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TUDOR PICKERING HOLT & CO | ENERGY INVESTMENT & MERCHANT BANKING

Distressed Energy: Midstream Agreements — Impact on E&P Creditor Recovery

Tuesday, March 8, 2016

About the Speakers

Aaron S. Blomquist

Head of Infrastructure, Managing Director, Investment Banking
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Aaron is a Managing Director in Investment Banking, covering midstream and MLPs. He was previously a director with the Global Energy & Power Group at Bank of America Merrill Lynch, where he focused primarily on midstream and MLP clients. Prior to Bank of America Merrill Lynch, he was a vice president at Evercore Partners. Aaron holds a B.S. in finance from Louisiana State University, where he received the University Medal and graduated *summa cum laude*. He is a CFA charterholder.

Selected Transactional Experience

M&A Advisory

- Pioneer Natural Resources on the sale of its interest in EFS Midstream to Enterprise Products
- Morgan Stanley Infrastructure on its sale of Southern Star Central Corp. to GE Energy Financial Services & Caisse de dépôt et placement du Québec
- Crestwood Midstream Partners on its merger with Crestwood Equity Partners
- El Paso Pipeline Partners on its merger with Kinder Morgan Inc.
- Regency Energy Partners on its acquisition of PVR Partners
- Devon Energy Corporation on the combination of its midstream business with Crosstex Energy Inc. and Crosstex Energy LP
- Kinder Morgan Inc. on its dropdown of 50 percent of EPNG and 50 percent of El Paso Midstream to Kinder Morgan Energy Partners
- Phillips 66 on its sale of the Riverhead Terminal to United Refining
- Howard Energy Partners on its acquisition of Meritage Midstream Services
- MarkWest Hydocarbons Inc. in its sale to MarkWest Energy Partners LP
- Targa Resources Inc. on its acquisition of Dynegy Midstream LP
- GE Commercial Finance Energy Financial Services on the sale of its 40-percent LLC interest in CrossCountry Energy LLC to a consortium of investors

Midstream MLP IPOs

- PennTex Midstream Partners
- Phillips 66 Partners LP
- Summit Midstream Partners LP
- Susser Petroleum Partners LP
- American Midstream Partners LP
- Tesoro Logistics LP
- Targa Resources Corp.
- Targa Resources Partners LP
- Universal Compression Partners LP (re-named Exterran Partners LP)
- Buckeye GP Holdings LP

John Chapman

Vice President, Investment Banking
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John serves as a Vice President in Investment Banking, covering midstream and MLPs, in addition to Restructuring Advisory. He was previously an associate at Miller Buckfire in New York. John holds a B.A. in religion from Princeton University.

Selected Transactional Experience

- Advised GSO and co-investors on restructuring and sale of Chesapeake Cleveland-Tonkawa to FourPoint Energy
- Advised on dropdowns to SunCoke Energy Partners (fairness opinions)
- Advised on equity financing of Pro Oilfield Services
- Advised lenders on restructuring of Greenfield Energy Services
- Advised lenders on restructuring of Platinum Energy Solutions
- Advised on sale of Alaska Electric Light & Power to Avista Corp.
- Advised Oncor Electric Delivery in Energy Future Holdings restructuring
- Advised lenders on restructuring of Orchard Brands
- Advised on restructuring of American Capital Ltd.
- Advised on restructuring of European Capital Ltd.
- Advised PropCo lenders on restructuring of Station Casinos
- Advised on restructuring of Magnachip Semiconductor
- Advised on restructuring of Calpine Corp.

Lawrence V. Gelber

Partner
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Larry practices in the areas of distressed mergers & acquisitions, debtor-in-possession financing, corporate restructuring, creditors' rights and prime brokerage insolvency/counterparty risk. Larry's extensive experience in Chapter 11 reorganization cases includes his representation of debtors, secured and unsecured creditors, lenders, investors and acquirers. His debtor representations have included Quigley Company Inc., NTL Inc., Safety-Kleen Corp., Fansteel Inc. and CAI Wireless Systems Inc. Among his lender and creditor representations are Ableco Finance LLC, Cerberus Business Finance LLC and Wells Fargo Capital Finance. Investor and acquirer representations include Mount Kellett Capital Management LP, Petra Capital Management LP, Cerberus Capital Management LP and Prentice Capital Management LP.

In recognition of his professional excellence and his contributions to the fields of restructuring and insolvency, Larry was inducted as a fellow in the 25th Class of the American Bankruptcy College. He has also been recognized by *The Legal 500 United States* as a leader in his field. Larry is an active member of the American Bankruptcy Institute, the American Bar Association's Section of Business Law, the New York City Bar Association and the Turnaround Management Association. He is a regular contributor to *The Bankruptcy Strategist, Bankruptcy Law360* and *Norton Bankruptcy Law Adviser* and has spoken at conferences sponsored by the Practising Law Institute, American Bankruptcy Institute, the William J. O'Neill Great Lakes Regional Bankruptcy Institute and other organizations. Some of his recent presentation topics have covered challenges and opportunities in distressed retail, distressed acquisitions in Chapter 11 and pension plan liabilities.

Larry received his J.D., *cum laude*, from New York University School of Law and his B.A., *magna cum laude*, from Tufts University.

Adam C. Harris

Partner

Schulte Roth & Zabel

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Adam is a partner in the New York office, where he is chair of the Business Reorganization Group and a member of the firm's Executive Committee. His practice includes corporate restructurings, workouts and creditors' rights litigation, with a particular focus on the representation of investment funds and financial institutions in distressed situations. Adam has represented a variety of clients in connection with distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies, as well as in court-supervised and out-of-court restructurings. In addition to representing creditors and acquirers in distressed situations, Adam has represented Chapter 11 debtors, as well as portfolio companies in out-of-court exchange offers, debt repurchases and other capital restructurings. His recent representations include advising an ad hoc committee of holders of 6.50-percent notes issued by Seventy Seven Energy Inc., Cerberus Capital Management LP in connection with the Chapter 11 bankruptcy of RadioShack Corp., Mount Kellett Master Fund II in the Chapter 11 case of The Great Atlantic and Pacific Tea Company (as both lender and equity holder), and a group of private equity funds in the Allied Systems Holdings bankruptcy, in their capacity as first lien lenders, in a successful challenge to the efforts of a private equity sponsor that tried to acquire a controlling interest in the first lien debt.

Numerous ranking publications, including *The Best Lawyers in America*, *Chambers Global*, *Chambers USA*, *The K&A Restructuring Register* and *The Legal 500 United States*, have recognized Adam as a leader in his field. He has co-authored publications addressing cramdown plans, redemption option value, priming DIPs, out-of-court restructurings and proposals to reform Chapter 11. He also contributed to *Distressed Investing M&A* (SRZ in association with Mergermarket and Debtwire), and he co-authored "Health Care Business Restructuring for Secured Lenders," an SRZ guide republished by *Bloomberg BNA – Bankruptcy Law Reporter*. Adam also co-authors the "Out-of-Court Restructurings, the Bankruptcy Context, and Creditors' Committees" chapter in PLI's *Insider Trading Law and Compliance Answer Book*. He presents frequently on topics of concern to the private funds community, including, most recently, interlender arrangements, structuring credit funds, distressed investing in the health care sector, fraudulent conveyance laws and distressed private equity investments.

Adam earned his J.D., *magna cum laude*, from Georgetown University Law Center and his B.A. from Emory University.

David J. Karp

Partner
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David leads SRZ's Distressed Debt & Claims Trading Group, providing advice in connection with U.S., European and emerging market debt and claims trading matters, with a focus on special situations, corporate restructuring, and distressed mergers and acquisitions. David frequently 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 around the globe. He also advises investment funds in connection with oil and gas royalty trading and distressed energy credit investments. His recent energy representations include investors in Walter Energy Inc., Samson Resources, Energy and Exploration Partners Inc., Sabine Oil & Gas Corporation, Stallion Oilfield Services Ltd., Seahawk Drilling Inc., ATP Oil & Gas Corporation and Trident Resources Corporation.

David is 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 best: making sure funds and their investments are protected when transacting and executing trades in distressed debt and claims." He is an active member of the National Association of Royalty Owners and a frequent author for *The Hedge Fund Law Report*, *Bloomberg*, *The Bankruptcy Strategist* and *Corporate Rescue and Insolvency*. His recent publications include "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 Schulte Roth & Zabel

SRZ's Distressed Investing Group

As the premier brand in investment management in the world's two major financial markets — New York and London — Schulte Roth & Zabel is recognized as a key player in both the mature U.S. distressed investment market and the still-developing European distressed investment market. We have the experience and expertise to provide clients with comprehensive representation and advice in all manners of large and complex distressed situations across a wide range of industries and opportunities.

With market-leading capabilities on both sides of the Atlantic, our Distressed Investing Group provides business-savvy solutions by strategically blending expertise from our business reorganization, finance, investment management, mergers & acquisitions, real estate, tax and other practice areas. Our superior knowledge of the investment management industry and experience developing and implementing the structures and products that a distressed investor analyzes results in substantial synergies and gives us an insider's edge. Well-known for our distressed investing work, we advise on, and have extensive experience with, out-of-court transactions, navigating bankruptcies (including bankruptcy acquisitions, debt restructurings, loan-to-own strategies and debtor-in-possession and exit financings), distressed real estate, capital structure analysis and trading issues.

Structuring or restructuring a deal may also require collaboration by our clients with one or more other parties who have aligned interests in order to achieve their investment objectives. We regularly advise consortiums and syndicates in joint investments, whether those investments are structured as club deals or the group acts together as an informal, ad hoc committee, or otherwise. We are experienced in defining, negotiating and navigating those working relationships and managing the complex governance and tax issues that arise.

Select Energy Restructuring Representations

Seventy Seven Energy Ad Hoc Committee of Unsecured Bondholders	Milagro Exploration First Lien Lenders/ DIP Lenders	Global Geophysical Services First Lien Lenders	Sabine Oil & Gas Creditor	Walter Energy Creditor	Samson Resources Creditor
GlobalPower Creditors' Committee	Apex Silver Mines Limited Ad Hoc Committee of Unsecured Bondholders	ATP Oil & Gas Corporation Creditor	Boston Generating, A USPowerGen Company Creditor	Consol Energy, America's Energy Starts Here. Creditor	Energy Future Holdings Secured Lender
Enron Creditor	Foothills Resources, Inc. Secured Lender	Mahalo Energy Ltd. Secured Lender	Murray Energy Corporation Creditor	Oxford Resource Partners Second Lien Lender	Pacific Ethanol, Inc. Creditor
Patriot Coal Potential Bidder	Peabody Energy Activist Investor	Pen Holdings, Inc. and Elk Horn Coal Co. Creditor	Stallion Creditor	Stormcat Energy Corporation Secured Lender	Trident Resources Corp. Creditor

About Tudor, Pickering, Holt & Co.

Tudor, Pickering, Holt & Co. Overview

The firm's mission is to be the premier integrated energy investment and merchant banking firm, providing the highest quality advice and professional services to our institutional and corporate partners.

