The current oil and gas environment: Navigating distressed operators and business partners

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If my operator may go bankrupt, what should I be concerned about? For example, is a joint operating agreement subject to possible rejection of bankruptcy? If so, then what would happen following rejection of a JOA? Is there anything we can do in anticipation of that?

Rick Wynne: The JOAs are very common; they allow co-owners of undivided fractional interests to use a single operator, but they also are particularly vulnerable in a bankruptcy because they're normally executory contracts where there are obligations on both sides of the contract. That means until the debtor decides to assume or reject a contract, they're not enforceable against the debtors, but they are enforceable against the other parties, the contract counterparties. The bankruptcy code gives the debtor the very powerful right to assume or reject an executory contract at any time before confirmation of a plan of reorganization unless the court shortens that time. In particular decisions to reject an executory contract are based on the business judgment rule, and are almost never overruled by the court. On the contrary, decisions to assume an executory contract and potentially assign it do carry with it the requirements that the debtor cure all defaults and prove that they have an adequate ability to perform or that an assignee can perform. There's room for court intervention there, but rejection decisions are pretty much final if the debtor decides to reject the contract.

There are some legally unique but common in fact issues to focus upon in bankruptcies involving joint operating agreements. These include the debtor's failure to pay or even potentially collect some joint interest billings. There can be penalties that accrue. What is becoming a common practice in oil and gas bankruptcy cases is that a motion that the debtor, if they're an operator, will seek to have joint, operating agreements continue in full force in the facts for the interim period before they decide to assume or reject. This is important for the contract counterparties because without that sort of a motion, the debtor would only have to pay for the reasonable value of the services they received under the contract until assumption. That could be the same as the contract pricing or it might be different.

One important provision in the contract negotiation phase, which can be added to a JOA agreement, is that if the operator files for bankruptcy, the operator is deemed to have resigned under the terms of the JOA. That may or may not be enforceable in a bankruptcy case, and it may also in fact violate the automatic stay. So an enforcement provision has been put into a lot of JOAs that provides that the non-operators and the operator in the event of an operator's bankruptcy will form an interim operating committee to control the operations until the debtor elects to either accept or reject the JOA. This type of provision is more likely to be enforceable, but to be safe we still advise filing a motion with the bankruptcy court to determine that the automatic stay is not implicated and basically get court approval of this if the debtor is otherwise not abiding by the contract. It also provides some additional leverage when trying to negotiate appropriate treatment and first day motions.

Another provision that can be added if in a negotiating phase is to have specific language that the operator has been chosen for a specific individual skills and abilities, perhaps experience with that particular operation, in order to try to have the contract determined more to be a personal services contract and prevent it from being assigned by the debtor without the consent of the non-operators. This is less likely to be successful, but still something that would be helpful leverage.

Ultimately, if a debtor operator decides to reject a JOA in the bankruptcy case, there is very little that the non-operators could do to stop that decision. They would simply receive a general unsecured claim for damages, which could be worth nothing if the debtor is deeply insolvent or it could have some value, but it's really impossible to generalize as to the value. Given recent price drops and the prevalence of secured debt, it looks like it's under water right now. Unsecured claims are going to be worth very little in this coming wave of oil and gas bankruptcies.

Well, if an operator is not paying third parties, what happens to the third party claims related to the work performed for the operator?

Ron Silverman: This is one of the more important, interesting, and, perhaps, unappreciated aspects of E&P energy bankruptcy cases. Whether one is a secured lender, an unsecured lender, or a company that's providing services to an E&P company, these following issues can alter the normal expectations of priority of recovery in a bankruptcy case. Typically, people are familiar with secured lenders filing mortgages and are recording security agreements to perfect their security interest in their liens, such that the first in time, first in right concept is adhered to. That is the first one to get a filed and perfected lien, they come first to prospective proceeds and recovery from the collateral that's subject to the lien.

