

# Chapter 11 Overview

January 2016

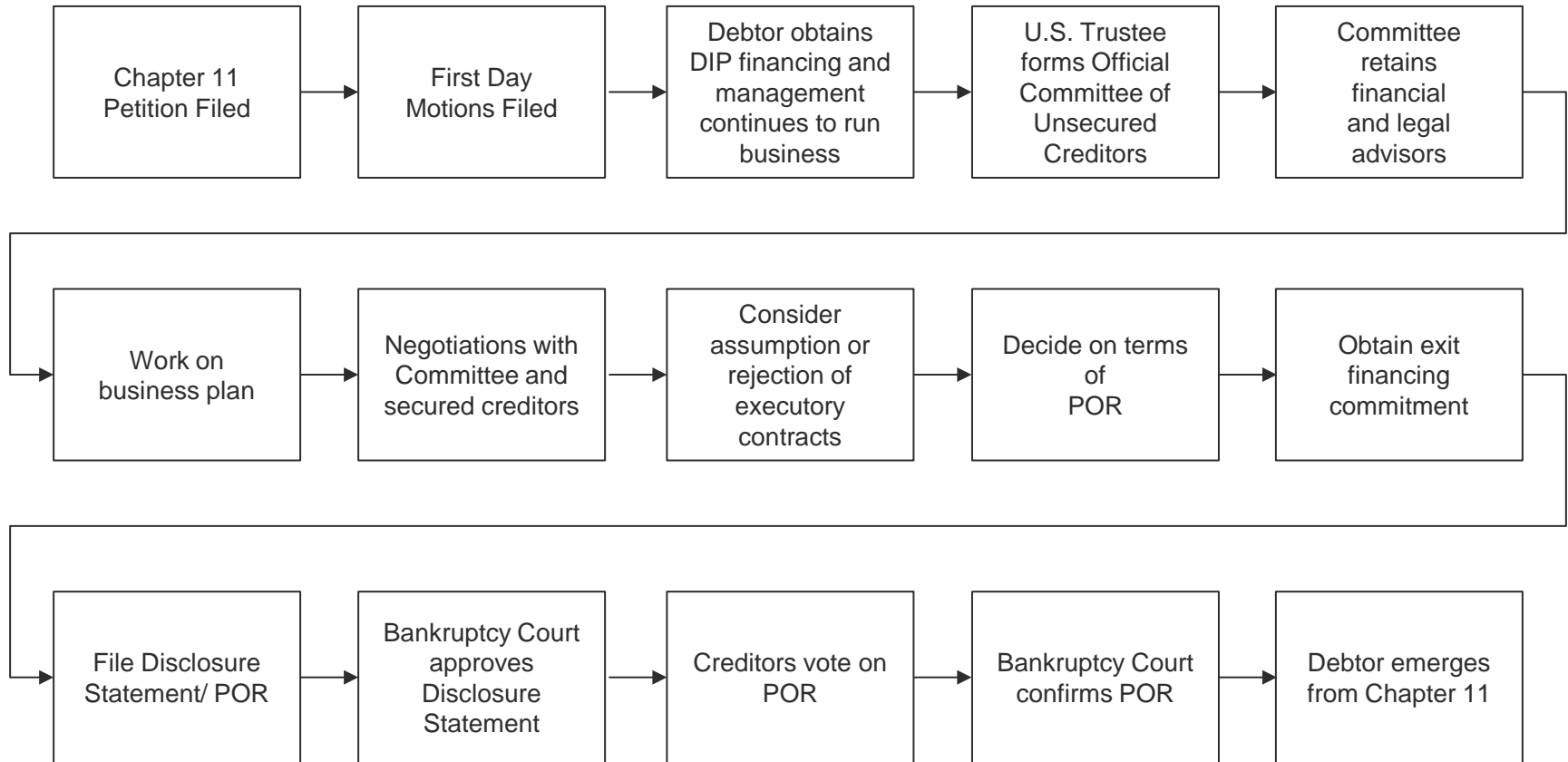
# Chapter 11 Overview

- Provide debtor with breathing space from litigation and collection actions
- “Automatic stay” under Section 362 of the Bankruptcy Code stops all foreclosure actions and lawsuits upon the filing of a Chapter 11 petition
- Give debtor time and ability to restructure balance sheet and business
- Facilitate access to working capital through DIP loan financing

