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**THIS LAND IS YOUR LAND, THIS LAND IS MY LAND:  
FARMOUT AGREEMENTS IN BANKRUPTCY**

Jason S. Brookner, Philip B. Jordan, Lydia R. Webb and Ethan M. Wood\*

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\* Jason S. Brookner is a partner and head of Gray Reed's Corporate Restructuring and Bankruptcy Group. Philip B. Jordan is a partner in Gray Reed's Energy Group and a board certified oil and gas attorney. Lydia R. Webb and Ethan M. Wood are associates in Gray Reed's Corporate Restructuring and Bankruptcy Group and Energy Group, respectively. The views expressed herein are those of the authors only.

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## **This Land Is Your Land, This Land Is My Land: Farmout Agreements in Bankruptcy**

### **I. AN UNFORGIVING LANDSCAPE**

Entering into farmout agreements is a common and familiar practice in the oil & gas industry. Farmees often invest millions of dollars to develop farmout acreage and can assign great value to undeveloped land that they intend to drill over the term of the agreement. However, when a farmor files for bankruptcy, the farmee can suddenly find itself in an unforgiving landscape where the treatment of its farmout agreement is far from certain. Land that the farmee rightfully believed it had the right to drill and develop can potentially be drawn into the farmor's bankruptcy estate and sold for the benefit of the farmor's creditors, resulting in high stakes litigation between farmor and farmee over the question of "whose land is it anyway?" (or perhaps more importantly, who gets to drill and develop the underlying minerals).

This fight most recently played out in the *Vanguard Natural Resources, LLC* bankruptcy (hereinafter the "VNR Bankruptcy"),<sup>1</sup> wherein debtor/farmor Vanguard Operating, LLC sought to reject its farmout agreement with Encana Oil & Gas (USA) Inc. and sell the subject acreage free and clear of Encana's drilling and development right.<sup>2</sup> Encana vigorously objected to Vanguard's attempt to reject the farmout agreement by asserting, among other things, that (i) the land subject to the farmout agreement was not property of Vanguard's bankruptcy estate in light of an express carve out in the Bankruptcy Code, and (ii) Encana's right to drill and develop the underlying acreage was a real property interest and a covenant running with the land under Texas law that could not be rejected in bankruptcy.<sup>3</sup> Vanguard countered that the farmout agreement

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<sup>1</sup> *In re Vanguard Natural Resources, LLC*, Case No. 17-30560 (MI) (Bankr. S.D. Tex. 2017).

<sup>2</sup> Gray Reed & McGraw was counsel to Encana in the VNR Bankruptcy. The authors of this paper worked on the case, along with James J. Ormiston and other colleagues at the firm.

<sup>3</sup> VNR Bankruptcy Docket Nos. 209 & 486.

was nothing more than an executory contract that could be rejected for a valid business purpose, the farmout agreement only gave Encana the “right to propose” wells rather than a separate and distinct real property interest, and Vanguard at all times retained the right to drill and develop the lands subject to the farmout agreement.<sup>4</sup> The bankruptcy court ruled that Vanguard could reject whatever the court ultimately determined was executory, and deferred ruling on the nature of the farmout agreement in the context of the rejection motion (and thus, whether it was an executory contract that could be rejected) pending the resolution of a separate adversary proceeding initiated by Encana seeking declaratory relief on the nature, scope and extent of the farmout.<sup>5</sup>

The parties were soon at odds again when Vanguard sought to sell the undeveloped leasehold underlying the farmout agreement.<sup>6</sup> Encana objected to any sale of the land free and clear of its drilling and development right – a real property interest recognized under Texas law.<sup>7</sup> Vanguard, citing a powerful provision of the Bankruptcy Code, asserted that it could nonetheless sell free and clear of Encana’s interest because the nature, scope and extent of that interest was in “bona fide dispute.”<sup>8</sup> Despite the uncertainties regarding, and the sparse case law on the treatment of, farmout agreements in bankruptcy, the bankruptcy court allowed Vanguard to proceed with the sale.<sup>9</sup> Prior to the bankruptcy court ruling on what interest Encana had as a result of the farmout agreement, the parties reached a settlement that led to a consensual confirmation of Vanguard’s plan of reorganization.

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<sup>4</sup> VNR Bankruptcy Docket Nos. 337 & 500.

<sup>5</sup> VNR Bankruptcy Docket No. 514.

<sup>6</sup> VNR Bankruptcy Docket No. 429.

<sup>7</sup> VNR Bankruptcy Docket Nos. 488 & 550.

<sup>8</sup> VNR Bankruptcy Docket No. 567.

<sup>9</sup> VNR Bankruptcy Docket No. 583.

Given that the oil and gas market continues to languish, the authors believe that the VNR Bankruptcy will not be the last time a question will arise over farmout issues in bankruptcy. This paper will address the potential issues parties to farmout agreements may face if the farmor enters bankruptcy, how those issues played out in the VNR Bankruptcy, as well as drafting considerations to try to avoid bankruptcy's harsh effects.

## II. WHAT ARE FARMOUT AGREEMENTS?

A farmout is an agreement in which the owner of an oil and gas lease agrees to assign that lease to an operator who undertakes the obligation to drill one or more wells on the assigned acreage in exchange for an interest in the completed wells.<sup>10</sup> The Bankruptcy Code also contains its own, arguably broader, definition of a farmout agreement in section 101(21A):

(21A) The term “farmout agreement” means a written agreement in which—

(A) The owner of a right to drill, produce, or operate liquid or gaseous hydrocarbons on property agrees or has agreed to transfer or assign all or a part of such right to another entity; and

(B) Such other entity (either directly or through its agents or its assigns), as consideration, agrees to perform drilling, reworking, recompleting, testing or similar or related operations, to develop or produce liquid or gaseous hydrocarbons on the property.<sup>11</sup>

Farmout agreements serve many purposes for both the assignor (the farmor) and the driller (the farmee). The farmor may need to quickly drill to preserve a lease, salvage a poor investment in a bad prospect, share the financial risks of drilling, obtain geological information for a general area without incurring the costs of drilling an exploratory well, obtain better market

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<sup>10</sup> *Mengden v. Peninsula Production Co.*, 544 S.W.2d 643, 645 n.1 (Tex. 1976) (quoting Williams and Meyers, OIL AND GAS LAW, MANUAL OF TERMS 167 (1971)); *but see Young Ref. Corp. v. Pennzoil Co.*, 46 S.W.3d 380, 389 (Tex. App.—Houston [1<sup>st</sup> Dist.] 2001, pet. denied) (holding that an agreement in which the holder of the lease agrees to drill in exchange for another party's investment in reworking operations, refinery upgrades or other operations connected with the field is, by definition, not a farmout).

<sup>11</sup> 11 U.S.C. § 101(21A).

access for hydrocarbons, obtain reserves, or to drill a well to satisfy implied lease covenants.<sup>12</sup> The farmee may find that a farmout agreement is the quickest or cheapest way to obtain or expand an acreage position, the best way to deploy capital and keep equipment utilized and personnel busy, an opportunity to take advantage of a farmor's poor evaluation of a prospect, or an avenue to become active in an area without individually taking on all of the risks of exploration.<sup>13</sup> Essentially, a party who owns or leases land will often seek to "farmout" the lease rather than spend its own money to drill on it, and negotiate a contract assigning that lease to a party that does wish to explore it for production.<sup>14</sup>

#### **A. TRADITIONAL FARMOUT AGREEMENTS VERSUS TERM ASSIGNMENTS**

Under a basic farmout agreement, the farmee receives an assignment in exchange for drilling on the acreage in the manner specified by the agreement (*e.g.*, location, depth, time of commencement or completion), and the farmor retains an interest in the property such as an overriding royalty interest or an overriding royalty interest that can be later converted into a share of the working interest.<sup>15</sup> There are two primary ways in which farmouts can be structured: agreements to transfer and conditional assignments.<sup>16</sup> In an agreement to transfer, the farmee obtains an assignment of the acreage after it performs the prerequisite conditions under the contract.<sup>17</sup> In a conditional assignment, the farmor assigns the acreage to the farmee when

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<sup>12</sup> See John S. Lowe, *Analyzing Oil and Gas Farmout Agreements*, 41 *SOUTHWESTERN L.J.* 759, 778-82 (1987).