In the E&P company circumstance, most state laws have provisions that permit and provide for contractors who provide services to E&P companies, the benefit of special liens that can give them priority over the otherwise recorded liens of other secured lenders. The way that works is that the statutes provide secured claims for those contractors that provide services to the E&P companies, but it's not necessary that the contractors have to file recordation and indications of those liens when they begin working. The statutes allow them to usually file within a certain period after the time when they stop working a lien filing, and give them a priority so that the priority of their lien relates back to the first time they began to work. In effect, they benefit from what are essentially secret liens that secured lenders may not appreciate when they are granting financing to a company. There are specific rules in every state as to how far and when the liens can relate back. There are rules about how far the gaps may be between providing work, stopping and providing work, and how long after a party stops working has to file a claim, but it has been the case that parties who provide services to the E&P companies can benefit from senior priority liens that relate back even years in time, back to a time when they began to work. In the context of an E&P company, where there are many contractors and millions of dollars of contracts of ongoing O&M, these are not insignificant issues and it can be the case that there are millions of dollars of secret priority claims, priority liens that can arise in an E&P case. It is very important for the parties that benefit from that, those contractors, to be careful and attentive to adhering to the filing regimes that give the benefit of that lien. Other parties that are financing E&P companies particularly in a situation where the company is in financial difficulty, need to be careful regarding unexpected liens and to do some analysis to take those into account.

Next, my company signed a farmout agreement, but it is unrecorded and the counterparty may go bankrupt. What should I be concerned about, and what can I do in anticipation of the bankruptcy?

Rick Wynne: There are significant bankruptcy issues relating to farmouts. The short answer is to record it and hope that the debtor company doesn't file within a 90-day preference period. Even if they do file, there are still some benefits and better protection to have the agreement recorded.

Let's talk about farmout agreements in general and expand on the short answer. This is a very common type of agreement where operators will have a lease, but they're not intending to drill at the time and they agree to assign that lease or some portion of it to another operator to drill. The assignor or the farmer will retain some carried interest back, either an overriding royalty or production payment or something. The biggest characteristic, however, of the farmout, is that the obligation of the assignee or the farmee to actually drill one or more of the wells on the farmed out acreage is a prerequisite to a completion of the assignment to that farmee. So, there is somewhat of a limbo period that performance has maybe not yet been concluded.

The issues obviously happen when there's not a recorded instrument and then you might have a bankruptcy filing. The bankruptcy code does exclude some production payment from being considered property of the debtor's bankruptcy estate. Bankruptcy code Section 541 provides that, in a bankruptcy estate created by the bankruptcy, that property does not include interest in liquid or gas that have been transferred pursuant to a farm-out or other written conveyance. That's helpful because that means that the farm-out agreement would not be an executory contract, the debtor would not be able to reject it under Section 365, so that would be very important.

This code provision would also generally deal with when the debtor is the farmer, but it's actually written where the debtor can be either the farmer or the farmee. That provides for some different legal issues depending on either situation. The first, where the debtor is actually the farmer, the farmee's interest that they've earned does not become part of that debtor's bankruptcy estate. That estate does not have the ability to say "because you didn't complete it" you don't have an interest. The farmee actually can complete the work, and it will not be property of the estate. That's an important protection. If the debtor is the farmee and is in the process of drilling to earn that farm-out agreement and benefits, and the debtor needs to complete it to have the earning event occur, you might have a situation where you have record title remaining with the farmer until the earning event, or even much later, but the debtor would have the equitable interest in the lease which would be earned. That would actually be property of that debtor farmee's estate.

It becomes more complicated when the farmee may assign out part of their interest to the geologist or to other people, so these can become quite technical. The basic benefit is that by having the farm-out interest not subject to property of the estate, they can have it excluded and the intent of the parties will prevail. It's always better to have it of record, so that people do have notice of it, and that you will get notice of any bankruptcy filing, and people will have to deal with the farmer or the farmee because it is of record. It is recommended to make it of record even though there are built-in protections in the bankruptcy code that don't depend upon it being recorded.

