Chapter 14

The Treatment of Oil and Gas Leases in the Context of Chapter 11 Bankruptcy Sales

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§ 14.01. Introduction.

As prices for domestic crude oil have continued the slide from 2014, and natural gas prices have languished, more and more oil and gas producers have joined the march to bankruptcy court. The year ending December, 2014 saw several small companies file for relief, and 2015, as of late July, has seen significantly larger companies joining them.¹

For cyclical businesses like oil and gas production, Chapter 11 bankruptcy can afford the type of temporary relief necessary to restructure debt obligations, jettison burdensome contracts, and adjust operations to reflect business realities, enabling the business to emerge from bankruptcy more fit to meet the economic challenges of the times. At least that’s the idea.

¹ Milagro Oil and Gas, Sabine Oil and Gas Corp. ($2.5 billion in assets and 2.9 billion in debt), Quicksilver Resources ($1.2 billion in assets and $2.3 billion in debt), BPZ Resources, Dune Energy, American Eagle Energy Corp.
For a variety of reasons, some will face the liquidation of substantially all of their assets in Chapter 11, while others may actually turn to Chapter 11 as a vehicle to sell substantially all of their assets.

§ 14.02. How Does Chapter 11 Bankruptcy Facilitate Assets Sales in a Distressed Industry?

In the past one could assume, probably correctly, that buyers would be hard to come by in a distressed industry. Unstable markets, unreliable valuations, and fear of successor liability did little to attract buyers to an insolvent seller.

The bankruptcy courts offer mechanisms to address those concerns, and perhaps in part for that reason, the “distressed asset” market has become an industry in itself. A bankruptcy filing mandates disclosure by the debtor of substantial information that a buyer outside of bankruptcy may have to discover on its own. The automatic stay against creditor action and the protections afforded lenders and suppliers willing to do business with a Chapter 11 debtor help preserve the “going concern” value of the debtor’s business pending a sale.

The sales process is conducted according to published procedures authorized by the bankruptcy court and is fairly transparent. This process can be for the particular assets, industry, and exigencies at work. Bidders willing to serve as the “stalking horse” may receive economic incentives such as expense reimbursement and breakup fees.

Assets will be acquired without fear of fraudulent transfer claims after the sale. And, of greatest interest to buyers, a sale properly conducted according to 11 U.S.C. § 363 will be authorized by an order of the U.S. Bankruptcy Court declaring the assets to be sold free and clear of liens, claims, interests, and encumbrances.

Of equal importance to Section 363 in a sale of substantially all of the assets of a Chapter 11 debtor is Section 365. This section governs the assignment of certain of the debtor’s contractual rights. In the oil and gas production business, where the “going concern” value resides in the oil and
gas leases, Section 365 may provide additional advantages to the debtor and its buyer which would not be available to them outside of bankruptcy.

§ 14.03. How Does Section 365 Facilitate Assignments of Unexpired Leases of the Debtor?

An oil and gas producer will be a lessee, either directly or by assignment, under numerous oil and gas leases. These leases commonly condition the lessee’s right to transfer its interest in the lease on the consent of the lessor. In a nonbankruptcy sale and assignment of the lessee’s interests under oil and gas leases, the seller will very likely be required to warrant to the buyer that all necessary consents to assignment have been obtained.

In many cases, particularly those involving smaller producers, the lessor was “Mom and Pop,” both of whom are now deceased, and their interests belong in varying portions to their children and/or their children’s heirs. Obtaining the consents necessary to assign leases and provide related warranties can be problematic, perhaps even impossible.

The Bankruptcy Code at 11 U.S.C. § 365(f)(1) provides that except in situations not applicable here, a Chapter 11 debtor may assign an “unexpired lease” of the debtor “notwithstanding a provision in an . . . unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions, the assignment of such . . . lease . . . .”

Thus, in a bankruptcy sale of substantially all of the assets of an oil and gas producing debtor, the debtor can assign its oil and gas leases which include consent requirements without obtaining such consents if its oil and gas leases qualify as “unexpired leases” under Section 365.

That said, the Code restores fairness to the lessor by imposing two other conditions on any assignment of an unexpired lease. The assignee must provide adequate assurances of its ability to perform under the lease, and both prepetition and postpetition defaults must be cured. In most cases, the first requirement is readily met. Either the buyer is well known in the industry or simply presents a better alternative to the insolvent seller such
that the lessors are willing to go along. Typically, the cost of curing defaults is considered in the calculation of the purchase price.

