Schulte Roth & Zabel

Distressed Investment Opportunities in Oil and Gas

Wednesday, March 25, 2015

About the Speakers

Guest Speakers

Timothy Fording
Managing Director
Cerberus Capital Management, L.P.

Tim rejoined Cerberus in January 2013. Prior to rejoining, he helped to create CorePointe Capital Finance, a specialty finance company focused on the capital needs of middle market companies, and co-headed the company while also serving on its Investment Committee from inception in July 2010. Prior to forming CorePointe, Tim spent over 12 years working for Ableco Finance LLC and Cerberus Capital Management, where he focused on direct lending, serving in a number of different capacities including origination, underwriting and portfolio management. Prior to joining Cerberus, he worked for Creditanstalt and Congress Financial. Tim is a graduate of Georgetown University.

Lance Gilliland
Managing Director
Tudor, Pickering, Holt & Co.
+1 713.333.7110 | lgilliland@tphco.com

Lance is responsible for Tudor, Pickering, Holt & Co.'s merger and acquisition activity, with particular focus on public company transactions, board and special committee advisory engagements, and cross-border and joint venture transactions. He also manages the infrastructure sector team. Previously Lance was with Goldman Sachs in Houston, New York and Menlo Park, Calif.

SRZ Speakers

Kirby Chin
Partner
New York Office
+1 212.756.2555 | kirby.chin@srz.com

Kirby focuses his practice on financing and debt transactions. He has substantial experience representing clients in transactions involving private and public debt financings, working with special distressed asset situations, and structuring and executing multi-layered debt tranches. Kirby represents finance firms, public and private companies, and hedge and private equity funds on matters that have included debtor-in-possession and exit financings; workouts and restructurings; private equity portfolio financings, including acquisition and leveraged buyout financings; traditional asset-based and working capital financings; cash flow financings; factoring and related transactions; term "B" financings; second lien and first-out/last-out financings; investment fund financings, including fund-of-funds financings; capital call and liquidity facility transactions; and subordinated and mezzanine debt offerings. He recently represented a U.S. finance company as agent in a syndicated senior secured revolving credit financing facility to a privately owned independent exploration and development company operating in the Appalachian region and an investment fund in a senior secured split collateral term loan financing facility to a firearms manufacturer. Kirby is also a member of the firm's Energy Group and Distressed Investment Group.

Kirby has been recognized by *The Legal 500 United States*, a listing of top lawyers by practice area. A member of the American Bar Association and the Commercial Law and Uniform State Laws Committee of the New York City Bar Association, he is often invited to speak at industry events. He most recently presented on energy funds as a new growth area for private investment funds, and on the annual financing and lending outlook for distressed markets.

Kirby earned his J.D. from New York University School of Law, where he served on the *Journal of International Law and Politics*, and his B.A., *cum laude*, from New York University.

Robert Goldstein
Partner
New York Office
+1 212.756.2519 | robert.goldstein@srz.com

Rob's practice focuses on private equity and leveraged buyout transactions, mergers and acquisitions, PIPE transactions, and capital markets and general corporate representations. Some of Rob's recent mergers and acquisitions representations include Baker & Taylor Inc. in the sale of its warehouse and marketing businesses to Readerlink Distribution Services LLC and the sale of an academic library business to EBSCO Information Services; Pouschine Cook Capital Management LLC in its sale of Great Lakes Caring Home Health & Hospice to Wellspring Capital Management; private equity fund Castle Harlan Partners V LP in its acquisition of Gold Star Foods Inc.; NextMedia Group Inc. in its sale of 33 radio stations to Digity Inc. and its separate sale of its outdoor advertising business to Lamar Advertising Co.; the sale of Pretium Packaging Corporation to GenStar Capital; Morton's Restaurant Group Inc. in its sale to affiliates of Tilman J. Fertitta; the sale of Ames True Temper to Griffon Corporation; the sale of Associated Packaging Technologies to Sonoco Inc.; and NewPage Corp. in its acquisition of the North American business of Stora Enso Oyj.

Rob has been recognized by *The Legal 500 United States* as a leading lawyer handling private equity buyouts and is often invited to write and speak on topics of interest to the industry. He authored "Distressed M&A: Lots of Distress and Not Much M&A — But Some Interesting Opportunities for Creative Private Equity Dealmakers" for *SRZ Private Equity Developments*, and he recently presented on minimizing post-acquisition disputes in private equity dealmaking and energy funds as a new growth area for private investment funds.

Rob received his J.D., *cum laude*, from Tulane University School of Law, where he served as executive editor of the *Sports Lawyers Journal* and was elected into the Order of Barristers, and his B.A. from Columbia University.

David J. Karp
Partner
New York Office
+1 212.756.2175
London Office
+44 (0) 20 7081 8048
david.karp@srz.com

David leads the firm's Distressed Debt & Claims Trading Group. He provides advice in connection with U.S., European, emerging market debt and claims trading matters, special situations and distressed investments, and distressed mergers and acquisitions. David frequently represents broker-dealers, hedge funds and private equity funds in connection with investments in distressed, non-performing assets and NPL portfolios across a wide range of industries and in jurisdictions across the globe. He also advises investment funds in connection with oil and gas royalty investments and leases and distressed energy credit investments. His recent energy representations include investors in Sabine Oil & Gas Corporation, Stallion Oilfield Services Ltd., Seahawk Drilling Inc., ATP Oil & Gas Corporation and Trident Resources Corporation.

Recognized as a leading lawyer by *New York Super Lawyers*, and by the founder of Reorg Research as "undoubtedly one of the best in the field at what he does: making sure funds and their investments are protected when transacting and executing trades in distressed debt and claims," David is an active member of the American Bankruptcy Institute, Loan Market Association, Asia Pacific Loan Market Association, INSOL Europe, Emerging Markets Trade Association, National Association of Royalty Owners and the Loan Syndication and Trading Association. He is a frequent author for *The Hedge Fund Law Report*, *Bloomberg*, *The Bankruptcy Strategist* and *Corporate Rescue and Insolvency*, and he recently wrote articles including "Structuring Winning Bids: European NPL Portfolio Transactions" and "Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations."

David earned his J.D. from Fordham University School of Law and his B.S. from Cornell University.

About SRZ

About SRZ's Energy Practice

Schulte Roth & Zabel's Energy Practice advises some of the world's top alternative asset managers in connection with oil and gas, coal, and the chemical and electric industries. We meet the investment fund and transactional needs of our clients by advising on sophisticated energy-related mergers and acquisitions, divestitures, proxy contests, workouts and restructurings, capital markets transactions, real estate transactions, distressed investments, tax issues with U.S. and non-U.S. capital, and the development and trading of new and complex financial products.

Our clients benefit from SRZ's premier practice in investment management, which allows us to provide unparalleled advice to energy-focused asset managers. Our lawyers are leaders in the industry, and we have a substantial and well-regarded private equity practice. We authored the leading treatise *Private Equity Funds: Formation and Operation* and partnered with Private Equity International to release *Fund Formation and Incentives Report*, a research study of senior private equity managers. A report released by *Hedge Fund Research Inc.* ranked SRZ as the top legal service provider for hedge funds based on assets under management, and we were named Investment Funds – Alternative/Hedge Funds Law Firm of the Year by *The Legal 500 United States* and the Leading Law Firm for New Fund Launches at The Hedge Fund Journal Awards 2014. We also possess extensive regulatory, employment and ERISA experience, and have a proven track record of success in federal and state litigation and arbitration proceedings.

SRZ's oil and gas experience extends to each link of the value chain. We have advised on upstream transactions covering exploration and production; midstream transactions dealing with gathering, storage, transportation and processing; and downstream transactions that involve refining, marketing, petrochemicals trading and derivatives, transportation and shipping.

Our lawyers are consistently recognized by *Chambers, The Legal 500* and *IFLR1000*. We have worked on numerous award-winning deals, including the M&A Atlas Awards' North America Private Equity Deal of the Year and the M&A Advisor's M&A Deal of the Year. Two of our partners were recently named 2014 Dealmakers of the Year by *The American Lawyer*, and our lawyers frequently publish in their areas of expertise, including the recent SRZ publication *Hot Topics in Coal Company Bankruptcies*, which provides an overview of the unique legal challenges coal companies face as they attempt to restructure their obligations. We are often placed at the top of league tables, such as the most current bankruptcy league table published by *The Deal* and the new WSJ-FactSet Activism Scorecard list ranking top law firms for advising on activist campaigns.

