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Protection for Creditors in Bankruptcy: Oklahoma's Unique Approach to Oil & Gas Leases

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NOTES AND COMMENTS

PROTECTION FOR CREDITORS IN BANKRUPTCY: OKLAHOMA'S UNIQUE APPROACH TO OIL & GAS LEASES

I. INTRODUCTION

In oil and gas bankruptcy cases an inherent tension exists between the attempt to carry out the purposes of the Bankruptcy Code¹ and the protection of the interests of the oil industry. While bankruptcy law is federal, and thus designed for national application, bankruptcy courts apply it locally to those debtors doing business where the court sits. A bankruptcy judge in Oklahoma is reminded daily of the importance of the oil and gas industry to Oklahoma. Uncertainty, however, abounds in the application of the present Bankruptcy Code to oil and gas leases in Oklahoma because of the difficulty in characterizing the property interest constituting an oil and gas lease and because of the lack of definition of important terms in the Code.

This examination of how the elusive nature of an oil and gas lease under Oklahoma law interacts with the Bankruptcy Code begins by exploring the unique character of an oil and gas lease in Oklahoma. Then come the three relevant sections of the Bankruptcy Code: section 365, which permits the trustee to assume or reject any executory contract or unexpired lease of the debtor with the court's approval; section 541(d),

1. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-151326 (1982 & Supp. I 1983, Supp. II 1984, Supp. III 1985)). The Bankruptcy Code was enacted on November 6, 1978, and became effective October 1, 1979.

The Code provides for three types of proceedings: (1) liquidation and distribution of all the non-exempt property of the debtor under Chapter 7; (2) rehabilitation under Chapter 11, which allows individuals, partnerships, or corporate debtors to reorganize and pay their debts out of future earnings on a pro rata basis within 10 years; and (3) rehabilitation under Chapter 13 which is limited to individuals who have a regular income and a limited amount of debt. In a voluntary proceeding the debtor institutes the bankruptcy by filing a petition under a particular chapter. 11 U.S.C. § 301 (1982).

This article will focus on reorganization proceedings under Chapter 11. The filing of a petition under Chapter 11 (1) immediately creates an estate for the benefit of the creditors and (2) automatically "stays" all entities with claims against the debtor from further action to collect their claims, to obtain, perfect, or enforce a lien, to enforce a prepetition judgment, etc. 11 U.S.C. § 362 (1982).

which excludes certain equitable interests from the estate of a bankrupt; and section 544(a), which gives the trustee the power to avoid transfers or liens. An analysis of the few cases in which these sections have been applied to Oklahoma oil and gas leases leads to a suggested approach for the holders of interests in oil and gas leases which will protect them in a manner consistent with the purposes of the Code.

II. THE OIL AND GAS LEASE AS PROPERTY IN OKLAHOMA

The Oklahoma Supreme Court has described an oil and gas lease as "the hybrid offspring of an intermarriage between real and personal property, an offspring which is neither entirely real nor personal property, yet which bears distinguishing characteristics of both."² Since oil and gas are viewed as *ferae naturae*,³ the fee simple owner of the land does not have, and cannot convey, an absolute right or title to those minerals.⁴ What the owner does possess and can convey is an "exclusive right, subject to legislative control," to explore for and to obtain and reduce oil and gas to possession, thus acquiring absolute title to the oil and gas as personal property.⁵ This right is considered separate from the possession of the land itself and is termed an "incorporeal hereditament; or more specifically, . . . a profit á prendre, analogous to a profit to hunt and fish on the land of another."⁶ The right granted is an interest in fee if granted "to one and his heirs and assigns forever" but is designated a "chattel real" if limited to a term of years.⁷

2. *Shields v. Moffitt*, 683 P.2d 530, 532 (Okla. 1984). The Oklahoma statutes define property as: "The ownership of a thing is the right of one or more persons to possess and use it to the exclusion of others . . . the thing of which there may be ownership is called property." OKLA. STAT. tit. 60, § 1 (1981). Property is classified as either "[r]eal or immovable; or personal or moveable". OKLA. STAT. tit. 60, § 4 (1981).

3. This term derives from the early view that oil and gas were migratory and flowed in underground streams. Despite increased knowledge of the migratory nature of oil and gas, the concept, and the law of capture, for which it forms the basis, still exist. 1 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 4.1 (1987).

4. *Rich v. Doneghey*, 71 Okla 204, 206, 177 P. 86, 89 (1918).

