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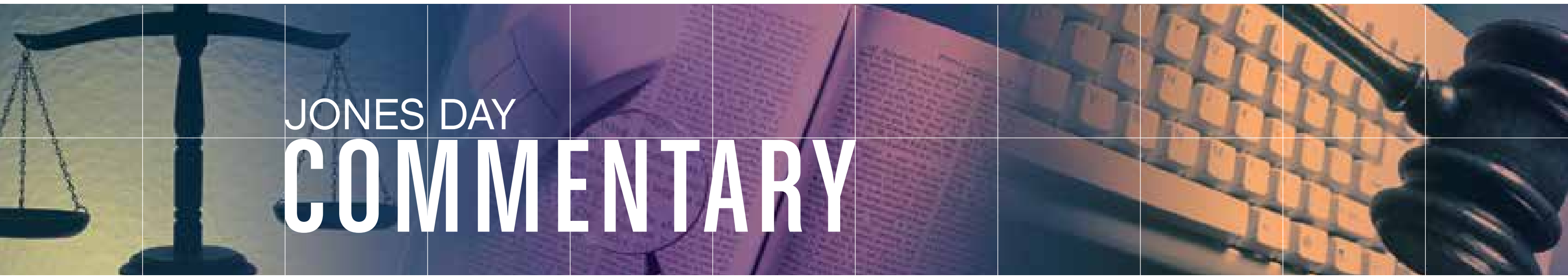

NGP v. ATP: SHOULD OVERRIDING ROYALTY INTEREST OWNERS BE CONCERNED?

A recent bankruptcy court decision denying a royalty owner's motion for summary judgment is highly relevant to any investor that currently owns a term royalty interest or is considering such an investment. The United States Bankruptcy Court for the Southern District of Texas found in *NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil & Gas Corp.)*, No. 12-3443, 2014 Bankr. LEXIS 33 (Bankr. S.D. Tex. Jan. 6, 2014) that issues of material fact existed regarding whether certain prepetition term overriding royalty transactions were properly characterized as debt financings or real property transactions. While the court's conclusions in *ATP* were made in connection with a summary judgment decision, the issues raised in the case are of significance to parties currently involved in or considering overriding royalty transactions because the court's opinion opens the door to the possibility that a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") may be able to recharacterize such transactions as loans to the severe detriment of the royalty owners.

TERM OVERRIDING ROYALTY INTERESTS IN BANKRUPTCY

Term overriding royalty interests are oil and gas interests in which the owner receives a share of oil and gas produced at the surface, free of the costs of production. Term overriding royalty interests are limited interests in that they terminate upon the occurrence of specified conditions, such as the achievement of a particular volume of production or the realization of a specified sum from the sale of oil or gas. Term overriding royalty interests are often described in the industry as being similar to a "loan" that is repaid through the production or monetization of oil and gas. Even so, while term overriding royalty interests may appear to have many characteristics of a loan, they are generally characterized by state law as transfers of interests in real property that have a limited duration or amount.

The real property transfer character of these transactions has important implications in bankruptcy. If a prepetition overriding royalty interest transaction is characterized as a transfer of real property (i.e., a sale), then the interest has effectively been transferred from the debtor's ownership and is not part of the bankruptcy estate. *See* 11 U.S.C. § 541(b)(4). The trustee or DIP, therefore, has no power to sell, assign, or transfer the interest. Additionally, if the transaction is considered a sale that is substantially completed prepetition, the transaction is not subject to the power of a trustee or DIP to assume and assign or reject executory contracts. Thus, if an overriding royalty transaction is considered a prepetition transfer of real property, the transaction will be immune from many of the powers of a bankruptcy trustee or DIP.

Recognizing the real property transfer nature of an overriding royalty interest, the Bankruptcy Code provides protection to owners of certain categories of overriding royalty interests. For instance, section 541(b)(4)(B) specifically 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 [as defined by section 101(42A)] to an entity that does not participate in the operation of the property from which such production payment is transferred…." Because a "production payment" is defined by section 101(42A) of the Bankruptcy Code as a type of "term overriding royalty," this provision specifically excludes certain overriding royalty interests from property of the estate. However, the Bankruptcy Code is not the end of the analysis.

Even if an overriding royalty transaction does not fit strictly within the Bankruptcy Code's provisions related to certain overriding royalty transactions, the transaction may nevertheless be excluded from the debtor's estate and therefore protected based on state law. Conversely, even if a transaction appears to fit within the Bankruptcy Code's provisions excluding certain overriding royalty interests from property of the estate, the transaction may nevertheless fail to qualify as a "transfer" of an "interest" of the debtor if the court determines, as a threshold matter, that the overriding royalty transaction is not a "transfer," but rather a disguised financing under applicable state law.

