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## Bankruptcy: Is 365 of the Bankruptcy Code Applicable to Oklahoma Oil and Gas Leases?

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## NOTES

### Bankruptcy: Is § 365 of the Bankruptcy Code Applicable to Oklahoma Oil and Gas Leases?

The economy of Oklahoma, as well as that of other oil-producing states, is suffering from the effects of an unstable world oil market. Simply put, when world crude oil prices are high, the demand for domestic oil increases as oil consumers search for alternatives to the world market. However, when world oil prices are low, oil consumers satisfy their need for crude oil in the world market, neglecting domestic oil producers. In a volatile world oil market, Oklahoma oil producers find their fate resting in the hands of those who control the supply, and consequently the price, of oil sold in the world's markets, namely the Organization of Petroleum Exporting Countries (OPEC).

The combination of these conditions has critically affected the Oklahoma oil company. With foreign oil markets driving down the price of foreign oil, Oklahoma oil producers find little demand for their oil unless they match the foreign price. However, Oklahoma oil producers cannot compete dollar for dollar with OPEC. Revenue produced from the sale of crude oil in Oklahoma has decreased considerably from the "boom" of the early 1980s. As a result, many Oklahoma oil producers have chosen to shut down producing wells rather than produce at a loss.<sup>1</sup>

The oil business is by nature a capital-intensive industry. A rig used to drill the oil wells can cost millions of dollars. With less revenue available from the production of Oklahoma oil, and little prospect for short-term improvements, more and more entities involved in the production and sale of Oklahoma crude are finding it difficult to stay ahead of their creditors. Consequently, bankruptcy is often the only remaining option.<sup>2</sup>

One of the first steps in the oil production process is securing an oil and gas lease from the mineral owner of the property. It is common for the landowner/lessor to enter into oil and gas leases with an entity interested in searching for and developing oil and gas minerals. This note addresses the protection afforded the landowner/lessor when a lessee defaults on royalty

1. United States crude oil production dropped by 340,000 barrels per day between December 1985 and August 1986 due to the collapse of world oil prices. *Daily Oklahoman*, Dec. 2, 1986, at 13, col. 1. Oklahoma's active drilling rig count on Nov. 11, 1985, was 259; the count on Nov. 10, 1986, was 132. *Daily Oklahoman*, Nov. 16, 1986, at C4, col. 1.

2. In a study of nine major oil-producing states by the American Petroleum Institute, Oklahoma had the largest increase in the number of bankruptcy cases filed. Through the third quarter of 1986, the number of bankruptcies filed had increased 65.5 percent over 1985. *Daily Oklahoman*, Nov. 16, 1986, at C4, col. 2.

payments owed to the landowner/lessor and subsequently seeks bankruptcy protection.

### *Section 365 of the Bankruptcy Code*

Section 365 of the Bankruptcy Code is designed to provide the debtor flexibility in dealing with executory contracts and unexpired leases.<sup>3</sup> This section allows the trustee, subject to court approval, to assume or reject any executory contract or unexpired lease of the debtor.<sup>4</sup>

The Code does not expressly define either executory contract or unexpired lease.<sup>5</sup> The legislative history of section 365 suggests that each party to a contract must have some performance remaining due for the contract to be executory.<sup>6</sup> Many courts have adopted Professor Vern Countryman's definition of executory contracts.<sup>7</sup> Professor Countryman defines an executory contract as one "under which the obligations 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."<sup>8</sup> Similarly, the Code does not define the term "lease."<sup>9</sup> Congress apparently realized the possibility of numerous and contradictory interpretations of the word "lease" and offered some guidance in section 365(m).<sup>10</sup>

Section 365 also provides various time limits in which the trustee must either reject or assume the executory contract or unexpired lease. A special sixty-day time limit is provided for rejection or assumption of unexpired leases of nonresidential real property in which the debtor is the lessee.<sup>11</sup> This provision could possibly apply to a lessee/debtor of an oil and gas lease seeking bankruptcy protection.

3. 11 U.S.C. § 365 (1982 & Supp. III 1985).

4. *Id.* § 365(a). Section 365(a) provides: "(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c) and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."

5. *Id.* § 365.

6. H.R. REP. NO. 595, 95th Cong., 1st Sess. 320 (1977), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6303 ("though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.").

7. See, e.g., *In re Knutson*, 563 F.2d 916 (8th Cir. 1977); *In re Fashion Two Twenty, Inc.*, 16 Bankr. 784, 786 (Bankr. N.D. Ohio 1982).

8. Countryman, *Executory Contracts In Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). See also 2 COLLIER ON BANKRUPTCY § 365.02 (15th ed. 1986).

9. 11 U.S.C. § 365 (1982 & Supp. III 1985).