5. *Id.*

6. *Id.*

7. *Id.* The nature of the interest possessed by a holder of an oil and gas lease for a primary term of years as extended by production is described as a qualified or determinable fee:

Where the lease is capable of being extended indefinitely by production of oil or gas, the interest created is a fee. Such fee is a base, qualified, or determinable fee for the reason that it may not endure forever. In those instances in which the courts have had the occasion to identify by name the estate created by such an oil and gas lease, the interest created has been identified as a determinable fee where the lease provided for a fixed term and for so long thereafter as oil or gas is produced.

2 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 26.2 (1989).

Oklahoma courts have frequently linked the terms "a chattel real, an incorporeal hereditament and a profit á prendre" in defining an oil and gas lease. *Casper v. Neubert*, 489 F.2d 543, 545 (10th

Because possession of the land is not conveyed, an "oil and gas lease" is not a true lease under Oklahoma law.⁸ The Supreme Court of Oklahoma in *Hinds v. Phillips Petroleum Co.*⁹ stated that

[t]he cluster of rights comprised within an instrument we refer to "in deference to custom" as an "oil and gas lease" includes a great variety of common-law interests in land. . . . Rather than a true lease, it is really a grant *in praesenti* of oil and gas to be captured in the lands described¹⁰

In describing the nature of a lessee's interest, during the primary term or as extended by production, as a "base or qualified fee, i.e., an estate in real property having the nature of a fee, but not a fee simple absolute,"¹¹ the court apparently views an "oil and gas lease" as more than a lease.¹²

Though not a "true" lease, an oil and gas lease constitutes a present interest or estate in real property.¹³ The exclusive right to explore for and obtain the oil and gas is accompanied by an "incidental right to occupy so much of the surface as required to do those things necessary to the discovery of and for the enjoyment of the principal right so to take oil or gas."¹⁴ In effect the lessee is granted a surface use easement.¹⁵

Oklahoma law creates further distinction between an estate or interest in realty as compared to real estate. In *De Mik v. Cargill*,¹⁶ the Oklahoma Supreme Court emphasized that

in the character of property created by an oil and gas lease, there is a recognizable distinction between *real estate* and *an estate in real property*. Not every kind of estate recognized in law as an interest in real property is real estate. Although an oil and gas lease creates an *interest*

Cir. 1973). According to one commentator these terms are contradictory "because a chattel real is personal property, an incorporeal hereditament is real property, and a profit à prendre may be either real property or personal property depending upon its duration." Emery, *Real Property Mineral Interests in Oklahoma*, 24 OKLA. L. REV. 337, 347 (1971). This view, which focuses on the inconsistencies of language, is disputed by Williams. See *infra* notes 30-31 and accompanying text.

8. "A lease is a contract between a lessor and lessee, which vests in the latter a right to possession of the land for a term of years and becomes an estate when it takes effect in possession." Howard v. Manning, 79 Okla. 165, 192 P. 358 (1920), quoted in Sublett v. City of Tulsa, 405 P.2d 185, 200 (Okla. 1965).

9. 591 P.2d 697 (Okla. 1979).

10. *Id.* at 698 (footnotes omitted).

11. Shields v. Moffitt, 683 P.2d 530, 532-33 (Okla. 1984) (footnote omitted).

12. See Note, *Bankruptcy: Is § 365 of the Bankruptcy Code Applicable to Oklahoma Oil and Gas Leases?*, 40 OKLA. L. REV. 99, 106-08 (1987).

13. Shields, 683 P.2d at 532 (quoting *Hinds*, 591 P.2d at 698-99).

14. Rich v. Doneghey, 71 Okla. 204, 207, 177 P. 86, 89-90 (1918).

15. Thompson v. Andover Oil Co., 691 P.2d 77, 81 (Okla. Ct. App. 1984) ("In Oklahoma, the surface estate is servient to the dominant mineral estate for purposes of the oil and gas lease.").

16. 485 P.2d 229 (Okla. 1971). See also *Phillips Petroleum Co. v. Jones*, 176 F.2d 737, 739 (10th Cir. 1949), cert. denied, 339 U.S. 904 (1950).

or *estate* in realty, such interest is not per se real estate.¹⁷
This distinction continues to be recognized.¹⁸

Although an oil and gas lease is not real estate per se, Oklahoma law treats it as real property for the purposes of some statutes which are phrased in terms of "interests in real property or conveyances affecting real property."¹⁹ For example, as an interest in real estate, an oil and gas lease or the assignment of such must be executed with the formalities required for the conveyance of any interest in real property.²⁰ Such a conveyance is subject to the statute of frauds and is restricted by homestead and Indian rights.²¹ An oil and gas lease may properly be the subject of a quiet title action and must be recorded in the same manner as any interest in real estate in order to obtain the benefits of notice. A mortgage on an oil and gas lease must be recorded as a real estate mortgage or it will have only the status of an unrecorded mortgage.²² Thus an oil and gas lease can be executed, conveyed, assigned, mortgaged, subjected to a vendor's lien, and subjected to federal documentary stamp tax in the same manner as real estate.²³ Under common law, the interest in land which passes under an oil and gas lease is "*divisible, assignable and inheritable.*"²⁴

