Oil & Gas Industry-Specific Bankruptcy Issues

Frank A. Merola, Moderator
Stroock & Stroock & Lavan LLP; Los Angeles

Jonathan P. Goulding
Alvarez & Marsal; Century City, Calif.

Hon. Barbara J. Houser
U.S. Bankruptcy Court (N.D. Tex.); Dallas

Deborah D. Williamson
Dykema Cox Smith; San Antonio

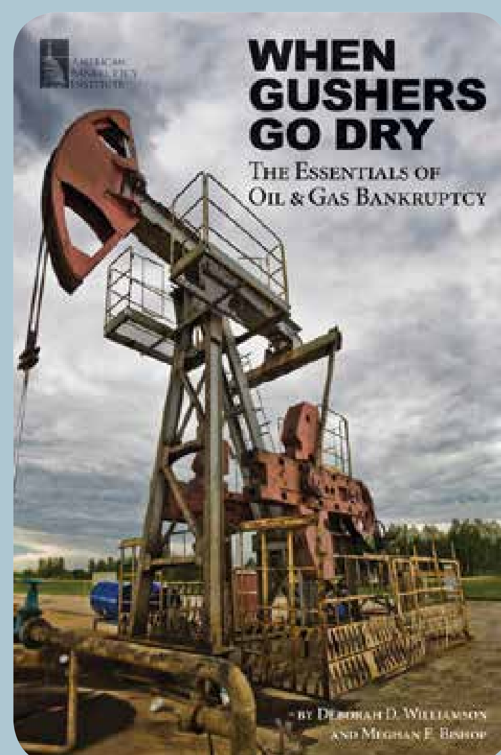
AMERICAN BANKRUPTCY INSTITUTE

NOW! in the ABI Bookstore

When Gushers Go Dry
The Essentials of Oil & Gas Bankruptcy

Perhaps more than any other industry, the U.S. oil and gas industry is vulnerable to the effects of myriad internal and external factors, ranging from global credit markets to domestic and foreign geopolitical events, and from technological developments and limitations to population growth and even the weather. These factors contributed to a dramatic increase in restructurings and bankruptcy filings during the first decade of the 21st century.

When Gushers Go Dry: The Essentials of Oil & Gas Bankruptcy is intended to give practitioners a better understanding of what happens when an oil, gas or other natural resources company goes bankrupt, presenting in detail the issues that are specific to this highly specialized industry.



Member Price: $50

Non-member Price: $75

Product #: 12_012

Order Your Copy Today!

www.abi.org/bookstore

CRITICAL LEGAL MATTERS IN BANKRUPTCY CASES INVOLVING OIL AND GAS INTERESTS

BANKRUPTCY TREATMENT OF (I) LEASES, (II) JOINT OPERATING AGREEMENTS ("JOAS") AND (III) FARMOUT/FARMIN AGREEMENTS

Materials By:

Deborah D. Williamson[1]
Dykema Cox Smith
112 E. Pecan Street, Ste. 1800
San Antonio, Texas 78205

I. Leases

A. Introduction. Oil and gas leases are the asset base on which an E&P company is valued. E&P valuation (and, therefore, lending) is almost exclusively reserve-based. There are two primary categories of reserves, under which several subcategories are secondarily categorized based on the relative level of risk associated with such assets and, therefore, the value.

1. Proved

a. Proved Developed Producing (PDP) – least risky, most valuable

b. Proved Developed Non-Producing (PDNP) – moderately risky, more valuable

c. Proved Undeveloped (PUD) – more risky, less valuable

2. Non-proved

a. Probable Reserves (PROB or 2P) – more risky, some value

b. Possible Reserves (POSS or 3P) – most risky, little (if any) value

B. Property Law Characterization of Leases.[2] The nature of an oil and gas lease is determined by the nature of oil, gas, and minerals under state law,[3] and the language of the granting clause as interpreted under state law.

---

[1] Meghan Bishop Debard co-authored the original version of this paper presented at the ABI Rocky Mountain Conference.

[2] For a thorough discussion of the legal significance of an oil and gas lease, *see* 2 & 3 E. Kuntz, *A Treatise on the Law of Oil and Gas* (1989)(hereinafter cited as "Kuntz").