10. Section 365(m) was added to the Code by the Bankruptcy Amendments and Federal Judgeship Act of 1984. Section 365(m) provides: "For purposes of this Section 365 and Sections 541(b)(2) and 362(b)(9), leases of real property shall include any rental agreement to use real property." *Id.* § 365(m).

11. *Id.* § 365(d)(4) ("in a case under any chapter of this title, if the trustee does not assume or reject any unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days . . . such lease is deemed rejected"). This provision was also added by the Bankruptcy Amendments and Federal Judgeship Act of 1984.

The most critical provision of section 365 is the adequate assurance requirements of subsection (b).<sup>12</sup> Section 365(b) highlights the pivotal question addressed in this note: Whether section 365 of the Code applies to unexpired oil and gas leases when the debtor/lessee has initiated proceedings for relief in bankruptcy. At issue is the potential protection afforded the lessor/creditor. Under the subsection, to reject or assume the contract or lease the trustee must either cure any existing default by the debtor or provide adequate assurance of a prompt cure. The lessor is a creditor of the lessee/debtor in the amount of the default on royalty payments. Thus, if section 365 applies to an Oklahoma oil and gas lease, the trustee in bankruptcy must cure this default on the royalty payments before the lease can be assumed by the debtor. If section 365 does not apply, the lessor is simply an unsecured creditor of the lessee without special protection.

This question was addressed by a bankruptcy court in Texas in *In re Trans-Western*.<sup>13</sup> The court held that Oklahoma oil and gas leases are neither executory contracts nor unexpired leases under section 265. *In re Trans-Western* addressed the applicability of section 365 to an Oklahoma oil and gas lease.

The debtors, Trans-Western Exploration, Inc. and Trans-Western Production, Inc., filed a joint Chapter 11 bankruptcy proceeding. In the course of their corporate existence, the debtors, as lessees, had entered into hundreds of oil and gas leases across Texas, Oklahoma, New Mexico, and Louisiana. The lessee/debtors were in default on royalty payments under many of the leases. The plan of reorganization presented to the court proposed that the leases be transferred to a third party for consideration. If section 365 applied, the default would have to be cured before the leases could be transferred; if section 365 did not apply, the leases could be transferred without the default being cured.

If section 365 applies, the trustee must assume the leases in accordance with the provisions of that section,<sup>14</sup> and therefore, for the trustee to transfer the leases, all defaults of royalty payments must be cured as a condition to the transfer.<sup>15</sup> On the other hand, if section 365 is not applicable, both the

12. Section 365(b) provides:

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

- (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
- (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
- (C) provides adequate assurance of future performance under such contract or lease.

13. *In re Trans-Western Expl., Inc.*, No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986) (order granting default judgment).

14. 2 COLLIER ON BANKRUPTCY, *supra* note 8, ¶ 365.07.

15. 11 U.S.C. § 365(b) (1982 & Supp. III 1985). See *supra* note 12.

trustee's and the creditors' rights and obligations are significantly altered. First, if the leases are neither executory contracts nor unexpired leases, the trustee's election to transfer the leases is not subject to court approval under section 365(a).<sup>16</sup> Therefore, the trustee will be without the protection and security of judicial approval of the transactions.<sup>17</sup> Second, if section 365 is inapplicable, the creditors are not afforded the protection of that section. The trustee would be under no obligation either to cure defaults or to provide adequate assurance of future performance.<sup>18</sup> Therefore, if the court should declare the oil and gas leases not to be executory contracts or unexpired leases, the leases could be assigned to a third party with the default never being cured. As the oil and gas economy continues to struggle in Oklahoma, the bankruptcy courts will be faced with this precise issue more frequently.<sup>19</sup>

Two preliminary points should be made at this time. First, when a court is confronted with interpreting section 365 of the Code, the first issue that must be determined is the source of controlling law. Whether the agreement at issue is an executory contract or an unexpired lease is determined by applying state law.<sup>20</sup> Therefore, whether an Oklahoma oil and gas lease is an executory contract or an unexpired lease is determined under Oklahoma law.

Second, under Oklahoma law, failure to pay royalty payments as required under an oil and gas lease does not necessarily forfeit the lease.<sup>21</sup> For section 365 to apply, the contract or lease at issue must actually be in existence.<sup>22</sup> Because Oklahoma law does not require forfeiture of an oil and gas lease for

16. *Id.* § 365(a). See *supra* note 4.

17. This explains why the debtors sought a declaratory order of the court that section 365 was inapplicable in *Trans-Western*. For an exhaustive discussion of the inherent risks when a trustee acts without court approval, see 4 COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 68.02 (1986).

18. 11 U.S.C. § 365(b) (1982 & Supp. III 1985). See *supra* note 12. For exhaustive discussion of creditors' rights and interests protected by section 365, see 4 COLLIER BANKRUPTCY PRACTICE GUIDE, *supra* note 17, ¶ 68.02.