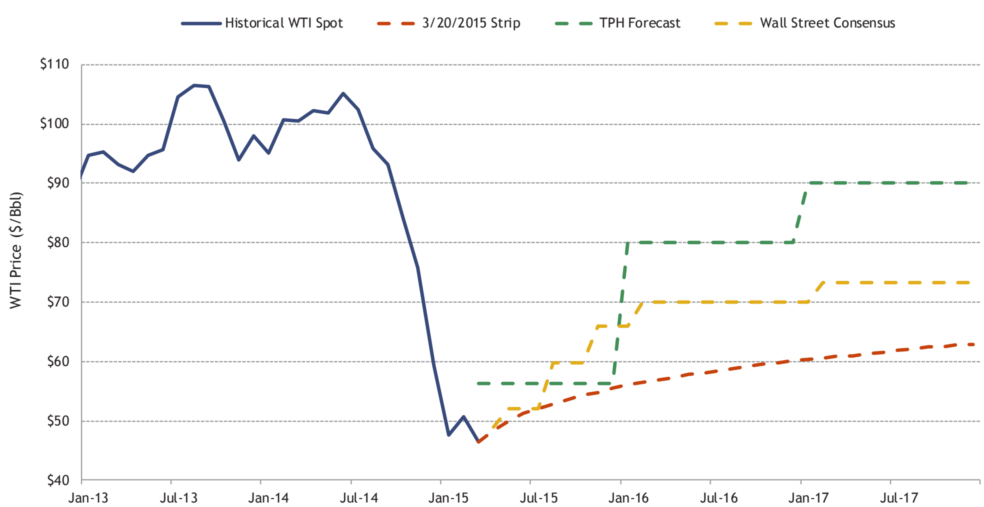
Presentation

Market Overview

Deal Environment and
Commodity Price Outlook

Schulte Roth&Zabel

WTI Historical Performance — Commodity Prices at Multi-Year Lows



Source: TPH Research, Bloomberg, FactSet as of 3/20/2015.

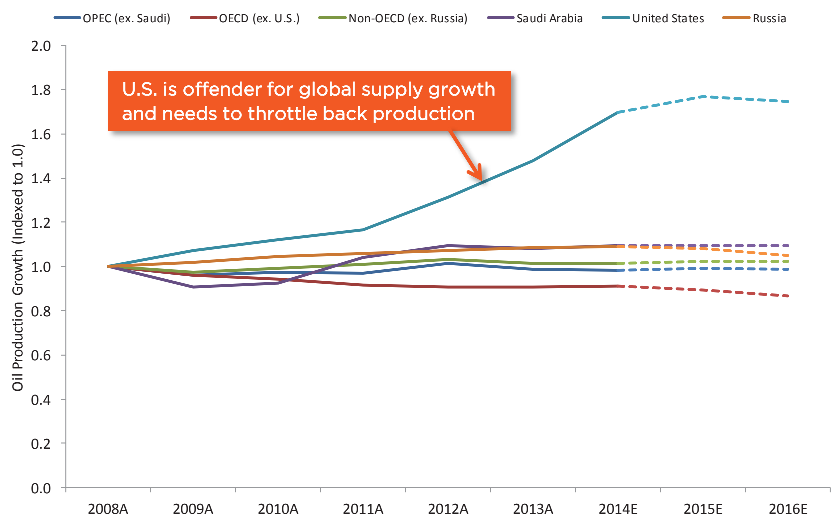
Schulte Roth&Zabel

TUDOR PICKERING HOLT & CO

Distressed Investment Opportunities in Oil and Gas

U.S. Caused This Problem...U.S. Will Fix It

Oil Production Growth by Country/Region



Is There a "Bullish" Case for Oil? — TPH Research Oil Forecast Update

	2015	2016	2017	2018	2019	2020
March '15 WTI Forecast	$56.25	$80.00	$90.00	$90.00	$90.00	$90.00

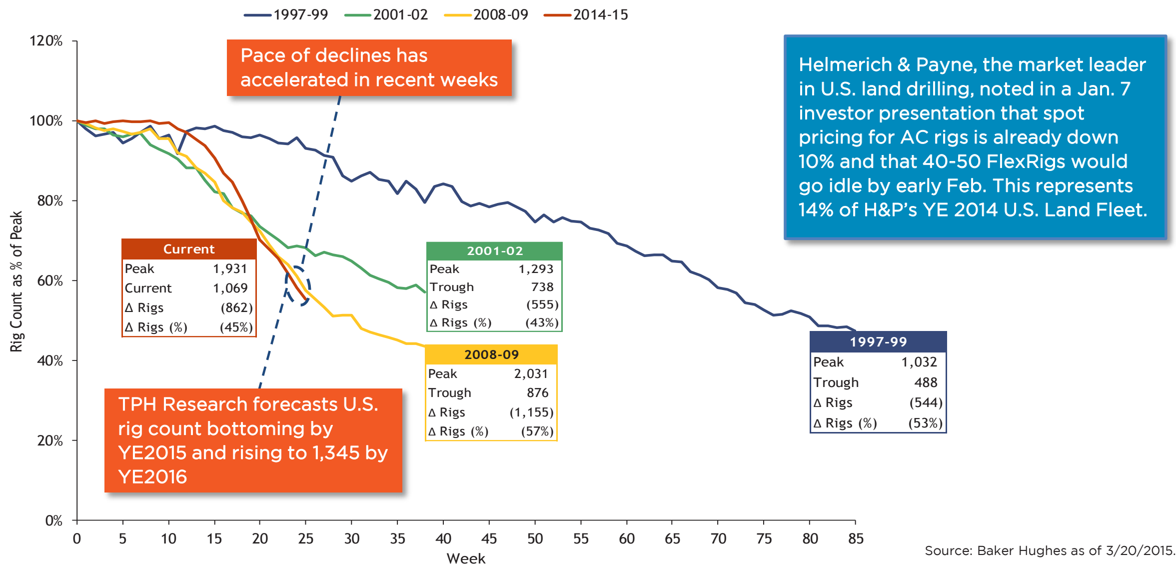
Key Takeaways

- U.S. rig drop pulls global supply/demand into balance by 2016
  - Oil price moves off lows Q3 2015 as supply growth taper becomes increasingly visible
  - ~800 rig drop in expected 2015 U.S. rig count drives move from growth to a 2016 contraction in US oil production
  - 1.5mmbpd of 2014 U.S. supply growth drops to 350kbpd in 2015
  - Supply growth transitions to contraction by 2016 averaging 250kbpd drop over the year
- Net impact of global prod. growth/declines augments U.S. changes

The Case For Recovery

- With no increase in 2016 U.S. activity, 2017 global market tight
  - $80/bbl 2016 price forecast drives a ramp back up in 2016 rig activity with nearly 300 rigs going back to work vs 2015
  - E&Ps not likely to add incremental rigs to their 2016 programs without a strong price signal
  - If 2016 rig activity stays flat y/y...global demand growth would need to be non-existent for the next 3 years for the market to balance

Relative Velocity of Recent Rig Count Declines



Schulte Roth & Zabel | Tudor Pickering Holt & Co

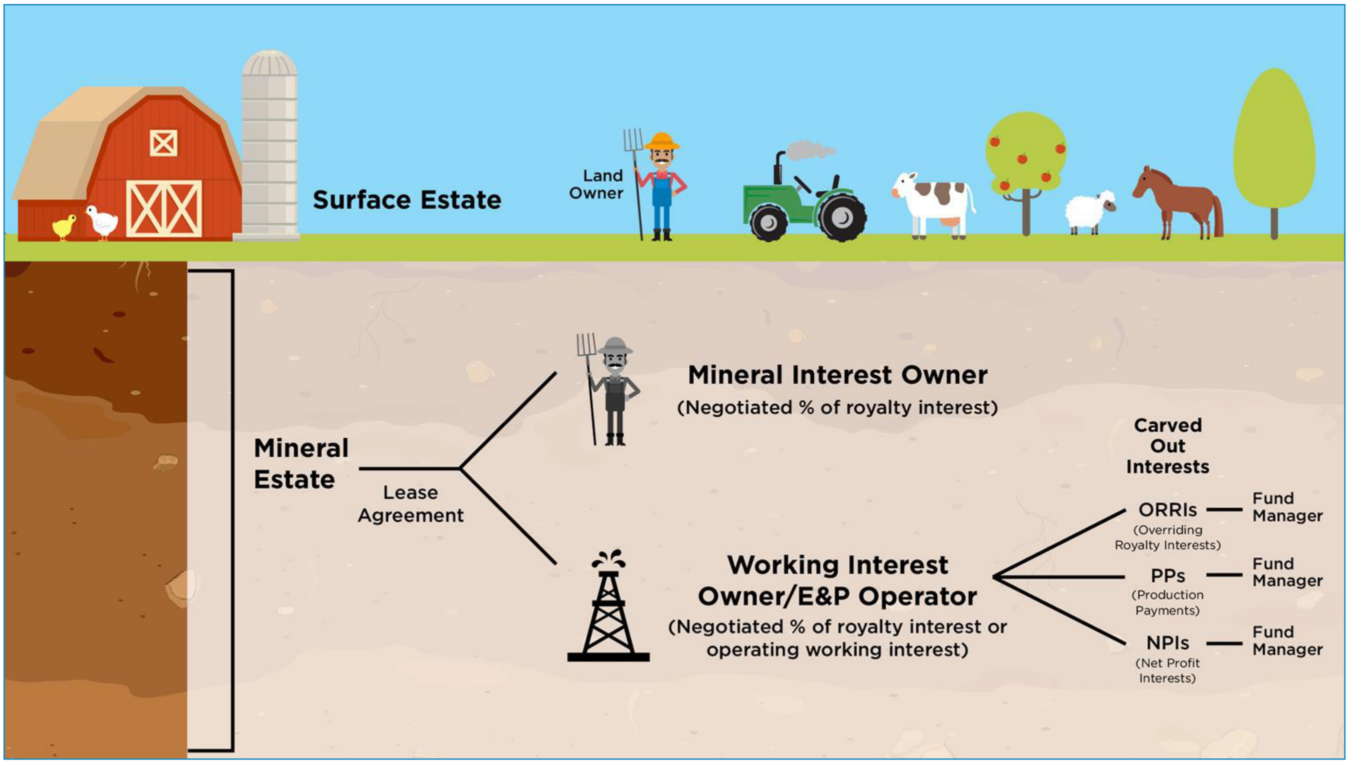
Distressed Investment Opportunities in Oil and Gas

