# The E&P Industry: Have All the Shoes Now Dropped?

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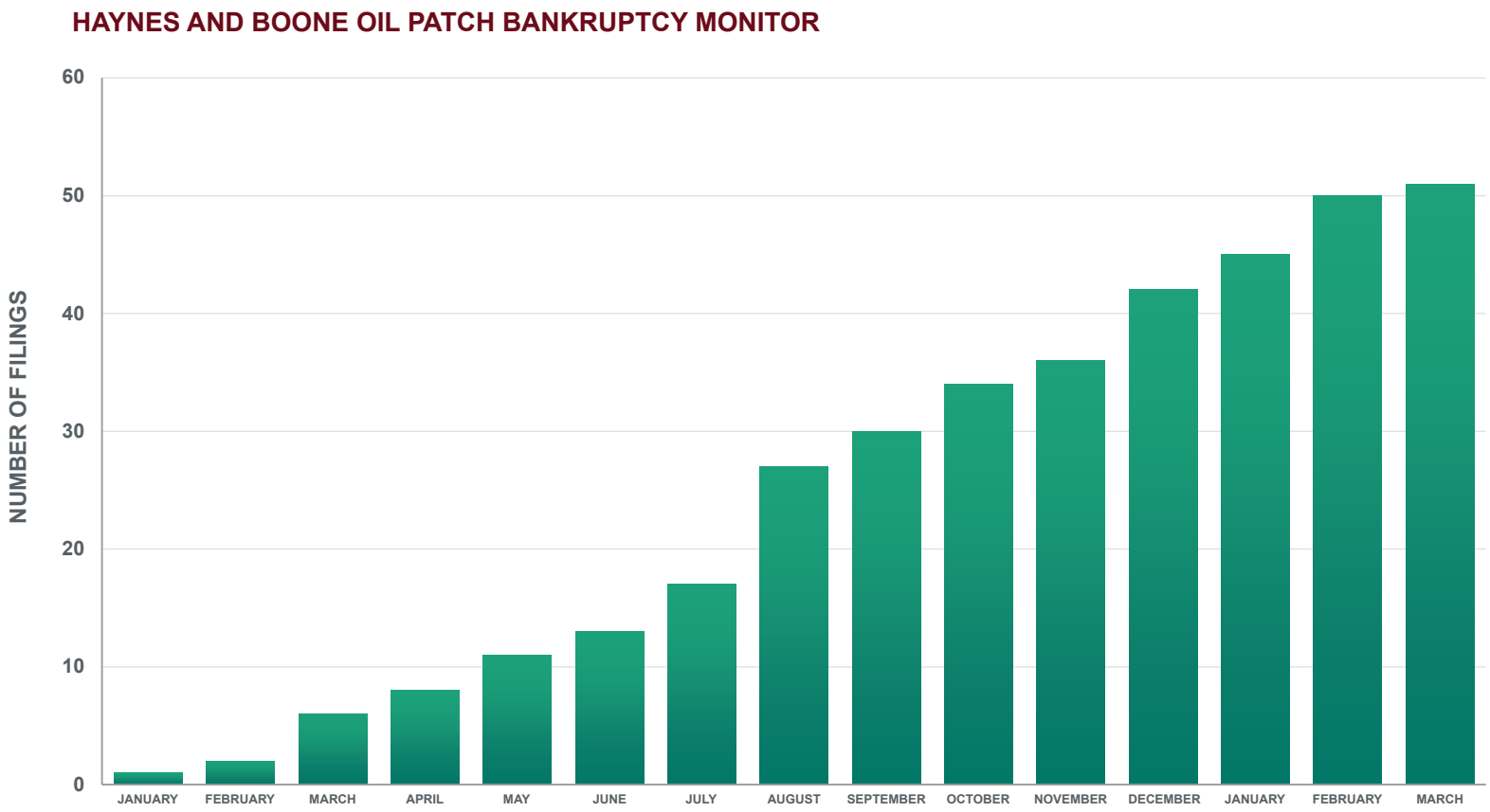
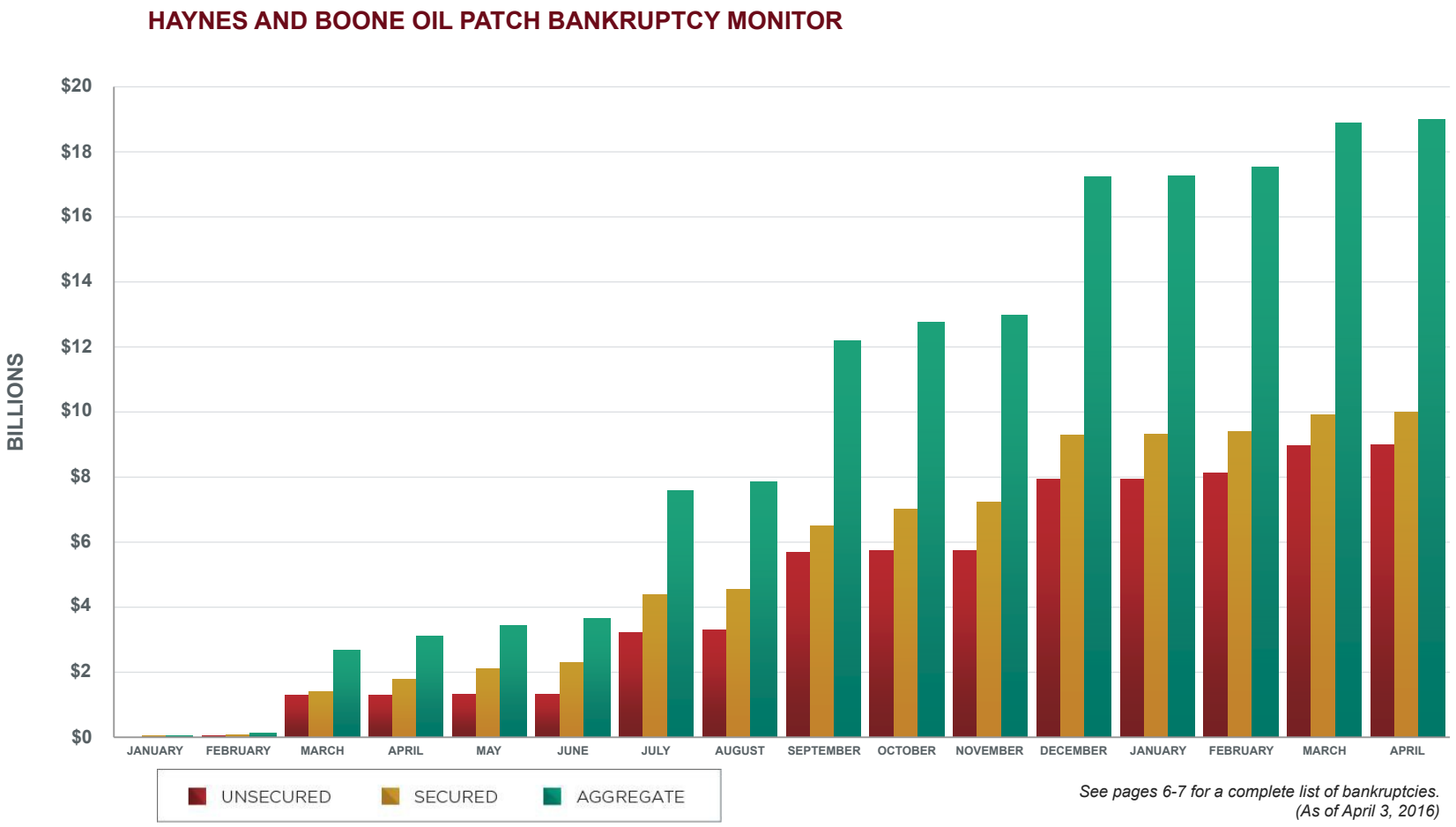
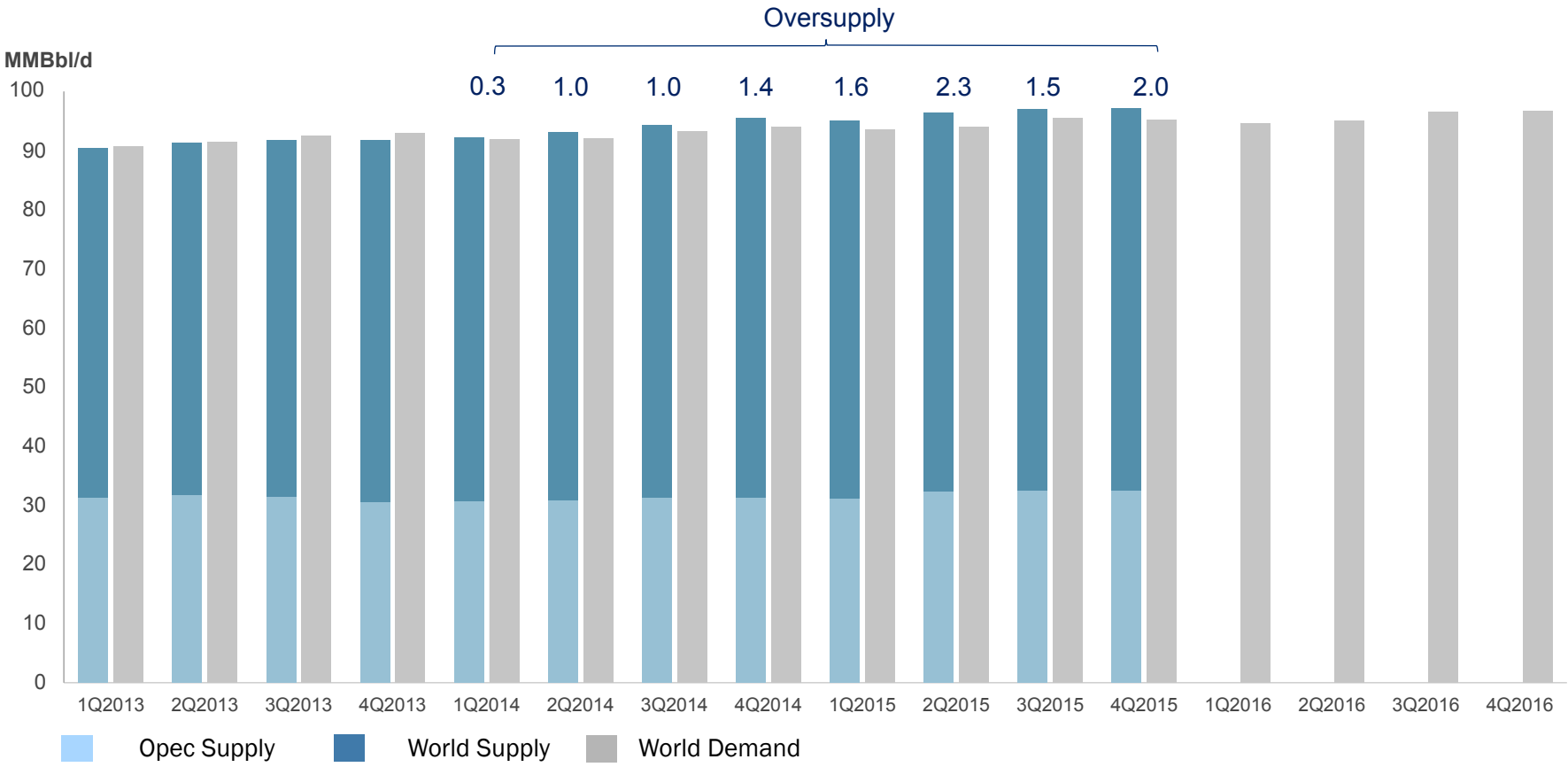
# 2015-2016 CUMULATIVE NORTH AMERICAN E&P BANKRUPTCY FILINGS