19. *In re Heston Oil Co.*, No. 85-C-929-B (N.D. Okla. Oct. 9, 1986) (order affirming bankruptcy court order holding Oklahoma oil and gas lease not subject to § 365 of the Code). *Heston Oil* addressed an issue very similar to that in *Trans-Western*. See also *In re Clark Resources, Inc.*, No. 86-00463 (N.D. Okla. Dec. 24, 1986) (order denying motion by lessor to reject oil and gas lease under § 365(d) of the Code and holding § 365 inapplicable).

20. *Butner v. United States*, 440 U.S. 48, 54 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."); *In re Myklebust*, 26 Bankr. 582, 583 (Bankr. W.D. Wis. 1983) ("Whether the agreement is an expired lease or an executory contract is determined under state law."); 2 COLLIER ON BANKRUPTCY, *supra* note 8, ¶ 365.02[1]. See also *In re J.H. Land & Cattle Co.*, 8 Bankr. 237 (Bankr. W.D. Okla. 1981).

21. See, e.g., *Cannon v. Cassidy*, 542 P.2d 514, 516 (Okla. 1975) ("[L]essee's failure to pay royalty as provided by the lease will not give lessors sufficient grounds to declare a forfeiture unless by the express terms of that lease they are giving that right and power. . . . [T]he overwhelming majority of jurisdictions which have considered this issue are in accord."); *Wagoner Oil & Gas Co. v. Marlow*, 137 Okla. 116, 278 P. 294, 306 (1929) ("A failure to pay royalty . . . as provided by the lease will not give the lessors sufficient grounds to declare a forfeiture.") (quoting THORTON ON OIL AND GAS 587 (1925)).

22. 2 COLLIER ON BANKRUPTCY, *supra* note 8, ¶ 365.02 ("If the contract or lease has expired by its own terms or has been terminated prior to the commencement of the bankruptcy case, then there is nothing left for the trustee to assume or assign.").

failure to pay royalty payments, the oil and gas lease is still in existence when the bankruptcy proceeding is commenced and will be protected by the Code's automatic stay.<sup>23</sup> Therefore, absent forfeiture, if the creditor is not afforded the protection of the default cure requirements of section 365(b), the creditor will only be an unsecured creditor prevented by the stay from proceeding against the debtor until the final bankruptcy decree.<sup>24</sup>

*Oklahoma Oil and Gas Lease: An Executory Contract?*

As discussed above, the Code does not explicitly define the term "executory contract."<sup>25</sup> Thus, state law will determine if the agreement is executory.<sup>26</sup> Oklahoma bankruptcy courts have adopted Professor Countryman's definition of an executory contract.<sup>27</sup> However, whether an Oklahoma oil and gas lease is an executory contract under the Code had not been addressed by the courts before *In re Trans-Western*, *In re Heston Oil Co.*, and *In re Clark Resources, Inc.*<sup>28</sup>

Contrary to popular understanding, there is no standard oil and gas lease.<sup>29</sup> However, a typical oil and gas lease will be for a term of years, provide for a cash bonus upon execution, royalty payments to the lessors based upon a specified percentage of revenue from production, and contain covenants requiring the lessee to develop the mineral interest or pay an annual rental fee (delay rental).<sup>30</sup> Typically, the lease term is automatically extended if the lessee has paid the delay rental fee or has commenced drilling operations.<sup>31</sup>

Arguably, once an oil and gas lease is executed, and delay rentals are paid or drilling operations commenced, the lessor has no further duties to perform. The duration of the lease is effectively left up to the lessee. The lessor

23. 11 U.S.C. § 362(a) (1982 & Supp. III 1985). The automatic stay prevents the commencement or continuation of all judicial and nonjudicial actions against the debtor or the debtor's property upon filing of the bankruptcy proceeding. Some exceptions to this stay exist. See generally *id.* § 362(b).

24. 11 U.S.C. § 362(b).

25. *Id.* § 365.

26. *In re Myklebust*, 26 Bankr. 582, 583 (Bankr. W.D. Wis. 1983). See *supra* note 20.

27. Countryman, *supra* note 8, at 460. See *In re Plasmarc Sys., Inc.*, 18 Bankr. 306, 308 (Bankr. W.D. Okla. 1982) (quoting *Jenson v. Continental Fin. Corp.*, 591 F.2d 477 (8th Cir. 1979) ("where the contractual obligations of the bankrupt and the other contracting party remain at least partially and materially unperformed at bankruptcy, the contract is executory"). See also *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir. 1960).

28. See *supra* notes 13, 19.

29. 2 E. KUNTZ, OIL AND GAS § 18.1 (1964).