# Chapter 11 Overview (cont'd)

- Facilitate a “clean start” and the reorganization of a viable business
  - Debt reduction
  - Rejection of unfavorable contracts under Section 365 of the Bankruptcy Code
- Foster equality of distribution to similarly situated creditors
  - Avoid “race to the courthouse”
  - Maximize value of assets and distributions

# Traditional Chapter 11 Timeline



# Bankruptcy Overview

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# Why Bankruptcy – Purposes

- Ensure equality of distribution among creditors
- Avoid a race to enforcement
- Maximize value of assets and distributions
- Provide discharge from indebtedness and “fresh start” to debtor
- Rehabilitate financially viable business – preserve operations and save jobs
- Provide debtor with time and ability to restructure balance sheet and business

# Why Bankruptcy – Causes

- Too much debt
- Not enough liquidity
- Industry/company decline
- Mismanagement and fraud
- Catastrophic event
- Preservation/maximization of value
- Strategic reason (Chapter 11)
  - Effectuate a transaction
  - Reject leases
  - Deal with labor

# The Bankruptcy Cast of Characters

- The Bankruptcy Court
- Company / Borrower / Debtor-in-Possession
  - Bankruptcy Trustee
- U.S. Trustee
- Creditors
  - Secured creditors
  - Unsecured creditors
  - Creditors' Committee
- Owners / Stockholders



The background of the slide features a photograph of several oil pumpjacks (jack-o'-lanterns) silhouetted against a sunset sky. The sky transitions from a deep blue at the bottom to a bright orange and yellow near the horizon. The pumpjacks are arranged in a line, receding into the distance. The overall mood is industrial and serene.

# Prearranged & Prepackaged Plan

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# Prearranged & Prepackaged Plans

- Prearranged Plans
  - Debtor files for Chapter 11 after having negotiated the key terms of a restructuring with at least one class of impaired creditors
  - Salient terms often contained in a “plan support agreement” or “lock-up”
- Prepackaged Plans
  - Debtor files for Chapter 11 only after its impaired creditors have voted in favor of the plan it has negotiated with its major stakeholders
  - Debtor can generally emerge quicker from Chapter 11 than under a prearranged plan

# The Bankruptcy Plan

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# The Plan — Priority of Claims

- “Priority” means that the particular unsecured claim is entitled to be put ahead of secured claims
- There are a total of ten statutory priority claims. The relevant pre-petition priority claims in Chapter 11 cases include:
  - Claims for wages and employee benefits up to a capped amount per employee earned 180 days before the petition date;
  - Claims for contributions to an employee benefit plan, up to a capped amount for each covered employee; and
  - Many types of tax claims

# The Plan — Priority of Claims (cont'd)

- Post-petition claims are generally given priority
- Certain claims are called “administrative expense claims” and they are for “actual and necessary costs and expenses of preserving the estate”
- To qualify as an administrative expense: (a) the claim must arise from a transaction with the Debtor-in Possession, not the pre-petition company; and (b) the debtor must receive a benefit
- Administrative expense claims typically include employee wages and salaries, payments for goods and services received post-petition, taxes, legal and professional fees

# The Plan – Classification of Claims or Interests

- The Bankruptcy Code provides that “a Plan may place any claim or interest in a particular class **only if such claim or interest is substantially similar to the other claims or interests of such class**”
- A claim is “any right to payment, whether or not such right is reduced to judgment”
- Claims may be liquidated, unliquidated, disputed, undisputed, fixed, contingent, matured or unmatured

# The Plan – General Rules Regarding Voting

- The “**voting classes**” include every class of “impaired” claims and interests
- A claim is considered “impaired,” unless:
  - The Plan leaves unaltered the legal, equitable, and contractual rights; or
  - The Plan cures any (non-bankruptcy) default, provides compensation for damages incurred, and does not otherwise alter the claimholder’s rights
- Outside of special “cramdown” rules, every impaired class must approve a plan of reorganization
  - “Approval” means acceptance by at least 2/3 in amount and more than 1/2 in number of those claims that vote

