

Enron Bankruptcy: Producer's Rights Under Product Purchase Contracts- Royalty Payments

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The bankruptcy filing by Enron Corp. and several of its subsidiaries, (including Enron North American, its principal energy trading subsidiary and Enron Natural Gas Liquids), creates a number of issues for our clients, including those clients who are in the exploration and production business and who have entered into contracts for the sale of crude oil and/or natural gas (product purchase contracts) with Enron or one of its subsidiaries.

As noted in our prior alert of December 4, 2001, a bankruptcy filing presents three immediate issues for companies that have contractual relationships with an Enron entity that has filed or may file for bankruptcy protection.

- The automatic stay. The automatic stay in bankruptcy will have two important consequences on your contractual relationships with a bankrupt debtor. First, it may prohibit you from terminating your contracts with the debtor for reasons related to the debtor's insolvency or financial condition without bankruptcy court approval. Second, it will prohibit you from off-setting amounts incurred before the bankruptcy with amounts incurred after bankruptcy without court approval.
- Preferences and fraudulent conveyances. A preference payment under the Bankruptcy Code is a payment made to a creditor on an pre-existing debt within 90 days of the bankruptcy filing. Preference payments must be returned to the bankrupt debtor, and the person who received the preference payment becomes a creditor in the bankruptcy. Similarly, a fraudulent conveyance is a transfer by a debtor where reasonably equivalent value is not received by the debtor, if the debtor is or is rendered insolvent or certain other conditions are met. Fraudulent conveyances may be avoided in bankruptcy.
- Rejection. A debtor in bankruptcy may petition the bankruptcy court to reject contracts. If a contract is rejected, the other party to the contract has a claim in the bankruptcy case against the debtor's estate. Rejection of a contract does not automatically terminate the contract, and there may be proactive steps that you can take to avoid or reduce the consequences of rejection of a contract.

The Bankruptcy Code contains provisions which provide special treatment for different types of derivative contracts.

- Exemptions from the automatic stay. The Bankruptcy Code exempts certain contracts from the provisions of the automatic stay prohibiting termination. You will therefore be able to exercise whatever contractual right you have to terminate such a contract without court approval.
- Exemption from preference and fraudulent conveyance provisions. Generally, amounts you receive prior to a bankruptcy filing under certain contracts will not be preferences. Also

subject to certain exceptions, such amounts should not be subject to challenge under the fraudulent conveyance provisions of the Bankruptcy Code.

Your ability to recover amounts from Enron or a subsidiary will depend on a number of factors, including the following:

- Which Enron entity filed for bankruptcy. The protections afforded to debtors under the bankruptcy laws apply only to the legal entity which files for bankruptcy. Enron Corp., the parent, publicly traded corporation, has filed for bankruptcy, as has Enron North America Corp., its principal trading subsidiary. However, if the Enron entity to your product purchase contract has not filed, the bankruptcy filings by its affiliates will not affect its obligations to make payments under your contracts or your ability to terminate the contracts pursuant to their terms. We have listed the Enron entities that filed for bankruptcy on Schedule A, although these entities may have conducted business under different names in the past.
- The terms of your contracts with the Enron entity. The terms of your contracts will be important in determining the amount of damages to which you are entitled, and may provide for steps, such as notice or demand for collateral.

If you are a party to a purchase contract with an Enron entity, you should identify each of your product purchase contracts and have them carefully reviewed to determine the following:

- The identity of the Enron entity that is the counter-party;
- Your rights to terminate the agreements;
- The procedures you must follow to terminate the agreements;
- The measure of damages, if any, for termination of the agreements; and
- The choice of law provisions.

Producers must determine first whether their crude oil or natural gas is being sold to an Enron entity, and whether that entity is one of the Enron entities that is in bankruptcy. Producers should be aware that there have been numerous reorganizations and name changes of the various Enron entities. Therefore, the Enron entity described in the product purchase contract may be one of the Enron entities in bankruptcy, but with a different name. Producers may not realize their gas is being sold to an Enron subsidiary, because they have committed their gas to a marketing agreement with a third party marketer and are receiving payment from the marketing company, rather than directly from the purchaser. (Note: Marketing contracts may provide that payment will be made after the marketer's receipt of funds from the purchaser of production. Producer's should examine their marketing contracts to determine their rights vis a vis the marketer.)

