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Wildcatter 101 – Oil and Gas Basics for Bankruptcy Professionals

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I. SCOPE OF ARTICLE

Every boom in the oil and gas industry has been followed by a bust. Volatile increases and declines in oil and gas commodity prices always leave failed enterprises in their dust. The significant decline in oil prices during the second half of 2014 and the sustained low prices thereafter have caused over a 100 (and counting) oil and gas producers to file bankruptcy since January 2015.¹ Many generally accepted legal principles, particularly those pertaining to contracts, real property and secured transactions, can be radically transformed or impacted in bankruptcy. Moreover, the significant increase in exploration and production in states where oil and gas law has historically been less developed will result in interesting issues as bankruptcy law intersects with applicable state law. This paper² is intended to be a broad overview of some general bankruptcy law issues as they relate to the oil and gas industry, including executory contracts, the debtor's avoidance powers, creditor remedies and derivatives. This paper will also highlight some of the emerging bankruptcy issues in states with relatively recent oil and gas development, and some interesting issues specific to offshore cases.

II. EXECUTORY CONTRACTS

Certain types of contracts – oil and gas leases, joint 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.

¹ See Haynes and Boone, LLP's Oil Patch Bankruptcy Monitor at <http://www.haynesboone.com/publications/energy-bankruptcy-monitors-and-surveys>.

² This paper is an updated adaptation of prior materials written and presented by Haynes and Boone, LLP.

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, it is well-settled that 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 provisions³ relating to executory contracts in the Bankruptcy Code are inapplicable to mineral leases.⁴ *Terry Oilfield Supply Co. v. American Security Bank, N.A.*, 195 B.R. 66, 73 (S.D. Tex. 1996); *see 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).⁵

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 courts 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 (W.D. La. 1996); *see also Delta Energy Resources, Inc. v. Damson Oil Corp.*, 72 B.R. 7, 11

³ 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).

⁴ 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.

⁵ 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).

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