# 2015-2016 CUMULATIVE E&P UNSECURED DEBT, SECURED DEBT AND AGGREGATE DEBT

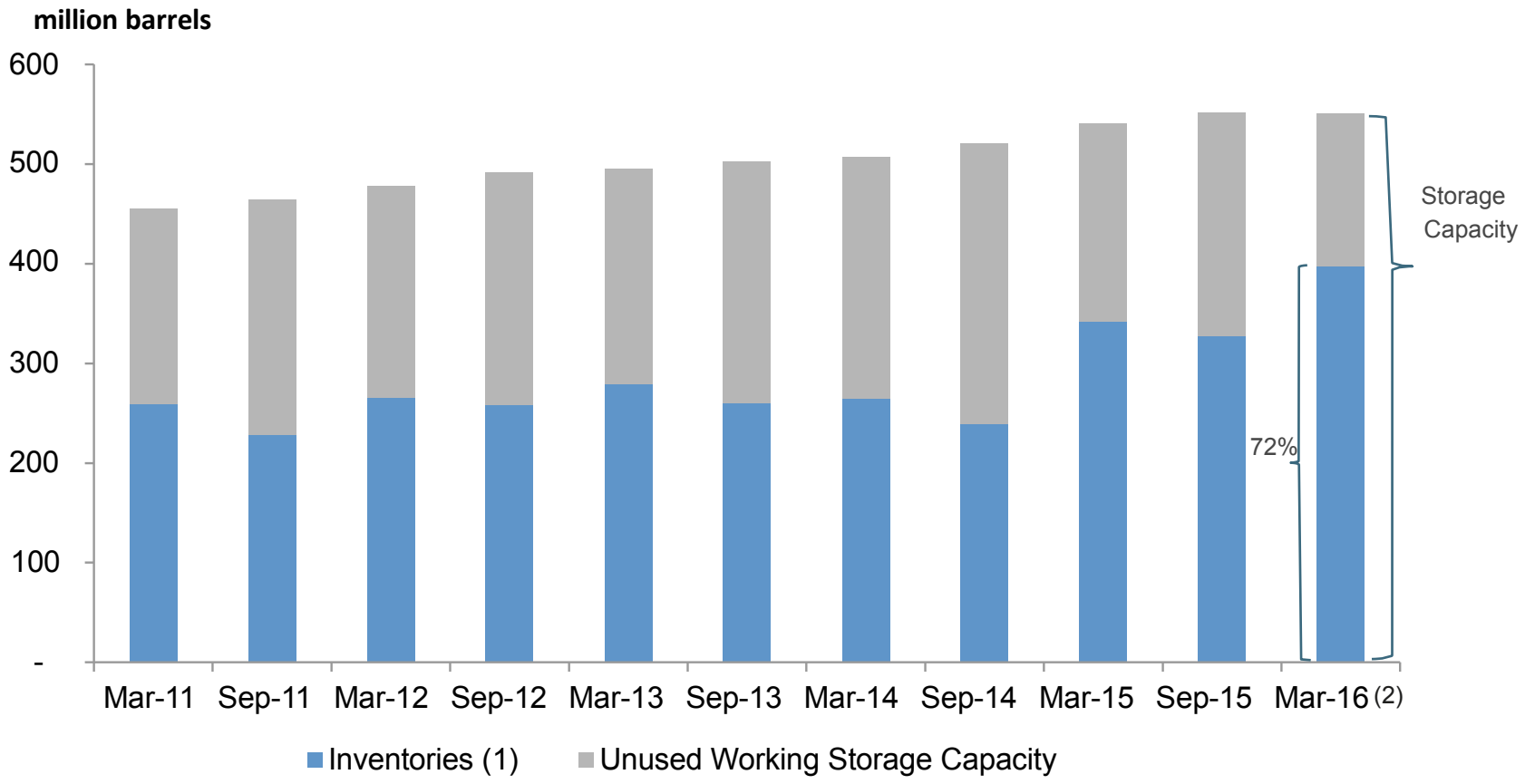



*See pages 6-7 for a complete list of bankruptcies.*
*(As of April 3, 2016)*




- Trend shows decelerations in demand growth
- Crude prices rose to their highest in three months in early March, with WTI above the $40/bbl level
- Opec and Non-Opec Producers meeting on April 17th

# US Commercial Crude Oil Storage Capacity and Utilization



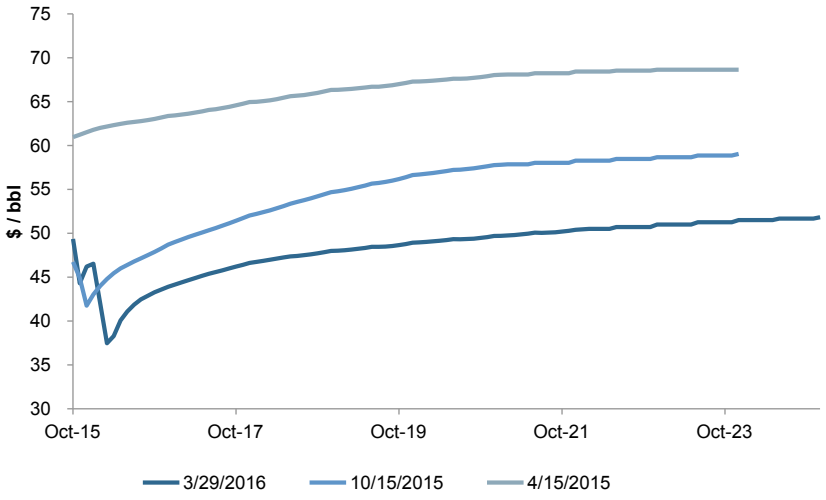

*Source: EIA*

*(1) Inventories shown in the graph do not include pipeline fill, lease stocks, or oil in transit from Alaska*

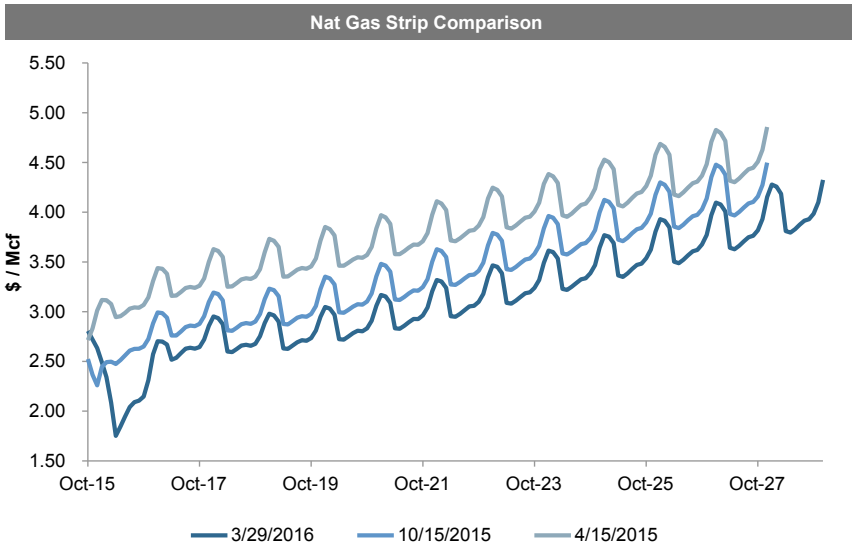
*(2) March 2016 shows crude oil inventories as of March 25 2016, adjusted for oil stocks in transit from Alaska, and for estimated lease stocks and pipeline fill. Storage capacity assumed constant to the capacity for September 2015*

# Market Update

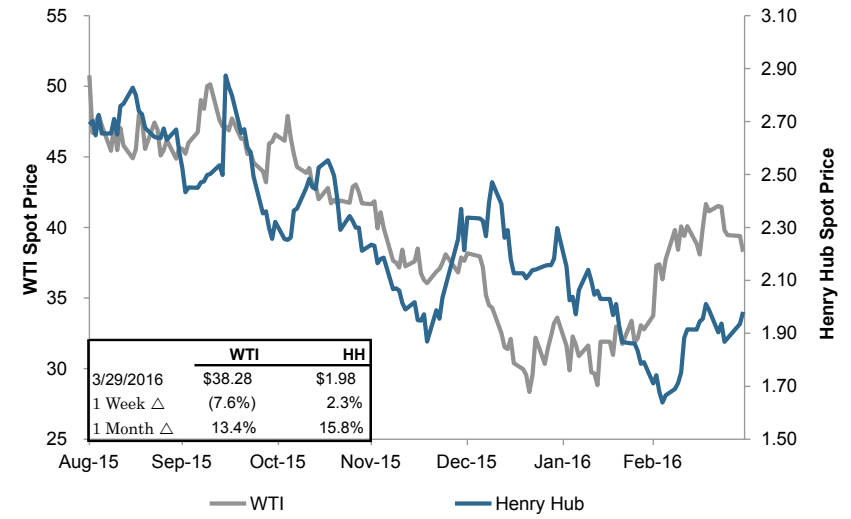
## WTI Strip Comparison




## Nat Gas Strip Comparison




## Historical Spot Prices



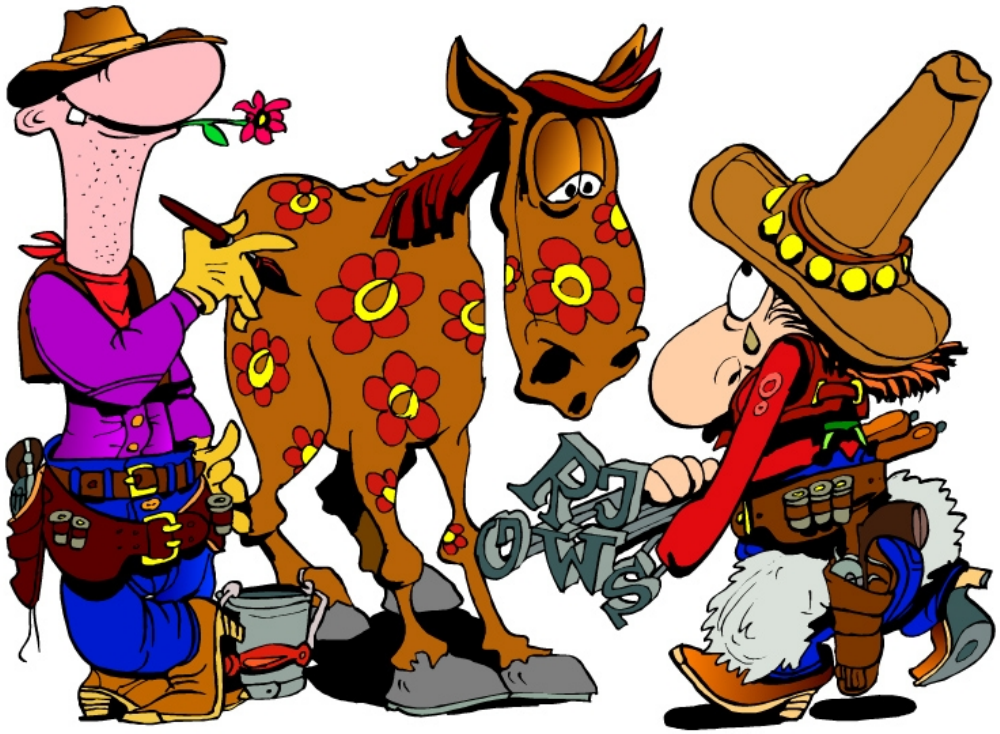

| | WTI | HH |
|---|---|---|
| 3/29/2016 | $38.28 | $1.98 |
| 1 Week △ | (7.6%) | 2.3% |
| 1 Month △ | 13.4% | 15.8% |

- Reserve Values
- Fair Market Value

# Valuation in Oil & Gas

# Restructure v. Sale

- What is Driving the Decision?
- In-court v. Out-of-court
- Recent Sales
- Conversion of Debt to Equity
- LOE
- Future CapEx
- Plugging and Abandonment Liability



# Liquidity

- Cash Collateral
- DIP Financing

- Executory Contracts & Gas Gathering Agreements
- Lessons from *Sabine & Quicksilver*
- Operational Impact
- Economic Impact

# Midstream Contracts

# For a Real Covenant to Run With the Land

## Conveyance + Real Covenant

- Horizontal Privity
- "Touch and Concern"
- Thing in Existence/Specifically Binds
- Intent
- Notice

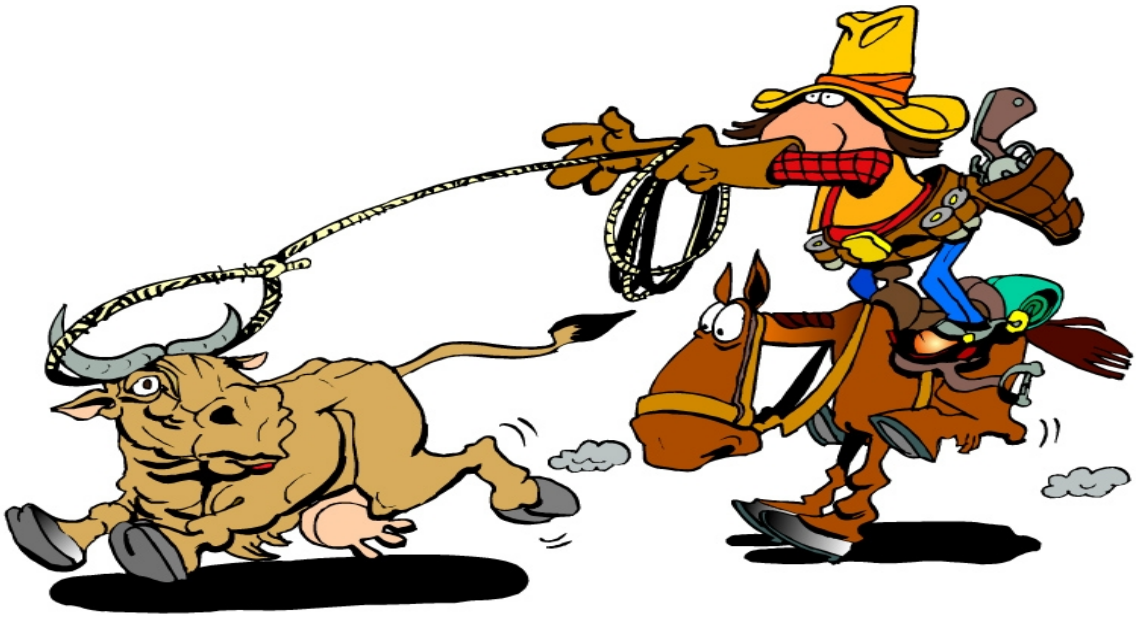
If Applicable, Vertical Privity is Required

# Dueling Debtors

- Which Bankruptcy Court gets to decide?
- Common Issue: Assumption/Rejection of Joint Operating Agreements ("JOAs")
- Recent Example: *Energy & Exploration Partners v. New Gulf Resources*

# Hedges

- Terminate hedge and offset RBL, or remain in place?