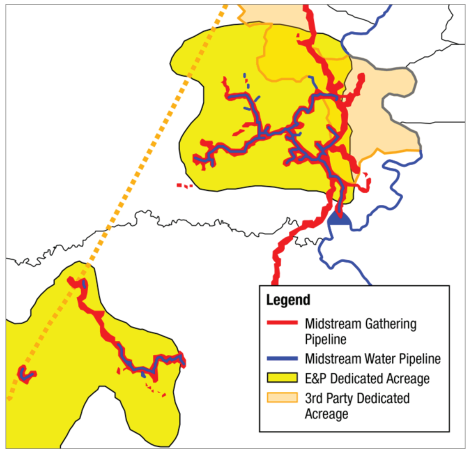
Energy Focused	▪ 170+ employees exclusively focused on energy ▪ Diversified lines of business designed to provide extensive industry and advisory expertise: Investment Banking, Securities, Acquisitions & Divestitures, Private Equity, Asset Management ▪ Headquartered in Houston with offices in New York, Denver, London and Calgary
Research, Sales & Trading	▪ Equity research covering 160+ energy companies ▪ Sales and trading exclusively covering energy ▪ Institutional investor focus
Investment Banking	▪ Integrated sector efforts in Upstream, Midstream/MLP, Downstream, Oilfield Services and Power ▪ M&A: strategic advisory, sell-side, buy-side, special committee assignments, fairness opinions and restructuring ▪ Capital markets: IPO, follow-on equity & debt offerings, private equity, private placements ▪ Dedicated Acquisitions & Divestitures practice ▪ Liability management, recapitalization and restructuring advisory ▪ Extensive technical knowledge of oil & gas
Asset Management	▪ Over $1.5 Bn of assets under management ▪ TPH Partners: private equity fund with seven active energy investments ▪ TPH Asset Management: group of long-only and hedge funds focused on energy securities ▪ Co-Investment: energy private equity co-investment strategy

PowerPoint Presentation

E&P / Midstream Interdependency

Notes:

Gathering, Processing and Transportation



Notes:

Dedications & Minimum Volume Commitments

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Notes:

Contract Rejection

What's at Stake?

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Notes:

Traditional Midstream View
Nothing to See Here

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Notes:

Traditional Midstream View

Covenants Running with the Land

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Notes:

Traditional View Collides with State Law Reality

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Notes:

Covenants Running with the Land

- Privity of estate
- Touching and concerning the land
- Relates to a thing in existence or specifically binding the parties and their assigns
- Intended by the original parties to run with the land
- The successor to the burden has notice

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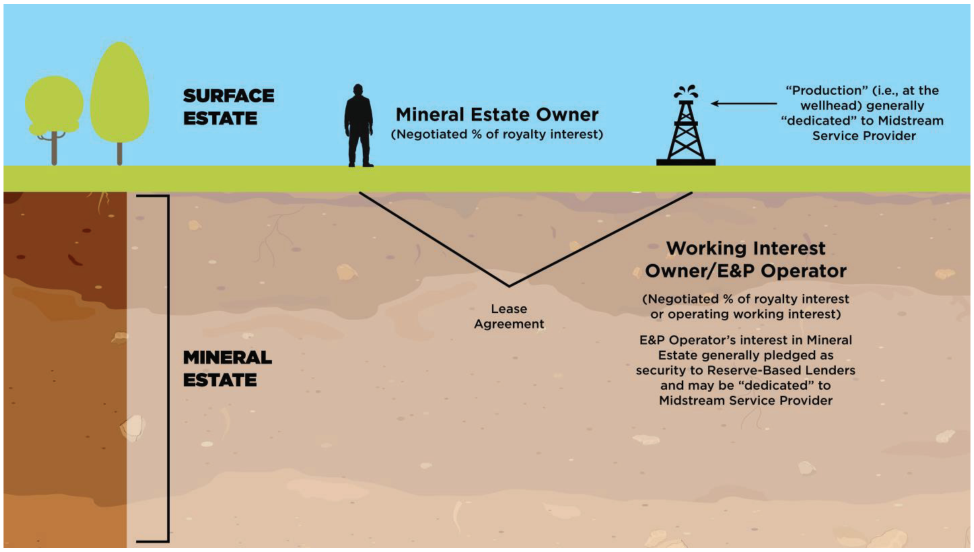
Notes:

Surface Estate vs. Mineral Estate



Notes:

Privity of Estate

Requirements to Establish Vertical and Horizontal Privity	
Vertical Privity Requirements	1. Relationship between transferor and transferee of property bound by the covenant; and 2. Covenant contained in a grant of land or grant of some property interest in the land
Horizontal Privity Requirements	1. Relationship between the original parties to the covenant at the time it was made; and 2. Covenant contained in a grant of land or grant of some property interest in the land

Notes:

Production Dedication vs. Mineral Estate Dedication

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Notes:

Mineral Estate

- “Sticks” in the Bundle of Rights
  - Right to develop
  - Right to lease
  - Right to receive bonus payments
  - Right to receive delay rentals
  - Right to receive royalty payments

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Notes:

Sabine

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Notes:

Quicksilver Resources

Impact on Asset Sales

Notes:

Distressed Energy: Midstream Agreements — Impact on E&P Creditor Recovery White Paper

Distressed Energy: Midstream Agreements — Impact on E&P Creditor Recovery

Exploration and production ("E&P") companies typically enter into wellhead service contracts (collectively, "Midstream Contracts") for gathering,[1] processing and transporting oil and gas to market. In exchange for these services and the capital commitment to build a gathering system, the E&P may provide the midstream counterparty ("Midstream Service Provider") with a dedication of reserves or acreage commitment for performance of the Midstream Contracts. (See Figure 1). A dedication of reserves is intended to assure an adequate utilization of the gathering and pipeline system and is often accompanied by a hydrocarbon purchase contract between the E&P and the Midstream Service Provider. In many cases, Midstream Contracts also include a commitment of a minimum volume of oil or gas ("Minimum Volume Commitment" or "MVC") that is produced and processed from the land on which the E&P operates, which requires the E&P to pay a fixed fee to the Midstream Service Provider if volume requirements are not met.

Creditors of and potential investors in both the E&P and the Midstream Service Provider should analyze the precise language and mechanics in the relevant party's Midstream Contracts because the provisions relating to dedication and MVCs will be significant in determining: (1) whether or not the Midstream Contract can be rejected, and (2) how the Midstream Contract claim will be treated in an E&P bankruptcy case. While case law addressing the treatment of midstream agreements is unclear and incomplete, and the outcome in each case is fact-specific and dependent on the law of the state where it is heard, recent bankruptcy case developments (e.g., *In re Sabine Oil & Gas Corporation* and *In re Quicksilver Resources*)[2] provide some measure of guidance for creditors and investors. Ultimately, the legal analysis of whether a Midstream Contract can be rejected must be incorporated into an economic analysis of these contracts and the alternatives available to the E&P and Midstream Service Provider.

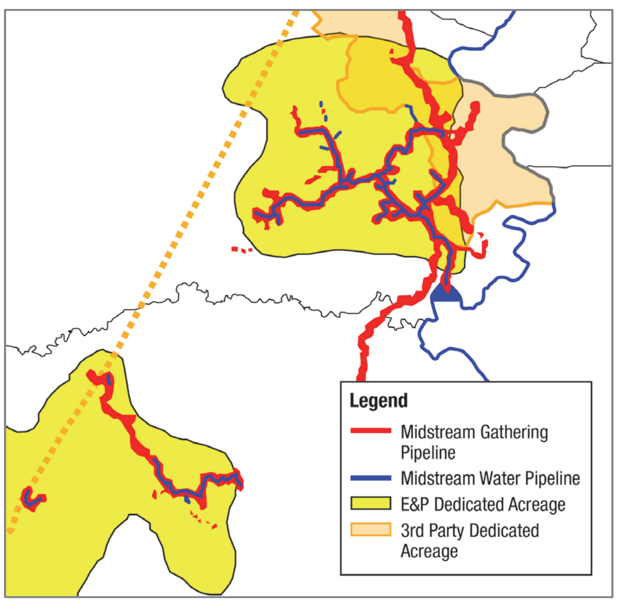

Figure 1

[1] "Gathering" refers to "the process of collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system." Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers Manual of Oil and Gas Terms* 433 (15th ed. 2012).

[2] In the *Sabine* bankruptcy case, the issues have been fully briefed by the debtors and the midstream gatherer counterparties respectively, and the presiding judge has heard oral arguments and indicated on the record that a bench decision is forthcoming. In the *Quicksilver* bankruptcy case, the debtors have filed a motion to reject executory contracts with certain midstream counterparties (Dkt. 1128). We are monitoring both cases and are happy to respond to any inquiries with respect to either case or the issues set forth in this *White Paper*. The *Sabine* and *Quicksilver* bankruptcy cases are currently pending under the captions *In re Sabine Oil & Gas Corporation, et al.* (Case No. 15-11835) (Bankr. S.D.N.Y.) and *In re Quicksilver Resources Inc., et al*. (Case No. 15-10585) (Bankr. D. Del.), respectively.

What's at Stake?

Midstream Providers have argued that midstream contracts with acreage dedications and language identifying such interests as "covenants that run with the land" are not property of the E&P's bankruptcy estate and not capable of being rejected as an executory contract. If Midstream Providers are correct, they would have significant leverage in renegotiating the terms of services with E&Ps, and the resulting decrease in the size of asset pool available for the E&P's creditors could lead to substantially diminished recoveries. In response, E&Ps and their creditors have argued that dedications merely create for a service provider a contractual interest that may be rejected in bankruptcy, resulting in a prepetition general unsecured claim for the damages flowing from rejection.

The dedication language and mechanics of a Midstream Contract can be granular and esoteric, but they require careful analysis given their potential implications in a bankruptcy case. To illustrate, based on Texas law — where oil or gas in the ground is real property, but once separated from the earth, becomes personal property — a provision that purports to dedicate an interest in the E&P's oil or gas "in place" (i.e., in the ground) would seem to create a covenant running with the land, whereas one dedicating an interest in its oil or gas "as and when produced" (i.e., at the surface or wellhead) may be read by a court to create a mere contractual interest.[3] (See Figure 2).

To determine whether or not Midstream Contracts are executory agreements that can be rejected, a bankruptcy court will likely consider numerous factors, including: (1) the parties' expressed intent to create (or not create) a conveyance of a real property interest or covenant that runs with the land; (2) the point at which such interest is deemed fully vested; (3) real property filings recorded or agreed to be recorded; (4) holder(s) of title to production; (5) rights to control and risk for losses; (6) definition of the dedicated interests (i.e., minerals in place, production or both); (7) the E&P's right to sell or transfer minerals and leases with or without binding successors and assigns; and (8) the existence of MVCs.

