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IS YOUR ORRI WHAT YOU THINK IT IS?

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Bankruptcy Court reinforces importance of parties' intent in determining the nature of overriding royalty interests under state law.

On April 2, 2015, the United States Bankruptcy Court for the District of Delaware (the Court) issued an opinion in *In re Delta Petroleum Corporation* addressing whether certain overriding royalty interests (ORRIs) constitute interests in real property under applicable state law. The Court's interpretation of the underlying assignment agreements focused on the intent of the parties to create either a real property interest, which would be excluded from the debtors' bankruptcy estate, or a contractual right to payment, which would be included in the estate and subject to discharge in the bankruptcy proceeding. This Client Alert provides a brief discussion of the primary issues addressed in the Delta opinion and the lessons to be learned from the Court's holdings.

Background

In 1994, defendant BWAB Limited Liability Company (BWAB) acquired an option to purchase, among other things, certain interests in oil and gas leases related to property located off the coast of California (the Properties) from Union Pacific Resources Corporation. BWAB then assigned its option to Whiting Petroleum Corporation (Whiting) in exchange for either: "(i) an undivided 6.5% of the net rights acquired by Whiting in the Properties after the exercise of [the] option; or [ii] a proportionately reduced 3.5% overriding royalty interest out of the net revenue interest acquired by Whiting after the exercise of [the] option, in either case...by an assignment in recordable form." After exercising the option, Whiting entered into the Assignment of Overriding Royalty (the 1994 Assignment) with BWAB, a copy of which was recorded. The 1994 Assignment provided that "Whiting does hereby grant, convey, assign, set over, and deliver to BWAB an overriding royalty consisting of an undivided 3.5% interest in Whiting's Net Revenue Interest from the Subject Properties" (the 1994 ORRI).¹

After a series of transactions, in 1999, Whiting executed a Conveyance and Assignment to debtor Delta Petroleum Corporation (Delta), in which Whiting conveyed a net operating interest (NOI) in the Properties to Delta (the Conveyance). The Conveyance defined the NOI as follows:

"the monthly payable positive or negative cash flow resulting to the Interests from the following eight step calculation:

- (i) oil and gas revenue;
- (ii) less royalties and overriding royalties; (iii) less Unit lease operating expenses;
- (iv) less severance, production, or ad valorem taxes, if any;
- (v) less capital expenditures;
- (vi) less Unit fees to the Unit operator;
- (vii) plus the positive or less the negative cash flow from the Partnerships;
- (viii) plus or minus any other miscellaneous costs or revenues that may be related to these interests or operations."

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The NOI was not recorded in the relevant real property records, as would normally be required with respect to real property interests, as Delta and Whiting were concerned that the co-tenants in the properties would object to this assignment.²

In December, 1999, Delta entered into an Assignment of Overriding Royalty Interest with BWAB, pursuant to which Delta granted BWAB “an overriding royalty interest of three percent in and to the oil and gas leases and lands...which shall burden all the oil, gas and other leased minerals produced, saved and sold from or allocated to the lands covered by said Leases” (the BWAB 1999 ORRI). Delta entered into a similar agreement with Aleron Larson, Jr., the former Chief Executive Officer and Chairman of the Board of Directors of Delta (Larson), granting him an ORRI of one percent (together with the BWAB 1999 ORRI, the 1999 ORRIs). Like the NOI, neither of these 1999 ORRIs were recorded in the relevant real property records because of the concerns that the co-tenants would object.

On December 16, 2011, Delta and certain of its affiliates (the Debtors) filed for relief under chapter 11 of the Bankruptcy Code. The Bankruptcy Court confirmed the Debtors' plan of reorganization (the Plan) on August 16, 2012. Upon the effective date of the Plan, the Debtors' assets vested in, among other entities, the Delta Petroleum General Recovery Trust (the Trust), free and clear of all claims, encumbrances, and liens. On January 4, 2013, the Trust and one of the reorganized debtors (together, the Plaintiffs) filed a complaint against BWAB and Larson seeking, among many other things, a declaration that the 1994 ORRI, the 1994 Assignment, the 1999 ORRIs, and any rights arising thereunder, were contractual interests that were extinguished by the Debtors' Plan. After the Plaintiffs filed a motion for summary judgment, BWAB and Larson each responded with cross-motions for summary judgment, asserting that their respective interests were real property interests that were not part of the Debtors' bankruptcy estate.

Decision

The true nature of ORRIs and other production payments (real property vs. contractual right) is a pivotal issue that will determine how an interest owner's rights will be affected by a chapter 11 proceeding. Under Section 541(a)(1) of the Bankruptcy Code,³ subject to certain exceptions, “all legal or equitable interests of a debtor in property as of the commencement of the case” will become property of the estate. Thus, a debtor's interests in contractual rights will be deemed estate property under Section 541, while real property interests conveyed to a third party prior to the commencement of the case will be excluded from the estate.⁴ The distinction is crucial. Holders of a contractual interest will be treated like any other creditor of the debtor, with their claims subject to discharge in the bankruptcy proceeding. However, holders of interests in real property that are not part of the bankruptcy estate will likely see their rights pass through the bankruptcy proceeding unaffected.