With respect to net profit interest and overriding royalty interests, how will those fare if the underlying assets are part of a bankruptcy estate, and what can I do in anticipation of a bankruptcy?

Ron Silverman: Overriding royalties and net profits interest are unique to oil and gas financing. Typically an overriding royalty is considered to be a real property interest, an asset that was sold by a company, and therefore both under state law and under bankruptcy law provisions the overriding royalty interests isn't property of the debtor and not subject to the bankruptcy estates. That's if all goes well. However, in modern financing convention, parties often try to push the envelope on their financing and put on bells-and-whistles as to increase the benefit to the recipient. When that goes too far, there's risk that in a bankruptcy those types of interests can be re-characterized or looked upon as disguised financings, resulting in very bad problems in recoveries for the recipient.

Erin Brady: An overriding royalty interests (ORRI) is a non-possessory interest in oil and gas minerals production or revenue. It's not an interest in the minerals itself, but it's an interest in the proceeds from the production of minerals that goes away; once a lease expires then the ORRI expires as well.

ORRIs are typically used to finance operations for oil and gas companies. Conceptually, most people would think of them as a loan that's going to be repaid through the production and monetization of oil and gas, but as a legal matter under state law, as long as the issue is not pushed, most ORRIs are going to be characterized as an interest in real property. That is an important fact when analyzing how they're going to be treated in bankruptcy. Let's compare the ORRI to the net profits interests (NPI).

Like ORRIs, NPIs are typically carved out of the working interest, but unlike ORRIs, the NPI's net percentages are a percentage of the net profits. That means that it isn't free and clear of the cost of production; instead it's that it factors into the cost of production when it's paid. In a lot of other respects it can be thought of similarly to an ORRI.

So what does this mean in a bankruptcy? Typically, under state law, ORRIs in particular are really seen as real property interests, and if a bankruptcy court agrees with that and the ORRI is characterized as a real property interest, it won't be deemed property of a debtor's bankruptcy estate, and therefore the trustee or debtor in possession isn't going to have any power to sell, assign, or transfer the interests. A debtor or a trustee won't be able to assume or reject the contract and the debtor in possession or trustee also won't be able to exercise any turnover rights or similar rights they would otherwise have under the bankruptcy code.

If an ORRI or an NPI is viewed as a financing or disguised financing, its holder is going to be viewed as holding a contractual interest. What that means is that their interest is going to be property of the bankruptcy estate, and then it's going to be subject to all of the things that a bankruptcy trustee or debtor in possession can do.

There was a ruling recently in a case called ATP that really put this into perspective. That case looked at an interest and determined that even though the holder believed that it was not a contractual interestthat it was rather a real property interest—the court looked behind the characterization under state law and determined, based on the very unique facts of that case, that it was unclear—for purpose of summary judgement—that the interest was clearly a real property interest and not a contractual interest. APP doesn't decide the issue once and for all; it was one court that looked at an issue on summary judgement as opposed to in trial, but the moral of the story is that no longer can people simply rely on the fact that under state laws an interest is supposed to be a real property interest as opposed to a contractual interest. Bankruptcy courts have shown that they're willing to dive below the surface and put substance over form to figure out what's really going on in a particular instrument.

What can a company do about this? The first thing to do is know what the relevant state law says about your interest. Are they real property interests? Are they loan interests or contractual interest? To the extent they are real property interests, make sure they are properly recorded under state law. The worst thing would be to have these addressed and not have recorded them properly.