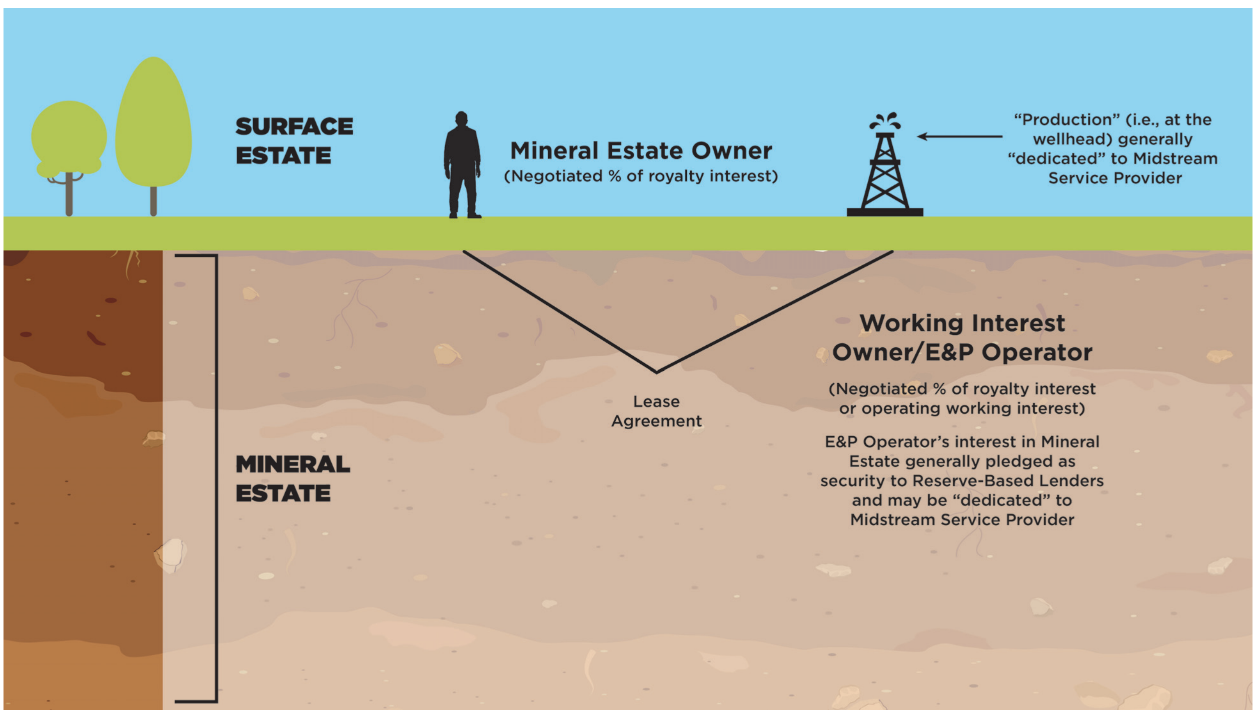

Figure 2

[3] Under Texas law, once minerals are produced, they cease to be real property and instead become personalty. *See, e.g.*, *Sabine Production Co. v. Frost Nat. Bank San Antonio*, 596 S.W.2d 271, 276 (Tex. App. 1980) ("Once minerals have been severed from the reservoir or strata wherein they were originally contained, such minerals ... become personalty."); *Colorado Interstate Gas Co. v. Hunt Energy Corp.*, 47 S.W.3d 1, 10 (Tex. App. 2000) ("Once oil or gas has been severed from the ground, it becomes personalty."); *Riley v. Riley*, 972 S.W.2d 149, 155 (Tex. App. 1998) (*citing Phillips Petroleum Co. v. Adams*, 513 F.2d 355, 363 (5th Cir. 1975) (under Texas law, "[o]il and gas are realty when in place and personalty when severed from the land by production").

Priority of Dedication and Minimum Volume Commitment

Secured creditors to E&Ps historically may have given little thought to the possibility of competing claims by Midstream Providers, because it was generally accepted by market participants that any such claims would be junior to the secured creditors' claims in the E&P's bankruptcy case. Recently, however, some Midstream Providers have argued that even though no transfer of any interest in the debtor's mineral estate took place, the dedications in their Midstream Contracts are actually real property interests or covenants running with the land that are not subject to the preexisting liens or claims of any of the debtor's other creditors and should receive payment — in amounts calculated based on any MVC and remaining contract term — prior to any cash flowing into the creditor waterfall, or be afforded an elevated payment priority in the E&P's bankruptcy.

Midstream Contract Rejection and Treatment of Claims

A distressed E&P may determine that its Midstream Contracts render development of its assets uneconomical, especially where such a contract includes an MVC that is not being satisfied or is too expensive. Under Section 365 of the Bankruptcy Code, an E&P debtor has the ability to "reject" executory contracts.[4] Rejection means that the E&P debtor may, with the bankruptcy court's approval, choose to stop performing under the contract, leaving the counterparty with a prepetition unsecured damages claim that will be paid pro rata with other unsecured creditors.[5]

A covenant running with the land, however, is treated as attached to the underlying real property, and therefore, may not be capable of being rejected. A dedication that is deemed to be a covenant running with the land could thus dilute other creditors' recoveries, potentially including those of senior secured claims, by siphoning value from the mineral estate. The case law regarding interpretation of dedication provisions — whether as real property interests, a covenant that runs within the land, some type of "senior interest" or mere contractual rights — is unsettled, and some dedications may not fit neatly into a single category. Even if it appears in the express terms of the document and real property records indicate that an interest in the mineral estate or leases has been conveyed by dedication, it may be that a dedication is not one of the state law-recognized ways of transferring such an interest and, accordingly, that no such interest has, in actuality, been transferred.[6]

The inclusion of MVCs may make a Midstream Contract more prone to rejection if the E&P is unable to satisfy the MVC, thereby forcing the E&P to pay additional fees when it is not meeting the minimum volume. MVCs also may be viewed as inconsistent with a real property interest or covenants running with the land, as the credit support they provide may be viewed as less consistent with transfers of the risks associated with ownership and more consistent with an unsecured borrowing.

Sabine

Midstream Contract rejection is being litigated in the *Sabine* bankruptcy case. In *Sabine*, the debtors filed a motion to reject two gathering agreements. The counterparties (the "Gatherer Counterparties") opposed rejection on the basis that their contracts contained covenants that ran with the land and were not capable of being rejected. The Gatherer Counterparties relied heavily on the U.S. Court of Appeals for the Fifth Circuit's decision in *In re Energytec Inc.*, 739 F.3d 215, 221 (5th Cir. 2013), which held that certain interests securing fees owed to an affiliate of the seller of a gas pipeline were covenants running with the land and therefore could not be rejected. One critical difference, however, is that the *Energytec* court considered an encumbrance on production passing through a gathering system and the gathering system itself *after the wellhead*; the facts in *Sabine* (and the issue with many other Midstream Contracts) concern a possible covenant running with the land *before the wellhead* and as part of the mineral estate interest.[7]

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[4] The "Countryman" definition of an executory contract, which has been accepted by most courts, 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." Depending on the language and mechanics of a Midstream Contract, it may be considered "executory" under the Countryman definition — thereby subjecting it to rejection under Section 365. Prof. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 458-62 (1973).

[5] *See* 11 U.S.C. § 365; *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984) ("Damages on the contract that result from the rejection of an executory contract … must be administered through bankruptcy and receive the priority provided general unsecured creditors.").

[6] Texas courts determining whether a mineral estate (or any right therein) has been conveyed consistently require the grant of an *interest in the mineral estate*. *See French v. Chevron*, 871 S.W.2d 276 (Tex. App. 1994).

[7] Further, the beneficiary of the covenant running with the land in the *Energytec* case benefited from a security interest and lien on the pipeline system that generated the fee subject to the covenant running with the land. This security interest influenced the court as the recovery may be the same, or similar, whether a claim is based on a covenant running with the land or is a secured claim. The court noted, "Newco's interests, including a transportation fee, security interest and rights to consent to assignments, are covenants running with the land."

This distinction and whether the dedication covers "production" or an interest in the mineral estate (i.e., leases and oil and gas in the ground) is critical.

The *Sabine* litigation is currently ongoing, but the issues raised by the debtors and the Gatherer Counterparties discussed below are instructive. While no decision has yet been rendered, after hearing oral arguments on the specific contracts subject to rejection, the bankruptcy court judge advised the parties that she is "inclined" to rule that the dedications at issue in *Sabine* are not covenants running with the land and that the contracts could therefore be rejected.

Breakdown of Claims

Timing and use of the gathering system also impact a Midstream Provider's potential claim against an E&P debtor. A Midstream Contract claim may arise from activity or damages that accrued: (1) from utilization of the Gathering System before the Chapter 11 petition was filed, which gives rise to a prepetition unsecured claim; (2) in connection with rejection of a contract, for the remaining term of the contract and MVC fees (e.g., from an E&P debtor's rejection of a Midstream Contract, which gives rise to a prepetition damages claim); or (3) from an E&P debtor's post-petition utilization of the Midstream Provider's services, which may give rise to a higher priority administrative claim.

A prepetition claim may arise for as-yet-unpaid-for services rendered by the Midstream Provider and generally will share in the recovery pool pro rata with other unsecured creditors.[8] A rejection damages claim would arise after a Midstream Contract is rejected, as discussed above, and would also result in a prepetition general unsecured claim for damages flowing from the rejection and established by the counterparty in an amount reflecting the total remaining value due under the contract.[9] A post-petition administrative claim, on the other hand, may arise after a debtor utilizes the services of the Midstream Provider during the pendency of its bankruptcy case. Valid post-petition administrative claims must be paid in full in cash before any plan of reorganization can be confirmed,[10] thereby ensuring that the Midstream Provider receives payment ahead of general unsecured creditors and potentially diluting their recovery pool.[11]

State Law Application: Covenants Running with the Land

The issue of whether or not the contract creates a real property interest is governed not by bankruptcy law, but by applicable state law. Often, that applicable state law is Texas law, which provides that a covenant running with the land is not created simply by being denominated as one in a contract.[12] Instead, under Texas law, a covenant runs with the land when:

1) There is privity of the estate;
2) The covenant touches and concerns the land;
3) The covenant relates to a thing in existence or specifically binds the parties and their assigns;
4) The covenant is intended by the original parties to run with the land; and
5) The successor to the burden has notice.[13]

Of course, Texas law does not apply in other states; each state has its own statutes and case law that require tailored consideration. Nonetheless, an analysis of the required elements in Texas for a covenant that runs with the land is instructive for investors and creditors that wish to evaluate the likelihood of a dilution in the value of their claims against an E&P debtor. The first, second, and fourth elements above are likely to be the most heavily contested.

[8] State law statutory liens may spring in connection with prepetition and post-petition utilization of the midstream system; however, such amounts due to such use are less likely to materially impact creditor recoveries than the potential for a secured liquidated damages claim spanning the entire remaining term of the contract.

[9] *See* 11 U.S.C. § 365.

[10] *See* 11 U.S.C. § 1129(a)(9).

[11] *See* 11 U.S.C. §§ 507(a)(2), 503(b).

[12] *See, e.g.*, *Musgrave v. Brookhaven Lake Property Owners Ass'n*, 990 S.W.2d 386, 395 (Tex. App. 1999) (holding that terminology relating to the parties' intent is not dispositive of whether an obligation runs with the land).

[13] *See Inwood North Homeowners' Ass'n v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987).

Privity of the Estate

The Texas Supreme Court has held that privity of the estate is required for a covenant to run with the land. However, the court has not clarified whether this "privity" requirement refers solely to "vertical privity," or whether "horizontal privity" is required as well. Horizontal privity requires a relationship between the original parties to a covenant at the time the covenant was made. Such a relationship may be created by a grant of a legally recognized interest in real property; the covenant takes the form of a promise made by the recipient of that interest. Vertical privity requires a successor relationship between a transferor and transferee of a property bound by a covenant.

