AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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News at 11

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Oil and Gas Decommissioning: At Whose Expense?

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In recent bankruptcy cases in the U.S.[2] and Canada,[3] debtors have sought to abandon oil and gas assets and attached plugging, abandonment and decommissioning (collectively, "decommissioning") obligations. In those cases where abandonment is granted, state and local governments, co-lessees and predecessors-in-interest, among other parties, are often left holding the bag with respect to the substantial cost of decommissioning.[4]

This article discusses the seminal case setting forth the rule governing abandonment when there is environmental liability attached to an asset, recent bankruptcy litigation involving abandonment of oil and gas assets with outstanding decommissioning obligations, the potentiality of entitlement to an administrative expense claim for decommissioning costs paid, and proposed best practices for state and local governments and regulators, co-lessees and predecessors-in-interest to proactively protect themselves in the event of a future bankruptcy filing of an oil and gas company.

Abandonment of Property in Bankruptcy

Section 554 of the Bankruptcy Code allows for the trustee or debtor in possession to "abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate."[5] Similarly, § 365(a) allows the trustee to reject related burdensome executory contracts and unexpired leases.[6] Abandoned property usually reverts to the person having a possessory interest in the property.[7]

Although the trustee or debtor may abandon property in bankruptcy, as explained by the U.S. Supreme Court in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, the right to abandon is not unfettered.[8] The public's health and safety is one paramount consideration when deciding an abandonment request.[9]

Midlantic Rule

In *Midlantic*, the Supreme Court articulated the general rule on abandonment of assets that might pose a threat to public health or safety.[10] In that case, the debtor, Quanta Resources Corp., processed waste oil at facilities in New York and New Jersey.[11] The New Jersey Department of Environmental Protection (NJDEP) found that Quanta had accepted oil contaminated with highly toxic carcinogens,[12] and ordered Quanta to cease operations and clean up the New Jersey site.[13]

It was also discovered that at the New York facility, Quanta had stored toxic contaminated oil in containers that were leaking and deteriorating.[14] Given the costly burden of cleaning up the contamination at both facilities, the chapter 7 trustee, pursuant to § 554, sought to abandon the environmental liability-laden New Jersey and New York properties.[15]

1 This article represents the views of the author, and such views should not necessarily be imputed to Simmons Legal PLLC or its respective affiliates and clients.
2 *See, e.g., In re Venoco LLC*, Case No. 17-10828, Dkt. Nos. 495, 496, 506, 516, 528-30, 532, 535, 537, 540, 543, 546, 554, 556, 595, 598, 608, 611 (Bankr. D. Del. April 17, 2017); *In re Shoreline Energy LLC*, Case No. 16-35571, Dkt. Nos. 362, 386, 388, 407, 415, 416, 429, 432, 437-40, 442, 443, 449, 485, 493, 551, 591 (Bankr. S.D. Tex. Nov. 2, 2016).
3 *See* Kelly Cryderman, "Supreme Court Case on Oil Wells Pits Provincial Environmental Rules Against Federal Insolvency Laws," *The Globe and Mail* (Feb. 13, 2018), *available at* theglobeandmail.com/news/alberta/supreme-court-case-pits-provincial-environmental-rules-against-federal-insolvency-laws/article37973819 (last visited Feb. 20, 2018).
4 *See, e.g., In re Tri-Union Dev. Corp.*, 314 B.R. 611 (Bankr. S.D. Tex. 2004); *In re ATP Oil & Gas Corp.*, No. 12-36187, 2013 WL 3157567, at *1 (June 19, 2013).
5 *See* 11 U.S.C. § 554(a).
6 Section 365(a).
7 *See, e.g.*, S. Rep. No. 95-989, at 2 (1978); *reprinted in* 1978 U.S.C.C.A.N. 5787, 5788; *Ohio v. Kovacs*, 469 U.S. 274, 284-85, n.12 (1985).
8 474 U.S. 494 (1986).
9 *Id.*
10 *Id.*
11 *Id.* at 496-97.
12 *Id.* at 497.
13 *Id.*
14 *Id.*
15 *Id.* at 497-99.