To the extent that they're going to be viewed as financings, make sure that the liens are properly recorded. That's critical to enforcing rights in bankruptcy or even outside of bankruptcy. If a transaction looks like it is a real property interest, nonetheless consider the economic consequences and the practical consequences if the court were to re-characterize the transaction as a loan. Thinking through those issues ahead of time in the context of negotiations or in the context of considering what to do in bankruptcy will help to better plan for what to do. A company should obtain lien searches to figure out where in the priority waterfalli it will sit if the interest is re-characterized. They should also consider obtaining back-up liens on the same property from which they would be entitled some royalty payment, recognizing that if the entity is nearing bankruptcy they could have some fraudulent transfer issues, and so to beware. They need to understand what kind of statutory liens could end up senior to their liens if their interest is ultimately treated as a financing. Finally, keep an eye on the owner and operator.

If am entitled to a royalty, will I be able to collect those in a bankruptcy? If challenged, is there anything I can do to improve the situation?

Erin Brady: In many cases, if a company is entitled to a royalty, it's likely that they will be paid to those in a bankruptcy. That's probably more true these days as a practical matter as opposed to as a result of enforcing legal rights. Let's point out three big-picture facts that play into why these payments are often ultimately paid in bankruptcy.

When royalty interests are in the nature of real property interests, they're not going to be property of the estate and aren't going to be subject to the jurisdiction of the bankruptcy court. Also, when royalty interests are in the nature of a contractual interest, those are going to be property of the bankruptcy estate and will be subject to the powers of the trustee and the debtor in possession of the bankruptcy court. In many cases, although not all, the interests are going to be entitled to some level of security such as a lien on the production and its proceeds, which would give the holders of those rights a statutory lien on the property. While not as good as having the property outside of the estate, it still does provide a senior right of recovery.

The third big picture point to think about is that in some cases mineral leases are going to contain provisions that would provide for the termination of a lease in the event that royalties aren't paid.

While it's far from certain that these clauses could be effectively enforced in a bankruptcy at all, some courts have enforced them which leads to a realistic threat to a company looking to file bankruptcy that their leases could be in some jeopardy if royalties aren't paid.

Overall, the best bankruptcy case is one that implements a consensual resolution, thereby avoiding the case in which a disgruntled royalty owner or interest holder could threaten to act and could conceivably act in ways that could quickly derail a debtor's reorganization efforts. Given the importance of a consensual restructuring, debtors are generally cautious in their approach to dealing with royalty holders. As a result, it's become pretty commonplace for debtors who are going into bankruptcy to ask the bankruptcy court at the outset of the case for authority to make undisputed royalty payments to interest holders. In making this request, it's probably not surprising that the debtors cite the three factor discussed. Bankruptcy courts have largely bought into this idea and the rationale, and these motions are being granted in Texas, New York, and Delaware on a pretty regular basis.

In the event the debtor doesn't file this motion to seek to pay royalties, of course a royalty holder can use the court process to put pressure on them to do so and to move forward to pay the royalty, to ask for authority to pay the royalty current. Royalty holders have some leverage in this respect: a royalty holder could file a motion for relief from the automatic stay, to terminate the leases, or to foreclose on collateral. That's a legitimate threat. A royalty holder could also threaten to object to financing that's being brought into a bankruptcy case, especially to the extent that that financing is seeking to prime or step ahead of their interests. Royalty holders do have some ability to create some issues in a bankruptcy case in an effort to be paid current.

Regardless of whether the debtor is paying royalty interest current in the bankruptcy case or not, royalty holders really should be sure to file a proof of claim with the bankruptcy case, evidencing its right to payment from the bankruptcy estate. This will ensure that the royalty holder's rights are dealt with in the context of the bankruptcy estate. That is true even if the holder is relatively confident that their rights would be considered outside the debtor's estate. There's a recent case that came out of the District of Delaware called Delta Petroleum. In that case, there were two royalty interest holders, A and B, who continued to receive royalty payments during the case. A and B did not file proofs of claim in the bankruptcy case, and then after the plan in that case was confirmed and everybody's probably wiping their brow saying "thank goodness we made it through and got paid," a post-confirmation recovery trust was put in place to pursue claims that the debtor's estate held. Among the claims that that trust pursued were claims against A and B seeking to claw back their pre- or post-petition royalty payments.

