LexisNexis®

Oil and Gas: Exploration and Production Agreements

A Lexis Practice Advisor® Practice Note by Ira L. Herman, Blank Rome LLP

Ira L. Herman
Blank Rome LLP

This practice note discusses the treatment of certain agreements typically used in connection with the exploration and production of hydrocarbons—oil and gas assets. The status of rights under such agreements, including oil and gas leases, joint operating agreements, and farmout agreements, can be affected by the operation of the Bankruptcy Code.

As a rule, even after a bankruptcy is filed, non-bankruptcy law governs the property rights of the parties to agreements typically used in connection with the exploration and production of hydrocarbons. Only once the non-bankruptcy property rights of the parties to an agreement are understood, can a court presiding over a bankruptcy case analyze the effect of the Bankruptcy Code on the agreement at bar. It is therefore crucial to be aware of how the mineral law of the applicable state characterizes your client's rights. For example, while joint operating agreements are almost always executory contracts, an oil and gas lease may, depending on the governing non-bankruptcy law, constitute either evidence of an interest in real property that is not subject to assumption or rejection under Section 365 of the Bankruptcy Code or an unexpired lease that is subject to assumption or rejection under Section 365.

This practice note addresses oil and gas agreements as follows:

- Oil and Gas Leases
- Safe Harbor Provision for Farmout Agreements
- Joint Operating Agreements

For related content, see Oil and Gas Assets and Distressed Investing in Upstream Oil and Gas.

Oil and Gas Leases

Despite employing the noun "lease" in its description, an oil and gas lease is not necessarily an unexpired lease subject to rejection in bankruptcy and may actually instead be a real property interest. The question of whether an oil and gas lease falls within the definition of either executory contract or unexpired lease, as those terms are used in Section 365 of the Bankruptcy Code, is determined by referring to the applicable non-bankruptcy law. Butner v. United States, 440 U.S. 48 (1979). The nature of the property right created by an oil and gas lease varies from state to state. In Texas and Pennsylvania, for example, oil and gas leaseholds are classified as real estate (a fee simple determinable), while in Kansas, a lease is essentially a license to go upon the land in search of oil and is subject to assumption or rejection under Section 365 of the Bankruptcy Code. Terry Oilfield Supply Co. v. Am. Sec. Bank, 195 B.R. 66, 70 (S.D. Tex. 1996); Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 772 (W.D. Pa. 2004).

If a lease is classified as a real property interest rather than as a lease, a debtor who is a lessor cannot reject the lease and thus deprive the lessee of its expected benefits under the lease. In states that treat mineral leases as executory contracts, some states treat oil and gas leases as creating an interest in personal property while others treat it as creating an interest in the real property. This distinction will impact whether Section 365(h) of the Bankruptcy Code may apply following rejection of the lease. Section 365(h) allows a lessee of an unexpired and already commenced lease of real property to retain its rights under the lease that are in or appurtenant to the real property for the balance of the term of the lease; "[r]ejection does not alter the substantive rights of the parties to the lease," and, thus, "the lessee 'may remain in possession of the leasehold . . . for the balance of such term and for any renewal or extension of such term . . . .'" Megafoods Stores, Inc. v. Flagstaff Realty Assocs. (In re Flagstaff Realty Assocs.), 60 F.3d 1031, 1034, 1037 (3d Cir. 1995) (quoting 11 U.S.C. § 365(h)(1)). Although the parties cannot control whether a lease will be characterized as an executory contract or unexpired lease, a lessee can prepare for the risk of rejection in bankruptcy by crafting and defining its rights under the lease so that they will likely be found to be "in and appurtenant to the real property" under Section 365(h) in states that treat mineral leases as leases of real property. By contrast, in In re J.H. Land & Cattle Co., 8 B.R. 237 (Bankr. W.D. Okla. 1981), the court held that a Kansas oil and gas lease created only an interest in personal property and thus Section 365(h) did not apply. For general information on Section 365 of the Bankruptcy Code, see Assumption, Assignment, and Rejection of Executory Contracts.

Safe Harbor Provision for Farmout Agreements

Section 541(b)(4) of the Bankruptcy Code provides that mineral rights leases covered by certain types of farmout agreements (as defined by the Bankruptcy Code) are not property of the debtor's estate. In the oil and gas industry, a farmout is a contractual arrangement by which one party (the farmee) earns all or a portion of the interest in a property owned by another (the farmor) in exchange for the performance of certain tasks such as, for example, drilling or completing certain wells. In a typical farmout, the farmee drills a well and, upon satisfactory completion, earns a percentage of the acreage and additional rights going forward. Title remains in the name of the farmor pending the farmee's completion of the contractual obligations.