# The Plan – Cramdown Rules

- The Plan can only be confirmed over the rejection of an impaired class if it:
  - Satisfies the other confirmation requirements;
  - Is accepted by at least one impaired class, excluding votes of insiders;
  - **Does not discriminate unfairly** as to each dissenting impaired class; and
  - **Is fair and equitable** as to each dissenting impaired class



# The Plan – Cramdown Rules (cont'd)

- “Fair and Equitable” Standard
  - For Secured Creditors, the Plan must provide one of the following: (1) that a secured creditor retains its lien or receives cash payments that equal its allowed secured claim; (2) if collateral is sold, the secured creditor retains liens on proceeds; or (3) the realization of “indubitable equivalent” of such claims
  - For Unsecured Creditors, the Plan must meet the **Absolute Priority Rule**: the Plan must either (1) satisfy allowed unsecured claims in full; or (2) provide that junior claims or interests “will not receive or retain under the Plan on account of such junior claim or interest any property”

# The Plan — Confirmation Standards

- A Plan may not be confirmed unless:
  - It complies with the law;
  - It was proposed in good faith;
  - It provides required treatment of priority claims, retiree benefits and fees;
  - “Best interest of creditors’ test” must be satisfied: creditors must receive under the Plan “property of a value . . . that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7;” and
  - Implementation of the Plan must be feasible: confirmation should not be followed by the liquidation, or the need for further financial reorganization, of the debtor

# Important Rule – Automatic Stay

- Once a bankruptcy case is commenced, all creditor rights to initiate enforcement actions come to a grinding halt, including:
  - Acts to control property of the estate or from the estate;
  - Any effort to collect, assess or recover claims;
  - Starting or continuing lawsuits;
  - Creating, perfecting or enforcing liens; and
  - Exercising setoffs (with exceptions)

# Claims & Interests

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# Claims and Interests

- After a bankruptcy case has commenced, it must be determined who has rights relating to the property of the estate
- Broadly speaking, there are three types of rights:
  - Secured claims;
  - Unsecured claims; and
  - Interests

# What is a Claim?

- A claim is “any right to payment, whether or not such right is reduced to judgment”
- Claims may be liquidated, unliquidated, disputed, undisputed, fixed, contingent, matured or unmatured
- Non-bankruptcy law grounds for a debtor to dispute claims are still valid in bankruptcy, most of the time

# Secured Claims

- “Secured claim” up to value of the interest in the lien on the collateral
- “Unsecured claim” to the extent the amount of the claim exceeds the value of the interest in the lien
- Where the value of the interest in the lien exceeds the amount of the claim, the creditor is oversecured
- Bankruptcy law bifurcates undersecured creditors’ claims

# Illustration of Oversecured and Undersecured Claims

- Assume all of the debtor's assets are pledged to secure \$100MM of first-lien debt and \$50MM of second-lien debt
  - If assets are worth \$175MM, the first- and second-lien lenders are oversecured and have “allowed secured claims” equal to the amount of their debt
  - If assets are worth \$125MM, the first-lien lenders are oversecured and second-lien lenders are undersecured and have an allowed secured claim for \$25MM and an allowed unsecured claim for \$25MM
  - If assets are worth \$75MM, the first-lien lenders are undersecured and have an allowed secured claim for \$75MM and an allowed unsecured claim for \$25MM. The second-lien lenders are unsecured and have an allowed unsecured claim for \$50MM



# Unsecured Claims

- Claims not supported by an interest in collateral are unsecured claims
- Under the Bankruptcy Code, if a security interest is not valid and perfected on the petition date, the lien is not enforceable and the claim is unsecured
- Liens otherwise valid and perfected on the petition date can, under certain circumstances, be avoided

