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A Close Look At Overriding Royalty Interest Transactions

Law360, New York (June 13, 2014, 11:02 AM ET) -- Overriding royalty interests, commonly referred to as ORRIs, have been used for decades by oil and gas exploration and production companies as mechanisms for obtaining funding, particularly in situations where more traditional methods, such as bank loans, are not available on attractive terms. An ORRI is an interest that is carved out of the lessee's leasehold working interest and transferred to a third party in exchange for assets — typically cash — specified in the transfer documents.

ORRIs come in two forms (though there are many variations of each): "term" ORRIs and "perpetual" ORRIs. Term ORRIs are limited in duration, either by a period of time or until the project produces a specified quantity of hydrocarbons or proceeds from the sale of those hydrocarbons. So-called dollar-denominated, or volumetric production, payments generally provide for the reversion to the grantor of the interest conveyed, upon receipt by the purchaser of an amount equal to the specified sum advanced by the purchaser along with, typically, an additional amount such that the total amount received produces a targeted internal rate of return, or "IRR," for the purchaser.

In contrast, perpetual ORRIs generally provide no right of reversion; instead, in exchange for the specified consideration, the third party retains a "perpetual" right to a percentage of the hydrocarbons or the sale proceeds attributable to the carved-out interest for as long as that property continues to produce.

Parties have frequently used the ORRI structure with an understanding that the interest being transferred is an absolute conveyance of a real property interest, to be held for the term of the ORRI by the entity "purchasing" the right to the production payment. And indeed, the local laws of many states support that understanding.

The characterization of the interest being transferred as an absolute conveyance of a real property interest, rather than as merely collateral securing a financing transaction, becomes particularly important in bankruptcy, where characterization of the transfer as absolute results in the exclusion of the interest from the debtor's bankruptcy estate, while treatment as a collateral interest to secure a

financing transaction means that the interest will remain part of the estate of the debtor and subject to the jurisdiction of the bankruptcy court.

The likely characterization of an ORRI interest is thus an important consideration for a capital provider considering the risks and benefits of an ORRI transaction compared to a traditional debt or equity investment, because it may determine whether a transferee will have to stand in line with the rest of the creditors in the context of a bankruptcy case. However, several recent court opinions question this interest application.

In In re: ATP Oil & Gas Corp., the Houston Division of the Southern District of Texas, applying Louisiana law, recently affirmed decisions of the bankruptcy court denying motions for summary judgment made by holders of ORRIs and net profits interests (NPIs) on the ground that the proper characterization of the transactions involved depended upon the true commercial nature of the transaction, notwithstanding the explicit language of the transaction documents. The decisions made clear that, in most cases, the legal characterization of a term ORRI, at least for bankruptcy purposes on properties located in federal waters adjacent to Louisiana, is highly fact-specific.

Prior to its bankruptcy, ATP had entered into a number of production payment transactions involving properties located in federal waters on the Outer Continental Shelf adjacent to Louisiana. In its bankruptcy proceeding, several of the holders of these interests brought adversary proceedings contending that their interests constituted real property, and, as such, the transfers were complete at the time of closing, excluding the interests from the estate of the debtor.

In response, ATP, as debtor in possession, argued that the various term ORRIs that it transferred to third parties in exchange for cash should be considered to be "disguised financings," as opposed to absolute conveyances, or "true sales," of real property interests, and the underlying assets should therefore be considered part of the bankruptcy estate. The holders of the term ORRI interests moved for summary judgment on the characterization issue, arguing that as a matter of Louisiana state law, a term ORRI is an absolute conveyance of a real property interest.

Judge Marvin Isgur denied the holders' summary judgment motions, relying on the holding of the Louisiana Supreme Court in Howard Trucking Co. v. Stassi, 474 So.2d 915 (La. 1986), to conclude that the best evidence of the parties' intent as to characterization is "what the parties agreed to do," i.e., the "economic substance of the transactions."

The bankruptcy court then held that there was a genuine issue of material fact as to the economic substance of the term ORRI transactions. In so holding, the court looked past the language of the transaction documents and focused on the economic terms and circumstances of the transactions. For instance, the court noted:

(1) the transactions included the use of a designated IRR and cash-on-cash hurdles that were to be paid to the ORRI purchaser on top of the "purchase" price, a provision that ATP argued is analytically equivalent to the payment of interest on a loan;

(2) in certain instances, ATP, as opposed to the buyers, took the risk of performance and was responsible for ensuring that the buyers achieved their designated IRR;

(3) certain transactions provided for conditional increases in distribution and royalty percentages, such that royalty percentages increased if ATP failed to reach certain milestones by a given date;

(4) certain transactions provided for cross-collateralization such that the buyer was entitled to receive full production payments across multiple leases, even where one lease ceased production; and

(5) certain transactions contained a protective mortgage (i.e., a security agreement that granted a security interest in the specified amounts owed to the buyer) that would take effect in the event a court found the interests did not constitute real property interests. Judge Isgur's rulings denying summary judgment have since been affirmed by the district court.

For now, the cases continue, and the end result cannot be predicted. In the meantime, therefore, capital providers that are considering entering into term ORRI transactions, or similar transactions, such as NPI transactions, must take into consideration the possibility that the interest they acquire may be similarly treated in the event of the bankruptcy of the lessee of the property.

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