

# Oil and Gas, Natural Resources, and Energy Journal

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Volume 5 | Number 1


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June 2019

## A Purchase or a Loan? Rethinking the Transactions Private Equity-Backed Oil and Gas Companies Encounter in Uncharted Waters

Daniel Tavera

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### Recommended Citation

Daniel Tavera, *A Purchase or a Loan? Rethinking the Transactions Private Equity-Backed Oil and Gas Companies Encounter in Uncharted Waters*, 5 OIL & GAS, NAT. RESOURCES & ENERGY J. 41 (2019), <https://digitalcommons.law.ou.edu/onej/vol5/iss1/3>

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# ONE J

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## A PURCHASE OR A LOAN? RETHINKING THE TRANSACTIONS PRIVATE EQUITY-BACKED OIL AND GAS COMPANIES ENCOUNTER IN UNCHARTED WATERS

DANIEL TAVERA \*

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\* The author is a second-year student at the University of Oklahoma College of Law. The author sincerely thanks Mr. Rhett G. Campbell and Professor F. Stephen Knippenberg, the ideas presented below would not have been possible without their suggestions and guidance. He also thanks his roommate and friend, Reed C. Trechter, for his help and support in earlier drafts. Finally, he thanks the dedicated editors of the *Oil and Gas, Natural Resources, and Energy Journal* at the University of Oklahoma College of Law.

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### *I. Introduction*

The manner in which a bankruptcy court determines whether a conveyance for future production is a transfer of real property or disguised financing is crucial for the oil and gas industry. This answer is crucial for the oil and gas industry because these commonly used business transactions are treated differently in bankruptcy. Depending on the court’s method, a bankruptcy court could treat a once-purported sale as an executory contract of the debtor’s estate, allowing a debtor to assume or reject the instrument freely under § 365 of the Bankruptcy Code (“Code”).<sup>1</sup> These instruments tempt parties to recharacterize these transactions, depending on the benefited legal treatment.<sup>2</sup> The need and seeming inability to distinguish between a purchase and a loan has led bankruptcy courts to employ different authorities to face this issue.<sup>3</sup>

In the oil and gas industry, a bankruptcy court’s inability to uniformly define the interests under state law for oil and gas leases or conveyances

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1. *See* *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 610 (7th Cir. 2005).

2. *Id.* (“What is a ‘lease’ in federal bankruptcy law? Businesses that do not pay up front for assets may acquire them via unsecured debt, secured debt, or lease; in each event the business pays over time. Similar economic function implies the ability to draft leases that work like security agreements, and secured loans that work like leases.”).

3. *Compare* *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139 (10th Cir. 2015) (recognizing the authority under 11 U.S.C. § 105(a) (2012) for recharacterization purposes), *with* *Grossman v. Lothian Oil, Inc. (In re Lothian Oil, Inc.)*, 650 F.3d 539, 542–44 (5th Cir. 2011) (concluding that recharacterization is appropriate under § 502(b) and applicable state law).

causes significant confusion. Under traditional oil and gas law, an oil and gas lease is an absolute conveyance of a fee simple determinable. Under bankruptcy law, an absolute conveyance is not an executory contract, which means it cannot be assumed or rejected under § 365 of the Code. In the context of federal offshore leases, this distinction becomes murkier, because an offshore lease is treated as a true lease and not a conveyance. Since federal leasing law controls, in the context of a federal offshore lease, the instrument may qualify as a true lease under § 365 of the Code and be subject to assumption or rejection.

For a debtor to freely assume or reject an oil and gas instrument under § 365 of the Code depends on the nature of the interest created as defined by state law.<sup>4</sup> For example, if an oil and gas transaction conveys a real property interest, as opposed to a personal property interest, it will not be subject to assumption or rejection.<sup>5</sup> A real property interest vests in the grantee and is a transfer of ownership. The interest is neither an executory contract, because it is a consummated conveyance, nor an unexpired lease, because of the transfer of ownership. For these reasons, courts must distinguish these oil and gas instruments from executory contracts and a true leases, so the parties to the transaction retain their property interests in the event of bankruptcy.

Under state law, a lessee in an oil and gas lease can carve out interests and convey to a grantee either a share of ownership in production in kind or entitlement to a share of the proceeds. In the context of state law, the interests carved out can be divided into two general categories: (1) overriding royalty interests, which take a percentage of the oil and gas before drilling, free from production costs; and (2) net profit interests, which take a percentage of the oil and gas after drilling after production costs, which include the costs to operate and maintain wells, equipment, and facilities. It is common for parties to enter into transactions where the lessee agrees to convey either type of interest in increments over time, and the counterparty agrees to pay up front for this interest to finance lessee's oil and gas operations. These transactions help exploration and production ("E&P") companies obtain financing for their ongoing business needs. Due to E&P companies' declining access to the traditional commercial bank markets,<sup>6</sup> there is a renewed interest in carving out interests and conveying

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4. See *Butner v. United States*, 440 U.S. 48, 55 (1979).

5. Compare *Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70-71 (S.D. Tex. 1996), with *In re J. H. Land & Cattle Co.*, 8 B.R. 237, 239 (W.D. Okla. 1981).

6. See Laura Freeman, *Billions of Dollars of Bad Oil and Gas Loans*, OIL & GAS FIN. J., Sept. 2017 at 6, 6-9 <https://perma.cc/9EV8-AW29>.

them to parties who agree to finance a lessee's operation.<sup>7</sup> Mainly in part because smaller companies are actually better suited to be more innovative in the way they secure investments.

When an operator conveys an overriding royalty interest to a party financing the operation, and the royalty interests are limited by time, quantity, value, and are free from production costs, the Code protects this "term overriding royalty interest" from becoming property of the debtor's estate in the event the operator files for bankruptcy.<sup>8</sup> In other words, after production has begun and a producer conveys an overriding royalty that is limited by time, quantity, value, and free from production costs, the debtor should not be able to assume or reject the conveyance in order to obtain ownership for distribution to creditors under § 365 of the Code. However, other types of interests may not be protected by the Code.<sup>9</sup>

The protections of this safe harbor are not automatic, and structuring the term overriding royalty as a conveyance of production payments as defined under the Code is crucial. Although "[t]here is little, if any, case law interpreting these provisions," parties must be sure that their transaction is correctly structured so that it falls within the definition of a production payment or term overriding royalty interest provided in the Code.<sup>10</sup> Despite the scant case law interpreting these provisions, companies have been willing to use production payments to obtain liquidity by monetizing future oil and gas production.<sup>11</sup> Both parties enter into the transaction intending to make and receive an absolute conveyance of a real property interest.<sup>12</sup> However, depending on a court's interpretation of the conveyed interest, in the event of bankruptcy, the debtor could reject the instrument, forcing the

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7. See Peter J. Speer, *Volumetric Production Payments—Analytical Implications and Adjustments for E&P Companies*, MOODY'S INVESTORS SERV. SPECIAL COMMENT Mar. 2006, at 1 <https://perma.cc/8MJY-R7PF>.

8. See 11 U.S.C. § 541(b)(4)(B) (2012).

9. Cf. *id.* § 541 (requiring production payments—similar in concept to royalty interests—to be transferred by a written conveyance to an entity that does not participate in the production of oil and gas).

10. *Delta Petroleum Gen. Recovery Tr. v. BWAB Ltd. Liab. Co. (In re Delta Petroleum Corp)*, Nos. 12-50877 (KJC), 2015 WL 1577990, at \*17 (Bankr. D. Del. Apr. 2, 2015) (recognizing the small amount of case law for the issue that if the overriding royalty interests fall within the definition of "production payment" or "term overriding royalty," they would be excluded from "property of the estate" pursuant to § 541(b)(4)(B) of the Code).

11. See James P. Benson, *Private financing Alternatives for the Independent*, Executive Report, OIL & GAS INV'R; HOUS., Spring 1994, at 11 <https://perma.cc/6GNE-DBLE>.

12. See generally William Knull, Jessica Crutcher, Kevin Shaw, *ORRIs, NPIs and PPs: Are They What You Think They Are?*, 34 OIL & GAS INV'R 10 (2014) <https://perma.cc/D8GK-U2HZ>.

counter-party to file a claim for rejection damages and become a creditor, rather than a property owner. Thus, to ensure a court can identify a real property conveyance, parties must properly draft an instrument that will effectuate the intentions of the parties as measured by the documents they signed, the parties' conduct, and their course of dealing.<sup>13</sup>

Producers that can monetize large amounts of future oil and gas production are likely to enter into these transactions because it can be easier to obtain financing than traditional commercial bank markets.<sup>14</sup> For example, producers on the Outer Continental Shelf ("OCS") can monetize future oil and gas production, which require large amounts of capital, making it easy to enter into transactions that convey oil and gas interests in return for needed funds.<sup>15</sup> The OCS refers to all submerged land, its subsoil, and seabed that belong to the United States. These are the lands extending outward around the United States. The OCS regions of the Pacific coast, the coast of Alaska, and the Gulf of Mexico are commonly known for vast amounts of oil and gas production.<sup>16</sup>

Production in the Gulf of Mexico will likely continue to grow in the future because of the yearly increase in production.<sup>17</sup> Oil and gas companies interested in expanding to the OCS may enter into transactions to finance their costly operations. Therefore, understanding the implications of conveyances in relation to potential bankruptcy proceedings is essential to OCS investors.

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13. For a further discussion examining the current state of law on debt recharacterization and its development, see Lawrence Ponoroff, *Whither Recharacterization*, 68 Rutgers U. L. Rev. 1217 (2016).

14. See, e.g., CHRISTOPHER L. CULP, CORPORATE AFTERSHOCK: THE PUBLIC POLICY LESSONS FROM THE COLLAPSE OF ENRON AND OTHER MAJOR CORPORATIONS 183-86 (Christopher L. Culp & William A. Niskanen eds., 2003).