The City and State of New York (collectively, "New York") and NJDEP objected to the abandonment requests.[16] New York argued that abandonment threatened the public's health and safety, resulting in violation of federal and state law, and that bankruptcy estate assets should fund the clean-up.[17] NJDEP likewise argued that the trustee should use estate funds to remediate the hazard at the New Jersey facility.[18] Overruling their objections, the bankruptcy court approved the abandonment.[19] On appeal, the district court affirmed the abandonment decisions.[20] However, the Third Circuit Court of Appeals reversed and remanded the decisions to abandon.[21]

In reviewing the Third Circuit's decision to reverse abandonment, the Supreme Court, in construing legislative intent, concluded that bankruptcy courts do "not have the power to authorize an abandonment without formulating conditions that will adequately protect the public's health and safety."[22] The court further held "that a trustee may not abandon property in contravention of a state statute or regulation that is reasonably designed to protect the public health or safety from identified hazards."[23]

The majority of courts applying the *Midlantic* rule have looked to footnote 9 of the opinion, which provides that "[t]he abandonment power is not to be fettered by the laws or regulations not reasonably calculated to protect the public health or safety from imminent and identifiable harm."[24] These courts have carved out a narrow exception to the trustee's abandonment power and only preclude abandonment upon a finding that the environmental law violation or obligation poses an immediate and identifiable threat of harm to public health or safety.[25] In contrast, a minority of courts have applied the *Midlantic* rule broadly and have concluded that a debtor may not abandon estate property if a law designed to protect public health or safety has been violated.[26]

Recent Litigation

In recent litigation in the chapter 11 proceedings of Venoco LLC and its affiliates (collectively "Venoco"), Hon. **Kevin Gross** followed the majority of courts that require a showing of imminent identifiable harm to the public's health or safety. In *Venoco*, prior to its bankruptcy filing the debtor was the operator of a producing oil and gas well site in Beverly Hills, Calif.[27] The site is owned by the Beverly Hills Unified School District, is on the grounds of Beverly Hills High School, and sits in close proximity to a residence and hospital.[28]

Pre-petition, Venoco's right to produce oil and gas from the site was terminated.[29] Within 90 days of the termination, Venoco was required to cease operations and decommission the site.[30] Post-petition, Venoco communicated its intent to completely vacate the site without satisfying its decommissioning obligations.[31] Both the California Department of Conservation's Division of Oil, Gas and Geothermal Resources (DOGGR) and Beverly Hills issued orders to Venoco demanding that the company comply with its decommissioning obligations.[32] DOGGR and Beverly Hills also sought an injunction seeking an order, among other things, directing Venoco to decommission the site.[33]

Judge Gross denied the request to force compliance on the basis that (1) as of the petition date, Venoco held no possessory interest in the site; (2) the mineral lease was terminated before the petition date; (3) neither the site nor the fixtures at the site were property of the Venoco bankruptcy estate; (4) there was no imminent identifiable harm; and (5) decommissioning costs could be best addressed through the bankruptcy-claims process.[34] In addition, Judge Gross ordered that Venoco continue monitoring the site until DOGGR and Beverly Hills hired a third party to take over monitoring the site.[35] DOGGR and Beverly Hills would be responsible for decommissioning and could later assert a claim against the estate for the associated costs.[36]

In October 2017, Judge Gross, over the objections of Santa Barbara County and California's Office of the State Fire Marshal, also allowed Venoco and affiliated debtors to abandon two oil pipelines, despite decommissioning obligations, after finding that there was no imminent and immediate identifiable danger posed by the pipelines.[37] Santa Barbara County had requested administrative expense priority for the decommissioning costs,[38] but taxpayers might ultimately pick up the decommissioning tab.

