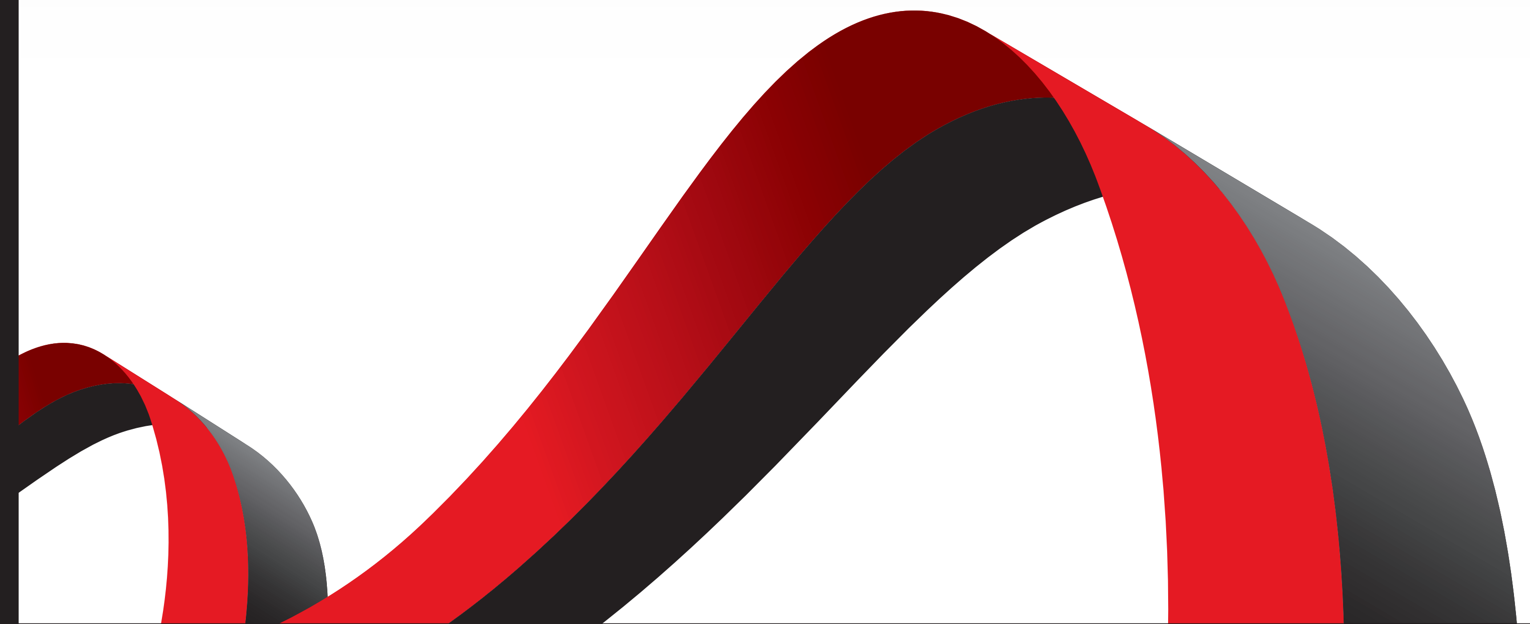
Banking & Finance Law Report

Blog series:
Oil and Gas Leases in Bankruptcy



A relationship of a different stripe.

porterwright

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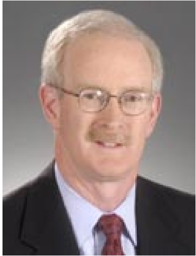
Porter Wright's Banking & Finance and Bankruptcy, Workout & Creditors' Rights practice groups include more than 30 attorneys with extensive experience in energy sector financing. These attorneys include:

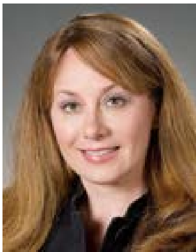


Tim Grady chairs Porter Wright's Banking & Finance practice group. His puts his depth of financing experience to work for a diverse group of industries and owners. He also advises clients on letters of credit and swap transactions, and conducts seminars on secured transactions under Article 9 of the UCC. (Columbus, OH)

Jim Botti, who chairs the firm's Bankruptcy & Reorganization practice group, has spent his 30-year career representing banks and other financial institutions in negotiating and documenting complex commercial loan transactions, and in handling troubled "workout" situations both inside and outside of bankruptcy. (Columbus, OH)

Andy Bojko advises lenders and borrowers in commercial lending, asset-based financing, mezzanine debt and leveraged buyouts. He also handles a variety of real estate matters, with an emphasis on construction and permanent loans, leasing and acquisitions/divestitures. (Columbus, OH)

Don Fisher has substantial experience in the areas of secured transactions, particularly in connection with documentation of loans and workouts, and representing financial institutions in matters involving lender liability claims, letters of credit, bankruptcy, creditor rights and foreclosure and collection litigation. (Cleveland, OH)



Polly Harris counsels financial institutions in commercial transactions and litigation. She represents lenders in commercial loan documentation, workouts, collections, foreclosures and bankruptcies as well as in lender liability, lending discrimination, contract and commercial paper actions. (Columbus, OH)

Tami Hart Kirby practices in the areas of creditor's rights, real estate, and commercial and business transactions. She represents financial institutions and businesses in all aspects of creditor's rights, including the rights and remedies available under UCC, the Bankruptcy Code and applicable state law. (Dayton and Cincinnati, OH)

Phil Langer represents banks and financial institutions on lender liability issues, loan work out, commercial litigation, loan restructuring and documentation. He has also been involved in more than 200 acquisitions of bankrupt companies or their assets, and was lead counsel in several debtor cases. (Cleveland, OH)

Walter Reynolds has developed an excellent reputation representing brokerage firms, banks, insurance companies, savings and loan associations and other financial institutions. He has handled many construction disputes representing owners, contractors, subcontractors, and material suppliers. (Dayton, OH)

Grant Stephenson has vast experience in the law and regulation of financial institutions. He represents clients regarding business acquisitions, financial institution mergers and acquisitions, issuing public and private securities, corporate reorganization and bankruptcy, and technology matters. (Columbus, OH)

Bill Weir represents a variety of financial institutions in the areas of real estate lending. He regularly represents lending institutions as lead counsel in multi-million dollar construction loans on projects located throughout the United States. He also represents financial institutions in real estate loan workouts and restructurings. (Cleveland, OH)

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What Goes Up … A Quick Glance at Ohio Oil and Gas Leases in Bankruptcy

March 4, 2013 | Andy Nicoll

As Ohio enjoys its latest boom in oil and gas exploration, it is important to understand how oil and gas leases are treated in bankruptcy. Unsettled Ohio law regarding whether a debtor owns unextracted oil and gas as part of the debtor's real property can make this a difficult issue.

In *In re Loveday*, No. 10-64110, 2012 WL 1565479 (Bankr. N.D. Ohio May 2, 2012), the Northern District of Ohio examined whether a Chapter 13 debtor had properly included in his bankruptcy schedules his interest in unextracted oil and gas relating to the debtor's real property. Whether the debtor's oil and gas rights were properly scheduled was a significant factor in determining whether the debtor could retain the proceeds of the sale of his oil and gas rights. But more importantly, for the companies who sought to purchase the debtor's oil and gas rights, knowing whether such rights were properly scheduled was necessary to determine whether the debtor had unfettered authority to sell his oil and gas rights without court approval.

The *Loveday* debtor argued that his oil and gas rights were properly scheduled because these rights were part of his real property, which real property he had listed in his bankruptcy schedules. By operation of law and the debtor's Chapter 13 plan, all the debtor's interest in his properly scheduled assets were vested with the debtor on confirmation of his Chapter 13 plan. Thus, as the debtor argued, because his oil and gas rights were inherently part of his properly scheduled real property, such oil and gas rights were scheduled and the debtor was empowered to sell such rights and entitled to retain the proceeds from the sale.