Parties frequently go to great lengths to include express provisions demonstrating the real property transfer character of the transaction in the underlying transactional documents (which are typically styled as conveyances and/or purchase and sale agreements). However, a recent bankruptcy court decision from the Southern District of Texas calls into question the long-standing treatment of these transactions as real property transfers.

NGP CAPITAL RESOURCES CO. v. ATP OIL & GAS CORP. (IN RE ATP OIL & GAS CORP.)

In an uncommon move for an operator in chapter 11, ATP Oil & Gas Corporation ("ATP") went on the offensive against its royalty investors soon after the commencement of its bankruptcy case, and it indicated that it would seek to recharacterize a number of overriding royalty interest transactions as debt financings. Before determining whether the overriding royalty interests were excluded from property of ATP's estate under the terms of the Bankruptcy Code, the court first sought to determine whether certain purported overriding royalty transactions were actually real property conveyances (as the documents themselves suggested) or whether they were debt instruments (based on the "economic substance" of the transactions) under applicable state law.

Some of the contested transactions involved NGP Capital Resources Company ("NGP"). Prepetition, ATP and NGP entered into a series of agreements that the parties characterized as overriding royalty transactions (the "ORRI Transactions"). Under the ORRI Transactions, NGP purchased term overriding royalty interests ("Term ORRIs") related to six leases on two properties for a total purchase price of $65 million. Pursuant to the relevant documents, the Term ORRIs would remain in effect until the cumulative royalty payments received by NGP equaled the original purchase price plus interest at a "Notional Rate" of 13.2 percent per year. Further, if ATP was late in making payments, NGP could impose a default rate of 14.5 percent per year. In effect, these provisions virtually guaranteed NGP a certain rate of return regardless of the rate of production, oil and gas prices, or ATP's interest in the leases. In fact, due to the structure of the interest rate provisions, NGP actually stood to earn more from the agreement if oil and gas production was low. In other words, the interest rate provisions effectively shifted the risk of loss on the investment to ATP.

ATP argued, among other things, that the interest rate provisions were inconsistent with the definition of a term overriding royalty interest under Louisiana law. NGP countered that the text of the Louisiana Mineral Code was broad enough to encompass a term override with these types of provisions. The bankruptcy court ultimately rejected NGP's argument that Louisiana law was as broad as NGP suggested and went on to examine the transaction's provisions in detail to determine whether they were consistent with the transfer of an overriding royalty interest under Louisiana law.

As an initial matter, the court rejected the proposition that the ORRI Transactions were secured financing transactions. However, the court found that at least four aspects of the transactions resembled an unsecured debt financing transaction. First, the parties treated the NGP transaction like a loan, and NGP represented it as one to the public. Second, the transaction had several characteristics of a loan under accounting standards, including GAAP. Third, the parties treated the transaction as a loan for tax purposes. Fourth (and most importantly), because of the interest rate provisions, income from the Term ORRIs did not fluctuate based upon the revenues from the properties. Rather, NGP's rate of return remained relatively constant. Thus, although the court found that ATP was expressly not obligated to repay any amount to NGP and its obligation to make payments was, on the face of the documents, entirely contingent on the production of oil, it also concluded that the economic substance of the transaction appeared to make the production condition "an artificial one." As the court noted: "An ORRI that is virtually certain to be satisfied in full from production is the economic equivalent of an 'obligation to repay'" or an unsecured loan.

CONCLUSION

While the court's ruling in *ATP* was a denial of NGP's summary judgment motion and NGP may ultimately prevail at trial, the issues raised in the case are of significance to parties entering into overriding royalty transactions. Specifically, the *ATP* decision suggests that despite artful drafting and the long-standing treatment of such transactions as real property transfers, a bankruptcy trustee or DIP may be able to recharacterize a Term ORRI transaction as an unsecured financing, to the detriment of the royalty owner. Further, given ATP's success in surviving a motion for summary judgment, there is the potential that more debtors may take a similar approach, potentially adding more uncertainty to transactions that were once thought to be untouchable in the oil and gas industry.

ATP may eventually be regarded as an extraordinary situation, but time will tell if there is indeed any lasting precedent generated. Accordingly, parties entering into overriding royalty transactions should review the court's ruling in *ATP* to better understand the risks, and structure their transactions to minimize those risks.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Thomas A. Howley
Houston
+1.832.239.3790
tahowley@jonesday.com

Scott Schwind
Houston
+1.832.239.3710
sschwind@jonesday.com

Locke R. McMurray
New York
+1.212.326.3774
lmcmurray@jonesday.com

Paul M. Green
Houston
+1.832.239.3892
pmgreen@jonesday.com

Jeffrey A. Schlegel
Houston
+1.832.239.3728
jaschlegel@jonesday.com