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## News at 11

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### Is That Exploration and Production Lease Really a Lease?

Notwithstanding the technological advances in recent years that have significantly increased oil and gas production in the U.S., there is a growing global focus on the use of cleaner renewable energy sources, such as geothermal energy.<sup>2</sup> In bankruptcy cases, legal issues often arise with respect to exploration and production projects, including the question of whether an oil and gas or geothermal lease can be assumed or rejected by the debtor.

This article discusses the relevance of characterization of an exploration and production lease for purposes of assumption and rejection under § 365 of the Bankruptcy Code. It also explores and examines, more generally, the treatment of oil and gas and geothermal leases in and outside of bankruptcy.

#### Characterization Determines Assumption and Rejection

The classification of the nature of a lease is critical in determining whether the lease might be assumed or rejected by the debtor in bankruptcy. Section 365 authorizes a debtor to elect to assume or reject an unexpired lease or contract. The debtor's election is subject to court approval; further, courts generally will defer to a debtor's exercise of its business judgment in choosing which agreements to retain or reject for the benefit of the estate.

However, an agreement may only be assumed or rejected if it is an "executory contract" or "unexpired 'true' lease."<sup>3</sup> Moreover, the Code does not create or define property interests.<sup>4</sup> Since

the Bankruptcy Code does not define "executory contract" and "unexpired lease," courts apply nonbankruptcy state and federal law to determine the nature of a lease interest for the purposes of assumption and rejection.<sup>5</sup>

An executory contract is generally understood to mean an agreement where both the debtor and the counterparty to the agreement have sufficient remaining performance obligations under the agreement, the nonperformance of which would result in a material breach of the agreement.<sup>6</sup> Further, as discussed *infra*, whether a lease is a "true lease" varies across jurisdictions.

Practitioners should also note that even if a debtor's request to reject is granted, the rejection of an exploration and production lease might still prove futile, as a court might classify the lease as a "rental agreement to use real property,"<sup>7</sup> which would enable the lessee, pursuant to the Code, to exercise all "rights appurtenant to the lease," including remaining in possession of the lease for the remainder of the lease term, developing the premises, and exploring, drilling and producing oil, gas and other resources.<sup>8</sup>

In addition, if a lease is deemed not subject to rejection under § 365, then (unless it terminates by its own terms during bankruptcy) the lease simply passes through bankruptcy unaffected. The parties to the lease retain and must comply with all obligations, burdens and benefits under the lease.

#### Classification of Oil and Gas Lease Interests Under State Law

Generally, state law determines the proper characterization of an onshore private oil and gas



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<sup>2</sup> Geothermal energy is generally considered heat from the earth, and the projects mirror oil and gas projects. Wells are drilled to access the heat underground, then the operator uses hot water and/or steam to generate additional forms of energy, such as electricity and heat for homes and other facilities. Due to the similarities in oil and gas and geothermal energy exploration and production infrastructure and techniques, exploration and production operators are often equipped to co-produce both oil and gas and geothermal resources.

<sup>3</sup> See 11 U.S.C. § 365(a).

<sup>4</sup> See, e.g., *Butner v. United States*, 440 U.S. 48, 54-55 (1979).

<sup>5</sup> See, e.g., *In re Montgomery Ward LLC*, 469 B.R. 522, 528-29 (Bankr. D. Del. 2012).

<sup>6</sup> See, e.g., *In re Goodrich Petroleum Corp.*, 554 B.R. 817, 821 (Bankr. S.D. Tex. 2016).

<sup>7</sup> 11 U.S.C. § 365(m).

<sup>8</sup> 11 U.S.C. § 365(h)(1)(A)(ii).

lease interest,<sup>9</sup> but state treatment of oil and gas leases varies greatly across the nation. For example, in Texas, oil and gas leases are considered fee interests in real property and are therefore not “true leases” or executory contracts that could be assumed or rejected under § 365.<sup>10</sup> Rather, the oil and gas lessee holds a fee-simple determinable interest.<sup>11</sup> The lessor holds a reversionary interest with a possibility of a reverter.<sup>12</sup> Thus, if the lease terminates, the lessee’s possessory interest in the mineral estate will revert back to the mineral estate owner.<sup>13</sup>

Similarly, oil and gas leases of mineral estates in Oklahoma, North Dakota, Colorado and New Mexico are considered interests in real property and therefore appear not to be “true leases” or executory contracts that might be assumed or rejected under § 365.<sup>14</sup> On the other hand, courts in Michigan and Ohio have held that oil and gas leases are indeed true leases that fall under the ambit of § 365.<sup>15</sup>

Kansas law has yet another interpretation of the nature of an oil and gas lease. In Kansas, an oil and gas lease is neither an interest in land nor a true lease, but is generally considered a conveyance of a license to enter upon the land and explore for minerals, a personal property right.<sup>16</sup> To complicate the matter further, while the U.S. Bankruptcy Court for the Northern District of Oklahoma concluded that a Kansas oil and gas lease could be rejected or assumed in bankruptcy, the U.S. Bankruptcy Court for the Southern District of Texas reached the opposite conclusion and found that Kansas oil and gas leases are not subject to § 365.<sup>17</sup>

