BANKRUPTCY ISSUES IN THE OIL PATCH

By Michael E. Riddick[1]

An unfortunate result of the downturn in oil and gas prices beginning last year has been the dramatic increase in bankruptcy filings by oil and gas producers. Notable filings include large independents such as Samson Resources Corporation, Quicksilver Resources, Magnum Hunter Resources Corporation, Sabine Oil & Gas and Swift Energy Company. While most of the filings to date have been in either Texas or Delaware, a few smaller bankruptcy filings have been made in Louisiana. Initially, the decision to file bankruptcy is driven by obligations to secured lenders, bond holders and trade claims, but once a filing is made, the dominoes begin to fall and other parties are affected.

As land professionals, a bankruptcy filing can affect your work in various ways. Oil and gas activities involve a variety of contracts, including oil and gas leases, joint operating agreements, marketing or transportation agreements, farmout agreements or other participatory agreements. Bankruptcy law gives the debtor the right to assume or reject certain contracts deemed to be executory contracts or unexpired leases in order that the debtor may avoid unfavorable or unprofitable contracts. Accordingly, it is important to determine how the various industry contracts might be classified in a bankruptcy proceeding. In addition, since a bankruptcy filing necessarily means the debtor is unable to satisfy some or all of its financial obligations, it is important to know how or whether you can protect the financial interests of your employer, clients or self.

Executory Contracts

An executory contract is one where "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Whether or not an agreement is an executory contract or unexpired lease is determined by the application of state property law. A bankruptcy trustee or debtor may assume or reject any executory contract or unexpired lease belong to the debtor's estate under ***11 U.S.C. §365***. In many instances, the ability to reject an oil and gas contract can prove beneficial to the debtor by eliminating unfavorable transportation,

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marketing or operating agreements or converting a claims under those contracts to unsecured claims in the bankruptcy proceeding. The rejection of an executory contract or unexpired lease is a breach of contract and gives rise to a claim for damages, but that claim is unsecured and generally worth only a fraction of its face amount.

Gathering and Transportation Agreements

The contracts receiving the most publicity recently are transportation and gathering agreements executed in response to the shale boom. In order to secure the construction of the pipeline infrastructure necessary to develop the major shale plays, producers entered into long term transportation and gathering agreements requiring the commitment and delivery of large quantities of natural gas. As development slowed with the fall in commodity prices, many producers were burdened with contracts for the transportation of quantities of gas far in excess of that available and potentially crippling deficiency charges. The Court in the Sabine Oil & Gas Corporation bankruptcy issued a decision on March 6, 2016, finding the gathering contracts were executory contracts and could be rejected by Sabine. The gatherers did not object to the rejection of the contracts but argued the dedication language in the contracts was a covenant running with the land under Texas law that could not be extinguished in a bankruptcy proceeding, therefore, Sabine had to negotiate new contracts with the same gatherers. The Court noted that the issue of whether the dedication was a covenant running with the land must be resolved in a separate adversary proceeding, but provided its analysis as to why the Court did not believe the dedications were covenants running with the land which would free Sabine to negotiate with any party for service. That issue is yet to be resolved.

A similar issue likely exists under Louisiana law. ***La. Civ. Code art. 476*** provides that real rights exist as established by law, which do not expressly include gathering or transportation agreements. It is unclear whether you may create new real rights not regulated by the Civil Code, however. ***Article 12*** of the ***Mineral Code*** notes there are three types of mineral rights that may be created by a landowner, the mineral servitude, the mineral royalty and the mineral lease, but states that it does not prevent the creation of other mineral rights by the landowner. There are also provisions of the Mineral Code that suggest it may be possible for a gathering or transportation agreement to create a real right. For example, ***Mineral Code Article 212.1***, allows a landowner or owner of a mineral right to record and make subject to the laws of registry contracts affecting minerals after they are severed from the land. ***Article 216*** allows owners of mineral rights to record

agreements regarding joint exploration, development, operation or production and thereby make those agreements binding upon third parties. While the answer is not clear since Louisiana has not recognized transportation or gathering agreements as real rights, it appears there are reasonable arguments under Louisiana law that where those agreements have been recorded, they may in fact create covenants running with the land which could survive a bankruptcy proceeding, as least as to the dedication. A separate issue may exist under Louisiana law, in that the recorded transportation and gathering agreements generally contain broad omnibus type descriptions and not descriptions of specific leases, so such broad descriptions may be ineffective as to third parties. One potential solution is to obtain a conventional mortgage covering the dedicated leases securing performance under the gathering or transportation agreements, but that would not provide a mechanism to "dedicate" future leases.