<sup>13</sup> See *id.*

<sup>14</sup> See, *e.g.*, *Amoco Prod. Co. v. Texaco, Inc.*, 02-240 (La. App. 3 Cir. 1/29/03); 838 So. 2d 821, 839, *writs denied*, 03-1102 (La. 6/6/03); 845 So. 2d 1096, 03-1104 (La. 6/6/03); 845 So. 2d 1096.

<sup>15</sup> See, *e.g.*, 3 Smith & Weaver, *TEX. LAW OF OIL & GAS* § 16.3, at 16-6.1 – 16-7; see also *Young Ref. Corp.*, 46 S.W.3d at 389.

<sup>16</sup> See *Eland Energy, Inc. v. Rowden Oil & Gas, Inc.*, 914 S.W.2d 179, 182 n.2 (Tex. App.—San Antonio 1995, writ denied) (citing Lowe, *supra* at 796).

<sup>17</sup> *Id.*

the agreement is made, but is required to re-convey the interest if its obligations under the agreement are not performed.<sup>18</sup> Although it may be simpler for the farmor to structure a farmout as an agreement to transfer rather than a conditional assignment (because the farmor retains title to the property, it saves the farmor the time and expense of having to clear title should the farmee fail to perform), the potential pitfalls for the farmee—especially when it comes to scenarios in which the farmor goes bankrupt—cannot be overstated.<sup>19</sup>

Conversely, in a conditional assignment, the farmee acquires title to the property when the agreement is made, subject to either an obligation to re-convey its interest if its obligations under the agreement are not completed or to automatically terminate if the conditions subsequent are not performed.<sup>20</sup> These conditional farmouts often take the form of a term assignment wherein the farmor executes an assignment to the farmee for a specific term, and at the expiration of that term, the farmee retains a certain number of acres around each well drilled under the assignment and re-conveys the remaining acreage to the farmor.<sup>21</sup> For the farmee, a conditional assignment (term assignment) avoids many of the problems inherent in an agreement to transfer – for example, farmors who are slow to provide earned assignments or quick to argue that an assignment has not been earned, liens that may have attached after the farmout agreement is entered into but before the assignment is executed and filed of record, or the bankruptcy of the

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<sup>18</sup> *Id.*

<sup>19</sup> *See generally* Lowe, *supra*, at 796.

<sup>20</sup> *Id.* (citing *Vickers v. Peaker*, 300 S.W.2d 29, 31-34 (Ark. 1957) as an example of a conditional assignment subject to automatic termination and *Mengden*, 544 S.W.2d at 647-49 as an example of a conditional assignment with an obligation to reassign).

<sup>21</sup> *See, generally* William B. Burford, “Operating Agreements, Farmouts, Term Assignments, AMIs, Reassignment Obligations, and Rights of First Refusal,” *Advanced Mineral Title Examination – Oil, Gas, and Mining*, Paper 6, Page No. 12 (Rocky Mt. Min. L. Fdn. 2014).

farmor.<sup>22</sup> As discussed below in “Drafting Considerations,” the ability of the farmee to obtain the more favorable conditional assignment or term assignment structure depends on many factors.

## **B. THE RIGHT TO DRILL VERSUS THE RIGHT TO PROPOSE**

In Texas, the mineral estate consists of (i) the right to develop (drill for and produce hydrocarbons), (ii) the right to lease, (iii) the right to receive bonus payments, (iv) the right to receive delay rentals, and (v) the right to receive royalty payments.<sup>23</sup> Of the “bundle of sticks,” an oil and gas lease conveys to the lessee only the right to develop in fee simple determinable and the lessor-mineral owner retains a possibility of reverter in the development right and the remaining rights in the bundle.<sup>24</sup> Generally, a farmout agreement, immediately upon its execution, serves as an assignment to the farmee of the right to enter onto land and drill for minerals, together with certain other contingent interests associated with such drilling right.<sup>25</sup>

However, in the VNR Bankruptcy, Vanguard argued that the farmout agreement only granted Encana “the right to propose” wells, and thus, Encana had no real property interest in the underlying acreage because – according to Vanguard – a “right to propose” is a contractual right

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<sup>22</sup> See generally Lowe, *supra*, at 796.

<sup>23</sup> *Lightning Oil Co. v. Anadarko E&P Onshore, LLC*, No. 15-0910, 2017 WL 2200343, at \*6 (Tex. May 19, 2017); *Hysaw v. Dawkins*, 483 S.W.3d 1, 9 (Tex. 2016); *French v. Chevron U.S.A., Inc.*, 896 S.W.2d 795, 797 (Tex. 1995).

<sup>24</sup> See *Lightning Oil Co.*, 2017 WL 2200343, at \*6; see also *Mitchell Energy Corp. v. Samson Res. Co.*, 80 F.3d 976, 982 (5th Cir. 1996) (“[i]n Texas, an oil and gas lease conveys an estate in real property to the lessee, namely, a fee simple determinable in the mineral estate”); *McMillan v. Dooley*, 144 S.W.3d 159, 183 (Tex. App.—Eastland 2004, pet. denied) (noting that in Texas, a mineral lease assigns to the lessee a fee simple determinable in certain interests in the mineral estate – including the right to develop the minerals – while the lessor retains other interests in the estate, including the right to receive royalty payments and the right to receive delay rentals).

<sup>25</sup> See *Clayton Williams Energy, Inc. v. BMT O & G TX L.P.*, 473 S.W.3d 341, 353 (Tex. App.—El Paso 2015, pet. denied) (finding that upon execution of a farmout agreement, the “[farmee] received valid, fully operative drilling rights, which can be separately held from [farmor’s] ownership rights”).

and not a real property right.<sup>26</sup> To Vanguard, the use of the phrase “right to propose” implied that through its farmout agreement, Encana acquired on the ability to ask to drill a well, with Vanguard having the right to decline any and all of Encana’s well proposals.<sup>27</sup> Encana argued that considering the word “propose” in a vacuum was contrary to the rules of contract interpretation; one must consider the words in the context of the agreement as a whole to determine the parties’ original intent with regard to a particular phrase.<sup>28</sup>

Further, and perhaps more importantly, Encana argued that in the oil and gas industry, the “right to propose” a well is not simply the ability to “request permission.” Instead, a right to propose is synonymous with the right to actually drill a well.<sup>29</sup> The “right to propose” a well in

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<sup>26</sup> See *Encana Oil & Gas (USA) Inc. v. Vanguard Operating, LLC*, Adv. No. 17-3058 (Bankr. S.D. Tex.) (hereinafter, the “Encana Adversary”) Docket No. 19. The specific language in the farmout agreement on which Vanguard relied was as follows:

8. **SUBSEQUENT WELLS:** Once [farmee] has drilled and completed the Commitment Wells set forth above, [farmee] shall have the right to propose additional wells in each area. For these wells, the working interests will remain the same (Vanguard/Encore 30% and [farmee] 70%, proportionately reduced where applicable), but Vanguard/Encore’s options to participate will changes as follows:

- Option 1: Vanguard/Encore can participate heads-up with up to 30% of its WI, meaning Vanguard/Encore can participate with anywhere from 1% - 30% WI.
- Option 2: Vanguard/Encore may elect not to participate and be subject to a 150% Non-consent penalty[.]

Should Vanguard/Encore elect Option 2 above, [farmee] shall earn and Vanguard/Encore shall deliver a proportionately reduced 75% NRI in the leases, keeping the difference between burdens of record and 25% as overriding royalty interest, but in no event shall the ORRI be less than 2%.

<sup>27</sup> See *Quicksilver Resources, Inc. v. Reliant Energy Services, Inc.*, No. 2-02-249-CV, 2003 WL 22211521, at \*9 (Tex. App. —Fort Worth Sept. 25, 2003, no pet.) (mem. op.) (concluding that the use of the word “propose” in a gas purchase contract, combined with the absence of any requirement that the proposal be accepted by the counterparty, meant that, by implication, a proposal could be rejected).

<sup>28</sup> VNR Bankruptcy Docket No. 550. See also *State Farm Life Ins. Co. v. Beaton*, 907 S.W.2d 430, 433 (Tex. 1995); see also *Reilly v. Rangers Mgmt., Inc.*, 727 S.W.2d 527, 530 (Tex. 1987) (“[a] court should construe contracts from a utilitarian standpoint bearing in mind the particular business activity sought to be served and need not embrace strained rules of interpretation which would avoid ambiguity at all costs”); *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 134 (Tex. 1994) (“[n]o one phrase, sentence, or section [of a contract] should be isolated from its setting and considered apart from the other provisions”).