15. See *Gulf of Mexico*, U.S. DEP'T OF THE INTERIOR: NAT. RESOURCES REVENUE DATA, <https://revenuedata.doi.gov/explore/offshore-gulf/> (last visited Jan. 18, 2019). See also Shuqiang Feng, *Insights From Stratats Advisors: Deepwater Exploration Preserves 37 OIL & GAS INV'R 6* (2014).

16. See *Pacific OCS Region*, BUREAU OF OCEAN MGMT., <https://www.boem.gov/Pacific-Region/> (last visited Jan. 18, 2019); *Alaska OCS Region*, BUREAU OF OCEAN MGMT., <https://www.boem.gov/Alaska-Region/> (last visited Jan. 18, 2019); *Gulf of Mexico OCS Region*, BUREAU OF OCEAN MGMT., <https://www.boem.gov/Gulf-of-Mexico-Region/> (last visited Jan. 18, 2019).

17. See Jude Clemente, *The Quiet Rise in U.S. Offshore Oil Production*, FORBES (Apr. 10, 2018 1:13 PM), <https://www.forbes.com/sites/judeclemente/2018/04/10/the-quiet-rise-in-u-s-offshore-oil-production/#29d69c92136e>.

However, the 2010 drilling moratorium in the Gulf of Mexico continues to have lasting effects on operators.<sup>18</sup> Compounded with the cyclical nature of the industry, operators may wind up filing for bankruptcy. Parties investing in operations on the OCS must take the necessary steps to structure the transaction carefully as a true sale of a real property interest that will not allow the debtor to reap the benefit of assumption or rejection under § 365 of the Code. Thus, because it is rare for an operator and an investor to have completely fulfilled their obligations to the agreement, it is essential for parties interested in purchasing term overriding royalties or production payments on the OCS to structure the transaction so that the absolute conveyance instrument supports a true sale.

In support of this proposal, Part II outlines the mineral estate, § 541 of the Code, and its applicability to oil and gas interests. Part III describes some issues governing the applicability of § 365 to oil and gas leases and its effects on a lessor's conveyance. Part IV examines the OCS and issues that arise when applying both sections of the Code to conveyances of oil and gas interests. This comment explores an investor's risks regarding oil and gas conveyances in the event of an E&P company's bankruptcy and why investors should be careful when entering into transactions with E&P companies on the OCS.

## *II. Fundamental Concepts: Property, the Mineral Estate and the Bankruptcy Estate*

### *A. Property*

Property has a distinct meaning. Laypersons often think of property as a physical object of which they can obtain physical possession—a “thing” they can grab. However, in the legal context, property is not just a “thing.” Instead, property is the relationship between a person and the “thing.”<sup>19</sup> This relationship is known as the “property interest.”<sup>20</sup> The relationship to the thing, often analogized as a “bundle of sticks” in which one or more parties might hold any combination of “sticks,” describes the collection of individual rights in the property.<sup>21</sup> This analogy can also describe

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18. See Amanda Hale, *The Moratorium and the Damage Done: Offshore Drilling After the Gulf of Mexico Drilling Moratorium and Whether Moratoria Should Be Used*, 6 *LSU J. ENERGY L. & RESOURCES* 410, 416–19 (2018).

19. See WILLIAM B. STOEBCUK & DALE A. WHITMAN, *THE LAW OF REAL PROPERTY* 5 (3rd ed. 2000).

20. See *id.* at 7.

21. *Id.* at 3.

ownership in mineral property, composed of separate and individual property interests.<sup>22</sup> For mineral property, some of the bundle of sticks consist of the right to develop, right to make decisions in regard to E&P, and, importantly, the right to receive and convey the lessee's remaining share of the mineral estate.<sup>23</sup>

### *1. The Basics of Oil and Gas Conveyancing*

A landowner traditionally owns all that lies above and below, all the way to heaven and all the way to hell, with certain exceptions.<sup>24</sup> Generally, the landowner may convey “leasehold interests, mineral interests, and royalty interests.”<sup>25</sup> A leasehold interest is the right to go upon the land for “prospecting for oil and gas [and usually other minerals also], severing and removing the same.”<sup>26</sup>

The interests that may be created in oil and gas are best understood in relation to fee simple absolute ownership of land.<sup>27</sup> A, the owner in fee simple absolute of Blackacre has the same rights to the minerals under the surface as he has to the surface.<sup>28</sup> Thus, A may lease, grant, or reserve the totality of this subsurface interest separate from the surface. This severance creates the mineral estate, the most complete ownership of oil and gas recognized in law. B, the new owner of the mineral estate, has the same rights as A had previously. B, therefore, is the owner of all the minerals under the surface.<sup>29</sup>

The mineral owner holds several rights and as a result, can sever and convey any or all of these interests.<sup>30</sup> B, as the mineral owner, can convey a

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22. See Monika U. Ehrman, *One Oil and Gas Right to Rule Them All*, 55 Hous. L. Rev. 1063, 1064–65 (2018).

23. *Id.*

24. 1 HOWARD R. WILLIAMS & CHARLES J. MEYERS, WILLIAMS & MEYERS OIL AND GAS LAW § 202 (Patrick H. Martin & Bruce M. Kramer eds., 2018) (2018).

25. *Id.*

26. *Id.* § 202.1.

27. *Id.* § 301.

28. *Id.*

29. See generally David D. Hunt, II, *Oil and Gas Title Examination: The Basics*, 1 OIL & GAS, NAT. RESOURCES & ENERGY J. 43, 58 (2016) (describing the ownership of the mineral estate and the oil and gas leasehold).

30. See OWEN L. ANDERSON ET AL., HEMINGWAY OIL AND GAS LAW AND TAXATION § 9.6, at 472 (4th ed. 2004); see also Jordan D. Volino, *Midstream Acreage Dedications: Covenants Running with the Land or a Conveyancing Confusion?* 2 OIL & GAS, NAT. RESOURCES & ENERGY J. 397, 408 (2016).



share of either the production or the proceeds.<sup>31</sup> The mineral owner can sever these interests into fractions and convey them to several people.<sup>32</sup> These fractional interest owners each hold their share of the mineral estate in its entirety.<sup>33</sup> However, once an owner severs and conveys a mineral interest, he loses ownership and cannot convey it again because “an owner cannot convey more than he owns.”<sup>34</sup> Recognizing that a mineral owner can convey small fractions of his interest to different parties will provide context for common oil and gas transactions.

## *2. The Types of Interest in the Mineral Estate*

The owner of the mineral estate can convey different types of fractional interests. A royalty interest owner is usually entitled to payment of money measured by the proceeds of production. Typically, this royalty interest holder does not have to pay the costs of exploration or production.<sup>35</sup> A royalty interest is commonly known as a “nonworking” interest, because they do not interfere with production but receive the benefit of the production.<sup>36</sup> Royalty interest owners derive their interest from the mineral estate itself. The royalty interest and the mineral interest may or may not be shared by a joint owner. So, where a holder of a royalty interest is not also a holder of the associated mineral interest, they will not be involved with the use of the land and will only receive the benefit of production.

An overriding royalty is much like a royalty interest but is generally “used to describe a royalty created from a lease that is in favor of a person other than the lessor.”<sup>37</sup> In other words, the party receives what is known as a non-landowner royalty, not an overriding royalty. Rather, this additional royalty other than the royalty created in the original lease allows a lessee to carve and convey an overriding royalty out of his interest. So, continuing the example above, the owner of the mineral estate can sever and convey an overriding royalty interest.<sup>38</sup>

Net profit interests are like overriding royalty interests. Usually, a net profit interest is a contractual, rather than property, right to receive an

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31. 1 MARTIN & KRAMER, *supra* note 24, § 301.

32. *Id.*

33. *See* ANDERSON, *supra* note 30, § 9.8, at 481.

34. *Davis v. Blige*, 505 F.3d 90, 103 (2d Cir. 2007); *see also* *Wagner & Brown, Ltd. v. Sheppard*, 198 S.W.3d 369, 377 (Tex. App.-Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

35. 1 MARTIN & KRAMER, *supra* note 24, § 202.3.

36. *Id.*

37. *Id.*

38. *See id.*

amount of money from production measured by a contractual formula. Net profit interests are only payable to the net profit interest holder after the mineral owner profits from production in excess of the formulaic amount during the contractually agreed-upon period.<sup>39</sup> A true net profit interest is not an absolute conveyance. However, it is possible to create an absolute conveyance of a net profit interest for a term of years or measured by money, which can begin to look like a production payment discussed below. The more the net profit interest looks like a production payment, the more it resembles an absolute conveyance. Still, these interests are only payable after production costs have been satisfied.<sup>40</sup>

Production payments, known as term overriding royalty interests, oil payments,<sup>41</sup> and volumetric production payments (collectively “Production Payments”),<sup>42</sup> are also similar to an overriding royalty interest. This interest is a fractional interest “carved out” from the lessee’s interest, the working interest, “which is a share of the minerals produced from described premises, free of the costs of production at the surface.”<sup>43</sup> A mineral owner’s conveyance of a Production Payment ends when the agreed-upon “volume of production has been paid over or when a specified sum from the sale of such oil” has been realized.<sup>44</sup> Production Payments are common when an investor purchases some of the mineral interest in order to finance an E&P company’s operations. For example, a mineral owner may use Production Payments for debts owed to lenders or investors. An investor can also use Production Payments to obtain a return on capital provided to the operator.<sup>45</sup> Once the Production Payment holder has received their portion of production, the interest terminates.<sup>46</sup>

The difference between a Production Payment and an overriding royalty interest is that a Production Payment is “limited to the time required for the stated number of units of production or the sum specified in the instrument creating the oil payment.”<sup>47</sup> An overriding royalty will normally have “the same duration as the working interest out of which it was

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39. *See id.* § 424.1.

40. *Id.*

41. *Id.* § 422.

42. *See, e.g.,* *McCall v. Chesapeake Energy Corp.*, 509 F. App’x 62, 64 (2d Cir. 2013).

