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News at 11

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Codification of Oil and Gas Lien Claimants' Preference Defense?

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Crude oil and natural gas prices began to decline in the third quarter of 2014. From the beginning of the third quarter of 2014 to the beginning of the third quarter of 2016, the price of crude oil declined approximately 60 percent. Natural gas prices also suffered a significant decline during that time period. Consequent to the decline in commodity prices, more than 80 oil and gas companies filed for bankruptcy protection in 2015 and 2016.[2]

On July 20, 2016, C&J Energy Services Ltd. and its affiliates (collectively, "C&J Energy") filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of Texas. C&J Energy provides, among other oilfield services, well construction, well completion and well support services to exploration and production (E&P) companies.

On the first day of the bankruptcy filing, the debtor filed an emergency motion requesting that the court allow C&J Energy to pay, among other vendors, subcontractors that provided essential materials and services for its operations and E&P customers' oil and gas projects (the "mineral contractors").[3] C&J Energy emphasized that upfront payment of the pre-petition amounts owed was critical because should C&J Energy default on any payment obligation, the mineral contractors would likely assert liens against the debtor's E&P customers' property, including leaseholds, oil or gas wells, and oil and gas leases. Further, as a result of the assertion of statutory liens, the E&P companies might refuse to pay, or even sever the business relationship with C&J Energy. To buttress the justification for the requested relief (which was granted), C&J Energy underscored that in the recent wave of oil and gas bankruptcies, courts have increasingly authorized upfront payment of pre-petition amounts owed to mineral contractors.

As opposed to obtaining upfront post-petition payment for pre-petition services rendered, some mineral contractors instead receive payment from bankrupt companies within 90 days prior to the bankruptcy filing. In those cases, the mineral contractors are at risk that the debtor will seek to avoid (or "claw back") the pre-petition payment. In light of this risk, mineral contractors are proactively providing notice to debtors that a certain common law defense precludes such a clawback. This article discusses preferential-transfer avoidance under § 547(b) of the Bankruptcy Code in general, the fixing of a statutory lien defense under § 547(c)(6), contractors' common law preference defense and whether Congress should codify the common law defense.

Preferential Transfer Clawbacks in Bankruptcy

Section 547(b) provides a debtor-in-possession or trustee with the authority to claw back payments made to creditors prior to a bankruptcy filing. Generally, a trustee may claw back any payments made to noninsider creditors of the debtor within 90 days prior to the bankruptcy filing (the "lookback period") if the trustee establishes that the payments were made

> (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made — (A) on or within 90 days before the date of the filing of the peti-

1 This article represents the author's views, and such views should not necessarily be imputed to Simmons Legal PLLC or its respective affiliates and clients. The author represents certain parties in the Sabine Oil & Gas Corp. bankruptcy proceedings that may be affected by the issues discussed in this article.

2 *See Haynes and Boone LLP Oil Patch Bankruptcy Monitor*, dated June 30, 2016, *available at* haynesboone.com/~/media/files/attorney%20publications/2016/energy_bankruptcy_monitor/oil_patch_bankruptcy_20160106.ashx.

3 *See CJ Holding Co., et al.*, Case No. 16-33590, Dkt. Nos. 6, 61 (Bankr. S.D. Tex. July 20, 2016).

tion; or (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if — (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the [Code] provisions.[4]

Accordingly, mineral contractors providing goods and services for oil and gas projects and other potential statutory lien claimants face preference exposure risk if the contractors receive any payments from a distressed company within 90 days before the company's bankruptcy. As discussed *infra*, these contractors may assert a common law defense to a preference action brought against them.

Fixing of a Statutory Lien Safe Harbor under § 547(c)(6)

Most states have enacted statutes that protect certain material and service providers by allowing the providers to assert liens against a debtor's property. Many of these statutes relate to the provision of materials and services for improvements related to construction and oil-and-gas exploration and production projects. Should a debtor default on its payment obligation to the contractor, the contractor could fix a statutory lien to the debtor's property to secure payment.

With respect to the date of perfection of the lien, many statutes and other applicable state laws provide that the lien-perfection date is considered the earliest date on which the provisions of services and/or materials commenced. In many instances, all lien claimants with respect to a construction or oil and gas project enjoy equal priority status. That is, all lien claimants' dates of lien perfection are considered the first date of work or provision of materials of the earliest lien claimant.

Under Texas law, mineral contractors may assert liens to secure payment for any services and materials provided in furtherance of "mineral activities."[5] Mineral activities include "digging, drilling, torpedoing, operating, completing, maintaining, or repairing an oil, gas, or water well, an oil or gas pipeline, or a mine or quarry."[6] Further, the mineral contractor must formally assert the lien within six months after materials and/or services were last furnished.[7] Advance notice of the lien filing must occur at least 10 days before the filing.[8] A properly filed mineral lien may attach to critical assets of an oil and gas company such as the land, leasehold, wells and pipelines.[9]

Section 547(c)(6) protects from avoidance assertion of true statutory liens, such as mineral liens asserted under Texas law.[10] As discussed below, numerous courts have expanded this safe-harbor provision to include payments made in lieu of the fixing of a statutory lien. So, in the cases where a contractor accepted payment within the 90-day lookback period instead of asserting its statutory lien rights, these courts have concluded that the payments are likewise protected from avoidance.