Oil and Gas Leases

The ability to reject a contract is not a particularly valuable right to an oil and gas company which files bankruptcy since most leases grant the lessee the right to release a lease at any time and terminate further obligations without liability. A lessee who files bankruptcy would not, however, want its leases classified as executory contracts or unexpired leases since ***§365*** provides that the trustee may not assume such contracts unless it cures or can provide adequate assurance that it can cure, any default under the contract. If a lessor files bankruptcy, rejection of a lease may prove beneficial in order to obtain a more favorable royalty fraction, bonus payment or lease terms, but there would remain the issue as to damages from the rejection.

Courts addressing the issue of whether an oil and gas lease is an executory contract or unexpired lease under Louisiana law have reached different conclusions. In ***Texaco, Inc. v. Louisiana Land and Exploration Co.***, 136 B.R. 658 (M.D. La. 1992)[2], Texaco sought to assume various Louisiana State leases or obtain a ruling that they were not subject to ***§365***, over the objection of the State. The Court held the leases were executory contracts and Texaco was entitled to assume them. Subsequently, however, in the case of ***In re WRT Energy Corporation***, 202 B.R. 579 (W.D. La. 1996), the Court rejected the conclusion of the Court in ***Texaco*** and found that the remaining obligations of the lessor are essentially passive, not to interfere with the lessee, so the lessor's failure to perform would not constitute a material breach excusing the future performance of the lessee under the lease. The ***WRT*** Court also found that since the Mineral Code vests an oil

[2] ***In re Ham Consulting Co./William Lagnion/JV***, 143 B.R. 71 (W.D.La. 1992), citing Texaco.

and gas lessee with real rights, as opposed to only personal rights under a general lease of real property , the oil and gas leases are not covered by the "expired lease" provision of ***§365*** of the Bankruptcy Code. It would appear that the more detailed discussion in ***WRT*** reaches the correct answer regarding the nature of Louisiana oil and gas leases under the Bankruptcy Code, but the conflict remains and a lessee filing bankruptcy may need to give consideration to assuming its leases or seeking a ruling as in ***Texaco***. Conversely, where a bankrupt lessee is in default under a lease, the lessor could attempt to require the lessee to assume or reject the lease and, by assuming the lease, cure any default.

<u>Joint Operating Agreements</u>

Typically unitized working interest owners or other co-owners enter into a joint operating agreement ("JOA") to govern their operations. The most familiar and common form is some version of the A.A.P.L. Form 610 Model Form Operating Agreement. Bankruptcy Courts applying Texas law have held these agreements to be executory contracts that are subject to acceptance or rejection. It is likely the same analysis would apply under Louisiana law. The funds at risk in the event of a bankruptcy filing are, for the operator, any unpaid costs due from a non-operating working interest owner, and for the non-operator, the proceeds due from the operator for hydrocarbons it has sold for the non-operator. If the bankrupt party assumes the JOA, then it would have to cure any default and satisfy outstanding claims under the contract. If the JOA is rejected by the bankrupt party, an unsecured claim for breach would accrue to the other party.

Accordingly, the main risk is the rejection of a JOA by a bankrupt party. There are some mechanisms to protect your interest. Under Louisiana's Mineral Code, JOAs or recording supplements may be recorded in order to establish rights with respect to third parties. If recorded prior to mortgages or other security interests, the contractual lien rights provided in the standard JOA may prime those secured interests. The standard JOA language, however, does not, without modification, necessarily create a conventional mortgage under Louisiana law. Specifically, a mortgage in Louisiana must specify the amount or the maximum amount of a secured obligation and must describe the immovable property given as security. Accordingly, you should review your standard form JOA to determine if it creates a conventional mortgage securing amounts that might be due in the event of a rejection in bankruptcy. In the alternative, there are also certain statutory lien rights that can be retroactively applied which are discussed below.

