

Oh Dear! What Can the Matter Be? What Will Become of My Oil and Gas Lease in Bankruptcy?

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Synopsis

§ 9.01.	Introduction	237
§ 9.02.	Oil and Gas Agreements and Interests	240
	[1] — Mineral Ownership Interest	241
	[2] — Working Interest	242
	[3] — Royalty Interests	244
§ 9.03.	Conclusion	245

§ 9.01. Introduction.

Bankruptcy may not be the “dirty word” that it was prior to the implementation of what is commonly referred to as “the Bankruptcy Code,” the term used to distinguish the 1978 enactment (as amended) from prior iterations of bankruptcy law.¹ The Bankruptcy Code was codified on November 6, 1978 in the Bankruptcy Reform Act² and, with numerous amendments, has been in effect as the governing law since it took effect on October 1, 1979. Despite its nearly four-decade history, the bankruptcy process is dynamic and many issues remain unresolved. One of those issues is the impact of state law on the determination of what constitutes an interest in property and how that determination will play out in the bankruptcy courts.

This chapter will address how oil and gas interests are treated in bankruptcy, discuss the impact of state law in the determination of whether the lease is a “true” lease or a property interest, and point to cases that arrive at different conclusions based on the underlying state law:

¹ 11 U.S.C. § 101, *et seq.*

² Pub. L. No. 95-598, 92 Stat. 2549 (November 6, 1978).

Federal bankruptcy law is aimed at providing fair and orderly relief for the “honest but unfortunate debtor,” who can obtain a “fresh start” by distributing available assets to creditors and discharging debts left unpaid.³

It should be noted that a debtor seeking a remedy for all his financial woes through bankruptcy is not guaranteed a solution. A debtor can have his or her case dismissed for acting in bad faith prior to or during the bankruptcy proceeding. Additionally, not all types of debts are subject to discharge. Types of claims that are nondischargeable include claims for child support, alimony, and funds obtained by fraud. While state law determines the validity of a creditor’s claim, nondischargeability is governed by federal law in the Bankruptcy Code.

In contrast to the commonly known Chapter 7 liquidation and Chapter 13 reorganization processes often utilized by individuals, Chapter 11 bankruptcies are primarily selected by large businesses seeking to reorganize debts and continue operating but can also be a remedy for individuals with large debts. Where the analysis of an individual’s estate may often be clear for the vast majority of no-asset Chapter 7s, and the processes in place in various courts well-defined for Chapter 13s, simplicity is not the general rule in Chapter 11 cases. This chapter, which addresses oil and gas leases and their treatment in Chapter 11, will highlight that the myriad issues are anything but clear.

Chapter 11 of the Bankruptcy Code is commonly used by large companies in their quest to remain in possession of assets and continue to operate while reorganizing their financial affairs. The Bankruptcy Code provides the debtor with some measure of flexibility in reorganizing its financial affairs. The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.⁴ The heart of this provision is to enable the parties to negotiate and reach a settlement that will avoid greater losses and, through the reorganization, minimize the adverse consequences that financial failure causes to many people.

³ See *In re Jahrling*, 816 F.3d 921, 924 (7th Cir. 2016) quoting *Grogan v. Garner*, 498 U.S. 279, 286–87, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991).

⁴ See H.R. Rep. No. 95-595, p. 220 (1977).

When a bankruptcy is filed, an estate is created that consists of all property and property interests of the debtor, with limited exceptions.⁵ This principle is axiomatic, but here is a case decided not long after the Bankruptcy Code took effect that sets out the general rule:

The defendant's contention that a distinction exists between the property of the debtor and the estate of the debtor is without merit. There can be no estate prior to the filing of a petition in bankruptcy. The commencement of such a case creates an estate which is made up of all legal or equitable interests of the debtor in property. 11 U.S.C. s 541(a)(1). Thus, when one enters bankruptcy, the property of the debtor is the property of the estate.⁶

An individual debtor has choices when seeking bankruptcy as a solution to his financial woes. Under Chapter 13, an individual develops a plan to repay all or almost all of his debts under a payment plan. This payment plan allows the debtor to remain in possession of all or almost all of his assets and stops any existing foreclosure actions. A debtor seeking a solution under Chapter 7 will keep all of his exempt assets but will have his non-exempt assets liquidated to pay creditors. Chapter 7 is open to individuals and companies as long as certain other requirements are met.

Prior to undertaking a deeper analysis of treatment of oil and gas interests, it is important to distinguish between the varying types of oil and gas interests which may come before our bankruptcy courts. Oil and gas interests that may be analyzed, and to differing results, are often considered in three general categories: (1) mineral ownership interests; (2) working interests in a lease; and (3) royalty interests. Understanding the differences in these interests is important to bankruptcy law because what constitutes "property of the estate" is governed by federal law, but what constitutes "an interest in property" is governed by applicable non-bankruptcy law. So whether an interest under a lease becomes property of the estate is of the utmost importance to a determination of what disposition may be made of that interest.

⁵ 11 U.S.C. § 541.

⁶ *In re A. J. Nichols, Ltd.*, 21 B.R. 612, 614 (Bankr. N.D. Ga. 1982).

Property interests are created and defined by applicable non-bankruptcy (that is, generally, state) law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a state serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving “a windfall merely by reason of the happenstance of bankruptcy.”⁷ “The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.”⁸

§ 9.02. Oil and Gas Agreements and Interests.

One of the most important, yet most difficult, question regarding a Chapter 11 bankruptcy as it relates to oil and gas leases is the application (or non-application) of Section 365 of the Bankruptcy Code. Section 365 is titled “Executory Contracts and Unexpired Leases.” On its face, from the title alone, one may be led to believe that the underlying provisions of this section would contain all the answers necessary for the application of bankruptcy to oil and gas leases that are still in effect. They are, after all, “unexpired leases.” And the very first provision of the section gives a clear and distinct ability to the trustee in bankruptcy, subject to the court’s approval, to either assume or reject any executory contract or unexpired lease of the debtor.

It is no surprise that the interpretation and application of section 365 has become a topic of concern. The oil and gas leases of an exploration and production company (E&P Company) are the underlying assets through which everything else functions. Without valid leases, there are no rights to operate producing wells, and no established leasehold by which to pursue more exploration for future producing wells. In short, there is no way to produce revenue. The leases are the base assets by which E&P Companies

⁷ Lewis v. Mfgs. Nat’l Bank, 364 U.S. 603, 609 (1961), 81 S. Ct. 347, 350, 5 L. Ed. 2d 323.

⁸ Butner v. United States, 440 U.S. 48, 54-55, 99 S. Ct. 914, 917-18 (U.S. 1979) (footnotes omitted)(superseded in part on other grounds by Pub. L. 103-394).