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## News at 11

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### Offshore Oil and Gas Leases: The Unanswered Question

Despite some recent government action,<sup>2</sup> the oil-and-gas market has yet to rebound to where it was three years ago. It is not certain when the next wave of oil-and-gas bankruptcies will hit, but when it does, we might see more companies engaging in offshore exploration and production seeking bankruptcy protection.

Exploration and production (E&P) companies and other parties involved in offshore drilling face uncertainty in bankruptcy. Courts have yet to determine whether an offshore oil-and-gas lease may be assumed or rejected in bankruptcy.

This article discusses assumption and rejection under § 365 of the Bankruptcy Code, the law that is generally applicable to offshore oil-and-gas leases, and bankruptcy litigation in which parties debated the proper characterization of an offshore lease, yet the issue was never resolved in that matter. The article concludes with an analysis of how Congress may resolve the issue.

#### Assumption and Rejection Under § 365

Section 365 serves as a powerful tool for debtors desiring to rid themselves of burdensome agreements. Using § 365, the debtor may pick and choose among its agreements and assume those that are beneficial and reject those that are burdensome or otherwise not beneficial to the estate.<sup>3</sup> Further, the majority of courts will defer to a debtor's business judgment in determining whether to approve assumption or rejection of an agreement.<sup>4</sup>

However, a debtor may only assume or reject agreements that are "executory contracts" or "unexpired leases,"<sup>5</sup> which are not defined in the Bankruptcy Code. An executory contract is generally understood to mean an agreement where the debtor and a counterparty to the agreement have significant remaining performance obligations under the agreement, the nonperformance of which would result in a material breach of the agreement.<sup>6</sup> Further, a lease must be "unexpired" on the bankruptcy filing date<sup>7</sup> and a "true lease," and not, among other interests, a disguised security agreement or financing arrangement.<sup>8</sup>

The Code does not create nor define property interests.<sup>9</sup> Therefore, courts generally apply non-bankruptcy law, often state law, in order to determine whether a lease, including a federal onshore oil-and-gas lease, is a "true lease" for purposes of assumption and rejection under § 365.<sup>10</sup>

Some bankruptcy courts applying state law have found that onshore oil-and-gas leases are leases of real property.<sup>11</sup> Leases of real property "include any rental agreement to use real property."<sup>12</sup> If an oil-and-gas lease is characterized as a lease of real property, the lessee may invoke the protections afforded lessees under § 365(h)(1)(A)(ii).

Section 365(h)(1)(A)(ii) provides that if a debtor who is a lessor under a real property lease rejects the lease, the lessee under the lease may then opt to exercise all "rights appurtenant to the lease," includ-



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<sup>2</sup> In April, President Donald Trump signed an executive order, the goal of which is to expand offshore exploration and drilling for oil and gas. His plan faces opposition from numerous entities, including environmentalists and state governments.

<sup>3</sup> *In re Lake Dearborn LLC*, 534 B.R. 747, 751 (Bankr. N.D. Ill. 2015).

<sup>4</sup> *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 188 (Bankr. S.D.N.Y. 2009).

<sup>5</sup> *See* 11 U.S.C. § 365(a).

<sup>6</sup> *See, e.g., Vern Countryman*, "Executory Contracts in Bankruptcy, Part I," 57 *Minn. L. Rev.* 439, 460 (1973); *In re Goodrich Petroleum Corp.*, 554 B.R. 817, 821 (Bankr. S.D. Tex. 2016).

<sup>7</sup> *See, e.g., In re Imperial Beverage Grp. LLC*, 457 B.R. 490, 496 (Bankr. N.D. Tex. 2011).

<sup>8</sup> *See, e.g., In re Montgomery Ward LLC*, 469 B.R. 522, 527 (Bankr. D. Del. 2012).

<sup>9</sup> *See, e.g., Butner v. United States*, 440 U.S. 48, 54-55 (1979).

<sup>10</sup> *See, e.g., Montgomery Ward LLC*, 469 B.R. at 528-29.

<sup>11</sup> *See Frontier Energy LLC v. Aurora Energy Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010); *In re Gasoil Inc.*, 59 B.R. 804 (Bankr. N.D. Ohio 1986).

<sup>12</sup> 11 U.S.C. § 365(m).

ing remaining in possession of the lease for the remainder of the lease term.<sup>13</sup> Rights appurtenant to the lease may also include the exclusive right to enter upon the land, develop the leased premises, and explore, drill and produce oil and gas.

If an oil-and-gas lease is not considered a true lease or executory contract that might be assumed or rejected 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 all obligations, burdens and benefits under the lease. The lessor must defend the title to the land and not interfere with the lessee's operations, and the lessee must perform its obligations under the lease during bankruptcy. A bankruptcy court has not yet determined whether an offshore oil-and-gas lease is an executory contract and/or unexpired lease that might be assumed or rejected in bankruptcy.