- Redetermination of Borrowing Bases
- Going Concern Opinions
- Delays in Borrower's Requests to Draw
  - Syndicate Consent
  - Reasonable Due Diligence Clauses
- DIP Loans as Alternatives to Draw

# Undrawn Revolving Facilities

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# When the Boom Goes Bust: Unique Issues Arising in Oil and Gas Bankruptcies

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Every good boom in the oil and gas industry has been followed by a great bust. Volatile increases and declines in oil and gas commodity prices always leave a few failed enterprises in their dust. Some of these companies will, undoubtedly, end up in bankruptcy court. Many generally accepted legal principles, particularly those pertaining to contracts, real property and secured transactions, are radically transformed in bankruptcy law. Moreover, with the oil and gas industry moving into new territory as it chases additional sources of oil and gas, the oil and gas industry is also entering uncharted legal territory in the offshore arena and in states where oil and gas law has historically been less developed. This paper is intended to be a broad overview of some general themes of bankruptcy law as they relate to legal issues in the oil and gas industry, including executory contracts, the debtor's avoidance powers, and creditor remedies. Further, this paper will also highlight some of the emerging bankruptcy issues in the offshore arena and in states with relatively recent oil and gas development.

## I. EXECUTORY CONTRACTS

Certain types of contracts – oil and gas leases, operating agreements and farmout agreements, to name a few – are ubiquitous in the modern oil and gas industry. It comes as no surprise, then, that reorganization in an oil and gas context raises important questions about how these types of contracts are treated under the Bankruptcy Code.

The starting point for understanding the Bankruptcy Code's treatment of these types of oil and gas contracts is the concept of the executory contract. While the term "executory contract" is not defined in the Bankruptcy Code, there is a widely accepted definition: a contract is executory if the obligations of both parties are so far unperformed that the failure of either party to perform would be a material breach. *See* Vern Countryman, *Executory Contracts and Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973); *see also In re Liljeberg Enters., Inc.*, 304 F.3d 410, 436 (5th Cir. 2002). Section 365 of the Bankruptcy Code gives the debtor the option,

subject to a few notable exceptions and approval by the Bankruptcy Court, to honor (assume) or repudiate (reject) its executory contracts. Those contracts not deemed executory – i.e., those that have been fully or substantially performed by a party – are considered either the bankruptcy estate's property under Section 541 (if the debtor has performed but the other party has not) or a prepetition claim (if the other party has performed but the debtor has not).

Whether a contract should be deemed executory is a question of federal law. *In re Alexander*, 670 F.2d 885 (9th Cir. 1982). Although the executory nature of a contract is a federal question, the definition of an executory contract necessarily implicates state law because the question of whether a failure to perform will constitute a material breach discharging the other party's further performance can only be answered by evaluating the legal consequences of the particular breach, which are set forth by state law.

### A. Oil and Gas Leases

Whether an oil and gas lease constitutes an executory contract is a question dependent upon how applicable state and other law classifies the type of interest created by an oil and gas lease.

#### (i) Texas, Oklahoma, and New Mexico

In Texas, an oil and gas lease cannot be an executory contract because Texas law does not consider the lease to be a contract at all – rather, the lease constitutes a conveyance of an ownership interest in real property. *Cherokee Water co. v. Forderhause*, 641 S.W. 2d 522, 525 (Tex. 1982); *see also Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002) ("A Texas mineral lease grants a fee simple determinable to the lessee."). Therefore, in Texas and other states that characterize oil and gas leases as conveyances of real property, such as

Oklahoma and New Mexico, Section 365 and all other provisions[1] relating to executory contracts in the Bankruptcy Code are inapplicable.[2] *Terry Oilfield Supply Co. v. American Security Bank, N.A.*, 195 B.R. 66, 73 (S.D. Tex. 1996); s*ee also In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (determining oil and gas lease is fee estate in real property and therefore not within purview of Section 365); *In re Clark Resources*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986) (finding, under Oklahoma law, oil and gas lease is not executory contract or unexpired lease under Section 365); *In re Antweil*, 91 B.R. 65 (Bankr. N.M. 1989) (holding that oil and gas leases are not executory contracts).[3]

**(ii) Louisiana**

In Louisiana, whether oil and gas leases are considered executory contracts for the purposes of Section 365 remains a controversial and undecided issue. Where the debtor wanted to assume the leases and clearly had the ability to perform, Louisiana courts have ruled oil and gas leases to be executory contracts. *Texaco Inc. v. Louisiana Land Exploration Co.*, 136 B.R. 658, 668 (M.D. La. 1992); *see also In re Ham Consulting Co./William Lagnion/JV*, 143 B.R. 71, 73-75 (Bankr. W.D. La. 1992) (finding Louisiana mineral lease not an unexpired lease but is executory contract under Section 365). Other Louisiana judges have rejected this analysis as contrary to the Countryman definition and held oil, gas and mineral leases in Louisiana are not executory contracts under Section 365. *See*, *e.g.*, *In re WRT Entergy Corp.*, 202 B.R. 579, 583

[1] This includes Section 365(d)(4), which provides that unexpired leases of nonresidential real property to which the debtor is lessee are deemed automatically rejected if not assumed within 60 days from the date of the order for relief. 11 U.S.C. 365(d)(4). *See, e.g., In re WRT Energy Corp.*, 202 B.R. 579 (Bankr. W.D. La. 1996); *In re Clark Resources, Inc.*, 68 B.R. 358 (Bankr. N.D. Okla. 1986); *In re Hanson Oil Co., Inc.*, 97 B.R. 468, 470 (Bankr. S.D. Ill. 1989); *In re Frederick Petroleum Corp.*, 98 B. R. 762 (S.D. Ohio 1989).

[2] Sections 362 and 363 of the Bankruptcy Code, which relate to property of the estate, would, however, apply to oil and gas leases in states that consider them conveyances of real property.

[3] It appears that an oil and gas lease is a conveyance of a real property interest under California law and would therefore not be an executory contract. *See Laugharn v. Bank of Am. Nat. Trust & Savings Ass'n*, 88 F.2d 551, 553 (9th Cir. 1937) (holding that the oil and gas leases at issue were conveyances of interests in real property under California law and were therefore not executory contracts).

(W.D. La. 1996); s*ee also Delta Energy Resources, Inc. v. Damson Oil Corp.*, 72 B.R. 7, 11 (W.D. La. 1985) (finding Louisiana mineral leases to be rights to incorporeal immovables and not contracts contemplated by Section 365).

**(iii) Other States**

In contrast, Section 365 and the Bankruptcy Code's other executory contract provisions may apply in states where oil and gas leases are not considered real property interests, such as Kansas and Ohio. *See*, *e.g. In re J.H. Land & Cattle Co., Inc*., 8 B.R. 237, 239 (Bankr. W.D. Ok. 1981) (holding oil and gas leases to be executory contracts in Kansas because Kansas law considers them personal property and a profit a prendre); *In re Integrated Petroleum Co., Inc.*, 44 B.R. 210 (Bankr. N.D. Ohio 1984) (holding oil and gas leases treated as executory contracts under Ohio law).

Until recently, it seemed that oil and gas leases governed by Pennsylvania law may be subject to assumption or rejection under Section 365 of the Bankruptcy Code. In *In re Powell*, the United States Bankruptcy Court for the Middle District of Pennsylvania held that under Pennsylvania law, no real property interest is conveyed until oil or gas production occurs. *In re Powell*, 482 B.R. 873, 878 (Bankr. M.D. Pa. 2012). Because there was no production under the lease in question as of the petition date, the bankruptcy court applied contract principles—and not real property law—in determining whether Section 365 applied to the lease. *Id.* Notably, the bankruptcy court suggested that if production had occurred, the production would have "vested" the lessee with a fee simple determinable interest, thereby terminating the executory nature of the oil and gas lease. *Id.* at 877 ("'If development during the primary term is unsuccessful, no estate vests in the lessee. If, however, oil or gas is produced, a fee simple determinable is created in the lessee, and the lessee's right to extract the oil or gas becomes vested.' . . . Vesting is critical to the analysis, since the 'vesting' is that of a fee simple

determinable which terminates the executory nature of the contract and takes this interest, be it license, lease, or other and converts it to a real property interest in the mineral estate. It has generally been observed that § 365 does not apply to a real property interest or freehold estate.") (quoting *T.W. Phillips Gas and Oil Co. v. Jedlicka*, 42 A.3d 261 (Pa. 2012)).

On appeal, the district court concluded that the bankruptcy court erred in determining that oil and gas leases were executory contracts under Pennsylvania law. *Chesapeake Appalachia, LLC v. Powell (In re Powell)*, 2015 U.S. Dist. LEXIS 152509, at *17 (M.D. Pa. Nov. 10, 2015). The district court found that the cases cited by the bankruptcy court did not support the bankruptcy court's conclusion that oil and gas leases are executory contracts; rather, the cases explained that as a matter of interpretation, oil and gas leases should be construed as contracts rather than leases governed by landlord and tenant law. *Id.* at *16-17. The district court further found that the bankruptcy court misinterpreted the discussion of inchoate rights in the case law: "[T]he inchoate nature of the lessors' title merely affected the value of their conveyance and not its nature as an interest in real property. An estate in property has still been conveyed even if the title remains inchoate." *Id.* at *18. The district court stopped short of determining that all oil and gas leases are conveyances of real property interests as a matter of law in Pennsylvania, and found that oil and gas leases should be construed in accordance with their terms to determine whether they constitute conveyances of real property. *Id.* at *23-24. Thus, the issue of whether an oil and gas lease is an executory contract based on Pennsylvania law may vary from case to case.

The issue of the nature of oil and gas leases may become particularly important in North Dakota, where oil and gas exploration and production surged during recent years when oil prices were high but may be declining at significantly lower oil prices. There is a lack of case law on

the issue of whether an oil and gas lease is an executory contract under North Dakota law, so it remains to be seen how this issue will be determined in a bankruptcy case involving oil and gas assets located in North Dakota.

**(iv) Offshore**

The determination of whether state or federal law applies to offshore oil and gas leases depends on where the leased interests are located. Generally, state law applies to the area extending up to three (3) geographical miles from the state's coast. *See* 43 U.S.C. § 1312. Federal law governs the area extending from the offshore state boundary to at least two hundred (200) nautical miles from the shore. This offshore area is known as the Outer Continental Shelf. *See* 43 U.S.C. § 1331(a) ("The term 'outer Continental Shelf' means all submerged lands lying seaward and outside of the area [of state control], and of which the subsoil and seabed appertain to the United States and are subject to its jurisdiction and control.").[4]

Oil and gas leases on the Outer Continental Shelf are granted by the United States Department of the Interior ("Interior") and are governed by the Outer Continental Shelf Lands Act ("OCSLA"). *See* 43 U.S.C. § 1334. Courts have found that a lease granted under OCSLA "does not convey title in the land, nor does it convey an unencumbered estate in the oil and gas." *Union Oil Co. of Cal. v. Morton*, 512 F.2d 743, 747 (9th Cir. 1975) (citing *Boesche v. Udall*, 373 U.S. 472, 478 (1963); *McKenna v. Wallis*, 344 F.2d 432, 440-41 (5th Cir. 1965), vacated, 384 U.S. 63 (1966)). Interior has thus argued that oil and gas leases on the Outer Continental Shelf are "rental agreements to use real property" within the meaning of Section 365(m) of the Bankruptcy Code and are therefore "unexpired leases" that are subject to assumption or rejection under Section 365. *See, e.g.*, United States' Motion to Intervene, Ex. A at 5, *Diamond Offshore*

[4] For a detailed discussion of the legal framework governing offshore oil and gas leases, see ADAM VANN, CONG. RESEARCH SERV., RL 33404, OFFSHORE OIL AND GAS DEVELOPMENT: LEGAL FRAMEWORK (2010).

*Co. v. ATP Oil & Gas Corp.*, No. 12-03425 (Bankr. S.D. Tex. Oct. 31, 2012).[5] No court has yet decided the issue of whether an oil and gas lease on the Outer Continental Shelf is an executory contract or unexpired lease that is subject to assumption or rejection under Section 365 of the Bankruptcy Code. As one commentator has noted, "the question of whether an OCS lease is a true lease or an executory contract under § 365 of the Bankruptcy Code is difficult, unanswered, and subject to much dispute." Rhett G. Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, Tex. J. Oil Gas & Energy L., 2009-2010, Issue No. 2, at 265, 272.