43. *QEP Energy Co. v. Sullivan*, 444 F. App’x. 284, 289 (10th Cir. 2011).

44. 2 PATRICK H. MARTIN AND BRUCE M. KRAMER, WILLIAMS & MEYERS, OIL AND GAS LAW § 422 (LexisNexis Mathew Bender 2018) (footnote omitted).

45. *Id.*

46. *Id.*

47. *Id.* § 422.3.

created.”<sup>48</sup> Therefore, E&P companies have more freedom and liquidity with Production Payments because an interest holder can convey Production Payments frequently and to many different parties. Although a Production Payment relationship is advantageous in some respects, some courts have suggested the transaction creates a debtor-creditor relationship.<sup>49</sup> However, commentators believe this is erroneous.<sup>50</sup> The differing analyses have resulted in divergent state law approaches as bankruptcy courts apply applicable state law to determine the debtor-creditor relationship.

### *B. Bankruptcy*

The Code explicitly adopts the legal definition of property.<sup>51</sup> The instant a person files bankruptcy, an “estate” is created, which consists of “all legal or equitable interest of the debtor in property.”<sup>52</sup> The interests in “property” the debtor holds, i.e., whichever stick he holds, is brought into the estate and is known as property of the estate.<sup>53</sup> As a result, whatever interest in property the debtor holds as of the date of filing will become property of the estate.<sup>54</sup>

#### *1. Property of the Estate and the Types of Interests in the Mineral Estate*

The concept of “property of the estate” in a bankruptcy case is important because it “establishes the ‘what’ in the core question of ‘who gets what’ in the bankruptcy distribution.”<sup>55</sup> State law limits whether the debtor holds an interest in property and the analysis of that interest will differ from state to state.<sup>56</sup> The Code’s “property of the estate” is applied in broad strokes in an attempt to capture every imaginable interest.<sup>57</sup> For this reason, the debtor

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48. *Id.*

49. *E.g.*, *PSI, Inc. of Mo. v. Aguillard (In re Senior-G & A Operating Co.)*, 957 F.2d 1290, 1297 (5th Cir. 1992); *Posey v. Fargo*, 174 So. 175, 180 (La. 1937).

50. 2 MARTIN, *supra* note 44, § 422.2 (“An occasional case, erroneously we believe, has said that the relationship created by an oil payment is that of debtor and creditor.”).

51. 11 U.S.C. § 541(a) (2012).

52. *Id.* § 541(a)(1).

53. *Id.* § 541(a)

54. *Id.*

55. CHARLES J. TABB, *LAW OF BANKRUPTCY*, 415 (4th ed. 2016) (“The Code embodies a strong congressional policy favoring maximization of the size of the estate so that creditors may be paid as much as possible on their claims.”).

56. *See Bd. of Trade of Chi. v. Johnson*, 264 U.S. 1, 10 (1924).

57. *See TABB, supra*, note 55 at 396.

and his creditors, the “who,”<sup>58</sup> will try to capture every conceivable interest the debtor may hold, so property owned by the debtor becomes “property of the estate” and there is more to distribute to creditors in the bankruptcy case.<sup>59</sup> Parties who arguably already own property interests formerly belonging to the debtor will attempt to keep their interest severed to prevent the interest from becoming property of the estate.

That said, just as the Code defines what becomes “property of the estate,” it also defines what “property of the estate does not include.”<sup>60</sup> The Code provides a “safe harbor” for certain kinds of oil and gas interests.<sup>61</sup> Section 541(b)(4)(B) of the Code provides that the assignee of a Production Payment takes title to the interest and that interest will not become property of the estate if the assignor files for bankruptcy.<sup>62</sup> The Code defines the term “production payment” as a “term overriding royalty satisfiable in cash or in kind” that is “(A) contingent on the production of liquid or gaseous hydrocarbon from particular *real property*; and (B) from a specified volume, or specified value, from the liquid or gaseous hydrocarbon produced from such property.”<sup>63</sup> The Code also defines a “term overriding royalty” as “an interest in liquid or gaseous hydrocarbons in place or to be produced from particular *real property* that entitles the owner thereof to a share of production, or the value thereof, for a term limited by time, quantity, or value realized.”<sup>64</sup> In simpler terms, when the debtor conveys Production Payments to a party, these interests will not become property of the estate.

This interpretation is consistent with the section’s legislative history, which reveals that Congress did not intend 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

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58. The estate representative (i.e., the trustee or the debtor in possession) acts under provisions of the Code to benefit the debtor’s estate, which ultimately benefits the debtor’s creditors upon distribution. *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1348 (7th Cir. 1987) (“It is axiomatic that the trustee has the right to bring any action in which the debtor has an interest.”).

59. *See e.g., Abele v. Phoenix Suns Ltd. (In re Harrell)*, 73 F.3d 218, 219 (9th Cir. 1996) (rejecting the argument that debtor’s ability to renew Phoenix Suns season tickets was property under Arizona state law as such an opportunity is a mere expectancy).

60. 11 U.S.C. § 541(b) (2012).

61. *Id.* § 541(b)(4)(B) (amended in 1994 to exclude oil and gas interest from property of the estate).

62. *Id.* § 541(b)(4)(B).

63. 11 U.S.C. § 101(42A) (2012) (emphasis added).

64. *Id.* § 101(56A) (emphasis added).

section 365 of the Bankruptcy Code.”<sup>65</sup> Section 541(b)(4)(B)’s safe harbor provides that “any interest of the debtor in liquid or gaseous hydrocarbons to the extent” that the debtor has “transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the operation . . . the estate could include the interest . . . only by virtue of section 365 or 542 of this title.”<sup>66</sup> Thus, Production Payments will not become “property of the estate” if the transferee can demonstrate (1) the existence of a transfer of the “production payment” pursuant to a written conveyance; (2) the grantee does not participate in the operations; and (3) the debtor could only include Production Payments into the bankruptcy estate by virtue of other sections of the Code.<sup>67</sup>

### *III. Issues in § 365 of the Code*

Section 365 of the Code provides that a trustee or debtor in possession “may assume or reject any executory contract or unexpired lease of the debtor.”<sup>68</sup> This power is broad and allows the debtor to choose which instruments to assume and reject since “burdensome obligations can impede a successful reorganization.”<sup>69</sup> A debtor can assume favorable executory contracts and unexpired leases, so the debtor can benefit from them throughout reorganization.<sup>70</sup> Section 365 of the Code is a valuable tool that benefits the debtor’s estate in bankruptcy.<sup>71</sup> Although § 365 of the Code has nothing to do with a debtor-creditor relationship, if the debtor rejects a § 365 executory contract, then the counter-party has the right to file a claim for rejection damages, eventually becoming a creditor of the estate, if successful.

Determining whether § 365 of the Code applies to an oil and gas transaction presents troubles in its application, because state law ultimately decides whether a debtor can assume or reject an instrument that was originally intended to convey fee simple rights. Thus, the important point for § 365 of the Code is to determine if the relevant interest is an absolute

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65. 140 CONG. REC. E2204-01 (daily ed. Oct. 8, 1994) (statement by Rep. Brooks).

66. 11 U.S.C. § 541(b)(4)(B) (2012) (emphasis added).

67. *Id.*

68. 11 U.S.C. § 365(a).

69. *Century Indem. Co. v. Nat’l Gypsum Co. Settlement Tr. (In re Nat’l Gypsum Co.)*, 208 F.3d 498, 504 (5th Cir. 2000) (quoting *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984)).

70. *Carlisle Homes, Inc. v. Azzari (In re Carlisle Homes, Inc.)*, 103 B.R. 524, 534 (Bankr. D.N.J. 1988).

71. *See id.*

conveyance of a property interest. If so, then the interest is outside the scope of § 365.

*A. Executory Contracts v. Unexpired Leases*

In the context of bankruptcy, the ability to assume or reject an oil and gas lease and the resulting applicability of § 365 of the Code depends on the nature of the interest as determined by state law.<sup>72</sup> In bankruptcy, the use of specific terms within a conveyance does not automatically render the property interest therein as real property, the primary consideration a court will use to determine whether an interest passes into the debtor's estate. If state law characterizes the conveyed interest as a real property interest, then the debtor cannot assume or reject the instrument because it is a true sale of ownership and not a "true lease," as the legislative intent suggests.<sup>73</sup>

As sales of real property are not typically undertaken through an executory contract or a lease, the determination of an absolute conveyance has important implications in a bankruptcy proceeding. A debtor that can assume or reject an instrument under § 365 of the Code has substantial power to assume beneficial contracts or reject burdensome leases. However, if the instrument cannot be assumed or rejected, then the parties retain all obligations, burdens, and benefits under the instrument.

*1. What is an Executory Contract?*

An executory contract is one where failure to perform the ongoing obligations on both sides must be such that a failure to perform those continuing obligations would constitute a material breach of the contract.<sup>74</sup> If an instrument before a bankruptcy court is an executory contract, then § 365 of the Code governs, and the debtor may assume or reject the interest. The Code does not define the term executory contract but generally includes contracts where there are material unperformed obligations on both sides; executory contracts can cover various types of transactions.<sup>75</sup>

Most transactions will involve some type of executory contract. For example, a purchase and sale agreement is an executory contract. Other similar agreements can also be executory contracts. Although a sale of a

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72. See *Butner v. United States*, 440 U.S. 48, 54-55 (1979).

73. See *In re Clark Res., Inc.*, 68 B.R. 358, 359 (Bankr. N.D. Okla. 1986) (noting the Bankruptcy Amendment and Federal Judgeship Act of 1984 intended to remedy § 365 of the Code when applied to commercial leases and not necessarily oil and gas leases).

74. *E.g., id.*

75. See *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1075 n.13 (3d Cir. 1992) (noting an agreement to provide medical services to be executory).

term overriding royalty interest as defined under the Code may look like an executory contract, a debtor cannot assume or reject the instrument if § 541(b)'s safe harbor applies. However, as discussed *infra*, if § 541(b) does not apply, the debtor may assume or reject the instrument by virtue of § 365 of the Code.