## Offshore Leasing and Governing U.S. Law

U.S. offshore leasing involves the leasing of Outer Continental Shelf (OCS) lands. OCS lands are all submerged lands, and its subsoil and seabed that belongs to the U.S. OCS lands are essentially those submerged lands beneath navigable waters three geographical miles offshore from state coastlines.<sup>14</sup>

The U.S. federal government, rather than individual states, has ownership, control and jurisdiction over OCS lands.<sup>15</sup> Further, the Outer Continental Shelf Lands Act (OCSLA) authorizes the federal government to lease OCS lands to private E&P companies.<sup>16</sup> The Bureau of Ocean Energy Management and the Bureau of Safety and Environmental Enforcement of the U.S. Department of the Interior (DOI) manage the leasing and regulation of OCS lands.<sup>17</sup> The DOI is the lessor under the offshore oil-and-gas lease.

Although OCSLA governs offshore oil-and-gas leasing, the OCSLA does not include a provision that characterizes the nature of the offshore oil-and-gas lease interests. Thus, courts must apply applicable nonbankruptcy law to determine proper characterization of the interest being conveyed under the offshore lease.

To determine the nature of the offshore oil-and-gas interest, OCSLA provides that a court is allowed to apply the law of the state that is adjacent to the offshore leasing area, but only to the extent that the state law is not inconsistent with federal statutory and federal common law.<sup>18</sup>

However, the courts are in uncharted waters (no pun intended) with respect to offshore leasing given that there exists no federal statutory or federal common law that provides for the characterization of the nature of an offshore oil-and-gas lease interest. Parties may look to federal common law authority to determine the nature of interests involving the leasing of non-offshore federal lands, but they cannot do so for offshore lease interests.<sup>19</sup> As discussed *infra*, liti-

gating parties in the *ATP Oil & Gas Corp.* bankruptcy proceedings sought resolution of the question, but the question remains unanswered.

**The new provision under OCSLA could reflect the DOI's position that offshore oil-and-gas leases are both true real property leases (rental agreements to use real property) and executory contracts.**

## ATP Litigation

On Aug. 17, 2012, Texas-based ATP Oil & Gas Corp., an E&P company, filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of Texas.<sup>20</sup> Pre-petition, ATP conveyed various overriding royalty interests (ORRI) and net-profit interests (NPI) in the production of hydrocarbons in certain offshore oil-and-gas leases. During ATP's chapter 11 case, the holders (the "claimants") of the ORRIs and NPIs commenced litigation against ATP seeking a declaration from the court regarding the proper characterization of the ORRIs and NPIs conveyed to them.<sup>21</sup>

To determine the nature of the ORRIs and NPIs, a court must first determine the nature of the oil-and-gas lease because the party to an oil-and-gas lease cannot convey a greater interest than what it possesses.<sup>22</sup>

Therefore, if a lease is in the nature of personal property, a royalty interest in that lease will also be characterized as personal property. If the lease is characterized as a fee interest in real property, the royalty interest will also be classified as a fee interest in real property.<sup>23</sup>

The claimants argued that pursuant to Louisiana law, Texas law, and the plain language of the conveyance documents, the interests were vested real-property interests.<sup>24</sup> Therefore, they maintained that ATP could not assume or assign the interests, and the interests did not become property of the bankruptcy estate.<sup>25</sup>

ATP argued to the contrary that the offshore oil-and-gas ORRIs and NPIs conveyed by ATP were personal property rights under OCSLA and disguised financing transactions.<sup>26</sup> DOI intervened in the litigation.<sup>27</sup> Although the claimants asserted that pursuant to OCSLA, the law of the state adjacent to the offshore area — Louisiana or, alternatively,

20 See *In re ATP Oil & Gas Corp.*, Case No. 12-36187 (Bankr. S.D. Tex. Aug. 17, 2012).

21 See *Diamond Offshore Co. v. ATP Oil & Gas Corp.*, Adv. No. 12-03425, Dkt. No. 1 (Bankr. S.D. Tex. Oct. 2, 2012); *TM Energy Holdings LLC, et al. v. ATP Oil & Gas Corp.*, Adv. No. 12-03429, Dkt. No. 1 (Bankr. S.D. Tex. Oct. 3, 2012); *Bristow U.S. LLC v. ATP Oil & Gas Corp.*, Adv. No. 12-03440, Dkt. No. 1 (Bankr. S.D. Tex. Oct. 15, 2012); *NGP Capital Res. Co. v. ATP Oil & Gas Corp.*, Adv. No. 12-03443, Dkt. No. 1 (Bankr. S.D. Tex. Oct. 17, 2012); *Seacor Marine LLC v. ATP Oil & Gas Corp.*, Adv. No. 12-03450, Dkt. No. 1 (Bankr. S.D. Tex. Oct. 26, 2012).

22 *In re Walter Energy Inc.*, Case No. 15-02741-TOM11, 2015 WL 9487718, at \*6 (Bankr. N.D. Ala. Dec. 28, 2015) (citations omitted).

23 *Id.*

24 See, e.g., *Diamond Offshore Co.*, Adv. No. 12-03425, Dkt. No. 1.

25 *Id.* See also 11 U.S.C. §§ 541(a) (defining property of bankruptcy estate); 541(b)(4) (excluding from property of estate certain of debtor's transfers of interests in liquid or gaseous hydrocarbons).