**B. Farmout Agreements & Section 541(b)(4)**

A farmout agreement is a contractual arrangement in which the owner of a lease on or rights to a property (the farmor) agrees to assign some or all of their interest in the property to another party (the farmee) in exchange for the performance of certain tasks, such as the drilling or completion of wells.[6] Typically, record title in the property remains with the farmor pending the farmee's completion of their contractual tasks. In most instances, farmout agreements that have not been fully performed are treated as executory contracts by the Bankruptcy Code and subject to all applicable executory contract provisions, including Section 365's powers of assumption or rejection. Applying Section 365 and the Bankruptcy Code's other executory

[5] Interior has also argued that oil and gas leases on the Outer Continental Shelf are executory contracts within the meaning of Section 365 because both the lessor and the lessee typically have unperformed obligations: the lessor (Interior) must make the lands available to the lessee, and the lessee must pay Interior royalties for its use of the land. *See id.* at 5-6. Interior has taken a similar position with respect to onshore oil and gas leases on federal lands in the bankruptcy case of Swift Energy Company. *See* Objection by the United States to the Debtors' Sale Motion, *In re Swift Energy Co.*, No. 15-12670 (Bankr. D. Del. Jan. 22, 2016) ("Section 365 of the Bankruptcy Code applies to the federal oil and gas leases and contracts, and therefore, the Debtors, or any other buyer or assignee, must assume all obligations, including, *inter alia*, the decommissioning obligations under oil and gas leases and contracts.").

[6] The Bankruptcy Code formally defines a "farmout agreement":

> (21A) "farmout agreement" means a written agreement in which –
> (A) the owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and
> (B) such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing, or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property.

11 U.S.C. 101(21A).

contract provisions to farmout agreements creates many different consequences, depending on the arrangement of the debtor vis-à-vis the farmout agreement:

**(i) The Debtor as Farmor**

Section 365 allows the debtor to assume or reject executory contracts, including uncompleted farmout agreements.[7] Often times, when the debtor is the farmor and the farmee has drilled a producing well, the debtor can realize a substantial windfall by rejecting the farmout agreement, rather than accepting the contract and recognizing the farmee's interest. Such a situation proves particularly burdensome to the farmee when, as is often the case in the oil and gas industry, it has sold its interests in the property to be acquired under the farmout agreement to third parties. Congress eliminated this unintended windfall to the debtor-farmor by enacting Section 541(b)(4) of the Bankruptcy Code. This provision limits Section 541(a)'s definition of property of the bankruptcy estate, and provides:

> (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 interest pursuant to a farmout agreement; and
>
> (ii) but for operation of this paragraph, the estate could include the interests referred to in clause (i) only by virtue of section 365 or 544(a)(3) of this title; or
>
> (B)(i) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from which such production payment is transferred; 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 542 of this title;…

11 U.S.C. § 541(b)(4).

[7] A farmout agreement that is uncompleted as of the date on which the debtor files for bankruptcy is likely an executory contract capable of rejection. *In re Texaco, Inc*., 79 B.R. 560, 563 (Bankr. S.D.N.Y. 1987).

Section 541(b)(4) acts as a "safe harbor" for farmees in two ways. First, Section 541(b)(4)(A)(ii) excludes from property of the estate, any interest in liquid or gaseous hydrocarbons that the debtor "has transferred or agreed to transfer" pursuant to a farmout agreement and thereby extinguishes the debtor-farmor's ability to invalidate the farmee's right to receive title to what it has earned on the date of filing by rejecting the farmout agreement under Section 365. Second, 541(b)(4)(A)(ii) declares that a farmee's right to assignment of title, if properly earned, is not defeated by the mere fact that the farmee's interest is not of record.[8]

The unearned/unperformed portion of a farmout agreement remains an executory contract – Section 541(b)(4) only excludes the earned portion of farmout agreements from the definition of property of the estate – but whether this section precludes the debtor-farmor's ability to assume or reject the rest of the agreement remains unclear. It is not apparent, from the plain language of the provision, whether Section 541(b)(4) addresses the earned as well as unearned portions of a farmout agreement. There are no cases interpreting the scope of Section 541(b)(4) or its effect on the executory contract provisions of the Bankruptcy Code.

**(ii) The Debtor as Farmee**

Although Section 541(b)(4) is widely understood to contemplate farmout agreements when the debtor is the farmor, this provision could also be interpreted to provide relief to debtor-farmees who find themselves in the unfortunate situation of having sold – but not yet recorded an assignment of – their interests under a farmout agreement to third parties. In this situation, if the debtor assumes the farmout agreement under Section 365, what happens to the debtor-farmee's interests that were sold and assigned, but not recorded, to third parties? If Section 541(b)(4)(A)(i) applies, the debtor-farmee could not void the assignment under Section

[8] Section 544(a)(3) of the Bankruptcy Code empowers the debtor to avoid an assignment of property if a bona fide purchaser for value could take title superior to the assignee.

544(a)(3) even though it is unrecorded. Whether Section 541(b)(4) applies to these types of debtor-farmee assignment scenarios, however, is an open question not yet confronted by any bankruptcy court. The answer to this question will likely turn on what the phrase "pursuant to a farmout agreement" in Section 541(b)(4)(A)(1) is interpreted to require of the governing farmout agreement. On one hand, a court could determine the phrase requires the relevant farmout agreement to make explicit reference to third parties. If no reference is present, such a court may refuse to apply Section 541(b)(4)(A)(1). On the other hand, a reasonable court could also find a debtor-farmee's assignment arrangement is "pursuant to a farmout agreement" when the debtor-farmer's ability to perform under the farmout agreement arises, in part or whole, from the assignment to third parties.

### C. Joint Operating Agreements

The oil and gas business, and exploration activity in particular, are capital intensive enterprises. In an effort to share the burden and manage the risk posed by these large initial capital investments, it has become commonplace for oil and gas companies to enter into standard form joint operating agreements, wherein one party is designated the operator, and the financial and non-financial duties and obligations of the operators and non-operators are set forth.

Are joint operating agreements treated as executory contracts in bankruptcy and, therefore, subject to assumption or rejection by the debtor under Section 365? The answer is, arguably, not as clear as it may seem upon first glance. When non-operators have continuing obligations arising out of continuing performance, joint operating agreements have been characterized as executory contracts subject to assumption or rejection by the debtor. *Wilson v. TXO Production Corp.* (*In re Wilson)*, 69 B.R. 960 (Bankr. N.D. Tex. 1987) (finding joint operating agreement was executory contract in ruling operators' lien ineffective against the debtor for failure to record notice). While the *Wilson* opinion supports labeling joint operating

agreements as executory contracts, it does not end the discussion for two reasons. First, from a technical standpoint, Judge Akard's characterization of the joint operating agreement at issue was pure dictum and not central to the holding of the case. Second, and more importantly, the all-encompassing and complex nature of the provisions of most joint operating agreements makes unilateral characterization of these contracts both undesirable and inaccurate. A joint operating agreement is a "complex instrument of interdependent provisions and contains independent real property interests." Gary Conine, *Property Provisions of the Operating Agreement – Interpretation, Validity and Enforceability*, 19 Tex. Tech L. Rev. 1263 (1988). The typical joint operating agreement, then, would be expected to contain executory and non-executory provisions. An astute and creative bankruptcy court might treat a joint operating agreement as divisible, permitting the debtor to assume or reject certain provisions as executory while prohibiting them from doing the same to those of a non-executory nature. There is precedent in the Fifth Circuit for distinguishing the separate provisions of an agreement as executory and non-executory. *Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co.*, 83 F.3d 735, 741-742 (5th Cir. 1996) (finding that where a personal property lease embraces several distinct agreements, some of which are executory and others fully or substantially performed, only the executory portions of the document are subject to rejection). Should a joint operating agreement be explicitly restricted under its own terms, it could be treated as entirely executory, or executory only as to those provisions a court deems sufficiently executory in nature.

Assuming a joint operating agreement is at least partially executory, what are the rights and duties of the parties under a joint operating agreement while the debtor considers assumption or rejection? Here, again, the *Wilson* case is instructive. In that case, the court held that an executory contract is not enforceable against a debtor-in-possession prior to assumption. *Wilson*,

69 B.R. at 966. Elaborating on this situation, a more recent case suggests that, prior to assumption, the non-debtor party to the contract is obligated to perform its contractual obligations even though the debtor is not obligated to perform and, in exchange, performing non-debtors are entitled to assert administrative claims for the reasonable value of their performance. *In re El Paso Refinery L.P.*, 220 B.R. 37, 43 (Bankr. W.D. Tex. 1998). Imposing one-sided obligations on the non-debtor will, if carried to the logical extreme, run contrary to the Countryman definition of executory contracts, but the *El Paso Refinery* opinion does not address whether a non-debtor would be obligated to perform under a contract if the debtor materially breached prior to assumption or rejection.

## II. AVOIDANCE ISSUES

As hinted at in the discussion of the "safe harbor" provision for farmout agreements, upon commencement of a bankruptcy case the Bankruptcy Code confers on the debtor certain legal statuses under which avoidance rights, as determined by non-bankruptcy (state) law, can be exercised. The purpose of these rights is to help debtors strike down "secret" liens and other suspect or inequitable dealings, thereby increasing the pool of assets available for distribution to creditors. Specifically, Section 544(a) of the Bankruptcy Code, affectionately known as the "strong arm" clause, confers upon the debtor three hypothetical roles – that of judicial lienholder, unsatisfied execution creditor or bona fide purchaser of real property – under which it can exercise avoidance rights. 11 U.S.C. § 544. The exercise of these avoidance rights in the oil patch, however, can create some thorny issues.

### A. Debtor-Assignors and Putative Assignees: Section 544(a)(3) vs. Section 541(d)

The widespread use of various financing arrangements in the oil and gas industry creates many instances of unrecorded interests in oil and gas leases. The treatment of these unrecorded

interests can create tension between different provisions of the Bankruptcy Code, particularly when an assignor files for bankruptcy before recording an assignment of interest in an oil and gas lease due to a third-party.[9]

**(i) The Debtor's Avoidance Power under Section 544(a)(3)**

Section 544(a)(3) provides:

> (a) The Trustee shall have, as of commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
>
> …
>
> (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such purchaser exists.

11 U.S.C. § 544(a)(3).

Section 544(a)(3) puts the debtor, for avoidance purposes, "in the same position, with respect to real estate, as if he were a bona fide purchaser who bought the property from the debtor on the filing date and simultaneously perfected the transfer by recording a deed." *In re Reasonover*, 236 B.R. 219, 227 (E.D. Va. 1999). In essence, Section 544(a)(3) empowers the debtor to avoid any liens or conveyances a bona fide purchaser could avoid, as determined by applicable state law. Even where applicable state law allows bona fide purchasers to prevail over previous unrecorded interests, however, Section 544(a)(3) does not make it certain that a debtor-assignor would be able to avoid a prepetition assignee's unrecorded interest in an oil and gas

[9] In Texas, the holder of an unrecorded interest in an oil and gas lease may attempt to impose a constructive trust on the oil and gas lease in which the holder claims an interest so as to be recognized as an owner. A constructive trust is not actually a trust but rather an equitable remedy imposed by law to prevent unjust enrichment resulting from an unconscionable act. *Haber Oil Co., Inc. v. Swinehart* (*In re Haber Oil Co., Inc.*), 12 F.3d 426, 435-37 (5th Cir. 1994). Establishing the existence of a constructive trust involves elements that are difficult to prove in the typical oil and gas case. E.g., *Haber Oil*, 12 F.3d at 437. Thus, it is relatively rare that an unrecorded assignee will prevail on a constructive trust theory in Texas. E.g., *Wilson v. Parson* (*In re Jones*), 77 B.R. 541 (Bankr. N.D. Tex. 1987).

lease. In those cases where the right to an assignment is contingent or otherwise not effective upon delivery of funds, a recordation of a memorandum of the agreement *may* provide sufficient notice to cut off the rights of a hypothetical bona fide purchaser.

**(ii) Property Excluded from the Debtor's Estate under Section 541(d)**

Section 541 of the Bankruptcy Code prescribes the composition of the bankruptcy "estate" – that is, the pool of the debtor's assets (including real property) available for distribution to creditors. Section 541(a) explains what is included in the bankruptcy estate; Section 541(d) explains what is not:

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest…becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.
>
> 11 U.S.C. § 541(d).

Armed with this provision, the putative assignee of an unrecorded interest in an oil and gas lease from a debtor-assignor could argue that the interest never entered into the bankruptcy estate as property of the debtor because the debtor held mere legal title to the interest, while the putative assignee maintains a qualifying equitable interest in the assignment. Section 544(a)(3) applies, by its own terms, only to property of the estate. Application of Section 541(d) would, therefore, entirely preclude any power the debtor-assignor has to avoid the unrecorded assignment as a hypothetical bona fide purchaser.

**(iii) Resolving the Dispute between Section 544(a)(3) and Section 541(d)**

Courts and commentators disagree when it comes to resolving competing claims to unrecorded interests based upon Section 544(a)(3) and Section 541(d). The Fifth, Tenth and Eleventh Circuit Courts of Appeal have held that Section 541(d) prevails over an avoidance claim made under Section 544(a)(3). *See*, *e.g.*, *City Nat'l Bank of Miami v. General Coffee*

*Corp.* (*In re General Coffee Corp.*), 828 F.2d 699 (11th Cir. 1987), *cert. denied* 485 U.S. 1007 (1988); *Turley v. Mahan & Rowsey, Inc.* (*In re Mahan & Rowsey, Inc.*), 817 F.2d 682 (10th Cir. 1987); *Sandoz v. Bennett* (*In re Emerald Oil Co.*), 807 F.2d 1234 (5th Cir. 1987); *Vineyard v. McKenzie* (*In re Quality Holstein Leasing*), 752 F.2d 1009 (5th Cir. 1985) (dictum). These cases argue that Section 541(d) must generally prevail over the debtor's avoidance powers because "Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own." *Emerald Oil. Co.*, 807 F.2d at 1238 (quoting *Quality Holstein Leasing*, 752 F.2d at 1013).

