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Subrogation Shutdown: Texas Southern District Court Upholds Exercise of Bankruptcy Code Provisions to Strip Subrogation Rights Against Asset Purchaser

March 24, 2023

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In a decision that once again evidences the Fifth Circuit's strong stance on the finality of asset sales in bankruptcy absent a stay of the applicable order, on March 8, 2023 the United States District Court for the Southern District of Texas published a memorandum opinion and order affirming a bankruptcy court's exercise of Bankruptcy Code provisions to strip subrogation rights of certain sureties (the "Sureties") against an asset purchaser. The Sureties appealed certain provisions in the order confirming the chapter 11 plan in *In re Fieldwood LLC**[1]** that authorized the sale of the debtors' assets free and clear of the Sureties' subrogation rights. The District Court focused its decision on (a) the Sureties' failure to obtain a stay of the confirmation order, (b) the plan's substantial consummation at the time of the appeal, and (c) the effect the Sureties' requested relief would have on third parties. While the decision has been appealed to the Fifth Circuit, for now asset buyers in bankruptcy cases in the Southern District of Texas can take comfort that a free and clear sale may insulate them from potential subrogation claims of sureties post-closing.

Fieldwood commenced its "chapter 22" bankruptcy in August of 2020 seeking to dispose of certain of its offshore oil and gas assets in a series of transactions that, after heavy negotiations from dozens of parties, included: (a) the sale of certain offshore oil and gas assets to their secured lenders in a credit bid transaction for approximately $1.03 billion, (b) the transfer of certain oil and gas assets to prior interest owners in exchange for funding contributions from these parties, and (c) the abandonment of certain oil and gas assets to prior interest owners.

Of particular importance throughout the bankruptcy was the United States Department of the Interior's (the "DOI") approval of the sale and abandonment of the subject assets on the grounds that the restructuring would not result in plugging and abandonment liabilities falling to taxpayers. Following months of negotiations, Fieldwood's emergence from bankruptcy in August of 2021 was the product of a complex web of compromises, all of which hinged on the DOI not opposing confirmation.

Key to the sale component of the confirmation order, and subject to vigorous debate at the confirmation hearing, was the proviso that the sale of Fieldwood's assets would be free and clear of all liens, claims, charges, interests, or other encumbrances, including the Sureties'

subrogation rights against the debtors, post-effective date debtors, prior interest owners, and the lenders/credit bid purchaser, unless the subrogation rights relate to obligations that both (a) accrue post-effective date and (b) arise from post-effective date activity and, with respect to the lenders/credit bid purchaser, relate to the sale assets. In plain language, if the plan was confirmed the Sureties would lose the recourse to stand in the shoes of the government and sue the purchaser to recover on their obligations. In the Sureties' words, this effectively converted the bonds "into letters of credit or cash demand instruments."***[2]***

The confirmation order was entered over the Sureties' objections on June 25, 2021 and the plan went effective on August 27, 2021. While the Sureties sought to stay the portion of the confirmation order relating to their subrogation rights, their efforts were unsuccessful and many of the transactions contemplated in the plan and confirmation order were consummated while the subrogation issue appealed. On appeal, Fieldwood argued that the Sureties' challenges were (a) statutorily moot under section 363(m) of the Bankruptcy Code***[3]*** because the Sureties failed to obtain a stay of the specific provisions of the confirmation order pending appeal and (b) equitably moot because any appeal would affect third parties not present. In response, the Sureties argued that 363(m) did not apply because (a) the challenged provisions were not integral to the sale of the assets to the lenders/credit bid purchaser and (b) the purchaser was not a good-faith purchaser.

Analyzing the Sureties' argument, the District Court began by recognizing that under Fifth Circuit law, section 363(m) only applies where a challenged provision is integral to the sale of a debtor's assets, *i.e.*, where the provision is so entwined in the sale that undoing it would alter the parties' bargained-for exchange. The District Court took note of Fieldwood's CFO's testimony that the subrogation provision was "paramount to [purchaser's] consideration of how they would be willing to proceed with purchasing [the debtor's] assets and contributing capital for all purposes of the plan."***[4]*** This testimony led the District Court to find that the deal would not likely close absent the provision and that the subrogation provision was indeed integral to the sale. The District Court further bolstered its finding by suggesting that the DOI would likely have objected to the plan had the sale not been consummated, thus completely unraveling the plan and sale.

The District Court additionally found that the Sureties waived their right to object to the purchaser as being a good faith purchaser by failing to make that objection during the bankruptcy and, in any event, the record did not support the Sureties' argument. Further, in response to the Sureties' argument that, notwithstanding the application of Section 363(m), the District Court could review the confirmation order as clearly erroneous, the District Court noted that Section 363(m) "provides the *sole* process for challenging a confirmation order: obtaining a stay of the ruling before presenting the challenge to a reviewing court."***[5]***

Lastly, the District Court agreed with Fieldwood that the appeal was equitably moot because (a) a stay had not been obtained, (b) the plan had been substantially consummated, and (c) the requested relief on appeal would affect the rights of parties not before the District Court. Specifically, the District Court found that granting the Sureties' requested relief would likely dismantle the sale of Fieldwood's assets, which, in turn, would likely dismantle the entire plan due to the DOI rescinding its approval.

While the District Court's decision has been appealed to the Fifth Circuit, the decision currently serves as a reminder of the Fifth Circuit's deference to the finality of asset sales where a stay of

the applicable order has not been obtained. Indeed, the District Court was able to completely avoid considering the merits of the Sureties' arguments regarding their subrogation rights by staking its decision on the transaction's finality. Accordingly, buyers and sellers can enjoy some comfort that the provisions of their free and clear sales will not be undone on appeal where the appellant has not obtained a stay.

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[1] *In re Fieldwood Energy LLC*, Case No. 20-33948 (MI) (Bankr. S.D. Tex. 2020).

[2] *Id.* at Dkt. No. 1640, ¶ 7.

[3] Section 363(m) provides that "[t]he 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." 11 U.S.C. § 363(m).

[4] Opinion at 6.

[5] *Id.* at 8.

A version of this update was published as an article by Law360 on April 7, 2023.