ORRIs, NPIs, and VPPs: Considerations for the Current Financial Environment

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In light of the recent drop in oil prices, it is no surprise that the availability of continuing liquidity for some oil and gas producers is a matter of concern. Overriding royalty interests, net profits interests and production payments have been used for decades by oil and gas exploration and production companies as mechanisms for obtaining liquidity by monetizing the future production of oil and gas. These transactions can offer a number of benefits to both sides of the transaction; in the present context, for the producer, the chief benefit is liquidity where more "traditional" bank financing is not available on attractive terms. However, these transactions also present unique risks to the financing party that should be accounted for, particularly in situations where there is a perceived risk of insolvency or bankruptcy.

ORRI and NPI-type transactions are frequently entered into with an understanding by the parties to the transaction that the interest being transferred is an absolute conveyance of a real property interest, to be held for the term of the ORRI by the entity "purchasing" the production payment. The characterization of the interest as real property versus merely collateral securing a financing transaction (or perhaps an unsecured loan) becomes key if the question of who retains ultimate ownership of the property, and is thus first in line to receive the proceeds from production, is raised in a litigation proceeding, such as—for instance—a bankruptcy proceeding.

The most recent judicial commentary on the issue, which came in the form of decisions issued in some of the adversary proceedings brought as part of the *ATP* bankruptcy proceedings in the Southern District of Texas, suggests that the characterization of these interests in litigation, *i.e.*, treatment as the transfer of an interest in real property or as a form of debt financing, is not nearly as predictable as many previously believed.[1] The real-world effect of a potential recharacterization will, of course, vary based on the circumstances. For instance, in bankruptcy, characterizing the transfer as an absolute conveyance of real property results in the exclusion of the interest from the debtor's bankruptcy estate, while treating the transfer as a collateral interest to secure a debt financing transaction means that the interest will remain part of the estate of the debtor and subject to the jurisdiction of the bankruptcy court, where the transferee may be standing in line with or without priority over the rest of the creditors. In short, in light of the *ATP* decisions, understanding the potential risks of these transactions, and considering the ways to try to minimize those risks, will be important to any parties who wish to engage in these transactions going forward.

Prior to its bankruptcy, ATP had entered into a number of production payment transactions that were characterized in the transaction documents as ORRIs and NPIs, involving properties located in federal waters on the Outer Continental Shelf adjacent to Louisiana. In the bankruptcy proceeding, the debtor obtained an order permitting continued payment to the holders of these interests, subject to their agreement to repay any such payments if it were subsequently determined that the transactions constituted financings rather than real property transfers. Most holders agreed to the terms, but several brought adversary claims, contending that their ORRI and NPI interests constituted interests in real property, thus excluding those interests from the debtor's estate. In response, ATP, as debtor in possession, acting to maximize the value of the estate, argued that the ORRI and NPI interests should be considered "disguised financings," as opposed to absolute conveyances, or "true sales," of real property interests, such that the underlying assets would be considered part of the bankruptcy estate.

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[1] *See In re: ATP Oil & Gas Corp.*, 2014 Bankr. LEXIS 33 (S.D. Tex. Bankr., Jan. 6, 2014) (Case No. 12-36187, Adversary No. 12-03443); *In re: ATP Oil & Gas Corp.*, 497 B.R. 238 (S.D. Tex. Bankr. 2013) (Case No. 12-36187, Adversary Nos. 12-03425, 12-03429).

The transactions at issue in the *ATP* adversary proceedings involved two broad categories of grantees: vendors and capital providers. The vendors were oilfield service providers who originally provided vendor services to ATP in return for payment in cash, but, in the face of the 2009 market downturn, agreed to accept payment in the form of NPIs instead. The capital providers were made up of funds and other investment vehicles and provided liquidity in return for the transfer of ORRI interests. Neither the vendors nor the capital providers were operators of oil and gas properties, and ATP remained operator of these properties. All of the challenged production payment transactions were "term," as opposed to "perpetual," conveyances. With a "term" conveyance, upon repayment of a specified amount of funds, plus, in general, a designated internal rate of return ("IRR") or return on investment ("ROI"), the interest terminates and that share of production reverts back to the grantor.

The holders of the term ORRI and NPI interests acquired from ATP moved for summary judgment on the characterization issue, arguing that as a matter of Louisiana state law such interests are absolute conveyances of real property interests. The Bankruptcy Court for the Southern District of Texas denied summary judgment, holding that there was a genuine issue of material fact as to the economic substance of the transactions. The court held that under the Louisiana Supreme Court's decision in *Howard Trucking Co. v. Stassi*, 474 So.2d 915 (La. 1986), the proper characterization of the transactions depended on the true commercial nature of the transaction, notwithstanding the explicit language of the transaction documents. the court concluded that the best evidence of the parties' intent as to characterization is "what the parties agreed to do," i.e., the "economic substance of the transactions," not the description of the transaction set out in the transaction documents.[2] In concluding that there was a genuine issue of