A substantial number of other courts and commentators, including the Seventh and Ninth Circuit Courts of Appeal, have reached the opposite conclusion, finding that the debtor's avoidance power under Section 544(a)(3) should trump claims based solely on the debtor's lack of equitable title. *See*, *e.g.*, *Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir. 1989); *Chbat v. Tleel* (*In re Tleel*), 876 F.2d 769 (9th Cir. 1989); *In re Ebel*, 144 B.R. 510 (D. Colo. 1992); *see also* David Gray Carlson, *The Trustee's Strong Arm Power under the Bankruptcy Code*, 43 S.C. L. REV. 841, 930 (1992). These cases contend that a modification, made in 1984, to Section 541 of the Bankruptcy Code makes Section 541(d) inapplicable to exclude from the debtor's estate property recovered by the debtor using Section 544(a)(3).[10] Therefore, these cases and

[10] Specifically the 1984 amendment to Section 541(d) struck the phrase "under subsection (a) of this section" and replaced it with "under subsection (a)(1) or (2) of this section." Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 456, 98 Stat. 363, 376 (1984). This amendment altered the operation of Section 541(d) to exclude only property coming into the estate under Section 541(a)(1) or (2), not under (a)(3). Section 541(a)(3) brings into the debtor's estate any interest in property recovered by the debtor under Section 550, which, in turn, allows the debtor to recover transfers avoided by the debtor's strong-arm powers under Section 544(a)(3). Thus, Section 541(d) does not apply to property recovered by the debtor with its avoidance power under Section 544(a)(3).

commentators conclude, the 1984 amendment signals Congressional intent for the debtor's avoidance powers to trump claims based on Section 541(d).[11]

For the time being, there is no clear resolution to the conflict between Section 541(d) and Section 544(a)(3). In the Fifth, Tenth and Eleventh Circuits, a putative assignee of an oil and gas interest will likely be able to defend its assignment, despite lack of recordation, from avoidance by a debtor-assignor. In the Seventh and Ninth Circuits and, to a lesser extent, Colorado, such an attempt by the debtor-assignor will probably be successful, making recordation a particularly important concern for putative assignees in oil and gas financing arrangements in these jurisdictions.

## III. ISSUES INVOLVING PRODUCTION PAYMENTS AND OVERRIDING ROYALTY INTERESTS IN BANKRUPTCY

As an alternative to conventional financing, a producer seeking to finance drilling operations will convey a fixed quantity or value of production to a purchaser-lender to be delivered according to a mutually agreed upon schedule, as opposed to borrowing under a traditional loan. These payments, usually secured by the producer-borrower with a deed of trust covering the properties subject to the agreement, are known as production payments.[12] In recent years, oil and gas producers have increasingly turned to production payments as a source of cash to fund ongoing operations. The increasing number (and often increasing value) of production

[11] For a detailed discussion of cases interpreting Sections 544(s)(3) and 541(d) with respect to unrecorded oil and gas interests, see Rhett G. Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, Tex. J. Oil Gas & Energy L., 2009-2010, Issue No. 2, at 265, 272-79 (noting that the Fifth Circuit has not faced the tension between Sections 544(a)(3) and 541(d) since the 1984 amendment to Section 541(d), "which, by implication, take[s] § 544(a)(3) out from the § 541(d) safe harbor").

[12] Section 101(42A)(A) & (B) of the Bankruptcy Code define a production payment as:

(42A) The term "production payment" means a term overriding royalty satisfiable in cash or in kind—
(A) contingent on the production of a liquid or gaseous hydrocarbon from particular real property; and
(B) from a specified volume, or a specified value, from the liquid or gaseous hydrocarbon produced from such a property, and determined without regard to production costs.

11 U.S.C. 101(42A)(A) & (B).

payments brings certain issues, including avoidance of such interests, to the forefront of oil and gas bankruptcy cases.

### A. Avoidance Issues

Before 1994, production payments, and/or the contract that created the obligation to make them, were subject to avoidance and rejection by producer-borrower debtors under Sections 544 and 365 respectively. The Bankruptcy Reform Act of 1994 changed this by adding Section 541(b)(4)(B), which provides:

> (b) Property of the estate does not include…
>
> (4) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that –
>
> (B)(i) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from which such production payment is transferred; 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 542 of this title; …

11 U.S.C. § 541(b)(4).

Section 541(b)(4), similar to its treatment of farmout agreements, specifically excludes from the property of the estate any interest in transfers made under most production payment agreements and that would otherwise be included pursuant to Section 542.[13] Since Sections 544 and 365, by their own terms, only apply to property of the estate, Section 541(b)(4)(B)'s exclusion of production payments from the estate prevents them from being subject to avoidance or rejection under Section 365 or 544, respectively.

### B. The Nature of Production Payments and Overriding Royalty Interests

The increasingly diverse and complex methods used to finance oil and gas properties and operations, coupled with a dearth of published case law on the issue, has left an area of some

[13] Section 542 of the Bankruptcy Code governs turnover of the debtor's property held by a third party to the estate.

uncertainty regarding what types of interests will constitute "production payments" for purposes of Section 541(b)(4)(B). The type of interest involved, the terms of the conveyance instrument, and the applicable state law are all important in determining whether or not a mineral interest will be excluded from property of the bankruptcy estate.

The first inquiry should be whether the written conveyance transferring the mineral interest accomplishes a conveyance of a real property interest under applicable state law. *See, e.g.*, *Sheffield v. Hogg*, 124 Tex. 290, 77 S.W.2d 1021, 1024 (1934) (overriding royalty interest is an interest in real property). To the extent the conveyance is a transfer of a real property interest under applicable law, the transferred mineral interest should be excluded from property of the estate under Section 541(a), without the need for reference to Section 541(b).[14]

By way of example, a typical production payment may be treated as either a real property interest, analogous to an overriding royalty interest, or as security for a debt, depending on the applicable state law. *See EOG Res. V. Dep't of Revenue*, 86 P.3d 1280, 1282-1283 (Wyo. 2004). When applicable state law provides that a production payment is a real property interest of the production payment owner, the interest should be excluded from property of the production payment seller's bankruptcy estate generally under Section 541(a), and specifically under Section 541(b)(4)(B). *See* Jeffrey S. Munoz, *Financing of Oil and Gas Transactions*, 4 TEX. J. OIL GAS & ENERGY L. 223, 234 (2009).

The application of Section 541(b)(4) to net profits interests ("NPIs") raises additional questions. NPIs do not typically constitute "production payments" under the Bankruptcy Code because NPIs are arguably determined *with* regard to production costs (*i.e.*, net of production costs). *Id.* at 240. To the extent an NPI would be recognized as a real property interest under

[14] Nevertheless, it is not uncommon in bankruptcy cases for the owners of overriding royalty interests to assert that their interests are excluded from property of the estate under both Sections 541(a) and (b) of the Bankruptcy Code.

applicable state law, however, the NPI may be excluded from property of the estate under section 541(a). *Id.*

There is limited case law addressing whether NPIs constitute real property interests under Texas law. But the available Texas authority supports the position that NPIs constitute interests in real property. *See, e.g.*, *LaRue v. Wiggins,* 277 S.W.2d 808, 811 (Tex. Civ. App. – Waco 1944, writ ref'd n.r.e.). While the issue has not been conclusively resolved, it appears that an NPI created under Texas law may be excluded from property of the NPI seller's bankruptcy estate.

In those instances when the interest constitutes a "production payment" under the Bankruptcy Code but is not otherwise excluded from property of the estate under Section 541(a), the inquiry shifts to the requirements of Section 541(b)(4)(B). Specifically, the interest must have been transferred by a "written conveyance," and the interest owner must not "participate in the operation of the property" subject to such interest. 11 U.S.C. § 541(b)(4)(B)(i).

***(i) In re ATP Oil & Gas Corp.***

Even though it may appear straightforward to determine whether a production payment is property of the estate, the addition of debt-like features could cause the production payment to be recharacterized as a financing and therefore, the production payments will remain as property of the bankruptcy estate. The bankruptcy of ATP Oil & Gas Corporation ("ATP") raised the issue of the nature of overriding royalty interests ("ORRIs") and NPIs. ATP was a Houston-based corporation engaged in the acquisition, development, and production of oil and natural gas properties, primarily in the Gulf of Mexico. Prior to its bankruptcy filing, ATP obtained leasehold interests in offshore blocks on the Outer Continental Shelf of the Gulf of Mexico (the "OCS Leases") from Interior. To fund its operations, ATP conveyed certain ORRIs and NPIs

(the "Subject Interests") to third parties (the "Interest Owners") in exchange for cash payments.[15] *See* Debtor's Emergency Motion for an Order Authorizing (1) Payment of Funds Attributable to Overriding Royalty Interests in the Ordinary Course of Business and (2) Payment of Funds Attributable to Net Profits Interests Subject to Further Order of the Court Requiring Disgorgement Thereof Pursuant to (a) Sections 105(a), 363(b) and 541(a) of the Bankruptcy Code and (b) the Procedures for Complex Chapter 11 Bankruptcy Cases for the United States Bankruptcy Court for the Southern District of Texas at 8, *In re ATP Oil & Gas Corp.*, No. 12-36187 (Bankr. S.D. Tex. Aug. 17, 2012) (hereinafter, the "ORRI Payment Motion"). The NPIs entitled the holders thereof to receive a specified percentage of net profits of production from a given well until the holders received a specified dollar amount. *Id.* The ORRIs entitled the holders thereof to receive a specified percentage of gross proceeds attributable to ATP's interest in the hydrocarbons attributable to a given well until the holders received a specified dollar amount, including a specified return. *Id.* ATP filed for relief under Chapter 11 of the Bankruptcy Code on August 17, 2012. As of the date of commencement of its Chapter 11 case, ATP stated that it had "outstanding balances under the ORRIs and NPIs in excess of $489 million." *Id*. at 7.

Following its bankruptcy filing, ATP sought authority to continue paying the ORRIs in the ordinary course of business because it asserted that such interests were "production payments" under the Bankruptcy Code and thus were excluded from property of ATP's estate under Section 541(b)(4)(B). *Id.* at 11-12. ATP expressed doubt, however, regarding whether the NPIs constituted "production payments" that would be excluded from property of ATP's estate

[15] In some instances, it appears that ATP conveyed ORRIs and/or NPIs as payment for goods and/or services provided by a vendor. *See, e.g.*, Diamond Offshore Company's Complaint for Declaratory Judgment and Alternative Relief Against ATP Oil & Gas Corporation at 7-8, *Diamond Offshore Co. v. ATP Oil & Gas Corp.*, No. 12-03425 (Bankr. S.D. Tex. Oct. 2, 2012).

under Section 541(b)(4)(B). *Id.* at 12-15. ATP argued that "production payments" are limited to payments that are "determined without regard to production costs." *Id.* at 12. Because the NPIs were calculated net of the costs of production, ATP argued that the NPIs, by definition, were not "production payments" under the Bankruptcy Code. *Id.* ATP noted the complex analysis inherent in evaluating whether the NPIs were property of ATP's bankruptcy estate, including the question of whether state or federal law applies to determine the nature of an NPI conveyed from a federal offshore oil and gas lease. *Id.* at 13. ATP thus proposed to continue paying the NPIs in the ordinary course of business while ATP and other parties in interest (such as the unsecured creditors' committee) analyzed whether the NPIs were property of ATP's bankruptcy estate. *Id.* at 14. The Court authorized ATP to continue paying the Subject Interests in the ordinary course of business, but the payment of the of the Subject Interests was conditioned on the agreement of the Interest Owners to disgorge any post-petition funds they received if it was later determined that the Subject Interests were property of ATP's bankruptcy estate. *See* Order Regarding Debtor's Emergency Motion for an Order Authorizing (1) Payment of Funds Attributable to Overriding Royalty Interests in the Ordinary Course of Business and (2) Payment of Funds Attributable to Net Profits Interests Subject to Further Order of the Court Requiring Disgorgement Thereof Pursuant to (a) Sections 105(a), 363(b) and 541(a) of the Bankruptcy Code and (b) the Procedures for Complex Chapter 11 Bankruptcy Cases for the United States Bankruptcy Court for the Southern District of Texas, *In re ATP Oil & Gas Corp.*, No. 12-36187 (Bankr. S.D. Tex. Aug. 24, 2012).

In light of the doubt raised by ATP regarding the nature of the Subject Interests, several Interest Owners commenced adversary proceedings against ATP seeking, *inter alia*, a judgment declaring that the Subject Interests are real property interests and are not property of ATP's

bankruptcy estate.[16] The Interest Owners also sought judgments declaring that the conveyances of the Subject Interests are not executory contracts or unexpired leases subject to assumption or rejection under Section 365 of the Bankruptcy Code.