Farmout Agreements and Overrides

Another common oil and gas industry contract that could be impacted by a bankruptcy filing is the farmout or similar participation agreement. Those agreements generally provide that an owner of a mineral lease or other right, the farmor, will transfer an interest in those rights upon performance of drilling or similar operations by the farmee. The concern, obviously, is that the services are provided by the farmee prior to a bankruptcy filing, but the farmor seeks to reject the farmout agreement prior to transferring the interests. ***Section 541(b)(4)*** provides that any interest transferred or agreed to be transferred pursuant to a written farmout agreement is not part of the bankrupt party's estate, effectively depriving the bankrupt party from rejecting the contract. It is unclear, however, whether ***§541(b)(4)*** would apply to a farmout agreement if the farmee has not started or completed performance. You should insure that any farmout agreements or similar agreements are in writing and clearly describe the interests to be earned.

Similarly, overriding royalty interests or production payments, being payments attributable to non-operating interests that do not bear operating costs and are contingent on production of hydrocarbons from particular property, are not property of the bankrupt estate pursuant to ***§541(b)(4)(B)***. The agreement must also be in writing.

Protecting Your Claims

The first question you may often face when a bankruptcy filing is made will be whether money is owed to you and how do you protect your claim. There is the obvious requirement that you file a proof of claim in the bankruptcy case within the time allowed by the Court, but without more, that filing simply memorializes an unsecured claim and places you it what is often the least funded group in the bankruptcy.

Your objective should be to secure your claim with some property of the estate. As discussed above, with proper language negotiated in advance, it is possible to create conventional mortgages under JOA's or other agreements, but those are concessions often difficult to obtain when default is not threatened. Furthermore, notwithstanding the rules that classify certain interests as not part of the bankrupt estate, you should obtain and record assignments of working or royalty interests, joint operating agreements, farmout agreements or other agreements creating or granting interests in mineral rights to avoid any dispute as to the proper classification or true owner.

The ***Louisiana Oil Well Lien Act, La. R.S. 9:4861, et seq.***, provides another potential avenue to protect your claim. Generally, parties providing services or materials with respect to mineral properties, including operators, are granted lien rights to secure the payment for their services and materials. Similarly, non-operators are entitled to a lien for the payment of amounts due them from the sale of hydrocarbons by the operator (but apparently not claims against other non-operators). What happens, however, when an interest owner files bankruptcy before the claimant has had a chance to perfect its lien? In the normal situation, once a bankruptcy case is filed, the automatic stay imposed by the Bankruptcy Code bars any effort to perfect a lien on the property of the debtor. Fortunately, the Bankruptcy Code provide an exception which protects certain statutory liens in ***11 U.S.C. §546***. If a claimant has the right to a statutory lien that permits retroactive perfection, such as a lien under ***LOWLA***, then the filing and perfection of that lien after the bankruptcy case is filed is not barred by the automatic stay. ***LOWLA*** establishes a privilege effective when services commence at the wellsite, when material are delivered to or lease property placed on the well site or, as to claims of operators and non-operators, when the obligation is incurred. ***La. R.S. 9:4864 and 9:4884***. Typically, the privilege will cease to have effect one hundred eighty days after the last activity which gives rise to the privilege unless a statement of privilege is filed in the mortgage records of the Parish where the property is located. It is important to note that the retroactivity is limited in time, so if you are aware a working interest party is experiencing financial difficulty and unable to pay current bills, in the current economic environment, delay could be costly. The procedure for establishing and preserving a privilege under ***LOWLA*** are fairly detailed and are beyond the scope of this article, but quick action in the event of a bankruptcy filing can preserve a secured claim that might otherwise have been lost.

The concept of "recoupment" also allows a creditor to offset amounts owed it by the bankrupt party against obligations of the creditor under the same contract which arise after bankruptcy is filed. For example, under a JOA, if the operator files bankruptcy while owing non-operator payments for production marketed by the operator, the non-operator may have the right to offset future operating costs against those funds. This relief is not automatic and the creditor should file a motion to lift the automatic stay and obtain approval for recoupment.

The Bankruptcy Code is complex and contains many rules that are unique to the bankruptcy practice. In addition, once a bankruptcy petition is filed, no action can be taken against the debtor without the permission of the Bankruptcy Court. Accordingly, while the above discussion

identifies some actions you can take to protect your interests, either prior to or after the filing of a bankruptcy petition, it is important you obtain knowledgeable counsel immediately upon receipt of notice that a party with whom you have a business relationship has instituted bankruptcy proceedings.