Contract Termination

Product purchase contracts are subject to Article 2 of the Uniform Commercial Code, which may afford producers certain remedies, as more particularly described below, which vary depending on whether the Enron entity with which the producer contracted is in bankruptcy or not.

Producers must first determine the term of their product purchase agreement. If, for example, natural gas is being sold under a GISB Base Contract for Short-Term Sale and Purchase of natural gas, then the contract may be terminated upon 30 day's notice, but remains in effect until the latest delivery period of any transaction confirmations. However, the automatic stay in bankruptcy may prevent producers from terminating these contracts. The automatic stay prohibits termination of

contract related to the insolvency or financial condition of the bankrupt company, but does not prohibit termination for other reasons. For example, if your contract allows you to terminate it upon 30 days notice, this termination provision will not be affected by the automatic stay, and termination will be permitted. Product purchase contracts entered into in connection with production payments most often provide that they shall remain in effect for so long as the production payment exists. Most other types of long term contracts for the sale and purchase of natural gas also do not have early termination provisions.

Also, if a producer's product purchase agreement is a "forward contract" under the terms of the Bankruptcy Code, the producer may terminate the agreement despite the automatic stay. In broad terms, a "forward contract" is one for the purchase or sale of a commodity — such as oil or natural gas — with a maturity date more than two days after the date the contract is entered into. This definition includes, among others, such arrangements as swaps and hedge transactions. Unfortunately, the classification of a product purchase agreement as a "forward contract" is not always clear and has not been well defined. In the end, the determination may ultimately have to be made by the bankruptcy court on a case by case basis.

Some producers may wish to merely stop delivering natural gas as a self-help remedy. However, under most contracts for the sale and purchase of natural gas, the seller is liable for imbalance penalties imposed by the transporter, if seller does not deliver quantities of gas equal to the amount scheduled pursuant to the nominations process. In most cases the Enron entity will be making the nominations, pursuant to the terms of the product purchase agreement. Therefore, producers must evaluate what liability for imbalance penalties they may incur for failure to deliver gas equal to their nominations with the Enron entity. While the Enron entity may have a duty to mitigate damages, most of the product purchase contracts with Enron entities provide that the Enron entity can net amounts owed it by the seller from the amount it is obligated to pay as the purchase price.

Secured Status

For most companies that have product purchase contracts with Enron, or a bankrupt subsidiary, the only way to obtain payment for crude oil or natural gas already delivered to Enron or a bankrupt subsidiary may be to file a proof of claim with the bankruptcy court for the amount owed to you. However, the Texas Uniform Commercial Code may give you status as a secured, rather than an unsecured, creditor in the bankruptcy proceedings. Article 9, Section 3.343 provides owners of oil and gas production a security interest to secure the obligation of the first purchaser of oil and gas production to pay the purchase price. This security interest is perfected automatically without the filing of a financing statement. Not all states, however, have such a provision included in their Uniform Commercial Code. If the product purchase agreement is governed by Texas law, then the producer may be able to claim the protections of Article 9, Section 3.343, even if the delivery point for the crude oil or natural gas is not in Texas.

Reclamation Notice

Producers may want to give notice of reclamation for production sold to any insolvent buyer. While the right of reclamation is not a "silver bullet" solution for producers, it does lay the predicate for a priority claim that is superior to that of an unsecured creditor, and should be carefully evaluated. Article 2, Section 702 of the Uniform Commercial Code provides that if a seller of goods discovers that the buyer received the goods on credit while insolvent, the seller may reclaim the goods upon demand made within ten days after the buyer's receipt of the goods. If there has been a written misrepresentation of solvency within the last three months, the 10-day limitation does not apply.

