

# ADMINISTRATIVE WATCH

## ADDRESSING ENVIRONMENTAL, ENERGY AND NATURAL RESOURCE ISSUES



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### **Pennsylvania Oil and Gas Law and Section 365 of the Bankruptcy Code – Can an oil and gas lease be rejected in bankruptcy?**

The recent boom in gas drilling in Pennsylvania due to the development of the Marcellus Shale would seem to be a windfall to landowners who have signed leases for the development of gas reserves on their property. When such a landowner becomes a debtor in a bankruptcy case, however, the value of such a lease can be put at issue. The anticipated royalties under such a lease could mean the difference between a fully funded plan and an unfortunate liquidation.

But what if the lessor/debtor, or a bankruptcy trustee, believes the lease is not lucrative enough, or interferes with other uses of the property? Can the lease be rejected under the Bankruptcy Code? As it turns out, the answer is not entirely clear in Pennsylvania, at least at this point, and may depend upon whether gas production has commenced under the lease.

Under Section 365 of the Bankruptcy Code, a debtor may assume or reject any executory contract or unexpired lease. This provision allows a debtor to accept and continue to enjoy the benefits of favorable contracts, and reject and refuse to perform unfavorable ones. If a debtor rejects an executory contract during the bankruptcy case, the rejection is treated as a breach of the contract, which breach is deemed to have occurred immediately prior to the bankruptcy filing. Thus, a claim for damages resulting from such a breach is a pre-bankruptcy unsecured claim.

As a practical matter, this means that a debtor might decide to reject an executory contract or unexpired lease if the debtor believes it can enter into a new contract or lease on more favorable terms. For example, the debtor may wish to obtain another signing bonus and/or a higher royalty percentage. If the rejection of an executory contract or unexpired lease is approved by the Bankruptcy Court, the debtor no longer has to perform its obligations, and the non-debtor party will then have a claim against the debtor for damages as a result of the breach. Since the Bankruptcy Code treats such a claim as a general unsecured pre-bankruptcy claim, such a claim will likely be entitled to pennies on the dollar under a confirmed Plan of Reorganization or in a liquidation.

It would seem intuitive that an oil and gas lease is a “lease”, or at least a “contract”, and therefore subject to rejection under Section 365, but the plain meaning of the words “contract” or “lease” are not the end of the analysis. While the Bankruptcy Code is interpreted as a matter of federal law, state law determines the rights created and or conveyed under an oil and gas lease. Accordingly, Pennsylvania state law controls whether an oil and gas lease is treated as a contract, a lease or something else entirely.

As it turns out, under Pennsylvania law, an oil and gas lease is actually a conveyance of inchoate legal title to the oil and gas in place – meaning that title to the oil and gas is not fully vested or perfected until the leasehold property is brought into production. At that time, the lessee gains a fee simple determinable to the oil or gas (over)

in place, or in other words, an interest so long as gas exists on the property unless and until the lease is terminated or abandoned, and may continue to reap the benefit of its efforts in accordance with the terms and conditions of the lease.

Accordingly, under Pennsylvania law, an oil and gas lease may not actually be a “lease” at all, but instead represents a conveyance of the oil and gas estate underlying the leasehold property, albeit a conveyance that is subject to reversion until production has commenced. However, the exact status of an oil and gas lease with a bankruptcy debtor/lessor prior to the commencement of production (and thus whether it is subject to rejection under Section 365 as an unexpired lease) is not clear under Pennsylvania law.

The determination of whether an oil and gas lease is an “executory contract” under the Bankruptcy Code is significant because only an executory contract can be rejected under Section 365. Unfortunately, the Bankruptcy Code does not define the term “executory contract.” Case law generally holds that an executory contract is a contract under which the obligation of both the bankrupt party and the other party are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the performance of the other party. Thus, a contract is considered executory only if each party has an unperformed obligation at the time of the bankruptcy filing that would constitute a material breach if not performed. If the obligations of one party to the contract have been fully performed, the contract may not be found to be executory, and therefore, would not be subject to rejection under Section 365, notwithstanding that the other party has obligations remaining to be performed.

Applying that analysis to a typical oil and gas lease, the obligations of the operator/lessee to pay royalties (or delay rental or shut-in rental) are obvious and continue throughout the secondary term. The obligations of the lessor, however, are less obvious. Indeed, it might be argued that (aside from the exercise of consent rights and obligations under some leases) the lessor has no material, non-contingent obligations at all under the oil and gas lease, having granted to the lessee access to the land and rights to the oil and gas in place. If that were found to be the case, then the oil and gas lease might not be considered an executory contract at all, and therefore not subject to rejection under Section 365.

As of mid-2011, no Bankruptcy Court in Pennsylvania nor the Third Circuit has ruled on the issue of whether a Pennsylvania oil and gas lease is an executory contract or unexpired lease subject to rejection under Section 365. Based upon interpretations of Pennsylvania law and an analysis of bankruptcy courts interpreting the laws of other states, it seems that the answer may depend upon whether the lessee’s rights to the gas in place have vested and become a determinable fee. If a lessee has not brought or attempted to bring a leasehold property into production, then the lessee may have less than a determinable fee interest in the oil and gas under lease, and the status of the oil and gas lease as an executory contract or unexpired lease for purposes of Section 365 is not clear. However, if a lessee has brought a leasehold property into production and is removing gas from the property, a sale of the oil and gas estate in fee simple will likely be found to have occurred under Pennsylvania law. In such event, the oil and gas lease would likely not be subject to rejection.

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