Lease Interest v. Financing: What Do I Have?

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Oil and Gas — Hot Issues and Recent Cases
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ABCS OF NPIS, ORRIS AND VPPS

- Borrower conveys property interests via ORI, VPP, NPI
  - **ORI**: interest in production free of expense
  - **VPP** (“Term ORI”): interest in limited fixed quantity of product, free of expense
  - **NPI**: share of production burdened by certain expenses

- Bankruptcy risk of recharacterization as:
  - Secured claim (subject to cram down)
  - Unsecured claim (subject to discharge)
  - Executory contract (subject to rejection)
  - Fraudulent transfer (subject to avoidance)

- Example: *ATP Oil & Gas*

ABCS OF NPIS, ORRIS AND VPPS

Overriding Royalty Interest

- Override, ORRI, ORI
- "A non-expense bearing interest in oil and gas produced and saved, ***free of the expense of production***…"
  - Free of exploration and production expenses
  - "At the well" - bears its share of "post-production" expenses (transportation, processing, treatment and marketing)
  - Ad valorem, production, severance, gathering and other taxes chargeable against the Overriding Royalty Interest
- Interest in "production" – ORRI holder has a right to accept production in-kind, though rarely used and often waived
- Typically limited access to well information, operations

ABCS OF NPIS, ORRIS AND VPPS

Net Profits Interest

- "A share of gross production, measured by grantor's net profits from the operation of the property"
- Limited to revenue from production
- Similar to an ORI, except that certain costs are *deducted* from the gross proceeds
  - NPI holder must bear certain costs and expenses of production
- "Net" of What? – Need to itemize permitted charges and deductions
  - "Net" calculation cannot be less than $0 (i.e. require any payment from the NPI holder), but can carry-forward losses
- Are charges well-by-well or aggregated on a fieldwide basis?

ABCS OF NPIS, ORRIS AND VPPS

Volumetric Production Payments

- "An interest *limited to a fixed quantity of production*, free of the expense of production…"
  - Frequently called a "Term Overriding Royalty Interest"
- The VPP will terminate when the scheduled quantities have been delivered
  - Whereas ORIs and NPIs are often perpetual
- Non-Recourse outside of production volumes
- Production is often taken in-kind

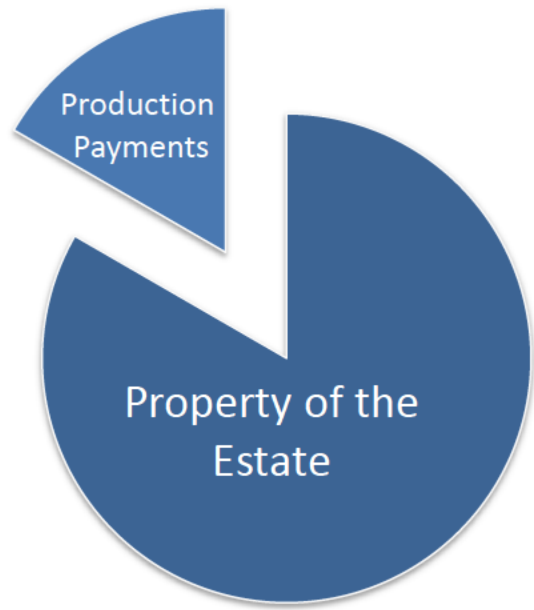
Treatment of ORRIs, NPIs, and VPPs in Bankruptcy

FINANCING TRANSACTIONS IN BANKRUPTCY

Property of the Estate

Section 541(b)(4)(B) excludes "Production Payments" from property of the estate

If not property of the estate, then:
- no automatic stay against collection
- debtor cannot use, sell or lease
- no treatment under plan