# Claims Subject to Disallowance

- Bankruptcy law provides additional grounds for a debtor to dispute claims, including:
  - Claims for “unmatured interest”
    - Such claims are not allowable in bankruptcy
  - Cap on long-term real property lease claims
    - Amount of claim is limited to rent reserved by lease (without acceleration) for the greater of (a) 1 year or (b) 15%, not to exceed 3 years of the remaining term of lease
  - Certain contingent claims
    - Contingent claims for reimbursement or contribution of an entity that is liable with the debtor

# Secured vs. Unsecured Claims

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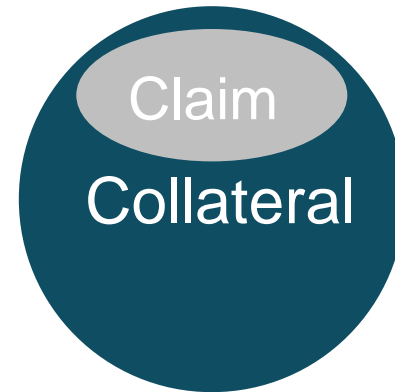
# Secured Creditors

- Pre-petition liens are generally respected, if perfected
- Secured creditors are entitled to “adequate protection” of their interests and, if over-secured, post-petition interest and any reasonable fees, costs or charges
- Secured lenders often work closely with the debtor throughout a restructuring
  - **Workout:** secured lenders often lead efforts to restructure a potential debtor outside of court
  - **Bankruptcy:** “cash is king” and where it is needed, secured lenders typically provide DIP Loans and use loan terms as a method of controlling the case. Debtor will need lenders’ consent to use cash collateral after filing, and lenders condition that consent (see discussion in later slides)

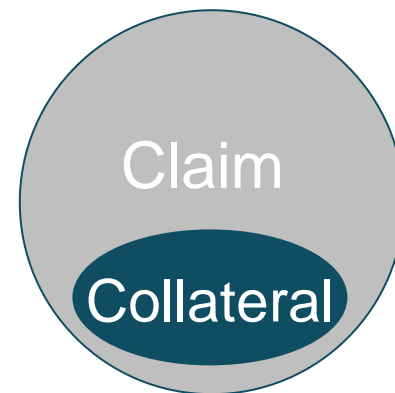
# Secured Creditors (cont'd)

- Secured creditors have a “secured claim” up to the value of their interest in collateral, and an “unsecured claim” to the extent the amount of the claim exceeds the value of the interest
- So, bankruptcy bifurcates treatment of “undersecured” creditors’ claims

## Oversecured Claim



## Undersecured Claim



# Unsecured Creditors

- Claimants that do not have a security interest in collateral
  - Examples include: trade creditors, lessors, bondholders, etc.
- Usually represented by the official committee of unsecured creditors, but can take individual positions
- The U.S. Trustee may appoint an unsecured Creditors' Committee shortly after the petition date
  - The committee is tasked with representing the interests of the diverse unsecured creditor body
  - The committee will insert itself into the negotiations of the terms of all key issues

# Equity Holders

- Stockholders are known as “interest holders” in bankruptcy
- Not entitled to any recovery until all creditors (secured and unsecured) recover in full
- Existing stock is generally cancelled upon emergence from bankruptcy and new stock in reorganized company is issued pursuant to the Plan

# Automatic Stay

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# Some Important Special Rules – Automatic Stay – Scope

- Once a bankruptcy case is commenced, all creditor rights to initiate enforcement actions come to a grinding halt, including:
  - Acts to control property of the estate or from the estate;
  - Any effort to collect, assess or recover claims;
  - Starting or continuing lawsuits;
  - Creating, perfecting or enforcing liens; and
  - Exercising setoffs (with exceptions)

# Some Important Special Rules – Automatic Stay – Exceptions

- The Automatic Stay does not apply to:
  - Criminal proceedings;
  - Acts to perfect, or maintain or continue perfection of, security interest in property if permitted elsewhere in the Bankruptcy Code;
  - Proceedings by governmental unit to enforce its “police and regulatory” power; or
  - Exercise of contractual rights under repurchase agreements, swap agreements, commodity contracts, forward contracts and securities contracts