[3] For a more thorough discussion of the real vs. personal property nature of oil and gas, see Patrick H. Martin and Bruce M. Kramer, WILLIAMS AND MEYERS, OIL AND GAS LAW (Lexis Nexis, Matthew Bender 2011) (hereinafter Williams and Meyers).

6163963.1

There are two primary theories governing the property law characterization of unsevered oil, gas, and other minerals – (i) the oil and gas in place theory, and (ii) the non-ownership theory. The primary difference between the ownership in place theory and non-ownership theory, from a real property law standpoint, is the present right of possession. The present right of possession is the defining factor between a corporeal interest (carries with it the right of possession and cannot be abandoned) and an incorporeal interest (does not have a right of possession, but rather a right of use which can be abandoned).[4] Thus, oil and gas rights in the states following the non-ownership theory are subject to loss by abandonment or, in the case of Louisiana, codified prescription for non-use. [5]

1. Ownership in place theory.

   a. In "ownership in place" states (the majority rule), the oil and gas under the ground is most often a fee simple absolute estate in land, giving the holder of such rights ownership of the oil and gas in place, subject to the right of others to divestiture.

   b. Under the ownership theory, the entire real property "bundle of sticks" is bestowed upon the owner.

      (1) This "bundle of sticks" includes, (i) the right to present possession of the oil and gas in place; (ii) the right to search for, develop and produce minerals; (iii) the right to profits; (iv) the obligation for costs; (v) the right to lease or sell the mineral interest; and (vi) the right to enjoy benefits under an oil and gas lease.

      (2) These rights include an implied right to reasonable use of the surface to realize the benefits of the mineral estate.

      (3) States that ascribe to the ownership theory are, for example, are Texas, New Mexico, Pennsylvania, Colorado, and Kansas.

2. Non-ownership theory.

   a. Under the non-ownership theory, a landowner does not own the oil and gas in place, and thus there is no "mineral estate" from which to carve a leasehold

---

4 *See*, 2 Kuntz § 2.4.

5 *See* Cmt. La. R.S. § 31:114 and La. R.S. § 31:115. Under Louisiana's Civil Law regime, the strong policy in favor of beneficial usage of land results in a codified prescriptive period for non-use, which is 10 years. Good faith operations for the exploration, development and production of oil and gas will prevent the prescriptive period from running. La. R.S. § 31:149. A caveat to this rule is that mineral servitudes in favor of the United States, the State of Louisiana, or any of their respective agencies or subdivisions, are imprescriptible while owned by the government. La. R.S. § 31:29.

6163963.1

interest. Instead, a mineral servitude (as it is called in Louisiana) or a license, or a profit à prendre (as it is sometimes known in California) is imposed upon land giving its holder the right to explore for, develop and produce oil and gas. The mineral lease creates a real right, but is not subject to prescription of non-use. The lease is a real property interest allowing the holder to remove a part of the substance of the land.

b. There is no conveyance of a fee interest. The mineral estate is still dominant in non-ownership states, meaning that there is an implied right to reasonable use of the surface.

c. States such as Oklahoma, Louisiana, California, and Wyoming, are non-ownership theory states.

C. Treatment of Leases under the Bankruptcy Code. 11 U.S.C. § 365 deals with bankruptcy treatment of executory contracts and unexpired leases. Although the determination of whether an oil and gas lease is an executory contract is a question of federal law, the classification of the real property interest is determined by state law.[6] Thus, the analysis of whether an oil and gas lease is subject to § 365 depends on the character of the estate conveyed or created in the particular state in which the property is located.

On one end of the spectrum is the characterization of oil and gas leases as real property interests in oil and gas in-place states that are therefore not subject to 11 U.S.C. § 365.[7] In the middle, are the cases in which courts have recognized a mineral lease as an "incorporeal immovable," such as in Louisiana, and though most courts note these are not of the type of "contracts" contemplated by § 365, the case law is conflicting both as to executory contract status and whether an oil and gas lease is an unexpired lease.[8] Also in the middle is the treatment of Outer

---

6 *See, e.g., Terry Oilfield Supply Co. v. American Security Bank, N.A.,* 195 B.R. 66, 73 (S.D. Tex. 1996).