Requirements to Establish Vertical and Horizontal Privity	
Vertical Privity Requirements	1. Relationship between transferor and transferee of property bound by the covenant; and 2. Covenant contained in a grant of land or grant of some property interest in the land
Horizontal Privity Requirements	1. Relationship between the original parties to the covenant at the time it was made; and 2. Covenant contained in a grant of land or grant of some property interest in the land

Texas intermediate appellate courts have interpreted the "privity" requirement to include both vertical and horizontal privity, holding that "for a covenant to run with the land, the covenant must be made, and must be contained in a grant of land or in a grant of some property interest in the land."[14] However, in *Energytec*, the Fifth Circuit cast some doubt on the viability of the horizontal privity doctrine, noting that it was guided, but not bound, by the decisions of these intermediate courts. In *Sabine*, one of the Gatherer Counterparties argued that horizontal privity was present because the covenants at issue were granted by the debtor directly to the counterparties; however, the debtors may have strong counter-arguments, as no grant of an interest in the mineral estate coincided.

Touching and Concerning the Land

The Texas Supreme Court has acknowledged that the tests used to determine whether a covenant touches and concerns the land "are far from absolute."[15] However, the court has noted two tests that have been applied in Texas:

1) A covenant will run with the land "if it affected the nature, quality, or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it"; and

2) "If the promisor's legal relations in respect of the land in question are lessened — his legal interest as owner rendered less valuable by the promise — the burden of the covenant touches or concerns the land; if the promisee's legal relations in respect to the land are increased — his legal interest as owner rendered more valuable by the promise — the benefit of the covenant touches and concerns the land."[16]

In *Sabine*, the Gatherer Counterparties alleged that the dedications touch and concern the land because the debtors seek to use their mineral interests to produce hydrocarbons, and because market rates for gas and transportation could render their mineral interests either more or less valuable. Where contracts specifically dedicate an interest in "production" as opposed to an interest in the mineral estate, however, this argument may not survive scrutiny.

[14] *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. 2013).

[15] *Westland Oil Dev. Corp v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

[16] *Id.*

Parties' Intent

Under Texas law, the language used in an agreement is the primary evidence of intent.[17] A valid transfer of an interest in the mineral estate requires "operative words or words of grant showing an intention of the grantor to convey an interest to the grantee."[18] In addition, courts "attempting to ascertain the intention of the parties … must look to the entire instrument in the light of the stated covenant."[19] Texas appellate courts have also held that where an agreement inures to the benefit of successors and assigns, this is suggestive (but not determinative) of an intent for a covenant to run with the land.[20]

In *Sabine*, the Gatherer Counterparties argued that the gathering agreements expressly state that the dedications are covenants running with the land and contain provisions specifying that the agreement is enforceable by, and binding on, the parties' successors and assigns. The *Sabine* debtors did not specifically dispute these arguments; rather, they simply reiterated their previous position that the debtor did not convey any interest to the counterparties in a manner recognized by state law.

Whether the parties to an agreement (in *Sabine* or in any E&P bankruptcy) actually intended to convey a covenant running with the land may be evident from the specific interests actually conveyed. Under Texas law, a mineral estate contains five interests: (1) the right to develop; (2) the right to lease; (3) the right to receive bonus payments; (4) the right to receive delay rentals; and (5) the right to receive royalty payments.[21] Bonus payments, delay rentals and royalties "have a well understood meaning in the oil and gas business" as interests in real property.[22] The presence of several or all of these elements as part of a dedication may persuade a court that the intent of the parties was to convey an interest in the mineral estate.

MVC Compared with Production Payments

The legal status of certain of these interests, such as the right to receive royalty production payments, can be particularly confounding in this regard. Production payments may be construed or characterized as either conveyances of real property ("true sales"), or as disguised financings or borrowings that are merely contractual in nature. Under Texas law, production payments, whether volumetric or dollar-denominated, are real property interests if they are dependent on production from the mineral estate.[23] However, where the production payments contain provisions for minimum net volume, fixed duration, minimum interest rate thresholds and/or minimum payments due, which are not correlated with production or market risks associated with commodity prices, the contract may be recharacterized as a disguised financing (i.e., borrowings), regardless of its label.

In this regard, dedication provisions with an MVC may be somewhat analogous to certain types of production payments; whether such agreements should be characterized as real property interests or contractual obligations will be highly dependent on the terms of the agreement. If a Midstream Provider is entitled to payments regardless of whether oil and gas are produced from the mineral estate (e.g., from MVCs), such an agreement could be more likely to be characterized as a contractual interest that could be rejected by an E&P in bankruptcy.[24]

'Free and Clear' Sales Under Section 363

The resolution of the *Sabine* litigation may bring some level of clarity as to whether certain types of dedications are covenants running with the land. But even in *Sabine*, the debtors acknowledged they had additional Midstream Contracts in place with explicit language that appeared to meet all state law requirements for a dedication to be recognized as a covenant that ran with the land. As a result, the debtors did not attempt rejection. Further, even if a

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[17] *See Perry Homes v. Cull*, 258 S.W.3d 580, 606 (Tex. 2008).

[18] *MASGAS v. Anderson*, 310 S.W.3d 567, 570 (Tex. App. 2010).

[19] *Billington v. Riffe*, 492 S.W.2d 343, 346 (Tex. App. 1973).

[20] *See Monfort v. Trek Resources, Inc*. 198 S.W.3d 344, 355 (Tex. App. 2006).

[21] *In re Estate of Slaughter*, 305 S.W.3d 804, 808 (Tex. App. 2010).

[22] *Id*.

[23] *See, e.g., Tenant v. Dunn* 110 S.W.2d 53, 57 (Tex. 1937) (holding that oil and gas royalties retained by the lessor of a mineral estate "whether payable in kind or in money … [are] present interests in land").

[24] For an overview of investing in oil and gas royalties, please see the SRZ *White Paper* "Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations," available at www.srz.com/Investing_in_Oil_and_Gas_Royalties_Distressed_Counterparty_Risk_Considerations/.

Midstream Contract is found to be (or contains) a covenant running with the land, an E&P debtor may still be able to sell the underlying land free and clear of that interest pursuant to Section 363(f)(5) of the Bankruptcy Code.

Under Section 363(f)(5), a debtor may sell property of the estate free and clear of any third party's interest in the property if "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[25] Based on existing case law, it is possible that a debtor could sell "free and clear" of a covenant running with the land pursuant to Section 363(f)(5) because the Midstream Provider could be compelled to accept money satisfaction of its interest. In *Energytec*, the debtor sold a pipeline system that was burdened by a security interest and lien securing the debtor's obligation to pay the transportation fee. The sale was approved by the bankruptcy court as well as by the district court on appeal, but the district court's judgment was ultimately vacated and remanded for further proceedings.[26] The jurisprudence remains unsettled as to when a Midstream Provider may be compelled to accept money satisfaction of its covenant running with the land under Section 363(f)(5).

The outcome of a Section 363 sale may depend heavily on the status of an E&P's Midstream Contracts and any rejection damages claims. First, the resolution of Midstream Contract issues may provide the opportunity for a more economic agreement to be put in place, which in turn may facilitate drilling, profitability and the receipt of higher bids from any interested buyers. Second, as illustrated in the *Quicksilver Resources* bankruptcy case, it is less likely that a potential buyer will be willing to purchase assets that are subject to a battle over rejection damages claims; instead, the buyer may want to have Midstream Contract issues resolved before consummation of the sale.

In *Quicksilver Resources*, the debtor commenced a process to sell substantially all of its assets via a Section 363 sale process. The winning bidder for Quicksilver's Barnett Shale assets, Bluestone Natural Resources II ("Bluestone"), conditioned its bid on the rejection of certain Midstream Contracts with Crestwood Midstream Partners. While it is possible that the bidder and Crestwood may settle, or agree to amend and assume and assign a modified version of the Midstream Contract, by its actions Bluestone has made it clear it is not interested in buying into a contract rejection dispute.

Conclusion

Midstream Contract claims may significantly impact the recovery value of a creditor's claim against an E&P debtor's estate, and uncertainty over treatment of Midstream Contracts may impair asset sale prospects. Depending on the precise language used and applicable state law, dedication provisions could be classified by a court either as mere contractual interests granted within the scope of a services agreement, or as covenants that run with the land or conveyances of real property to a third party. Should a court reach the latter finding, secured and unsecured E&P creditors alike may face significant claim dilution. While the cases discussed in this *White Paper* are instructive, they are far from the last word on the issue of how dedications of reserves and MVCs will be interpreted in any given situation.

[25] 11 U.S.C. § 363(f)(5).

[26] *Newco Energy, Inc. v. Energytec, Inc.*, 2012 WL 4627028 (E.D. Tex. 2012), *vacated and remanded sub nom, In re Energytec, Inc*., 739 F.3d 215 (5th Cir. 2013).

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Valuation Issues in Oil and Gas Bankruptcies Outline

Valuation Issues in Oil and Gas Bankruptcies

I. Valuation Generally

A. Valuation is a critical, and often hotly disputed, issue in most bankruptcy cases. Enterprise valuations drive creditor recoveries and solvency valuations are often outcome determinative for the success (or failure) of fraudulent transfer and other bankruptcy-related litigation. Despite its importance, the valuation exercise is highly subjective and "reasonable minds can and often do disagree. This is because the output of financial valuation models are driven by their inputs, many of which are subjective in nature." *Peltz v. Hatten*, 279 B.R. 710, 737 (D. Del. 2002). Valuation has been aptly described by courts as a "guess compounded by an estimate." *In re Tribune Co.*, 464 B.R. 126, 147 (Bankr. D. Del. 2011) (citing 7-1129 Collier on Bankruptcy ¶ 1129.05[3][c]). As a result, valuation disputes often become a mini-battle of the experts, the reasonableness of their assumptions and their relative credibility.

B. Valuations in the context of oil and gas bankruptcy cases are significantly more complicated than valuations of operating companies in other industries. Moreover, bankruptcy courts have considerably less familiarity with the geologic issues, engineering data and pricing assumptions that drive the valuation exercise. As a result, the next wave of bankruptcy cases, especially those in the exploration and production industry, will almost certainly involve heavily contested valuations (or at least the credible threat of litigation to maximize recoveries).

II. Relevancy of Valuations in Bankruptcy

A. Collateral and business enterprise valuations are relevant in numerous different contexts within a bankruptcy case, including plan confirmation, post-petition financing, avoidance actions and other contexts. A brief summary of the context in which valuation is relevant is set forth below.

B. Plan Confirmation. Valuation is the primary factor that drives plan negotiations because the value of a reorganized debtor determines the distribution of value (whether cash, debt or new equity) among stakeholders. Valuation is relevant to confirmation of a contested plan. It is necessary to value the debtor when at least one impaired class rejects the plan and the plan proponent seeks to confirm the plan pursuant to the so-called "cram down" provisions of the Bankruptcy Code. *See* 11 U.S.C. § 1129(b). In this context, an enterprise valuation is often necessary to determine whether senior creditors are receiving distributions in excess of their allowed claims to the detriment of junior stakeholders (subordinated debt or equity). Valuation is also relevant in the plan context when there are minority dissenting creditors in a class that votes to accept the plan. In this scenario, the plan proponent must demonstrate that the plan provides dissenting creditors with a distribution equal to at least as much as what such creditors would receive in a hypothetical liquidation. *See* 11 U.S.C. § 1129(a)(7)(A)(ii). This is referred to as the "best interests test" and requires an enterprise valuation showing creditor distributions under a liquidation scenario.