Market Overview

Basic Terms and Players

Schulte Roth & Zabel

Distressed Investment Opportunities in Oil and Gas



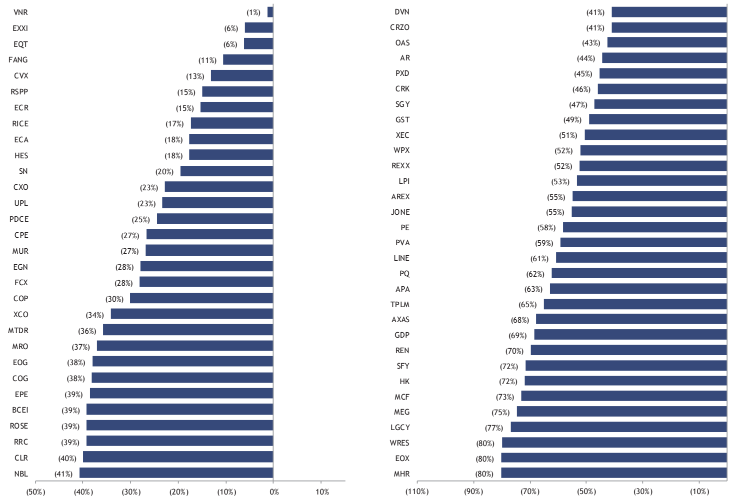
Market Overview

Impact of Drop in Oil and Gas Prices on E&P

SchulteRoth&Zabel

Distressed Investment Opportunities in Oil and Gas

Significant Reductions in Drilling Activity — 2015E vs. 2014E Capital Spending



Capex is expected to decline 43% on average in 2015; though production will still grow 19%

Source: TPH Research, company filings.
Based on March 2015 capital budget revision.

Schulte Roth&Zabel

TUDOR PICKERING HOLT & CO ENERGY INVESTMENT & MERCHANT BANKING

Distressed Investment Opportunities in Oil and Gas

Market Overview

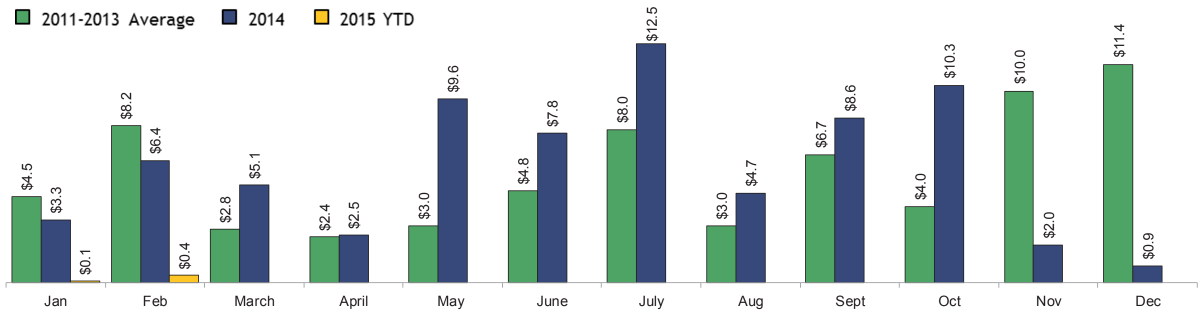
M&A Opportunities

Schulte Roth&Zabel

Distressed Investment Opportunities in Oil and Gas

What Has Been Impact on U.S. M&A Market? — Activity Has Slowed in Wake of Commodity Price Declines

...Volume Down Materially in 4Q 2014 and 1Q 2015($Bn)



Sources: IHS Herold, PLS, company press releases, FactSet. Note: M&A volumes include U.S. deals with announced transaction values >$50 million. (1) Excludes private equity transactions.

Market Overview

Credit Market Observations

Reserve-Based Lending Market — Overview and Outlook

- Senior secured; dominated by large banks with in-house engineering staff
- Historical effective advance rates range from 60-75% of the PV-10 value of Proved Developed Producing (PDP) Reserves with pricing ranging from L+1.5% to L+4.0% with no floors
- Availability typically based on review of third-party reserve reports and use of price deck discounted off of WTI oil prices and NYMEX natural gas prices
- Borrowing Base re-determinations occurring in late March – early April (based on reserves as of 12/31/14) will set the tone for how banks react to the commodity price downturn
  - Banks have generally signaled a benign approach to allow breathing room to E&P borrowers for the current re-determination
  - Availability will likely shrink for most, but not severely for most borrowers
  - Amendments likely available with covenant relief ranging from 6 to 12 months
- Current market consensus is that banks will likely take a harder line and revert to typical metrics for the September/October re-determination (based off of mid-year reserves) if prices remain at or near current depressed levels

Financing Options for Distressed E&Ps

- The capital markets are still open for larger issuers, but will be more selective and expensive with less tolerance for CapEx exceeding free cash flow. Supply of capital seeking low-mid teen yields and exposure to energy recovery is relatively high.
- New fund formation has also been announced recently by funds bullish on energy-related opportunities in the debt and equity markets.
- **Who will provide capital to stressed and distressed companies?**
  - Alternative Non-Bank Lenders
  - Hedge Funds — Energy-focused, Credit Opportunity and Special Situation funds
- **What structures will likely be available?**
  - Second Liens – both Broadly Syndicated (larger credits) and Club Deals/single lender deals
  - Amended and Restated First Lien Revolvers — Acquire Revolver and restructure to fit situation
  - Volumetric Production Payments
  - Reversionary Interest deals — Potential capital for new drilling

Schulte Roth & Zabel   Cerberus Capital Management, L.P.   Distressed Investment Opportunities in Oil and Gas

High Yield Energy Universe

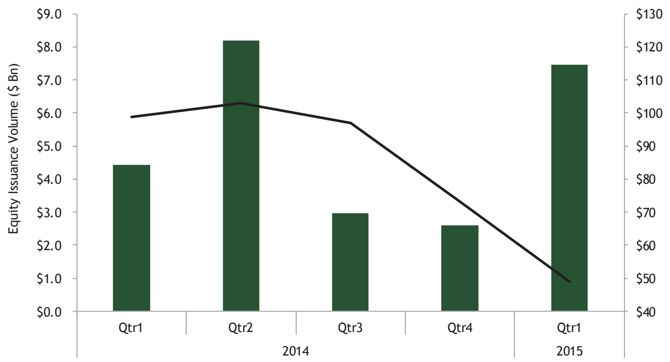
- The High Yield energy universe has traded down sharply as a result of the current and forecasted impact of recent commodity price declines.
- Based on estimates from various trading desks, there are 93 HY issues trading at 80 or lower with aggregate face values of approximately $50 billion.
  - E&P: 71 issues trading at or below 80 with face value of $40B (out of $121B, or 33%)
  - Services: 22 issues trading at or below 80 with face value of $10B (out of $29B, or 33%)
  - Total: 93 issues trading at or below 80 for $50B out of $150B
- The magnitude of the opportunity set has attracted many distressed and special situation investors, both energy-focused and generalists.

Transaction Issues

Senior Secured Reserved-Based Loans vs. Typical Senior Secured Debt

Right Time to Issue Equity?

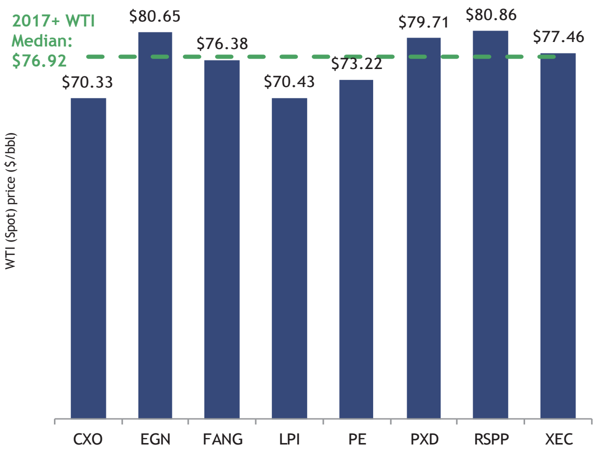
Current



Source: Dealogic, TPH Research, Company Filings, FactSet as of 3/20/2015.
Note: Includes U.S. offerings only.

