

Recording JOAs In the Face of Looming Bankruptcies: Better Now Than Never

Holland & Hart News Update

While the oil and gas industry has experienced a significant downturn as a result of the collapse of global and regional oil prices, it wasn't so long ago that times were booming and wells were being drilled at a rapid pace. During the recent boom years, everyone in the industry was scrambling to keep ahead of the curve, and some tasks previously viewed as routine fell to the way side. One action item that has been increasingly overlooked in recent years is the recording of a joint operating agreement, or a memorandum thereof (generally herein, including the recording of a memorandum applicable, a "JOA") to provide notice of the operator's lien rights. Considering the current downturn, the failure to record a JOA could come back to bite operators as defaults and bankruptcies appear to be looming for many players in the industry. As an operator, there still may be time to repent and record those agreements in order to protect your rights and interests.

The most current 1989 A.A.P.L Model Form of Operating Agreement, and most other commonly used agreements for joint operations, contains provisions whereby each party to the JOA grants a lien upon any interest it owns or acquires in real or personal property in the contract area covered by the agreement to secure such party's obligations under the JOA.¹ The form JOA contains provisions allowing for the recording of a memorandum (or "recording supplement") of the JOA, or the agreement itself, which is acceptable in most states, to perfect the liens granted in the agreement.

It is generally well known that recording the JOA acts to perfect the operator's lien of record as to competing lienholders. For example, if a JOA is recorded and there is later recorded a judgment lien against a non-operator, the operator's lien would be superior to the claims of the later judgment creditor. As the current industry slowdown continues, and the risks of bankruptcies of non-operators looms, what is the impact of the failure to record a JOA upon the filing of Chapter 11 bankruptcy by the non-operator?

Upon filing for bankruptcy under Chapter 11 of the bankruptcy code, the appointed bankruptcy trustee of the debtor has the authority to either accept or reject "executory contracts." 11 U.S.C. 365. An executory contract is a contract wherein there are ongoing or unperformed obligations on both sides. It is generally held and expected that JOAs will most likely be deemed executory contracts under the bankruptcy code. If a bankruptcy trustee accepts an executory contract, that will mean that the debtor, as an ongoing concern, will cure past defaults under the contract, compensate for default damages or losses, and give assurances for future performance. However, a bankrupt debtor that is a non-operator under a

JOA will often have an incentive to reject a JOA as an executory contract. If a JOA is rejected, then ongoing rights and obligations of operators and non-operators, including the non-operator debtor, will likely be governed by common law tenants-in-common principles. If a bankruptcy trustee rejects an executory contract, then that is treated as a breach of the contract and the creditor party to the executory contract is granted damages resulting from the default under the rejected contract. Whether a JOA is recorded or not will not impact whether a JOA is an executory contract, but it will impact whether or not the damages granted to the operator under the rejected JOA will be secured or unsecured. If a JOA was never recorded, then the operator will be deemed an unsecured creditor and join the pool of other unsecured creditors (which creditors will either not get paid at all or may get pennies on the dollar for outstanding debts). But if the JOA was properly placed of record to perfect lien rights, then the damages afforded to the operator upon rejection of the JOA as an executory contract will give the operator a secured lien.

Of course, just because a recorded JOA perfects an operator's lien, that does not mean it is necessarily first in time and has a superior lien position. For example, a non-operator may have granted a prior recorded mortgage or deed of trust for the benefit of a bank, which first-recorded lien could trump a later-recorded JOA (or memorandum thereof). Ideally, operators should obtain subordinations to the JOA from holders of outstanding mortgages or deeds of trust (much like operators do for important oil and gas leases or surface use agreements), but in practice this rarely occurs. But certainly recording the JOA will perfect the operator's lien as to subsequently recorded liens (and remove the operator from the general unsecured creditor pool in bankruptcy).

The question facing land departments now is: what if we didn't record a JOA at the time of execution – is it too late? The answer, as most other answers offered by attorneys, is: it depends. Within 90 days of filing for bankruptcy, any payments made for prior debts by a debtor in bankruptcy to certain creditors, but not others, can be held to be preferential transfers under the bankruptcy code. A preferential transfer is most typically a payment made to and for the benefit of one creditor, to the detriment of other creditors, within 90 days of the bankruptcy filing. A Texas bankruptcy court has held that recording a JOA within 90 days prior to the bankruptcy filing was a preference that benefited a single creditor to the detriment of other creditors and was thus invalid.² You cannot forecast if and when a non-operator will file for bankruptcy. But one thing is certain - it doesn't hurt to record the JOA. If you record and a non-operator does file for bankruptcy within 90 days, the recording may be invalidated. But if the non-operator files for bankruptcy on the 91st day, you may have been fortunate enough to perfect your operator's lien. Also, while you may have lost lien priority during any delay in failing to promptly record the JOA, you might still have time to perfect your lien as to other subsequent lien claimants down the road (and you may still have time to secure a first-position lien). Being a second position lienholder on oil and gas assets under a JOA behind the first lien of, for example, a non-operator/debtor's bank, will still grant you certain advantages in terms of negotiating an acquisition of those assets or preserving some rights to proceeds (certainly

over and above the rights of unsecured creditors).

So in the face of potential loan defaults, judgment liens, bankruptcies, and all the other unfortunate events that result from oil and gas downturn cycles, operators should act soon to record JOAs. Obviously, priority should be given to agreements where there are sizeable and mounting debts by certain non-operators. While there may be findings down the road that the late recording of a JOA fails to perfect lien rights, there are no good reasons not to simply record JOAs today.

¹See Article VII.B of 1989 Model Form Operating Agreement.

²See *In Re Wilson*, 69 B.R. 960 (Bankr. N.D. Tex. 1987).

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