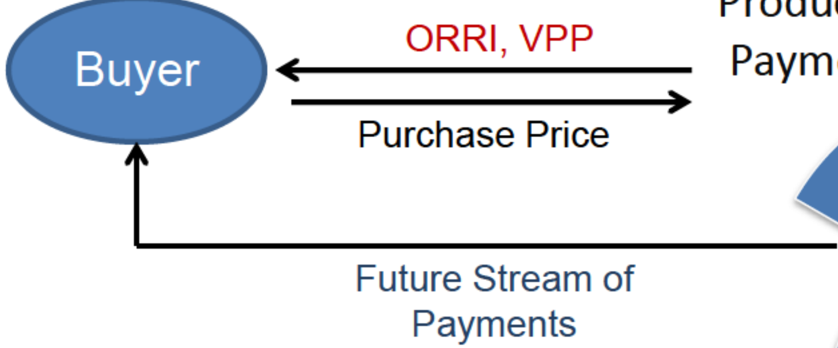
FINANCING TRANSACTIONS IN BANKRUPTCY

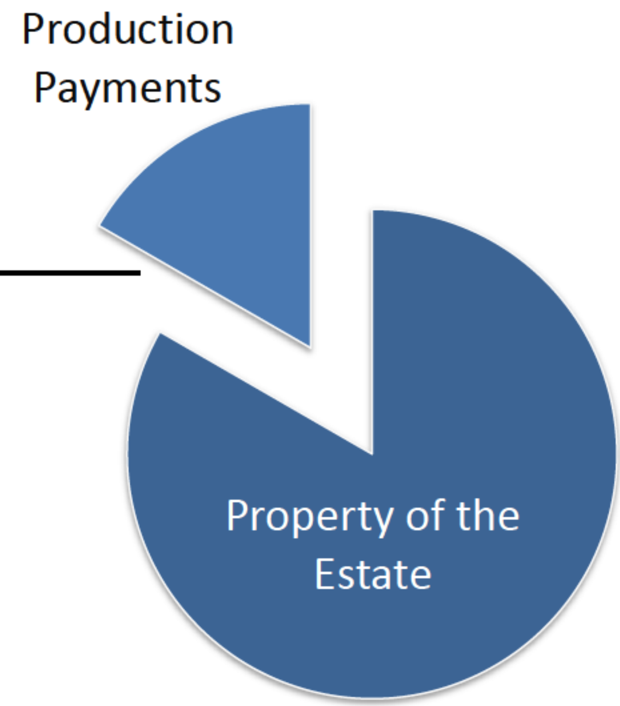
Bankruptcy Code Defines “Production Payment”

- “Production payment” is:
  - — Term ORRI
  - — Satisfiable in cash or in kind
  - — Contingent on production from particular property
  - — Specified volume or specified value from the hydrocarbons produced from such property
  - — Determined without regard to production costs
- NPIs do not fit the definition
- 11 U.S.C §101(42A)