How the Market Views Long Term WTI

Select Permian Producers



Source: Dealogic, TPH Research, Company Filings, FactSet as of 3/20/2015.
Note: Includes U.S. offerings only.

Schulte Roth & Zabel

Distressed Investment Opportunities in Oil and Gas

Distressed Counterparty Risk

Overriding Royalty Interest, Net Profit Interest, Production Payment

Schulte Roth & Zabel

Distressed Investment Opportunities in Oil and Gas

Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations

Schulte Roth & Zabel

Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations

By David J. Karp and Parker J. Milender

March 2015

Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations[1]

By David J. Karp and Parker J. Milender

As oil and gas prices decline and the availability of reserved-based senior credit becomes increasingly scarce, exploration and production ("E&P") companies are seeking to refinance into more traditional term loans or to divest royalties in an effort to raise cash. Whether acquired as part of a recent restructuring initiative or historical purchase, investors who own carved out royalty interests need to take inventory of counterparty risk and how these positions will be treated in a bankruptcy, including the potential risks of contract recharacterization or rejection and clawbacks of payments already received.

Investors were once generally confident that most types of carved out interests would be treated by bankruptcy courts as "true sales" of real property.[2] But recent case law suggests that while such transactions may be labeled "sales," in certain instances a court might instead recharacterize the carved out interest transactions as "financings" or "debt instruments." This distinction becomes critical if the E&P company that maintains the working interest files for bankruptcy. While carved out interests that were conveyed in a true sale will not be property of the company's bankruptcy estate, carved out interests that are recharacterized as financings will be brought into the bankruptcy estate — and the "purchaser" of those interests will become a creditor fighting for uncertain recovery under a plan of reorganization or liquidation via distributions from the estate.

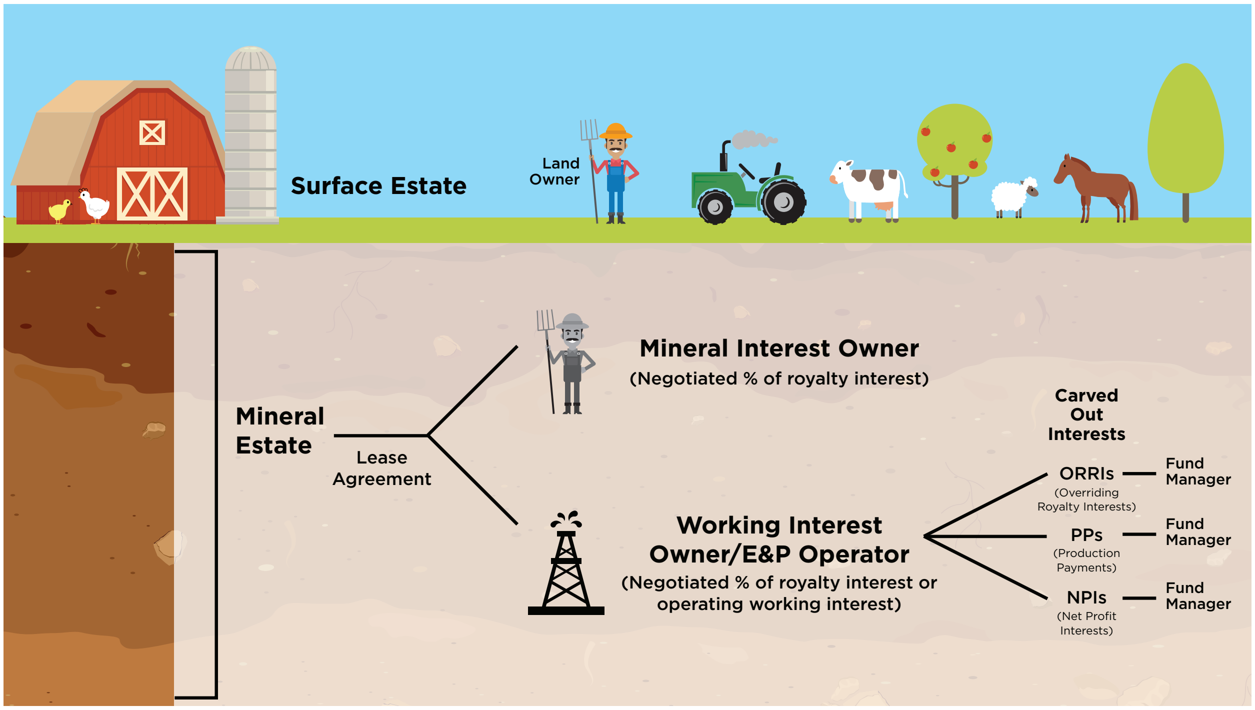
In the ongoing case *In re ATP Oil & Gas Corporation*,[3] the U.S. Bankruptcy Court for the Southern District of Texas denied a carved out interest investor's motion for summary judgment on the issue of whether conveyances of certain oil and gas carved out interests were true sales of real property or simply "disguised" financing transactions. The *ATP* case is still awaiting a final decision in the Bankruptcy Court, but the court's initial holdings should serve as a warning to investors that their carved out interest transactions may be scrutinized when an E&P files for bankruptcy.

Types of Oil and Gas Carved Out Interests

Before carved out interest transactions take place, a landowner — who often owns both the surface estate and the mineral estate — will lease a working interest in the mineral estate. The lessee of the working interest has the exclusive right to explore, drill and produce oil and gas from a specific tract of property.[4] The lessor or landowner retains a royalty interest, which is a percentage of oil and gas that is produced from the leased land and is generally free of the costs of producing the oil and gas; however, the landowner's royalty interest is often responsible for a share of post-production transportation, treatment and marketing costs.

The working interest includes the operating and non-operating working interests under an oil and gas lease. Non-operating working interests that are carved out include: overriding royalty interests ("ORRIs"), net profits interests ("NPIs") and production payments ("PPs").

On one side of a carved out interest transaction is the investor, who contributes capital in exchange for a financial interest in an oil- or gas-producing property and/or corresponding royalty payments. On the other side is the lessee-owner of the operating working interest in the property, who receives the investor's capital and subsequently distributes the agreed-upon royalty payments or proceeds to the investor. While carved out interests are all similar in this regard, they differ from one another in certain respects that may prove significant to investors when a lessee-owner becomes distressed.



Overriding Royalty Interests ("ORRIs")

An ORRI is an ownership stake in a percentage of production or production revenues from an oil- or gas-producing property. The investor's stream of payments from an ORRI is consistent in duration with the existing lease or working interest[5] and continues for so long as the working interest exists. However, investors may also negotiate for a "Term ORRI" with a shorter fixed duration.[6]

ORRIs are generally not subject to production expenses for the development, operation or maintenance of the property.[7] Production expenses are the costs associated with bringing oil and gas from the reservoir to the surface[8] and commonly include labor, equipment, drilling, pipe and well completion costs.[9] Production taxes may also be excluded for purposes of an ORRI.[10]

While ORRIs are generally free from production expenses, they are often subject to post-production expenses[11] that arise after the oil or gas is removed from the "wellhead,"[12] which generally refers to the point at the top or "head" of the actual well where the oil or gas is severed or removed from the ground.[13] Post-production costs are the expenses associated with rendering the gas "marketable" and include dehydrating, compressing and transporting the gas to the market, as well as extraction costs resulting from processing.[14]

Net Profits Interests ("NPIs")

An NPI is similar to an ORRI in that it is carved out of the working interest of an oil- or gas-producing property.[15] But NPIs differ in that they are measured by, and paid from, the net profits rather than the revenues realized from operation of the property[16] and are generally not free from either production expenses or post-production expenses — although post-production expenses can become a significant point of contention. For example, in *Lawrence v. Atlas Resources, Inc.*,[17] royalty interest owners alleged a breach of the terms of an oil and gas lease because, among other things, certain costs of transportation and compression were deducted on an allocated, rather than an actual, basis.[18]

NPI owners are thus subject to a level of operating performance risk that ORRI owners are not. For example, since NPI owners share in production expenses such as drilling costs, they may also assume a proportionate share of the costs associated with certain operational risks such as drilling cost inefficiencies. However, although NPI owners share in the costs of production, their liability is generally limited to their invested capital.[19]

Production Payments ("PPs")

PPs are a type of ORRI[20] and are likewise carved out of the working interest and paid out free from production expenses.[21] Additionally, PPs can be subject to termination if the lease or working interest expires.[22] The duration of PPs is generally fixed, however, and the PP will terminate once a pre-determined production amount or dollar amount from the sale of production is reached.[23]

PPs that terminate after a specified production amount is reached are called volumetric production payments ("VPPs"), while PPs that terminate after a specified production revenue amount is reached are called dollar denominated production payments ("DDPPs").[24] Since DDPPs give the carved out interest owner the right to receive a fixed dollar amount generated from the property (usually with a stated rate of interest),[25] DDPPs are generally less correlated with the market risks associated with commodity prices. Whether the property's production output (or the price of oil or gas) rises or falls, a DDPP owner is still contractually owed his or her fixed dollar amount subject to a fixed interest rate.