Oklahoma cases do not classify an oil and gas lease as "real property" when interpreting statutes using that term.²⁵ An oil and gas lease

17. *Cargill*, 485 P.2d at 232. In an earlier case, the syllabus of the court states:

While an oil and gas lease which "grants, leases, and lets" certain land for oil and gas mining purposes, conveys to the lessee an estate in the realty described therein, such interest is not real estate within the meaning of section 690, C.O.S.1921, 12 Okl.St. Ann. § 706, which gives a judgment creditor a lien upon the "real estate" belonging to the judgment debtor.

Pauline Oil & Gas Co. v. Fischer, 185 Okla. 108, 108, 90 P.2d 411, 412 (1939), *rev'd on other grounds*, 309 U.S. 294 (1940).

18. *Cate v. Archon Oil Co.*, 695 P.2d 1352, 1354 (Okla. 1985); *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 698-99 (Okla. 1979).

19. 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 214.2, at 170.7 (1988).

20. *Continental Supply Co. v. Marshall*, 152 F.2d 300, 306 (10th Cir. 1945), *cert. denied*, 327 U.S. 803 (1946).

21. *Id.* (oil and gas lease is within the statute of frauds); *Rich v. Doneghey*, 71 Okla. 204, 207, 177 P. 86, 89 (1918) (oil and gas lease is an alienation within the meaning of the acts of Congress relating to the alienation of Indian lands).

22. *Marshall*, 152 F.2d at 306.

23. *Phillips Petroleum Co. v. Jones*, 176 F.2d 737, 741 (10th Cir. 1949), *cert. denied*, 339 U.S. 904 (1950).

24. *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 699 (Okla. 1979) (emphasis in original) (footnote omitted).

25. WILLIAMS & MEYERS, *supra* note 19, § 214.2, at 171-73. *Contra*, *Casper v. Neubert*, 489 F.2d 543 (10th Cir. 1973) (treating an oil and gas lease as "real property" for purposes of statute creating a vendor's lien for the price of realty), *discussed in Davis, Unassigned Oil and Gas Interests in Bankruptcy*, 22 TULSA L.J. 325, 345 (1987).

is not considered "real estate" within the meaning of a statute creating a judgment creditor's lien.²⁶ Under the Probate Code, it is not a conveyance of real estate when granted by a guardian or administrator.²⁷ For the purposes of ad valorem taxation, oil and gas leases are personalty and thus not taxable as real property.²⁸ In determining the meaning of "real estate" or "real property" as used in the Oklahoma Real Estate Mortgage Tax Act, an Attorney General's opinion states that an oil and gas lease is personal property.²⁹

According to Williams and Meyers, this conflict in classifying oil and gas leases is more apparent than real.³⁰ Williams argues that while the language used to describe oil and gas interests in the different cases is inconsistent, the actual holdings are "substantially consistent" in treating an oil and gas lease as personal property.³¹ In *Cate v. Archon Oil Co.*³² the Oklahoma Supreme Court validated Williams' view by citing with approval the statement that "[i]t has been repeatedly and consistently held that such oil and gas mining leases are chattels real and are, therefore, personal property."³³

This unique approach by Oklahoma in characterizing an oil and gas lease as both personal property and an estate in real property requires careful analysis when applying Bankruptcy Code provisions to Oklahoma oil and gas leases.

III. BANKRUPTCY CODE PROVISIONS

A. Overview of the Purposes of the Bankruptcy Code

"One of the primary purposes of the bankruptcy act is to 'relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh'"³⁴ Debtors are not guaranteed a discharge from

26. See, e.g., *Pauline Oil & Gas Co. v. Fischer*, 185 Okla. 108, 90 P.2d 411 (1939), *rev'd on other grounds*, 309 U.S. 294 (1940); *First Nat'l Bank v. Dunlap*, 122 Okla. 288, 254 P. 729 (1927); *Hinds*, 591 P.2d at 699 n.5.

27. *Pluto Oil & Gas Co. v. Land*, 151 Okla. 117, 121, 2 P.2d 945, 949 (1931); *Duff v. Keaton*, 33 Okla. 92, 99, 124 P. 291, 294 (1912).