Section 541(b)(4)(A) prevents a debtor-farmor from withholding from its farmee an assignment of an interest if it is otherwise earned. By removing acreage subject to a farmout agreement from the bankruptcy estate, Section 541(b)(4) seeks to prevent a windfall to a debtor-farmor that elects to reject an executory farmout agreement that otherwise would result in the farmee's earning a percentage of the acreage of a successful well.

As a practical matter, in order to take advantage of the safe harbor, parties to certain types of agreements should ensure that their agreements fall within the Bankruptcy Code's definition of "farmout agreement," a definition that is broader than the standard industry understanding of a farmout agreement. The Bankruptcy Code's definition covers any agreement for the assignment of an interest in an oil and gas lease that includes, as consideration, defined operations upon the party. 11 U.S.C. § 101(21A). A prospective assignee under an agreement for assignment should thus ensure that the agreement falls within the Bankruptcy Code's definition so that a bankruptcy filing by the farmor will not result in a disruption of the farmee's expected rights.

Where the debtor entity is the farmee under an agreement and has promised to sell or has actually sold interests, the situation can be more complicated. If the assignments are not of record, it is unclear whether the interests will nonetheless become property of the estate. Under a broad reading of the phrase "pursuant to a farmout agreement" in Section 541(b)(4)(A)(i) of the Bankruptcy Code, the assignment to a third party could arguably be pursuant to the farmout agreement, especially if the debtor's ability to perform under the farmout agreement is dependent on the assignment to third parties.

A third party entering into an agreement to purchase interests from a farmee thereby incurs the risk that the farmor will file for bankruptcy relief and reject the agreement to sell the interests despite having already obtained funds from the third party to assist in operations. The rejection damages claim in such a circumstance would only give rise to an unsecured claim against the estate, and the party to whom the debtor promised to sell the interests may receive very little, while the debtor's estate would retain the interests that it acquires under the farmout. Although this risk cannot be eliminated, the third party advancing funds may mitigate the risk by insisting upon a recital that such funds are advanced "pursuant to" the farmout agreement and for the purpose of funding operations under the farmout agreement.

Joint Operating Agreements

Joint operating agreements uniformly are held to be executory contracts and can thus be assumed or rejected under Section 365 of the Bankruptcy Code. Wilson v. TXO Prod. Corp. (In re Wilson), 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987). Like any rights created under an executory contract, a party's rights under a joint operating agreement are at risk in the event of a bankruptcy filing. Although the risk of rejection cannot be entirely eviscerated, a party may mitigate that risk by (1) including a standard provision ensuring that the joint operating agreement is construed as an executory contract and providing for adequate assurance of performance, (2) filing a memorandum of the operating agreement of record to protect any contractual lien rights, (3) negotiating for and preserving offset and recoupment rights, and (4) drafting the operating agreement to protect certain rights as covenants running with the land, which are not subject to rejection in bankruptcy. See sample clause Joint Operating Agreement between Working Interest Owners (Identifying and Managing Bankruptcy Risk).

In addition, in the vast majority of oil and gas cases, the joint operating agreements are assumed likely because rejection does not affect the underlying working interests of the parties. Instead, as the court in *Wilson* acknowledged, rejection only means that the operator and nonoperator must then apply default common law rules of cotenancy, which has been an unattractive alternative for virtually every Chapter 11 debtor in the recent oil and gas downturn.

Adequate Assurance

Under Section 365(b)(1)(A) of the Bankruptcy Code, a party assuming an operating agreement will be required to provide adequate assurance of future performance under the agreement if there has been a default. To mitigate the risk that the bankruptcy court's determination of adequate assurance will not sufficiently protect the non-debtor's interests, the parties should agree in advance on the nature of adequate assurance by including the following standard provision from the AAPL Model Form:

> If, following the granting of relief under the Bankruptcy Code to any party hereto as debtor thereunder, this agreement should be held to be an executory contract under the Bankruptcy Code, then any remaining party shall be entitled to a determination by debtor or any trustee for debtor within thirty (30) days (inclusive of Saturday, Sunday and legal holidays) from the date an order for relief is entered under the Bankruptcy Code as to the rejection or assumption of this agreement in its entirety. In the event of an assumption, such party seeking determination shall be entitled to adequate assurances as to the future performance of debtor's obligation hereunder and the protection of the interest of all parties. The debtor shall satisfy its obligation to provide adequate assurances by either advancing payments or depositing the debtor's proportionate share of expenses in escrow.

Contractual Lien Rights

An operating agreement also may create contractual lien rights, which are preserved even if the operating agreement is rejected. Operating agreements often grant the operator a contractual, consensual lien on the nonoperator's mineral interest to secure the nonoperator's obligations under the agreement. If the nonoperator files for bankruptcy, it cannot reject the lien even if it rejects the operating agreement. However, the lien is not binding on third parties unless (1) the operating agreement (or a memorandum of it) is filed of record, (2) constructive notice to the world is given in some other context, such as possession, or (3) the lien claimant is in possession of the collateral. An operator in possession of a property likely is not in possession as the agent of the nonoperator so as to give notice of the lien, so it is critical that a party entitled to a contractual lien file a memorandum of the operating agreement of record to ensure that its lien rights will be enforceable in bankruptcy.