This structure can create situations in which if a DDPP owner is entitled to a contractually higher rate of interest for untimely (or missed) payments, he or she may be incentivized to hope for decreased production and/or commodity prices in order to receive slower payments and a higher rate of return. DDPPs are defined as "borrowings" by the Financial Accounting Standards Board ("FASB"), while VPPs are defined as "the transfer of a mineral interest."[26] The FASB does not consider VPPs to be borrowings; rather it considers them sales in which the entity's obligation is accounted for as an obligation to deliver, free and clear of all expenses associated with operation of the property, a specified quantity of oil or gas to the purchaser out of a specified share of future production.[27] This difference means that DDPPs may be more likely to be recharacterized as debt instruments than VPPs.

Characteristics	ORRI	NPI	VPP	DDPP
Carved out of working interest	✓	✓	✓	✓
Subject to pre-production costs	X	✓	X	X
Contractually-determined termination point	X	X	✓	✓
Greater production volume equals greater profitability	✓	✓	✓*	X
Sensitivity to commodity prices	✓	✓	✓	X**

*But not beyond the pre-determined quantum of production
**May benefit from decrease in commodity prices

True Sale or Disguised Financing?

In the *ATP* case, the defendant and working interest lessee (ATP) had conveyed to the plaintiff investor (NGP) more than $700 million worth of ORRIs and NPIs.[28] But after it was dramatically impacted by the 2010 Deepwater Horizon explosion and ensuing moratorium on drilling in the Gulf of Mexico,[29] ATP filed for Chapter 11 protection and disputed whether these carved out interests were true sales or disguised financings under applicable law.[30]

The court's analysis in *ATP* raises three major concerns for carved out interest investors:

- **The court's potential willingness to recharacterize a sale transaction as a financing agreement**. If a carved out interest is recharacterized as a financing agreement, the investor would become a creditor and the agreement would become part of the bankruptcy estate. As a result, the former expectation of a stream of payments from an ownership interest would yield to the reality of distributions (if any) under a plan of reorganization or liquidation.
- **State law definitions of real property interests**. Whether or not a court will recharacterize a sale transaction as a financing agreement is dependent on applicable state property laws, and the outcomes for carved out investors can vary by state.
- **The possibility of contract rejection pursuant to Bankruptcy Code Section 365, which allows a debtor to reject certain "executory contracts" entered into prior to the debtor filing for bankruptcy**. The applicability of Section 365 also depends on the applicability of the Section 541 "safe harbor."

Recharacterization

Perhaps the most important aspect of the *ATP* decision was the court's willingness to recharacterize the transactions notwithstanding the parties' unambiguous labels and statements of intent as contained in the contract.[31] Rather than analyzing the parties' subjective intent, the court instead chose to analyze the objective substance of the transaction.[32] This decision could have a profound effect on investors who believe they are purchasing a real property interest and even label it as such because the courts may choose to ignore labels and expressions of intent.

The *ATP* court is not alone in this regard. Other courts have also been willing to reject the transacting parties' labels and subjective intent in favor of examining the substance of the carved out interest transaction. For example, in *Tidelands Royalty v. Gulf Oil*, the U.S. Court of Appeals for the Fifth Circuit ignored the contracting parties' label and subjective intent in ascertaining the true legal nature of ORRI transactions and held that under Louisiana law, "The assignment of a lease with the retention of an overriding royalty creates a sublease, regardless of how the parties style their agreement."[33] Thus, parties seeking to avoid true sale versus financing issues should not rely solely upon labels or declarations of intent.[34] Rather, they should structure their transactions as true sales and avoid certain hallmarks of financing agreements such as fixed payment terms or other financial guarantees.

State-Specific Legal Considerations

Whether seeking exposure to the consistent production of the Haynesville Basin in Louisiana, the Eagle Ford, Permian and Barnett Basins in Texas, or potential stacked play returns of the Utica Shale and Marcellus Shale in Pennsylvania, investors must consider applicable state law property rights as part of the diligence process when investing in oil and gas carved out interests. Property interests are created and defined by state law,[35] and the particular state law applied by a bankruptcy court could be crucial in determining whether or not a conveyance of a carved out interest should be classified as a true sale of real property or a debt instrument.

Louisiana

Louisiana state law, the applicable state law in *ATP*, does not define an ORRI. The court therefore looked to generally accepted oil and gas law principles and Louisiana case law.[36] Under this framework, the court's default view was that ORRIs and PPs are "overriding royalties," classified as a "real right[s]" in "incorporeal immovable property."[37] The court nevertheless chose to characterize the royalty transactions based on their economic substance. In doing so, it highlighted the following characteristics as *being consistent with* (or not contrary to) a true sale of a real property interest under Louisiana law:

- **Reversionary Interest**. ORRI conveyances that revert to the grantor after the agreed upon condition is satisfied can be consistent with a true sale.[38]
- **Satisfaction of the Term Override from Multiple Properties**. In the conveyance at issue, a satisfaction provision that entitled NGP to the same stream of royalty payments until it reached its total sum — even if ATP lost one of its leases (i.e. cross-collaterization)[39] — was not viewed as being inconsistent with sale treatment.[40]
- **Burdens and Benefits of Ownership**. While failing to retain the "burdens and benefits of ownership" is generally inconsistent with ownership of a real property interest under Louisiana law,[41] the court did not find this problematic for an ORRI. Because Louisiana case law considers an overriding royalty to be a passive interest without the right to explore or develop a property,[42] it requires no general burden or benefit of ownership.

The court also identified several characteristics which are, or could be, *inconsistent with* a true sale of a real property interest (or consistent with a debt instrument) under Louisiana law:

- **Subordinated Interest**. NGP agreed to subordinate its interests to a third party, which was subsequently entitled to receive full royalty payments before NGP.[43] The court found an issue of material fact as to whether such a provision was consistent with a true sale under Louisiana law.[44]
- **Interest Rates/Payments Terms**. NGP paid a total amount of $65 million in exchange for an overriding royalty, which would terminate when the agreed upon "Total Sum" was paid to NGP.[45] The terms of the initial conveyance stated that if ATP was late in making its overriding royalty payments, it would be charged a default rate of interest.[46] The court found this arrangement to be inconsistent with a true sale for two reasons. First, since NGP would charge ATP a *higher* rate of interest if ATP failed to timely make its royalty payments, this could have the inverse effect of NGP receiving *more* money in periods of lower production or lower oil prices due to ATP's slower repayment.[47] Correspondingly, increased production from the properties would inversely lead to a *decrease* in NGP's royalty income due to a lower interest rate.[48] Second, the formula used to calculate NGP's "Total Sum" was based on a fixed annual rate of interest.[49] Therefore, fluctuations in oil and gas revenues due to changes in commodity prices or production would have only a "trifling impact" on NGP's rate of return.[50]
- **Resemblance to an Unsecured Loan**. NGP was due to receive a fixed "Total Sum" notwithstanding any fluctuations in commodity prices or volumetric changes in production.[51] Normally, such an agreement would not be considered a loan under Louisiana law because payment was not guaranteed; the conveyance stipulated that NGP "shall look solely to the Royalty payments for satisfaction and discharge of the Term Overriding Royalty, and [ATP] shall not be personally liable...."[52] However, the court noted that if the risk of non-payment is so low that repayment is effectively guaranteed, then the "condition" (that payments are distributed only if and when production occurs) is an artificial one.[53] Thus, an ORRI that is "virtually certain to be satisfied in full" could be construed as the economic equivalent of an "obligation to repay"[54] and not consistent with a true sale.

- **Foreclosure**. While the right to foreclose on the subject property was not an issue in the *ATP* case, the court recognized it as something that would be consistent with a mortgage or a security interest rather than a true sale of real property.[55] The court further noted that the foreclosure remedy includes having a receiver appointed to operate the properties,[56] although receivership would be permitted so long as NGP would have no control over whether to "sell the properties, continue production thereon, or to shut-in the properties that the receiver is permitted to control."[57] Thus, investors should understand the risks of having a foreclosure remedy — even through a receiver.

