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Editorial Offices
630 Central Ave., New Providence, NJ 07974 (908) 464-6800
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200
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Drilling Down: A Deeper Look into the Distressed Oil & Gas Industry—Part II: The Treatment of Oil and Gas Interests in Bankruptcy

*By Charles M. Persons**

In the first part of this multi-part article, which appeared in the March issue of Pratt's Energy Law Report, the author provided an overview of the oil and gas industry and a discussion of some of the unique challenges currently facing this sector. This second part discusses the treatment of specific oil and gas property interests in the bankruptcy context.

“In attempting to convert dreams of black gold to hard cash, aspiring capitalists split the property interest in oil into more fragments than the atom or the rainbow.”

—*Jones v. Salem Nat'l Bank (In re Fallop)*¹

Appearances are not everything in this industry. A person standing on their property in Midland, Texas, might look out across the fence and see a typical family home, and a short distance away, a pumpjack moving up and down. The logical presumption might be that the homeowner owns the pumpjack, as well as any crude oil it happens to be pulling out of the ground.

In reality, the homeowner probably has no interest in the pumpjack or the manner in which it is operated, has no right to produce the oil or gas below his feet, and almost certainly owns only a small fraction, if any, of what is being produced in the nearby well. Indeed, the homeowner may have no interest in the minerals under his home at all. The operator of the pumpjack may itself only own a small percentage of the production, having long ago doled out portions of its interest to perhaps dozens of other parties—including owners of a nearby pipeline, parties that provided initial financing for the drilling project, and perhaps even an oilfield services company that maintains the well itself.

Splitting these inherently speculative oil and gas interests by distributing tiny fractions of the production among several (and often dozens) of parties minimizes the risks for all. But this form of risk distribution requires careful consideration in the bankruptcy context of the derivation and type of interest held by a debtor or creditor.

DISPARATE STATE LAWS DETERMINE HOW OIL AND GAS INTERESTS ARE TREATED

Before considering specific oil and gas property interests, it is important to

* Charles M. Persons is an associate in the Business Finance & Restructuring Department of Weil, Gotshal & Manges LLP, where he concentrates his practice in the area of business reorganizations, including debtor and creditor representations in Chapter 11 cases, refinancings, and acquisitions of distressed companies. He may be contacted at charles.persons@weil.com.

¹ 6 F.3d 422, 424 (7th Cir. 1993).

remember some ground rules. First, Section 541(a) of Bankruptcy Code² provides that, upon the commencement of a bankruptcy case, all legal and equitable interests of the debtor become property of the debtor's bankruptcy estate. However, whether a debtor or creditor has a legal or equitable interest in that property is determined not by the Bankruptcy Code, but by applicable non-bankruptcy law.³ Unfortunately, to describe oil and gas laws among the states as "disparate" would be a gross understatement.⁴ Certain jurisdictions—often jurisdictions for whom the extraction of these precious resources is part of their core identity—elevate interests in minerals,

² 11 USC Sec. 541

Sec. 541. Property of the estate

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

- (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.
- (2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is-
 - (A) under the sole, equal, or joint management and control of the debtor; or
 - (B) for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.
- (3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.
- (4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.
- (5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date-
 - (A) by bequest, devise, or inheritance;
 - (B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or
 - (C) as a beneficiary of a life insurance policy or of a death benefit plan.
- (6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.
- (7) Any interest in property that the estate acquires after the commencement of the case.

³ *Butner v. United States*, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."). Typically, this means applying the oil and gas law of the state in which the interest was created (i.e. where the minerals reside). However, in certain situations involving onshore interest on federal lands and interests located more than three miles from shore on the outer continental shelf, specific federal laws serve as the applicable non-bankruptcy law. The consequences of applying these federal laws are outside the scope of this article.