### 2. *What is an Unexpired Lease?*

A debtor can only assume true leases under § 365 of the Code. As the Code does not define an unexpired lease, courts will apply state law.<sup>76</sup> Courts look behind the label of the instrument to decide its true character.<sup>77</sup> For example, a true lease is one where the landlord turns over possession to the tenant in exchange for rental payments and provides the lessee a simple possessory interest, rather than ownership.

Bankruptcy courts have used § 365 of the Code to recharacterize a purported lease as disguised financing arrangements by sheer vigilance.<sup>78</sup> These courts resolve whether a transaction was a disguised financing instrument by applying state law.<sup>79</sup> In adopting the Code, Congress intended for courts to examine the true substance of the transaction on a case-by-case basis to discover if a lease is a true lease or a financing instrument.<sup>80</sup> The legislative history states that “the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright *ownership* of the property is more indicative of a *financing transaction* than of a true lease.”<sup>81</sup> Thus, courts scrutinize leases for substance over form to determine if the lessee has more than just a possessory interest and is, in fact, an owner.<sup>82</sup>

### 3. *How Are They Similar and How Are They Different?*

At first glance, the similarity between executory contracts and unexpired leases may be apparent. First, both parties still have certain obligations to

76. *River Prod. Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990) (“While we interpret the Bankruptcy Code as a matter of federal law, state law determines whether these contracts constitute unexpired leases subject to Section 365.”).

77. *See United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 612 (7th Cir. 2005).

78. 3 COLLIER ON BANKRUPTCY ¶ 365.02[3] (16th ed. 2013).

79. *Id.*

80. *See* S. REP. NO. 95-989, at 64 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5850 (“Whether a ‘lease’ is a true or bona fide lease or, in the alternative, a financing ‘lease’ or a lease intended as security, depends upon the circumstances of each case.”).

81. *Id.* (emphasis added).

82. *See United Airlines, Inc.*, 416 F.3d at 612.

perform. Second, both are a type of agreement to perform obligations within a certain time period. However, scrutinizing these instruments show their differences.

An instrument may not be an executory contract if the only remaining performance to be rendered is a payment of money.<sup>83</sup> In contrast, if the remaining performance is a payment of money, the conveyance may be deemed an unexpired lease if the lessee has a possessory interest and the lessor is the owner.<sup>84</sup> Some bankruptcy courts may consider transactions over drilling rights for oil and gas as unexpired leases of real property if drilling never occurred because the agreement was a right to use the real property, not own it.<sup>85</sup>

Considering whether there has been an effective and consummated conveyance under state law is the key to determining if an instrument is an executory contract in bankruptcy. However, if an instrument is neither an executory contract nor an unexpired lease, then § 365 of the Code will not apply at all.<sup>86</sup>

#### *B. The Applicability of § 365 to Oil and Gas Leases*

The reliance of bankruptcy courts on respective state laws to establish the classification of the rights in an instrument, creates disparate results. The initial question to consider before considering conveyances of Production Payments is what an oil and gas lease is. At its core, the oil and gas lease represents an owner selling his interest to someone that will remove oil and gas in the future. In the context of state law, the execution of an oil and gas lease removes some of the lessor's sticks in the bundle, such as the "right to possess, use, or dispose of the oil and gas in, upon or under the land in question," and vests them in the lessee.<sup>87</sup> In other words, the lessor is giving ownership of the oil and gas to the lessee.

Some states have recognized that an oil and gas lease grants an ownership interest in the oil and gas.<sup>88</sup> In these cases, such a lease is a "sale

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83. See *Magdovitz Family Tr. v. KY USA Energy, Inc.* (*In re KY USA Energy, Inc.*), 449 B.R. 745, 750 (Bankr. W.D. Ky. 2011).

84. See, e.g., *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 82 (Bankr. S.D.N.Y. 2004).

85. See *In re Gasoil, Inc.*, 59 B.R. 804, 806 (Bankr. N.D. Ohio 1986).

86. See *In re KY USA Energy, Inc.*, 449 B.R. at 748; see also *United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 610 (7th Cir. 2005).

87. Wayne C. Byers & Timothy N. Tuggey, *Oil and Gas Leases and Section 365 of the Bankruptcy Code: A Uniform Approach*, 63 AM. BANKR. L.J. 337, 339 (1989) (citing *Texas Oil & Gas Corp. v. Ostrom*, 638 S.W.2d 231, 234 (Tex. Ct. App. 1982) (citation omitted)).

88. *Id.*



of a fee interest in the oil and gas in place.”<sup>89</sup> As such, some states acknowledge “[t]he term ‘lease,’ when used in an oil and gas context, is a misnomer.”<sup>90</sup> Instead, “[t]he common oil and gas lease creates a determinable fee. It vests the lessee with title to oil and gas.”<sup>91</sup> The “rules applicable to ordinary tenancies” do not apply, because these leases do not create the ordinary landlord-tenant relationship that grants a lessee a possessory interest rather than ownership.<sup>92</sup> In other words, in these states, an oil and gas lease can best be described as a conveyance of ownership rights with a reversionary interest in the remaining mineral estate after the producer has extracted oil and gas.

The conveyance in oil and gas leases is distinct from an ordinary lease. Although the conveyance vests the lessee with ownership in the minerals, in the bankruptcy context, it often appears to be an executory contract or an unexpired lease, invoking § 365 of the Code. Although the lessee returns the property to the lessor after he has removed the oil and gas that has been conveyed to him, the transaction seems to be both a true sale and an instrument that fits under § 365 of the Code. The nature of the reversionary interest has confused some bankruptcy courts, despite the conveyance of a real property interest.<sup>93</sup> Under state law, some oil and gas leases convey ownership with a reversionary interest, but oil and gas leases have disparate interpretations in bankruptcy when applying § 365 of the Code.<sup>94</sup>

The Fifth Circuit has recognized § 365 of the Code’s applicability to this distinction.<sup>95</sup> It noted that “oil and gas leases considered to be freehold estates by the governing state law do not constitute ‘unexpired leases’ under the Code and therefore Section 365 does not govern their assumption or rejection.”<sup>96</sup> For example, the court noted, “[i]n Oklahoma, oil and gas leases are not unexpired leases of real property subject to assumption or

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89. *Id.*

90. *Cherokee Water Co. v. Forderhause*, 641 S.W.2d 522, 525 (Tex. 1982).

91. *Id.*

92. Phillip G. Whaley, *Bankruptcy: Is § 365 of the Bankruptcy Code Applicable to Oklahoma Oil and Gas Leases?*, 40 OKLA. L. REV. 99, 105 (1987).

93. *See generally* Mark W. Wege, Oscar N. Pinkas & Lauren Macksoud, *Does the Second Circuit in Sabine Have the Final Word on Texas Law?* 37-AUG AM. BANKR. INST. J. 24, 78 (discussing a court’s decision holding gathering agreements as executory contracts allowing the debtor to reject the gathering agreements).

94. *Id.*

95. *See River Prod. Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990).

96. *Id.*

rejection.”<sup>97</sup> However, when there is a reversionary, and therefore leasehold, interest “Section 365 does govern their disposition.”<sup>98</sup>

An “unexpired true lease” and an “executory contract” differ from each other but courts use the terms executory contract and unexpired lease interchangeably when applying them to oil and gas leases. Generally, courts understand an executory contract to mean an instrument where both the debtor and the counter-party have sufficient remaining obligations that nonperformance would not constitute a material breach, and a “true lease” varies across jurisdictions.<sup>99</sup> Since the Code fails to define either term, “courts apply nonbankruptcy state and federal law to determine the nature of the interest for the purposes of assumption or rejection.”<sup>100</sup> Therefore, the different approaches by bankruptcy courts in determining whether an oil and gas lease is a true lease or an executory contract is relevant to § 365’s applicability when applied to conveyances of Production Payments because courts will follow the same approach.

#### *1. Oil and Gas Leases as Executory Contracts?*

Whether the oil and gas lease qualifies as an executory contract depends on different factors. If an oil and gas lease can be an executory contract, then it problematically “ignores the fundamental principles of executory contract theory and the substantive nature of the rights created by an oil and gas lease.”<sup>101</sup>

In states where there is a conveyance of ownership rights in real property, an oil and gas lease can never be executory because both sides have materially performed their obligations with respect to the conveyance. If there is an absolute conveyance of a property interest, then it is not an executory contract and cannot be rejected under § 365 of the Code. Although there is plenty to be done by the lessee, such as operations, these operations do not have to be done in order for the conveyance to be effective. So whether an oil and gas lease is within reach of § 365 ultimately depends on whether the oil and gas lease conveys a real property interest.

Whether parties to an oil and gas lease have performance due on both sides depends on the terms of the oil and gas lease. It is uncommon for an

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97. *Id.* (citing *In re Clark Res. Inc.*, 68 B.R. 358 (Bankr. N.D. Okla. 1986).

98. *Id.*

99. See Camisha L. Simmons, *Is That Exploration and Production Lease Really a Lease?*, 37-DEC AM. BANKR. INST. J. 50, 50 (2018).

100. *Id.*

101. Byers & Tuggey, *supra* note 87, at 352.

oil and gas lease to be executory because neither party has unperformed material obligations. The oil and gas lease is an absolute and consummated conveyance. Thus, nothing is left for an effective conveyance. For example, once there has been an effective conveyance, the lessee must commence drilling operations. The lessor has no further obligations, and the lessee's sole remaining obligation is to make royalty payments to the lessor(s).<sup>102</sup> However, it is crucial to recognize that the operations or royalty payments do not have to be performed in order for the conveyance to be effective. For this reason, an oil and gas lease is not executory. Naturally, if operations are not commenced or continued within the negotiated primary term, then the mineral estate will revert to the lessor, but this reversion is unrelated to whether the original conveyance was effective.

