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Protecting Royalty Owner Rights Against a Financially Distressed Lessee

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I. INTRODUCTION

In 2020, numerous oil and gas operators or service providers filed for bankruptcy. Although COVID-19 may be partially to blame, the discount price war between Saudi Arabia and Russia resulting from the collapse of the OPEC+ agreement carried its share of the fault, as well. In response to these external pressures, investors and traders panicked, particularly on fears that domestic crude oil storage was severely limited (amidst a flotilla of oil tankers carrying 50 million barrels of product bound for U.S. shores). At the time, it seemed as if an operator would have no place to send its production.

Indeed, the events of April and May 2020 proved to be unprecedented for the oil and gas industry, with financial markets, operators, and regulatory authorities responding in ways never experienced before. For instance, at its May 5, 2020 conference, the Railroad Commission of Texas entered a temporary exception to permit oil and gas operators to store crude oil in underground geologic formations—an operation never (legally) authorized in the history of oil and gas production Texas. In April 2020, financial fears peaked with West Texas Intermediate prices falling into negative territory, nearly as low as -$38.00 per barrel.

Looking back, however, some of these fears may have been unfounded, but it was too late: the Texas oil and gas industry was wounded. For some, the stress proved too much and a flurry of industry bankruptcies followed.

As the dust settled, royalty owners received their first communication from the bankruptcy courts: notice that their lessee filed for bankruptcy protection. This paper is intended as a non-exhaustive "roadmap", explaining what a mineral royalty owner can expect when its operator files for bankruptcy and what actions it may take to protect its interests during the process.

II. WHICH CHAPTER?

As provided for in the Bankruptcy Code, an operator (referred to as the "debtor") is required to provide notice of the bankruptcy to a "creditor," such as a royalty owner under an oil and gas lease, designating and notifying same of the protection sought.[1] The operator should mail such notice to the royalty owner at the same address used to remit royalty payments.

[1] *See* 11 U.S.C. § 342.

In general, an oil and gas operator may seek protection under one of three "categories" of bankruptcy, (1) Chapter 7,[2] (2) Chapter 11,[3] or (3) Chapter 13.[4]

As a practical matter, however, a Texas oil and gas operator is not likely to file for bankruptcy under Chapter 13, as explained in further detail below, but is more likely to seek protection under Chapter 7 or Chapter 11.

A. Chapter 7 bankruptcy

In short, Chapter 7 bankruptcy involves liquidating an operator's assets (including an oil and gas lease) to satisfy debts it can no longer pay. In other words, an oil and gas lease may be sold under a Chapter 7 proceeding to satisfy the bankrupt operator's debts.

Also, under Chapter 7, a trustee is typically appointed/elected to "stand-in" for the bankrupt entity and works with the bankruptcy court to facilitate the bankruptcy proceedings.[5] Such a trustee maintains several duties relating to the proceedings, including, accounting for all property received and "investigat[ing] the financial affairs of the debtor."[6]

B. Chapter 11 bankruptcy

Chapter 11 allows an operator to "reorganize" and the operator is burdened with the rights and powers of a Chapter 11 trustee and fiduciary.[7] These duties include accounting for property, examining claims, and filing reports as required by the court and the U.S. trustee or bankruptcy administrator, such as monthly operating reports.[8] The operator may engage accountants, attorneys, appraisers, and auctioneers during the Chapter 11 process, also. Oftentimes, an operator will seek protection under Chapter 11, rather than under Chapters 7 or 13.

For the royalty owner, however, it is advisable to maintain close watch over Chapter 11 proceedings. For instance, the bankruptcy court will establish strict deadlines for filing proof of claims (i.e., underpayment of royalty discovered during the course of a royalty audit) or administrative claims. In other instances, a bankruptcy court could misclassify a royalty owner as an unsecured creditor, even though Texas enjoys its First Purchaser Statute, discussed *infra.*

These types of substantive errors were raised in *Espinosa*, albeit in the context of a Chapter 13 bankruptcy, but which nonetheless could apply to a Chapter 11 proceeding.[9] *Espinosa* is a Chapter 13 bankruptcy case where the debtor failed to follow proper bankruptcy procedure,

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[2] *See id.* §§ 701 *et seq.*

[3] *See id.*§§ 1101 *et seq.*

[4] *See id.*§§ 1301 *et seq.*

[5] *See id.*§§ 701, 702, 703.

[6] *Id.* § 704.

[7] *Id.*§ 1107.

[8] *Id.* §§ 1106, 1107; FED. R. BANKR. P. 2015(a).

[9] *United States Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 130 S. Ct. 1367, 176 L. Ed. 2d 158 (2010).

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