<sup>29</sup> VNR Bankruptcy Docket No. 550-2 (Declaration of Dorsey T. Roach).

no way provides a non-operator with the right to refuse or otherwise veto drilling. The farmor (Vanguard) had to either elect to participate by paying its proportionate share of upfront drilling and completion costs, or not participate and incur a penalty as a result of not participating.<sup>30</sup>

### **C. MUST THE DRILLING RIGHT BE “EXCLUSIVE” TO BE A REAL PROPERTY INTEREST?**

The right to develop (or the drilling right) is a real property interest that has been described as the right to (i) possess, use, and appropriate gas and oil, (ii) appropriate the minerals to any extent desired by a grantee and his assigns, (iii) conduct operations to mine, store, and transport the minerals, and (iv) prospect for, produce and dispose of the minerals.<sup>31</sup> Although the owner of a real property interest – such as the right to develop – generally has the right to exclude all third parties from use of the property (often referred to as “exclusivity”), it does not follow that only one party can own the real property interest.<sup>32</sup> For instance, cotenants of an unleased mineral estate each have the undivided right to develop the minerals.<sup>33</sup> A cotenant has the right to drill a well and extract minerals (*i.e.*, develop) from the common property without first obtaining the consent of his cotenants, subject only to his duty to account to his cotenants for their proportionate share of the value of the oil and gas produced, less the non-developing

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<sup>30</sup> Encana also argued that this interpretation of a “right to propose” was further evidenced by the applicable joint operating agreement, which was based on the A.A.P.L. Form 610 – 1989 Model Form Operating Agreement, and provided Vanguard with only two choices when receiving well proposals: participate, or not participate and incur a penalty.

<sup>31</sup> *E.g.*, *Greer v. Shook*, 503 S.W.3d 571, 577 (Tex. App.—El Paso 2016, pet. filed) (stating “the right to develop [is] the right to explore and drill for minerals”); *Ryan Consol. Petroleum Corp. v. Pickens*, 266 S.W.2d 526, 530 (Tex. Civ. App.—Texarkana 1954, *aff’d* 285 S.W.2d 201, *cert. denied*, 351 U.S. 933) (describing the right to develop as “the right to prospect for, develop and produce the oil and gas lying in place under . . . land”); *Stradley v. Magnolia Petroleum Co.*, 155 S.W.2d 649, 651 (Tex. Civ. App.—Amarillo 1941, writ ref’d) (describing the right to develop as “the right of ingress and egress upon . . . land to prospect for, develop, produce, transport and store all minerals and mineral products that are produced”).

<sup>32</sup> See *Lightning Oil Co.*, 2017 WL 2200343, at \*4.

<sup>33</sup> *Cox v. Davidson*, 297 S.W.2d 200, 201 (Tex. 1965); *Burnham v. Hardy Oil Co.*, 147 S.W. 330, 334 (Tex. Civ. App.—San Antonio 1912) *aff’d on other grounds* 195 S.W. 1139 (1917).

cotenants' proportionate share of the drilling and operating expenses.<sup>34</sup> The “exclusivity” of the development right applies only to exclude (i) the lessor where a lease has been entered into and (ii) strangers to title to the mineral estate.<sup>35</sup>

In the VNR Bankruptcy, in the context of what interests were conveyed to Encana pursuant to the farmout agreement, Vanguard argued that the right to drill had to be an exclusive right in order to be considered a real property interest under Texas law.<sup>36</sup> Encana contended that Texas law does not require the right to drill be exclusive and, thus, the right to drill is a real property right that may be divided, or shared, among multiple parties.<sup>37</sup>

There is no Texas case stating that the development right may only be held by one person or entity. Indeed, lessees routinely assign undivided interests in an oil and gas lease to other leasehold cotenants, each of whom have the right to drill wells and produce oil and gas from the lease (*i.e.*, develop the lease).<sup>38</sup> Relatively few Texas cases describe the “right to develop” as an “exclusive right,” and those that do only describe it as being exclusive against lessors or third parties.<sup>39</sup> Because a lessee may convey all or part of its development right to another under a

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<sup>34</sup> *Wagner & Brown v. Sheppard*, 282 S.W.3d 419, 426 (Tex. 2008); *Cox*, 297 S.W.2d at 201.

<sup>35</sup> *See, e.g., Byrom v. Pendley*, 717 S.W.2d 602, 605 (Tex. 1986) (holding that a leasehold owner has the right to develop oil and gas without the permission of his leasehold cotenant, whether or not his leasehold cotenant's ownership interest is in dispute); *Radcliffe v. Tidal Petroleum Inc.*, No. 04-15-00644- CV, 2017 WL 511219, at \*6 (Tex. App.—San Antonio Feb. 8, 2017, pet. filed) (stating that “[o]wners of undivided portions of oil and gas rights in and under real estate are tenants in common, and an oil and gas lessee of a cotenant becomes a cotenant with the cotenants of his lessor”).

<sup>36</sup> Encana Adversary Docket Nos. 19 & 36.

<sup>37</sup> Encana Adversary Docket No. 37.

<sup>38</sup> *See, e.g., Cone v. Fagadau Energy Corp.*, 68 S.W.3d 147, 157–58 (Tex. App.—Eastland 2001, pet. denied) (relying on the general rule that each leasehold cotenant has the right to develop without first obtaining the consent of the other leasehold cotenants)

<sup>39</sup> *See, e.g., Lightning Oil Company*, 2017 WL 2200343, at \*6 (citing *Stephens County v. Mid-Kansas Oil & Gas Co.*, 254 S.W. 290 (Tex. 1923) in support of its assertion that the right to develop is “the exclusive right [of all lessees or cotenants] to possess, use, and appropriate gas and oil”); *Petro Pro, Ltd. v. Upland Resources, Inc.*, 279 S.W.3d 743, 752 (Tex. App.—Amarillo 2007, pet. denied) (describing the right to develop as “exclusive” insofar as it applies to severed wellbore interests).

farmout agreement, a conveyance of the development right need not be exclusive in order to be considered a real property interest.<sup>40</sup>

### **III. OIL & GAS BANKRUPTCY 101**

Since 2015, over 120 U.S. oil and gas companies have filed for bankruptcy in the wake of falling prices and a struggling commodities market.<sup>41</sup> Upon filing for bankruptcy, a debtor is protected by an automatic stay that stops almost all actions taken against the debtor or its property, as long as that property remains in the debtor's bankruptcy estate.<sup>42</sup> Determining what is or is not in a debtor's bankruptcy estate is often a key part of an oil & gas bankruptcy and can be the subject of intense litigation.

#### **A. WHAT IS AN EXECUTORY CONTRACT AND WHY DOES IT MATTER?**

Section 365(a) of the Bankruptcy Code provides that, subject to bankruptcy court approval, a debtor in possession may assume or reject any executory contract or unexpired lease.<sup>43</sup> Rejection of an executory contract or lease constitutes a breach of the agreement, effective immediately prior to the time the bankruptcy was filed, and a claim for rejection damages (*i.e.* breach) is calculated pursuant to the terms of the contract under applicable non-bankruptcy law and is treated as a prepetition general unsecured claim.<sup>44</sup>

The Bankruptcy Code does not define the term "executory contract." However, the legislative history and an overwhelming majority of courts addressing the issue have adopted the

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<sup>40</sup> See *Clayton Williams*, 473 S.W.3d at 353.

<sup>41</sup> Haynes and Boone, Haynes and Boones Oil Patch Bankruptcy Monitor, February 20, 2017, available at [http://www.haynesboone.com/~media/files/energy\\_bankruptcy\\_reports/2017/2017\\_oil\\_patch\\_monitor\\_20170220.a\\_shx](http://www.haynesboone.com/~media/files/energy_bankruptcy_reports/2017/2017_oil_patch_monitor_20170220.a_shx)

<sup>42</sup> 11 U.S.C. §§ 362 & 541.

<sup>43</sup> 11 U.S.C. § 365(a).