(a) *The 1994 ORRIs*

In general, real property interests are governed by state law.⁵ Accordingly, the Court analyzed the nature of the 1994 ORRI under California and Colorado law.⁶ In doing so, the Court found that both California and Colorado courts have determined that a true ORRI is an interest in real property. The analysis, however, did not end there. As the Court explained, whether the assignment agreement actually created an ORRI depends on the intent of the parties in entering into the agreement. “The intent of the parties to a contract is to be determined primarily from the language of the instrument itself...written contracts that are complete and free from ambiguity will be found to express the intention of the parties and will be enforced according to their plain language.”⁷ Notably, “whether the interest is an overriding royalty (or something else) depends on the true nature of the particular conveyance which gives rise to the interest. Because merely

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calling an interest an overriding royalty interest is not conclusive of its true status, provisions relevant to the grant of an overriding royalty interest are germane.”⁸

The Plaintiffs took the position that the 1994 ORRI is not a true overriding royalty interest because the 1994 Assignment granted BWAB only an interest in Whiting's “net revenue interest” in Delta, which, they asserted, is an interest in a revenue stream, rather than an interest in the land or hydrocarbons. Depending on the applicable state law, some courts, in determining the proper characterization of royalty interests, have drawn distinctions between royalty interests that are payable in kind, and those that are payable in cash from the proceeds of the lessee's sale of the hydrocarbon.⁹ However, the Court here once again turned to California state law, which gave no weight to such distinction. Rather, California state law provides that net profits interests should be treated in the same manner as overriding royalties.¹⁰ Thus, focusing on the language of the 1994 Assignment,¹¹ which demonstrated the parties' intent to grant BWAB a fractional interest in the revenue received from the hydrocarbons produced by Whiting's working interest in the Properties, the Court concluded that the 1994 ORRI is properly classified as an interest in real property under California and Colorado state law.¹²

The Plaintiffs argued in the alternative that the 1994 ORRI was expunged by the Debtors' Plan because the 1994 ORRI was part of the Debtors' estate by virtue of the fact that it was paid from the net revenue stream generated by the Properties and, in 1999, that net revenue stream was conveyed to the Debtors. The Court was not persuaded, finding that the NOI conveyed by Whiting to Delta in 1999 consisted of the positive or negative cash flow resulting from the interest in the Properties, determined pursuant to a calculation that specifically carved out overriding royalties. Thus, Delta's NOI consisted of the cash flow after deducting the 1994 ORRI and, therefore, the Debtors' Plan could not affect the 1994 ORRI between Whiting and BWAB. Based on the foregoing, the Court denied the Plaintiffs' motion for summary judgment declaring that the 1994 ORRI was a contractual interest discharged by the Plan and granted BWAB's cross-motion for summary judgment with respect to its counterclaim that the 1994 ORRI is a real property interest that was not extinguished, stripped, or avoided by the Plan.

(b) The 1999 ORRIs

With respect to the 1999 ORRIs, the Plaintiffs asserted that the NOI that Whiting transferred to the Debtors was not a real property interest and, therefore, the 1999 ORRIs arising out of that NOI cannot be real property interests. The Court agreed that “an assignee's rights are derivative of whatever rights the assignor may have,”¹³ and, therefore, an analysis of the nature of the NOI was necessary. Because the parties each presented conflicting evidence as to whether they intended the conveyance of the NOI to create a real property interest, the Court found an issue of material fact concerning the true nature of the NOI and denied the summary judgment motions in connection with the 1999 ORRIs.

Implications

The Court's opinion serves as a reminder that prospective owners of oil and gas interests — such as ORRIs — should conduct a thorough analysis of both the underlying assignment agreements and the state law that governs such agreements in order to understand the true nature of the conveyance.

Before entering into an agreement, prospective interest owners would be wise to consider factors such as:

- Which state law will govern the transaction;
- Whether ORRIs are typically characterized as real property interests under such applicable state law (and what effect the distinction between interests payable in kind or payable in cash will have on such analysis, if any);

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- Whether the express language of the agreement clarifies each party's intent to convey a real property interest;
- Whether the intended conveyance of a real property interest to the prospective owner is actually feasible given any prior transactions that may have taken place in connection with the land; and
- The applicable state law formalities that should be followed with respect to perfecting the interest the parties intended to create.

A thorough examination of such issues may prevent parties from having their rights significantly impaired—or discharged altogether—in a bankruptcy proceeding.

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Endnotes

¹ BWAB's affiliate, BWAB Incorporated, initially acquired the purchase option, which it subsequently assigned to Whiting. BWAB Incorporated then conveyed the 1994 ORRI to BWAB, as permitted by the 1994 Assignment.