30. See generally *id.*; R. HEMINGWAY, OIL AND GAS § 6.3 (2d ed. 1983).

31. R. HEMINGWAY, *supra* note 30, § 6.3:

Under the customary "unless" lease it is provided that the lease will terminate at the end of the first year of the primary term "unless" the lessee does either of two things: (1) commence the operations for the drilling of a well, or (2) pay a rental payment to the lessor for the express purpose of delaying development.

has completely performed his obligations under the lease; therefore, the lease should not be held to be an executory contract.

However, at least one leading commentator on oil and gas law rejects this theory. Professor Kuntz describes an oil and gas lease as a continuing relationship between the parties. "It is also 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>32</sup> This argument is even more compelling if the lessor is still in a position to breach the lease. This would be the case where the lessor retains in the lease a duty to allow the lessee access to the leasehold property and could materially breach the lease by denying the lessor access.

Even so, Judge Abramson, in his order granting default judgment in *Trans-Western*, conclusively held that oil and gas leases in Oklahoma are not executory contracts.<sup>33</sup> While Judge Abramson did not specifically state the reasoning behind his order, one must assume he was persuaded by the debtor's arguments.

The debtor argued that where an oil and gas lessor receives a cash bonus in payment for an oil and gas lease for the primary term and executes an instrument conveying to the lessee the right to explore for oil and gas for the primary term, both the lessor's and the lessee's duties under the oil and gas lease have been fully performed.<sup>34</sup> The debtor further argued that even where production has been established and continues, only the lessee continues to have duties.<sup>35</sup> Therefore, with only one party owing performance, Professor Countryman's test is not met, and the contract between the parties is not executory.<sup>36</sup>

Judge Abramson was persuaded that an oil and gas lease did not meet the Countryman test and was, therefore, not executory. Similarly, Judge Brett, in affirming *In re Heston Oil Co.*, also held that an oil and gas lease was not an executory contract within the purview of section 365 of the Code.<sup>37</sup> Unlike Judge Abramson, Judge Brett explicitly relied on the Countryman test to determine that the oil and gas lease was not an executory contract.<sup>38</sup>

The facts in *Heston Oil Co.* and *Clark Resources, Inc.* are almost identical

32. 2 E. KUNTZ, *supra* note 29, § 18.2.

33. *In re Trans-Western Expl., Inc.*, No. 385-31045-A-11 at 2 (Bankr. N.D. Tex. Aug. 15, 1986) ("oil and gas leases in Oklahoma are neither executory contracts nor unexpired leases pursuant to § 365 of the Bankruptcy Code.")

34. Brief for Debtor at 3, *Trans-Western*, No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986).

35. *Id.*

36. *Id.*

37. *In re Heston Oil Co.*, No. 85-C-929-B at 4 (N.D. Okla. Oct. 9, 1986) ("This court agrees with the Bankruptcy Court's ruling that the nature of this oil and gas lease is not that of an executory contract."). The issue in *Heston Oil* was whether an Oklahoma oil and gas lease qualified as an executory contract or an unexpired lease under section 365.

38. *Id.* (citing *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir. 1960) for the proposition that an executory contract is one where neither party has completely performed and the obligations of each remain complex).

to *Trans-Western*. As in *Trans-Western*, the debtor in *Clark Resources* was the lessee of oil and gas leases. Two oil wells were drilled on the leasehold and continued to produce oil and gas. However, the lessor/creditor was not paid any royalty payments for the oil and gas production. Because the oil and gas lease is not held to be an executory contract or an unexpired lease under the Code, the lessor/creditor was only an unsecured creditor of the lessee/debtor.

The Oklahoma Supreme Court has never expressly held that an Oklahoma oil and gas lease is an executory contract and has certainly never addressed the applicability of section 365 of the Code.<sup>39</sup> The only courts to address the issue hold Oklahoma oil and gas leases are not executory within the meaning of section 365 of the Code.<sup>40</sup> These courts have relied on Professor Countryman's definition and have interpreted the Oklahoma law on this point.<sup>41</sup>

However, the creditor is not automatically stripped of the default-curing protection of section 365 just because an Oklahoma oil and gas lease is not executory. Section 365 requires the trustee to cure any existing default if the agreement at issue is either an executory contract or an unexpired lease.<sup>42</sup> Therefore, the next step in analyzing the applicability of section 365 to Oklahoma oil and gas leases is to determine if such a lease is an unexpired lease under the Code.