§ 14.04. Is an Unexpired Oil and Gas Lease an “Unexpired Lease” of the Debtor?

As the Fifth Circuit Court of Appeals wrote in 1990, “the term ‘oil and gas lease’ is a misnomer because the interest created by an oil and gas lease is not the same interest created by a lease governed by landlord and tenant law.” In other words, an oil and gas lease in existence on the date of the bankruptcy filing is not always an “unexpired lease” under Section 365.

The interest created by an oil and gas lease recognizes the migratory nature of oil and gas and its tendency to move toward areas of lesser pressure. Oil and gas located under a tract of land may actually be produced by a well located on another tract of land.

Therefore, as a general matter, oil and gas leases convey rights to explore for oil or gas on a given tract, conduct drilling activities on the tract, produce oil or gas from wells located on the tract, and sell the oil or gas produced from the wells on the tract.

Whether those rights constitute a lease governed by Section 365 of the Bankruptcy Code depends upon the law of the State where the land subject to the lease is located. Some states take the view that the owner of the land on which the lease is located does not own the oil and gas beneath his land, and, therefore, cannot convey any interest in the oil and gas. Instead, as the property owner, he has the exclusive right to use the land to explore for and develop oil and gas. In these states, called “nonownership” states, an oil and gas lease is considered a lease of the property owner’s right to explore for and produce oil and gas on the subject land.5

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2 In re Topco, Inc., 894 F.2d 727, 740, n. 17 (5th Cir. 1990).
4 In re Topco, supra.
5 See Byer and Tuggey, supra n. 3 at 338, 339, 340 n.14; (California, Illinois, Indiana, Kentucky, Louisiana, New York, Oklahoma and Wyoming are considered “nonownership”
Other states consider the property owner to be the owner of all oil and gas under the property, subject to divestment of such interest upon migration of the oil and gas from beneath the tract. In these “ownership in place” states, an oil and gas lease is a conveyance of a fee simple interest in the oil and gas rather than a lease.6

As might be expected, oil and gas leases in nonownership states are generally considered to be true leases, thus subject to Section 365 of the Bankruptcy Code.7 The logical corollary is that oil and gas leases in ownership in place states, where oil and gas leases are considered transfers of a fee simple interest in the oil and gas, would never be subject to Section 365 of the Bankruptcy Code. However, although ownership in place states transfer a fee interest in the oil and gas, the fee interest is not vested at the time the lease is signed.8 Generally, in those states, the fee interest does not vest in the lessee until oil or gas has been produced in paying quantities from the leased property.9

While upon and after vesting the lease would fall outside the scope and effect of Section 365, what about the period of time after the lease is signed but before it has vested? What is the nature of an oil and gas lease in an ownership in place state prior to vesting, and does Section 365 apply?

It has been held that an oil and gas lease in Pennsylvania prior to vesting was an agreement “to use real property.” And, since Section 365(m) provides

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6 See Byers and Tuggey, supra n.3 at 338, 339, 340 n.14. (Alabama, Arkansas, Colorado, Michigan, Mississippi, Montana, New Mexico, Ohio, Pennsylvania, Tennessee, Texas and West Virginia are considered “ownership in place” states). See Burkley, “Navigating Oil and Gas Leases,” supra n.6 at 18, 7879; see also Isenberg and DiSabatino, “The ‘Peculiar’ Lease: Powell and the Treatment of Oil and Gas Leases,” XXXII ABI Journal 3, 14, 15, n. 6 at 14, April, 2013.
9 Id.
that for purposes of Section 365, leases of real property shall include “any rental agreement to use real property,” the lease was, on the date of the lessee’s bankruptcy filing, an unexpired lease of property subject to Section 365.\textsuperscript{10} Thus, even in ownership-inplace states, Section 365 may govern oil and gas leases.

\section*{§ 14.05. If an Oil and Gas Lease Is Not a Lease Under Section 365, Then What Is It, and What Difference Does This Make in a Chapter 11 Case?}

The commencement of the bankruptcy case creates an estate comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case,” including its proceeds, product and profits.\textsuperscript{11} If an oil and gas lease is not a lease under Section 365 of the Bankruptcy Code, and the applicable state law provides that the debtor is the owner of a fee simple interest in the oil and gas, the interest of the debtor is simply property of the debtor’s bankruptcy estate under Section 541 of the Code, with one relevant exception.