Nonetheless, a leading commentator has described an oil and gas lease as always being executory in nature.<sup>103</sup> Professor Kuntz has recognized the lessor-lessee relationship as an "executory contract in that it contains elaborate contractual provisions which continue in force between the lessor and the lessee during the life of the interest granted"<sup>104</sup> This argument is "even more compelling if the lessor is still in a position to breach the lease."<sup>105</sup> Thus, an oil and gas lease may appear to fit into the definition of an executory contract.

Despite this argument, the legislative history of § 365 of the Code might provide a more applicable definition for conveyances of an oil and gas interests.<sup>106</sup> The legislative history provides that while "there is no precise definition of what contracts are executory, it generally includes contracts on which performance is due to some extent on both sides."<sup>107</sup> Some courts accept this as the definition of an executory contract.<sup>108</sup> However, the competing theories of Professor Kuntz's definition and the traditional definition of an executory contract in § 365's legislative history causes different results.

For example, if an oil and gas lease contains agreements to discover and produce gas, and parties have not commenced these obligations, a court may conclude that the lease is an executory contract; had lessees complied

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102. See Whaley, *supra* note 92, at 103.

103. *Id.*

104. *Id.* (internal quotations marks omitted).

105. *Id.*

106. Byers & Tuggey, *supra* note 87, at 343.

107. S. REP. NO. 95-989, at 58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844; *See id.*

108. Byers & Tuggey, *supra* note 87, at 344, n.29.

and discovered gas, the property interest, the gas, would have vested in the lessee.<sup>109</sup> On review of *In re Powell*, however, an appellate opinion vacated and remanded the bankruptcy's courts legal conclusion that the oil and gas lease is an executory contract or unexpired lease.<sup>110</sup> Thus, the issue of whether the oil and gas lease creates an executory contract seemingly turned on whether there was a conveyance of, or an agreement to use, certain property that would then vest after the party satisfied their obligation.<sup>111</sup>

The different definitions from Professor Kuntz and the legislative history can lead courts to contradictory results for this one instrument. However, is it reasonable that the continued payment of specified royalties is enough to characterize an oil and gas lease as an executory contract because the payment of royalties constitute an ongoing obligation? According to the Code,<sup>112</sup> once the lessee conveys the interest in the oil and gas lease, it will vest in the lessee.<sup>113</sup> The correct analysis thus provides that an oil and gas lease could never be executory, because if there is an absolute conveyance that is effective and consummated, as there is in an oil and gas lease, then it is not executory.<sup>114</sup>

## 2. *Oil and Gas Leases as Unexpired Leases?*

Individuals familiar with an oil and gas lease know that it is not an ordinary lease. As discussed above, the term “oil and gas lease” is a misnomer because the interest created by an oil and gas lease is not the same interest created by a lease under landlord and tenant law.”<sup>115</sup> Nonetheless, this instrument may constitute an unexpired lease under § 365 of the Code depending on how state law treats the mineral estate.<sup>116</sup>

In states where the fee simple owner of the mineral estate severs and divests the mineral estate through an oil and gas lease, the owner makes a

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109. *Powell v. Anadarko E&P Co. (In re Powell)*, 482 B.R. 873, 877–78 (Bankr. M.D. Pa. 2012), *vacated in part*, 2015 WL 6964549.

110. *Chesapeake Appalachia LLC v. Powell (In re Powell)*, 2015 WL 6964549, at \*8 (M.D. Pa. 2015). A party will appeal a bankruptcy court's finding to the district court.

111. *See id.*

112. 11 U.S.C. § 101(56A) (2012).

113. *See Tennant v. Dunn*, 110 S.W.2d 53, 56 (Tex. 1937).

114. *Id.*

115. *River Prod. Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 740 n.17 (5th Cir. 1990).

116. *See id.*

conveyance of a real property interest.<sup>117</sup> If an oil and gas lease were an unexpired lease, and a debtor could apply § 365 of the Code, the result would be “quite simply an exaltation of form over substance.”<sup>118</sup> The lessee would have ownership if he complies with the lease. For example, bankruptcy courts applying Texas state law have established that an oil and gas lease is not a true lease but instead is a transaction that conveys a real property interest.<sup>119</sup> As a result, under Texas law, an oil and gas lease is not an unexpired lease; if the debtor is a lessor, then he is not an owner. He may not assume the lease into the bankruptcy estate, and the lessee retains his ownership interest.<sup>120</sup>

Bankruptcy courts have reached a similar conclusion when applying Oklahoma law.<sup>121</sup> The specific legal right transferred under an oil and gas lease in Oklahoma is something more than an “incorporeal hereditament or a profit à prendre.”<sup>122</sup> The interest is one in land and grants the lessee the rights to explore remove something from the land to the lessee’s benefit.<sup>123</sup> As a result, under Oklahoma law, an oil and gas lease is not an unexpired lease because an oil and gas lease is termed as a qualified fee simple, not a true lease.<sup>124</sup>

Federal law governing oil and gas leases is also inconsistent. The Tenth Circuit noted “where no right of the federal government is involved, state law governs,” and federal courts will look to state law to decide the nature of the onshore oil and gas lease interest.<sup>125</sup> In *Bolack*, the Tenth Circuit applied state law to hold that the interest in a federal onshore oil and gas lease was real property.<sup>126</sup> Thus, if applicable state law established the interests were real property interests, making the lessee the owner of the mineral estate, a bankruptcy court would likely find that a federal onshore

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117. See, e.g., *Terry Oilfield Supply Co. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 70 (S.D. Tex. 1996) (finding that a debtor cannot assume or reject a mineral lease since it conveys real property).

118. Byers & Tuggey, *supra* note 87, at 353.

119. *Terry Oilfield Supply Co.*, 195 B.R. at 70.

120. *Id.*

121. *Contra In re Clark Res., Inc.*, 68 B.R. 358, 359 (Bankr. N.D. Okla. 1986) with *Shields v. Moffitt*, 984 OK 42, ¶¶ 10–13, 683 P.2d 530, 532.

122. *Id.*

123. *Id.*

124. *Shields v. Moffitt*, 984 OK 42, ¶¶ 10–13, 683 P.2d 530, 532.

125. *Bolack v. Underwood*, 340 F.2d 816, 819–20 (10th Cir. 1965).

126. *Id.*

oil and gas lease would not be subject to assumption or rejection under § 365 of the Code.<sup>127</sup>

Determining property interests is also complicated for federal offshore oil and gas leases. The United States has asserted that an OCS lease is a true lease of real property because it is a rental agreement to use real property and does not give the lessee ownership rights in the mineral estate.<sup>128</sup> The United States asserted that the OCS leases were also executory contracts because the lessee must continue to make royalty and rental payments and the United States must provide the lands for development and supervise development.<sup>129</sup> For these reasons, the United States argued that the oil and gas leases are within reach of § 365 of the Code.<sup>130</sup> That said, bankruptcy courts have yet to resolve how to classify offshore oil and gas leases.<sup>131</sup>

#### *IV. How the Applicability of the Code Will Affect Production on the OCS*

##### *A. What is the OCS?*

The United States regulates the OCS through the Outer Continental Shelf Lands Act (“OCSLA”).<sup>132</sup> The OCS is comprised of the submerged lands three miles offshore from state coastlines.<sup>133</sup> The OCS consists of 1.7 billion acres divided into four regions of submerged lands, subsoil, and seabed: the Gulf of Mexico, Atlantic, Pacific, and Alaska regions.<sup>134</sup> In January 2017, the Federal Gulf of Mexico contributed 1.7 million barrels per day and accounted for the highest annual average of crude oil production to date due to new projects and increased production.<sup>135</sup> As new projects continue to be planned and approved, production will likely

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127. *See id.*

128. *See, e.g.*, NGP Capital Res. Co. v. ATP Oil & Gas Corp. (*In re* ATP Oil & Gas Corp.), No.12-03443, 2014 WL 61408 (Bankr. S.D. Tex. Jan. 6, 2014).

129. *See, e.g., id.*

130. *See* NGP Capital Resources Co.'s Complaint for Declaratory Judgment Against ATP Oil & Gas Corp. at 9, NGP Capital Res. Co. v. ATP Oil & Gas Corp. (*In re* ATP Oil & Gas Corp.), No.12-03443, 2014 WL 61408 (Bankr. S.D. Tex. Jan. 6, 2014) (No. 12-36187).

131. Camisha L. Simmons, *Offshore Oil and Gas Leases: The Unanswered Question*, 36-SEP AM. BANKR. INST. J. 18, 19 (2017).

132. 43 U.S.C. § 1332 (2012).

133. *Id.* § 1301(a).

134. *The Continental Shelf*, BUREAU OF OCEAN ENERGY MGMT., <https://www.boem.gov/The-Continental-Shelf/> (last visited Jan. 18, 2019).

135. *Gulf of Mexico crude oil production, already at annual high, expected to keep increasing*, U.S. ENERGY INFO. ADMIN., TODAY IN ENERGY (Apr. 12, 2017), <https://www.eia.gov/todayinenergy/detail.php?id=30752>.

continue to increase and operators will likely consider production on the OCS and use the associated capital to fund their projects. The vast quantities of production available give operators the ability to monetize future production to obtain capital for projects.<sup>136</sup> Therefore, E&P companies will be attracted to produce on the OCS and consider monetizing future oil and gas production in order to expand and continue projects.