#### *Oklahoma Oil and Gas Lease: An Unexpired Lease?*

The oil and gas lease is unique. It is extremely difficult for a court to pinpoint and identify the property rights and the relationship between the parties created by an oil and gas lease.<sup>43</sup> However, it is clear that the term "lease" should not be interpreted as a technical term representative of, or inherent in, landlord and tenant law.<sup>44</sup> It is well-settled law in Oklahoma that an oil and gas lease does not give rise to the ordinary relationship of landlord and tenant, and the rules applicable to ordinary tenancies are not directly applicable.<sup>45</sup> Therefore, most courts addressing the applicability of section

39. Federal courts have exclusive jurisdiction over bankruptcy proceedings. U.S. CONST. art. I, § 8, cl. 4.

40. *Trans-Western*, No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986); *Heston Oil*, No. 85-C-929-B (N.D. Okla. Oct. 9, 1986); *Clark Resources*, No. 86-00463 (N.D. Okla. Dec. 24, 1986).

41. *Trans-Western* impliedly rested on the Countryman test; *Heston Oil Co.* and *Clark Resources* expressly did so.

42. 11 U.S.C. § 365(b) (1982 & Supp. III 1985); see text of § 365(b), *supra* note 12.

43. For an exhaustive discussion and review of the Oklahoma law identifying the nature of property rights created by an oil and gas lease, see generally *Cate v. Archon Oil Co.*, 695 P.2d 1352 (Okla. 1985) (addressing issue of whether oil and gas lease is personalty or an interest in real estate); *Shields v. Moffitt*, 683 P.2d 530 (Okla. 1984) (Oklahoma oil and gas lease is a qualified fee); *Hinds v. Phillips Pet. Co.*, 591 P.2d 697 (Okla. 1979) (Oklahoma oil and gas lease is incorporeal hereditament or *profit a prendre*); *State v. Shamblyn*, 185 Okla. 126, 90 P.2d 1053 (1939) (Oklahoma oil and gas leases are chattels real).

44. See, e.g., *Rich v. Doneghy*, 71 Okla. 204, 177 P. 86, 90 (1918).

45. *Id.*, 177 P. at 90; *Hinds*, 591 P.2d at 698 (use of the term "lease" is more in "deference

365 to documents involving mineral interests focus on the unique rights created under state law by those documents.<sup>46</sup>

An oil and gas lease under Oklahoma law is a cluster of rights that include a great variety of common law interests in land.<sup>47</sup> This is clear from the historical treatment of oil and gas leases by the Oklahoma courts. The legal right transferred pursuant to an oil and gas lease has been characterized as an incorporeal hereditament or a *profit a prendre*.<sup>48</sup> Whatever the name used, the interest represented is one in land, even though the lease itself does not operate as a conveyance of any oil or gas *in situ* but constitutes merely a right to search for oil and gas and reduce it to possession.<sup>49</sup>

The Oklahoma Supreme Court has distinguished between a true lease and an oil and gas lease.<sup>50</sup> In Oklahoma, an oil and gas lease is not a true lease.<sup>51</sup> It creates an interest or estate in realty, but it is not deemed *per se* real estate.<sup>52</sup> Therefore, Oklahoma law recognizes a distinction between real estate and an estate in real property.<sup>53</sup> The importance of this distinction is evident when one applies section 365 of the Code. Whether the Oklahoma oil and gas lease can be characterized either as an "unexpired lease,"<sup>54</sup> an

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to custom" than a description of the legal relationship involved). See also 2 E. KUNTZ, *supra* note 29, § 18.2.

46. See generally *Laugharn v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 88 F.2d 551 (9th Cir.) (holding a California oil and gas lease is not an executory contract), *cert. denied*, 301 U.S. 699 (1937); *In re Gasoil*, 59 Bankr. 804 (Bankr. N.D. Ohio 1986) (holding Ohio oil and gas lease subject to § 365(d)(4) of the Code); *In re Myklebust*, 26 Bankr. 582 (Bankr. W.D. Wis. 1983) (holding Wisconsin mineral lease is an unexpired lease and not an executory contract under § 365(a) of the Code); *In re J.H. Land & Cattle Co.*, 8 Bankr. 237 (Bankr. W.D. Okla. 1981) (holding § 365(h)(1) applicable to Kansas oil and gas lease). See also *In re Tilco, Inc.*, 408 F. Supp. 389 (D. Kan. 1976) (holding gas purchase contracts are executory contracts under the Code), *rev'd and remanded on other grounds*, 558 F.2d 1369 (10th Cir. 1977).

47. See, e.g., *Hinds*, 591 P.2d at 698 ("oil and gas lease includes a great variety of common-law interests in land").

48. *Id.* ("These [interests in land] fall under the rubric of *incorporeal hereditament* or *profit a prendre*").

49. *Id.* ("Rather than a true lease, [an oil and gas lease] is really a grant *in praesenti* of oil and gas to be captured in the lands described during the term."). This is the nonownership theory of oil and gas. The lease does not represent any ownership of oil and gas in place, only a right to search for and reduce them to possession. See *Rich v. Doneghey*, 71 Okla. 204, 177 P. 86, 89 (1918); R. HEMINGWAY, *supra* note 30, § 1.3 ("little uniformity exists as to the nature of the right [in a nonownership jurisdiction], and rarely have the courts attempted to define this right or interest with any particularity").