26 See, e.g., *NGP Capital Res. Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, Case No. 12-36187, Adv. No. 12-03443, 2014 WL 61408, at \*1 (Bankr. S.D. Tex. Jan. 6, 2014); *Diamond Offshore Co.*, Adv. No. 12-03425, Dkt. No. 194 (Bankr. S.D. Tex. Sept. 17, 2013).

27 See, e.g., *Diamond Offshore Co.*, Adv. No. 12-03425, Dkt. Nos. 14, 28, 45.

13 11 U.S.C. § 365(h)(1)(A)(ii).

14 See 43 U.S.C. § 1301.

15 See 43 U.S.C. § 1332(1).

16 See 43 U.S.C. § 1337.

17 See "The Reorganization of the Former MMS," Bureau of Ocean Energy Management, available at [boem.gov/Reorganization](http://boem.gov/Reorganization) (last visited July 28, 2017).

18 See 43 U.S.C. § 1333(a)(2)(A).

19 Applying New Mexico law, the Tenth Circuit has concluded that that interests in federal onshore oil-and-gas leases are real property. *Bolack v. Underwood*, 340 F.2d 816, 819-20 (10th Cir. 1965) (noting that "[t]here is no federal statute governing disputes between private individuals regarding rights to federal oil-and-gas leases, and in such instance, where no right of the federal government is involved, state law governs").

Texas — applied to the determination of the nature of the leases, the DOI argued otherwise.<sup>28</sup>

According to the DOI, pursuant to applicable federal law, the offshore oil-and-gas leases and, consequently, the derivative ORRIs and NPIs held by the claimants were both executory contracts and unexpired leases, thus property of the bankruptcy estate and assumable and assignable.<sup>29</sup> Further, the DOI contended that applicable Louisiana and Texas law, which characterized the interests as vested real-property interests, conflicted with applicable federal law and therefore, pursuant to § 1333(a)(2)(A) of OCSLA, did not apply.<sup>30</sup>

The DOI asserted that offshore oil-and-gas leases are true leases of real property because they are by their essence and, according to OCSLA language, rental agreements to use real property.<sup>31</sup> The lessee is granted the right to explore, develop and produce oil and gas and pay rental payments to the U.S. government.<sup>32</sup> Though the DOI cited case law to support its position that the leases were true leases of real property, none of the cases cited specifically held that offshore leases are true leases.<sup>33</sup> Rather, the cases simply noted that the lease “does not convey title in the land, nor does it convey an unencumbered estate in the oil and gas.”<sup>34</sup>

To support its assertion that offshore oil-and-gas leases were also executory contracts, the DOI maintained that each party under an offshore lease had continuing performance obligations.<sup>35</sup> “Under the Federal Leases at issue, ATP [was required] to continue making royalty and rental payments; and the United States [was required] to make the OCS lands available for development and supervise all development on the OCS.”<sup>36</sup>

The court issued a written decision in the adversary proceeding commenced by the claimant, NGP Capital Resources Co., but the court only analyzed and determined, under Louisiana law, the issue of whether the ORRIs and NPIs were disguised financing transactions.<sup>37</sup> The court did not determine the proper characterization of the nature of an offshore oil-and-gas lease interest.<sup>38</sup> The question remains unanswered.

## How Might the Issue Be Resolved?

Congress could resolve this outstanding issue by amending OCSLA to provide a specific provision addressing the characterization of offshore leases. The new provision under OCSLA could reflect the DOI’s position that offshore oil-and-gas leases are both true real property leases (rental agreements to use real property) and executory contracts. If the lease is defined as a real property lease, then there is a possibility that despite rejection, pursuant to § 365(h)(1)(A)(ii) of the Bankruptcy Code, the lessee under the lease could remain in possession of the lease and exercise other appurtenant lease rights.

<sup>28</sup> *Id.*; *United States’ Motion to Intervene*, Dkt. No. 14, Dkt. No. 14-1.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* See also 11 U.S.C. § 365(m) (defining leases of real property to include rental agreements to use real property).

<sup>32</sup> See *Diamond Offshore Co.*, Adv. No. 12-03425, Dkt. No. 14, Dkt. No. 14-1 (quoting 43 U.S.C. § 1337).

<sup>33</sup> *Id.* (citations omitted).

<sup>34</sup> *Id.* (quoting *Union Oil Co. v. Morton*, 512 F.2d 743, 747 (9th Cir. 1975)).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* (citations omitted).

<sup>37</sup> See *NGP Capital Res. Co.*, Case No. 12-36187, Adv. No. 12-03443, 2014 WL 61408, at \*1.

<sup>38</sup> *Id.*

Instead of specifically defining the nature of the offshore oil-and-gas lease, Congress may add a provision to the OCSLA that simply states that the law of the state adjacent to the offshore area is applicable to the determination of the proper characterization of the lease. This option will likely create a lack of uniformity.

Lastly, alternatively, Congress can simply fail to act and leave resolution of the issue to the judiciary. **abi**

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