“Property of the estate” does not include any interest of the debtor in “liquid or gaseous hydrocarbons” to the extent that the debtor has transferred or agreed to transfer the interest under a farmout agreement or a written agreement related to a farmout agreement. In addition, a production payment from gaseous or liquid hydrocarbons is not property of the estate if transferred by the debtor pursuant to a written conveyance to an entity that does not participate in the operation of the property against which the payment is granted.\textsuperscript{12}

\begin{footnotes}
\item[10] Id.
\item[12] Id.
\end{footnotes}
As we have stated, a debtor may sell property of the estate under Section 363 of the Bankruptcy Code. Unlike Section 365, Section 363 does not abrogate consent requirements that may be contained in the lease. Arguably, such requirements are binding notwithstanding the treatment of the lease as a conveyance of the oil and gas. An argument may be made that the appropriate remedy for a breach of such an obligation is a claim for damages assessable against the bankruptcy estate and subject to proof. In that case, assuming no damages have, in fact, been suffered, the breach would have no consequence but the cost of litigation. However, in a liquidating Chapter 11, the estate may not have the ability to pay those litigation costs, and the uncertainty such litigation presents could complicate the process.

On the positive side, however, under Section 541 the debtor is not required to assume or reject the “lease,” but under Section 365, it is, and these concepts have consequences. Further, before any lease governed by Section 365 may be assigned to a buyer, it must be assumed by the debtor. Assumption is the commitment of the estate to fulfill the terms of the lease. Any default thereafter gives rise to a claim against the estate for damages. Rejection is a breach of the contract, and gives rise to a claim against the estate for damages as well.

However, the claim created upon rejection is a pre-petition claim, but the claim created upon default after assumption is a post-petition “administrative” claim which is entitled to be paid ahead of any pre-petition claim. Moreover, the debtor may not be permitted to confirm a plan of reorganization (and thereby obtain a discharge of certain debt) if it is financially unable to pay all administrative claims in full. Thus, classification of a lease as a true lease governed by Section 365 means that any default after assumption of the lease places an economic burden on the debtor which could jeopardize its ability to confirm a plan. Section 363 which governs the sale of the oil and gas conveyed under the lease in ownership in place states contains no assumption or rejection requirement.

Additionally, under Section 365, unexpired (true) leases must be “assumed” or “rejected” by the debtor by the earlier of the date 120 days
after filing or the date of the entry of an order confirming a plan, subject to one extension of no more than 90 days.13

A failure to timely assume renders the lease rejected, and therefore, breached, and of no value to the debtor or its buyer. Absent this deadline, a debtor would delay assumption until it had procured a buyer because it does not want to create the potential for a post assumption default that will increase the cost to a buyer (or until it knows the lease will be assigned and the resulting claim will be paid from the purchase price).

Thus, the imposition of this deadline relatively early in a Chapter 11 case forces the debtor into one of a few undesirable situations. It must either assume leases before it is certain it has a buyer in order to preserve the going concern value of the business, thus creating the potential for an administrative claim; or, it must devote its time and resources very early in the case to procuring a buyer whether it has determined a buyer is both necessary and possible, and when it could be exploring reorganization prospects; or, it delays filing until it has a buyer lined up, so that it can assume on a timely basis and immediately sell.

The latter risks too much delay, which can damage the company’s value, the ability to reorganize, and the potential for a sale. In ownership in place states, where Section 365 is not applicable to oil and gas leases, at least after vesting, the debtor is not constrained by these concerns.

§ 14.06. Conclusion.

Before any oil and gas producer seriously considers a Chapter 11 filing, or any buyer seriously considers a purchase of oil and gas leases from a Chapter 11 debtor, it is critical that he or she first determine whether the state in which the leases are located is a non-ownership state, or an ownership-in-place state.

This determination will indicate whether the oil and gas leases will be treated as true leases subject to 11 U.S.C. § 365, or will be treated as conveyances of fee simple interests in the oil and gas underlying the leased properties, which are not subject to Section 365. The distinction dictates

certain conditions upon which the oil and gas interests may be assigned, whether assumption is required and when, and what the lessor is entitled to receive in connection with assumption and assignment of the oil and gas interests, all of which should bear on the decision to file, and any decision by a buyer to seek to acquire such interests.