# Obtaining Relief From the Automatic Stay

- The bankruptcy court may grant relief from the automatic stay:
  - “For cause,” such as lack of adequate protection
    - A party with an interest in collateral that is subject to the automatic stay is entitled to “adequate protection” to the extent the automatic stay diminishes the value of the party’s interest in the collateral
  - If the debtor does not have an equity in the collateral and the collateral is not necessary to an effective reorganization

# Preferences & Fraudulent Transfers

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# Preferences & Fraudulent Transfers

- Preference (Section 547 of the Bankruptcy Code) and fraudulent transfer law (Section 548 of the Bankruptcy Code) provides after the fact protection to the debtor's creditors
- Preference statute covers payments on debt of "arms-length" creditors within 90 days of bankruptcy and payments on debt to "insiders" within one year
- Fraudulent transfer provision of the Bankruptcy Code covers transfers of property for less than reasonably equivalent value ("REV") within two years of bankruptcy. In certain instances, a longer look back is available

# Preferential Transfers

- **Bottom line summary:** prevent change in status quo “immediately” prior to bankruptcy (90-day look back period from petition date for non-insiders; 1 year for insiders)
- Main purposes
  - Discourage the race to dismember the debtor
  - Facilitates equality of distributions
  - Need to balance above with reasonable expectations of creditors (covered by affirmative defenses)
- Intent or motive is **NOT** relevant

# Preferential Transfers (cont'd)

- Any transfer of an interest of the debtor in property:
  - To or for the benefit of a creditor;
  - For or on account of an **antecedent debt** owed by the debtor before such transfer was made;
  - Made while the debtor was **insolvent** (presumed for the 90-day period prior to the petition date);
  - Made (i) on or within **90 days** before the date of the filing of the petition; or (ii) between **90 days and 1 year** before the date of the filing of the petition, if such creditor at the time of such transfer was an **insider**; **and**
  - That enables such creditor to receive more than such creditor would receive if (i) the case were a case under Chapter 7; (ii) the transfer had not been made; and (iii) such creditor received payment of such debt to the extent provided by the provisions of this title
- Unless all elements stated above are proven, a transfer is not avoidable as a preference (Section 547 of the Bankruptcy Code)

# Preferential Transfers (cont'd)

- If debtor proves all five elements, then a prima facie preference exists (debtor's burden of proof)
- To avoid disgorgement, creditor must then prove that one or more of the preference defenses exist (creditor's burden)
- The defenses are only relevant if prima facie preference exists
  - Contemporaneous Exchange Defense
  - Ordinary Course of Business Defense (ordinary for industry or between the parties)
  - Subsequent New Value Defense



# Fraudulent Transfers

- What can be avoided?
  - Any transfer of an interest of the debtor in property
  - Any obligation incurred
- Two year look-back under Section 548 of the Bankruptcy Code
  - Bankruptcy Code also incorporates state fraudulent transfer law (some states have 10-year look-back period, but most range from 4 to 6 years)

# Fraudulent Transfers (cont'd)

- Unwind transaction which either:
  - Had as its purpose an intent to hinder, delay or defraud the debtor's creditors (*actual fraud test*), **or**
  - Was made while the debtor was insolvent, causes the debtor to become insolvent or left the debtor with unreasonably small capital **and** the transaction did not provide the debtor with **REV** in return (*constructive fraud test*)

# Fraudulent Transfers – Actual Intent

- Requires a purposeful act intended specifically to defraud creditors and it is not necessary that any particular creditor be the subject of such intent (Ponzi scheme)
- The three intents that the debtor can form (hinder, delay, defraud) are distinct elements, any one of which is sufficient
- Good faith of, and value given by, the transferee is irrelevant to this test (but will be relevant to recovery amount as discussed below)
- Insolvency of the debtor is also irrelevant

# Fraudulent Transfers – Constructive Fraud

- Actual intent of the debtor is not relevant
- Inquiry focuses instead on what the debtor received in return from the creditor and the financial condition of the debtor both immediately before and after the transfer
- If debtor received REV, then the transfer is **NOT** constructively fraudulent:
  - “Value” means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor
  - Whether the value given to the debtor is REV depends on the facts and circumstances of each case and requires comparison of what was given by and to the debtor