Setoff and Recoupment Rights

Even if an operator has failed to perfect its operator's lien, the operator may exercise setoff and recoupment rights against a bankruptcy estate under the terms of the governing operating agreement. Security Pac. Nat'l Bank v. Enstar Petroleum Co. (In re Buttes Resources Co.), 89 B.R. 613, 617 (S.D. Tex. 1988) (operator's claim to production runs is characterized as recoupment, and the stay is lifted to allow effectuation of setoff); Farmers Union Cent. Exch., Inc. v. Security Pac. Nat'l Bank (In re Buttes Gas & Oil), 72 B.R. 236, 239 (Bankr. S.D. Tex. 1987) (operator's right to recover costs from production runs is recognized as recoupment). A party entitled to setoff must obtain relief from the stay before exercising its rights, although an "administrative freeze" is available pending relief from the stay. Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995).

The automatic stay does not stay a recoupment given that recoupment does not involve any action against property of the estate. Rather, recoupment is an equitable defense in that involves a determination of the proper amount of the estate's claim against the party seeking the recoupment.

See, e.g., Beaumont v. United States (In re Beaumont), 2008 Bankr. LEXIS 2127, at *8 (Bankr. E.D. Okla. Aug. 7, 2008) ("If the recoupment doctrine applies, then there is no 'debt' or 'claim' here as defined in the Bankruptcy Code, and [the] [d]efendant has not violated the automatic stay."), aff'd, Beaumont v. Dep't of Veteran Affairs (In re Beaumont), 586 F.3d 776, 781 (10th Cir. 2009); Kosadnar v. Met. Life Ins. Co. (In re Kosadnar), 157 F.3d 1011, 1016 (5th Cir. 1998) ("Post-petition recoupment does not violate the automatic stay imposed by the bankruptcy court.").

The recoupment rights of the operator may be superior to a mortgage lien encumbering the estate's interest in the property subject to the recoupment. In one case, a bank intervened in a motion to lift the stay and unsuccessfully argued that its mortgage was prior to the operator's right of recovery. See Buttes Resources Co., 89 B.R. at 617. In Buttes Resources Co., the court noted that the claim of the debtor was "subject ab *initio* to reduction for the very expenses that were required to produce the oil." Id. For more information about setoff, see Setoff. For more information about recoupment, see Recoupment.

Covenants Running with the Land and Gas Gathering Agreements

Operating agreements sometimes contain provisions that may be characterized as covenants running with the land, which cannot be assumed or rejected in bankruptcy. See Newco Energy v. Energytec, Inc. (In re Energytec, Inc.), 739 F.3d 215, 224–25 (5th Cir. 2013) (holding that a bankruptcy sale was not free and clear of a party's rights pursuant to covenants running with the land). Thus, from a practical perspective, a party seeking to maximize the chances that its rights under the operating agreement will be preserved even in the event of bankruptcy should (1) draft the operating agreement to recognize those rights as covenants running with the land and to bind the parties and their assigns and (2) file the operating agreement of record.

It is important to note that not all rights can be characterized as covenants running with the land. State law universally defines a covenant running with the land as a right that touches and concerns the land. Common elements include whether the right (1) touches and concerns the land, (2) relates to a thing in existence or specifically binds the parties and their assigns, and (3) is intended by the original parties to run with the land. Another Common element is when the successor to the burden has notice. Inwood N. Homeowners' Ass'n, Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987). Thus, a right that plainly does not concern the land cannot be characterized as a covenant running with the land even if the operating agreement defines it as such.

However, all but the first element can be satisfied by careful drafting and recording of the operating agreement. As a practical matter, the operating agreement should plainly state that the right binds the parties and their assigns, and the explicit characterization of the right as a covenant running with the land in the operating agreement will leave no room for doubt as to the parties' intent. Recording the operating agreement ensures that any notice element is satisfied. Additionally, where a right is in some way connected to the use of the land—for example, a right to consent before the assignment of the land or a right to receive a fee for certain uses of the land—carefully crafting the definition of the right can improve the chances that it will be construed as touching and concerning the land.