² The co-tenants in the property had a consent right with respect to any transfer of the property by Whiting.

³ 11 U.S.C. § 541(a)(1).

⁴ Even if an ORRI is not considered to be a real property interest excluded from the bankruptcy estate under applicable non-bankruptcy law, holders of ORRIs may assert that their interests are not property of the estate

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under Section 541(b)(4)(B) of the Bankruptcy Code, which excludes from property of the estate "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 of the property from which such production payment is transferred..." 11 U.S.C. § 541(b)(4)(B). The Bankruptcy Code defines a production payment as a type of "term overriding royalty" or "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." See 11 U.S.C. §§ 101(42A) and (56A), respectively, for the definitions of "production payment" and "term overriding royalty." Neither party addressed the issue of whether the ORRIs fall within the definition of a "production payment," which would, in turn, exclude them from "property of the estate" pursuant to Section 541(b)(4)(B). However, the Court stated that the parties will have the opportunity to brief the issue in connection with certain issues surrounding the 1999 ORRIs.

⁵ Even if an ORRI is not considered to be a real property interest excluded from the bankruptcy estate under applicable non-bankruptcy law, holders of ORRIs may assert that their interests are not property of the estate under Section 541(b)(4)(B) of the Bankruptcy Code, which excludes from property of the estate "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 of the property from which such production payment is transferred..." 11 U.S.C. § 541(b)(4)(B). The Bankruptcy Code defines a production payment as a type of "term overriding royalty" or "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." See 11 U.S.C. §§ 101(42A) and (56A), respectively, for the definitions of "production payment" and "term overriding royalty." Neither party addressed the issue of whether the ORRIs fall within the definition of a "production payment," which would, in turn, exclude them from "property of the estate" pursuant to Section 541(b)(4)(B). However, the Court stated that the parties will have the opportunity to brief the issue in connection with certain issues surrounding the 1999 ORRIs.

⁶ The 1994 Assignment is governed by Colorado state law; however, the parties cited to California case law in their pleadings because the Properties were located in California. The Court did not find any material difference between the laws of Colorado and California with respect to the issues presented.

⁷ *Ad Two, Inc. v. City and County of Denver*, 9 P.3d 373, 376 (Colo. 2000) (citations omitted).

⁸ *Foothills Texas, Inc. v. MTGLQ Investors (In re Foothills Texas, Inc.)*, 476 B.R. 143, 149 (Bankr. D. Del. 2012).

⁹ Typically, a royalty interest in oil will be payable in kind, while a royalty interest in gas will be payable in cash from the proceeds of the lessee's sale of the gas.

¹⁰ The Court cited an opinion from the Supreme Court of California providing that: "[t]he rights of the holders of royalty assignments to an interest in the proceeds of oil produced by an assignee of the leasehold should not depend on whether the assignment is of a percentage of the oil 'to be produced, saved, and sold,' ...or is of a percentage of the net proceeds..." *Schiffman v. Richfield Oil Co. of Cal.*, 64 P.2d 1081, 1088 (Cal. 1937). The Court also cited another opinion, in which the court applied Texas state law, that stated that "a net profits interest should be treated in much the same manner as an overriding royalty and that it should be classified as an interest in land." *T-Vestco Litt-Vada v. Lu-Cal One Oil Co.*, 651 S.W.2d 284 (Tex. App. 1983).

¹¹ Specifically, the Court focused on the definition of "Net Revenues" in the 1994 Assignment as "the difference between (A) the gross revenues received by Whiting from the sale of its fractional or percentage share of Hydrocarbons from the Subject Properties, after the deduction of all lessor's royalties, overriding royalties, and other burdens and payments out of gross production that burden Whiting's fractional or percentage share, and (B) the sum of Whiting's fractional or percentage share of third party (i) transportation expenses, (ii) treatment and processing expenses, (iii) compression expenses, and (iv) severance taxes, occupation taxes, and other like taxes based on the production of Hydrocarbons."

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¹² For another example from this Court of the importance of state law in determining royalty owners' rights, see *Mull Drilling Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 82 (Bankr. D. Del. 2009). There, the Court addressed whether Article 9.343 of the Texas Business and Commercial Code governed the perfection and priority of interest owners' security interests in oil and gas extracted by the debtors, which were incorporated in Delaware. The Court noted that Delaware courts apply the Restatement (Second) of the Law, Conflict of Laws in analyzing choice of law issues and, as such, it was required to follow Section 9-301 of the Delaware U.C.C. (6 Del. C. § 9-301). The Delaware U.C.C. provides that as a general rule, the local law of the jurisdiction where a debtor is located governs the perfection and priority of a security interest in collateral. Accordingly, the Court concluded that the Delaware U.C.C. governed and that the claimants were not entitled to a first priority security interest.

¹³ *Creative Ventures, LLC v. Jim Ward & Assoc.*, 195 Cal. App. 4th 1430, 1447 (Cal. App. 2011).