<sup>44</sup> 11 U.S.C. §§ 365(g)(1) & 502(g)(1).

so-called Countryman definition, which states that an executory contract is “a contract under which the parties’ obligations are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”<sup>45</sup>

Whether certain oil & gas agreements constitute executory contracts that may be rejected in bankruptcy has become a hot button issue. Producers and midstream companies have squared off over whether dedications in gathering and processing agreements are real property interests, and therefore immune from the reach of the bankruptcy court, or whether the agreements are executory contracts that may be jettisoned through the bankruptcy process.<sup>46</sup> Because non-debtor counterparties have often invested millions of dollars in reliance upon these agreements, the determination of whether they are executory could potentially make or break a business. At a minimum, the determination could render a significant investment virtually worthless.

However, the analysis does not end once a court determines that a contract is executory. Courts apply the business judgment test to a debtor’s decision to assume or reject an executory contract or unexpired lease.<sup>47</sup> Under that analysis, a bankruptcy court examines the situation to determine whether assumption or rejection is prudent and will benefit the estate.<sup>48</sup> Thus, if a

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<sup>45</sup> Vern Countryman, *Executory Contracts in Bankruptcy (Part 1)*, 57 MINN. L. REV. 439, 460 (1973); *In re Murexco Petroleum, Inc.*, 15 F.3d 60, 62-63 (5th Cir. 1994); *see also Stewart Title Guaranty Co. v. Old Republic National Title Insurance Co.*, 83 F.3d 735, 741 (5th Cir. 1996).

<sup>46</sup> *See, e.g., In re Sabine Oil & Gas Corporation*, Case No. 15-11835 (Bankr. S.D.N.Y. 2015); *In re Quicksilver Resources Inc., et al*, Case No. 15-10585 (Bankr. D. Del. 2016).

<sup>47</sup> *Richmond Leasing Co. v. Capital Bank, N.A. (In re Richmond Leasing Co.)*, 762 F.2d 1303, 1309 (5th Cir. 1985) (“It is well established that the question [of] whether a lease should be rejected . . . is one of business judgment”); *Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099 (2d Cir. 1993).

<sup>48</sup> *Orion Pictures Corp.*, 4 F.3d at 1099 (“In reviewing a trustee’s or debtor-in-possession’s decision to assume [or reject] an executory contract . . . , a bankruptcy court sits as an *overseer of the wisdom* with which the bankruptcy estate’s property is being managed by the trustee or debtor-in-possession”).

court finds that the rejection of an executory contract would be a detriment to the debtor's estate, it may refuse to approve the rejection.<sup>49</sup>

The business judgment test is deferential and relatively easy to satisfy.<sup>50</sup> Frequently, the justification is that the contract is burdensome to the debtor and above market. In applying the business judgment test, some courts presume that the debtor "acted prudently, on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the bankruptcy estate," and that rejection should be approved unless the "conclusion that rejection would be advantageous is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice."<sup>51</sup> In contrast, at least one bankruptcy court in Texas has noted that it "is unwilling to presume Congress, by providing that authority to bankruptcy courts, intended a bankruptcy court, as opposed to exercising actual oversight of determinations of how to deal with contracts, to serve as no more than a rubber stamp for the trustee or debtor in possession."<sup>52</sup>

## **B. THE DEBTOR'S RIGHT TO SELL FREE AND CLEAR OF CLAIMS AND INTERESTS**

Another powerful tool held by a debtor is the ability to sell its property free and clear, thereby effectively clearing title to an asset through the bankruptcy process.<sup>53</sup> A bankruptcy

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<sup>49</sup> *In re Angelika Films 57th Inc.*, No. 97 Civ. 2239 (MBM), 1997 WL 283412, at \*6 (S.D.N.Y. May 29, 1997) (affirming bankruptcy court finding that debtor did not exercise its business judgment in a manner consistent with the estate's best interest by seeking to assume and assign movie theater lease); *In re Matusalem*, 158 B.R. 514, 522 (Bankr. S.D. Fla. 1993) (debtor failed to demonstrate good business judgment for seeking to reject sub-franchise agreement for use of licensed intellectual property, as rejection would result in no economic benefit to the estate and its creditors and would "utterly destroy" the debtor's business).

<sup>50</sup> See, e.g., *Richmond Leasing*, 762 F.2d at 1309; *In re Pilgrim's Pride Corp.*, 403 B.R. 413, 426 (Bankr. N.D. Tex. 2009) ("In applying the business judgment rule in deciding whether to grant a debtor's motion to reject a contract a court is not adjured to blindly accept, but rather only to show proper deference to the business judgment of the debtor's management").

<sup>51</sup> *In re Pomona Valley Medical Group*, 476 F.3d 665, 670 (9th Cir. 2007).

<sup>52</sup> *Pilgrim's Pride*, 403 B.R. at 426 n.31.

<sup>53</sup> See 11 U.S.C. § 363(b).

court will typically authorize a sale of the debtor’s assets outside of the ordinary course of business if the debtor can demonstrate “some articulated business justification” for the sale.<sup>54</sup> This standard is essentially identical to the business judgment standard applied to the assumption and rejection of executory contracts and is a relatively low bar to achieve.

Section 363(f) of the Bankruptcy Code permits a debtor to sell property of the estate free and clear of interests in the property if any one of five conditions is met.<sup>55</sup> One of those conditions – section 363(f)(4) – is particularly relevant in the context of a dispute regarding the scope and extent of an interest in real property. Section 363(f)(4) authorizes the sale of a debtor’s interest in property if the interest is subject to a bona fide dispute. Similar to executory contracts, the term “interest” is not defined in the Bankruptcy Code.<sup>56</sup> Holders of an alleged ownership interest in the debtor’s property have used this ambiguity to argue that a debtor cannot sell free and clear of a disputed ownership interest absent a determination that the property to be sold is in fact property of the debtor.<sup>57</sup>

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<sup>54</sup> *Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc.*, (In re Continental Air Lines, Inc.), 780 F.2d 1223, 1226 (5th Cir. 1986); *Committee of Equity Sec. Holders v. Lionel Corp.* (In re Lionel Corp.), 722 F.2d 1063, 1070 (2d Cir. 1983).

<sup>55</sup> See 11 U.S.C. § 363(f).

<sup>56</sup> See *Folger Adam Sec., Inc. v. Dematteis/MacGregor, JV*, 209 F.3d 252, 257 (3d Cir. 2000) (“The term ‘any interest’ as used in section 363(f), is not defined anywhere in the Bankruptcy Code”); *Minstar, Inc. v. Plastech Research, Inc.* (In re Arctic Enter., Inc.), 68 B.R. 71, 78-79 (D. Minn. 1986) (construing “interests” under § 1141(c) to include liens).

<sup>57</sup> *In re Wilkinson*, No. 07–50189, 2012 WL 112945, at \*5 (Bankr. W.D. Tex. Jan. 12, 2012) (“Sales of property under 363(f) are limited to sales of property of the bankruptcy estate”) (quoting *Central State Bank v. McCabe* (In re McCabe), 302 B.R. 873, 877 (Bankr. N.D. Iowa 2003)); *Darby v. Zimmerman* (In re Popp), 323 B.R. 260, 266 (B.A.P. 9th Cir. 2005) (“even before one gets to section 363(f), section 363(b) . . . requires that the estate demonstrate that the property it proposes to sell is ‘property of the estate’ ”); *Moldo v Clark* (In re Clark), 266 B.R. 163, 172 (B.A.P. 9th Cir. 2001) (“[T]he property that can be sold free and clear under section 363(f) is defined by subsections (b) and (c) of section 363 as ‘property of the estate’ ”); *In re Coburn*, 250 B.R. 401, 403 (Bankr. M.D. Fla. 1999) (finding it necessary to determine whether an asset is property of the estate in order to decide whether the trustee is entitled to sell the asset pursuant to section 363(f)); see also *In re Whitehall Jewelers Holdings, Inc.*, No. 08-11261, 2008 WL 2951974, at \*6 (Bankr. D. Del. July 28, 2008) (burden is on the debtor to prove that it owns the property that is the subject of the proposed sale).

A bona fide dispute exists when there is an objective basis for either a factual or legal dispute as to the validity of an interest in property.<sup>58</sup> To authorize a sale under section 363(f)(4), the bankruptcy court only has to determine whether a dispute exists; it need not decide the outcome of that dispute.<sup>59</sup> As discussed in further detail below in the context of the VNR Bankruptcy, this can put a non-debtor interest holder (like a farmee) in a difficult situation, cut off its right to the property, and effectively limit its recourse to the proceeds of sale.

