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Protections for Oil and Gas Operators and Working Interest Owners in a Bust Cycle

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Still-plummeting energy prices have wreaked havoc on a multitude of fallen and falling exploration and production companies. Among the wounded are a collection of foundering oil and gas operators and working interest owners struggling to maintain their businesses. As partners in joint development operations are unable or unwilling to pay their bills, these partners seek advice about how to withstand the challenges in the current climate. This article presents a number of legal tools and strategies to help owners and operators mitigate the risks of nonpayment and manage the onslaught of distressed operations.

Setoff and Recoupment

One legal doctrine available to help joint owners of production is the doctrine of setoff. In general, the equitable concept of setoff is broad enough to permit setoff of mutual debts, even if the mutual obligations arise from different transactions. As stated by the U.S. Supreme Court, "[t]he right of setoff (also called 'offset') allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[1] Thus, an operator or working interest owner that is owed money by another owner may net or offset the debt owed by that owner against obligations to be paid, and this remains true even if the mutual obligations are owed on unrelated wells, properties or projects. For example, if A and B were jointly developing two properties and B failed to pay its share of operation costs on one of them, A (as an operator) could withhold B's share of revenue from the other property.[2]

Setoff is an equitable doctrine that arises under nonbankruptcy law, but in bankruptcy cases, the Bankruptcy Code expressly recognizes the doctrine, with certain limitations. Thus, § 553 of the Bankruptcy Code permits "a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case."[3] In essence, the Code incorporates the state law requirement that the debts that are owed be mutual and also requires that both debts arose prior to the bankruptcy filing. In addition, § 362(a)(7) of the Bankruptcy Code provides that the setoff of debt owing to the debtor against a claim against the debtor is subject to the automatic stay, meaning that post-bankruptcy, setoff may only be exercised after relief from stay is granted. Magically, if setoff is permitted, a creditor will collect 100 percent of the debt owed, rather than its potentially menial share of the estate pot as an unlucky unsecured creditor.

More powerful than setoff, the doctrine of recoupment — a kissing cousin to setoff — permits the offset of pre- and post-petition debt without the need to obtain stay relief.[4] In order to apply the doctrine of recoupment, though, the creditor must show that the mutual obligations owed to and from the debtor arise from "the same transaction."[5] Whether mutual obligations arise from a single transaction is a question of fact, but when mutual debts flow from a single contract, it should be easy to argue that the claims derive from the same transaction.[6] Accordingly, obligations owed under the same joint operating agreement might be recouped. Taking the concept one step further, where multiple joint operating agreements for different projects are specifically made subject to an overarching "netting agreement" between partners in which their intent to offset all mutual debts is clearly stated, the parties should be able to argue for recoupment under the same contract. The authors suggest that this device might be a practical mechanism to ensure that offset is available in bankruptcy.

Oil and Gas Lien Statutes

In general, a creditor's best protection against an insolvent or bankrupt debtor is a lien on the debtor's assets. Most states have enacted statutes

1 *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18-19, 116 S. Ct. 286, 289 (1995) (citing *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528, 33 S. Ct. 806, 808 (1913)). *See also Dakota Partners LLP v. Glopak Inc.*, 634 N.W.2d 520, 525 (N.D. 2001); *Forbes Equity Exch. Inc. v. Jensen*, 841 N.W.2d 759, 763 (N.D. 2014); *Capital Concepts Properties 85-1 v. Mut. First Inc.*, 35 F.3d 170 (5th Cir. 1994).

2 In *Anderson v. Vinson Exploration Inc.*, 832 S.W.2d 657, 666 (Tex. App. El Paso 1992, writ denied), an oil and gas operator asserted claims for nonpayment under a joint operating agreement. In this case, the claims of indebtedness involved the same parties and arose from the same general agreements, but originated with different leases. The court held that a claim for a credit that one party had paid on one lease could be set off against the amounts claimed on another lease. *Anderson*, *supra*, 832 S.W.2d at 666.

3 11 U.S.C. § 553.

4 *In re Mirant*, 318 B.R. 377, 380-82 (Bankr. N.D. Tex. 2004).

5 *In re Lawrence United Corp.*, 221 B.R. 661, 669 (Bankr. N.D.N.Y. 1998).