In answering each of the Complaints, ATP asserted counterclaims against the Interest Owners seeking, *inter alia*, a judgment declaring that the conveyances of the Subject Interests were "disguised financings." *See, e.g.*, ATP Oil & Gas Corporation's Answer and Affirmative Defenses to Diamond Offshore Company's Complaint and Counterclaim for Declaratory Judgment and Other Relief at 25-26, *Diamond Offshore Co. v. ATP Oil & Gas Corp.*, No. 12-03425 (Bankr. S.D. Tex. Oct. 31, 2012). ATP asserted that the "economic realities" of the conveyances were "consistent with a traditional financing arrangement and not a sale or absolute conveyance of a property interest." *Id.* at 26. Accordingly, ATP requested entry of judgments in its favor declaring that the conveyances of the Subject Interests constituted "disguised financing arrangements," and that the hydrocarbons produced from ATP's offshore oil and gas leases and any proceeds thereof were property of ATP's bankruptcy estate and not property of the Interest Owners. *Id.*

ATP also asserted a counterclaim seeking a judgment declaring that the conveyances of the Subject Interests were executory contracts and/or unexpired leases within the meaning of Section 365 of the Bankruptcy Code. *Id.* at 26-27. In support of this counterclaim, ATP asserted that under OCSLA,[17] its title to the OCS Leases "was that of a lessee and did not constitute absolute title in the Leased Lands." *Id.* at 26. Accordingly, "ATP could convey to [the Interest

[16] See Diamond Offshore Co. v. ATP Oil & Gas Corp., Adv. Proc. No. 12-03425 (Bankr. S.D. Tex.); TM Energy Holdings LLC, et al. v. ATP Oil & Gas Corp., Adv. Proc. No. 12-03429 (Bankr. S.D. Tex.); Bristow U.S., LLC v. ATP Oil & Gas Corp., Adv. Proc. No. 12-03440 (Bankr. S. D. Tex.); NGP Capital Res. Co. v. ATP Oil & Gas Corp., Adv. Proc. No. 12-03443 (Bankr. S.D. Tex.); SEACOR Marine, LLC v. ATP Oil & Gas Corp., Adv. Proc. No. 12-03450 (Bankr. S.D. Tex.); Macquarie Invs. LLC v. ATP Oil & Gas Corp., et al., Adv. Proc. No. 12-03516; Keba Energy LLC v. ATP Oil & Gas Corp., et al., Adv. Proc. No. 12-03517.

[17] For a discussion of OCSLA, see *supra*, § I.A(iv).

Owners] no greater title in the [OCS] Leases and the Hydrocarbons produced therefrom than that which it obtained from the Government." *Id.*

To date, the Bankruptcy Court has considered and denied motions for summary judgment in three (3) of the adversary proceedings.[18] In denying summary judgment in the adversary proceeding filed by NGP Capital Resources Company ("NGP"), the Court scrutinized various aspects of ATP's conveyance of the term ORRI to NGP and found that there was "a genuine issue of material facts as to whether the NGP-ATP transaction is consistent with a 'Term ORRI' under Louisiana law."[19] *See* Memorandum Opinion at 15, *NGP Capital Res. Co. v. ATP Oil & Gas Corp.*, Adv. Proc. No. 12-03443 (Bankr. S.D. Tex. Jan. 6, 2014) (hereinafter, "Memorandum Opinion"). The Court relied on the Louisiana Fifth Circuit Court of Appeals' opinion in *Howard Trucking Co. v. Stassi*[20] to look beyond the labels of the transaction documents to determine whether the legal effect of the transaction was to create a loan or a sale of a real property interest. *See* Memorandum Opinion, at 9-10 ("[U]nder Louisiana law, the parties' intent as to the legal effects of their contract has no bearing on whether those legal effects are in fact created."). Specifically the Court noted that "at the summary judgment stage, ATP only needs to show that there is a genuine issue of material facts as to whether the transaction is inconsistent with a term ORRI ***or*** that the transaction is consistent with a loan under Louisiana law." *Id.* at 12-13.

[18] The Court has considered motions for summary judgment filed by Diamond Offshore Company (Adv. Proc. No. 12-03425), TM Energy Holdings LLC, GMZ Energy Holdings LLC, and CLP Energy LLC (Adv. No. 12-03429), and NGP Capital Resources Company (Adv. No. 12-03443).

[19] Under OCSLA, the laws of the state adjacent to the location of the OCS Leases govern to the extent they are not inconsistent with OCSLA. 43 U.S.C. § 1333(a)(2). Because ATP's OCS Leases were located off the coast of Louisiana, the Court analyzed the nature of the Subject Interests under Louisiana law. *See* Memorandum Opinion, at 8.

[20] 474 So.2d 955 (La. Ct. App. 1985).

In finding that there was a genuine issue of material fact as to whether the NGP transaction was consistent with a term ORRI under Louisiana law, the Court observed that "ATP has not shown that any one provision, in isolation, is inconsistent with a Term ORRI under Louisiana law. However, the Court has not determined that a transaction that contains all of the terms in the NGP documents is consistent with the transfer of a real property interest under Louisiana law." *Id.* at 15 n. 10. Among other things,[21] the Court scrutinized a provision in the conveyance to NGP that provided that NGP agreed to subordinate its interest to the interests of other ORRI holders, such that NGP would not receive any payments on account of its term ORRI until the other ORRIs had been paid in full. *Id.* at 17-20. The Court found that there was a genuine issue of material fact as to whether this type of subordination provision was consistent with a term ORRI under Louisiana law. *Id.* at 20.

The Court also scrutinized the payment terms under NGP's term ORRI, which provided that NGP would receive monthly payments until ATP had paid the "Total Sum," which was calculated as the Primary Sum "plus accrued interest on the un-liquidated balance of the Primary Sum at a stated Notional Rate of 12.35% per annum." *Id.* at 21. The Court evaluated "whether the calculation of an overriding royalty interest using a formula that provides for a specified return on investment is consistent with a Term ORRI under Louisiana law." *Id.* at 24. In finding that there was a genuine issue of material fact with respect to the formula payment terms, the Court explained:

> For the NGP Term ORRI, increased revenues result in faster repayment and thus lower interest income accrued during the term of the ORRI. The fact that

[21] The two aspects of the transaction discussed in this paper are the primary aspects for which the Court found that there were genuine issues of material fact as to whether such aspects were consistent with a term ORRI under Louisiana law. The Court also scrutinized ATP's reversionary interest in the term ORRI (Memorandum Opinion, at 15-16), the fact that the term ORRI was to be satisfied from production from multiple properties (*Id.* at 16-17), and ATP's retention of the burdens and benefits of the OCS Leases (*Id.* at 20-21).

> increased revenue from the properties leads to a decrease in NGP's income appears to be at odds with real property ownership.

*Id.* at 25 (internal quotation and citation omitted). Although the Court found that there were genuine issues of material fact as to whether the NGP term ORRI was consistent with a term ORRI under Louisiana law, the Court also found that there was a genuine issue of material fact as to whether the NGP term ORRI was consistent with a loan under Louisiana law. *Id.* Specifically, the Court found that the lack of a foreclosure remedy rendered the NGP term ORRI inconsistent with a mortgage and loan under Louisiana law. *Id.* at 27-28. NGP also argued that the fact that ATP is not obligated to pay any amounts under the term ORRI absent production rendered it inconsistent with an unsecured loan under Louisiana law. *Id.* at 28. The Court rejected this argument, explaining that "if the risk of non-payment was so low that ATP effectively guaranteed repayment of the purchase price and the agreed upon rate of return, then the 'condition' (that NGP would receive royalty payments *only if and when* production occurred) is an artificial one. An ORRI that is virtually certain to be satisfied in full from production is the economic equivalent of an 'obligation to repay.'" *Id.* at 28-29. The Court thus was concerned that shifting the risk of non-production (and thus non-payment) from NGP to ATP suggested that the NGP transaction was more like a loan than a sale of a real property interest.

While the Court has denied motions for summary judgment in which the Interest Owners sought to preclude ATP from recharacterizing the conveyances of the Subject Interests as "disguised financings," it remains to be seen whether ATP will prevail on its recharacterization theory. ATP has argued that the economic substance of the conveyances is inconsistent with sales of real property interests; rather, the economic substance is consistent with a loan-type transaction, and as such, the Court should recharacterize the conveyances as loans. If ATP prevails on its recharacterization theory, the hydrocarbons attributable to the Subject Interests

would remain property of ATP's bankruptcy estate, and the Interest Owners would have claims against ATP's bankruptcy estate. Further, certain of the Interest Owners may be required to disgorge payments they received during the bankruptcy case on account of the Subject Interests.[22]

A number of procedural changes have occurred during the course of the adversary proceedings. Specifically, Bennu Oil & Gas LLC ("Bennu"), the entity formed to acquire certain of ATP's assets as part of a credit bid by the Agent for ATP's debtor-in-possession financing, substituted for ATP with respect to claims related to the assets that Bennu purchased. In addition, following the Court's denial of summary judgment in three of the adversary proceedings, ATP's Chapter 11 bankruptcy case was converted to Chapter 7. As a result, a Chapter 7 Trustee was appointed, and has stepped into ATP's role in the litigation on behalf of ATP's bankruptcy estate.[23] As a result of the sale of certain of ATP's assets, a dispute arose between Bennu and the Trustee regarding whether the recharacterization causes of action were sold to Bennu or remained property of ATP's bankruptcy estate. The Court ultimately concluded that Bennu acquired the recharacterization causes of action, as well as the estate's causes of action under Section 549 of the Bankruptcy Code. *See Diamond Offshore Co. v. Bennu Oil & Gas, LLC (In re ATP Oil & Gas Corp.)*, 2015 Bankr. LEXIS 3693, at *7-*15 (Bankr. S.D. Tex.

[22] *See* Order Regarding Debtor's Emergency Motion for an Order Authorizing (1) Payment of Funds Attributable to Overriding Royalty Interests in the Ordinary Course of Business and (2) Payment of Funds Attributable to Net Profits Interests Subject to Further Order of the Court Requiring Disgorgement Thereof Pursuant to (A) Sections 105(a), 363(b) and 541(a) of the Bankruptcy Code, and (B) the Procedures for Complex Chapter 11 Bankruptcy Cases for the United States Bankruptcy Court for the Southern District of Texas at 2-3, *In re ATP Oil & Gas Corp.*, No. 12-36187 (Bankr. S.D. Tex. Aug. 24, 2012).

[23] After his appointment, the Chapter 7 Trustee also filed adversary proceedings against other holders of ORRIs seeking judgments declaring, *inter alia*, that the ORRIs are disguised financings rather than sales of real property interests. See *Tow v. HBK Main Street Invs., L.P.*, Adv. Proc. No. 14-03286 (Bankr. S.D. Tex.); *Tow v. Sankaty ATP, LLC,* et al., Adv. Proc. No. 14-03287 (Bankr. S.D. Tex.). The Trustee has settled the estate's claims against the defendants in these two adversary proceedings.

Oct. 28, 2015). The Court found, however, that the Trustee retained the exclusive right to pursue preference claims against the Interest Owners. *Id.* at *7-*8.

The Interest Owners filed motions to dismiss the Trustee's Section 547 claims on the grounds that the Trustee would be unable to prove the elements of a preference without recharacterizing the Subject Interests as disguised financing transactions. *Id.* at *15-*16. In denying the motions to dismiss the Section 547 claims, the Court found that the Trustee may be able to prove that payments made to the Interest Owners on account of their Subject Interests during the 90-day period prior to ATP's bankruptcy filing were preferences, regardless of whether the Subject Interests were real property interests or disguised financing transactions. The Court explained:

> The Court will assume, without deciding, that each ORRI agreement created a real property interest under Louisiana law, owned by the ORRI holders. If ATP were to have breached its duty under the applicable agreements to forward the property to the ORRI holders, that breach would have caused ATP to incur a debt to the ORRI holders. If ATP were to have diverted the property for its own use—and then replenished the property via payment to the ORRI holders—ATP's replenishment would have been payment of the incurred debt.

*Id.* at *23-*24. The Court concluded that "[e]ven if the Court were to determine that the underlying instruments were entirely consistent with a real property interest and inconsistent with a debt instrument under Louisiana law, this would not preclude the Court from finding that the relevant transactions constituted a payment of a 'debt' under the Bankruptcy Code." *Id.* at *25. Accordingly, regardless of whether the Subject Interests are ultimately recharacterized as disguised financing transactions, the payments that the Interest Owners received during the preference period may be at risk of avoidance as preferences. Following the Court's denial of the Interest Owners' motions to dismiss the Section 547 claims, the adversary proceedings currently remain unresolved.