#### **IV. FARMOUT LESSONS FROM THE VNR BANKRUPTCY**

There are no reported opinions on whether undrilled and unearned property subject to a farmout agreement falls into the bankruptcy estate or is excluded from the estate under section 541(b)(4)(A) (discussed below). Indeed, opinions on how farmouts are generally treated in bankruptcy are scarce. Although the treatment of Encana's farmout agreement was a central issue in the VNR Bankruptcy, it was ultimately settled. Despite the lack of a full adjudication, lessons nonetheless can and should be learned that will serve as a guide for future litigants.

##### **A. SECTION 541(B)(4)(A): IS A FARMOUT AGREEMENT AN INTEREST EXCLUDED FROM THE BANKRUPTCY ESTATE?**

Section 541(b)(4)(A) of the Bankruptcy Code excludes from property of the estate a debtor's interest in liquid or gaseous hydrocarbons that it has transferred or agreed to transfer pursuant to a farmout agreement if, but for section 541(b)(4), the interest would come into the estate as a result of rejection or avoidance.<sup>60</sup> Section 541(b)(4)(A) was enacted by Congress in

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<sup>58</sup> *In re Octagon Roofing*, 123 B.R. 583, 590 (Bankr. N.D.Ill. 1991) (“To determine . . . what constitutes a bona fide dispute, ‘the bankruptcy court must determine whether there is an objective basis for either a factual or a legal dispute as to the validity of debt’”) (quoting *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987)).

<sup>59</sup> *Milford Grp., Inc. v. Concrete Step Units, Inc. (In re Milford Grp., Inc.)*, 150 B.R. 904, 907 (Bankr. M.D. Pa. 1992) (permitting a sale of a portion of the debtor's real estate under section 363(f)(4) free and clear of an alleged lien because testimony at a hearing showed the alleged lien was in bona fide dispute).

<sup>60</sup> Section 541(b)(4)(A) of the Bankruptcy Code provides as follows:

(b) Property of the estate does not include –

1992 as part of the Energy Policy Act of 1992,<sup>61</sup> and was intended to avoid an unfair enrichment of the debtor-farmor's estate at the farmee's expense. The legislative history of section 541(b)(4)(A) reflects that "[t]he current state of the bankruptcy law has created uncertainty surrounding the use of farmout agreements" and that it was "in the national interest for this uncertainty to be eliminated to foster the continued exploration for, and development of, domestic oil and gas reserves."<sup>62</sup> The addition of section 541(b)(4)(A) was intended "to prohibit farmouts and related agreements from being rejected as executory contracts or being voidable by the trustee as a hypothetical bona fide purchaser, where such action would add value to the debtor's estate."<sup>63</sup>

So, what happens when a farmor files for bankruptcy? Is the undrilled and unearned acreage subject to the farmout agreement kept out of the estate since, pursuant to the farmout agreement the debtor "transferred or agreed to transfer" the acreage in question? Or does section 541(b)(4)(A) only apply to acreage that was drilled and earned but unassigned as of the petition date, thereby resulting in the undrilled and unearned acreage coming into the bankruptcy estate for use or sale by the debtor?

There are no reported opinions on this issue. As a result, practitioners have to resort to legal commentators, state law and industry practice to mount their arguments. While it would appear obvious and there otherwise appears to be some consensus in the literature that drilled

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- (4) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that—  
(A) (i) the debtor has transferred or has agreed to transfer such interest pursuant to a farmout agreement or any written agreement directly related to a farmout agreement; and  
(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 544(a)(3) of this title;

<sup>61</sup> Pub. L. No. 102-486, 106 Stat. 2776.

<sup>62</sup> H.R. Rep. No. 102-474 (VII) (1992), *reprinted in* 1992 U.S.C.C.A.N. 2271, 2277-78.

<sup>63</sup> *Id.*

and earned but unassigned acreage under a farmout agreement is covered by section 541(b)(4)(A) (and thereby excluded from the bankruptcy estate),<sup>64</sup> there is disagreement on whether the carve out applies to unearned, undeveloped acreage.<sup>65</sup>

Whether section 541(b)(4)(A) applies to undeveloped leasehold was hotly contested in the VNR Bankruptcy. Encana asserted that its right to drill and earn wells on the undeveloped land subject to the farmout agreement fell squarely within the carve out of section 541(b)(4)(A), was outside of Vanguard's bankruptcy estate, and Encana thus retained the right to continue drilling and earning despite Vanguard's attempt to reject the agreement.<sup>66</sup> Vanguard, as lessee under the leases, was conveyed the right to develop its leases in fee simple determinable. By virtue of the farmout agreement, Vanguard assigned the development right – together with the right to earn a working interest in the leases – to Encana. Encana fully earned its right to drill and earn the undeveloped acreage as a result of its drilling and completion of certain commitment wells and its compliance with its continuous development obligation under the farmout agreement. Accordingly, the right to enter onto the leasehold to drill and earn was a

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<sup>64</sup> Rhett G. Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, 5 TEX. J. OIL GAS & ENERGY L 265, 281-82 (2010) (“If the debtor is a farmor under a farmout, the property interest that is earned by the farmee is not property of the estate except to the extent of the contract rights of the farmor under the farmout agreement. That is, the debtor-farmor cannot ‘reject’ the farmout and take away the farmee's right to receive an assignment of the title earned by the farmee).

<sup>65</sup> Compare Mitchell Ayer, *The § 541(b)(4) Safe Harbor for Recipients of Farmouts from Debtors in Bankruptcy*, 34 E. MIN. L. FOUND. § 7.06 (2013) (“What about a situation where the Debtor has been paid two million dollars to farmout an area in which 10 wells can be drilled and 10 separate assignments will be made for the acreage surrounding the wells. At the time of filing of the petition, three wells have been drilled. Clearly the farmee has earned that acreage. But what about the rights to earn the acreage for the other seven wells? The answer is not clear but we submit the farmee should be entitled to drill and earn the remaining acreage”), with Rhett G. Campbell, *A Survey of Oil and Gas Bankruptcy Issues*, 5 TEX. J. OIL GAS & ENERGY L 265, 282 (2010) (“True, § 541(b)(4) the safe harbor protects the farmee as to that part of the farmout that “the debtor has . . . agreed to transfer,” but it is unclear whether that phrase is limited to the earned but untransferred portion of the farmout as of the date of filing, or whether it also operates in futuro as to the to-be-earned farmout. The latter reading would deprive the debtor of the ability to reject the unearned portion of the farmout, a construction at odds with the express language of § 365”).

<sup>66</sup> VNR Bankruptcy Docket No. 486.

valid real property interest held by Encana either exclusively or as cotenant with Vanguard that could not be rejected in bankruptcy.<sup>67</sup>

Conversely, Vanguard argued that it never “transferred or agreed to transfer” the right to drill the undeveloped acreage to Encana and the farmout agreement lacked sufficient granting language.<sup>68</sup> Vanguard contended that it maintained the exclusive right to drill the undeveloped acreage, so Encana could have no reasonable expectation thereto. Additionally, Vanguard argued, construing section 541(b)(4)(A) to apply to undeveloped acreage would result in a windfall for the farmee and an unconstitutional taking from the farmor.<sup>69</sup>

Because Encana and Vanguard reached a settlement, the bankruptcy court never had the opportunity to rule on the section 541(b)(4)(A) issue. However, the judge did state “for the record” at a hearing on Vanguard’s motion to dismiss certain of Encana’s causes of action for declaratory relief, that he was “heavily weighing into my mind . . . the article that was cited by Vanguard written by [Rhett] Campbell” – which would seem to imply that the court would have potentially come down in favor of the farmor.<sup>70</sup>

**B. SECTION 363(F)(4): CAN A DEBTOR-FARMOR SELL ITS LEASEHOLD FREE AND CLEAR OF A FARMOUT AGREEMENT?**

Outside of bankruptcy, a farmor who wants to sell its interest in a leasehold would typically do so subject to an existing farmout agreement. But what happens in bankruptcy? In the VNR Bankruptcy, Vanguard sought to sell its leasehold free and clear of the existing farmout agreement and succeeded over Encana’s objection.