Two decisions out of the Southern District of New York, concerning gas gathering agreements, are of great interest in this regard. First, the Bankruptcy Court, Shelley C. Chapman, J., held that debtor would be allowed to reject its executory gathering contracts, pursuant to which debtor was required to deliver hydrocarbons in certain minimum quantities that it could no longer viably achieve or to make contractual deficiency payments, despite contention that debtor's obligations ran with the land. In re Sabine Oil & Gas Corp., 547 B.R. 66 (Bankr. S.D.N.Y. 2016), aff'd, 567 B.R. 869 (S.D.N.Y. 2017), aff'd, 734 F. App'x 64 (2d Cir. 2018). The District Court, Jed S. Rakoff, J., then held that covenants contained in Chapter 11 debtor's gathering agreements with companies that processed gas and other hydrocarbons removed from debtor's wells (1) did not touch and concern the land, and thus were not covenants running with the land, such as debtor was barred from rejecting and (2) benefited only the processing companies themselves, and not the land which they were given to construct their processing facilities, and did not constitute equitable servitudes. In re Sabine Oil & Gas Corp., 567 B.R. 869 (S.D.N.Y. 2017), aff'd, 734 F. App'x 64 (2d Cir. 2018).

Subsequently, two bankruptcy courts came to a different conclusion on the question of whether an agreement was an executory contract amenable to assumption or rejection or was an executed agreement providing for the transfer of an interest in real property. First, in Monarch Midstream, LLC v. Badlands Production Company (In re Badlands Energy Utah LLC), 2019 Bankr. LEXIS 3414 (Bankr. D. Colo. Sept. 30, 2019), the U.S. Bankruptcy Court for the District of Colorado denied a Chapter 11 debtor's motion to sell its oil and gas assets free and clear of certain gas gathering and processing agreements and saltwater disposal agreements. The Badlands court's decision was based on a finding that the agreements at issue created covenants running with the land under Utah law, thereby preventing a sale free and clear of the rights of the non-debtor counterparties under such agreements. Second, in

Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Resources, Inc.), 2019 Bankr. LEXIS 3859 (Bankr. S.D. Tex. Dec. 20, 2019), Judge Marvin Isgur held that the gathering agreements could not be rejected by the Chapter 11 debtors because the agreements created covenants running with the land, a real property interest under the applicable Oklahoma law. For a further discussion of these cases, see Oil and Gas Industry Update Sabine Oil Not the Last Word on Treatment of Gathering Agreements in Bankruptcy.

Sabine, *Badlands*, and *Alta Mesa* illustrate that applicable non-bankruptcy (state) law and the specific facts, contract language, and circumstances of any given case will all be considered by a court assessing whether a gas gathering agreement, or other agreement like the saltwater disposal agreement in *Badlands*, is an executory contract that can be rejected in bankruptcy or an agreement that creates a covenant running with the land—a property right that is not subject to Section 365 of the Bankruptcy Code, and therefore cannot be rejected. Also, choice of venue should be considered, as the law continues to develop in this area and as the courts employ different approaches when analyzing these agreements.

The author would like to express his gratitude to James Grogan, a Partner at Blank Rome LLP, for his research and editorial support. The views expressed herein are solely those of the author as of the date this article was written and such views should not be attributed to Blank Rome LLP or to any of its clients.

Ira L. Herman, Partner, Blank Rome LLP

Ira Herman is a Partner in Blank Rome's New York office. He concentrates his practice on domestic and cross-border insolvency matters, commercial litigation, and related corporate governance issues. He regularly represents buyers of distressed assets and provides counsel concerning troubled commercial real estate, including securitized loans (CMBS). As a mediator, Ira has been able to facilitate the resolution of controversies involving U.S. and non-U.S. parties concerning bankruptcy and commercial law issues. Additionally, Ira works with for-profit and nonprofit entities on data privacy and cybersecurity issues.

Currently he serves as Steering Committee Chair for the New York City Bankruptcy Assistance Project. He is a member of the President's Council for the Food Bank for the City of New York. He is the Editor-in-Chief of the American Bankruptcy Institute's (ABI) Section 363 Asset Sales Databank and Co-Chair of the ABI Assets Sales and Real Estate Committees. Ira is an Adjunct Professor of Law at Pace University School of Law and St. John's School of Law in the Bankruptcy LL.M. Program.

Ira received his J.D. from Boston University School of Law where he graduated cum laude with distinction and was the Editor of the Boston University International Law Journal. He has a B.A. in Political Science from Yeshiva University. Ira is a member of the New York State Bar and New York City Bar Associations.

This document from Lexis Practice Advisor®, a comprehensive practical guidance resource providing insight from leading practitioners, is reproduced with the permission of LexisNexis®. Lexis Practice Advisor includes coverage of the topics critical to practicing attorneys. For more information or to sign up for a free trial, visit lexisnexis.com/practice-advisor. Reproduction of this material, in any form, is specifically prohibited without written consent from LexisNexis.

LexisNexis, Lexis Practice Advisor and the Knowledge Burst logo are registered trademarks of RELX Inc.
Other products or services may be trademarks or registered trademarks of their respective companies. © 2020 LexisNexis

LexisNexis®