Possible Entitlement to an Administrative Expense Claim

Parties that find themselves stuck paying the cost of decommissioning inactive or abandoned oil and gas assets might be entitled to an administrative expense priority claim. Administrative expenses and costs are those expenses and costs incurred out of necessity to preserve estate assets.[39] If the paying party is granted an administrative expense priority claim, then the claim will have priority of payment over other unsecured claims.[40] Further, under its chapter 11 plan, a debtor must pay administrative expense claims in full.[41]

Although not a decision discussing the issue of abandonment, in the chapter 7 case of *State v. Lowe (In re H.L.S. Energy Co.)*, the Fifth Circuit Court of Appeals granted the state of Texas an administrative expense priority claim for decommissioning costs.[42] Under Texas law, an oil and gas company must commence decommissioning operations on dry and inactive wells within one year after drilling or operations cease.[43]

In the *H.L.S. Energy* case, the obligation to commence decommissioning arose post-petition.[44] At the time the obli-

16 *Id.* at 498-99.
17 *Id.* at 498.
18 *Id.* at 498-99.
19 *Id.*
20 *Id.* at 498.
21 *Id.* at 499.
22 *Id.* at 506-07.
23 *Id.* at 507.
24 *Id.* at n.9.
25 *See, e.g., In re Howard*, 533 B.R. 532, 545-46 (Bankr. S.D. Miss. 2015) (citing and quoting decisions from 16 different courts) (citations omitted).
26 *See, e.g., id.* (citing four courts applying rule broadly) (citations omitted).
27 *City of Beverly Hills v. Venoco LLC (In re Venoco LLC)*, 572 B.R. 105, 108 (Bankr. D. Del. 2017).
28 *Id.*
29 *Id.* at 109.
30 *Id.*
31 *Id.* at 111.
32 *Id.* at 111-12.
33 *Id.* at 107.
34 *Id.* at 112-14.
35 *Id.* at 116-17.
36 *Id.*
37 *See Venoco LLC*, Case No. 17-10828, Dkt. Nos. 598, 611. *See also id.* at Dkt. Nos. 506, 509, 530, 535, 537, 540, 542, 543, 546, 554, 608.
38 *See id.* at Dkt. No. 692.
39 *See* 11 U.S.C. § 503(b)(1)(A).
40 *See* § 507(a).
41 *See* § 1129(a)(9).
42 151 F.3d 434 (5th Cir. 1998).
43 *See* Tex. Nat. Res. Code Ann. § 89.011; 16 Tex. Admin. Code § 3.14(b) (1998).
44 *See H.L.S. Energy*, 151 F.3d at 436.

gation arose, the bankruptcy estate had insufficient funds to pay the decommissioning costs.[45] Consequently, the trustee and Texas agreed that Texas would pick up the tab and would be reimbursed by the bankruptcy estate.[46]

After the decommissioning funded by Texas was completed, Texas asserted an administrative expense priority claim.[47] The chapter 7 trustee objected, arguing that the claim was a nonpriority unsecured claim.[48]

The Fifth Circuit allowed the claim as an administrative expense[49] and noted that a trustee is required to comply with state law, including state law aimed at protecting public health and safety.[50] Further, the decommissioning cost incurred by Texas was an "actual and necessary cost" of managing and preserving the estate because, among other reasons, "[t]he unproductive wells operated as a legal liability on the estate, a liability capable of generating losses in the nature of substantial fines every day the wells remained unplugged."[51]

Likewise, the U.S. District Court for the Northern District of Texas granted the U.S. government an administrative expense claim for costs associated with an environmental liability.[52] After considering the evidence and applicable law, the court held that costs paid post-petition for environmental-remediation liability for pre-petition conduct were priority administrative costs if "such costs were necessitated by conditions that posed an imminent and identifiable harm to the environment and public health."[53]