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<sup>67</sup> *Id.*; see also VNR Bankruptcy Docket No. 550.

<sup>68</sup> Encana Adversary Docket No. 9; VNR Bankruptcy Docket No. 500.

<sup>69</sup> Encana Adversary Docket No. 9.

<sup>70</sup> Transcript of proceedings before Hon. Marvin Isgur, April 13, 2017, at p. 131:11-132:6.

Recall the chronology:

- Vanguard files for chapter 11 and promptly seeks to reject its farmout agreement with Encana,<sup>71</sup>
- Encana files an objection to the rejection motion and simultaneously files an adversary proceeding against Vanguard, seeking a declaratory judgment that (among other things) (i) the undrilled and unearned lands are excluded from the estate under section 541(b)(4)(A) of the Bankruptcy Code or, in the alternative, (ii) the farmout agreement served to provide Encana with a real property interest in the undrilled and unearned lands, which property interest was not subject to rejection;<sup>72</sup>
- Vanguard files a motion to sell its interests in the undrilled and unearned acreage subject to the Encana farmout agreement.<sup>73</sup>

At the hearing on the rejection motion, the bankruptcy judge said, in sum and substance “there is an adversary proceeding pending wherein I will determine the nature of Encana’s interest and the scope of section 541(b)(4)(A). However, as it pertains to the requested rejection, I will enter an order allowing Vanguard to reject, but what is actually being rejected and the scope of that rejection will be determined in the adversary.”

Subsequently, while the adversary proceeding was pending and briefing was under way on Vanguard’s motion to dismiss, Vanguard sought to sell its interest in the undrilled and unearned acreage. Encana raised three central arguments against the sale. First, Encana argued that because it held a standalone real property interest in the leasehold (the right to drill and develop), Vanguard did not have an alienable interest. Second, to the extent that Vanguard and Encana shared an undivided interest in the drilling right, Vanguard could not sell Encana’s co-owned interest outside of an adversary proceeding. Third, in the event that the bankruptcy court

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<sup>71</sup> VNR Bankruptcy Docket Nos. 1 & 16.

<sup>72</sup> VNR Bankruptcy Docket No. 209; Encana Adversary Docket No. 1.

<sup>73</sup> VNR Bankruptcy Docket No. 429.

was inclined to authorize a sale, Encana could not be forced to accept monetary satisfaction (*i.e.*, a portion of the sale proceeds) for its unique real property interest.<sup>74</sup>

As to the first argument, if the farmout agreement conveyed a real property interest to Encana, Vanguard could not use the Bankruptcy Code to sell assets free and clear of that interest. It is axiomatic that a debtor may not use the Bankruptcy Code to sell (i) assets that are not property of its bankruptcy estate or (ii) more than it had on the petition date.<sup>75</sup> Because the bankruptcy court deferred ruling on the extent of Encana's interest in the underlying leasehold, Encana faced the unenviable task trying to overcome a section 363(f)(4) sale before it had the opportunity to fully prove up its ownership interest (or, conversely, that Vanguard did not have an interest). Encana argued that the bankruptcy court should delay authorizing any sale of Vanguard's property in which Encana claimed an interest until the court determined exactly what rights Encana and Vanguard had to that property.<sup>76</sup> Moreover, because Encana claimed a real property interest in the leasehold, the interest allegedly in bona fide dispute was an ownership interest, so section 363(f)(4) did not apply.<sup>77</sup>

Vanguard countered that Encana did not have a real property interest because (i) the farmout agreement contained nothing more than a right to propose wells, since Vanguard retained the exclusive right to drill, (ii) the farmout agreement could not have conveyed a real property interest to Encana because it did not express a present intent to convey such interest or

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<sup>74</sup> VNR Bankruptcy Docket No. 550.

<sup>75</sup> *See, e.g., In re Mirant Corp.*, 389 B.R. 481, 492, (Bankr. N.D. Tex. 2008) (“The bankruptcy court’s authority under section 363 is limited to cleansing what a debtor owns from the claims, encumbrances and charges of third parties that are (or can be) quantified as claims under 11 U.S.C. § 101(5) or 102(2). Neither section 363 nor any other provision of the Bankruptcy Code gives the bankruptcy court the power to enhance or improve whatever ownership interest was held by the debtor prepetition that became property of the estate”).

<sup>76</sup> VNR Bankruptcy Docket No. 550.

<sup>77</sup> *See* cases cited at note 57, *supra*.

contain an adequate description of the property to be conveyed, and (iii) even if Encana had some ownership interest in the drilling right and/or the underlying leasehold, 363(f)(4) encompasses disputed ownership interests, so Vanguard could still sell free and clear of Encana's interest.<sup>78</sup>

Second, Encana argued that section 363(f) did not apply to the proposed sale because Encana and Vanguard were co-owners of the drilling right. It is well-settled Texas law that owners of undivided portions of oil and gas interests are tenants in common.<sup>79</sup> Thus, absent Encana's consent, Vanguard could not sell its undeveloped leasehold outside of an adversary proceeding brought pursuant to section 363(h) of the Bankruptcy Code, which governs the sale of co-owned interests.<sup>80</sup> Vanguard of course maintained that the bankruptcy court could nevertheless sell the leasehold interest pursuant to section 363(f)(4).<sup>81</sup> The court ultimately agreed that there was a bona fide dispute pursuant to section 363(f)(4) and that the potential application of section 363(h) was not a gating issue.

Finally, Encana argued that because it claimed a real property interest in Vanguard's undeveloped leasehold, and because Texas law recognizes a property interest as unique, Encana could not be forced to accept monetary satisfaction for its interest and thus, could not be adequately protected in the sale proceeds.<sup>82</sup> The party seeking to sell the property free and clear

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<sup>78</sup> VNR Bankruptcy Docket No. 567.

<sup>79</sup> *Willson v. Superior Oil Co.*, 274 S.W.2d 947, 950 (Tex. Civ. App. — Texarkana 1954, writ ref'd n.r.e.); *Glover v. Union Pac. R. Co.*, 187 S.W.3d 201, 213 (Tex. App. — Texarkana 2006, pet. denied); see also *Rankin v. Naftalis*, 557 S.W.2d 940, 946 (Tex. 1977) (JOAs create a cotenancy relationship) (cited by *Cass v. Stephens*, 156 S.W.3d 38, 61 (Tex. App.—El Paso 2004, pet. denied) (“Here, the JOAs created a cotenancy relationship”)).

<sup>80</sup> See 11 U.S.C. § 363(h) (setting forth procedure for selling interest of co-owner); *In re Lane*, No. 08-80414-G3-7, 2010 WL 4607527, at \*2 (Bankr. S.D. Tex. Nov. 4, 2010) (denying sale motion under section 363(b) for failure to comply with adversary proceeding requirement of section 363(h)).

<sup>81</sup> VNR Bankruptcy Docket No. 567.

<sup>82</sup> VNR Bankruptcy Docket No. 550.

bears the burden of proving that asserted interests are adequately protected.<sup>83</sup> When the nature of the creditor's interest is such that adequate protection cannot be given, or when the debtor fails to satisfy its burden with respect to adequate protection, the court must prohibit any sale of the property to which that interest attaches.<sup>84</sup> Sales free and clear of non-lien interests in real property have been rejected as being the sort of interests for which adequate protection cannot be given.<sup>85</sup> If Encana could not be adequately protected through the escrowing of sale proceeds, then the leasehold must be sold "subject to" rather than "free and clear."<sup>86</sup> The bankruptcy court held that even if Encana had a real property interest, there is nothing unique about what amounts to a purely commercial asset that could not be compensated through the proceeds of sale. As a result, the bankruptcy court escrowed the proceeds pending a later determination of the parties' relative rights, cutting off Encana's rights to the leasehold itself.<sup>87</sup>

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<sup>83</sup> 11 U.S.C. § 363(p) ("the [debtor] has the burden of proof on the issue of adequate protection"); *see also In re AMR Corp.*, 490 B.R. 470, 477 (S.D.N.Y. 2013).

