



Buying and Selling Oil & Gas Assets In Bankruptcy Cases

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Two Main Paths for Disposition of Debtor's Assets and/or Business Through Bankruptcy

- Section 363 sale – advanced by motion practice
- Plan of reorganization under § 1129 – advanced by a confirmation process



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Common Characteristics of Bankruptcy Sales

- Only § 541 “property of the estate” may be sold – this is particularly important when it comes to selling oil & gas assets in bankruptcy cases
- May limit successor liability of certain types, subject to regulatory issues, and there are many in the context of oil & gas assets



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Contracts and Leases – § § 363 and 365 Matters

- Asset sales frequently are tied to the assumption and assignment of executory contracts and unexpired leases
- › Later in the program, we will discuss at length how § § 363 and 365 apply to oil & gas leases and other contracts that regularly are used in connection with exploration & production efforts



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The Bankruptcy Marketing Process Issues

- Debtor opens data room
 - › Potential purchasers conduct due diligence – special oil & gas concerns
 - Later in the program we will discuss (a) various types of economic interests (ownership and others) that may exist with regard to oil & gas assets, and (b) regulatory issues that impact the ownership, production and purchase and sale of oil & gas assets
 - Both of these items create due diligence issues unique to oil & gas transactions
- Timing of a sale can be driven by due diligence and regulatory issues unique to oil & gas transactions



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The Bankruptcy Marketing Process Issues (Cont.)

- Selection of a “Stalking Horse” bidder in oil & gas cases
 - › the bidder has to be able to buy and operate and meet any regulatory requirements that may govern in the applicable jurisdiction
- The terms of the stalking horse asset purchase agreement can establish a viable framework for all bids and can anticipate regulatory and other issues that will have to be addressed by any competing bidders
- The Importance of back-up bidders in oil & gas cases



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Sales of Substantially All Assets Under § 363

- Most bankruptcy judges will permit a § 363 sale of substantially all assets of a debtor outside of a chapter 11 plan
- Some judges will NOT allow § 363 sales of substantially all assets of a debtor outside a chapter 11 plan
- If a freestanding § 363 sale is the goal, care must be taken to select a “friendly forum”



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Oil and Gas Regulatory Obligations

- State and federal obligations will likely impact buyers and sellers of oil & gas assets:
 - › *E.g.*, TEX. NAT. RES. CODE ANN. § 89.011- plugging requirement; and
 - › *E.g.*, 30 CFR § 256.52 - surety bonds.



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Applicable Energy Regulatory Risks and Considerations

- Issue: May a debtor exercise its “abandonment” or “rejection” power to avoid regulatory obligations germane to oil & gas assets?
- When a debtor’s property includes interests in unproductive assets, the debtor may seek to abandon such interest to relieve the estate of burdensome liabilities pursuant to 11 U.S.C. § 554 or 11 U.S.C § 365.



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Oil and Gas Regulatory Obligations (Cont.)

- Courts generally have held that a debtor's abandonment and/or rejection power does not release or modify regulatory obligations
- A bankruptcy court generally does not substitute its judgment for the judgment of a regulatory authority



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Oil and Gas Interests and their Treatment in Bankruptcy

- *“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), 6 F.3d 422, 424 (7th Cir. 1993)*



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Oil and Gas Interests and their Treatment in Bankruptcy (Cont.)

- Disparate State and Federal Non-Bankruptcy Laws Determine How Oil and Gas Interests Are Treated



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Mineral Interests

○ *Mineral Rights Ownership*

- › The owner of oil and gas deposits under the surface, including the exclusive right to explore, drill, and produce



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Mineral Interests (Cont.)

- These distinctions are rendered moot for Bankruptcy Code purposes, as **mineral interests** held by a debtor are within the broad definition of “property of the estate” under § 541
- › Thus, even when such **mineral rights** may be considered to be contingent or non-possessory under applicable state law – such **interests** still are “property of the estate”



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Mineral Interests (Cont.)

- › States classify minerals in different ways



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Working Interests

- *Working Interests*

- › *A mineral interest owner* – whether an individual or government entity – often is not in the business of exploration and production
- › Lack of expertise
- › Need for capital



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Working Interests (Cont.)

- What does a working interest entail? The exclusive right to explore, drill, and produce the oil and gas.
- Interest conveyed
 - › operating interest
 - › Working interest
 - › The working interest holder pays all expenses for exploration, development, and, eventually (hopefully) production



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Working Interests (Cont.)

- A **working interest** does not exist in perpetuity.
- Termination may be due to:
 - › The failure to meet specified production requirement sof the end of the productive life of a well
 - › A date agreed upon by the parties



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Working Interests (Cont.)

- The treatment of working interests under §§ 363 and 365
 - › Non-bankruptcy law will govern the legal character of a working interest.
 - › Query: Is the working interest an “executory contract” or “unexpired lease,” subject to assumption and assignment or rejection under § 365 or is the working interest a different type of property interest that is not subject to the § 365 regime?



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Royalty Interests

- *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 interest** is not obligated to pay any of the costs associated with exploration or production



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Royalty Interests (Cont.)

- A “landowner’s royalty interest” is a type of interest commonly dealt with by bankruptcy courts, as it is the interest retained when a mineral right owner grants a working interest
- Are funds held by an E&P debtor, subject to a landowner’s royalty interest, property of the bankruptcy estate?



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Overriding Royalty Interests

- *“Overriding Royalty Interests (“ORRIs”)*”
 - › Unlike a landowner’s royalty interest , “overriding royalty interests” typically are carved out of a working interest
 - › As a general matter –
 - “perpetual ORRIs” last for the life of the lease between the working interest holder and the mineral rights holder,
 - “term ORRIs” are limited in duration until a specified volume of production or stated value of production is reached



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Net Profits Interests

- *Net Profits Interests*
- Similar to ORRIs, “net profits interests” or “NPIs,” are carved out of a working interest, but net profits interests are only payable to the NPI holder out of the profits earned from production over a contractually agreed-upon time period
- Under state law NPI’s generally are considered to be an interest in personal property rather than real property, even in jurisdictions where royalty interests are considered to be interests in real property



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Production Payments

- Production Payments
- 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
- Production payments, in contrast, terminate either
 - › Upon the expiration of the lease, or
 - › When the owner of the production payments has received the agreed quantum of production or dollar amount from the sale of production



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Production Payments

- Production payments sometimes are called “term ORRIs” because they operate like an overriding royalty interest with a specified term.



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The End



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