The characterization of an oil and gas lease interest is currently unsettled under Pennsylvania law. The Supreme Court of Pennsylvania explained that an oil and gas lease is an inchoate conveyance of title that simply gives the lessee the right to explore and develop during the agreed-upon term.<sup>18</sup> Once production commences, the court noted, the lessee obtains a vested fee-simple determinable real property interest.<sup>19</sup>

Initially, the U.S. Bankruptcy Court for the Middle District of Pennsylvania interpreted the Pennsylvania Supreme Court’s explanation to mean that before oil or gas is discovered and/or produced, the unexpired oil and gas lease might be assumed or rejected in bankruptcy because it would be classified as a true lease or executory contract.<sup>20</sup> However, once production has commenced, a debtor can no longer reject or assume an unexpired oil and gas lease because the interest in the lease would be a vested real property interest.<sup>21</sup>

In that case, prior to the bankruptcy filing, discovery and production of gas had not yet commenced under the lease.

9 See, e.g., *In re Sandridge Energy Inc.*, Case No. 16-32488, Adv. No. 16-3223, 2018 WL 889357, at \*9 (Bankr. S.D. Tex. Feb. 5, 2018).

10 See, e.g., *Terry Oilfield Supply Co. v. Am. Sec. Bank NA*, 195 B.R. 66, 70-71 (S.D. Tex. 1996).

11 See, e.g., *Hysaw v. Dawkins*, 483 S.W.3d 1, 9 (Tex. 2016) (citation omitted).

12 *Id.*

13 *Id.*

14 See, e.g., *In re Heston Oil Co.*, 69 B.R. 34 (N.D. Okla. 1986); *Mar Win Dev. Co. v. Wilson*, 104 N.W.2d 369 (N.D. 1960); *Hagood v. Heckers*, 31 Colo. App. 172, 175-76 (Colo. App. 1972); *In re Antweil*, 97 B.R. 65, 66 (Bankr. D.N.M. 1989).

15 See, e.g., *Frontier Energy LLC v. Aurora Energy Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 680-81 (Bankr. W.D. Mich. 2010), *aff’d*, No. 1:12-CV-424, 2013 WL 1289362, at \*7 (W.D. Mich. March 27, 2013); *In re Gasoil Inc.*, 59 B.R. 804, 808-09 (Bankr. N.D. Ohio 1986).

16 See, e.g., *Denver Nat. Bank of Denver Colo. v. State Comm’n of Revenue and Taxation*, 176 Kan. 617, 621 (Kan. 1954).

17 Compare *In re J.H. Land & Cattle Co.*, 8 B.R. 237, 239 (Bankr. W.D. Okla. 1981), with *Sandridge Energy Inc.*, 2018 WL 889357, at \*10.

18 *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261, 267 (Pa. 2012).

19 *Id.*

20 *Powell v. Anadarko E&P Co. (In re Powell)*, 482 B.R. 873, 877-78 (Bankr. M.D. Pa. 2012).

21 *Id.*

Therefore, the court concluded that the lease was a “true” unexpired lease,<sup>22</sup> but found that no evidence had been presented to support the rejection, and denied rejection of the lease.<sup>23</sup>

On appeal, the district court vacated and remanded the bankruptcy court’s legal conclusion that Pennsylvania oil and gas leases are neither executory contracts nor unexpired leases.<sup>24</sup> Moreover, the district court instructed the bankruptcy court on remand to evaluate the express language of the oil and gas lease at issue to determine what interest was conveyed under the lease.<sup>25</sup>

## Classification of Federal Oil and Gas Leases

In addition to the complicated state law landscape set forth herein, courts may also have to look to federal common law and statutory authority to determine the nature of interests involving leasing of onshore federal lands and federally protected Indian lands.<sup>26</sup> In a suit between private individuals involving federal leases, the Tenth Circuit applied New Mexico state law and reached the conclusion that interests in federal onshore oil and gas leases are real property.<sup>27</sup> In light of that conclusion, a bankruptcy court might find that federal oil and gas leases in New Mexico are not subject to assumption or rejection under § 365.

In addition, the court’s conclusion that “where no right of the federal government is involved, state law governs” indicates that in those cases where the federal government is a party, the court will first look to federal statutory and common law in order to determine the nature of the oil and gas lease interest.<sup>28</sup>

However, application of federal law to certain oil and gas leases could lead to a different result than the one reached by the Tenth Circuit. In addition, classification of offshore oil and gas leases is more uncertain than the federal onshore oil and gas lease classification addressed by the Tenth Circuit. The federal government, as the lessor of offshore oil and gas leases, has taken the position (in litigation) that offshore oil and gas leases are both true leases and executory contracts.<sup>29</sup> However, bankruptcy courts have yet to determine the correctness of the government’s position that offshore oil and gas leases are in the nature of executory contracts and/or true leases that qualify for assumption or rejection in bankruptcy.<sup>30</sup>

## Classification of Geothermal Leases

Just as there is no uniformity regarding the characterization of an oil and gas lease interest, classification of geothermal resources also varies across jurisdictions. The difficulty with classifying geothermal energy lies in the fact that heat energy (including hot water, steam and hot brines) underlying the earth’s surface is not technically a “mineral.”