**(ii) *In re Delta Petroleum Corp.***

The United States Bankruptcy Court for the District of Delaware has also addressed the nature of an ORRI in the context of an action to determine that certain interests were in fact claims that were discharged by the debtor's Chapter 11 plan, rather than conveyances of real property interests that were not property of the debtor's bankruptcy estate. *See Delta Petroleum General Recovery Trust v. BWAB Ltd. Liability Co. (In re Delta Petroleum Corp.)*, 2015 Bankr. LEXIS 1067, at *22-40 (Bankr. D. Del. Apr. 2, 2015). Prior to its bankruptcy filing, Delta Petroleum Corporation ("Delta") sought to acquire certain oil and gas leases from Whiting Petroleum Corporation ("Whiting"). *Id.* at *9-10. Whiting was unable to obtain the consent of the other working interest owners in the unit, who were concerned about Delta's ability to fulfill Whiting's working interest obligations. *Id.* at *10. Whiting and Delta thus agreed that Whiting would convey a "net operating interest" (the "NOI") to Delta "that would provide the economic equivalent of conveying title to the Properties." *Id.* at *10-11. Delta subsequently conveyed overriding royalty interests to third parties out of its NOI (the "1999 ORRIs"). *Id.* at *12-14. Prior to the conveyance of the NOI, Whiting had conveyed an overriding royalty interest (the "1994 ORRI") to BWAB LLC ("BWAB"). *Id.* at *7-8. Following confirmation of Delta's Chapter 11 plan (the "Delta Plan"), the Delta Petroleum General Recovery Trust (the "Trust") created under the Delta Plan sought judgments declaring that the 1994 ORRI and the 1999 ORRIs constituted contractual rights to payment or claims that were discharged pursuant to the Delta Plan, or in the alternative, the 1994 ORRI and the 1999 ORRIs were real property interests that may be avoided and recovered pursuant to Sections 544(a)(3) and 550 of the Bankruptcy Code. *Id.* at *4-5.

In examining whether the 1994 ORRI was a contractual right to payment or a real property interest, the court reviewed the treatment of overriding royalty interests under state

law.[24] Although the court found that overriding royalty interests were considered real property interests under applicable state law, the court further examined the terms of the conveyance of the 1994 ORRI to determine whether the parties intended to convey an overriding royalty interest. *Id.* at *25-26 ("The analysis must look beyond titles. '[W]hether the interest is an overriding royalty (or something else) depends on the true nature of the particular conveyance which gives rise to the interest. Because merely calling an interest an overriding royalty interest is not conclusive of its true status, provisions relevant to the grant of an overriding royalty interest are germane.'") (quoting *Foothills Texas, Inc. v. MTGLQ Investors (In re Foothills Texas, Inc.)*, 476 B.R. 143, 149 (Bankr. D. Del. 2012)). The court ultimately concluded that although the 1994 ORRI resembled a net profits interest, it was nonetheless a real property interest under applicable state law. *Id.* at *29-30.

In evaluating the 1999 ORRIs, the court noted that the 1999 ORRIs were derived from Delta's NOI. *Id.* at *37-38. The court also determined that there was "an issue of material fact about whether Delta and Whiting intended the NOI to be a real property interest or contractual right to payment." *Id.* at *38. Because the 1999 ORRIs were derivative of Delta's interests in the NOI, the court also found that there was a genuine issue of material fact regarding whether the 1999 ORRIs were real property interests. *Id.* at *38-40. The court therefore granted summary judgment in part and denied summary judgment in part on the issue of the nature of the interests at issue in the case.

After reviewing the nature of the interests, the court examined whether the 1999 ORRIs, which were not recorded, could be avoided pursuant to Section 544(a)(3) of the Bankruptcy

[24] Because the properties were located off the coast of California, the parties cited California law regarding the nature of the 1994 ORRI. The terms of the conveyance of the 1994 ORRI provide that it was to be governed by Colorado law. The court found that there was not a "material difference between the laws of California and Colorado regarding the issues raised." *Id.* at *22-23.

Code assuming that the 1999 ORRIs were real property interests. *Id.* at *40-49. The holders of the 1999 ORRIs argued that recording their interests would have been futile because the NOI conveyance from Whiting to Delta was not recorded, and the recording of the 1999 ORRIs would have been a "wild deed" that would not have provided constructive notice to subsequent purchasers. *Id.* at *43. The court determined that if the 1999 ORRIs were real property interests, they were subject to avoidance under Section 544(a)(3) because the holders of the 1999 ORRIs had not recorded their interests. *Id.* at *49. The court found that the fact that recording the 1999 ORRIs would have been a "wild deed" was irrelevant; recording of the 1999 ORRIs was required to perfect the interests under California law. *Id.* at *45. The holders of the 1999 ORRIs were thus left either with claims that were discharged under the Delta Plan or with real property interests subject to avoidance under Section 544(a)(3) of the Bankruptcy Code.

## IV. CREDITOR REMEDIES

Since state law forms the corpus of most creditor remedies in oil and gas law, responsible discussion of the enforceability of contractual and statutory lien rights, as well as other concepts such as setoff and reclamation, requires mention of many possible exceptions lurking to the analysis provided below.

### A. Liens

Various forms and types of liens are present in the bankruptcy of a business involved in the oil and gas industry. State law forms the basis of statutory liens and prescribes the priority and validity of both statutory and contractual liens. Those oil and gas creditor remedies set forth by Texas law are generally enforceable in bankruptcy.

#### (i) Producers' Liens

Many states grant statutory liens to protect sellers of hydrocarbons so that sellers will have a secured claim for hydrocarbons sold but not paid for as of the date a bankruptcy petition

is filed. TEX. BUS. & COM. CODE § 9.343 (Vernon 2002); KAN. U.COM. CODE §84-9-339a (2003); NEW MEX. STAT. § 48-9-3, § 70-10-1 (2005). Some states require filing to perfect producers' liens, others – including Texas – do not and provide for automatic perfection of such liens. The most important issue raised by the filing of a bankruptcy petition, with respect to producers' liens, is whether they may be avoided by the debtor. Statutory liens such as producers' liens are avoidable under Section 545(2) of the Bankruptcy Code to the extent that such liens are not enforceable against a bona fide purchaser of production.

In Texas, producers' liens are not valid against a bona fide purchaser of production,[25] but these liens do attach to the proceeds from the eventual sale of the oil and gas production by the first purchaser.[26] Statutory liens created by Section 9.343 held by royalty and working interest owners and attached to the account proceeds of oil and gas production are not susceptible to being cut off by a bona fide purchaser under Texas law. *In re Tri-Union Development Corp.*, 253 B.R. 808 (Bankr. S.D. Tex. 2000). Therefore, in Texas, producers' liens that attach to proceeds of oil and gas production cannot be avoided by a debtor relying on Section 544(a)(3) of the Bankruptcy Code.

*The SemCrude Decisions*

Despite the clear intention of producers' lien statues to protect sellers of hydrocarbons from financially distressed buyers, decisions in three adversary proceedings in the bankruptcy case of SemCrude, a large Oklahoma based purchaser of oil and gas, have undercut the priority of producers' liens in relation to other security interests.

[25] The explicit language of Section 9.343(c)(1)(A) states "sale of such proceeds by a first purchaser to a buyer in the ordinary course of business…will cut off the security interest" and Section 9.343(e) also provides that "the security interests…are cut off by the sale to a buyer from the first purchaser who is in the ordinary course of the first purchaser's business…." Section 9.343, TEX. BUS. & COM. CODE (Vernon 2002).
[26] Section 9.343(c), TEX. BUS. & COM. CODE (Vernon 2002).

The three opinions issued by Judge Shannon of the United States Bankruptcy Court for the District of Delaware on June 19, 2009 address three adversary proceedings filed by holders of producers' liens under Texas, Kansas and Oklahoma law.[27] Each opinion addressed substantially the same issue: whether prior perfected Article 9 security interests asserted by Semcrude's lenders are superior to the security interests of holders of producers' liens.

In the Texas adversary proceeding, the holders of producers' liens argued that Section 9.343 automatically perfected their security interests and gave them priority over the prior-perfected security interests of the banks in production sold to first purchasers and the proceeds of that production. Applying the laws of Delaware and Oklahoma (because SemCrude and certain of its subsidiaries were organized in these states), the Bankruptcy Court found that the Delaware UCC did not contain a provision analogous to Section 9.343, and therefore the Texas producers could not rely on that provision for automatic perfection of their security interests. Under Delaware and Oklahoma perfection rules, because the Texas producers had not taken any action to perfect their security interests in Oklahoma or Delaware, pursuant to the applicable UCC provisions, their security interests were unperfected and therefore subordinate to the lenders' prior-perfected security interests. Thus, Texas producers' lienholders who sold and delivered oil and gas, in Texas, to SemCrude or its Oklahoma subsidiary could not rely on Texas Section 9.343 governing liens on production and proceeds.[28] On similar logic, the Bankruptcy Court

[27] The cases are numbered and styled: Arrow Oil & Gas, Inc., et al., v. Semcrude, L.P. et al., Adversary No. 08-11525 (Texas); Samson Resources Company, et al., v. Semcrude, L.P., et al., Adversary No. 08-51445 (Oklahoma); and Mull Drilling Company, Inc., et al., Semcrude, L.P., et al., Adversary No. 08-51446 (Kansas).

[28] *Arrow Oil & Gas, Inc., et al., v. Semcrude, L.P. et al.*, Adversary No. 08-11525 (Bankr. D. Del. June 19, 2009) (order subordinating producers' liens under Texas law).

arrived at substantially the same conclusions in the Kansas and Oklahoma adversary proceedings.[29]

While the Bankruptcy Court did certify all three decisions for direct appeal to the Third Circuit Court of Appeals, all three disputes were settled. Thus, the perfection and priority of producers' liens securing the obligations of out-of-state first purchasers under non-uniform provisions of the UCC remains in doubt.

**(ii) Operators' Liens**

Operators' liens, unsurprisingly, are those liens that arise from the provisions of standard form joint operating agreements. In most operating agreements, operators are granted liens to secure the unpaid obligations of the non-operating owners. Specifically, operators are usually granted a lien on the oil and gas property covered by the leasehold, as well as a security interest in all oil and gas produced, including proceeds paid to the operator. Often times, custom in the oil and gas industry is to hold off on filing the relevant operating agreement and thus the operators' liens remain unrecorded interests. Should a bankruptcy filing arise amongst the parties, these unrecorded operators' liens are subject to an avoidance claim by the debtor and the uncertainty of possible defense under Section 541.[30] In Texas, one possible method of recording operators' liens is to file a summary of the operating agreement, properly acknowledged by all parties, in the appropriate real property or UCC records. Such a summary probably would constitute notice, under Texas law, inasmuch as a purchaser is bound by every recital, reference and reservation contained in any instrument that forms an essential link in the chain of title. *See Westland Oil Development Corp. v. Gulf Oil*, 637 S.W.2d 903 (Tex. 1982).

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[29] *Samson Resources Company, et al., v. Semcrude, L.P., et al.*, Adversary No. 08-51445 (Bankr. D. Del. June 19, 2009) (order subordinating producers' liens under Oklahoma law); *Mull Drilling Company, Inc., et al., Semcrude, L.P., et al.*, Adversary No. 08-51446 (Bankr. D. Del. June 19, 2009) (order subordinating producers' liens under Kansas law).

[30] *Supra*, § II.A.

**(iii) Mechanics & Materialmen's Statutory Liens**

Certain states, including Texas and Louisiana, also provide liens to those who contribute labor, services and equipment – such as mineral contractors and subcontractors – to secure payment for work related to "mineral activities" or the "drilling of wells." *See*, *e.g.*, LA. R.S. § 9:4863 (1999); TEX. PROP. CODE § 56.002 (Vernon 2002). The statutes creating these types of liens are far from uniform and often vary in scope and level of protection provided. In both Texas and Louisiana, however, a mineral contractor has six months from the date of accrual of indebtedness in which to file the lien affidavit, and the lien relates back to the date of first work if the lien is timely filed. TEX. PROP. CODE § 56.021-024 (Vernon 2002); LA. R.S. § 9:4865 (1999).

A fundamental principle of bankruptcy law is the automatic stay – an injunction provided for by Section 362 of the Bankruptcy Code that arises by operation of law immediately upon commencement of the bankruptcy case – prohibiting all activity outside the bankruptcy forum to collect pre-petition debts from the debtor or assert or enforce claims against the debtor's pre-petition property. 11 U.S.C. § 362. Section 362(a)(5) prohibits, in most instances, steps taken to create, perfect, or enforce a lien against property of the debtor to secure a prepetition claim. Sections 362(b)(3) and 546(b)(1) operate to form an exclusion to this general rule for mechanics' and materialmen's liens, meaning that parties with statutory liens such as those provided for by Texas and Louisiana law may perfect, by filing, a lien after the commencement of a bankruptcy case without seeking relief from the automatic stay.[31] *See* 11 U.S.C. 362(b)(3) and 546(b)(1).

*Treatment of Texas Mineral Lien Claims in Bankruptcy*

[31] These liens are still subject to the applicable statutory deadlines for perfection, which for Texas and Louisiana is six months.

The statutory lien provided to mineral contractors and subcontractors in Texas secures payment for labor or services related to "mineral activities." TEX PROP. CODE § 56.002 (West 2009). The properties subject to this statutory mineral lien are:

> (1) the material, machinery, and supplies furnished or hauled by the lien claimant;
>
> (2) the land, leasehold, oil or gas well, water well, oil or gas pipeline and its right-of-way, and lease for oil and gas purposes for which the labor was performed or material, machinery, or supplies were furnished or hauled, and the buildings and appurtenances on this property;
>
> (3) other material, machinery, and supplies used for mineral activities and owned by the owner of the property listed in Subdivision (2); and
>
> (4) other wells and pipelines used in operations related to oil, gas, and minerals and located on property listed in Subdivision (2).