The case was relatively complicated and dealt with a lot of issues, but the court found that to the extent that the interests at issue were contractual rights to payments that were created pre-bankruptcy, those rights were claims subject to discharge in bankruptcy. Because A and B hadn't filed proofs of claim in the case preserving their rights to payment, probably because they assumed that their rights were outside of the estate or didn't need to because they were getting paid, the court found that the rights were lost, and this is a pretty tough result. The silver lining is that the court did note in its discussion of this issue that some of the royalty payments, if they could be characterized as production payments or ORRIs, might be permissible to be paid under another section of the bankruptcy code. The moral of the story is that a company should try to protect their interests so they don't end up in the situation of companies A and B.

If the pipeline holder has producers threaten to reject or gathering processing agreements in its bankruptcy, will they be able to do that and if so where does that leave me as a pipeline owner?

David Simonds: The key issue here is whether the bankruptcy court will treat a company's gathering agreements as covenants running with the land, which are real property rights, or alternatively as mere personal agreements that are subject to rejection as executory contracts under section 365 of the Bankruptcy Code. If the contract is rejected, the debtor essentially is authorized not to perform its obligations and the pipeline owner, unfortunately, is left only with the pre-bankruptcy claim for its rejection damages -- and those claims are typically only paid in cents on the dollar. Having a real property interest, by comparison, gives the pipeline owner much stronger rights in the bankruptcy case, including a continuing right to payment and to other performance by the debtor. As to this matter, each case is very fact-specific and state law-specific. Bankruptcy courts generally analyze the language in the gathering agreement and their requirements for creating a covenant running with the land under the state law where the pipelines are located. Although there are some general principles that are common in the various state laws, there are three typical requirements: the covenant needs to touch and concern the land, there needs to be so-called privity of estate (essentially where two or more parties hold an interest in the same real property or where on party is granted another party an interest in land), and the covenant must be intended to bind successors. There have been three significant cases that have addressed this topic in the last few years, two of which occurred in the past few months. The first is a controversial decision from the bankruptcy court in the Southern District of New York, and that decision was upheld by the 2nd Circuit Court of Appeals in 2018. That case held that certain midstream contracts governed by Texas law did not constitute covenants running with the land and could be rejected. The decision obviously was very debtor-friendly, as it gave the debtor a significant degree of flexibility in dealing with its gathering agreements, allowing it to either abandon its obligations to the pipeline owner or to force renegotiation. Commentators and courts have criticized this decision as being very result-oriented and inconsistent with a long-held understanding about the nature of gathering agreements. In the decision, the court focused on so-called horizontal privity and, essentially, found that there was not a common interest in the land, and also that the agreement benefited the pipeline as an entity, rather than the real property at issue.

The two more recent decisions, one from the bankruptcy court in Houston called Alta Mesa and another from Colorado called Monarch Midstream, found that the gathering agreements at issue were real property covenants under Oklahoma law in the case of Alta Mesa, which the court found similar to Texas law, and under Utah law in the case of Monarch Midstream. Those decisions are helpful and the trend is in the right direction for pipeline owners, but they're not binding precedent in other courts and there is the distinctly negative party of the Sabine decision for bankruptcy cases filed inside the 2nd Circuit. What's a pipeline owner to do? First, pipeline owners should have their midstream agreement reviewed and make the necessary modifications to ensure that they are able to establish horizontal privity and they have features that support that they touch and concern the land. For example, they should ensure that they specifically cover real property interests and the oil and gas should be specified as in place rather than as produced. Second, if possible, the pipeline should be given an express grant of real property interest like an easement connection to the agreement or grant of a mortgage right. Finally, the pipeline owner should ensure that their rights are recorded in the proper county office in accordance with the requirements of local law.

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