6 *In re Trans World Airlines Inc.*, 275 B.R. 712, 721 (Bankr. D. Del. 2002).

that create liens in oil and gas property for suppliers of goods and services. Although oil and gas service providers commonly use these statutes, cases have recognized that operators and working interest owners who develop oil and gas properties may also avail themselves of these statutory liens.[7] For example, the oil and gas lien statutes in North Dakota, Texas, Colorado and Wyoming may assist in providing an operator with additional remedies in the form of statutory liens.[8] In North Dakota, the Well or Pipeline Construction Lien statute defines those entitled to a lien as follows:

> Any person who shall, under contract with the owner of any leasehold for oil or gas purposes or any pipeline, perform any labor or furnish any material or services used or employed, or furnished to be used or employed in the drilling or operating of any oil or gas well upon such leasehold ... or in the constructing, putting together, or repairing of any material so used or employed, or furnished to be used or employed, is entitled to a lien under this chapter....[9]

Importantly, the term "contract" includes a "written or oral, express or implied, or partly express and partly implied" contract.[10]

The North Dakota statute expressly states that the lien extends to the whole of the leasehold to which the materials or services were furnished, all materials and fixtures owned by the owner of such leasehold and used or employed in the drilling or operating of the oil or gas well, and all oil or gas wells located on such leasehold, the oil or gas produced therefrom, *and the proceeds thereof inuring to the working interest*.[11] However, the lien is not effective against any purchaser of oil or gas unless written notice of the claim has been delivered to the purchaser.[12]

The Texas Property Code (TPC) permits "mineral contractors" to file liens against mineral property, defining the term as follows:

> "Mineral contractor" means a person who performs labor or furnishes or hauls material, machinery, or supplies used in mineral activities under an express or implied contract with a mineral property owner or with a trustee, agent, or receiver of a mineral property owner.[13]

The statute does not specifically reference proceeds of production as property subject to the lien. Rather, the property includes (1) the material, machinery and supplies furnished or hauled by the lien claimant; (2) the land, leasehold, oil or gas well, water well, oil or gas pipeline, and its right-of-way and appurtenances; (3) other material, machinery and supplies used for mineral activities and owned by the owner of the property; and (4) other wells and pipelines used in operations related to oil and gas located on the property. Based on the statute's plain language, Texas courts have held that mineral liens do not attach to the proceeds of production.[14]

Colorado's statute provides that a person or company who performs labor on an oil or gas well "by virtue of a contract ... with the owner or lessee of any interest in real estate" shall have a lien to secure payment upon the "properties mentioned belonging to the party contracting with the lien claimant."[15] Similar to Texas, Colorado courts have held that mineral liens do not attach to the proceeds of production.[16]

Wyoming's statute provides that liens extend to "[e]very person who works upon or furnishes material ... under contract with the owner of any interest in real estate" for work done to construct or operate wells, mines, or quarries" and for transportation, advertising and other costs.[17] So long as written notice of the claim is properly delivered, a lien in Wyoming covers production proceeds, as well as the leasehold, physical equipment on the leasehold, and pipelines and rights-of-way.[18]

In each of the aforementioned states — North Dakota, Texas, Colorado and Wyoming — the process to perfect a mineral lien is similar. Generally, the lien must be perfected by filing an affidavit with the clerk of the county in which the property is located no later than six months after the date that the claimant's labor was last performed or material or services were last furnished.[19] Each state also requires a description of the amounts claimed, the dates on which labor was performed, or material or services were furnished; the name of the owner of the leasehold or other property; the name of the claimant and its mailing address; and a description of the leasehold or other property.[20]

In North Dakota, a lien arises on the date of the furnishing of the first item of material or services, or the date of performance of the first labor.[21] In Texas, "the lien does not affect an encumbrance that attached to [the] land or leasehold before the lien's inception" — but the term "inception" is not defined.[22] To fill this gap, courts have looked to materialmen's and mechanic's lien law for guidance. Section 53.124 of the TPC states that the inception of a mechanic's lien is "the commencement of construction of improvements or delivery of materials to the land on which the improvements are to be located and on which the materials are to be used," or what is known as the date of "first work." If a bankruptcy case is ultimately filed, the lien claimant may file a notice of perfection of lien under 11 U.S.C. § 546(b) in lieu of (or in addition to) a filing of a lien affidavit in the county clerk's office.

7 *John Carey Oil Co. v. W.C.P. Invs.*, 533 N.E. 2d 851 (Ill. 1988) (owner-operator could attach statutory oil and gas lien upon interest of nonoperating co-owner under Illinois Oil and Gas Lien Act); *accord*, *Amarex v. El Paso Natural Gas Co.*, 772 P.2d 905 (Okla. 1987); *Kenmore Oil Co. v. Delacroix*, 316 So. 2d 468, 469 (La. Ct. App. 1975).

8 *See* North Dakota Century Code (NDCC) §§ 35-24-01, *et. seq.*; Texas Property Code (TPC) §§ 56.0001-56.045; Colorado Revised Statutes (CRS) §§ 38-24-101-38-24-111; and Wyoming Statutes (Wyo. Stat.) §§ 29-3-101-29-3-111.