*B. What is the OCSLA?*

OCSLA recognized the OCS as a “vital national resource reserve held by the Federal Government for the public, which should be made available for expeditious and orderly development.”<sup>137</sup> Specifically, OCSLA asserted that the OCS “appertain[s] to the United States.”<sup>138</sup> The intentional use of the curious phrase “appertain to,” rather than “owned by,” still declares that the OCS is subject to the United States’ jurisdiction, control, and power of dispositions, implying that the United States Federal Government is the owner of the OCS.<sup>139</sup>

Before the enactment of OCSLA, there was a significant dispute between the federal government and certain coastal states regarding the ownership of the OCS.<sup>140</sup> The United States sued California, Louisiana, and Texas,<sup>141</sup> arguing that the federal government’s rights over the continental shelf were “paramount over the rights of all three states.”<sup>142</sup> In response to the three cases, Congress enacted OCSLA and the Submerged Lands Act.<sup>143</sup>

OCSLA authorizes the federal government to lease OCS lands to private companies for E&P.<sup>144</sup> The Bureau of Ocean Energy Management (“BOEM”) and the Bureau of Safety and Environmental Enforcement (“BSEE”) are in charge of leasing and regulating OCS lands.<sup>145</sup> OCS leases

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136. Lauren Hunt Brogdon, Note, *A New Horizon?: The Need for Improved Regulation of Deepwater Drilling*, 37 COLUM. J. ENVTL. L. 291, 294 (2012).

137. 43 U.S.C. § 1332(3) (2012).

138. *Id.* § 1332(1).

139. Gerald F. Slattery, Jr., *Contractual Choice of Law Issues on the Outer Continental Shelf*, 49 TEX. TECH. L. REV. 737, 743 (2017) (citing § 1332 and discussing the odd phrasing and the United States’ legal battle to obtain ownership but ultimately using the language “appertain”).

140. *See generally id.* at 740-44.

141. *See id.*

142. *See id.*

143. *See id.*

144. *See* 43 U.S.C. § 1337 (2012).

145. *See The Reorganization of the Former MMS*, BUREAU OF OCEAN ENERGY MGMT., <https://www.boem.gov/Reorganization/> (last visited Jan. 18, 2019).

function similarly to a traditional oil and gas lease.<sup>146</sup> The United States receives profits in royalty and rental payments by leasing the rights to explore and drill for minerals to private developers.<sup>147</sup>

Operators are likely to consider production on the OCS because of its rise in crude oil production.<sup>148</sup> However, because of the continuing rise in bankruptcies proceedings, some involving oil and gas producers, and the general nature of the oil and gas industry, companies that engage in offshore E&P might seek capital from investors by offering Production Payments due to the guaranteed capital and secured financing.<sup>149</sup>

### *1. OCSLA's Choice of Law Provision*

Because bankruptcy applies state law, operators interested in capitalizing the OCS should pay particular attention to the choice of law scheme. The choice of law provision in OCSLA is a “densely worded” and important provision that decides what law applies.<sup>150</sup> Section 1333(a)(2)(A) adopts as surrogate federal law “the civil and criminal laws of each adjacent State” as long as they are “not inconsistent with this subchapter or with other Federal laws and regulations of the Secretary.”<sup>151</sup> The adjacent state’s law applies to the subsoil, the seabed, and artificial islands and fixed structures erected thereon.<sup>152</sup> The OCSLA considers a state adjacent if such areas, islands, or structures “would be within the area of the state if its boundaries were extended seaward to the outer margin of the outer Continental Shelf.”<sup>153</sup>

For example, offshore oil and gas contracts may include choice-of-law provisions where the parties agree that the law of a particular state will govern the interpretation and enforceability of their contract.<sup>154</sup> However, if OCSLA governs the contract, a bankruptcy court would apply the law of the adjacent state according to the federal statute and ignore the parties’

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146. *See* 43 U.S.C. § 1337.

147. *Id.*

148. *See* Slattery, *supra* note 139, at 738 n.2.

149. *See* HAYNES AND BOONE, LLP, OIL PATCH BANKRUPTCY MONITOR (Mar. 31, 2018), [http://www.haynesboone.com/~media/Files/Energy\\_Bankruptcy\\_Reports/2018/Oil\\_Patch\\_Bankruptcy\\_Monitor\\_09102018.pdf](http://www.haynesboone.com/~media/Files/Energy_Bankruptcy_Reports/2018/Oil_Patch_Bankruptcy_Monitor_09102018.pdf). Haynes and Boone updates its Oil Patch Bankruptcy Monitor often, and the number of bankrupt E&P companies will often change.

150. Slattery, *supra* note 139, at 744.

151. 43 U.S.C. § 1333(a)(2)(A).

152. *Id.*

153. *Id.*

154. *See* Slattery, *supra* note 139, at 749 (citing *Stoot v. Fluor Drilling Servs., Inc.*, 851 F.2d 1514, 1517 (5th Cir. 1988)).



choice of law provision.<sup>155</sup> The law of the adjacent state would then govern § 365's applicability to the oil and gas interests. Therefore, despite stating an axiomatic point, it is essential to know which state's law governs and the associated law of that state and its property rights.

### *C. Production Payments on the OCS*

As discussed earlier, for § 541(b)(4)(B) of the Code—regarding the analysis of Production Payment instruments as conveyances of real property—to apply and protect these interest in the event of bankruptcy, the debtor must show that (1) there was a transfer of the “production payment” pursuant to a written conveyance; (2) the grantee does not participate in production operations; and (3) other provisions of the Code, such as § 365, do not include the interest into the debtor's estate.<sup>156</sup> If a debtor meets these three elements, the Production Payments do not become property of the estate.

Similar to an oil and gas lease between a private surface owner and a business entity, the United States government only leases to individuals, corporations, and partnerships who are qualified to be an assignee of an OCS lease.<sup>157</sup> A leaseholder can assign its interest with BOEM approval.<sup>158</sup> However, this restriction only concerns the land, not anything an operator produces, such as oil and gas.<sup>159</sup> With conveyances, Production Payments, and similar “carved out” interests, the BOEM only requires a filing to have the transaction on record.<sup>160</sup> These non-required filings do not require approval.<sup>161</sup> As a result, the lessee in the OCS has the freedom to negotiate and enter into transactions with respect to oil and gas interests.

The transaction for a Production Payment consists of three documents: “[1] a Purchase and Sale Agreement, [(2)] a Conveyance of Overriding Royalty, and [(3)] a Production and Delivery Agreement.”<sup>162</sup> First, the purchase and sale agreement states the terms and conditions of the transfer that will govern the transfer of production from the grantor to the grantee. Second, the conveyance of the Production Payment addresses the transfer

155. *Id.*

156. 11 U.S.C. § 541(b)(4)(B) (2012).

157. *See* 30 C.F.R. § 556.402 (2016).

158. *Getting It Right the First Time*, BUREAU OF OCEAN ENERGY MGMT. (Sept. 28, 2017), <https://www.boem.gov/2017-NALTA-Presentation/>.

159. *See id.*

160. 30 C.F.R. 556.715 (2016).

161. *Id.*

162. Jeffrey S. Muñoz, *Financing of Oil and Gas Transactions*, 4 TEX. J. OIL GAS & ENERGY L. 223, 230 (2009).

of what the operator will produce and what adjustments might be necessary to make up for shortages. Finally, the production and delivery agreement covers issues of marketing, gathering and transportation, and processing. These documents allow the grantor and grantee the opportunity to mitigate risks in the transaction.<sup>163</sup> They also ensure there is a successful transaction between the parties.<sup>164</sup> This type of purchase and sale agreement is a common and properly structured conveyance of Production Payments.<sup>165</sup>

*1. Is it a Transfer?*

Bankruptcy courts could recharacterize the instrument because it is not a transfer of a Production Payment under a written conveyance. Analyzing the definition of a Production Payment under the Code presents issues. The Code defines the term “production payment” in two subparts.<sup>166</sup> First, the Production Payment or “term overriding royalty” is “contingent on the production of a liquid or gaseous hydrocarbon from particular real property.”<sup>167</sup> Second, the “term overriding royalty” must be “from a specified volume, or a specified value, from the liquid or gaseous hydrocarbon produced from such property and determined without regard to production costs.”<sup>168</sup> The Code further defines the term “term overriding royalty” as “an interest in liquid or gaseous hydrocarbons in place or to be produced from particular real property that entitles the owner thereof to a share of production.”<sup>169</sup>

The Code’s definitions for a Production Payment suggests that payments should be produced from the real property.<sup>170</sup> The provision may allow a producer to deliver regular shortfalls later with interest, as long as the Production Payment or term overriding royalty is still produced from the “real property.”<sup>171</sup> For example, if a provision in the instrument allows the producer to make up missed Production Payments or term overriding

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163. See Charles E. Harrell et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885, 906 (1997).

164. See *id.*

165. Muñoz, *supra* note 162, at 230.

166. 11 U.S.C. § 101(42A) (2012).

167. *Id.*

168. *Id.*

169. *Id.* § 101(56A).

170. See *id.*

171. See Jeff Nichols, Karl Burrell & Ellen Conley, *Volumetric Production Payments in Bankruptcy*, 58 S. TEX. L. REV. 1, 11 (2016).

royalties from the previous term, it is possible the transaction will not be at risk of recharacterization if they are still from “such property.”<sup>172</sup>

In contrast, if an operator substitutes missed Production Payments from other property not described in the instrument that produces oil and gas, then it may not meet the first element of a transfer. If there was a provision in the instrument that would force the grantor to substitute missed payments, it would likely still be a transfer. However, if the provision places a substantial penalty to ensure delivery and allows substituted Production Payments from other properties, it moves away from the Code’s definition of a transfer from “such property” and risks being possibly recharacterized as a loan.<sup>173</sup> In any event, classification and treatment will remain unsolved absent judicial guidance.

Although a provision that motivates or penalizes shortfalls in production but allows the grantor to make up these shortfalls may risk being recharacterized, parties must consider the context of the oil and industry. The volatility and continued exploration for production may increase a company’s ability to make up shortfalls on the OCS rather than onshore. A producer can make up shortfalls on the OCS because of the potential of vast future production, but a lessor in a state without such production capabilities will have trouble making up deficits.

The use of technical terms or descriptive titles is not determinative of whether the conveyance of Production Payments is a transfer or a disguised financing transaction.<sup>174</sup> Bankruptcy courts have held that “substance will not give way to form, that technical considerations will not prevent substantial justice from being done.”<sup>175</sup> Using their equitable powers,<sup>176</sup> or express provisions of the Code,<sup>177</sup> bankruptcy courts can interpret what was intended as a Production Payment or term overriding royalty as a disguised financing instrument.<sup>178</sup> Although determining whether a Production

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172. See 11 U.S.C. § 101(42A) (2012).