<sup>84</sup> *See Martin v. Commodity Credit Corp. (In re Martin)*, 761 F.2d 472, 478 (8th Cir. 1985) ("if adequate protection cannot be afforded under any circumstances, the debtor's request for [use or sale of the collateral] should be denied"); *In re Dewey Ranch Hockey, LLC*, 414 B.R. 577, 592 (Bankr. D. Ariz. 2009) ("the clear statutory statement in Section 363(e) requires that the court 'shall prohibit' any sale, where the interests sought to be removed by the proposed sale free and clear of such interests, can not [sic] be adequately protected"); *see also Rieser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 697 (6th Cir. 1992) (prohibiting sale of golf memberships where interests of parties on wait list could not be adequately protected).

<sup>85</sup> *In re Haskell L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005) (sale free and clear of leasehold in exchange for second lien on proceeds prohibited because value of leasehold interest was difficult, if not impossible, to calculate and because second lien on proceeds necessarily meant lessor would ultimately get nothing); *In re Southcreek Development, LLC*, No. 10-90327, 2011 WL 44703, at \*4 (Bankr. C.D. Ill. Jan. 6, 2011) (holding that a municipality could not be compelled to accept money satisfaction in lieu of equitable enforcement of an annexation agreement).

<sup>86</sup> *In re Dynamic Tooling Sys., Inc.*, 349 B.R. 847, 856 (Bankr. D. Kan. 2006) (ordering the debtor's customer's right to use intangible assets to remain in place after the sale as adequate protection); *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696, 711 (S.D.N.Y. 2014) (upholding bankruptcy court's sale of property subject to leasehold interest on the grounds that "it is difficult to value the lessee's *unique property interest*") (emphasis added).

<sup>87</sup> VNR Bankruptcy Docket No. 761.

### **C. SECTION 365: IS A FARMOUT AGREEMENT A COVENANT RUNNING WITH THE LAND NOT SUBJECT TO REJECTION?**

Real property interests, like covenants running with the land, are not subject to rejection under section 365 and thus continue to burden a debtor's property despite a bankruptcy filing.<sup>88</sup> Although it is a fact-intensive analysis largely dependent upon the language of a particular agreement, the authors contend that a farmout agreement may constitute a covenant running with the land.

To determine the nature of an interest in property, bankruptcy courts must look to applicable state law.<sup>89</sup> Under Texas law, a covenant runs with the land when (i) it touches and concerns the land; (ii) it relates to a thing in existence or specifically binds the parties and their assigns; (iii) the original parties to the covenant intend it to run with the land; (iv) the successor to the burden has notice; and (v) vertical privity exists between the parties.<sup>90</sup>

#### **1. Touch and Concern**

The Texas Supreme Court has held that a covenant touches and concerns the land when it affects the “nature, quality or value of the thing demised, independently of collateral circumstances, or if it affect[s] the mode of enjoying it.”<sup>91</sup> Put another way, Texas law requires

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<sup>88</sup> See *In re Energytec, Inc.*, 739 F.3d 215, 225 (5th Cir. 2013) (holding that bankruptcy sale was not free and clear of covenants running with the land); *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994) (finding section 365 of the Bankruptcy Code inapplicable to covenants running with the land because they are property interests); *In re Beeter*, 173 B.R. 108, 114 (Bankr. W.D. Tex. 1994) (same); *In re Banning Lewis Ranch Co., LLC*, 532 B.R. 335, 345–46 (Bankr. D. Colo. 2015) (same).

<sup>89</sup> See *Butner v. United States*, 440 U.S. 48, 55 (1979) (“[p]roperty interests are created and defined by state law”); *In re Universal Seismic Assocs., Inc.*, 288 F.3d 205, 208 (5th Cir. 2002) (same); *In re Prado*, 340 B.R. 574, 579 (Bankr. S.D. Tex. 2006).

<sup>90</sup> *In re Energytec, Inc.*, 739 F.3d at 221 (citing *Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987)).

<sup>91</sup> *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

that a burden created by a covenant have a direct impact upon the land itself and its value, not just the parties personally.<sup>92</sup>

The farmee's rights contained in a farmout agreement can directly impact the farmor's use and enjoyment of the underlying leasehold, thereby satisfying the touch and concern element. First, by farming out its right to enter, drill and develop the leasehold (which is a real property interest under Texas law),<sup>93</sup> a farmor creates a burden on the use of its real property in favor of the farmee that binds any successors.<sup>94</sup> Second, the farmor's leasehold is burdened by its obligation, upon drilling and completion of a well by the farmee, to assign to the farmee the portion of its working interest to which the farmee is entitled under the farmout agreement.<sup>95</sup> Third, a farmout agreement impacts the value of the underlying leasehold since the farmor cannot transfer the leasehold separate and apart from the farmee's right to drill.

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<sup>92</sup> See, e.g., *Westland Oil*, 637 S.W.2d at 911 (holding that a promise to convey interests in oil and gas leases via an area of mutual interest provision burdened the land by potentially rendering it less valuable); *Wimberly v. Lone Star Gas Co.*, 818 S.W.2d 868, 870 (Tex. App.—Fort Worth 1991, writ denied) (holding that a contract permitting a gas company to purchase water from wells on an owner's land was a covenant running with the land); *Prochemco, Inc. v. Clajon Gas Co.*, 555 S.W.2d 189, 192 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (holding that a covenant to provide gas ran with the land).

<sup>93</sup> *Texas Co. v. Daugherty*, 176 S.W. 717 (Tex. 1915) (holding that an oil and gas lease vests the lessee-owner with a fee simple determinable interest in the oil and gas in place).

<sup>94</sup> See, e.g., *Wimberly*, 818 S.W.2d at 870. In *Wimberly*, a landowner and the operator of a gas compressor station entered into a contract whereby the operator was permitted to enter onto the land to drill for and purchase water from the landowner's well for the operator's use "so long as [operator] operated the plant." The landowner sold the property to new owners, and the new owners tried to terminate the contract with the operator. On summary judgment, the new owners argued they were not bound to deliver water because the contract only benefitted the operator's gas plant, and not their own land. The court rejected this argument, holding that the original landowner's promise to provide access to the water touched and concerned real property. The right to enter upon land and drill for and purchase water in *Wimberly* is analogous to a farmee's drilling right under a farmout agreement since groundwater, like oil and gas, is considered real property while in the ground. TEXAS WATER CODE ANN. §36.002(a) ("a landowner owns the groundwater below the surface of the landowner's land as real property"); *Edwards Aquifer Auth. v. Day*, 369 S.W.3d 814 (Tex. 2012) (analogizing the characterization and ownership of groundwater to oil and gas).

<sup>95</sup> *Westland Oil*, 637 S.W.2d at 911 (holding that an area of mutual interest (AMI) provision satisfied the touch and concern requirement because it was a promise to convey interests in an oil and gas leasehold estate affects the nature and value of the land). It is the authors' opinion that if the Texas Supreme Court found that an AMI met the touch and concern requirement for real property interests to be acquired in the future, then a farmout agreement by implication also touches and concerns the land, given that a farmout involves a much more concrete interest in real property.

## **2. Relate to a Thing in Existence**

Farmout agreements relate to a thing in existence – the underlying leasehold.

## **3. Intended by the Original Parties to Run with the Land**

Texas courts have found that intent to run with the land is present when agreements are filed in the appropriate real property records.<sup>96</sup> An explicit reference in the agreement that it is binding on successors and assigns, while helpful, is not dispositive in determining intent.<sup>97</sup>

In the VNR Bankruptcy, Vanguard argued that the original parties could not have possibly intended for the farmout agreement to run with the land because the parties did not include successors and assigns language in the agreement.<sup>98</sup> To combat this argument, Encana turned to the joint operating agreement between the parties, which was specifically incorporated into the farmout agreement and did contain successors and assigns language.<sup>99</sup>

## **4. Successors in Interest Are on Notice**

The notice requirement is satisfied when a memorandum, of agreement is filed in the real property records.<sup>100</sup>

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<sup>96</sup> *Harris County Flood Control Dist. v. Glenbrook Patiohome Owners Ass'n*, 933 S.W.2d 570, 575 (Tex. App.—Houston [1st Dist.] 1996, writ denied).

<sup>97</sup> *Montfort v. Trek Resources, Inc.*, 198 S.W.3d 344, 355 (Tex. App.—Eastland 2006, no pet.).

<sup>98</sup> VNR Bankruptcy Docket No. 337; Encana Adversary Docket No. 9.