Texas

For carved out interest investors, Texas is generally friendlier than Louisiana or Pennsylvania (discussed below) because Texas courts allow for greater freedom of contract and will generally be less likely to recharacterize a carved out interest transaction. Under Texas state law, carved out interests are defined as ownership interests in land.[58] A Texas oil and gas lease is not a "lease" in the traditional sense of a lease of the surface of real property.[59] Instead, "[i]n a typical oil and gas lease, the lessor is a grantor and grants a fee simple determinable interest to the lessee, who is actually a grantee."[60] Thus, the default assumption in Texas is that conveyances of carved out interests are true sales rather than financing agreements.

But perhaps even more important to investors is Texas's jurisprudence on contract interpretation. Under Texas state law, the language in a contract must be given its plain meaning unless to do so would defeat the parties' intent.[61] When a written contract is clear and certain (i.e., labeled a "sale"), the instrument will be deemed to express the intent of the parties and will generally be enforced as written.[62] This freedom of contract allows the investor and the working interest owner to structure a carved out interest conveyance with a decreased risk of a court recharacterizing the transaction. For instance, Texas courts commonly define "royalty" as the landowner's share of production, free of all costs of development and production, but this general rule may be modified by the respective parties through agreement, a division order, or a gas purchase contract.[63]

Pennsylvania

Pennsylvania law provides perhaps the least clarity with regard to the treatment of carved out interests. Pennsylvania is unique in that prior to the discovery of oil or gas, the lease is merely a contract right under Pennsylvania law.[64] But if oil and gas is produced, the lease "springs" into a real property interest.[65]

This distinction could have a significant impact on carved out investors. For example, if no production of oil or gas has occurred, the working interest remains a mere contract right and the producer's bankruptcy estate may be able to reject (i.e., disaffirm) the working interest under Section 365 of the Bankruptcy Code (discussed below).[66] This could have a tremendous impact on investors because any carved out interests in this situation, even if conveyed in a true sale, would be effectively rejected along with the working interest. A carved out interest is coterminous with the working interest, and if the working interest is rejected under Section 365, so too are the associated carved out interests.

In the recent Third Circuit case *In re Mustafa Tayfur*, a Pennsylvania landowner and lessor under an oil and gas lease filed for bankruptcy and attempted to reject the lease pursuant to Section 365.[67] At the time of the lessor's motion to reject, the lessee still had not extracted any oil or gas from the property.[68] The Third Circuit affirmed the Bankruptcy Court's decision that rejection of the lease, while possible, was not in the best interests of the debtor-lessor's estate and therefore should be denied.[69]

While the *Tayfur* court ultimately did not permit the rejection of the oil and gas lease, the case is nonetheless probative of Section 365's potential power over Pennsylvania oil and gas leases in which extraction has not yet occurred. Further, *Tayfur* exemplifies the risk to carved out interest owners; if the lessee in *Tayfur* had carved out part of his working interest to investors, these carved out interests also could have been effectively rejected along with the working interest.

Executory Contract Rejection: Section 365 Versus Section 541

Under Section 365 of the Bankruptcy Code, a debtor's executory contracts and unexpired leases may be either assumed or rejected subject to the court's approval.[70] The Bankruptcy Code does not define "executory contract," but it is generally accepted that it is a "contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[71]

If a producer files for bankruptcy, the producer may be able to reject certain oil and gas leases if they are deemed to be executory contracts or unexpired leases. Section 365 may thus endanger future post-petition royalty payments to carved out interest owners.

The first concern for carved out interest owners is that their interest could be directly rejected under Section 365. The Delaware Bankruptcy Court dealt with this issue in the case of *In re Foothills Texas.*[72] Finding that the overriding royalty investor had fully performed under the contract by delivering valid consideration in exchange for the overriding royalty, the *Foothills* court held that the investor did not owe any remaining performance obligations under the agreement — therefore, the contract was not executory and not subject to rejection.[73] The court subsequently granted the investor's motion to dismiss.[74] While *Foothills* ultimately declined to allow Section 365 rejection of the overriding royalty interest, the case nonetheless illustrates that Section 365 should be on the minds of carved out interest investors as a potential concern.

One possible shield that carved out interest investors can use to protect themselves against executory rejection is the "safe harbor" under Section 541(b)(4)(B) of the Bankruptcy Code.[75] Congress enacted Section 541(b)(4)(B) to create uniformity in all states by treating "production payments" as conveyances of real property (i.e., true sales) in a bankruptcy.[76] "Production payment" is defined as "an interest in certain reserves of an oil or gas producer that lasts for a limited period of time and that is not affected by production costs"[77] — a definition that is likely to be inclusive of PPs and Term ORRIs, but not necessarily NPIs or non-Term ORRIs. The intent of Section 541(b)(4)(B) is to preclude certain royalties from being recharacterized and subsequently rejected under Section 365.[78]

It is possible that Section 541(b)(4)(B) would have rendered the court's analysis in *Foothills* moot since certain carved out interests may be statutorily precluded from being rejected; however, we have found no case to date that has addressed the Section 541(b)(4)(B) safe harbor. But similarly, while carved out interest investors should be wary of Section 365 rejection, there has also yet to be a notable instance of rejection in the carved out interests context.

The second concern for carved out interest owners is that their interest might be effectively (though not directly) rejected under Section 365. If the mineral owner/lessor and working interest owner/lessee are each separate entities (which is often the case) and the mineral owner/lessor subsequently files for bankruptcy, the carved out interest would not be subject to direct rejection because there would be no privity of contract between the mineral owner/lessor and the carved out interest owner; however, it could nonetheless be effectively rejected if the mineral owner/lessor rejects the working interest lease. Once the working interest lease is rejected, there would be no more revenue or production for the working interest owner/lessee to make royalty payments to carved out interest owners.

Whether an oil or gas working interest would be considered a "lease" that is subject to rejection, or a real property interest that is not subject to rejection, varies by state. As mentioned previously, an oil and gas lease in Texas is a fee simple determinable and therefore is not an executory contract that a debtor may accept or reject.[79] Thus, neither a carved out interest nor its underlying lease is likely to be subject to Section 365 rejection in Texas.

But Pennsylvania, with its aforementioned "springing" real property laws for oil and gas leases, might present an issue to carved out interest owners and owners of working interests/leases that have not yet produced oil or gas. Until production occurs, Section 365 will present a legitimate concern in Pennsylvania for both the working interest lessee and the carved out interest owner.

Louisiana carved out interest owners and working interest lessees may face even more uncertainty than those in Pennsylvania. The Louisiana courts are split as to whether oil and gas leases may be rejected pursuant to Section 365,[80] preventing investors from knowing for certain the likelihood of — or how to manage risk for — executory contract rejection pursuant to Section 365.

Preference and Fraudulent Conveyance Risk

A separate concern for carved out interest owners is preference and fraudulent transfer risk. Under Section 548 of the Bankruptcy Code ("Fraudulent transfers and obligations"), certain transfers or conveyances made by the debtor up to two years[81] before filing for bankruptcy, and up to four years in states like Texas and Pennsylvania can be avoided post-petition.[82] Transaction avoidance often arises from either the debtor's actual intent to hinder, delay or defraud its creditors, or from the failure to receive "reasonably equivalent value" in exchange for the transferred interest at a time when it was, or became as a result of the transfer, insolvent.[83] Thus, if a carved out interest is transacted within four years of a producer's bankruptcy, it may be subject to a fraudulent transfer "clawback" to recover the distributed proceeds or property if reasonably equivalent value was not received while the debtor was insolvent, or if actual intent is proven.

In the *ATP* case, for example, the Official Committee of Unsecured Creditors of ATP filed a motion requesting authority to bring a fraudulent transfer action against NGP, alleging that ATP did not receive reasonably equivalent value in exchange for the ORRIs.[84] The court abated the motion and decided that it would bifurcate consideration of the fraudulent transfer claims into a "Second Phase" of the Adversary Proceeding.[85] To date, the Second Phase of the *ATP* case has not begun.

Section 547 of the Bankruptcy Code ("Preferences") similarly permits the avoidance of certain pre-petition transfers of the debtor's property interests to creditors.[86] Section 547 is designed to prevent the preferential treatment of some creditors over others during the period immediately prior to bankruptcy. But unlike fraudulent transfer avoidance, the reach back period for preference payments is 90 days before filing for bankruptcy, or one year if such transfer was made to an insider.[87]

A case that illustrates the risk of carved out interest payments being attacked as preferential is *In re Rancher Energy*. In *Rancher*, the plaintiffs sought (i) to recover ORRIs and an NPI as constructive fraudulent transfers under Section 548 and Wyoming and Colorado state laws, and (ii) to avoid ORRI and NPI payments after a certain date as preferential transfers under Section 547.[88] The defendants in *Rancher* moved for summary judgment on both claims, but the court denied both motions citing "material disputes" regarding both the preference claim and the fraudulent transfer claim.[89] The case was settled before the court could rule on the merits of the preference and fraudulent transfer actions.

Given these concerns, carved out investors must be mindful of bankruptcy risks whether their interests are categorized as leases or true sales of real property. If a carved out interest (or the underlying working interest) is categorized as a lease under state law — or recharacterized as such by a court — it may be considered property of the estate or, alternatively, rejected under Section 365. And even if a carved out interest is categorized as a true sale of a real property interest, it may still be subject to fraudulent transfer and preference actions.