FINANCING TRANSACTIONS IN BANKRUPTCY

Intended Treatment

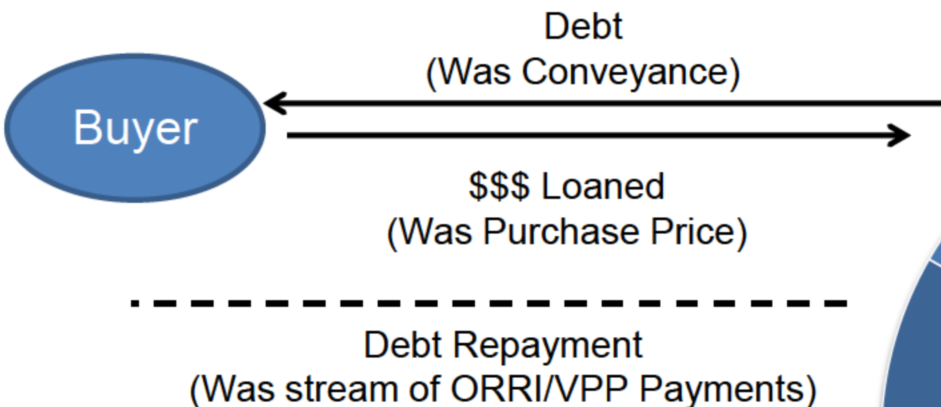


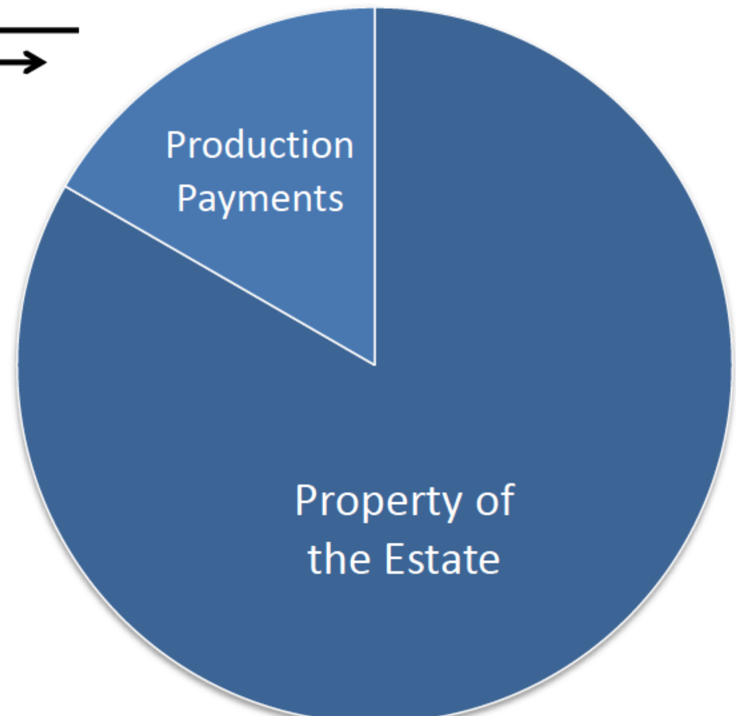


Distinguish between the original conveyance that created the ORRI or VPP and the future stream of payments that flow from that conveyance