TEX. PROP. CODE § 56.003 (West 2009). The Texas mineral lien statute has specific affidavit, recording and notice requirements. In order to perfect a mineral lien in Texas, the claimant must file an affidavit within six months of the day the indebtedness accrues, in the county in which the property is located, and a subcontractor claiming a lien must provide the property owner written notice of the lien claim at least ten days before the date the affidavit is filed. *See* TEX. PROP. CODE § 56.021-024 (West 2009). The Texas mineral lien statute sets forth the specific contents required to be included in the affidavit and subcontractor notice to the property owner. *See* TEX. PROP. CODE § 56.022-023 (West 2009).

The Texas mineral lien statute does not expressly extend to production proceeds, and allows the mineral lien to attach only to the property of the person with whom the mineral lien claimant contracted, with very limited exceptions. A Texas mineral contractor's lien does not attach to the interest of the non-operator working interest owners unless the lien claimant can establish that the non-operator working interest owners are mining partners or joint venturers or that an agency relationship exists. *See Youngstown Sheet & Tube Co. v. Penn*, 355 S.W.2d 239

(Tex. Civ. App.—Austin 1962), *modified on other grounds*, 363 S.W.2d 230 (Tex. 1963) (co-owners of oil and gas leases under a joint operating agreement or other contracting arrangement have an independent contractor relationship with the operator); *Ayco Dev. Corp. v. G.E.T. Serv. Co.*, 616 S.W.2d 184, 186 (Tex. 1981).

The Texas lien statute provides for a relation back in time to the commencement of work as the effective date of the lien. The effective date for determining lien priorities is when materials or services were first provided. *MEG Petroleum Corp. v. Halliburton Servs.*, 61 B.R. 14, 18 (Bankr. N.D. Tex. 1986). The Texas Property Code also provides a lien to the supplier of equipment with priority over an "earlier encumbrance on the land or leasehold on which the mineral, Machinery, supplies or improvement is placed or located." TEX. PROP. CODE § 56.004 (West 2009).

This relation back principle is generally recognized in the Bankruptcy Code for purposes of lien validity and perfection. Section 546(b) of the Bankruptcy Code provides that the bankruptcy trustee's avoidance powers are "subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection." 11 U.S.C. § 546(b).

As a corollary to this provision, there is an exception to the automatic stay allowing for "any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent the trustee's rights and powers are subject to such perfection under Section 546(b) of [the Bankruptcy Code]." 11 U.S.C. § 362(b)(3). Thus, a bankruptcy trustee may not avoid the lien provided under the Texas mineral lien statute even if a notice of lien is not filed prior to the bankruptcy case as long as the notice is filed within the prescribed 180 day period. Further, the bankruptcy stay does not prevent or enjoin the timely filing of a mineral lien notice.

*Cash Collateral and Adequate Protection Issues Related to Mineral Liens*

Some interesting issues have arisen in oil and gas bankruptcy cases regarding the extent to which mineral lien claimants should be entitled to protection for the debtor's use of production proceeds or the joint interest billings ("JIBs") related to lease interests in which the claimant asserts a mineral lien.

Section 363 of the Bankruptcy Code provides that a lien claimant is entitled to adequate protection to the extent its "cash collateral" (i.e. cash, cash equivalents, and proceeds of collateral) is used during the bankruptcy case. 11 U.S.C. § 363. Generally, the purpose of adequate protection is to protect a secured creditor against a decrease in the value of its collateral. *See In re Timbers of Inwood Forest Assocs.,* 793 F.2d 1380, 1389 (5th Cir. 1986).

The Texas mineral contractor's lien statute provides Texas mineral contractors a lien against the leasehold estate, but not against the proceeds of the hydrocarbons produced. *See Hess v. Bank of Oklahoma (In re Hess)*, 61 B.R. 977, 978-979 (Bankr. N.D. Tex. 1986); *see also Wilkings v. Fecht*, 356 S.W.2d 855 (Tex.Civ.App. – San Antonio 1962—writ ref'd); *Crowley v. Adams Bros. & Prince*, 262 S.W. 883 (Tex.Civ.App. – Amarillo 1924). Although some commentators have suggested that Sections 546(b)(1) and 362(b)(3) permit a mineral contractor to assert its lien against the cash proceeds of production by delivering notice to the debtor and the court of the claimant's assertion of its state law right to seize production proceeds pending a judicial foreclosure of the lien, as discussed below, a recent unpublished decision by the U.S. Bankruptcy Court for the Western District of Texas suggests otherwise.

Apart from a mineral contractor's potential ability to extend its lien to the cash proceeds of production, a mineral contractor may also argue that it is entitled to adequate protection for the diminution of its interest in a leasehold estate during the pendency of a bankruptcy case.

Section 363 of the Bankruptcy Code does not expressly state which party has the burden of proof in regard to the diminution of value in a claimant's collateral. Accordingly, if a mineral lien claimant seeks protection for any diminution in value of its collateral resulting from the debtor's use of that collateral, the claimant should be prepared to establish its lien claim and make a case for how the use of production proceeds or JIBs will result in a diminution in value relating to the claimant's interest. Against this backdrop, an issue that commonly arises in bankruptcy cases is the debtor's need to use production proceeds and JIBs for working capital needs in the face of secured lenders and mineral lien claimants that oppose the debtor's use of production proceeds (*i.e.*, cash collateral) in the absence of adequate protection against any potential diminution in the value of the cash collateral.

Additionally, in some cases there may also be a lender providing debtor-in-possession financing ("DIP Financing") on terms that require priming and/or replacement liens in all of the debtor's assets. These competing interests often result in litigation over the debtor's use of cash and the form and extent of adequate protection to which secured lenders and lien holders are entitled.

Many of these issues came to a head in the *TXCO Resources* bankruptcy case. *See In re TXCO Resources, Inc., et al.*, Case No. 09-51807 (Bankr. W.D. Tex., San Antonio Division). In *TXCO*, the bankruptcy court determined that the Texas mineral lien statute did not provide for a lien on the proceeds of production (*i.e.*, cash flow) or JIBs owed to the debtors. Finding that the Texas mineral lien claimants did not have an interest in the debtors' cash, and, therefore, that the debtors' cash was not the claimant's "cash collateral," the bankruptcy court ruled that the Texas mineral lien claimants were not entitled to adequate protection for the debtors' use of cash. *In re TXCO*, Case No. 09-51807, Docket No. 220.

One of the debtors' service company creditors filed an appeal based on its status as a mineral contractor or mineral subcontractor under Chapter 56 of the Texas Property Code ("Mineral Lien Claimant"). *See Schlumberger Technology Corp. v. TXCO Resources, Inc., et al. (In re TXCO Resources, Inc. et al.*), Civil Action No. SA-09-CA-638-FB (W.D. Tex., San Antonio Division). A central issue on appeal was whether the bankruptcy court erred in finding that the production from Texas oil and gas wells and JIBs associated therewith is not the cash collateral of the Mineral Lien Claimant.

On appeal, the Mineral Lien Claimant relied mainly on *Abella v. Knight Oil Tools*[32] to support its position that a mineral lien holder in Texas is entitled to a lien on production proceeds and JIBs. *Schlumberger Technology Corp. v. TXCO Resources, Inc., et al.*, Docket No. 3. The debtors countered that the bankruptcy court did not err in its ruling because *Abella* is the only case ever to reference any rights of a mineral lien claimant in proceeds of production and, in doing so, went against decades of case law. *Schlumberger Technology Corp. v. TXCO Resources, Inc., et al.*, Docket No. 5. Further, the debtors asserted that no other reported decision has cited *Abella* for the proposition that a Texas mineral lien claimant is entitled to a lien on proceeds of production. *Id.*

The Mineral Lien Contractor ultimately decided not to continue prosecution of the appeal, and the appeal was dismissed by agreement. *Schlumberger Technology Corp. v. TXCO Resources, Inc., et al.*, Docket No. 12. This issue will likely remain a source of contention in future bankruptcy cases.

Note that the outcome on this issue may be different in jurisdictions outside Texas. In determining the extent and validity of a statutory lien, a bankruptcy court must apply the substantive law of the state from which the statutory right arises. *See Barnhill v. Johnson*, 503

[32] *Abella v. Knight Oil Tools*, 945 S.W.2d 847 (Tex. App.—Houston [1st Dist.] 1977, no writ).

U.S. 393, 398 (1992). As discussed above, the Texas mineral lien statute does not provide for attachment of the lien against proceeds of production. By contrast, statutes in other mineral producing states, such as Louisiana, do expressly provide that mineral liens attach to proceeds of oil and gas production. Accordingly, the scope of the *TXCO* ruling is limited to situations where the Texas mineral lien statute, or other similar statute, is applicable.

### B. Other Remedies

#### (i) Setoff

Section 553 of the Bankruptcy Code permits a creditor to offset pre-petition debt owed to a debtor against a pre-petition claim due the creditor from the debtor, if the debts are mutual. 11 U.S.C. § 553. Although the Bankruptcy Code does not define the term "mutual" and the case law surrounding the issue is voluminous and confusing, a few widely accepted elements of mutuality, for the purposes of setoff in bankruptcy, have emerged. Debts are "mutual" if the debts at issue are owed between the same parties, in the same right or capacity and are of the same kind or quality. Natalie Regoli, *Setoff in Bankruptcy: A Practical Guide to 11 U.S.C. Section 553*, 38 TEX. J. BUS. LAW No. 2 (2002). A creditor's claim that is subject to setoff under Section 553 is given secured status to the extent of the amount subject to setoff. 11 U.S.C. § 506(a); *see also In re Enron Corp.*, 349 B.R. 108, 112 (Bankr. S.D.N.Y. 2006); *In re Univ. Med. Ctr*, 973 F.2d 1065, 1078 (3rd Cir. 1992) ("setoff, in effect, elevates an unsecured claim to secured status").

#### (ii) Recoupment

Recoupment, as distinguished from setoff, allows netting of pre-petition and post-petition claims arising out of a single integrated transaction. Shalom L. Kohn, *Recoupment Re-Examined*, 73 AM. BANKR. L. J. 353 (1999). Recoupment has been permitted where an operating agreement provides for netting production revenue against production costs. *Buttes Resources*

*Co. v. Enstar Petroleum Co. (In re Buttes Resources)*, 89 B.R. 613 (S.D. Tex. 1988); *see also In re R & C Petroleum, Inc.*, 247 B.R. 203 (Bankr. E.D. Tex. 2000) (applying recoupment where post-petition credit and pre-petition debt arose out of same gas gathering agreement and were traceable to same transaction); *B & L Oil Co. v. Appel* (*In re B & L Oil Co.*), 782 F.2d 155 (10th Cir. 1986) (creditor could recoup overpayments made pursuant to pre-petition oil division order by withholding money owed for purchases that creditor made post-petition).

**(iii) Termination of Leases for Non-Payment of Royalties**

In most instances, an unpaid royalty claim existing on the bankruptcy petition date will be treated as a general unsecured claim against the debtor. However, many jurisdictions, including Texas, permit the enforcement of "termination for non-payment" clauses – provisions for the automatic termination of a lease upon non-payment of a royalty – in mineral leases. *See, e.g.*, *Hitzelberger v. Samedan Oil Corp.*, 948 S.W.2d 497, 505 (Tex. App.—Waco 1997, writ denied). With respect to oil and gas leases on the Outer Continental Shelf ("OCS"), the United States Bureau of Ocean Energy Management's ("BOEM") regulations expressly grant BOEM the right to terminate OCS leases upon non-payment of a royalty. *See* 30 C.F.R. § 256.77(b).

In many cases, the debtor's solution to this quandary has been to file a motion for bankruptcy court approval of the postpetition payment of prepetition royalties. While these motions, like their cousin the critical vendor motion, are generally disfavored because they provide for postpetition payment of prepetition unsecured claims, courts have routinely approved these motions because payment of prepetition royalties preserves valuable estate assets for the benefit of all creditors.[33] *See, e.g.*, In *re ATP Oil & Gas Corp.*, Case No. 12-36187 (Bankr. S.D. Tex. 2012), Docket No. 191; *In re Probe Resources US, Ltd., et al.*, Case No. 10-40395 (Bankr.

[33] *In re Probe Resources US, Ltd., et al.*, Case No. 10-40395 (Bankr. S.D. Tex.), Docket No. 163; *In re Energy Partners, Ltd, et al.*, Case No. 09-32957 (Bankr. S.D. Tex.), Docket No. 89.

S.D. Tex.), Docket No. 163; *In re Energy Partners, Ltd, et al.*, Case No. 09-32957 (Bankr. S.D. Tex.), Docket No. 89.[34]

## V. CONCLUSION

Many of the issues discussed in this paper are remnants of litigation stemming from the oil and gas bust of the 1980s. Some of these issues were not resolved at that time and remain open today. Further complicating the oil and gas legal landscape are the issues being raised in states with historically less developed oil and gas case law and the issues being raised in the offshore arena, which is largely governed by federal law. Accordingly, an oil and gas bankruptcy case may face many complex legal issues without clear solutions. It remains to be seen how courts will navigate these complex legal issues in the future.

[34] Note that at least one jurisdiction, the Southern District of Texas, has enacted specific provisions for the treatment of postpetition royalties. *See* Procedures for Complex Chapter 11 Bankruptcy Cases adopted by the U.S. Bankruptcy Court for the Southern District of Texas.