Under 2-702, the seller's reclamation rights are subject to the rights of buyers in the ordinary course and other good-faith purchasers or lien creditors. The right to reclaim goods sold to an insolvent buyer is neither dependent on nor defeated by the buyer's bankruptcy filing.

If the buyer is in bankruptcy, Section 546(c) of the Bankruptcy Code recognizes state-law reclamation rights and gives the seller a 20-day window from the date of the buyer's receipt of the goods to make a reclamation demand if the original 10-day reclamation period expires after the commencement of the bankruptcy case. A bankruptcy court may deny a timely reclamation demand only if the court grants the seller an administrative claim or a lien. The act of sending a reclamation demand is not a violation of the automatic stay provided by Section 362(a) of the Bankruptcy Code. If the bankrupt buyer does not concede to the demand, however, bankruptcy court approval would be required to repossess the goods.

The reclaiming seller will have a priority interest in any proceeds traceable to the goods only if the collateral value is sufficient to pay the secured creditor in full. A reclamation right exists only in goods that were in the possession of the debtor and identifiable at the time of demand. Oil and gas sold to a bankrupt purchaser of production will be fungible and arguably will lose their identity when commingled with like oil and gas. A seller of goods will retain a priority status only to the extent that there are traceable proceeds from the sale of those goods.

Because oil and gas are typically sold continuously over an extended period of time, the 10-day limitation results in the right of reclamation affording more limited relief to a producer. The 10-day limitation, coupled with the difficulties posed by the commingling and tracing issues, prevents the reclamation right from serving as a completely effective remedy. Nevertheless, the right of reclamation may allow a producer to improve its legal position and ultimate recovery in a material way.

Payment of Royalty

If crude oil or natural gas were delivered prior to the bankruptcy of Enron and its subsidiaries, payment for that product will mostly likely be made as part of the settlement of the bankruptcy estate by filing a proof of claim. However, in Texas the Texas Natural Resources Code §91.402 provides that payment is due for product sold based on the date production is sold, not upon the receipt of funds from the purchaser of production. If the lease does not specify time for payment, then proceeds must be paid 60 days after the end of the calendar month in which crude oil is sold and 90 days after the end of the calendar month in which natural gas is sold. If payment is not so made, then interest accrues on the unpaid proceeds (§91.403) and the unpaid owner may recover attorney fees in a suit to collect unpaid proceeds of production (§91.406). Other states have similar statutes concerning payment of the proceeds of production.

Right to Adequate Assurances

If a producer's product purchase contract is not with an Enron entity in bankruptcy, then there are several alternatives available to a producer who is insecure about continuing to sell its crude oil and/or natural gas to an Enron entity. If the product purchase contract contains a termination provision, then producers may want to terminate their contract with an Enron entity and make other arrangements for the sale of their production. If the product purchase contract does not contain a termination provision, a producer may wish to proceed under Texas Uniform Commercial Code Section 2.609. If the producer, in good faith determines that there are reasonable grounds to be insecure about the ability of the Enron entity to perform under a product purchase contract, then a

producer may demand adequate assurances of future performance and suspend performance until such assurances are provided. If the Enron entity does not provide adequate assurances within a reasonable time, not exceeding 30 days, then the producer may treat this as repudiation of the contract by the Enron entity and make other arrangements for the sale of its product.

SCHEDULE ?A?

Filings on December 2, 2001:

Enron Corp.

Enron Metals & Commodity

Enron North America Corp.

Enron Power Marketing, Inc.

PBOG Corp.

Smith Street Land Company

Enron Broadband Services, Inc.

Enron Energy Services Operations, Inc.

Enron Energy Marketing Corp.

Enron Energy Services, Inc.

Enron Energy Services L.L.C.

Enron Transportation Services Company

BAM Leasing Company

ENA Asset Holdings, L.P.

Additional Filings After December 2, 2001:

Enron Gas Liquids, Inc. (filed December 3, 2001)

Enron Global Markets, LLC (filed December 4, 2001)

Enron Net Works, LLC (filed December 4, 2001)

Enron Industrial Markets, LLC (filed December 4, 2001)