173. See Speer, *supra* note 7, at 2 (discussing how “make-whole” provisions apply to interruptions of production payments).

174. See *PSI, Inc. of Mo. v. Aguillard (In re Senior-G & A Operating Co.)*, 957 F.2d 1290, 1296 (5th Cir. 1992).

175. *Pepper v. Litton*, 308 U.S. 295, 305 (1939).

176. *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1148, (10th Cir. 2015).

177. See *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539, 544 (5th Cir. 2011) (noting that state law principles can be used to determine if a transaction needs to be recharacterized); see also *Butner v. United States*, 440 U.S. 48, 51–54 (1979).

178. See, e.g., *Cor Route 5 Co., v. Penn Traffic Co. (In re Penn Traffic Co.)*, 466 F.3d 75, 77 n.2 (2d Cir. 2006) (recognizing the party’s attempt to recharacterize the instrument).

Payment is an executory contract or a disguised financing instrument is within the bankruptcy court's power, it can have devastating effects on the evaluation of Production Payments.

Recharacterization is the power of a bankruptcy court to examine the economic reality of an instrument and establish the true substance of the transaction.<sup>179</sup> In the bankruptcy context, recharacterization is fact specific and determined "case-by-case."<sup>180</sup> Although recharacterization rarely takes place within the oil and gas context, the body of law that has developed in oil and gas transactions can help to understand how courts establish the true character of a transaction.

Although there is a "strong presumption that a deed and lease . . . are what they purport to be," a bankruptcy court can still find that the transaction is something other than a conveyance if certain factors are present.<sup>181</sup> Bankruptcy courts will use various factors to determine the correct characterization of the transaction.<sup>182</sup> The factors are similar to determining whether a transaction constitutes a true lease: (1) whether the transactions were rental payments or were structured to ensure or guarantee a return on an investment;<sup>183</sup> (2) whether the purchase price related to fair market value or whether it was calculated as the amount necessary to finance the transaction;<sup>184</sup> (3) whether the property was purchased for the lessee and not the lessor; and (4) whether the lessee assumed many of the obligations normally associated with ownership.<sup>185</sup>

In sum, the "question for the court then is whether . . . the true nature of the transaction, [is] such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale."<sup>186</sup> Although the Code facially intends to exclude Production Payments from the debtor's estate, such payments still result in contested interpretations due to the absolute conveyance of oil and gas reserves and

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179. *Redmond v. Jenkins (In re Alternate Fuels, Inc.)*, 789 F.3d 1139, 1146–48 (10th Cir. 2015).

180. *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 454–56 (3d Cir. 2006).

181. *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 804 F.2d 193, 200 (2d Cir. 1986) (quoting *Fox v. Peck Iron & Metal Co.*, 25 B.R. 674, 688 (Bankr. S.D. Cal. 1982)).

182. *See Hotel Syracuse Inc. v. City of Syracuse Indus. Dev. Agency (In re Hotel Syracuse, Inc.)*, 155 B.R. 824, 838 (Bankr. N.D.N.Y. 1993).

183. *Id.*

184. *See id.*

185. *See id.*

186. *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538, 544 (3d Cir. 1979) (footnote omitted).

an obligation to produce and deliver the Production Payments.<sup>187</sup> In other words, the absolute conveyance of a Production Payment begins to look similar to a financing transaction or a loan. Because Production Payments risk being recharacterized, parties should avoid providing a court with the ability to recharacterize a transfer of Production Payments into a loan.

In *In re Senior-G & A Operating Co.*, an E&P company entered into a “Production Payment Loan Agreement” with an investor.<sup>188</sup> The investor advanced \$5.1 million to the E&P company in exchange for Production Payments.<sup>189</sup> The E&P company filed bankruptcy and the bankruptcy trustee asserted that the investors were secured creditors and would need to pay certain costs with the maintenance and improvement of its collateral.<sup>190</sup> Investors denied that they were secured creditors and asserted they were owners of term overriding royalty interests who were receiving Production Payments.<sup>191</sup> The Fifth Circuit found that, because the interest did not constitute a term overriding royalty, the investors were not owners.<sup>192</sup> Furthermore, the court relied on the instrument’s language to determine that the investors were secured creditors and that there was a lien on the hydrocarbons.<sup>193</sup> The Fifth Circuit recharacterized the agreement to convey these interest into a loan.

In *In re ATP*, the defendant, a lessee on the OCS, conveyed to the plaintiff, an investor of the defendant’s company, \$700 million worth of term overriding royalty interests and net profit interests through sixteen agreements.<sup>194</sup> The defendant argued that these transactions were “disguised financing” transactions and should be part of the bankruptcy estate.<sup>195</sup> Although the transactions were labeled unambiguously, the court analyzed the objective substance of the transaction.<sup>196</sup> The court ultimately recharacterized the transactions as loans because of the high interest rate,

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187. See Speer, *supra* note 7, at 2 (recognizing that production payments are a type of hybrid transaction that require both a conveyance and an obligation to produce and deliver oil and gas reserves).  
produce and deliver those reserves.”).

188. *In re Senior-G & A Operating Co.*, 957 F.2d at 1293.

189. *Id.*

190. *Id.* at 1294–95.

191. See *id.* at 1295.

192. See *id.* at 1296.

193. *Id.* 1296–97.

194. *NGP Capital Res. Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No.12-03443, 2014 WL 61408, at \*1 (Bankr. S.D. Tex. Jan. 6, 2014).

195. *Id.*

196. *Id.* at \*5.

the characteristics of a loan, the treatment of the conveyance as a loan for tax purposes, and the production as artificial to payment.<sup>197</sup> To the court, the terms were consistent with a disguised financing instrument.<sup>198</sup>

Although state law establishes the nature of the interests, there are some precautions individuals can take to avoid a court recharacterizing a true sale as disguised financing. If the parties can effectuate a conveyance of real property, such transactions should avoid a relationship analysis as between a secured creditor and debtor.<sup>199</sup> These secured creditor rights, such as a “lien and security interest secure only the . . . obligations under the purchase and sale agreement.”<sup>200</sup> The benefit of conveying real property is that it segregates the provisions creating the secured creditor rights from the conveyance, “which will (hopefully) assist a court’s interpretation of the documents.”<sup>201</sup> Moreover, there would be no language in the conveyance that would make investors a secured creditor, unlike in *In re Senior-G & A*.<sup>202</sup> Although bankruptcy courts can use the “collapse doctrine” to collapse a “series of transactions and treat[] them as a single integrated transaction,” parties can minimize the risk of a court construing the transaction as a whole by containing the debtor-creditor rights within the final purchase and sale agreement.<sup>203</sup>

Individuals looking to enter transactions with producers on the OCS should avoid the factors courts use to evaluate whether a conveyance of oil and gas interests is a loan.<sup>204</sup> In structuring these transactions, individuals should not emphasize the return on investment and instead emphasize the fact that it is a purchase of Production Payments owed over a period of time.<sup>205</sup> Structuring the transaction to avoid classification as a loan under tax law will help.<sup>206</sup> Individuals should also be sure to describe specifically

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197. *Id.*

198. *Id.*

199. See Michael P. Pearson, *A Primer on Production Payments*, 28TH ANN. ADVANCED OIL, GAS AND ENERGY RESOURCES L. COURSE, (State Bar of Tex., Austin, Tex.), Sept. 16-17, 2010, at ch. 11, 25-26, <https://docplayer.net/6362040-A-primer-on-production-payments-by-michael-p-pearson-jackson-walker-l-l-p-houston-texas.html>.

200. *Id.* at 35.

201. *Id.*

202. See *PSI, Inc. of Mo. v. Aguillard (In re Senior-G & A Operating Co.)*, 957 F.2d 1290, 1299 (5th Cir. 1992).

203. *LaRosa v. LaRosa*, 482 F. App’x, 750, 755 n.3 (4th Cir. 2012) (quoting *In re Sunbeam Corp.*, 284 B.R. 355, 370 (Bankr. S.D.N.Y. 2002)).

204. See, e.g., *In re PCH Assocs.*, 804 F.2d 193, 200–01 (2d Cir. 1986).

205. See *id.*

206. See 12 U.S.C. § 636(b) (2012).

the Production Payments by volume or time instead of by revenue or total price in order to distinguish their Production Payments from dollar dominated production payments (“DDPP”). Because “‘DDPP’ give the carved out interest owner the right to receive a fixed dollar amount generated from the property” they differ from Production Payments and are defined as “‘borrowings’ by the Financial Account Standards Board.”<sup>207</sup> However, the Financial Account Standards Board defines Production Payments as a “transfer of a mineral interest.”<sup>208</sup> The differences are essential in determining how likely a court is to recharacterize the debt instrument. Thus, individuals interested in entering into transactions with producers on the OCS need to carefully structure and draft their transactions.

## *2. Is the Individual Participating in the Operation?*

The second element to establish that a Production Payment does not enter the debtor’s estate under § 541(b) of the Code requires the buyer not to participate in the production or operation of the property from which the Production Payments are transferred from. The Code uses the terms “participate” and “operations,” but does not define them.<sup>209</sup> Therefore, bankruptcy courts employ the plain meaning of the words, in which “participation” generally means “take part.”<sup>210</sup> The term “operations,” within the context of oil and gas leases, means the “production of minerals.”<sup>211</sup>

Determining if the operator participates in the operations is resolved by looking at the instrument and the parties’ conduct.<sup>212</sup> For example, many agreements contain a provision that requires the grantee’s consent to enter into certain contracts.<sup>213</sup> Additionally, this definition excludes Production

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207. DAVID J. KARP & PARKER J. MILENDER, *INVESTING IN OIL AND GAS ROYALTIES: DISTRESSED COUNTERPARTY RISK CONSIDERATIONS*, at 3 (Mar. 2015), (citations omitted) <https://perma.cc/2UEY-RM97> (explaining that the difference means production payments can be more likely to be recharacterized if the owner of the production payment is entitled to higher interest for late payments).