7 *River Prod. Co., Inc. v. Webb* (*In re Topco, Inc*.), 894 F.2d 727, 739 n. 17 (5th Cir. 1990); *Terry Oilfield Supply Co., Inc. v. Am. Security Bank, N.A*., 195 B.R. 66, 70 (S.D. Tex. 1996); *see also, In re TXCO Res., Inc.,* 2009 Bankr. LEXIS 5379, 4-5 (Bankr. W.D. Tex. Dec. 15, 2009) (holding that oil and gas leases covering mineral interests in the states of Texas [including any Texas offshore leases], Oklahoma, Mississippi, North Dakota, South Dakota, Colorado and Montana are not "unexpired leases" subject to the provisions of 11 U.S.C. §365, however no Colorado Bankruptcy Court has similarly ruled and the Texas court order does not cite to any authority for its holding as to Colorado leases); *In re Clark Resources*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986) (holding that Oklahoma oil and gas leases are neither executory contracts because the lessee's only remaining obligation is the payment of money and the lessor's only to defend title to the leased land and not to interfere with the lessee's drilling operation - the breach of either not excusing performance by the party not in breach, but merely abating the obligation of the non-breaching party for as long as the breaching party was in breach, nor an unexpired leases of non-residential real property because the interest created by an oil and gas lease is "merely a license to explore, not an interest in real property"); *In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (holding that an Oklahoma oil and gas lease was not an executory contract because the lessor's "only obligations under the contract is to defend her title to the leased land and not to interfere with the lessees' drilling operation. Breach of these duties would not excuse performance by [the lessee], but would merely abate [the lessee's] obligation for so long as [the lessor] was in breach.").

8 Cases holding that Louisiana oil and gas leases are not executory contacts are: *In re WRT Entergy Corp*., 202 B.R. 579, 583-84 (W.D. La. 1996) (applying the Countryman definition of executory contract in holding that Louisiana oil and gas leases are non-executory because "the lessor's failure to perform would constitute material breach so as to excuse the lessee

Continental Shelf ("OCS") leases, the status of which likewise is ambiguous.[9] On the other extreme of the spectrum are those states where oil and gas leases are not considered interests in real property and, as personal property, are treated as executory contracts.[10]

The significance of an oil and gas lease being subject to § 365 is 1) the ability to accept or reject, and the timing therefor, 2) the necessity of curing pre-petition defaults if assumed, and 3) the requirement to pay damages if rejected.

1. Leases that are not subject to § 365.

    a. Fee simple determinable - The characterization of the rights created by an oil and gas lease in ownership in place states begins with the lease granting clause and almost always conveys a fee simple determinable. This is because the typical language creates an interest to continue indefinitely (the "fee simple") subject to the occurrence (or lack of an occurrence) of a specified event (the "determinable"), which is usually the lack of production, failure to pay delay rentals or, in some cases, the failure to pay royalties or continuously drill.

    These leases treated as real property assets, subject to termination under the terms of the leases, but not pursuant to § 365.

---

from its obligations under the lease. . . ."). Cases holding that Louisiana oil and gas leases are executory contracts are: *Texaco, Inc. v. Louisiana Land & Exploration Co*., 136 B.R. 658, 668 (M.D. La. 1992) (applying a broader standard than the Countryman definition in determining that a Louisiana mineral lease is executor because it is not "fully performed," with virtually all performance is by the lessee throughout the entire term of the contract); *In re Ham Consulting Company/William Lagnion/JV*, 143 Bankr. 71 (Bankr. W.D. La. 1992)(relying on *Delta Energy Res., Inc. v. Damson Oil Corp.* [*infra*.], Texaco, Inc. [*supra*.] and *In the Matter of Topco* [*infra*.] to determine that Louisiana oil and gas leases are executory and subject to the requirements of § 365). Cases holding that Louisiana oil and gas leases are not unexpired leases are: *In re WRT Entergy Corp*., 202 B.R. at 583-84 (holding that Louisiana oil and gas leases are not unexpired leases because looking at "the interplay between the Mineral Code, the Civil Code, and the jurisprudence of the State of Louisiana, the OG&ML vests the lessee with real rights whereas a lease of real property creates only personal rights."); *In re Ham Consulting Company/William Lagnion/JV*, 143 Bankr. 71 (Bankr. W.D. La. 1992) (holding that though a LA oil and gas lease is an executory contract, it is not an unexpired lease – or at least not the type of unexpired lease contemplated by § 365); *see also*, *Delta Energy Resources, Inc., v. Damson Oil Corp*., 72 B.R. 7, 11 (W.D. La. 1985) (stating that a Louisiana oil and gas lease "is not the conventional lease contemplated by Section 365, but is in fact a real right in favor of another); *In re Topco, Inc*., 894 F.2d at 739 n. 17 (noting in a footnote that Louisiana oil and gas leases are not unexpired leases). The authors know of no cases specifically holding that Louisiana oil and gas leases are unexpired leases for purposes of § 365.