# Fraudulent Transfers – REV

- If debtor did **not** receive REV, then one of the following financial conditions must exist and be proven (no presumption of insolvency like with preference actions):
  - Debtor was insolvent on date the transfer was made or obligation incurred or became insolvent as a result of such transfer or obligation;
  - Debtor had, or was left with, unreasonably small capital; or
  - Debtor would not be able to pay debt as such debts matured

# Fraudulent Transfers

- Innocent Transferee Defense:
  - A transferee or obligee of such a transfer or obligation that **takes for value** and **in good faith** has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, **to the extent that** such transferee or obligee gave value to the debtor in exchange for such transfer or obligation

# DIP & Exit Financing

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# DIP & Exit Financing

- A new money lender who provides funds to a company in bankruptcy typically will be granted “super-priority” status for its claim for repayment (*i.e.*, DIP lenders are paid first in a liquidation)
- DIP financing can be secured by:
  - A first lien on unencumbered property; or
  - With respect to encumbered property: (a) junior to existing lien; (b) pari passu with existing lien; or (c) senior to existing lien (“priming DIP”)



# DIP & Exit Financing (cont'd)

- A DIP loan will typically be negotiated prior to the filing, but must be approved by the Bankruptcy Court
- DIP lenders may be pre-existing or new money lenders
- Pre-petition lenders may want to serve as DIP lenders because:
  - Pre-petition loans may be “undersecured”
  - Additional funds may be necessary to protect going-concern value of the collateral
  - To ensure their claims remain the first in priority
  - Potential to earn higher fees and interest

# DIP & Exit Financing (cont'd)

- Adequate exit financing is often necessary to satisfy “Feasibility” standard for confirmation of a Plan
  - Funds from exit financing are generally used to:
    - Pay creditor claims under the Plan; and
    - Refinance existing indebtedness (*i.e.*, the DIP)
- Fund operations post-effective date
- Exit financing creates a fee opportunity

# Assumption/Rejection Overview

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# Assumption/Rejection of Oil and Gas Leases under the Bankruptcy Code

- One of the debtor's most powerful tools in Chapter 11 is the ability to assume or reject executory contracts and unexpired leases under Section 365 of the Bankruptcy Code
- Despite the nomenclature, oil and gas "leases" may not be executory contracts or true unexpired leases under the Bankruptcy Code
- Courts will look to the nature of the property interest under state law or other applicable non-bankruptcy law to determine whether an oil and gas lease is subject to Section 365 of the Bankruptcy Code

# Assumption/Rejection of Oil and Gas Leases under the Bankruptcy Code (cont'd)

- The majority view is that oil and gas leases are not true leases but are conveyances of real property
  - In these jurisdictions, including Texas, oil and gas leases fall outside the ambit of Section 365 of the Bankruptcy Code
- Courts in some jurisdictions have held that oil and gas leases are true unexpired leases, while other courts have held that an oil and gas lease creates an interest in personal property (*i.e.*, a license to enter and search for oil and gas) and may be considered an executory contract
  - Section 365 of the Bankruptcy Code is applicable in these jurisdictions
- The status of the law is unsettled in many jurisdictions

# Cramdowns

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# Cramdowns

- A Plan can be confirmed over the objection of a class of claims or interests if the Plan:
  - Satisfies the other confirmation requirements (e.g., good faith, feasibility, best interest of creditors, etc.);
  - Is accepted by at least one impaired class, excluding votes of insiders;
  - Does not discriminate unfairly as to each dissenting impaired class; and
  - Is fair and equitable as to each dissenting impaired class

# More on Cramdowns – Unfair Discrimination

- Equal classes can be given different kinds of consideration under a Plan, so long as they receive rough equivalents
- Not all discrimination is unfair
- Courts are divided in the standard they use to assess “unfair” discrimination among equivalent classes
  - Restrictive application: Some courts have only applied the unfair discrimination standard in cases where claims and interests have been subordinated
  - Broad application: Some courts have found that unfair discrimination exists where a Plan segregated multiple similar claims or groups of claims into separate classes and provided disparate treatment for those classes