50. See *Shields v. Moffitt*, 683 P.2d 530, 531 (Okla. 1984) (quoting *Hinds*, 591 P.2d 697 (Okla. 1979)).

51. Therefore, the oil and gas lease is not directly susceptible to all landlord-tenant implications of a "lease."

52. See *Cate v. Archon Oil Co.*, 695 P.2d 1352, 1354 (Okla. 1985) ("We find that an oil and gas lease creates an interest in realty although it is not *per se* real estate."). See also *Hinds*, 591 P.2d at 699 ("an oil and gas lease creates an *interest or estate in realty*, it is not deemed *per se* real estate").

53. *Hinds*, 591 P.2d at 699.

54. 11 U.S.C. § 365(a)(b)(c) (1982 & Supp. III 1985).

“unexpired lease of nonresidential real property,”<sup>55</sup> or “any rental agreement to use real property,”<sup>56</sup> will determine if section 365 is applicable.

Similarly, an Oklahoma oil and gas lease is more in the nature of a conveyance than a true lease.<sup>57</sup> Indeed, in *Shields v. Moffitt*,<sup>58</sup> the Oklahoma Supreme Court characterized the nature of an oil and gas lease as a “qualified fee.” As authority, the court cited Professor Kuntz’s treatise on the law of oil and gas.<sup>59</sup> But *Shields* did not overrule Oklahoma’s precedent as a nonownership jurisdiction.<sup>60</sup> There are two meanings of the word “fee.”<sup>61</sup> One is to designate the creation of a fee estate (fee simple absolute, a determinable fee, or a conditional fee), and the other is to designate the duration of an interest.<sup>62</sup> *Shields* must have been referring to the duration of the interest created in an oil and gas lease because it did not attempt to address the nonownership precedent of Oklahoma law. However, the Court’s use of the word “fee” highlights the fact that an Oklahoma oil and gas lease is something more than a true lease.

One must assume that the Oklahoma Supreme Court did not intend for *Shields* to characterize the nature of an oil and gas lease in Oklahoma as a conveyance. To do so would have rewritten Oklahoma oil and gas law. However, the court explicitly discussed the hybrid characteristics of an oil and gas lease (characteristics of both personal and real property). While the court did not hold that an oil and gas lease was a true conveyance, it did hold that the oil and gas lease was *something more* than a lease.<sup>63</sup>

*Shields* implies that there exists a scale or continuum upon which one may graph the various rights or interests that one may possess in real estate. At the far left of this continuum is a license: a mere right to go upon land and not be considered a trespasser. Farther to the right on this continuum is a

55. *Id.* § 365(d)(4). See *supra* text accompanying note 11.

56. *Id.* § 365(m). See *supra* text accompanying note 10.

57. An oil and gas lease is a hybrid offspring of an intermarriage between real and personal property, an offspring which is neither entirely real nor personal property, yet which bears distinguishing characteristics of both . . . the holder of an oil and gas lease during the primary term or as extended by production has a base or *qualified fee*, i.e., an estate in real property having the nature of a fee, but not a fee simple absolute.

*Shields v. Moffitt*, 683 P.2d 530, 532-33 (Okla. 1984) (emphasis added).

58. *Id.*

59. 2 E. KUNTZ, *supra* note 29, § 26.2:

Where the lease is capable of being extended indefinitely by production of oil and gas, the interest created is a fee. Such fee is a base, qualified, or determinable fee for the reason that it may not endure forever. In those instances in which the courts have had the occasion to identify by name the estate created by such an oil and gas lease, the interest created has been identified as a determinable fee where the lease provided for a fixed term and for so long thereafter as oil or gas is produced.

60. See *supra* note 49.

61. Discussion Note, *Shields v. Moffitt*, 81 Oil & Gas Rptr. 159, 161-62 (1984).

62. *Id.*

63. *Shields*, 683 P.2d at 532-33. See *supra* note 57.