[9] The Bureau of Ocean Energy Management Regulation and Enforcement ("BOERME" [formerly MMS]) has argued that an OCS lease is an unexpired lease of non-residential real property or an executory contract due to the unique nature because OCS leases "convey neither title nor any unencumbered estate in the land or the minerals" and are more akin to a profit-à-prendre in that they simply afford the right, subject to revocation, to go upon land and extract the minerals, the MMS has argued that this definition of "lease" should also apply to §365 on the belief that Congress intended the use of the same word to mean the same thing. There is case law that OCS leases are or should be considered "true leases" although the settlement of the question remains subject to dispute.

[10] *In re J. H. Land & Cattle Co*., 8 B.R. 237 (Bankr. W.D. Okla. 1981) (holding that under Kansas law an oil and gas lease created a license to enter which is an intangible personal property right and, therefore, was an unexpired lease of real property under 11 U.S.C. § 365(h)(1)).

b. Profit à prendre or license (to explore for oil and gas)

Although these leases often found to have aspects of contracts, they are not necessarily subject to § 365 because such "contracts" are not executory under the Countryman definition because the lessee's only remaining obligation is the payment of money and the lessor's is only to defend title to the leased land and not to interfere with the lessee's drilling operation. The breach by either of these of their obligations would not excuse performance by the party not in breach, but would merely abate the obligation of the non-breaching party for as long as the breaching party was in breach. Further, oil and gas leases that are characterized as licenses are not unexpired leases of non-residential real property because the interest created by an oil and gas lease is "merely a license to explore, not an interest in real property"). *See, In re Heston Oil Co.*, *infra.*

2. Leases that are subject to § 365.

If the oil and gas lease is subject to § 365 then, depending on whether the lease is assumed or rejected, the debtor may be obligated to pay cure costs or the rejected counterparty may have a rejection damage claim.

a. Assumption.

The debtor must (i) cure, or provide adequate assurance that it will promptly cure, all defaults relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, (ii) compensate, or provides adequate assurance that the debtor will promptly compensate, a counterparty to an assumed contract of lease, for any actual pecuniary loss to such party resulting from such default, and (iii) provide adequate assurance of future performance under such contract or lease.

Assuming an oil and gas lease for which there are multiple defaults, including failure to property pay royalty, breach of the covenant to develop or violations of surface use provisions, can be extremely costly and, at times, an impediment to assuming the lease.

b. Rejection.

The Code treats this as a breach of contract claim, with damages calculated as if the debtor had breached the lease on the petition date.[11] The lessor is entitled to damages, which claim receives the priority of an unsecured claim.[12] Rejected

---

11 *Id*. § 365.

12 *Id*.

6163963.1

leases that had significant defaults often result in lessors comprising a large part of the unsecured creditor pool.

c. Timing of assumption or rejection. An unexpired "true" lease must be assumed within 120 days from the petition date or it will be deemed rejected.[13] A one-time extension of 90 days is permitted on motion of the Debtor or lessor, for cause and any subsequent extension may be had only by prior written consent of the lessor.[14] An executory contract does not have to be assumed or rejected until confirmation of a plan.[15] For leases in states with "true" leases, the time frame is short for a determination of whether to assume or reject, and this can have major implications for the ultimate success of a plan of reorganization.