FINANCING TRANSACTIONS IN BANKRUPTCY

Recharacterized as Disguised Financing



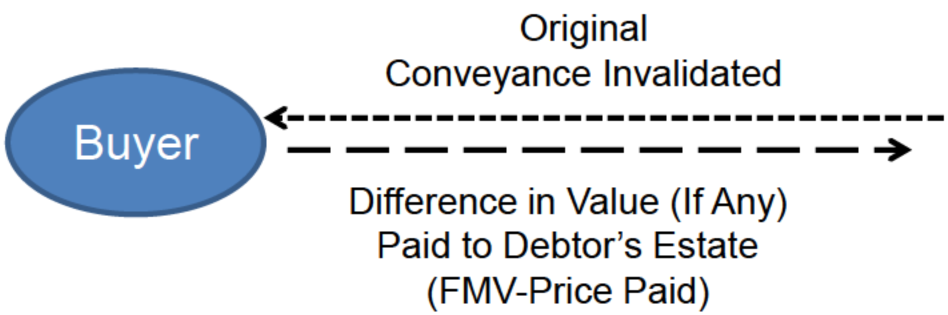


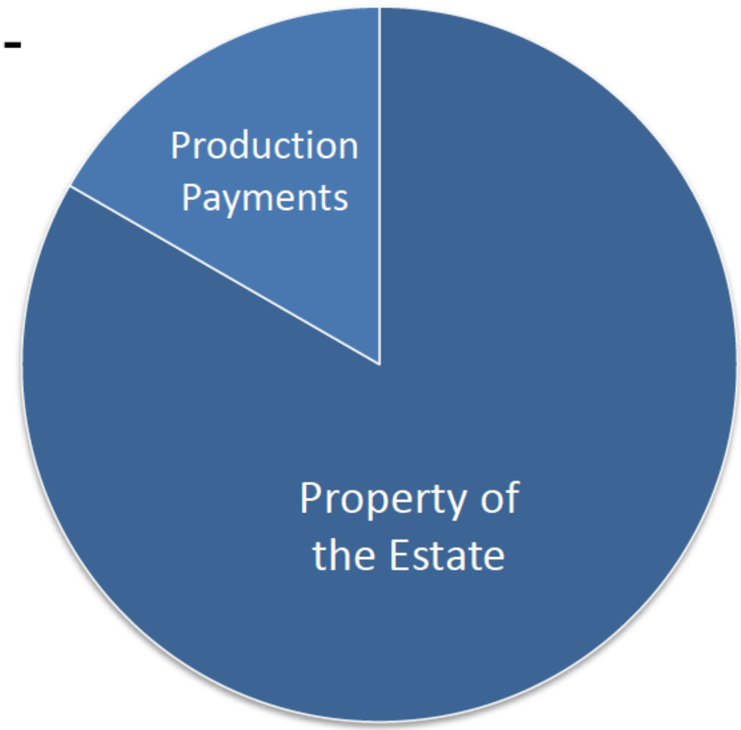
Potential consequences:

- Debt instead of conveyance
- Property of estate
- Prepetition preference payments
- Post-petition avoidable transfers
- Debt undersecured (or unsecured)
- Debt treated under plan
- 363 sale of collateral

FINANCING TRANSACTIONS IN BANKRUPTCY

Fraudulent Conveyance



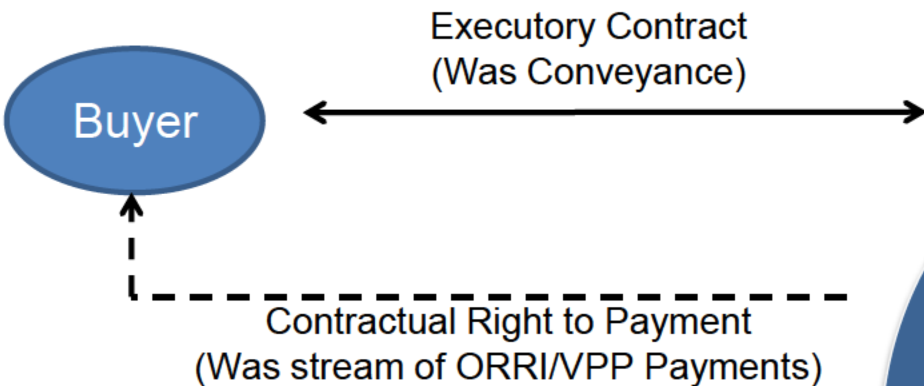


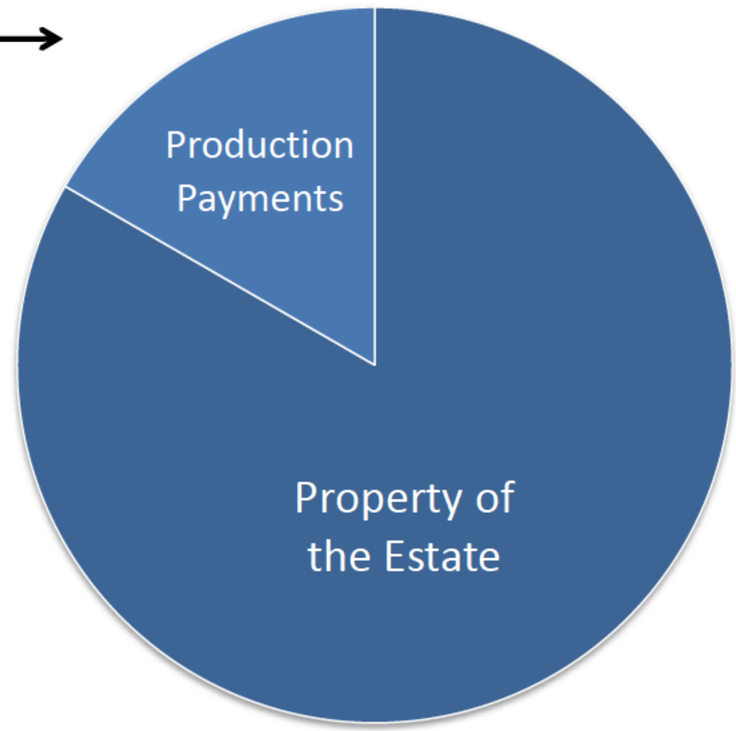
Potential consequences:

- Conveyance avoided
- Property of estate
- Unsecured claim

FINANCING TRANSACTIONS IN BANKRUPTCY

Executory Contracts





Consequences

- Subject to rejection
- Property of estate
- No collateral or security interest
- Unsecured claim for rejection damages

OVERVIEW OF BANKRUPTCY ANALYSIS

Bankruptcy Risk Landscape

Original Conveyance Transaction
(Creation of VPP, ORRI, Production Payment)

True Conveyance?

Fraudulent Conveyance?

YES

- Conveyance avoided
- Property of estate
- Unsecured claim

NO

- 541(b)(4)(B)
- Not property of estate
- Keep payments

Disguised Financing?

- Debt instead of conveyance
- Property of the estate
- Potential preference
- Post-petition transfers
- Debt undersecured
- Debt treated under a plan
- 363 sale of collateral

Executory Contract?

- Rejection of Contract
- Property of the estate
- No collateral or security interest
- Unsecured claim for rejection damages

Rethinking ORRIs and VPPs
ATP Bankruptcy Case

ATP BANKRUPTCY CASE OVERVIEW

- Offshore oil and gas production in Gulf of Mexico
- Numerous operational issues led to decreased revenue and increased expenses
- During Chapter 11, defaulted under $800 MM DIP facility
- DIP lenders acquired assets through credit bid
- Case converted to Chapter 7 in June 2014

ORI/NPI LITIGATION

- ATP raised $500 MM pre-bankruptcy through assignment of ORRI/NPI interests
- After filing, ATP alleged that ORRI/NPI interests may be “disguised financing transactions” that remain property of ATP
- ORRI/NPI holders sued for determination that transfers were true sales of real property interests (not disguised financing)

ORI/NPI LITIGATION

Summary Judgment Issues

- ORRI/NPI holders requested summary judgment that they (rather than ATP) own the interests
- Court denied summary judgment, finding that there are issues of fact with respect to the “economic substance” of the ORRI/NPI transactions
  - Court scrutinized the ORRI/NPI transactions to evaluate whether the “economic substance” was more like a sale of a real property interest or more like a loan

Specific Deal Points Scrutinized by Court

Original Conveyance Transaction
(ATP's Conveyance of ORRIs and NPIs)

True Conveyance?

Fraudulent Conveyance?

YES

- Conveyance avoided
- Property of estate
- Unsecured claim

NO

- 541(b)(4)(B)
- Not property of estate
- Keep payments

Disguised Financing?

- Debt instead of conveyance
- Property of the estate
- Potential preference
- Post-petition transfers
- Debt undersecured
- Attachment and priority of liens

Deal Points:

Internal rate of return

Recordation of mortgage by ORRI/NPI holders

Payment of ORRIs/NPIs from production from multiple leases

Increase in royalty percentage if certain payment milestones not met

Subordination of ORRIs/NPIs to other interests

ORI/NPI LITIGATION

Current Status

- Summary judgment denied in 3 proceedings
- Court found asset purchaser, Bennu Oil & Gas, holds exclusive right to pursue ATP’s claims to recharacterize ORRIs/NPIs
- Chapter 7 Trustee holds exclusive right to avoid payments made to ORRI/NPI holders under Sections 547 and 548
- Court found prepetition payments to ORRI/NPI holders may be avoidable as preferences regardless of outcome of recharacterization claims
- Bottom Line: outcome of litigation remains uncertain