# More on Cramdowns – “Fair and Equitable” as to Secured Claims

- To satisfy the condition that a plan be “fair and equitable,” the Plan must provide:
  - For the secured creditor to retain the lien and for the provision for cash payments that (in the aggregate) equals the allowed secured claim and that has present value “of at least the value of such holder’s interest in the estate’s interest in such property;”
  - For the sale of any collateral, free and clear of liens, with the secured creditors’ liens attaching to the proceeds of the sale; or
  - For the realization of “indubitable equivalent” of such claims

# More on Cramdowns – “Fair and Equitable” as to Unsecured Claims

- Absolute Priority Rule:
  - Plan must provide to each holder of an unsecured claim property with the present value of the allowed amount of its claim (*i.e.*, “paid in full”); or
  - Plan must provide that junior claims or interests “will not receive or retain under the Plan on account of such junior claim or interest any property”

# Section 363 Sales

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# Section 363 Sales

- Section 363 of the Bankruptcy Code permits a debtor to sell assets “free and clear” of claims, liens and interests outside of a Chapter 11 plan
  - Claims, liens and interests will attach solely to the sale proceeds
  - Generally, no successor liability for purchaser
- Section 363 sales are often used to avoid the time and costs of Chapter 11 plan confirmation process and valuation fights (auction establishes value)

# Section 363 Sales (cont'd)

- Stalking-horse bidder negotiates purchase agreement and sets floor price for auction in exchange for bidder protections
  - Break-up fee (approximately 3% of purchase price)
  - Expense reimbursement
- Stalking-horse bidder is at risk of being “topped” at a public auction, usually held around day 60–70 of the Chapter 11 case
- The Chapter 11 process is designed to maximize the value of the debtor’s assets through a post-petition marketing and sale process

# Section 363 Sales (cont'd)

- Private sales can often occur much faster than Section 363 sales
- Private sales do not require “remarketing” process or involve Creditors’ Committee
- Private sales do, however, require the express consent of lienholders for “free and clear” sale
  - No ability to force lienholders to accept less than the face amount of their debt in out-of-court sale
  - Must either expressly consent or be paid in full in cash from sale

# Section 363 Sales (cont'd)

- Section 363(k) of the Bankruptcy Code expressly permits credit bidding by secured lenders, unless limited for “cause”
  - Generally able to bid up to the face amount of debt, regardless of whether the debt was acquired at a discount
- A dollar of credit bid is considered equivalent to a dollar of cash
- Even a successful credit bidder will generally be required to provide at least some new cash to the debtor in a going concern sale (*i.e.*, to cure contracts that the debtor will assume)

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# Plugging & Abandonment Liability

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# Plugging and Abandonment Liability

- Under state and federal law, E&P companies are typically obligated to plug and abandon a well after operations cease
- State law provides for specific procedures to properly plug and abandon a well and often requires companies to provide bonds to ensure that funds are available to cover P&A obligations
- Companies operating offshore on the OCS are obligated to plug a well within one year of the end of production and must comply with requirements set forth by the Bureau of Ocean Energy Management (“BOEM”)

# Plugging and Abandonment Liability (cont'd)

- All companies operating offshore must provide basic bonding
  - May be lease-specific or area wide
  - The amount of the bond will depend on the level of activity
- Companies that fail to meet certain financial thresholds may also be required to provide supplemental bonding, potentially in substantial amounts
  - To show financial ability to meet P&A obligations, a company typically must show a minimum net worth, have a minimum debt to equity ratio and provide audited financial statements
- It is typically a condition to the lease that a company meet BOEM's requirements. If the bond is not provided, the lease is subject to forfeiture

