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Dealing With Fractional Oil, Gas Interests In Bankruptcy

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As depressed oil and gas commodity prices inevitably lead to difficult times and ultimately bankruptcy for some borrowers in the oil and gas industry, the structure of debtors' financing arrangements will come under scrutiny. One issue that arises with respect to oil and gas financings is whether transactions involving fractional oil and gas interests effectuate true property conveyances or are simply disguised loans in which the oil and gas interest is not actually conveyed. Another is the scope of protection provided by a safe harbor in the Bankruptcy Code concerning certain fractional oil and gas interests. Decisions from a bankruptcy winding through the Southern District of Texas provide insight into both issues.

Fractional Oil and Gas Interests

During an oil or gas production project, a mineral estate can be — and frequently is — split into a number of fragments called fractional interests. Typically, an exploration and production (E&P) company will enter into a lease with a mineral estate owner (who may or may not also own the surface estate) for the exclusive right to drill for and produce hydrocarbons for a period of time. This leased portion of the estate is known as the "working interest."

The owner of the mineral estate usually retains a "royalty interest" — a share of the production, or its monetary equivalent, free of operational costs. An E&P company holding a lease can in turn carve out any number of additional fractional interests from its working interest. Some of the most common carveouts are:

- *Overriding royalties* — a portion of all production obtained during the term of the lease;

- *Production payments* (also called "oil payments") — specified volumes of production or sums derived from the sale of produced oil or gas; and

- *Net profits interests* — a share of gross production measured by the net profits from the operation of the property.

The ability to convey and encumber these fractional interests is critical to financing oil and gas projects.

For example, farmout arrangements (in which an operator owning one or more leases agrees to assign some or all of the leased acreage to another operator who conducts the drilling operations) often rely on overriding royalties interests. And production payments are such a frequently used component in financing transactions between E&P companies and banks that the Office of the Comptroller of the Currency has issued specific guidance to examiners on the topic. See Office of the Comptroller of the Currency, Oil & Gas Production Lending: Comptroller's Handbook (Apr. 2014).

Recharacterizating in Bankruptcy

An issue that has received lots of recent attention in the oil and gas world is the possibility that a bankruptcy court might recharacterize a conveyance of property by the debtor as a loan. Property that appeared to have been transferred out of the estate could remain in the debtor's estate, and a party that believed it owned oil and gas property could suddenly find itself lumped in with unsecured creditors and out millions of dollars.

The Texas ATP case

The current interest in the recharacterization of oil and gas interests comes from a 2014 Texas bankruptcy case, NGP Capital Res. Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.), No. 12-36187, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014). In In re ATP, the debtor, ATP, entered into a transaction whereby it appeared to covey a limited term overriding royalty (ORRI) interest to a finance company, NGP, in exchange for $65 million. Unlike the typical ORRI, which entitles the owner to a share of hydrocarbons produced or the monetary equivalent, the ORRI given to NGP required ATP to pay an amount that equaled a specified return on the original amount paid to purchase the ORRI.

The crux of the ATP decision was whether the purported ORRI transaction should be recharacterized from a real property conveyance to a debt financing as a matter of law. The court looked to the governing Louisiana state law to determine if the transactions should be recharacterized in this manner. The court analyzed the existence of material factual issues concerning whether the transaction was (a) inconsistent with an overriding royalty interest under Louisiana law, and (b) consistent with a loan under Louisiana law.

Facts Inconsistent with Outright Conveyance of an ORRI

The court identified two provisions that it believed could be inconsistent with an ORRI under Louisiana law. First, NGP agreed to subordinate its interest to another party. Second, ATP's payments were subject to an interest rate with a specified return on investment such that increased revenues to ATP from the sale of hydrocarbons would result in faster repayment and thus a lower overall payment to NGP over the term of the ORRI. The court noted that "[t]he fact that increased revenue from the properties leads to a decrease in NGP's income appears to be at odds with real property ownership."

Facts Inconsistent with a Loan

Considering whether the transactions were inconsistent with a loan under Louisiana law, the court found that the contingent nature of the royalty payments (i.e., that they were based upon production) and the potentially unguaranteed rate of return were inconsistent with loan terms under Louisiana law. However, the court dismissed these issues as potentially “artificial” since the low risk of nonpayment could make NGP’s rate of return effectively guaranteed.