28. *State v. Shamblin*, 185 Okla. 126, 129, 90 P.2d 1053, 1055 (1939).

29. 7 Op. Att'y Gen. No. 11215 (1966).

30. WILLIAMS & MEYERS, *supra* note 19, § 214.2, at 170.6-173.

31. WILLIAMS & MEYERS, *supra* note 19, § 214.2 at § 170.7. *Contra Emery*, *supra* note 7 (arguing that an oil and gas lease for a limited duration is personal property, but one for an unlimited term should be classified as real property).

32. 695 P.2d 1352 (Okla. 1985).

33. *Id.* at 1354 n.1 (quoting *State v. Shamblin*, 185 Okla. 126, 129, 90 P.2d 1053, 1055 (1939)).

34. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. United States Fidelity & Guar. Co.*, 236 U.S. 549, 554-55 (1915)).

their debts, but most do receive one.³⁵ An equally important goal is to preserve the existing assets of the debtor and maximize the value of the estate for the benefit of all creditors. A third goal is to provide fair but not necessarily equal treatment to creditors and others with rights and interests in the estate.³⁶

Though a bankruptcy court is both a court of law and a court of equity,³⁷ equitable principles are an "overriding consideration" in governing the exercise of bankruptcy jurisdiction.³⁸ The bankruptcy judge, who is responsible for furthering the purposes of the Bankruptcy Code, must weigh the rights of all parties and seek equity for the creditors as well as the debtors.³⁹ Although the court must exercise its equitable powers within the limits of the Code, those powers give the court flexibility in exercising its discretion to reach common sense results.⁴⁰ This is particularly important when the court is called upon to interpret undefined terms in the Code.

B. Section 365

Section 365⁴¹ allows a trustee in bankruptcy⁴² to "assume or reject any executory contract or unexpired lease of the debtor" subject only to the court's approval.⁴³ The Code does not define "executory contract"

35. D. EPSTEIN, DEBTOR-CREDITOR LAW 131 (1980).

36. The Bankruptcy Code establishes different classes of creditors, such as secured and unsecured creditors. Secured creditors are given priority over unsecured creditors. But within a particular class, all creditors are treated equally.

37. *In re El Patio, Ltd.*, 6 Bankr. 518, 523 (Bankr. C.D. Cal. 1980).

38. *Bank of Marin v. England*, 385 U.S. 99, 103 (1966).

39. *In re Sung Hi Lim*, 7 Bankr. 316, 318 (Bankr. D. Haw. 1980).

40. *Id.*

41. 11 U.S.C. § 365 (1982 & Supp. III 1985).

42. Although section 365 speaks in terms of a "trustee", that term includes the "debtor in possession" in a Chapter 11 reorganization case. "[A] debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter." *Id.* § 1107(a).

43. Section 365 provides in pertinent part:

(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

Id.

or "lease"; nor does it provide any guidance as to the standard to be used by the trustee in rejecting an executory contract or unexpired lease. Congress has left it to the courts to make those determinations. Although bankruptcy law is federal law, the bankruptcy court normally applies the law of the situs (state law) when determining property rights.⁴⁴

The rule allowing rejection by the trustee in section 365 evolved from the long-established principle that a trustee does not have to accept property which is valueless to the estate of the debtor.⁴⁵ At one time the courts required that a contract or lease must cause an "actual economic loss to the estate" for the trustee to be able to reject the contract or lease.⁴⁶ However, in the context of a railroad reorganization case, the Supreme Court held that the appropriate test was one of "business judgment"⁴⁷ and allowed rejection of a lease that produced a "net financial benefit."⁴⁸ While a substantial minority continues to favor the "burdensome to the estate" test, a majority of the courts, including the Tenth Circuit, utilizes the "business judgment" test.⁴⁹

Because the Code does not define the term "lease," its definition is generally determined by state law. However, in the 1984 amendments to the Code, Congress provided some guidance by adding section 365(m), which provides that "[f]or purposes of this section 365 and sections 541(b)(2) and 362(b)(9), leases of real property shall include any rental agreement to use real property."⁵⁰ This amendment does not apply to cases commenced under Title 11 within ninety days following July 10, 1984.⁵¹

The definition of "executory contract" is crucial in determining

44. *Butner v. United States*, 440 U.S. 48, 54 (1979); *In re Myklebust*, 26 Bankr. 582, 583 (Bankr. W.D. Wis. 1983) (state law determines whether the agreement is an expired lease or an executory contract).

45. Cook, *Bankruptcy: Judicial Standards for Rejection of Executory Contracts In Bankruptcy Code Reorganization Cases*, 1980 ANN. SURV. OF AM. L. 689, 692.