The existence of the § 547(c)(6) safe harbor for statutory lien claimants suggests that Congress considers statutory lien claimants a special class of creditors.

Contractors' Common Law Defense: Accepting Payment in Lieu of Fixing Statutory Lien

Courts' expansion of the § 547(c)(6) safe harbor to include payments made in lieu of the fixing of statutory liens has essentially evolved into a common law defense. In *Cimmaron Oil Co. Inc. v. Cameron Consultants Inc.*, the debtor, Cimmaron Oil Co. Inc., engaged in oil-and-gas exploration, development and production operations.[11] During the 90-day lookback period, Cimmaron made payments to a contractor, Cameron Consultants Inc., for the geological services performed by its consultants with respect to two wells.[12] Seeking to claw back the payments made to the consultants prior to the bankruptcy filing, Cimmaron argued that the payments were preferential transfers under § 547(b) of the Bankruptcy Code.[13] The U.S. District Court for the Northern District of Texas analyzed the issue through an equitable lens and pointed out an earlier case in which a sister court drew attention to the risk inherent in not excepting from avoidance those payments made to contractors who could assert statutory liens:

> [A] debtor could avoid compensating its creditors (in this case its subcontractors) by paying them during the preference period after substantial completion of their work and then simply waiting until after the expiration of the lien under applicable state law before filing an action to recover a preference. The creditor would thereby effectively be denied its lien rights.[14]

In addition to this inherent risk, the court also looked to the legislative history and concluded that Congress intended that § 547(c)(6) "also exempt from the trustee's avoiding powers 'transfers in satisfaction of [statutory] liens.'"[15] In expanding § 547(c)(6) to also protect pre-petition payments that in effect avoided the fixing of a statutory lien, the court presumed that the contractors would assert and enforce their lien rights.[16] Therefore, the contractors would enjoy secured creditor status during the bankruptcy case.

In the *Official Committee of Unsecured Creditors of 360 Networks (USA) Inc. v. AAF-McQuay (In re 360Networks (USA) Inc.)*, the unsecured creditors' committee sought to avoid payments made to certain contractors that provided

4 11 U.S.C. § 547(b).
5 Tex. Prop. Code §§ 56.001(1) and 56.002.
6 *Id.* at § 56.001(1).
7 *Id.* at § 56.021(a).
8 *Id.* at § 56.021(b).
9 *Id.* at § 56.003.
10 11 U.S.C. § 547(c)(6) (providing that trustee may not claw back transfer "that is the fixing of a statutory lien that is not avoidable under section 545 of this title").

11 71 B.R. 1005, 1006 (N.D. Tex. 1987).
12 *Id.*
13 *Id.* at 1007.
14 *Id.* at 1010 (citing *In re Dick Henley Inc.*, 38 B.R. 210, 215 (Bankr. M.D. La. 1984)).
15 *Id.* (quoting S. Rep. No. 989, 95th Cong., 2d Sess. 88, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5874; H.R. Rep. No. 595, 95th Cong., 1st Sess. 374, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6330).
16 *Id.* at 1011.

construction or building-related materials to the debtors.[17] The bankruptcy court followed an older Second Circuit case that held "that [the] 'payment itself should not be less secure than the lien [that] could have secured it.'"[18] Accordingly, the court exempted the payments made to the contractors from avoidance and narrowed its conclusion with the following caveat:

> [P]ayments made to the holder of an inchoate statutory lien during the preference period are not avoidable where, at the time of the payment, the lienholder: i) remained eligible to perfect the lien pursuant to relevant State law, and ii) such perfection would not otherwise have been avoidable under the Bankruptcy Code.[19]

The court further noted that the value of the collateral that would secure the liens had yet to be determined.[20]

Codification of Common Law Defense?

C&J Energy and other bankrupt oil and gas companies have recently acknowledged that mineral contractors are essentially "critical" vendors with respect to oil-and-gas operations. Courts have given credence to the acknowledgment by allowing upfront payment of pre-petition amounts owed to mineral contractors to avoid the bite of statutory liens. The existence of the § 547(c)(6) safe harbor for statutory lien claimants suggests that Congress considers statutory lien claimants a special class of creditors. This might be so because the materials and services provided by this protected class of contractors are deemed essential to construction and oil-and-gas operations. Should these contractors choose to sever business ties with distressed companies, the distressed companies' business operations could grind to a halt.

Thus, it begs the question of whether Congress should codify the common law defense by adding it to the avoidance exceptions under § 547(c). The codified defense would only allow protection for those contractors (1) whose time to perfect their liens had not expired at the time of payment, (2) who otherwise remained eligible to perfect their liens under state law and (3) whose asserted liens could withstand a challenge under § 545 of the Bankruptcy Code. For purposes of the new codified exception, one must presume that contractors would have perfected their liens at or near the time of payment.

A new avoidance exception would definitely provide comfort and certainty to contractors providing materials and services to distressed companies. It is, however, understandable that Congress may leave application of such a defense to judicial discretion rather than legislative mandate. abi

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17 327 B.R. at 189.
18 *Id.* at 190 (quoting *Ricotta*, 264 F.2d at 750-51).
19 *Id.* at 193.
20 *Id.*