II. Joint Operating Agreements ("JOAs") and Joint Exploration Agreements ("JEAs")

A. Description. The JOA is an agreement between co-owners of the rights to explore for and develop the oil and gas in a certain described lands, usually called the "contract area." While the co-owners usually own undivided fractional oil and gas leasehold interests, the JOA can also cover owners of the fee oil and gas estate who would rather participate in the cost and risk of exploration and development than execute an oil and gas lease and participate only as a royalty owner. The JEA generally describes an agreement in which at least one party "drills to earn" acreage, expending the costs of drilling to earn an assignment of a working interest in the acreage.

B. Bankruptcy Treatment under § 365. Applying the Countryman definition to JOAs and joint exploration agreements, most of the time these agreements will be executory because exploration and development (*i.e.* drilling) is ongoing on the properties and there always remain unperformed duties, the lack of performance of which would constitute a material breach. However, there are arguments as to why certain of these agreements, should not simply be assumed to be executory and therefore subject to § 365 without further analysis. For example, there may be an argument that provisions in a JOA actually are separate contracts and, therefore, depending on the status of fulfilled obligations may or may not be executory, even if other provisions remain executory.[16] In addition, some joint exploration agreements contain various "phases" under each of which are distinct responsibilities and benefits. Such a JEA may be ripe for argument that each "phase" is its own contract or the JEA may be so fully consummated at the time § 365 becomes an issue that it is no longer executory. Notwithstanding these

---

13 11 U.S.C. § 365(d)(4)(A).

14 *Id*. § 365(d)(4)(B).

15 *Id*. § 365.

16 *See, e.g. Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co*., 83 F.3d 735, 742 (5th Cir. Tex. 1996) (holding that where a trustee rejects a severable contract containing both an executed and an executory agreement, such rejection is not equivalent to the breach or rescission of the executed agreement nor does it require the undoing or reversal of already executed portions of the contract).

arguments, most of the time, JOAs and JEAs are executory and must be assumed or rejected within the time frames specified by § 365.

III. Farmouts and Farmins

A. Description. A very common form of agreement between operators, whereby a lease owner not desirous of drilling at the time agrees to assign the lease, or some portion of it (in common or in severalty) to another operator who wants to drill on the tract. The assignor in such a deal may or may not retain an overriding royalty or production payment. The primary characteristic of the farmout is the obligation of the assignee to drill one or more wells on the assigned acreage as a prerequisite to completion of the transfer to him.

B. Safe Harbor Provisions. The farmout safe harbor" is spelled out in § 541(b)(4). This Code section was designed to give protection for those entities that have spent time, effort and capital farming-in to a particular lease (the "farmee") but who have not yet received an assignment of the farmed-in property from the farmor when the farmor files for bankruptcy protection.

Section 541(b)(4)(A) states that:

(b) "Property of the estate does not include - . . .

> (4) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that –
>
> (A)(i) the debtor has transferred or has agreed to transfer such interests pursuant to a farmout agreement or any written agreement directly related to a farmout agreement;
>
> and
>
> (ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 544(a)(3) of this title[.]"

As can be gleaned from the statutory language, this section of the Code provides that interests of the debtor covered by certain types of farmout arrangements are not property of the estate, either by negating the debtor's ability to reject as an executory contract an otherwise earned farmout (§ 365) or declaring that the farmee's right to an earned assignment cannot be defeated due to lack of recordation (§ 544(a)(3)). Despite clearly being drafted with the assumption that the debtor is the farmor, this section is nonetheless applicable both with the debtor is the farmor and the farmee, leading to a distinct set of legal issues depending on which is the case.

1. The Debtor as Farmee. When the debtor has agreed to "drill to earn" and has therefore contracted with a third-party leasehold owner to drill (and likely, also complete) wells to earn acreage, such debtor usually must meet drill to certain specifications (successfully completing the "earning event") before it is entitled to an assignment of acreage or working interest in acreage. Record title, therefore, remains with the farmor until the

6163963.1

earning event (and, often, in practice, even until much later). When the debtor is the farmee, and only in cases where the earning event has been met, the argument is simply that the debtor owns the equitable interest in the lease (that which was earned) and, therefore, such is property of the estate, regardless of the status of assignment or recordation of assignment. However, the situation becomes more complicated if the debtor/farmee has contracted to assign farm-in interests to third-parties (for example, an overriding royalty interest to the debtor/farmee's chief geologist). The assignee's best argument likely would be that the assignment is a "written agreement directly related to a farmout agreement" and, therefore, the estate does not include the assignee's interest under §541(b)(4)(A)(ii). There is an especially compelling case where the assignee's performance contributed to the farmee's ability to successfully meet its earning event obligations in the first place. Note that the protections afforded by this section require that "the estate could include the interest . . . only by virtue of section 365 or 544(a)(3)" thus likely necessitating that the farmout is an executory contract under § 365. Otherwise the Debtor could avoid the assignment because it is not of record.