Appendix 1

Structure and Documentation of ORRIs, NPIs, and VPPs

ORRI & NPI STRUCTURE AND CALCULATION

- Common structures
  - Fixed percentage
  - Reducing percentage – set percentage until a “target”
    - i.e. an IRR or cash-on-cash calculation based upon equity contribution or debt provided
  - “Convertible” Interest – a fixed ORRI that converts to an NPI upon a “conversion event”
    - i.e. repayment of a loan facility, pay-out, etc.
- Calculated based upon specific wells, leases, fields or AMI
- NPI cannot be supplemented post-conveyance without inviting potential scrutiny

ORRI & NPI DOCUMENTATION

- Document "light"
- In non-equity kicker transactions, a modified oil and gas purchase and sale agreement
- Typically, a single conveyance document
  - Setting forth the calculations, deductions and other mechanics
- A short form memorandum is recorded in the county where the leases are located
- Performance obligations can be secured by a mortgage

VPP STRUCTURE AND DOCUMENTATION

- Calculated as a percentage of production, with a daily minimum and maximum volume requirements
  - Subject to make-up volumes
  - Limited volumes are <u>reserved by the VPP Grantor</u> to cover LOE and other costs of development and production
  - Liquids treatment varies
- Production and Marketing Agreement
  - Marketing requirement (some include repurchase obligation by VPP Grantor)
  - Operational covenants
  - <u>Mortgage lien</u> granted to secures grantor's obligation under the PMA – but not the delivery requirement

Appendix 2

Key Considerations When Documenting ORRIs, NPIs, and VPPs

GENERAL CONSIDERATIONS

- Savings Provisions
  - Prevention of top leases, application to lease renewal and extension
  - Pooling and unitization coverage
- Operational covenants
  - Alignment of interests inversely proportional to the ORRI, NPI and VPP percentage
- Tag/Drag/Call Rights
- Consider access to reserve and geological/geophysical information – increased marketability and future ability to leverage asset

LIMIT RECOURSE TO PRODUCTION

- If there is no production, the grantor never comes "out of pocket" to pay any amounts to the ORI/NPI or VPP grantee
- With a VPP, if there is no production, the monthly production or cash payment obligation can roll to the next month
  - But if the properties never produce, the VPP grantor does not owe any money to the grantee
- With an NPI, deductions can result in an NPI account totaling zero, but if costs continually outweigh proceeds of production, the NPI grantee is not owed any additional amounts
- Simply, the ORI/NPI and VPP grantee must bear production risk
  - No unconditional payment obligations permitted

MORTGAGE AND SECURITY

- ORI/NPIs and VPPs often have a mortgage securing the performance obligations of the grantor
  - To prudently operate the properties
  - To market production
- Production shortfalls, or the failure of wells to produce, alone cannot create a default
  - Cannot secure a guaranteed rate of return or create an obligation to produce hydrocarbons
  - i.e. mortgage cannot require delivery of volumes or proceeds of production, of any quantity or amount, under a security document
- "Back up" security, provided in the event the conveyance is not a "true sale," should be carefully considered

CERTAINTY IN CALCULATION

- Must be finite and calculable based upon the properties included in the original grant
- No supplemental conveyances to "shore up" production risk
  - "Springing" or increasing interests in other wells, leases or fields permitted, though a point of criticism in ATP
- Cannot obligate the grantor to pay amounts in excess of the grantor's represented net revenue interest
- Cannot obligate grantor to pay under the ORI/NPI/VPP to the extent the purchaser has not paid proceeds to the grantor

THINK TWICE, E-MAIL ONCE

- ATP sought to discover "extrinsic" evidence related to the ORIs to prove that the transactions were structured similar to a bond or loan transaction
- E-mail correspondence (and term sheets) that analogize a NPI/ORI/VPP to a loan, with an imputed interest, can be highly prejudicial
- Merely copying internal or external legal counsel on <u>internal</u> communications will not prevent discovery
  - Legal advice must be sought or provided for communication to become privileged