In testing the debtor's argument, the bankruptcy court outlined two prevailing theories on oil and gas rights — one holding that an owner of real property holds a fee right in unextracted oil and gas that may be severed, and the other holding that rights to oil and gas require actual possession to establish ownership in such oil and gas, and a landowner has the right to reduce the oil and gas to possession or to sever this right for economic consideration. The court found that the "[c]ourts in Ohio are split regarding the treatment of oil and gas rights to an owner," but determined that "the nonownership theory is the more sensible approach to the ownership of oil and gas rights for purposes of valuation in bankruptcy." The court further explained that, "[g]iven the migratory nature of oil and gas, it is premature to give value to the oil and gas before they are extracted from the Land," and held that:

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In instances where a debtor retains the oil and gas rights to his property, he has a duty to disclose the retention of these rights on his schedules. … [T]the debtor cannot assert that the oil and gas rights are included in the value given to the real property on his schedules. When a debtor schedules real property, the court assumes that the debtor refers only to the top surface rights associated with the real property unless the debtor specifically schedules the retention of other rights associated with the real property. Given how many different rights can be associated with real property, e.g. easements, oil and gas rights, and countless other rights, a debtor need only indicate whether any of these rights have been conveyed, specifically listing which have been conveyed, or indicate that all rights associated with the real property are still retained.

Because the debtor had failed to expressly indicate that his scheduled real property included oil and gas rights, he was required to obtain court approval to sell such rights and retain the proceeds of the sale.

In practice, it would be unusual to find oil and gas rights separately scheduled or expressly noted on a Chapter 13 debtor's bankruptcy schedules. Thus, purchasers of such rights would be wise to condition their acquisition of oil and gas rights on approval by the Chapter 13 debtor's bankruptcy court unless the oil and gas rights are explicitly and unambiguously scheduled.

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What Goes Up...Quick Glance #2 at Ohio Oil and Gas Leases in Bankruptcy

April 15, 2013 | Andy Nicoll

As Ohio enjoys its latest boom in oil and gas exploration, it is important to understand how oil and gas leases are treated in bankruptcy. The importance of these issues are underscored by the frequency with which the courts confront them; hence we visit again this unsettled area and consider further the question of the ownership of unextracted oil and gas in a bankruptcy context.

In the recent case of *In re Cassetto*, 475 B.R. 874 (Bankr. N.D. Ohio 2012), a bankruptcy court for the Northern District of Ohio examined whether a bankruptcy trustee charged with administering the assets of an individual chapter 7 debtor could enter into an oil and gas lease despite the debtor's objections, and, if so, whether the debtor's homestead exemption would apply to the signing bonus for such lease.

The lease the trustee sought to enter into had a five year term and would permit the extraction of oil and gas in exchange for a $3,900 per acre signing bonus and royalties of 17.5% of the value of any oil and gas produced from the property. The trustee sought to enter into the lease, receive the signing bonus and thereafter abandon the lease to the debtor such that the debtor would be entitled to any royalty payments under the lease.

The debtor objected to the lease claiming that "(i) there are alleged environmental issues associated with hydraulic fracking; (ii) even without any environmental concerns, the massive machinery and noise would impair the use and enjoyment of the homestead and devalue the Debtors' property (iii) the Debtors' interest in the oil and gas is 'unsevered' from the Real Estate; and (iv) in the alternative, [the debtor] is entitled to her Homestead Exemption" from the signing bonus.

The court quickly dispensed with the first two issues finding that the debtor's claims to environmental issues were "unspecific and unsupported," and similarly that the debtor had offered "no support for the proposition that the alleged impairment in use and enjoyment and/or diminution in value of the Real Estate is sufficient reason to prohibit the Trustee from maximizing the value of the bankruptcy estate."

