L.L.C.*, 44 F.4th at 352–353, n. 4 (collecting cases and determining that “[t]he vast majority of circuits have adopted the Countryman test.”).

<sup>6</sup> *Id.* at 352.

<sup>7</sup> *Id.* at 355 (holding that a surety agreement did not constitute an executory contract because the second prong was not satisfied due to the irrevocable nature of the bonds).

<sup>8</sup> *See In re MCorp Fin., Inc.*, 122 B.R. 49, 52–53 (Bankr. S.D. Tex. 1990).

<sup>9</sup> Although beyond the scope of this paper, the issue of whether an agreement constitutes an executory contract or unexpired lease is also relevant to gathering agreements and other transportation agreements. Cases examining such agreements have differed in their conclusions, as such agreements may contain covenants running with the land. *See, e.g., In re Sabine Oil &*

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