<sup>99</sup> When interpreting the meaning or intent of a contract, courts treat the contract, together with any external agreements or documents referenced therein, as one single agreement. See *In re Bank One, N.A.*, 216 S.W.3d 825, 826 (Tex. 2007) (arbitration agreement referenced in executed contract was deemed to be part of the contract); *Chicago Dist. Council of Carpenters Pension Fund v. K & I Constr., Inc.*, 270 F.3d 1060, 1069 (7th Cir. 2001) (“[t]he reasonableness of a proposed interpretation of contractual language requires consideration of the contract as a whole, including terms incorporated by reference”).

<sup>100</sup> *Cooksey v. Sinder*, 682 S.W.2d 252, 253 (Tex. 1984) (holding that a purchaser is charged with knowledge of the provisions and contents of recorded instruments affecting its title).

## 5. Privity

The test for covenants running with the land set forth by the Texas Supreme Court in *Inwood* did not specifically require privity of estate between the parties. Nonetheless, the Texas Supreme Court went on to address privity of estate or “vertical” privity – that is, whether there is a mutual or successive relationship to the same rights of property – which it had discussed previously in *Westland Oil*.<sup>101</sup> In the context of a farmout agreement, vertical privity is present if there is a clear chain of title between original farmee/farmor and the current farmee/farmor, *i.e.*, if the original farmor sold its leasehold interest to another producer.

Some Texas courts have required the additional element of horizontal privity, which is a simultaneous existing interest between the original parties as either landlord and tenant or grantor and grantee.<sup>102</sup> In other words, horizontal privity requires that the covenant be created in conjunction with a conveyance of an estate in land.<sup>103</sup> Therefore, current Texas law appears to be unsettled with respect to whether the additional horizontal privity element is required for a covenant to run with the land. It is the authors’ opinion that horizontal privity is not a requirement for a covenant to run with the land since the Texas Supreme Court has never addressed horizontal privity, and instead, has found covenants not otherwise meeting the horizontal privity test to be covenants running with the land.<sup>104</sup>

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<sup>101</sup> *Inwood North*, 736 S.W.2d at 635; *Westland Oil*, 637 S.W.2d at 910-11.

<sup>102</sup> *Energystec*, 739 F.3d at 222. In *Energystec*, the Fifth Circuit noted that horizontal privity was not a requirement set forth by the Texas Supreme Court and that it is a “much-criticized doctrine that has been explicitly rejected by this latest Restatement [of Property].” *Id.* The Fifth Circuit, nevertheless, performed the horizontal privity analysis and determined that in the event horizontal privity was required, it was satisfied. *Id.* at 223.

<sup>103</sup> *Id.* (citing *Wayne Harwell Prop. v. Pan Am. Logistics Ctr., Inc.*, 945 S.W.2d 216, 218 (Tex. App.—San Antonio 1997, writ denied)); *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App.—Tyler 2013, no pet.).

<sup>104</sup> See *Inwood*, 736 S.W.2d at 635 (covenant created by land developer in declaration, not in grant); *Westland Oil*, 637 S.W.2d at 905-06, 910-11 (finding privity in successive ownership to property covered by AMI in assignment to farmout agreement).

However, at least one bankruptcy court has found that horizontal privity is a requirement for a covenant to run with the land under Texas law.<sup>105</sup> In the VNR Bankruptcy, Vanguard asserted that horizontal privity was required and that the farmout agreement could not satisfy this final element of a real covenant.<sup>106</sup> Encana argued that the farmout agreement did in fact meet the horizontal privity requirement because it contained a conveyance of real property – the right to drill and develop.<sup>107</sup> As a result, according to Encana, the original parties to the farmout agreement each possessed an interest in the leasehold sufficient to satisfy the requirement for horizontal privity.<sup>108</sup>

## **V. DRAFTING CONSIDERATIONS**

In light of the issues raised in the VNR Bankruptcy, practitioners, particularly those representing the farmee, must take careful note in drafting farmout agreements. At a minimum, there should be some granting language that transfers a vested real property right to the farmee.

### **A. ALTERNATIVE TO A FARMOUT AGREEMENT**

A farmout agreement typically implements a “drill-to-earn” structure. An alternative to a standard, or typical, farmout agreement is a term assignment. With a term assignment, the lessee executes an assignment of the oil and gas leases to the proposed assignee for a negotiated period of time. At the end of the term, the assignee typically retains a certain number of acres around each well drilled pursuant to the term assignment, and assigns the acreage not retained back to the original assignor. Therefore, a term assignment differs from a farmout agreement because it

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<sup>105</sup> *In re Sabine Oil & Gas Corp.*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016).

<sup>106</sup> VNR Bankruptcy Docket No. 337.

<sup>107</sup> *Clayton Williams*, 473 S.W.3d at 353 (holding that under a farmout agreement, a farmor assigns his property interest in developing his mineral estate to the farmee).

<sup>108</sup> *See MPH Prod. Co. v. Smith*, No. 06-11-00085-CV, 2012 WL 1813467, at \*6 (Tex. App.—Texarkana May 18, 2012) (grantor’s ownership of mineral estate and grantee’s ownership of right of first refusal as to mineral estate satisfied horizontal privity test).

structures the transaction as “drill-to-retain” rather than “drill-to-earn.” The benefit to the assignee/farmer from a term assignment is that the assignee is unquestionably vested with a fee simple determinable interest in the oil and gas leases. Therefore, the assignee should theoretically not be at risk of having its already-assigned acreage pulled into the assignor/farmer’s bankruptcy estate.

In some situations, however, it may be difficult to structure a transaction as a term assignment. A term assignment is typically used when the assignee pays value for the leases up front. On the other hand, a farmer typically pays no value up front for the farmout agreement. Therefore, if the assignee/farmer is unable or unwilling to pay for the assignment up front, it could be difficult to convince an assignor/farmer to execute a term assignment in lieu of a farmout agreement.

#### **B. CONVEYANCE OF “THE RIGHT TO DEVELOP”**

As previously discussed, the right to develop is (i) one of the sticks in the mineral estate bundle, (ii) a separate real property interest and (iii) freely alienable. The typical farmout agreement does not mention the “right to develop” in the legal sense and there is typically no assignment executed by the farmer until a well is drilled to the contractually required depth. The lack of a clear conveyance creates the gray area in which the farmer’s rights under the farmout agreement could be subject to rejection or sale by the debtor-farmer. Therefore, it is vital for a farmer wishing to avoid having its rights extinguished by a debtor-farmer that the farmout agreement transfer to the farmer a real property interest.

As an alternative to a term assignment, a farmer might request a specific conveyance of the farmer’s “right to develop.” This conveyance should be recorded in the real property records so that third parties are put on notice of the farmer’s rights. Although this kind of proposed

conveyance is not typical, it could make clear that the parties to the farmout agreement intended to, and did, transfer a vested real property right to the farmee. Such a conveyance would be unique and, as a result, it is difficult to know or project how a court might construe the same. However, this type of conveyance would put the farmee in a strong position to argue that the farmout agreement conveyed a real property interest to the farmee, and that such a real property right cannot be extinguished in bankruptcy.

### **C. OTHER ISSUES, TO PROPOSE OR NOT TO PROPOSE**

In the VNR Bankruptcy, Vanguard argued the word “propose” gave the party to whom the proposal was made the right to reject the proposal. In other words, Vanguard argued that it had the right to veto the drilling of wells by the farmee. The word “propose” is used both in farmout agreements and in JOAs. A farmor may have the right to propose the drilling of an initial well (in farmouts where the initial well is not an obligation) or it may have the right to propose the drilling of additional wells, after the drilling of the initial well. The word “propose” is almost universally understood in the oil and gas industry to give the party to whom the proposal is made the right to either participate in a well or not participate. This also comports with the common usage and understanding of the word “propose” as used in joint operating agreements. However, because the issue arose prominently in the VNR Bankruptcy, an astute farmee will want to make sure to clarify that its right to propose wells gives it the unconditional right to drill wells and that the farmor does not have a veto right.

It is also arguable that a farmout agreement constitutes a covenant running with the land or an equitable servitude. For that reason, a farmee should consider including language which stipulates that the farmout agreement is in fact a covenant running with the land (and an equitable servitude) that will be binding upon successors and assigns. Additionally, to satisfy

any horizontal privity requirements, a current conveyance of the right to develop is advisable. Furthermore, it is best practice to file a memorandum of the farmout agreement to be sure that any successors are on notice of the burdens created by the farmout agreement.