208. *Id.*

209. *See* 11 U.S.C. § 541(b) (2012).

210. *See* Powell Elec. Sys. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa., Civil Action No. H-10-993, 2011 WL 3813278, at \*7 (S.D. Tex. Aug 29, 2011).

211. *See* Nichols et al., *supra* note 171, at 12.

212. *See id.*

213. *See id.*, *See also* Muñoz, *supra* note 162, at 233.

Payments for service providers.<sup>214</sup> How broadly a court reads the terms “participate” and “operations,” will determine whether or not a grantee’s Production Payments are excluded from the debtor’s estate.<sup>215</sup> That said, courts have yet to develop this issue fully.<sup>216</sup>

Individuals who consider entering into transactions with producers on the OCS should not have a problem with this requirement. In *ATP*, the court recognized that the producer retained operational control and the counterparty had no right to develop or operate the property.<sup>217</sup> Because these operations are done on the OCS, the second requirement is easier to meet. However, if Offshore Support Vessels assist in production, this element would likely not be met, mainly because Offshore Support Vessels would assist in operations by participating and performing services.<sup>218</sup>

### 3. *Is it Subject to Inclusion Provisions of the Code?*

Part of the final requirement to exclude Production Payments from the debtor’s estate under § 541(b)(4)(B) is determining that the Production Payment would not be included in the debtor’s estate except by operation of § 365 of the Code.<sup>219</sup> As discussed *supra*, § 365 of the Code provides a debtor with certain powers regarding executory contracts and unexpired leases.<sup>220</sup> This section allows a debtor to reject a contract, which breaches the obligation and provides the counterparty with a right to file for rejection damages, then making the counterparty a creditor.<sup>221</sup> Section 541(b)(4)(B) would prevent the debtor from attempting to reject the agreement to retain the hydrocarbons used for the Production Payments unless the debtor can show the existence of the required elements.

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214. See Rhett G. Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, 5 TEX. J. OIL GAS & ENERGY L. 265, 284 (2010) (“This is unfortunate language because it is not uncommon for one party to take a production payment as compensation while providing services on the property, sometimes even conducting operations.”).

215. *See id.*

216. *See* Pearson, *supra* note 199, at 19.

217. *NGP Capital Res. Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No.12-03443, 2014 WL 61408 at \*11, \*12 (Bankr. S.D. Tex. Jan. 6, 2014).

218. *See* Robin Sebastian Koske Rose, *Future Characteristics of Offshore Support Vessels 27-34* (Mar. 22, 2011) (unpublished M.S. thesis, Massachusetts Institute of Technology) (on file with Massachusetts Institute of Technology) (discussing the future possibilities of Offshore Support Vessels) <https://perma.cc/XS7Y-SMBG>.

219. 11 U.S.C. § 541(b)(4)(B)(ii) (2012).

220. § 365(b).

221. *Id.*



However, debtors can also reject the instrument under principles of state law. The critical analysis is whether the interest conveyed is real or personal property. As discussed in Part III, if the oil and gas interests are real property, then there was an absolute and consummated conveyance out of the estate at the time of the transaction.<sup>222</sup> As a result, the same analysis to determine if § 365 applies to oil and gas leases can be applied to Production Payments. Primarily, if the considered interest is an absolute conveyance of a real property interest, then it is not an executory contract and cannot be rejected.<sup>223</sup>

OCSLA's choice of law scheme means that individuals must verify that the applicable state law defines the Production Payment as real property. For example, an individual interested in negotiating with a company drilling on the OCS off the coast of Alaska, Alabama, or Mississippi will need to determine the nature of the property interest conveyed in an oil and gas instrument to determine if the state has unsettled law characterizing and defining the property interest. In Louisiana, there is a split in law regarding whether an oil and gas lease is an executory contract or an unexpired lease.<sup>224</sup> Therefore, individuals interested in contracting with operators on the OCS adjacent to Louisiana would need to draft the intent of parties carefully.<sup>225</sup> However, if the OCS lease is adjacent to Texas, the property interest is real property. Thus, the investor's Production Payment would remain the property of the investor in the event of bankruptcy and would

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222. See *supra* Part III.

223. *Contra In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (holding that an oil and gas lease is not an unexpired lease or executory contract within the purview of 11 U.S.C. § 365 but is in the nature of an estate in real property having the nature of a fee) *with In re Gasoil, Inc.*, 59 B.R. 804, 808-09 (Bankr. N.D. Ohio 1986) (concluding that the oil and gas leases at issue are covered by § 365) *and In re P.I.N.E., Inc.*, 52 B.R. 463, 465 (Bankr. W.D. Mich. 1985) (holding § 365 did not apply to an oil and gas lease that expired in its primary term *and In re Integrated Petroleum Co.*, 44 B.R. 210, 214 (Bankr. N.D. Ohio 1984) (treating oil and gas leases as assumable or rejectable contracts).

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

225. See, e.g., Patrick S. Ottinger, *Principles of Contractual Interpretation*, 60 LA. L. REV. 765, 766-72 (2000).

not enter the debtor's estate because it was an effective and consummated conveyance at the time of transaction.<sup>226</sup>

Nonetheless, recharacterization for these transactions is still possible under § 365 and other provisions of the Code.<sup>227</sup> The issue is that transfers of Production Payments—and the context of their creation—do not fit neatly into every section of the Code. There is little predictability, because these transfers occur in the discretionary areas of the Code. To minimize the risk that a bankruptcy court will impose its own interpretation on an instrument, individuals should clearly structure their transaction as an absolute conveyance supporting a true sale rather than a loan in disguise.

The context of a transaction is relevant to a court's analysis and may be persuasive against finding a true sale. For example, an investment company that has entered into transactions with an operator and knows the operator may soon file for bankruptcy may seek to negotiate a new contract. If the instrument contains provisions that result in severe penalties for missed payments and allows for production from other operators, the resulting evidence suggests the investment company intends to take advantage of the soon-to-be-bankrupt operator. In other words, the investment company is forcing the operator to convey the rest of the soon-to-be debtor's property, leaving nothing for creditors. Bankruptcy courts will view this as a disguised loan and recharacterize the transaction. However, the cyclical nature of the oil and gas industry can disguise when a company is in true distress. The new contract may not have been predicated on potential bankruptcy at all, yet it may appear so to the bankruptcy court. Therefore, it makes it difficult to know when the transaction is disguised financing.

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226. *See River Prod. Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990).

227. The following cases represent examples of courts applying their recharacterization power. *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 455 (3d Cir. 2006), *Fairchild Dormier GHMB v. Official Comm. of Unsecured Creditors (In re Dornier Aviation (N. Am.) Inc.)*, 453 F.3d 225, 231 (4th Cir. 2006) (both courts authorizing judicial recharacterization under §105(a)); *City of S.F. Mkt. Corp. v. Walsh (In re Moreggia & Sons, Inc.)*, 852 F.2d 1179, 1182 (9th Cir. 1988) (“Our analysis of the Code and the legislative history and purpose of section 365(d)(4) convinces us that the appropriate focus is on the federal law purposes of Section 365(d)(4) and the economic realities of this particular arrangement.”); *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 804 F.2d 193, 198 (2d Cir. 1986) (“As discussed below, the legislative history of section 502(b)(6) of the Code mandates that a court look beyond mere form to the circumstances of each case, including the economic substance of the transaction, to determine whether a ‘true lease’ exists for purposes of the Code.”).

Some have opined that the OCS is only for “big players,” but this observation could reflect the difficulty smaller players face trying to receive the capital needed to produce.<sup>228</sup> Production Payments generally allow companies to become “big players,” but the OCS seems to restrict potential “big players” by preventing them from capitalizing on their production.<sup>229</sup> Therefore, the Code’s goal of incorporating every interest into the debtor’s estate potentially obstructs the development of oil and gas, with potential bankruptcies threatening the ownership rights of an investing party in its mineral interest.

The benefits of becoming a fractional interest holder of production off the OCS comes with associated risks. The Code’s underlying policy of creating an expansive debtor’s estate, arguably for the benefit of creditors, may hurt an investor’s incentive to finance future projects on the OCS. If the absolute conveyances are characterized as loans, bankruptcy proceedings could eliminate their financial interests.

#### *V. Conclusion*

Although varying results in bankruptcy may make investors wary of entering into oil and gas conveyances via Production Payments or term overriding royalty transactions, case law interpretation and the Code provide a road map of the risks associated with such transactions between producers and investors. The OCS is the second largest production region in the nation, and it may continue to grow. Those looking to produce on the OCS will need financing. Production Payments are an excellent way to invest in companies, and more significant investment opportunities lead to enhanced competition and better production of domestic resources. With increased production in the OCS in the coming years, the opportunities to invest will be greater, so long as the parties can mitigate the bankruptcy risks.

Parties need to take proper precautions when entering murky and uncharted waters of the OCS, notwithstanding the inherent risks of the oil and gas industry. The issues concerning OCS leases and transactions make it difficult for the smaller E&P companies to prosper, so investors should be

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228. Jordan Blum, *EnSCO buying Houston's Atwood Oceanics*, HOUS. CHRONICLE (May 30, 2017), <https://perma.cc/H242-NUGW>.

229. See Nerijus Adomaitis, *Out of bankruptcy, Seadrill eyes closer ties with oil service firms*, REUTERS (Apr. 18, 2018), <https://perma.cc/8FB2-DJJZ>; see also *Hyperdynamics files for bankruptcy*, OFFSHOREENERGYTODAY.COM (Dec. 28, 2017), <https://perma.cc/T4MF-UQD6>.

mindful of minimizing the risk of a bankruptcy court recharacterizing a purchase into a loan.