*profit a prendre*: the right to go upon another's land and remove something from it for your benefit. To the extreme right of this continuum would be a fee simple absolute: the full rights and privileges of ownership. Prior to *Shields*, the Oklahoma Supreme Court had graphed an oil and gas lease as a *profit a prendre* on this continuum.<sup>64</sup> However, *Shields* represents the court's willingness to move the interest inherent in an oil and gas lease farther to the right on this continuum, somewhere between a *profit a prendre* and a fee simple absolute: a qualified fee.<sup>65</sup>

This is the pivotal issue in determining whether an Oklahoma oil and gas lease is subject to section 365 of the Code. Regardless of the precise location of the oil and gas lease on the continuum, it is something more than a *profit a prendre*, and definitely something more than a true lease.<sup>66</sup> This is extremely important in examining other bankruptcy courts' analyses of the applicability of section 365 of the Code to various documents creating mineral interests. In *In re J. H. Land & Cattle Co.*,<sup>67</sup> upon which the lessor/creditors in *Trans-Western* heavily rely,<sup>68</sup> an Oklahoma bankruptcy court held that a Kansas oil and gas lease merely conveys a license to enter upon the land and explore for minerals.<sup>69</sup> The court further held that a Kansas oil and gas leasehold interest is "personal property—an incorporeal hereditament, a *profit a prendre*."<sup>70</sup> Therefore, the oil and gas lease was not an "unexpired lease of real property" under section 365(h)(1) of the Code.<sup>71</sup>

*J. H. Land* is distinguishable on two pivotal points from *Trans-Western*. This should have precluded Judge Abramson from following *J. H. Land*. First, *J. H. Land* applied Kansas law;<sup>72</sup> under Kansas law, an oil and gas leasehold is personal property.<sup>73</sup> *Trans-Western* applied Oklahoma law; under Oklahoma law, as discussed above, an oil and gas leasehold is something more than personal property.<sup>74</sup> Second, *J. H. Land* involved the applicability of section 365(h)(1).<sup>75</sup> The applicability of this section depends

64. *Hinds v. Phillips Pet. Co.*, 591 P.2d 697, 698 (Okla. 1984). See *supra* note 48.

65. *Shields*, 633 P.2d at 532-33. See *supra* note 57.

66. *Shields*, 633 P.2d at 532 (quoting *Hinds*, 591 P.2d at 698 ("Rather than a true lease, [an oil and gas lease] is really a grant *in praesenti* of oil and gas.")).

67. 8 Bankr. 237 (Bankr. W.D. Okla. 1981).

68. See generally Briefs for Creditors, Conoco, Inc. at 2-3, Minnie Weigind at 3-4, Jo Ann Frenz at 5, Public Service Co. of Oklahoma at 3-4, *Trans-Western*, No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986).

69. *J.H. Land & Cattle*, 8 Bankr. at 239 (Kansas oil and gas lease "merely conveys a license to enter upon the land and explore for such minerals and if they are discovered to produce and sever them.")).

70. *Id.*

71. *Id.* ("Inasmuch as under Kansas law an oil and gas lease creates a 'license to enter', an 'intangible personal property right, lessee . . . has no assertable right of possession . . . set forth . . . under . . . § 365(h)(1)'").

72. *Id.* ("Rights created by oil and gas leases covering Kansas land 'constitute intangible personal property.'").

73. *Id.*

74. *Shields*, 633 P.2d at 532-33. See *supra* note 57 and accompanying text.

75. *J.H. Land & Cattle*, 8 Bankr. at 238-39.

on whether the document at issue is an "unexpired lease of real property."<sup>76</sup> Because Kansas law considers an oil and gas lease personal property, an oil and gas lease cannot be an unexpired lease of *real* property. *Trans-Western* turned on the applicability of section 365(b)(1). Under Oklahoma law, an oil and gas leasehold is not a true lease and is in the nature of a qualified fee.<sup>77</sup> Judge Abramson determined that Oklahoma's characterization of an oil and gas lease removed it from the purview of section 365(b)(1).<sup>78</sup>

Therefore, the *Trans-Western* creditors' reliance on *J. H. Land* is clearly misplaced.<sup>79</sup> Indeed, *J. H. Land* offers no guidance for interpreting section 365 of the Code pursuant to Oklahoma law.<sup>80</sup>

In addition, the unique nature of an Oklahoma oil and gas lease was highlighted in two very recent bankruptcy cases noted above from the Northern District of Oklahoma.<sup>81</sup> *In re Heston Oil Co.* and *In re Clark Resources, Inc.* are similar to *Trans-Western*. However, the Code section at issue was section 365(d)(4).<sup>82</sup>

An Ohio case has considered the exact question at issue in *Heston Oil* and *Clark Resources*: Is section 365(d)(4) applicable to an oil and gas lease?<sup>83</sup> *In re Gasoil, Inc.* answered the question affirmatively. Under Ohio law, the oil and gas leasehold interest is in the nature of a use of property, but it is a leasehold interest.<sup>84</sup> But this characterization was not determinative; *Gasoil* turned on section 365(m) of the Code, which provides that an agreement that conveys a right to use real property is a lease under section 365.<sup>85</sup>

76. 11 U.S.C. § 365(h)(1) (1982 & Supp. III 1985).

77. *Shields*, 683 P.2d at 532. See *supra* note 66 and accompanying text.