Endnotes

[1] The authors wish to thank Dr. Patrick Fitzgerald, Distinguished Visiting Faculty in Energy Finance & Management at the University of Denver Daniels College of Business, for his advice and editorial comments in connection with preparing this article.

[2] For overriding royalty interests, *see generally* Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers Manual of Oil and Gas Terms* 726 (15th ed. 2012) (citing Meeker v. Ambassador Oil Co., 308 F.2d 875, 882, 18 O.&G.R. 642, 650 (10th Cir. 1962), *rev'd,* 375 U.S. 160, 19 O.&G.R. 363 (1963), *reh'g denied*, 375 U.S. 989 (1964)). For net profits interests, *see, e.g.,* Ferguson v. Coronado, 884 P.2d 971 (Wyo. 1994). For production payments, *see* 11 U.S.C. § 101(42A) and (56A), which define "production payment" as a type of term overriding royalty; 5 *Collier on Bankruptcy* P. 541.20, p. 541-88 (Alan N. Resnick & Henry J. Somme eds., 16th ed.); see 11 U.S.C. § 541(b)(4)(B), which excludes production payments from the bankruptcy estate.

[3] In re ATP Oil & Gas Corporation, 2014 WL 61408 (Bankr. S.D. Tex. Jan. 6, 2014). The plaintiff, NGP Capital Resources Company, has since changed its name to OHA Investment Corporation. This change is reflected in court documents. *See* adversary case no. 12-03443, document no. 222.

[4] *See Williams & Meyers* at 1147-48. A working interest is "a percentage of ownership in an oil and gas lease granting its owner the right to explore, drill and produce oil and gas from a tract of property." *Id.* It is generally synonymous with the term "leasehold interest." *See id.* at 1148.

[5] *See* Schlumberger, *Oilfield Glossary*, http://www.glossary.oilfield.slb.com/en/Terms/o/overriding_royalty_interest.aspx (last visited Nov. 19, 2014).

[6] *See Williams & Meyers* at 1057.

[7] R. King & Co., *What Is an Overriding Royalty Interest?*, http://www.rkingco.com/mineral-owners/what-is-an-overriding-royalty-interest/ (last visited Nov. 19, 2014).

[8] *See* PetroStrategies, Inc., http://www.petrostrategies.org/Learning_Center/production.htm#Production%20Costs (last visited Dec. 8, 2014).

[9] U.S. Energy Information Administration, *Oil and Gas Lease Equipment and Operating Costs 1994 Through 2009* (Sept. 28, 2010), *available at* http://www.eia.gov/pub/oil_gas/natural_gas/data_publications/cost_indices_equipment_production/current/coststudy.html.

[10] *See* Chesapeake Energy Corp., SEC Staff Comment Letter, 2014 WL 1380751 (March 27, 2014).

[11] *See* Martin v. Glass, 571 F. Supp. 1406, 1414 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984) (stating that "it appears that Texas and Louisiana law are the same; both jurisdictions allow the deduction of post-production cost when royalty is determined 'at the mouth of the well'") (citing Haynes v. Southwest Natural Gas Co., 123 F.2d 1011, 1012 (5th Cir.1941)).

[12] *See id.*; *see also Williams & Meyers* at 726, which states that an ORRI is an " interest in oil and gas produced at the surface." Post-production costs can only be assessed once the oil or gas reaches the wellhead. *See* ConocoPhillips Co. v. Lyons, 299 P.3d 844, 851 (New Mex. 2012) (citing Ramming v. Natural Gas Pipeline Co. of America, 390 F.3d 366, 369 (5th Cir. 2004)).

[13] *See Williams & Meyers* at 1133.

[14] *Martin v. Glass*, 571 F. Supp. at 1415.

[15] *Williams & Meyers* at 647.

[16] *Id.*

[17] (No. GD-10-011904) (Pa. Ct. Comm. Pl. Dec. 12, 2012) (mem.).

[18] *Id.* at 8.

[19] "While net profits interest owners are entitled to a percentage of the profits, they are not responsible for any portion of losses incurred in property development and operations. These losses, however, may be recovered by the working interest owner from future profits." *Williams & Meyers* at 647 (citing Charlotte J. Wright & Rebecca A. Gallun, *Fundamentals of Oil & Gas Accounting* 15 (5th ed. 2008)).

[20] *See* 11 U.S.C. § 101(42A) and (56A), which define "production payment" as a type of term overriding royalty.

[21] *Williams & Meyers* at 827.

[22] *Id*.

[23] *Id.* (citing QEP Energy Co. v. Sullivan, 444 Fed. Appx. 284, 289 (10th Cir. 2011)).

[24] *See* Ernst & Young, *The FIRPTA Investment Guide* 5, *available at* http://www.ey.com/Publication/vwLUAssets/FIRPTA_investment_guide/$FILE/FIRPTA_investment_guide.pdf.

[25] *See id*.

[26] *See* Financial Accounting Standards Board, FAS 133 Derivatives Implementation, *available at* http://www.fasb.org/derivatives/issueb11.shtml; Securities & Exchange Commission, Technical Amendments to Commission Rules and Forms Related to the FASB's Accounting Standards Codification, *available at* http://www.sec.gov/rules/final/2011/33-9250.pdf; *see also* Ernst & Young, *The Revised Revenue Recognition Proposal – Oil and Gas* (Feb. 2 2012), *available at* http://www.ey.com/publication/vwluassetsdld/technicalline_bb2276_revrecoilgas_2february2012/$file/technicalline_bb2276_revrecoilgas_2february2012.pdf?OpenElement.

[27] *See* Ernst & Young, *FIRPTA Investment Guide*.

[28] *See In re ATP*, *supra* note 3, at *1.

[29] Case No. 12-36187 [ECF No. 6], at 3-4.

[30] *See In re ATP*, *supra* note 3, at *1.

[31] The court cites to Howard Trucking Co. v. Stassi, 474 So. 2d 955 (La. App. 5th Cir.1985), which held that courts "are not bound by the label placed on a written agreement or the subjective intent of the contracting parties, but must look to the substance of the transaction." *Id.* at 960 (citing Pastorek v. Lanier Sys. Co., 249 So. 2d 224 (La. App. 4th Cir. 1971)).

[32] *See In re ATP*, *supra* note 3, at *5.

[33] *See id.* at *7 (citing Tidelands Royalty "B" Corp. v. Gulf Oil Corp., 804 F.2d 1344, 1349 (5th Cir. 1986) (applying Louisiana law)).

[34] The *In re ATP* court approvingly cites to *Howard Trucking* in its assertion that "the parties' intent in making the contract [is] irrelevant to the recharacterization analysis." *In re ATP*, *supra* note 3, at *6.

[35] Butner v. United States, 440 U.S. 48, 55 (1978). Unless some federal interest requires a different result, there is no reason why property interests would be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. *See id.*

[36] *In re ATP*, *supra* note 3, at *8. The court also notes the lack of a definition for "ORRI" under the Louisiana Mineral Code. Therefore, depending on the state in which an investor has purchased carved out interests, it would be advisable to consult with that state's mineral code if definitions of the relevant carved out interest are contained therein.

[37] *In re ATP*, *supra* note 3, at *8 (citing Duncan v. Paragon Res., Inc., 417 So. 2d 850, 854 (La. App. 3d Cir. 1982)); CLK Co. v. CXY Energy, Inc., 719 So. 2d 1098, 1101, 1104 (La. App. 4th Cir. 1998); La. Rev. Stat. Ann. § 31:18 (West, Westlaw through 2012 Legis. Sess.).

[38] *In re ATP*, *supra* note 3, at *9 (citing Bailey v. Meadows, 130 So. 2d 501, 503 (La. Ct. App. 1961)).

[39] *Id*.

[40] *Id*.

[41] *Id.* at *11.

[42] *Id.* at *12 (citing *Tidelands Royalty,* 804 F.2d at 1349-50 ("The distinguishing characteristic of a…royalty interest is its 'passive' nature. The royalty owner has no right to explore, develop, or lease the subject tract. Moreover, the landowner has no obligation to develop or lease the premises for the benefit of the royalty owner.")); *see also* Continental Oil Co. v. Landry*,* 41 So. 2d 73, 75 (La. 1949) ("It is also well settled that this [mineral royalty] right is merely one to share in the production of oil, gas, and other minerals if and when they are produced from the property subject to the right. It is passive in its nature, and there is no obligation on the royalty owner to develop the property, nor does he have this right. All that he acquires is a right attached to the land, the right to receive his share of the minerals if and when they are produced.").

[43] *In re ATP*, *supra* note 3, at *10.

[44] *Id.* at *11.

[45] *Id.* at *12-13.

[46] *Id.* at *12.

[47] *Id.* at *13-14.