C. Priming DIP Loan and Non-Consensual Use of Cash Collateral. Secured creditors are entitled to "adequate protection" against the erosion in their collateral value. A common type of collateral value erosion arises from the (i) incurrence of senior debt due to approval of a priming or *pro rata* post-petition loan or (ii) non-consensual use of cash collateral. In each of these circumstances, the secured creditor is entitled to adequate protection. *See* 11 U.S.C. § 363(e) (addressing adequate protection for cash collateral use) and § 364(d)(1)(B) (addressing adequate protection in connection with post-petition financing). Entitlement to adequate protection often requires a valuation of a secured creditor's collateral to determine whether the creditor is sufficiently protected with an equity cushion (as a form of adequate protection under § 361(3) of the Bankruptcy Code). *See In re Satcon Tech. Corp.*, 2012 WL

6091160 (Bankr. D. Del. Dec. 7, 2012) (valuation showed equity cushion and holding that secured lenders were adequately protected). An equity cushion exists when the value of the collateral exceeds value of the secured claim. Thus, a valuation of the collateral is required to determine the existence and size of the equity cushion.

D. Recovery of Post-Petition Interest. Secured creditors can recover post-petition interest and fees when the value of the collateral exceeds the value of the claim amount. *See* 11 U.S.C. § 506(b). Valuation of collateral is therefore necessary to determine whether a secured creditor is over-secured *(i.e.,* collateral value exceeds claim amount).

E. Automatic Stay Relief. A creditor can seek relief from the automatic stay for "cause," which includes a lack of adequate protection. *See* 11 U.S.C. § 362(d)(1). The concept of adequate protection (as discussed above) often requires a valuation to determine whether the debtor has any equity in the collateral.

F. Solvency. Valuation is relevant to establish the debtor's insolvency in connection with several bankruptcy-related claims.

1. *Fraudulent Transfer.* Fraudulent transfer litigation frequently involves disputes regarding valuation and solvency. These disputes arise in connection with "constructive fraudulent transfers" because the Bankruptcy Code and state fraudulent transfer law require evidence as to whether the debtor (i) was "insolvent" at the time of (or as a result of) the transaction at issue and (ii) received "reasonably equivalent value" or "fair consideration" in connection with the transaction at issue. *See* 11 U.S.C. § 548(a)(1)(B). Valuation and solvency are also relevant in "actual fraudulent transfer" actions because the debtor's insolvency and the sufficiency of the consideration are well-established "badges of fraud." *See, e.g., In re DBSI, Inc.*, 476 B.R. 413, 420 (Bankr. D. Del. 2012) (noting that insolvency and consideration for the transfer are among the "traditional badges of fraud").

2. *Preference.* Valuations to demonstrate insolvency are sometimes relevant in connection with an action to avoid a preferential transfer under Bankruptcy Code § 547(a). The issue is less frequently disputed (as compared to fraudulent transfer litigation) because the debtor is presumed to be insolvent for a period of 90 days before the bankruptcy petition's filing. *See* 11 U.S.C. § 547(f).

3. *Breach of Fiduciary Duty.* Solvency disputes often play a central role in litigation against directors and officers for breaches of fiduciary duty. In the bankruptcy context, these claims are often filed by trustees or creditors' committees seeking to enforce duties owed by directors and officers to the debtor's creditors (as opposed to shareholders). Valuation to determine the debtor's solvency at the time of the challenged board decision is relevant because fiduciary duties (at least under Delaware law) expand to include creditors only after the company becomes insolvent. *See generally*, *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92 (Del. 2006).

4. *Recharacterization.* Recharacterization is an equitable remedy that allows a court to recharacterize a debt instrument as an equity investment. *See, e.g.*, *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp)*, 432 F.3d 448, 456 (3d Cir. 2006). Valuation is relevant because most courts apply a multi-factor test, which includes an assessment of the debtor's solvency and financial condition at the time of transaction to determine whether an investment should be considered equity. *E.g., Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 752 (6th Cir. 2001).

G. Equity Committee Formation. Valuation is relevant in connection with the formation of an equity committee. The United States Trustee is more inclined to appoint an equity committee when there is evidence that the debtor's estate is not hopelessly insolvent. E.g. *In re Williams Commc'n Group, Inc.*, 281

B.R. 216, 223 (Bankr. S.D.N.Y. 2002) (“When a debtor appears to be hopelessly insolvent, an equity committee is not generally warranted . . . .”); *see also In re Spansion, Inc.*, 421 B.R. 151, 156 (Bankr. D. Del. 2009) (“[I]f equity holders have no reasonable prospect of receiving a meaningful distribution . . . an equity committee could serve no legitimate role . . . .”); *Exide Techs. V. Wis. Inv. Bd.*, 2002 WL 32332000, at *1-2 (D. Del. Dec. 23, 2002) (observing that additional factors are considered if it does not appear that the debtor is hopelessly insolvent).

III. Traditional Valuation Approaches

A. The three traditional valuation approaches most commonly used in bankruptcy cases are the income approach, the market approach and the asset approach.

1. Income approach, which attempts to estimate the present value of a future cash flow

2. Market approach, which uses data gathered from similar companies or industry transactions to apply metrics to the subject company

3. Asset approach, which establishes the net fair market value of a company’s assets.

B. Income Approach. The discounted cash flow (“DCF”) method is the most commonly used income approach when the subject company is expected to generate positive cash flow. The DCF method determines value based on the sum of two parts: (a) debt-free cash flow during the projection period (typically 3 to 5 years) and (b) terminal value, which represents the remaining value of the company outside the projection period.

1. The debt-free cash flow expected to be generated during the projection period must be reduced to its present value. To do this, the debt-free cash flow is discounted by the weighted average cost of capital (or WACC). The WACC is the combined cost of debt and cost of equity. The lower the WACC, the higher the present value of the cash flows. WACC starts with a risk-free rate and is built up with a number of components, including a company specific risk premium.

2. The terminal value is the remaining value of the company after the projection period. The terminal value can be calculated assuming a perpetual growth rate of the terminal debt-free cash flow or as a multiple of the company’s terminal EBITDA.

C. Market Approach

1. *Comparable Company Analysis*. This approach provides an indication of value of the business by developing valuation multiples based on the prices at which securities of similar companies trade in public market. The market-based multiples are then applied to the historical operating results (typically last twelve months EBITDA) of the subject business. E&P specific metrics per Sabine Expert Report in *In re Sabine Oil & Gas Corporation* (Bankr. S.N.D.Y.) submitted in December 2015:

(a) Adjusted Business Enterprise Value (BEV) (market value of equity plus market value of debt less cash)/LTM EBTIDA plus exploration expenses (“EBITDAX”)

(b) Adjusted BEV/LTM Adjusted Revenue

(c) Adjusted BEV

(i) Disputes often center on similarities of the peer companies to the subjective company (*e.g.,* size, industry, product/services, geographic region, customer base, profit margins, growth patterns). For E&P, other variables of comparability include: reserve base, natural gas v. oil mix, reserve life, area of operation.

(ii) According to a white paper published by Deloitte in January 2015, the comparable company method "is challenging for E&P companies to use because (1) finding new resource plays is difficult, (2) multiples in the same play can vary greatly, and (3) undeveloped acreage multiples from market transactions are rarely published."

2. *Precedent Transaction Analysis*. This approach provides an indication of value based on sale price in actual M&A transactions for comparable companies. Disputes often center on comparability of the target company with the selling company. According to the Sabine Expert Report, the "lack of recent comparable transactions, as well as the material down-turn in the process in the oil and gas markets" made this precedent transaction analysis "less reliable." For this reason, the expert did not rely on this approach to determine value. The valuation expert in *In re Cook Inlet Energy* followed the same approach.

3. *Other Market Approaches*. Courts have rejected expert testimony using traditional valuation approaches when there is contemporaneous market evidence of value. Several cases (including decisions from the Third and Fifth Circuit, and SDNY) have looked to the subject company's equity market capitalization as determinative of value in the context of fraudulent transfer actions when there was no reason to distrust the market (e.g., fraud, thinly traded market). *E.g.*, *VFB LLC v. Campbell Soup Co., 482 f.3d 624 (3d cir. 2007)*; *Iridium Operating LLC, et al v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007); *U.S. Bank N.A. v. Verizon Communications, Inc.,* 761 F.3d 409 (5th Cir. 2014)). We are not aware of any cases that use this approach to determine value for *distribution* purposes.

(a) In an unreported decision in the chapter 11 case of *Global Geophysical* (oil field services) the Texas bankruptcy court used this market approach to determine an equity cushion to support priming DIP financing on an interim basis. The Bankruptcy Court concluded that existing lenders could be primed based, in part, on the fact that subordinated debt was trading at 50% of par, suggesting that the bond market viewed the debtor's value as sufficient to pay the senior lenders in full with a return of 50% to the junior class. The case was settled before the final hearing.

(b) For companies with publicly traded debt, stakeholders will often cite to debt trading below par as evidence of value. It is important to note that for purposes of determining solvency, courts (including Third Circuit) have rejected the use of trading values of debt. "Unlike assets, debts are measured at their face value and not market value." *In re Lids Corp*., 281 B.R. 535, 545 (Bankr. D. Del. 2002) (*Travellers Int'l AG v. Trans World Airlines, Inc*., 134 F.3d at 193). Nevertheless, stakeholders regularly cite to the below-par trading price of debt instruments as evidence of insolvency.

D. Asset Approach

1. The "adjusted balance sheet test"/net asset value approach is sometimes used as a valuation method to determine insolvency. This test (i) starts with the company's balance sheet, (ii) makes adjustments (upward or downward) to asset values to reflect "fair value," (iii) makes adjustments for off-balance sheet assets and liabilities and (iv) compares the aggregate asset value to liabilities.

2. Courts will not accept a balance sheet on its face because unadjusted balance sheets prepared according to generally accepted accounting principles ("GAAP") are imperfect for the purposes of

bankruptcy insolvency analysis. Although some courts have used the adjusted balance sheet method, that method has been criticized as an unreliable methodology for valuing a going concern business.

IV. Valuation of Oil and Gas Reserves

A. The primary assets of an E&P company are its oil and gas reserves. Reserve estimates are uncertain and depend primarily upon the amount of geologic and engineering data available at the time of the estimate and the interpretation of that data. The starting point for the reserve valuation is the reserve report prepared by an engineer.

B. Reserve Quantity. The reserve report estimates the quantity (typically expressed as barrels of oil equivalent (“boe”) or thousands of cubic feet equivalent (“mcfe”) for gas) based on the following six categories:

Proved Developed Producing (PDP)

Proved Developed Non-producing (PDP)

Proved undeveloped (PUD)

Probable reserves

Possible reserves

Undeveloped reserves

1. Key Questions About Reserve Volumes

(a) How do projected volumes compare with historical production volumes? If materially different, why?

(b) What drilling and capital expenditures assumptions were used in developing the projections for PUDs? Probable? Possible?

(c) How concentrated is the production by well, by filed and by region? If one or only a few wells represents a significant portion of the projected production, a risk adjustment may be warranted.

C. Pricing Assumptions. Once the reserves are quantified by the engineer, the next material input affecting reserve value is the pricing assumption used to determine revenue. Any hedging contracts should be factored into the pricing assumptions. According to a white paper published by Deloitte in Jan 2015, “Generally, E&P companies use forward strip pricing as determined by the New York Mercantile Exchange (NYMEX) or other pricing benchmarks (e.g., Brent, WTI) in their DCF models. Forward strip pricing over a period of up to five years is useful for valuation purposes since there is active futures trading activity within that time horizon. Beyond the last date of the forward strip, a company should estimate prices by using more subjective judgments that typically involve applying an inflation factor to the NYMEX futures price. Pricing benchmarks can vary greatly depending on location. Commodity price differentials are another key metric that could affect the assumptions used in the DCF model. Oil and natural gas prices can vary as a result of multiple factors, including (1) quality, (2) transportation costs, and (3) proximity to market or delivery point.”