⁴ By way of example, American Law Reports maintains a database that chronicles the varied treatments of royalty interests among the states. Martin J. McMahon, Annotation, Oil and Gas Royalty as Real or Personal Property, 56 A.L.R. 4th 439 (1987). As of the publishing of this article, that article was 99 pages long.

oil, and gas to the status of “real property.” In other jurisdictions, certain oil and gas interests are little more than “personal property” rights, while in other jurisdictions they are a hybrid of real property and personal property.⁵

OVERVIEW OF COMMON OIL AND GAS INTERESTS AND THEIR TREATMENT IN BANKRUPTCY

Mineral Interest

The “mineral interest” consists of the ownership of the oil and gas in place under a parcel of property, typically in fee simple,⁶ and the exclusive rights to explore, drill, and produce that oil and gas from the land. Mineral interests are conveyed by a “mineral deed” after being severed from the surface interests. Though states classify these interests differently, the broad definition of “property of the estate” under Section 541 makes these distinctions moot for bankruptcy purposes,⁷ and mineral interests held by a debtor—even those that are contingent or non-possessory under state law—are considered property of the estate.

Working Interest

The owner of the mineral interest—often an individual landowner or government entity not in the business of oil and gas drilling—usually prefers that a sophisticated oil and gas exploration and production (“E&P”) company handle the extraction. In such cases, the mineral interest owner grants the exclusive rights to explore, drill, and produce the oil and gas by conveying an “operating interest” or “working interest”⁸ to an E&P company. The holder of a working interest in the property must bear the operating expenses associated with exploration, development, and, eventually, production.

Importantly, a working interest does not exist in perpetuity. Instead, the rights conveyed by the working interest typically revert back to the mineral interest owner if certain terms and conditions—usually certain production requirements—are not met.

Royalty Interests

The owner of a “royalty interest” is entitled to share in a stated portion of gross production, if any, but has no right to enter the land and extract the minerals itself. As such, the royalty interest is a “nonworking” interest—*i.e.* the holder of a royalty

⁵ H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 214 (13th ed. 2006).

⁶ A fee simple is “[a]n interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute.” BLACK’S LAW DICTIONARY (9th ed. 2009).

⁷ *In re McLain*, 516 F.3d 301 (5th Cir. 2008).

⁸ Working interests are conveyed by means of an “oil and gas lease,” and the owners of working interests and mineral interests are often referred to as a lessees and lessors. However, the oil and gas “lease” is a misnomer in many jurisdictions, as this “lease” conveys a freehold interest, as opposed to a leasehold interest.

interest is not obligated to pay any of the costs associated with exploration or production. One type of royalty interest commonly dealt with by bankruptcy courts is the royalty interest retained when the mineral interest holder grants a working interest—a “landowner’s royalty interest.” Courts have generally understood that funds held by the E&P debtor that are subject to a landowner’s royalty interest are not property of the estate, as the debtors are considered to hold only bare legal title, and not an equitable interest in such funds.⁹

Unlike landowner’s royalty interests, which are derived directly from the mineral estate, “overriding royalty interests” (“ORRIs”) are typically carved out of the working interest by a working interest holder. As a general matter, “perpetual ORRIs”¹⁰ last for the life of the lease between the working interest holder and the mineral rights holder, but “term ORRIs” are limited in duration until a specified volume of production or stated value of production is reached.

Net Profits Interests

Similar to ORRIs, “net profits interests” or “NPIs,” are carved out of the working interest, but net profits interests are only payable to the NPI holder out of the profits earned from production over the contractually agreed upon time period. NPIs are consistently considered to be personal property interests, rather than real property interests, even in jurisdictions where royalty interests are considered real property interests.

Production Payments¹¹

Production payments, like ORRIs, refer “to an interest created out of the lessee’s estate which is a share of the minerals produced from described premises, free of the costs of production at the surface But a production payment terminates when the lease expires, or sooner if the owner of the interest has received the agreed quantum of production or dollar amount from the sale of production.”¹² Working interest owners have long used production payments as a form of project lending, borrowing capital to finance the exploration and start-up production costs in exchange for a portion of the production. Once the loan is repaid from the production, the interest terminates.