9 NDCC § 35-24-02.

10 NDCC § 35-24-01(2).

11 NDCC § 35-24-03.

12 NDCC § 35-24-06.

13 TPC § 56.001(2).

14 *See In re Hess*, 61 B.R. 977, 978 (N.D. Tex. 1986); *Tex. E. Transmission Corp.*, 254 F. Supp. 114, 118 ("[I]n Texas the lien acquired by recording a judgment cannot attach to oil and gas after severance, or to proceeds resulting from its sale."); *Onyx Refining Co. v. Evans Prod. Corp.*, 182 F. Supp. 253, 257 (N.D. Tex. 1959); *Crowley v. Adams Bros. & Prince*, 262 S.W. 883, 885 (Tex. Civ. App. 1924, *no writ*) (holding that lien does not attach to proceeds because it attaches only to such property as is specifically mentioned in statute).

15 C.R.S. § 38-24-101.

16 *See Chambers Nation v. Chambers*, 29 Colo. App. 413, 418, 486 P.2d 460, 463 (1971); *aff'd*, 178 Colo. 124, 497 P.2d 5 (1972).

17 *See* Wyo. Stat. § 29-3-103 (2015).

18 *See* Wyo. Stat. § 29-3-105.

19 *See* NDCC § 35-24-11; TPC §§ 56.021; C.R.S. § 38-24-104; and Wyo. Stat. § 29-3-106 (statement must be filed within 180 days).

20 NDCC § 35-24-11; TPC § 56.023, C.R.S. § 38-24-104; and Wyo Stat. § 29-3-105.

21 NDCC § 35-24-08.

22 TPC § 56.004.

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Force-Pooling

Another tool to insulate against a nonpaying working interest owner is force-pooling under the state's oil and gas conservation statute. "Pooling" occurs when multiple separately owned tracts are combined or "pooled" into a single larger drilling area so that an operator can efficiently drill and develop a well. This can be done voluntarily (via a contract), or involuntarily through a compulsory or "forced" pooling order entered by a state regulatory agency. In a force-pooled area, an operator can drill a well without the consent and financial participation of other working interest owners and may deduct drilling and production costs from these nonconsenting owners' share of production.[23] In certain jurisdictions, a force-pooling order may be recorded as a lien in the county where the minerals are located. In these states, a force-pooling order can be especially effective at mitigating or eliminating the financial impact of a defaulting co-owner that fails to pay its share of the development costs.

In North Dakota in particular, § 38-08-08 of the NDCC provides that an operator has "a lien on the share of production from the spacing unit accruing to the interest of each of the other owners for the payment of his proportionate share of such expenses." To obtain this lien, the operator must file an affidavit with the recorder of the county where the property, or a portion of the property, is located, setting forth the amount due and the interest of the debtor in such production.[24] The operator "may, at the expense of the debtor, store all or any part of the production upon which the lien exists until the total amount due, including reasonable storage charges, is paid or the commodity is sold at foreclosure sale and delivery is made to the purchaser. The lien may be foreclosed as provided for with respect to foreclosure of a lien on chattels."[25]

23 For an additional explanation of force pooling and review of the force-pooling laws of individual states, *see* Abby Harder, "Compulsory Pooling Laws: Protecting the Conflicting Rights of Neighboring Landowners," National Conference of State Legislatures (Oct. 24, 2014), *available at* ncsl.org/research/energy/compulsory-pooling-laws-protecting-the-conflicting-rights-of-neighboring-landowners.aspx (last visited April 13, 2016).
24 NDCC § 38-08-10.
25 *Id.*

Several other states have force-pooling lien statutes. Notably, in Oklahoma, the statute provides that the operator of a force-pooled unit has a lien on the mineral estate and shares of production from the unit "to the extent that [the] costs incurred in the development and operation upon the unit are a charge against such interest by order of the Commission or by operation of law." The lien remains until the owner or owners drilling or operating have been paid the amount due under the pooling order. Alaska, Arizona, Iowa, Missouri and Nevada also have force-pooling lien statutes that authorize similar relief.[26]

Conclusion

Although there are many legal tools available to operators and owners, these tools must be affirmatively deployed in order to provide protection against a counterparty's bankruptcy. To obtain a force-pooling order, a party must pursue an action with the state regulatory commission. To obtain a statutory lien, the lien property must be identified and properly perfected by an affirmative and timely filing with the county clerk. For a creditor seeking to exercise setoff or recoupment, the best protection will also be obtained if the creditor identifies and documents the obligations to be offset. A bankruptcy practitioner should advise oil and gas owners and operators that risk mitigation requires more than just an understanding of the available remedies; it requires action *before* the bankruptcy of a debtor to ensure the fullest protection afforded by law. abi

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26 *See* Alaska Stat. § 31.05.100; Arizona Stat. § 27-505; Iowa Stat. § 458A.8; Missouri Stat. § 259.110; Nevada Stat. § 522.060.