D. "PV10 Value" is Not "Fair Market Value". The SEC mandates publicly traded companies include summary reserve report information in their annual Form 10-K filings, including calculation of the PV10 value, an acronym for "present value at 10%." Valuation experts appear to generally agree that PV10 does not represent "fair market value."

E. Significant "Professional Judgment" In Reserve Valuation. Set forth below is a reserve valuation of "Proved Reserve" from January 2016 submitted by PJT Partners in connection with the disclosure statement in Magnum Hunter's bankruptcy case pending in Bankruptcy Court in Delaware. *See In re Magum Hunter Resources Corp et al*. (Case No 15-12533 (KG)) Dkt No. 294. We have also noted differences from a reserve valuation (a) by Mesirow Financial from October 2015 in Sabine Oil and Gas bankruptcy case pending in the Southern District of New York and (b) by PJT Partners (fka Blackstone) in September 2015 in Samson Energy's bankruptcy case pending in Delaware. Even though the experts are valuing different companies, the differences in key assumptions illustrate how subjectivity and professional judgment can significantly impact the valuation range.

1. *Step 1*: Expert risk adjusted the reserves pursuant to discounts recommended by The Society of Petroleum Evaluation Engineers in the 34th annual survey dated June 2015.

Reserve Category	**Discount per Survey**	**Magum Hunter Discount**	**Sabine Discount**	**Samson Discount**
Proved Developed Producing (PDP)	0-10%	Not disclosed	8%	0%
Proved Developed Non-producing (PDNP)	5-50%	Not disclosed	10%	Not disclosed
Proved undeveloped (PUD)	10-50%	Not disclosed	15%	10-35%
Probable			50-70%	
Possible			75-90%	

2. *Step 2*: Estimate future production volumes attributable to the proved reserves and multiply by projected realized price. Experts did not disclose projected realized price.

3. *Step 3*: Subtract projected production taxes, ad valorem taxes, lease operating expenses, transportation expenses and capital expenses from revenue to calculate net cash flows.

4. *Step 4*: The net cash flows are then further discounted "at an industry standard 10% discount rate to estimate aggregate present value of the risk adjusted cash flows."

F. Other Methodologies for Undrilled Acreage Valuation. Magnum Hunter's expert also used (i) precedent transaction analysis and (ii) hypothetical drilling plan analysis to value the reserves.

1. Under this precedent transaction approach, the expert estimated value of the undrilled acreage by observing the price per acre multiples paid by buyers of comparable assets or business and applying those multiples to debtor's undrilled acreage. The expert then "normalized" selected precedent transactions to account for current pricing, local transportation costs and basis differentials. The expert also considered the impact that changes in well permits and active drilling rigs may have on market values.

2. Under the hypothetical drilling analysis, the expert estimated value of undrilled acreage by projecting net cash flows that can be generated from drilling economic wells on debtor's acreage and discounting cash flows at a discount rate of 10%. In projecting cash flow, the expert disclosed that he evaluated (i) acreage maps with potential drilling units and well paths, (ii) "independent type curves of offsetting wells and comparisons to the Debtors' type cures," (iii) local gathering and transportation costs and basis differentials, (iv) production taxes, ad valorem taxes, lease operating expenses and capital expenses.

G. Conclusion. Valuation in bankruptcy, especially in oil and gas, is predicated on a host of subjective assumptions that will be ripe for disputes. The subjective adjustments will have huge impacts on the valuation conclusions. As a result, the bankruptcy court will be faced with competing valuations that are materially far apart in their conclusions. Stakeholders will continue to use litigation valuation issues, or at least use the threat of litigation, to advance their respective positions. Investors will need to navigate these issues with credible experts to maximize their recovery.

Purchases of Oil and Gas Assets in Bankruptcy Outline

Purchases of Oil and Gas Assets in Bankruptcy

I. Types of Chapter 11 Sales

A. Asset sale — A sale of some, substantially all, or all of the assets of a Chapter 11 debtor outside the ordinary course of business, but not pursuant to a plan of reorganization or liquidation. 11 U.S.C. § 363(b).

B. Plan sale — A sale of some, substantially all, or all of the assets *or equity* of a Chapter 11 debtor pursuant to the terms of a confirmed Chapter 11 plan of reorganization or liquidation. 11 U.S.C. §§ 1123(a)(5), 1129.

II. Advantages of Chapter 11 Sales over Out-of-Court Sales

A. Title — A court-approved sale provides for the transfer of assets (or equity) “free and clear” of all existing liens, claims, interests, and encumbrances, provided the statutory and legal requirements for such a sale are met.

B. Minimize need for shareholder/lender consents — Chapter 11 sales can, under most circumstances, be approved and/or consummated even over the objection of lenders, creditors, or shareholders.

C. Mitigate risks associated with later bankruptcy filing by seller — Challenges by disgruntled creditors or shareholders to the propriety of a sale may be minimized by using the Chapter 11 process.

D. Mitigate fraudulent transfer, successor liability, statutory liability (e.g., tax, environmental, etc.) risks — A Chapter 11 sale order generally contains findings of fact and conclusions of law to mitigate and/or eliminate these and similar risks to the purchaser.

E. Potential to provide interim DIP financing as bridge to sale — If the debtor-seller cannot sustain its operations until consummation of a sale, the putative purchaser may be able provide financing, often on a superpriority and/or first lien basis, as a bridge to the sale.

F. Cherry picking by purchaser — Chapter 11 sales provide an enhanced ability to select precisely which assets, contracts, etc. are to be purchased and which are to be excluded.

III. Section 363 Sales

A. Process/Timing

1. *Stalking horse bidder vs. open auction.* Purchase agreements are often entered into prior to, and in anticipation of, the debtor-seller’s bankruptcy, but there is no requirement that a § 363 sale process begin with a stalking horse bidder. The benefit to the debtor-seller of having a stalking horse bidder is that its bid serves as a floor to attract higher or better offers, as potential bidders will recognize that the stalking horse has performed its due diligence and its proposed purchase price is thus an informed price.

2. *Benefits of being stalking horse.* To ensure a bidder’s interest and encourage that bidder to serve as the stalking horse, a debtor-seller may provide the bidder with certain protections. Bidding protections may include, among others, a break-up fee and expense reimbursement, usually payable upon the consummation of the sale to another purchaser, and limited exclusivity/non-solicitation provisions.

(a) Break-up fee — A fee paid by the debtor-seller to the stalking horse bidder if the contemplated transaction is not consummated under certain circumstances, most often because the debtor-seller consummates an alternate transaction with a different purchaser. The fee is intended to be an incentive payment to an unsuccessful bidder that had put the debtor-seller's assets into sale mode to attract other bidders. In determining whether a break-up fee is reasonable or warranted, a court will consider, among other things, whether it is so substantial as to have a chilling effect on other prospective bidders (the acceptable range is generally up to approximately 3% of the transaction value) and whether the stalking horse provided a benefit to the debtor-seller's bankruptcy estate by attracting other bidders.

(b) Expense reimbursement — The purpose of an expense reimbursement is to cover the stalking horse bidder's reasonable, out-of-pocket expenses incurred in connection with entering into the proposed transaction, in the event the stalking horse is not the successful bidder. There is no set formula for determining the amount to be reimbursed; it will largely depend on the transaction value and the scope and extent of required due diligence and the time and effort involved in reaching agreement on terms, and will be negotiated in the context of the purchase agreement.

(c) Exclusivity/non-solicitation provisions — Because one goal of bankruptcy is to maximize the value of the debtor's assets, courts are reticent to approve bidding procedures that do not allow the debtor-seller to entertain expressions of interest or proposals from other potential bidders. Some courts will allow "window shop" provisions under appropriate circumstances, *e.g.*, when the debtor-seller conducted a robust prepetition sale process and determined that the stalking horse bid was the highest or best offer available.

(d) Other bidding protections — In most § 363 sales of any size, the debtor-seller will seek approval of bidding procedures to govern sale process. Often these are negotiated by the debtor-seller and stalking horse bidder as part of the stalking horse's asset purchase agreement. Bidding procedures thus offer the stalking horse a chance to minimize competition while the debtor-seller maintains as level a playing field as possible during the sale process. Bidding procedures may include some or all of the following:

(i) Initial overbids must exceed a minimum amount (usually a specified amount above the proposed purchase price plus the amount of any break-up fee and expense reimbursement);

(ii) Subsequent bids must be in minimum increments, as must bids at any auction that is held;

(iii) Specific criteria for putative bidders to become qualified bidders;

(iv) Clearly defined time frames and parameters for due diligence;

(v) Access to copies of competing bids;

(vi) Specifying the form of consideration required for competing bids (*e.g.*, cash only); and

(vii) Limitations on the debtor-seller's ability to modify deadlines, bidding procedures, and auction rules once approved by court.

3. *Purchase Agreement.* The asset purchase agreement for a § 363 sale is generally similar to an asset purchase agreement for a sale outside of Chapter 11. One primary distinction, however, is that it is

not binding on the debtor-seller until it is approved by court (even if executed) at a sale hearing. Other differences may include that the § 363 asset purchase agreement:

(a) Contains provisions regarding sufficient notice of the sale and a requirement for entry of a final order by the bankruptcy court;

(b) Details multiple forms of consideration that will comprise the aggregate purchase price (*e.g.*, cash, equity, assumption of liabilities, etc.);

(c) Contains fewer representations and warranties, conditions to closing, and post-closing covenants;

(d) Specifies a process for designating, assuming and assigning executory contracts and unexpired leases; and

(e) Contains few, if any, indemnification rights against the debtor-seller.

B. Credit bidding — Section 363(k) of the Bankruptcy Code permits secured creditors to "credit bid" the amount of their secured claim as the purchase price, rather than paying cash or some other form of consideration. 11 U.S.C. § 363(k). Even undersecured creditors can credit bid, because secured creditors are permitted to bid the full face value of their secured claims under § 363(k). *See, e.g., In re Submicron Sys. Corp*., 432 F.3d 448, 459, 461 (3d Cir. 2006). This affords secured creditors a distinct tactical advantage in bidding on a debtor-seller's assets. *N.B.* — Often, to be successful, a bid primarily comprised of a credit bid also will need to contain a cash component (*e.g.*, to satisfy existing liens, obtain creditors' committee support (especially if there are no other unencumbered assets available for the unsecured creditors), and/or to purchase related unencumbered assets that are necessary for the going-forward operation of the business).

C. Legal standards

1. *Approval of sale.* The debtor-seller generally must show that it has a sound business justification for selling its assets outside of the ordinary course of business and other than under a plan of reorganization or liquidation. The court may look to such factors as the proportionate value of the assets to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan will be proposed and confirmed in the near future, the effect of the proposed distribution on future plans, the proceeds to be obtained as compared to any appraisals of the assets, and whether the assets are increasing or decreasing in value. *N.B.* In *In re Gulf Coast Oil Corp.*, 404 B.R. 407, 422-27 (Bankr. S.D. Tex. 2009) the court created a multi-factor test for approval of § 363 sales. (*See* Appendix 1 for the list of factors.) Some judges in S.D. Tex. continue to follow the *Gulf Coast* approach.