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As to the debtor's third and fourth grounds for objection, the debtor argued that, because the oil and gas rights had not been severed from the debtor's residential property, such oil and gas rights were subject to her homestead exemption. Relying on the case of *In re Thexton*, 39 B.R. 367 (Bankr. Kan. 1984) (applying Kansas law), the debtor argued that the homestead exemption prevented the trustee from entering into the lease. The court, however, explained that, while under Kansas law, a homestead exemption would apply all future royalty payments under an oil and gas lease, "the homestead exemptions in Kansas and Ohio are in no way similar."

Relying heavily on the decision in *In re Loveday*, No. 10-64110, 2012 WL 1565479 (Bankr. N.D. Ohio May 2, 2012) (for a discussion of *Loveday*, see our previous blog post), the court held that, despite a split among Ohio state courts, the better view of the ownership of unextracted oil and gas "recognizes the migratory nature of oil and gas, and requires actual possession to establish ownership of the resource, and the right held by the landowners is the right to reduce the oil and gas to possession or to sever this right for economic consideration" (referred to as the "nonownership theory"). Thus, under the nonownership theory:

[B]ecause the oil and gas rights cannot be valued until they are either removed from real estate or there is, at minimum, an offer to purchase the right to remove the oil and gas, the Homestead Exemption cannot apply to such rights. The Homestead Exemption exempts certain property of a debtor — up to a specified dollar amount — from execution by a creditor. If the oil and gas rights cannot be valued, how can a creditor know if the rights constitute an asset? How can a creditor execute on unvalued oil and gas rights? If a value cannot be placed on the property right, how can one know if the specified dollar exemption applies? Indeed, until oil and gas rights are valued by removal of the oil and/or gas or an agreement to remove, it is impossible to ascertain whether such alleged rights have any value.

Moreover, the Homestead Exemption does not apply to oil and gas once these resources are severed from the realty because, at that time, such oil and gas become personal property and cannot be part of the homestead.

Furthermore, the court noted that the only real question is whether the signing bonus is subject to the homestead exemption. The court explained that "[t]he Signing Bonus is separate and apart from the unsevered oil and gas rights," and held that the signing bonus constitutes personal property. Because it is personal property, a simple judgment lien would not attach to the signing bonus and in a related fashion, neither would Ohio's homestead exemption. Accordingly, the trustee was authorized to enter into the lease.

The *Cassetto* decision, like *Loveday*, serves to highlight the far reaching implications of the determination of whether unextracted oil and gas is owned by the landowner or not. Different states have answered this question in different ways, and, while Ohio courts are split on the issue, the clear trend among the state's bankruptcy courts is to recognize the nonownership theory of oil and gas rights, which requires extraction of oil and gas to establish ownership.

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What Goes Up … Quick Glance #3 at Ohio Oil and Gas Leases in Bankruptcy

Aug. 2, 2013 | Andy Nicoll

As with our prior posts on oil and gas leases in bankruptcy (located here and here), this post presents another thorny issue – namely, "Is an oil and gas lease a lease at all?"

Whether an oil and gas lease is a "lease" is significant in the bankruptcy context, because the Bankruptcy Code has several provisions regarding the treatment of leases.

This post considers two cases that interpret 11 U.S.C. § 365(d)(4), which provides that unless the bankruptcy court orders an extension, "an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by … the date that is 120 days after the date of the order for relief [(typically, the commencement of the case)]…." The Code further provides that "the rejection of an … unexpired lease of the debtor constitutes a breach of such contract or lease … immediately before the date of the filing of the petition."

The Code's treatment of nonresidential real property leases stands in contrast to the general treatment of executory contracts, which, in a chapter 11 bankruptcy, generally may be assumed or rejected at any time prior to the confirmation of a plan of reorganization. Section 365(d)(4)'s provisions can be problematic for two reasons. First, in order to assume a nonresidential real property lease, a debtor must first cure any monetary default, which, depending of the amount owing, may be more difficult early in a bankruptcy. Second, the fact that nonresidential real property leases are treated differently than personal property leases and executory contracts occasionally results in an inattentive debtor's counsel missing this deadline, especially when the purported nonresidential real property lease is not a typical lease of commercial space.