# Plugging and Abandonment Liability (cont'd)

- A claim for P&A liability may be entitled to administrative priority in a bankruptcy case
- *In re H.L.S. Energy Co., Inc.*, 151 F.3d 434 (5<sup>th</sup> Cir. 1998): Expenses incurred post-petition on account of a post-petition P&A obligation are generally entitled to administrative priority under the Bankruptcy Code
- *In re Am. Coastal Energy Inc.*, 399 B.R. 805 (Bankr. S.D. Tex. 2009): Expenses incurred post-petition on account of a pre-petition P&A obligation may be entitled to administrative priority
  - The court reasoned that, regardless of when the obligation first accrued, the continuing state law health and safety duty makes the P&A obligation a continuing post-petition obligation that is an actual and necessary cost of preserving the estate

# Treatment of Oil & Gas Leases in Bankruptcy

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# Treatment of Interests in Oil and Gas Production

- The obligation to pay royalties is a contract right and, therefore, a pre-petition claim for unpaid royalties would typically be treated as an unsecured claim in a bankruptcy case
- Some states provide for statutory liens to protect the rights of working interest owners and royalty owners
  - Examples: Texas, New Mexico, North Dakota, Kansas and Oklahoma
  - “This section provides a security interest in favor of interest owners, as secured parties, to secure the obligations of the first purchaser of oil and gas production, as debtor, to pay the purchase price.” Tex. Bus. & Com. Code § 9.343
  - Typically, a producer’s or royalty owner’s lien attaches to the production and the proceeds thereof and will be treated as a purchase money security interest for purposes of priority

# Treatment of Interests in Oil and Gas Production (cont'd)

- Royalty owners may have another form of protection if the oil and gas lease provides for termination of the lease after non-payment of royalties
  - Such provisions are enforceable in some states, including Texas
  - The automatic stay under Section 362 of the Bankruptcy Code does not preclude termination because the failure to pay royalties causes the lease to terminate automatically and, in jurisdictions like Texas that treat oil and gas leases as conveyances of real property, the ipso facto clause of Section 365 of the Bankruptcy Code will not apply

# Treatment of Interests in Oil and Gas Production (cont'd)

- **Overriding royalty interest (“ORRI”)**: an interest in oil and gas free of the expense of production
  - The owner of an ORRI is entitled to their share of production, without the requirement to share in the costs or expenses of production
- **Net profits interest (“NPI”)**: an interest in a share of the gross production from a property, measured by net profits from operation of such property
  - The owner of an NPI receives a share of the profits from the sale of production after expenses but is not personally responsible for any expenses
- Owners of ORRI and NPI rights typically do not have any rights with respect to operations

# Treatment of Interests in Oil and Gas Production (cont'd)

- A court may recharacterize an ORRI or NPI transaction as a financing arrangement under certain circumstances
- *In re ATP Oil & Gas Corp.*, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014):
  - Court denied summary judgment motion seeking a ruling that pre-petition ORRI transactions with the debtor were real property conveyances
  - Court held that the parties' intent to create a real property conveyance was irrelevant
  - Where the economic substance of the transaction points to a disguised financing, a court may recharacterize a real property interest as a debt arrangement
- Recharacterization means that the non-debtor's interests in the transaction would **not** be excluded from the debtor's estate
  - The debtor would be permitted to use the hydrocarbons and could "cram down" the non-debtor counterparty's claims in a plan of reorganization



# Treatment of Interests in Oil and Gas Production (cont'd)

- Section 541 of the Bankruptcy Code governs property of the debtor's estate
- An ORRI or NPI is typically conveyed as an interest in real property, which is excluded from the debtor's estate
  - The Bankruptcy Code excludes from the debtor's 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)
  - "Production payment" is defined 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." 11 U.S.C. §§ 42(A) and 56(A)

# Treatment of Interests in Oil and Gas Production (cont'd)

- Section 541(b)(4)(B) of the Bankruptcy Code provides a safe harbor for assignees of production payments
  - Section 541 codifies the view that assignees of production payments take title to the property, which then ceases to be property of the estate
- The safe harbor excludes from the estate production payments that are assigned “to an entity that does not participate in the operation of the property from which such production payment is transferred”
  - This language may be read to imply that the safe harbor is only available to assignees who provide financing, and not to assignees who received production payments as compensation
  - There is little case law on this issue and debtors and operating assignees may dispute whether the assigned interests in production payments should be excluded from the debtor’s estate