2. *Free and clear of "interests."* Section 363(f) affords a sale "free and clear" status if *any one* of the following five conditions are met:

(a) Applicable law permits a sale free and clear of interests — the relevant applicable law often is state law, such as state property law or UCC § 9-320(a), which permits buyers in the ordinary course of business to take goods free of security interests created by the seller;

(b) Each entity with an interest consents to the sale;

(c) The interest is a lien and the sale price exceeds the value of all liens — *N.B.:* Courts are split as to the meaning of "value." Some hold that the sale price must exceed the "face" value of the lien on the property; others find that the price must merely exceed the "economic value" of the lien, as determined by the property's fair market value;

(d) The interest is in bona fide dispute — this is a codification of long-established law that allows property to be sold free and clear of a disputed debt, permitting a sale where the fundamental validity of a lien or other property interest is in dispute, but it cannot be used as a mechanism to sell property that does not truly belong to estate; or

(e) The entity that holds the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its interest — this allows a sale over the objection of a secured creditor whose claim will not be paid in full by the purchase price whenever its release of its security hypothetically could be compelled, as in a foreclosure action by a lienholder senior to the objecting creditor. *N.B.:* Some courts have adopted a more liberal interpretation of the hypothetical "proceeding requirement and held that debtor-seller must merely establish the existence of a bankruptcy mechanism that would extinguish the creditor's lien or interest. The most commonly cited proceeding is a "cramdown" by a debtor confirming a Chapter 11 plan. *See, e.g.*, *In re Grand Slam U.S.A., Inc.*, 178 B.R. 460 (E.D. Mich. 1995); *In re Healthco Int'l., Inc.*, 174 B.R. 174 (Bankr. D. Mass. 1994); *In re Terrace Chalet Apartments, Ltd.*, 159 B.R. 821 (N.D. Ill. 1993); *In re WPRV-TV, Inc.*, 143 B.R. 315 (D.P.R. 1991).

3. Definition of "interests."

(a) General definition — Most courts have a very broad view of "interests," encompassing all liens, claims, and other encumbrances of any type or nature whatsoever. The rationale is that "free and clear" should be given an expansive meaning in the context of a § 363 sale in order to encourage purchasers to make their highest or best offer.

(b) Special "interests" that may be present in oil and gas cases.

(i) Specialty liens

(1) Liens to secure obligation to pay royalties — Many states (including Texas, Kansas, Oklahoma, Mississippi, North Dakota, and New Mexico) have first purchaser lien statutes that afford a producer or royalty owner a statutory lien against oil and gas (and sometimes accounts, chattel, inventory, etc.) transferred to a first purchaser (such as a midstream) until the producer or royalty holder is paid for such oil and gas. The purpose of these statutes is to minimize the risk to producers and royalty owners of non-payment for production. Absent such lien rights, royalty creditors are treated as general unsecured creditors.) Under Texas law, for example, the royalty holder's lien is treated as a purchase money security interest and no filing of a financing statement is required for perfection. Under Oklahoma law, similarly, no filing is required and, except for certain "permitted liens," a royalty holder's lien will take priority over any other lien, whether arising by contract, law, equity or otherwise. "Permitted lien" is narrowly defined in the Oklahoma statute and does not include typical finance liens. Ultimately, the relative priorities of royalty holders' liens vis-à-vis other lienholders will be decided by resort to applicable non-bankruptcy law.

(2) Mechanics' & Materialman's liens — Most states grant a statutory lien to mechanics and materialmen that provide materials and/or services to improve real property. Some states have specific M&M liens for oil and gas vendors (*e.g.* Texas, Oklahoma,

and Louisiana); others simply apply their general M&M lien provisions (*e.g.*, Alabama and West Virginia).

a. The precise scope of M&M liens varies from state to state.

b. In all states, to potentially preserve priority vis-à-vis other secured creditors, such as lenders, M&M liens must be perfected by filing.

c. The priority of an M&M lien vis-à-vis other secured creditors will be determined in accordance with applicable state law; however, the "first in time" rule is generally applicable and many state statutes provide that M&M liens arise as of the *first day* that work is performed or materials are provided.

(3) Operator's liens (under joint operating agreements ("JOAs") — To secure each party's proportionate share of all of its respective obligations under a JOA, including the payment of expenses, the parties grant to each other (A) a lien on and security interest in both current and future acquired real property located within the geographic area covered by the JOA and (B) a security interest in the currently-owned and after-acquired personal property and fixtures related to the real property. The lien and security interest also extend to oil and gas when extracted. To obtain and maintain priority vis-à-vis other secured creditors, which generally will be determined by the "first to file" rule, each party must perfect its security interests by a recording in the applicable state and county records. *See, e.g.*, A.A.P.L. Form 610-1989 Model Form Operating Agreement.

(ii) Environmental and other regulatory obligations (*e.g.*, plugging and abandonment obligations) — Many courts have held that a debtor cannot abandon property with outstanding unplugged wells in contravention of law, even when meeting plugging and abandonment obligations will leave nothing for the estate or its creditors. *See, e.g., Texas v. Lowe (In re H.L.S. Energy Co.),* 151 F.3d 434, 438 (5th Cir. 1998) (*citing Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 507, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986)). *But see In re ATP Oil & Gas Corp.*, 2013 WL 3157567 (Bankr. S.D. Tex. June 19, 2013)(abandonment of certain outer continental shelf properties permitted). In addition, some courts have held that claims for plugging and abandonment obligations that arise postpetition are entitled to administrative priority status in a Chapter 11 case; the status of similar prepetition claims is an unsettled matter. Purchasers of oil and gas assets must be mindful that environmental liabilities may be difficult to shed, even in the context of a "free and clear" sale under § 363.

4. *Good faith purchaser.* Section 363(m) of the Bankruptcy Code protects a good faith purchaser from invalidation of the sale if the sale order is later modified or overturned on appeal. Lack of good faith may include such things as fraud or collusion between the purchaser and other bidders (or the debtor-seller), or any attempt to take grossly unfair advantage of the debtor-seller or other bidders.

D. Sale order — The sale order may be the most important part of the § 363 process for the purchaser, because the purchaser will rely on it post-closing to protect itself from, among other things, claims of the debtor-seller's creditors, successor liability, additional cure amounts, liens, taxes, and the assertion of any "anti-assignment" clauses. The order contains critical terms to insulate the sale and the purchaser, such as findings regarding (i) the debtor-seller's business justification, (ii) the sale being in best interests of the debtor-seller's bankruptcy estate and creditors, (iii) the purchaser being a good faith purchaser, (iv) the purchase price being reasonably equivalent value (for fraudulent transfer purposes), and (v) perhaps most important, the transfer of the assets free and clear of all interests.

IV. Sales Under A Plan

A. When preferable or necessary — A sale under § 363 may not always be feasible or appropriate. In fact, sometimes it may be preferable, or even required, that an acquisition be consummated under a plan, such as in the following circumstances:

1. If the proposed transaction and/or the Chapter 11 case itself involves settlement of litigation claims;

2. If structural issues exist, such as the purchaser's desire to use equity of the reorganized company as currency for the acquisition;

3. If claims exist against the debtor-seller from which the purchaser wants insulation (*e.g.*, if there is significant potential for successor liability claims, a plan may insulate the purchaser through the discharge of those claims in a manner that is not possible with a § 363 sale order);

4. If there are significant transfer taxes involved (§ 1146(a) of the Bankruptcy Code specifically excludes from tax liability instruments of transfer delivered pursuant to a plan, but not transfers made pursuant to § 363);

5. If the purchaser does not want to be a stalking horse bidder and/or wishes to minimize the likelihood of a competitive bidding process;

6. If there are difficult executory contract assumption and/or assignment issues, which may be more susceptible to resolution under a plan than in a § 363 sale context (*e.g.,* contracts or leases that cannot be assigned without consent; a preference not to record multiple lease assignments, etc.);

7. If there is a need/desire to structure the acquisition so as to maximize future availability of the debtor-seller's net operating losses and/or other valuable tax attributes.

B. Plan process/timing — At a minimum, the plan process involves two hearings following the debtor's formulation and negotiation of a plan. First, there is a hearing to consider approval of the debtor's disclosure statement with respect to the plan, and later, a hearing to consider confirmation of the plan. Voting on the plan occurs during the period between the two hearings (generally 30-45 days). In a traditional Chapter 11 case, the plan process generally will be significantly longer (minimum of approximately 120 days, but often much longer) than would be a § 363 sale process (potentially as short as 30-60 days, but often 45-90 days); however, a prepackaged or prearranged plan may simultaneously afford many of the benefits of a plan (*i.e.*, global resolution of claims) and a § 363 sale (*i.e.*, speed/cost).

V. Advantages of § 363 Sales Over Plan Sales

A. Timing/cost — Generally, a § 363 sale process is of shorter duration and less expensive than a plan process.

B. Creditor/shareholder approval not required — There is no voting in the context of a § 363 sale, though creditors do have the right to object. In the plan process, all impaired creditors and interest holders receiving a distribution under the plan are permitted to vote to approve or reject it and/or to object to confirmation of the plan.

C. No involvement plan formulation/negotiation/process — A § 363 sale process allows the purchaser to avoid becoming embroiled in the formulation, negotiation, and confirmation of a plan, all of which may be time-consuming and costly and which may involve multiple constituencies (*e.g.*, secured lenders, noteholders, unsecured creditors, shareholders).

D. No need to meet statutory requirements for confirmation of a plan — A § 363 sale need only meet the requirements of § 363; there are a substantially greater number of statutory requirements for confirmation of a plan. *See, e.g.,* 11 U.S.C. §§ 1122-1129.

VI. Potential Issues Arising in §363 Sales

A. *Sub rosa* plan issues — Section 363 of the Bankruptcy Code does not allow the debtor-seller to avoid the statutory requirements for confirmation of a plan by establishing the terms of the plan *sub rosa* in connection with an asset sale under § 363. Thus, a "*sub rosa* plan" is an asset sale transaction that has the practical effect of dictating some or all of the terms of a future plan. For instance, where a sale requires specific terms for adopting a plan, dictates how the seller will distribute or use its assets or the sale proceeds, or otherwise exceeds the bounds of a mere asset sale, it cannot and will not be authorized by the bankruptcy court under § 363.

B. Collusive bidding issues

1. *Collusion between bidders.* Section 363(n) of the Bankruptcy Code provides that a sale may be voided if the sale price was controlled by an agreement among potential bidders. Merely affecting a sale price, however, is not enough to void a sale. Rather, the influence on the sale price must be an intended objective of the agreement among bidders (such as an agreement between potential bidders that if Bidder X refrains from bidding and Bidder Y is able to purchase the assets for less than a particular price, Bidder Y will then sell, lease, license or otherwise permit Bidder X's use of some or all of the assets), and not merely an unintended consequence. If a purchaser is found to have engaged in collusive bidding, it not risks the court voiding the sale, but could be subject to criminal penalties (both fines and up to 5 years imprisonment). *See* 18 U.S.C. § 152(6).