The court concluded its opinion with a summary analysis of the circumstances that made the transaction appear vulnerable to recharacterization: (1) both parties treated the NGP transaction like a loan and NGP represented it as one to the public; (2) the parties agreed to treat the transaction as a mortgage loan for federal tax purposes; (3) the transaction appeared to fall within the meaning of a loan under several accounting standards, including generally accepted accounting principles; (4) the risk of nonpayment was potentially so low that ATP effectively had an unconditional obligation to repay; and (5) since NGP was a third-party purchaser of the production payment, its interest rate reflected a risk-mitigating measure more similar to a loan than a real property purchase.

Although the case settled before the court resolved the issue, if the ATP court ultimately recharacterized the ORRI conveyance as a disguised financing, then NGP might have ended up as a mere unsecured creditor, likely recovering pennies on the dollar, unless some other means of excluding the ORRI from the debtor’s estate existed. One bankruptcy safe harbor seems like a possible candidate.

The Bankruptcy Safe Harbor

Section 541(b)(4)(B) of the Bankruptcy Code is a safe harbor provision that protects assignees of production payments (or overriding royalties) from having their oil and gas interests included in the bankruptcy estate. Section 541(b)(4)(B) provides, in pertinent part:

Property of the estate does not include —
...
(4) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that —
...
(B)
(i) the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation of the property from which such production payment is transferred; and
(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 542 of this title.

While the ATP court did not address the 541(b)(4)(B) safe harbor provisions in its January 2014 order regarding NGP, in an opinion entered on March 10, 2015, Tow v. HBK Main St. Invs. LP (In re ATP Oil & Gas Co.), No. 12-36187, 2015 Bankr. LEXIS 781 (Bankr. S. D. Tex. Mar. 10, 2015), the court held that the Section 541 safe harbor does not apply to disguised debt instruments.

In the Tow case, the trustee sought judgments under Section 550 of the Bankruptcy Code for preferential and fraudulent transfers and unauthorized post-petition payments from the debtor to production payment assignees under the theory that the production payment agreements were really disguised loan agreements that had not transferred title to the defendants. The defendants moved to dismiss the cases, claiming that they were protected by the safe harbor provision of Section 541(b)(4)(B). As an initial matter, the court ruled that to the extent that Section 365 (which concerns executory contracts) applied, the defendants were protected by the safe harbor. The remainder of the opinion focused on whether Section 542, which concerns turnover of property of the estate held by other parties, was applicable.

The court found that, while the definition of “production payment” under the Bankruptcy Code was broad enough to include an interest in hydrocarbons that served as security for a nonrecourse secured loan, since under a traditional financing transaction the debtor remained in possession of the collateral (as long as it was not seized by the lender), there was nothing for the lender to “turn over” under Section 542. The court went on to state that regardless of whether the underlying transactions were considered a loan or a transfer of title, Section 542 would be inapplicable.

In the former situation, the debtor would remain in possession of the collateral as of the petition date and therefore no property would need to be "turned over" under 542; in the latter, the production payment assignee would have legal title to the property and therefore would not hold property of the estate that would be subject to turnover. The court therefore denied the motions to dismiss.

This opinion begs the question of who does enjoy protection from the 541(b)(4)(B) safe harbor? First, it is those who have executory contracts or leases with the debtor and are therefore subject to Section 365. Second, the safe harbor would apply to parties in possession of estate property but who do not hold title to that property. The Tow court gave the example of an intermediary disbursing agent holding production payments that were property of the estate (which perhaps would include a first purchaser of oil and gas at the wellhead obligated to make distributions pursuant to a division order). This constricted view of the Section 542 portion of the safe harbor may run counter to some of the statute’s legislative history and the expectations of practitioners and commentators in the area, but the judge believed it was required by the plain language of the statute.

In light of the risk posed by recharacterization and the potentially narrow scope given to the Section 542 safe harbor, parties intending to transfer a fractional oil and gas interest (especially the recipient of such an interest) should be wary of terms that could be used in bankruptcy to argue that the transaction is in fact a loan.

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