In *In re Gasoil, Inc.*, 59 B.R. 804 (Bankr. N.D. Ohio 1986), the court concluded that an oil

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and gas lease is in fact a lease of nonresidential real property. After reviewing the requirement of Section 365(d)(4), the court reasoned that, at least as used in Section 365, the term "lease" was intended to be expansive. Indeed, 11 U.S.C. § 365(m) expressly provides that "[f]or purposes of this section 365 … leases of real property shall include any rental agreement to use real property." Given this language, the court concluded that "[i]t 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 section 365, they are 'leases' since they at least convey a right to use real property." As to whether such leases were of nonresidential real property, even when the parcel to which the lease related may serve as a residence, the court noted:

[T]here is in each lease a requirement that no well be drilled closer than 200 feet to a residence. Even if these parcels do have people residing on them, Gasoil's use would not affect those portions where persons do reside. … Under Ohio law, the real property that Gasoil has leased is the landowner's right to drill for the oil or gas underneath his land. It is not a lease of the surface per se, and is not a lease of real property where human beings reside.

Accordingly, the court found the leases to be of nonresidential real property subject to Section 365(d)(4).

However, in *In re Frederick Petroleum Corporation*, 98 B.R. 762 (S.D. Ohio 1989), the court rejected the reasoning in Gasoil, holding instead that Section 365(d)(4) was inapplicable to oil and gas leases under Ohio law. The court examined several Ohio cases that alternatively described an oil and gas "lease" as: a lease, *Langmede v. Weaver*, 65 Ohio St. 17, 60 N.E. 992 (1901) (for purposes of Ohio's attestation requirements); a "chattel real or estate for years," *Acklin v. Waltermier*, 19 Ohio C.C. 872 (1899) (for recording and levy purposes); a license or lease at will, *Jones v. Wood*, 9 Ohio C.C. 560 (1895); a sale of the oil and gas with a corresponding license to enter real property, *Miller v. Vandergrift*, 12 Ohio C.C. (n.s.) 475 (1892); an incorporeal hereditament entitling the purported lessee "the right to enter upon the land, to sink its wells, and to take from underneath the soil such oil as it may find," *Hollister v. Vandergrift*, 12 Ohio C.C. (n.s.) 586, 590 (1892); "not strictly a lease, but a license coupled with a conditional grant, conveying the grantor's interest in the gas well, conditioned that gas or oil is found in paying quantities," *Herrington v. Wood*, 6 Ohio C.C. 326, 330 (1892); a right to possession that is "not an estate in the land," that, upon discovery of oil or gas vests into an estate, *Tucker v. Watts*, 1 Ohio C.C. (n.s.) 589, 592–593; a grant, demise, and let of land for the limited purpose and period named in the lease — more than a mere license; it is a lease of the land for the purpose and period limited in the lease, Harris v. Ohio Oil Co., 57 Ohio St. 118, 48 N.E. 502 (1897).

Finally, the court discussed the more recent case of *Back v. Ohio Fuel Gas Co.*, 160 Ohio St. 81, 113 N.E.2d 865 (1953), which it found most instructive. In *Back*, the Ohio Supreme Court held that an outright assignment of unextracted oil and gas was in the nature of a license rather than assignment of a fee interest. Noting that both the agreement at issue in *Harris* and the one before it purported to transfer unextracted oil and gas with the exclusive right to extract, the *Frederick Petroleum*

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court reasoned that its purported lease must also be a license. The court then noted that an Oklahoma court found an oil and gas lease to be a license and it, together with another Oklahoma case and an Illinois case, concluded that Section 365(d)(4) does not apply to such purported leases. Based on *Back* and these Oklahoma and Illinois cases, the court reasoned that:

> [T]he Ohio courts appear to recognize that such leases create a license to enter upon the land for the purpose of exploring and drilling for oil and gas, and any oil and gas produced under the terms of the lease becomes the personal property of the lessee, with the exception of the one-eighth royalty reserved by the lessor. The court feels that the Ohio courts, if given the opportunity to do so, would characterize the property interest involved as being like or similar to the interest recognized under Oklahoma law.