To classify a geothermal interest, parties must first determine which state or federal law applies. Next, they

22 *Id.*

23 *Id.*

24 *Chesapeake Appalachia LLC v. Powell (In re Powell)*, Nos. 5:10-BK-06255-JJT, 3:13-CV-00035, 2015 WL 6964549, at \*8 (M.D. Pa. Nov. 10, 2015).

25 *Id.*

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

27 *Id.*

28 *Id.* at 820.

29 See, e.g., 43 U.S.C. §§ 1332(1), 1337; Camisha L. Simmons, “Offshore Oil and Gas Leases: The Unanswered Question,” XXXVI *ABI Journal* 9, 18-19, 77, September 2017, available at [abi.org/abi-journal](http://abi.org/abi-journal).

30 *Id.*

must establish whether the geothermal energy is part of the mineral estate or surface estate, or is something else (*i.e.*, a water right) and determine who owns the geothermal energy resource. Once these questions have been answered, all other legal issues (including characterization of the lease interest) can be determined.

California, the largest producer of geothermal energy in the U.S. and the world, classifies geothermal resources as minerals. Absent an express intent in the lease to the contrary, a general grant of minerals includes a grant of geothermal resources.<sup>31</sup> Therefore, in light of the fact that geothermal resources are included in the conveyance of the mineral estate, courts may classify California geothermal lease interests similarly as oil and gas lease interests held by a lessee (*i.e.*, an *incorporeal hereditament* in the nature of a *profit à prendre*).<sup>32</sup> One bankruptcy court has concluded that an *incorporeal hereditament* and a *profit à prendre* lease is not an executory contract or true lease.<sup>33</sup>

Under the Texas Geothermal Resources Act of 1975, geothermal resources are “treated and produced as mineral resources.”<sup>34</sup> However, the statute provides that the designation of geothermal resources as mineral resources does not “make any change in the substantive law of this state.”<sup>35</sup> Considering the statutory language, a court may conclude that a geothermal lease interest, like an oil and gas (mineral) lease interest, is a real property interest that is not subject to § 365.

Case law suggests that geothermal resources in New Mexico are also included in the mineral estate.<sup>36</sup> The U.S. Bankruptcy Court for the District of New Mexico recently granted, under the debtor’s confirmed reorganization plan, the assumption of two federal geothermal resource leases and one geothermal resource lease with private parties with respect to geothermal resources utilized in generating electricity at a geothermal plant in New Mexico.<sup>37</sup> Thus, the court determined that the leases were true leases and/or executory contracts despite the fact that oil and gas mineral interests in New Mexico are characterized as real property interests and not executory contracts or true leases.<sup>38</sup>

Under the Geothermal Steam Act of 1970, the Department of the Interior (DOI) has the authority to issue leases for geothermal development on federal lands.<sup>39</sup> The DOI may take the same position regarding geothermal lease interests as it does with respect to federal oil and gas lease interests and assert that they are executory contracts and true leases subject to assumption and rejection in bankruptcy.

## Key Takeaways

The determination of whether an oil and gas lease might be assumed or rejected in bankruptcy will largely depend on state law for onshore private leases and state and/or federal

law for federal leases. However, given that geothermal energy projects are currently not as widespread and common as oil and gas projects, many legal issues related to geothermal resources, including their treatment in bankruptcy, have yet to be thoroughly tested. Despite this fact, renewable energy resource production and utilization is the wave of the future, and awareness and forethought regarding the legal unknowns serve to benefit bankruptcy and insolvency practitioners. **abi**

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<sup>31</sup> See, e.g., *Geothermal Kinetics Inc. v. Union Oil Co.*, 75 Cal.App.3d 56 (1977).

<sup>32</sup> See, e.g., *Callahan v. Martin*, 43 P.2d 788 (Cal. 1935).

<sup>33</sup> See *In re Clark Res. Inc.*, 68 B.R. 358 (Bankr. N.D. Okla. 1986).

<sup>34</sup> See Tex. Nat. Res. Code Ann. § 141.002(4).

<sup>35</sup> See § 141.002(5).

<sup>36</sup> See, e.g., *United States v. 99, 223.7238 Acres of Land, more or less, in Sandoval and Rio Arriba Counties, N.M.*, No. Civ. 06-0933 RB/RHS, 2009 WL 10675512, at \*5-6 (D.N.M. Dec. 14, 2009) (explaining that geothermal resources were valued as part of mineral estate).

<sup>37</sup> See *Lightning Dock Geothermal HI-01 LLC, et al.*, Case No. 17-10567, Dkt. Nos. 379, 393, 2017 WL 2484826, (Bankr. D.N.M. June 8, 2017).

<sup>38</sup> See, e.g., *Antweil*, 97 B.R. at 66.

<sup>39</sup> See 30 U.S.C. § 1002.