78. *Trans-Western*, No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986) ("oil and gas leases in . . . Oklahoma are neither executory contracts nor unexpired leases pursuant to § 365 of the Bankruptcy Code").

79. See *supra* note 68.

80. *Contra*, Note, *Rejection of Unexpired Oil and Gas Leases in Bankruptcy Proceedings: In re J.H. Land & Cattle Co.*, 19 TULSA L.J. 68-99 (1983). This note purports to analyze the effect of *J.H. Land & Cattle* on Oklahoma oil and gas leases under the Code. However, its effect on Oklahoma oil and gas leases is negligible. *Shields* eliminated any effect of *J.H. Land & Cattle*. Kansas and Oklahoma do not characterize the nature of an oil and gas lease similarly. In Oklahoma, an oil and gas lease is clearly an "interest" in real estate. *Shields*, 683 P.2d at 532-33; *Hinds*, 591 P.2d at 698. Under Kansas law, an oil and gas lease is characterized only as personal property. *J.H. Land & Cattle*, 8 Bankr. at 239.

81. *Heston Oil*, No. 85-C-929-B (N.D. Okla. Oct. 9, 1986), and *Clark Resources*, No. 86-00463 (N.D. Okla. Dec. 24, 1986).

82. 11 U.S.C. § 365(d)(4) (1982 & Supp. III 1985). See *supra* text accompanying note 11. The issue was whether the oil and gas lease had been rejected by law under § 365(d)(4).

83. *In re Gasoil, Inc.*, 59 Bankr. 804, 806 (Bankr. N.D. Ohio 1986) ("The question this Court is asked to determine is whether or not 11 U.S.C. section 365(d)(4) applies to oil and gas leases.").

84. *Id.* at 807 ("The interest of the landowner in oil and gas in Ohio is in the nature of a use of real property. . . . The issue then is whether this interest was conveyed in fee, or is in the form of a lease. . . . However, Ohio cases have said that this interest is a leasehold rather than a fee interest.").

85. *Id.* at 806 ("It does not matter whether these oil and gas leases are viewed as licenses, granting only the right to go upon the land and search for oil . . . , or as leases. For purposes of

However, under Oklahoma law, an oil and gas lease has been termed a "qualified fee"<sup>86</sup> and is not a true lease.<sup>87</sup> Therefore, an Oklahoma oil and gas lease is not a mere leasehold estate as in Ohio and is more than a rental agreement to use real property as in section 365(m). *Heston Oil* and *Clark Resources*, consistent with *Trans-Western*, identified the unique nature of an Oklahoma oil and gas lease and held section 365 of the Code inapplicable.

### Conclusion

An Oklahoma oil and gas lease is a unique document. The Oklahoma Supreme Court has been much more specific about what an oil and gas lease is not than what it actually is. It is not a lease.<sup>88</sup> Its nature falls under the rubric of incorporeal hereditament.<sup>89</sup> The Oklahoma Supreme Court has had considerable difficulty precisely defining the nature of the right transferred by an oil and gas lease. It is not a lease, but it is not a grant *in situ* of the oil and gas; it is something in between.

The Bankruptcy Code provides special protection to creditors who have entered executory contracts or unexpired leases with the debtor.<sup>90</sup> Lessors of Oklahoma oil and gas leases who have not been paid royalty payments by their lessee/debtors will not be protected by section 365(b) of the Code. At best, they will be an unsecured creditor of the lessee/debtor.

The unique nature of an Oklahoma oil and gas lease causes it to fall through the cracks of section 365. Indeed, the only three courts to address this issue while applying Oklahoma law have seemingly widened the cracks of section 365.<sup>91</sup> Unless Congress specifically amends section 365 to include oil and gas leases, or the Oklahoma Supreme Court restricts the nature of the interest created to be that of a "true lease," section 365 of the Code does not offer protection to lessor/creditors of Oklahoma oil and gas leases.

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section 365, they are 'leases' since they at least convey a right to use real property.'"). See text of § 365(m), *supra* note 10.

86. *Shields*, 683 P.2d at 532-33.

87. *Id.* at 532; *Hinds*, 591 P.2d at 698.

88. *Shields*, 683 P.2d at 532 ("Rather than a true lease, it is really a grant *in praesenti* of oil and gas to be captured in the lands described."); *Hinds*, 591 P.2d at 698 (*Hinds* contains the exact language of *Shields*).

89. *Shields*, 683 P.2d at 532; *Hinds*, 591 P.2d at 698.

90. 11 U.S.C. § 365(b) (1982 & Supp. III 1985). See text of § 365(b), *supra* note 12.

91. *Clark Resources*, No. 86-00463 (N.D. Okla. Dec. 24, 1986); *Heston Oil*, No. 85-C-929-B (N.D. Okla. Oct. 9, 1986); and *Trans-Western*, No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986).