As such, the court concludes that oil and gas leases are not leases for purposes of 11 U.S.C § 365(d)(4).

Neither *Gasoil* nor *Frederick Petroleum* have ever been cited by any subsequent court, so you might be tempted to believe that Frederick Petroleum — being more recent, entered by a higher court, and engaging in a more robust examination of the relevant case law and legislative history (which we did not examine in this post), is the correct holding, but I have my doubts.

For starters, the facts of *Back v. Ohio Fuel Gas Co.* (the case holding the agreement at issue was in fact a license) are not as similar to the facts at issue in *Frederick Petroleum* as the *Frederick Petroleum* court would have you believe. Yes, the *Back* court did find it was dealing with a license, but it was not choosing between a license and a lease; it was choosing between a deed (which was to be filed with one set of real property records) and a lease or a license (which was required to be filed with a different set of property records). The agreement at issue purported to be an outright transfer of unextracted oil and gas, and in support of such an outright transfer, the agreement used granting language and purported to transfer such rights in perpetuity without the possibility of defeasment upon the happening of any condition. Furthermore, the *Back* agreement did not provide for the payment of any rent or royalty. As such, the oil company/purported lessee, who had recorded the agreement with the county's leases and licenses, was forced to acknowledge:

> Admittedly, the instrument in question is not a 'lease' because it grants rights in perpetuity, reserves nothing in the nature of rent, and the rights granted are not subject to defeasement upon the happening of any conditions.

Given the oil company's acknowledgement that it was not dealing with a lease, the court had to choose between a deed, supported by the agreement's language purporting to be an outright transfer of oil and gas, and a license. The court apparently, though not explicitly, espoused the "nonownership" theory of oil and gas rights (see our prior post here and here), concluding the agreement's assignment language was illusory because the purported lessor did not have any ownership rights to the

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unextracted oil and gas to transfer in the first place. Thus, the agreement did not transfer any property right and was not a deed. As the court reasoned, the agreement fell squarely in those to be recorded with the leases and licenses, which by statute included "[a]ll leases and licenses … given … for, upon, or concerning lands or tenements in this state, whereby any right is given or granted to operate, or to sink or drill wells thereon for natural gas and petroleum or either, or pertaining thereto."

If the agreement at issue in *Back* did not grant rights in perpetuity without the possibility of defeasement or if the agreement provided for something in the nature of rent, the Back court might well have found it to be a lease rather than a license (although it probably would not have chosen between a lease or a license because both types of instruments were filed in the same set of county records). But, while the instrument in Back lacked these two features, the agreement in *Frederick Petroleum* (as with most modern Ohio oil and gas leases) would expire for lack of production and it provided for the "payment of royalties in the form of a one-eighth part of the oil and gas produced, plus a sum referred to as 'delayed rentals' … payable each quarter until a well is constructed." Would this have been enough for the Back court to conclude that the agreement involved was a lease?

Ultimately, whether an Ohio oil and gas lease is a lease under the Bankruptcy Code may depend in large part on the language of the lease itself (individual leases vary widely) and the court considering the issue. *See e.g., Kramer v. PAC Drilling Oil & Gas, LLC*, 197 Ohio App. 3d 554, (Ohio Ct. App., Wayne County 2011) (relying principally on pre-Back cases and without discussing Back and holding that the terms of the lease before it created fee-simple determinable in an oil and gas estate subject to the possibility of reverter and not a lease.)

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