[48] *Id.* at *14.

[49] *Id*.

[50] *Id.*

[51] *See id.* at *10-15.

[52] *Id.* at *16.

[53] *Id.*

[54] *Id*.

[55] *Id.* at *14.

[56] *Id.* at *15.

[57] *Id.*

[58] *See, e.g.*, Stroud Production, L.L.C. v. Hosford, 405 S.W.3d 794, 818 (Tex. App. 2013) (citing EOG Res., Inc. v. Hanson Prod. Co., 94 S.W.3d 697, 701 (Tex. App. 2002) ("An overriding royalty is an interest in real property regarded as a covenant running with the land between the assignor and the assignee, and is enforceable by the assignor against the assignee." (citing Phillips Petroleum Co. v. Taylor, 116 F.2d 994, 995 (5th Cir. 1941))); Renwar Oil Corp. v. Lancaster, 154 Tex. 311, 276 S.W.2d 774, 776 (1955) ("[A]n oil and gas lease is … a conveyance of realty…."); Gruss v. Cummins, 329 S.W.2d 469, 500 (Tex. Civ. App. – El Paso, 1959, reh'ing denied) (stating that ORRI "is an interest in land"); Sheppard v. Stanolind Oil & Gas Co., 125 S.W.2d 643 (Tex. Civ. App. – Austin 1939, writ ref'd); Sheffield v. Hogg, 77 S.W.2d 1021 (1934) (production payments are interests in real property).

[59] *Stroud Production*, *supra* note 58 (citing Natural Gas Pipeline Co. of Am. v. Pool, 124 S.W.3d 188, 192 (Tex. 2003)); Chesapeake Exploration, L.L.C v. Dallas Area Parkinsonism Soc'y, Inc., 2011 WL 3717082, at *4 (Tex. App. 2011) (mem. op.). Instead, "[i]n a typical oil and gas lease, the lessor is a grantor and grants a fee simple determinable interest to the lessee, who is actually a grantee." *Natural Gas Pipeline Co.*, 124 S.W.3d at 192; *Chesapeake Exploration, L.L.C.*, 2011 WL 3717082, at *4.

[60] *Stroud Production*, *supra* note 58 (citing *Natural Gas Pipeline Co.*, 124 S.W.3d at 192; *Chesapeake Exploration, L.L.C.*, 2011 WL 3717082, at *4). The lessee's interest is "determinable" "because it may terminate and revert entirely to the lessor/grantor upon occurrence of events that the lease specifies will cause termination of the estate." *Id.*

[61] *Stroud Production*, *supra* note 58 (citing Baty v. Protech Ins. Agency, 63 S.W.3d 841, 848 (Tex. App. 2002)).

[62] *Stroud Production*, *supra* note 58 (citing *EOG Res.*, 94 S.W.3d at 701).

[63] Yturria v. Kerr-McGee Oil & Gas Onshore, LP, 2006 WL 3227326 (S.D. Texas 2006) (Laredo Division) (citing *Martin v. Glass*, 571 F. Supp. at 1410).

[64] T. W. Phillips Gas & Oil Co. v. Jedlicka, 42 A.3d 261, 267 (Pa. 2012) (citing Calhoon v. Neely, 201 Pa. 97, 101, 50 A. 967, 968 (1902)); Burgan v. South Penn Oil Co., 243 Pa. 128, 137, 89 A. 823, 826 (1914) ("The title is inchoate, and for purposes of exploration only until oil is found."); Hite v. Falcon Partners, 13 A.3d 942 (Pa. Super. 2011); Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 772 (W.D. Pa. 2004).

[65] *T. W. Phillips*, 42 A.3d at 267 (citing *Calhoon*, 201 Pa. at 101, 50 A. at 968; *Jacobs*, 332 F. Supp. 2d at 772-73; *see also* Barnsdall v. Bradford Gas Co., 225 Pa. 338, 74 A. 207, 208 (1909) (an oil and gas lease that results in production "creates a corporeal interest in the lessee in the demised premises, and is not merely a license to enter and operate for oil and gas").

[66] *See* Zachary D. Bombatch, *Pennsylvania Oil and Gas Leases in Bankruptcy: Rejection Should Occur Only Before Production*, 16 Duq. Bus. L.J. 267, 289 (Summer 2014).

[67] *In re Mustafa Tayfur*, No. 14-3478, 2015 WL 1219029 (3d Cir. March 18, 2015).

[68] *Id.* at *1.

[69] *Id.* at *6-7.

[70] 11 U.S.C. § 365(a).

[71] Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

[72] 476 B.R. 143 (Bankr. Del. 2012).

[73] *Id.* at 155-57.

[74] *Id.* at 157.

[75] 11 U.S.C. § 541(b)(4)(B).

[76] *See* Bankruptcy Code § 541 Legislative History, 3A Bankr. Service L. Ed. § 29:2 (citing 140 Cong. Rec. E 2204 (Oct. 8, 1994)).

[77] *See id*.

[78] Congress has stated that it is not the intent of Section 541(b)(4)(B) to permit a conveyance "of a production payment or an oil and gas lease to be recharacterized in a bankruptcy context as a contractual interest subject to rejection" under Section 365 of the Bankruptcy Code. *Id.*

[79] William Wallander, Bradley Foxman, John Napier & Casey Doherty, *Energy Restructuring and Reorganization*, 10 Tex. J. Oil Gas & Energy L. 1, 81-88 (citing Terry Oilfield Supply Co., v. Am. Sec. Bank, N.A., 195 B.R. 66, 70 (S.D. Tex. 1996)).

[80] *Id.*, *comparing* In re WRT Energy Corp., 202 B.R. 579, 583-84 (W.D. La. 1996) (holding that a mineral lease in Louisiana is not an executory contract) *with* Texaco, Inc. v. La. Land & Exploration Co., 136 B.R. 658, 668 (M.D. La. 1992) (holding that a mineral lease in Louisiana is an executory contract) *and* Texaco, Inc. v. Bd. of Comm'r for the LaFourche Basin Levee Dist. (In re Texaco Inc.), 254 B.R. 536, 565 (Bankr. S.D.N.Y. 2000) (same).

[81] 11 U.S.C. § 548.

[82] *See* Tex. Stat. V.T.C.A. Bus. & C. §§ 24.001 et seq.; Pa. Stat. tit. 12 Pa. C.S.A. § 5101 et seq.

[83] 11 U.S.C. § 548.

[84] NGP Capital Resources Company, Form N-2/A (filed April 22, 2013), at 72 ("Legal Proceedings"), *available at* http://www.sec.gov/Archives/edgar/data/1297704/000114420413023033/v339009_n2a.htm.

[85] *See id.*; Nov. 1 Tr. At 36:8-14, 134:12-15, 135:3-7.

[86] 11 U.S.C. § 547.

[87] *Id.*

[88] In re Rancher Energy Corp. v. Gas Rock Capital, LLC, 2011 WL 5320971, at * 2 (Bankr. D. Col. 2011).

[89] *Id.* at *4.

Authors

David J. Karp
New York: +1 212.756.2175
London: +44 (0) 20 7081 8048
david.karp@srz.com

David J. Karp is a partner in Schulte Roth & Zabel's New York and London offices where he leads the firm's Distressed Debt & Claims Trading Group and is a member of the firm's Energy Practice. David represents hedge funds and private equity funds in connection with investments in distressed and non-performing assets and NPL portfolios across a wide range of industries and in jurisdictions across the globe. He also advises investment funds in connection with oil and gas royalty investments, leasing and distressed energy credit investments including reserved based loans. His recent distressed energy credit representations include investors in Sabine Oil & Gas Corporation, Stallion Oilfield Services Ltd., Seahawk Drilling Inc., ATP Oil & Gas Corporation and Trident Resources Corporation. David is a longstanding member of the National Association of Royalty Owners.

Parker J. Milender
+1 212.756.2517
parker.milender@srz.com

Parker J. Milender is an associate in Schulte Roth & Zabel's Business Reorganization, Distressed Debt & Claims Trading, and Energy practices. Parker represents creditors, debtors and trustees in complex Chapter 11 cases, and he serves as counsel in reorganizations and other distressed investing situations.

About SRZ's Energy Practice

Schulte Roth & Zabel's Energy Practice advises some of the world's top alternative asset managers in connection with oil and gas, coal, and the chemical and electric industries. We meet the investment fund and transactional needs of our clients by assisting them with sophisticated energy-related mergers and acquisitions, divestitures, proxy contests, workouts and restructurings, capital markets transactions, real estate transactions, distressed investments, tax issues with U.S. and non-U.S. capital, and the development and trading of new and complex financial products. With experience that extends to each link of the value chain, we advise on upstream transactions covering exploration and production; midstream transactions dealing with gathering, storage, transportation and processing; and downstream transactions that involve refining, marketing, petrochemicals trading and derivatives, transportation and shipping.

Schulte Roth & Zabel

New York | Washington DC | London

www.srz.com