[2] *See In re: ATP Oil & Gas Corp.*, 497 B.R. at 244-45, 248-55; *In re ATP Oil & Gas Corp.*, 2014 Banrk. LEXIS 33, * 10-58.

material fact as to the economic substance of the transactions at issue, the court focused on the economic terms and circumstances of the transactions, including:

- the use of a designated IRR and cash-on-cash hurdles (ROI) that were to be paid to the interest-holder on top of the "purchase" price, provisions that ATP argued are analytically equivalent to the payment of interest on a loan;
- in certain instances ATP, as opposed to the interest holders, took the risk of performance and was responsible for ensuring that the buyers achieved their designated IRR and ROI;
- certain transactions provided for conditional increases in distribution and royalty percentages, such that royalty percentages increased if ATP failed to reach certain milestones by a given date;
- certain transactions provided for cross-collateralization, such that the buyer was entitled to receive full amount of its production payment across multiple leases, even where one lease ceased production; and
- certain transactions contained a protective mortgage, i.e., a security agreement that granted a security interest in the specified amounts owed to the buyer, which would take effect in the event a court found the interests did not constitute real property interests.[3]

The bankruptcy court's decision was the first time this economic substance argument had been addressed by a court in the specific context of production payment transactions. The holders of the ORRI and NPI interests subsequently filed an appeal with the United States District Court for the Southern District of Texas, challenging the bankruptcy court's denial of summary judgment. The district court ultimately denied leave to appeal, agreeing with the bankruptcy court that the appeal presented fact issues necessitating a trial on the merits rather than a pure legal question.[4]

It is unclear what the outcome would be if a final determination of this issue were made at trial. For now, the bankruptcy court's opinion denying summary judgment is the final word on

[3] *See id*.
[4] *See In re: ATP Oil & Gas Corp.*, Case No. 4:13-cv-02377, Dkt. No. 17 (S.D. Tex., Jan. 28, 2014) ("this appeal does not present a pure legal question. . . . deciding this appeal would likely require the construction of the meaning and import of a particular instrument's language . . ."); *In re: ATP Oil & Gas Corp.*, Case No. 4:13-cv-02381, Dkt. No. 17 (S.D. Tex., Jan. 28, 2014) (denying motion for leave to appeal on same grounds).

the subject. In addition, it should be noted that different courts outside the Southern District of Texas, applying different state laws, could reach different conclusions. On the other hand, most states have some legal authority, albeit not in the context of production payments, that addresses potential recharacterization issues in a manner similar to the Louisiana Supreme Court's approach in *Howard Trucking*. In short, there is now enough murkiness as to the potential outcome of a legal challenge to production payment transactions on the basis of "true economic substance" that future challenges are more likely in any proceedings where the legal characterization of the property interest will have a substantial effect on the financial outcome of the proceedings. And the one thing that is clear is that, in most cases, the legal characterization of term ORRIs, NPIs, and VPPs—at least for bankruptcy purposes on properties located in federal waters adjacent to Louisiana—is going to be highly fact-specific.

So what are purchasers of ORRIs, NPIs and VPPs to do to try to mitigate risk going forward? First, it is important to note that there is no clear answer. Decisions in the ATP cases—if they reach that point—may provide some clarity, but may also leave uncertainty about how other courts will handle the issue with different facts and different applicable law in the future. Paying attention to what happens in the courts will be key. Financing parties ought to be taking the usual steps to mitigate risk:

- Draft documents that are clear and effective under local law.
- Know what state law in the relevant state says about the characterization of ORRIs, NPIs, and PPs: are they considered real property interests, or loan financings?
- Know the basic nut and bolts of how the state's recording statutes work, and what interests the "purchaser" will take the production payment subject to.
- Obtain updated lien searches so as to know who is or might be senior to the production payment purchaser's interest.

- Consider obtaining liens on the production payment seller's remaining interest in the same properties to secure payment and performance of the production payment seller's operating covenants.

- Consider whether the trade payables are being kept current.

- Consider what sort of statutory M&M liens are available to lien claimants in the state, and how their lien priority might relate to other interests.

- Consider covenants limiting or prohibiting other senior debt or other obligations such as further production payment transactions.

- Size the transaction to account for the quantity of PDP reserves and for operating and production risk.

- Mitigate the commodity price risk and interest rate risk with hedging.

- Consider the existence of the factors focused on by the bankruptcy court in *ATP*.

- Consider the likely economic consequences if the transaction were recharacterized as a loan.

- Evaluate the grantor's financial condition carefully to assess the potential for bankruptcy or other circumstances likely to put the characterization of these interests in issue.

In sum, there may well be no one specific item that will provide absolute protection for the purchasers of ORRIs, NPIs and PPs. However, an awareness of the risks will provide parties considering engaging in ORRI, NPI, and PP transactions with some level of comfort that they have done everything reasonably possible to protect themselves.