In a later case, the U.S. Bankruptcy Court for the Southern District of Texas took a different approach.[54] In the *American Coastal Energy Inc*. case, the court granted the Texas Railroad Commission a priority administrative expense claim for costs it paid post-petition for pre-petition decommissioning obligations of the debtor, even though the court did not find an actual and imminent threat to public health or safety.[55] The court noted that the expense was actual and necessary given the debtor's continuing post-petition duty under state law to plug the wells.[56]

The aforementioned cases provide some comfort for parties left picking up the tab for decommissioning costs. However, administrative expense status might serve as little protection for these parties when the bankruptcy estate has insufficient funds to pay administrative expense claims.

In the *ATP Oil and Gas Corp*. bankruptcy case, the debtor's predecessor-in-interest, Anadarko E&P Onshore LLC, would bear the cost of decommissioning with no potential recourse.[57] In that case, Hon. Marvin Isgur allowed ATP to abandon offshore property related to a federal offshore lease.[58] The offshore property was a burden on the estate given that ATP received no income from the property, yet incurred substantial expenses in maintaining and operating the property.[59]

> **[A] party co-liable ... for decommissioning costs should insist on the debtor obtaining sufficient bonds and letters of credit, and/or set aside a reserve fund as security for satisfaction of decommissioning liability.**

Decommissioning the property would cost more than $100 million. The U.S. agreed to decommission the property after the lease terminated, then seek reimbursement from the estate for the cost, which was deemed to be a priority administrative expense.[60] However, the court explained that "it was unlikely that the estate will be capable of paying such a large administrative expense claim, presumably the United States will attempt to protect taxpayers by pursuing ATP's predecessors-in-interest (like Anadarko) for some or all of the decommissioning costs."[61] Acknowledging the unfortunate and expensive plight facing Anadarko as predecessor-in-interest, the court emphasized:

> Like many things in a bankruptcy case, the cost that Anadarko [might] bear is a reflection of the credit risk it took. Anadarko sold a portion of the Gomez Properties to ATP, and required ATP to bear the financial burden of plugging and abandonment in accordance with applicable federal law. This unfortunate position is no different from that of any other creditor that relies on the promise of performance from an eventually failed entity.[62]

Best Practices

The risk that a company may later file for bankruptcy is inherent in every business transaction. Therefore, parties should seek to hedge against bankruptcy risk at the outset of a business relationship. Whether prior to a bankruptcy filing or during a bankruptcy proceeding, a party co-liable with the debtor for decommissioning costs should insist on the debtor obtaining sufficient bonds and letters of credit, and/or set aside a reserve fund as security for satisfaction of decommissioning liability.

Parties that might be liable for decommissioning costs might also consider pushing for a sale of the inactive oil and gas assets. If the assets are sold, the purchaser will likely assume some or all decommissioning liability. abi

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45 *Id.*
46 *Id.*
47 *Id.*
48 *Id.*
49 *Id.* at 437-39.
50 *Id.* at 438 (citing 28 U.S.C. § 959(b) and *Midlantic*, 474 U.S. at 507)).
51 *Id.* at 438-39. *See also* Tex. Nat. Res. Code Ann. § 85.381 (providing fines of up to $10,000 per day for failure to plug inactive wells).
52 *See In re Nat'l Gypsum Co.*, 139 B.R. 397, 413 (N.D. Tex. 1992).
53 *Id. Cf. In re Mahoney-Troast Constr. Co.*, 189 B.R. 57, 63 (Bankr. D.N.J. 1995) (disallowing administrative expense priority status upon finding that environmental contamination posed no imminent threat of harm to public).
54 *See Am. Coastal Energy*, 399 B.R. 805.
55 *Id.* at 811-12.
56 *Id.*
57 *See ATP Oil & Gas Corp.*, 2013 WL 3157567, at *1.
58 *Id.* at *1-*3.
59 *Id.* at *1.
60 *Id.* at *2.
61 *Id.*
62 *Id.* at *3.