⁹ See *In re Endeavour Operating Corp.*, Case No. 14-12309 [D.I. 147] (Bankr. D. Del. 2014) (final order authorizing debtors to pay all prepetition and postpetition royalty interest holders); See generally *Beqier v. Internal Revenue Service*, 496 U.S. 53, 59, 110 S. Ct. 2258, 110 L. Ed. 2d 46 (1990) (“Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not ‘property of the estate.’”).

¹⁰ Some jurisdictions consider these interests as similar to covenants that run with the land, and thus such interests are transferred if the working interest is transferred. Other jurisdictions terminate these interests simultaneously with the cessation of the lease between the mineral rights holder and the working interest holder that granted the royalty interest.

¹¹ Another name for “production payments” is “oil payments,” which is an older term whose use is restricted to payments made on account of oil, as opposed to all minerals.

¹² *QEP Energy Co. v. Sullivan*, 444 Fed. Appx. 284, 289 (10th Cir. 2011).

A recent trend has been to refer to production payments as “term ORRIs” because they operate like an overriding royalty interest with a specified term, and the case law on overriding royalty interests is more robust. The Bankruptcy Code definition of “production payment” concurs with this broader definition.¹³ However, this creates an additional layer of complexity, because whether an interest is a true overriding royalty interest or something else depends on the true nature of the particular conveyance that gives rise to the interest.

Because of the disparity among state laws, the Bankruptcy Code attempts to introduce uniformity to the treatment of production payments. For example, Section 541(b)(4)(B) of the Bankruptcy Code states that where the assignee of a production payment takes title to that property, the interest conveyed as a production payment ceases to be property of the estate. Unfortunately, the express language of the statute does leave some room for ambiguity, which has led to uncertainty in the bankruptcy context. Specifically, the statute only covers interests borne of production payments made “to an entity that does not participate in the operation of the property”¹⁴ By its plain language, the statute seems to exclude from property of the estate only the interests of entities that provide financing and nothing more, but production payments can be granted to parties that provide services or conduct operations on the property.¹⁵ Indeed, by negative implication, it might appear that production payments that are granted to parties participating in operations are interests that *are* property of the estate under Section 541(a), though there is no indication that this was the intent of this language.

CONCLUSION

Understanding the varied oil and gas interests and their derivation is fundamental to understanding the issues facing bankruptcy courts in this area of the law. For instance, as discussed above, the royalty interest is “carved from the working interest in the land”¹⁶ This fact is important not just for the purposes of identifying the source of the royalty interest, but also for defining the outer limits of the rights conveyed. It is a “venerable principle” of property law that one “may not convey more than he owns.”¹⁷ Thus, if the jurisdiction considers the conveyance of the working interest by the mineral interest holder to be a conveyance of personal property, the royalty interest conveyed from that working interest can only be a conveyance of

¹³ 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 property, and determined without regard to production costs. 11 U.S.C. § 101(42A).

¹⁴ 11 U.S.C. § 541(b)(4)(B)(i).

¹⁵ *Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70 (S.D. Tex. 1996).

¹⁶ *In re Foothills Texas Inc.*, 476 B.R. 143, 149 (Bankr. D. Del. 2012).

¹⁷ *Davis v. Blige*, 505 F.3d 90, 99 (2d Cir. 2007) (holding that under copyright law a copyright owner may not convey a greater property interest than he owns at the time of the conveyance).

personal property. While some states consider conveyance of the mineral rights by the original mineral interest a grant of real property, they consider conveyances carved from the resulting working interest—like ORRIs—to be personal property that is contractual in nature. Finally, even in states where the grant of mineral rights is considered a conveyance of a real property interest, that conveyance is sometimes evidenced by an instrument that leaves both parties with material contractual obligations to perform. As a result, bankruptcy courts have struggled to deal with mineral leases on numerous different levels and the struggle will no doubt intensify in the current business climate.