2. *Collusion between purchaser and debtor-seller.* Collusive bidding between a purchaser and debtor-seller, such as an agreement between a purchaser and debtor-seller whereby the purchaser offers the debtor-seller's management lucrative bonuses or employment opportunities in exchange for advantages in the sale process, can vitiate the "good faith" protections afforded to a purchaser under § 363(m). Collusion between a purchaser and debtor-seller is not, however, subject to a voiding of the sale under § 363(n).

VII. Executory Contracts and Leases

A. Definition — "Executory" is not defined by the Bankruptcy Code. The most widely adopted definition 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." Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. R. 439, 460 (1973). Some courts, however, have moved away use of the Countryman definition and have adopted a "functional approach" which works backward from an examination of the purposes to be accomplished by rejection and if the purposes have already been accomplished, determines that the contract cannot be executory.

B. Legal standard for assumption/rejection — A debtor's decision to assume or reject an executory contract generally is subject to review under the business judgment standard.

1. *Assumption.* To assume (or assume and assign) an executory contract or unexpired lease, the debtor (or the purchaser/assignee of the contract or lease) must (A) "cure" defaults, to the extent provided in § 365 of the Bankruptcy Code, including defaults that arose before and after the petition date, and (B) provide adequate assurance of future performance under the agreement.

2. *Rejection.* Rejection of an executory contract constitutes a deemed breach of the contract as of immediately prior to the petition date. Thus, the non-debtor counterparty will have a prepetition unsecured claim for damages flowing from the rejection of its agreement.

C. Anti-assignment provisions — The Bankruptcy Code permits the assumption and assignment to a third party of executory contracts and unexpired leases despite the presence in a contract or lease of anti-assignment or consent provisions. *See* 11 U.S.C. §365(f). *N.B.:* Even §365(f) has its limits, however, such as (i) where applicable law would excuse a contract party from accepting performance from a third party (*e.g.*, government contracts, personal services contracts) and (ii) loan agreements or other contracts to provide financial accommodations.

D. Contract issues in oil and gas context

1. *Oil and gas leases.* Whether an oil and gas lease constitutes an executory contract depends on whether applicable state law classifies the type of interest created by an oil and gas lease as a real property interest (*e.g.,* Texas, Oklahoma, New Mexico) or personal property interest (*e.g.,* Kansas, Ohio, Michigan). In some jurisdictions, such as Pennsylvania, a lease to explore for minerals before minerals are discovered is an executory contract, but becomes a real property interest once discovery and production has begun. In still other jurisdictions, the issue is even less clear.

(a) If treated as a transfer of real property:

(i) Lease is not likely to be classified as an executory contract and will not be susceptible to assumption, assignment, or rejection by the debtor;

(ii) The debtor's only means of disposing of the lease likely would be via a sale under § 363(b), forcing the debtor to meet the requirements of § 363(f).

(b) If treated as an executory contract (or unexpired lease of non-residential real property):

(i) The 120/210 day limits of § 365(d)(4) may be applicable to debtor's decision to assume or reject;

(ii) Assumption (or assumption and assignment) of the lease would be subject to the "cure" and "adequate assurance" requirements of § 365;

(iii) Rejection of the lease would subject the debtor to a (potentially significant) rejection damages claim by the counterparty;

(iv) If the debtor is the lessor, the lessee may have "continuation" rights under § 365(h) following rejection of the lease by the debtor.

2. *Joint operating agreements ("JOAs").* Courts generally find JOAs to be executory contracts subject to assumption, assignment, or rejection. Prior to assumption, a JOA is enforceable *by* the debtor but not *against* the debtor. Thus, prior to assumption, the non-debtor party to the contract must perform under the JOA, while the debtor need not.

3. *Federal leases (e.g., Outer Continental Shelf ("OCS") leases)*. The US government takes the position that federal leases, such as OCS leases, are executory contracts that can be assumed or rejected under § 365 of the Bankruptcy Code. The government's rationale is that OCS leases are governed by federal law, not state law; thus they are subject to disposition under §§ 365 and 541 of the Bankruptcy Code based on the plain language of the Outer Continental Shelf Lands Act, which provides that OCS leases are "rental agreements to use real property." No bankruptcy courts have yet decided the issue of whether or not federal OCS leases are executory contracts for purposes of § 365.

4. *Midstream agreements for gathering, processing, transportation.* Depending on the precise language employed, a midstream agreement may be an executory contract, subjecting it to the possibility of assumption or rejection under § 365. The critical issue is whether or not the granting language in the agreement creates a covenant that runs with the land — a real property interest that is neither executory nor property of the debtor's bankruptcy estate and, accordingly, not susceptible of rejection. This issue is currently the subject of litigation in the *Sabine Oil & Gas Corporation* Chapter 11 case, where the debtors filed a motion to reject two gathering agreements that they believed to be executory. The counterparties objected, relying heavily on *In re Energytec Inc.*, 739 F.3d 215, 221 (5th Cir. 2013), which held that certain interests securing fees owed to an affiliate of the seller of a gas pipeline were covenants running with the land, and therefore real property interests that could not be rejected. The litigation remains pending, although on February 2, 2016, the judge overseeing the *Sabine* case said she was "inclined" to rule that the gathering agreements do not contain covenants running with the land. If they do not, the *Sabine* debtors would be permitted to reject the agreements.

5. *Overriding Royalty Interests ("ORRIs").* True ORRIs are not considered property of the bankruptcy estate under a safe harbor provision contained in § 541(b)(4)(B) of the Bankruptcy Code. Section 541(b)(4) was enacted to create uniformity in all states by treating "production payments" as conveyances of real property (*i.e.*, true sales) in a bankruptcy. "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."

   (a) The purpose of § 541(b)(4)(B) is to preclude certain royalties from being recharacterized and subsequently rejected as executory contracts under § 365.

   (b) For the ORRI holders, the safe harbor assures that their future streams of revenue will not be subject to cancellation or alteration under a reorganization plan. The debtor's creditors thus are incentivized to have ORRIs recharacterized as financings, because recharacterization would mean that the oil and gas subject to the ORRIs is property of the bankruptcy estate and (1) available to satisfy the claims of all creditors and (2) the ORRI holders' claims would be subject to impairment under a plan.

6. *Farmout agreements.* A farmout agreement is a written agreement by which an owner of a right to drill, produce, or operate hydrocarbons on property (farmor) transfers or assign all or a part of such right to another entity (farmee) in exchange for the other entity's agreement to drilling, rework, recomplete, test, and develop or produce hydrocarbons on the property. *See* 11 U.S.C. § 101(21A). Farmout agreements that have not been fully performed generally are treated as executory contracts by the Bankruptcy Code and are subject to all applicable executory contract provisions, including assumption or rejection under § 365. Section 541(b)(4) of the Bankruptcy Code excludes the earned portion of farmout agreements from the definition of "property of the estate," as long as the interest is in liquid or gaseous hydrocarbons transferred or agreed to be transferred. As a result,

the debtor-farmor cannot reject the farmout agreement to invalidate a farmee's right to receive an assignment of its interest.

7. *Royalties.* Generally, the failure to pay royalties does not give rise to automatic termination of an oil and gas lease; however, this is not true if applicable state law or the lease specifically provides otherwise. In the latter case, debtors will usually seek court approval to make prepetition royalty payments under the lease, the rationale being that such payments are necessary to avoid the forfeiture of valuable assets (*i.e.*, the leases).

Appendix 1 — *Gulf Coast* Factors

A. Whether there is evidence of a need for speed, *e.g.*, based on the perishable nature of assets or looming, adverse market conditions;

B. Whether there is business justification for sale and sale process, as well as for having sale process proceed apart from confirmation process;

C. Whether the case is sufficiently mature that parties in interest have received adequate notice, have obtained appropriate information, and have been able to participate;

D. Whether the proposed sales process is sufficiently straightforward to facilitate competitive bids;

E. Whether the assets have been aggressively marketed in active market;

F. Whether the fiduciaries that control the debtor are truly disinterested, so that the court can have faith in their business judgment;

G. Whether the proposed sale includes all of the debtor's assets or the "crown jewel" of such assets;

H. Whether the purchaser will receive any extraordinary protections;

I. Burdens of proposing sale as part of plan confirmation process;

J. Who will benefit from the sale;

K. Whether any special adequate protection measures are necessary or possible; and

L. Whether the hearing on proposed sale was true adversary presentation.

Investing in Oil and Gas Royalties: Distressed Counterparty Risk Considerations White Paper

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.

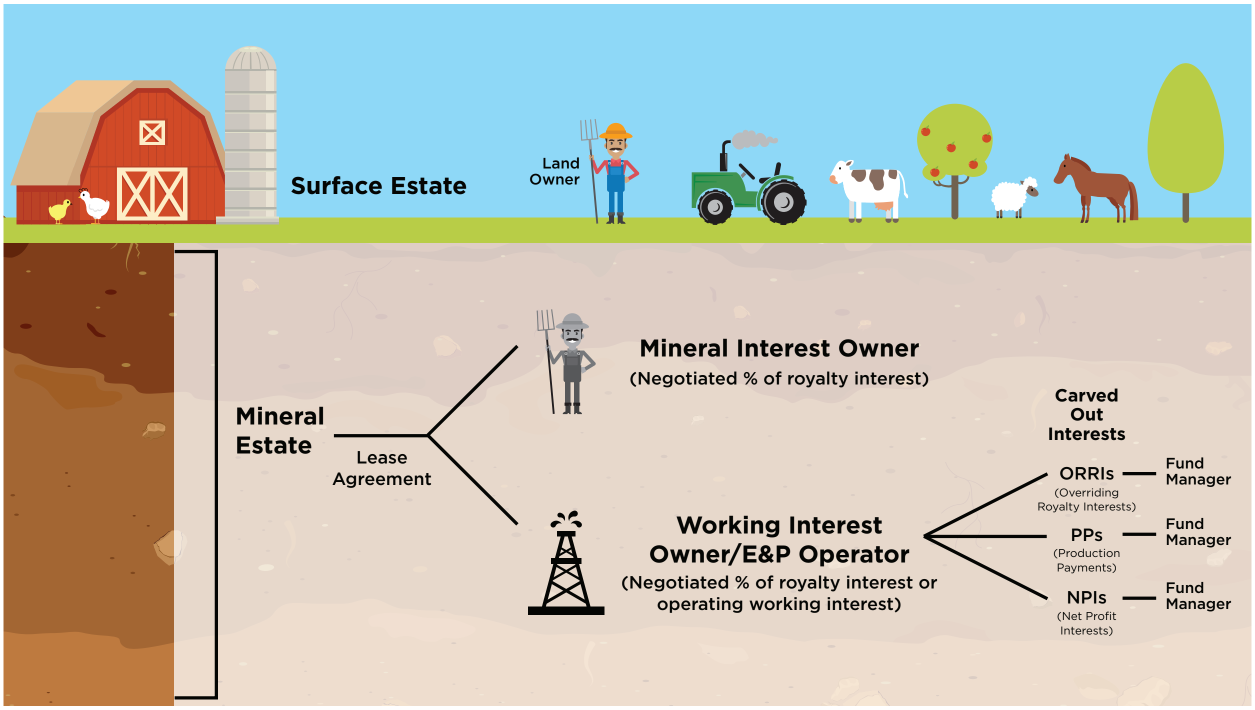
In the ongoing case *In re ATP Oil & Gas Corporation*,[3] the U.S. Bankruptcy Court for the Southern District of Texas denied a carved out interest investor's motion for summary judgment on the issue of whether conveyances of certain oil and gas carved out interests were true sales of real property or 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.

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