2. The Debtor as Farmor. The scenario of the debtor/farmor more squarely fits within the statutory language. Where the debtor is the farmor, the farmee's earned interest is not part of the estate, other than to include the rights of the farmor under the particular farmout agreement. Where the farmee has already earned interests under the farmout on the date of filing, the "safe harbor" provision kicks-in and protects the farmee's right to interests already earned. However, it is uncertain what the effect of this provision is on the unearned rights under the farmout. Depending on the benefit to the estate of the farmout, some practitioners have argued that the unperformed part of the farmout (that which is executory) cannot be rejected because of § 541(b)(4). The argument focuses on the language that the debtor has "agreed to transfer" and would include even unperformed farmout provisions as part of an "agree[ment[to transfer." There are no cases, reported or unreported, addressing this argument and, to these authors it seems a stretch that § 541(b)(4)'s language would trump the plain language of most farmout agreements (the agreement to transfer not being absolute in any sense, but subject at all times to the successful completion of certain conditions) or the long history of farmouts falling under the rubric of § 365.

C. Penalty Provisions. Another issue dealt with separately by the Code that is applicable to JOAs or JEAs is § 365(b)(2)(D) exception for requiring cure of all defaults, when such relates to a penalty rate or a penalty provision. For example, where the debtor is the operator under a JEA, and must drill a certain number of wells meeting certain specifications and within a certain time frame or pay a penalty (usually a set price/net mineral acre), there is an argument that such a provision constitutes an unenforceable penalty provision under § 365(b)(2)(D).[17]

---

[17] *In re DSBC Invs*., 2009 Bankr. LEXIS 2954, 5-6 (Bankr. D. Ariz. Sept. 11, 2009) (holding that a default interest rate provision was either a "penalty rate" or "penalty provision" within the meaning of § 365(b)(2)(D)).

6163963.1

D. Lien Issues. The method for perfecting a lien on an oil and gas lease depends upon the characterization of oil and gas leases. For example, where the oil and gas lease is a fee simple determinable, the method for perfecting a lien is by deed of trust. The deed of trust often will reference the lease, rather than provide a metes and bounds property description.

There are myriad issues regarding the extent and validity of liens in an E&P bankruptcy as it relates to farmouts. An E&P company may have an interest in a lease as to certain depths and, subsequent to a loan, acquire interests in other depths (which may or may not be covered by an after acquired property clause); a borrower may enter into a JEA either before or after a loan and "earn" acreage from the primary working interest owner by drilling; a lease may expire as to certain acreage not held by production, but not other acreage; a lease may be unitized or pooled only as to certain depths; or the mortgage itself may be limited only as to certain depths in a given lease.

1. Lien Avoidance. In theory, a lien should attach to the equitable but unassigned interest that may be owned by a debtor/farmee under the safe harbor provisions. However, § 544(a)(3) of the Bankruptcy Code creates the fiction that the debtor is in the same position as a bona fide purchaser for value, as of the filing date, and as if the debtor had recorded the interest. Because a bona fide purchaser can generally avoid unrecorded title, this section of the Bankruptcy Code has been argued successfully to allow the debtor to avoid transfers of oil and gas interests that are not recorded.

2. After acquired property. A security agreement and deed of trust often will state that after acquired property is covered by the holder of the security interest's lien. These documents also must provide a property description covered by the lien which, often, is a reference to the leases and/or wells covered. However, it is common that these documents reference the property description by lease or well, and the lease or well itself is depth severed. If acreage is earned by the borrower/farmee owner in other depths at a later date, such property will not necessarily be covered by the lien due to the security agreement and deed of trust's limiting property description in the referenced leases.