46. *Id.* at 693.

47. *Group of Institutional Investors v. Chicago, Mil., St. P. & Pac. R.R.*, 318 U.S. 523, 550 (1943). See Cook, *supra* note 45, at 695-98 for an analysis of *In re Minges*, 602 F.2d 38 (2d Cir. 1979) (holding that the "business judgment" test of *Institutional Investors* was not limited to railroad reorganization cases).

48. *Institutional Investors*, 318 U.S. at 549-50.

49. Law Student Essay Contest Winner, *Section 365 of the Bankruptcy Code of 1978: Is it Applicable to Gas Purchase Contracts?*, 6 E. MIN. L. INST. § 22.03, at 22-15 (1985) [hereinafter Essay] (discussing the "business judgment" standard and the "burdensome to the estate" standard). See *In re J.H. Land & Cattle Co.*, 8 Bankr. 237 (Bankr. W.D. Okla. 1981) (Whether the court or the trustee is to apply the business judgment test is not certain.); *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir. 1960).

50. Leasehold Management Bankruptcy Amendments Act of 1983, Pub. L. No. 98-353, § 362(b), 98 Stat. 361, 363 (1984) (codified as amended at 11 U.S.C. § 365(m) (Supp. III 1985)).

51. 11 U.S.C. § 365(m) (Supp. III 1985).

which contracts may be rejected. The term has never been statutorily defined, however the legislative history of section 365 indicates that executory contracts "generally include[] contracts on which performance remains due to some extent on both sides."⁵² An often-quoted definition is that proposed by Professor Countryman: A contract is executory when "the obligation[s] of both the bankrupt and the other party . . . are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."⁵³

In *Workman v. Harrison*,⁵⁴ the Tenth Circuit adopted a slightly different definition when it upheld the rejection by a bankruptcy trustee of a contract for the development of a shopping center. The debtor was to hold title to the property and provide financing to the promoter who was to develop the shopping center.⁵⁵ After the property was purchased, the debtor was adjudged bankrupt. With the trustee's agreement, the promoter continued the attempt to fulfill his obligations until the trustee rejected the contract. The court determined that the contract "was then executory in nature, neither party having completely performed and the obligations of each remaining complex."⁵⁶ The Tenth Circuit later applied the *Workman* definition in approving the rejection of a contract to purchase an interest in Canadian federal oil and gas exploration permits where only part of the purchase price had been paid.⁵⁷

Although both the *Workman* and the Countryman definitions require that some performance remain due on both sides, bankruptcy courts have been very result-oriented in determining what constitutes performance.⁵⁸ While finding such definitions helpful, one court stated that

[t]he key . . . to deciphering the meaning of the executory contract

52. H.R. REP. NO. 595, 95th Cong., 1st Sess. 347 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6303. For a discussion of the meaning of "executory contract" in the context of section 365, see Essay, *supra* note 49, § 22.03, at 22-11 to -15.

53. Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). See Essay, *supra* note 49, § 22.03, at 22-12 n.7 (listing recent cases using the Countryman definition).

54. 282 F.2d 693 (10th Cir. 1960).

55. *Id.* at 696.

56. *Id.* at 699. Such a definition would encompass an oil and gas lease if Professor Kuntz's characterization is accepted. Professor Kuntz describes an oil and gas lease as containing "elaborate contractual provisions which continue in force between the lessor and the lessee during the life of the interest granted." 2 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 18.2 (1989).

57. *King v. Baer (In re King Natural Resources)*, 482 F.2d 552, 557 (10th Cir.), cert. denied, 414 U.S. 1068 (1973).

58. Essay, *supra* note 49, § 22.03, at 22-13 to -15.

rejection provisions, is to work backward, proceeding from an examination of the purposes rejection is expected to accomplish. If those objectives have already been accomplished, or if they can't be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act.⁵⁹

The rejection provisions have a dual purpose: to protect the debtor by allowing rejection of a burdensome future obligation and affirmation of one which is beneficial and to bring in the largest possible number of creditors.⁶⁰ The non-debtor holder of an executory contract cannot make a claim against the debtor's estate until the contract is breached by rejection.⁶¹

While section 365(a) provides that the trustee "may assume or reject any executory contract or unexpired lease of the debtor,"⁶² section 365(d) requires that the trustee give notice of assumption within a time limit specified by the Code or the court.⁶³ If timely notice is not given, the contract or lease will be deemed rejected. For a Chapter 11 filing, the trustee may assume or reject an executory contract at any time before the confirmation of the plan unless the court, upon request, sets a time limit.⁶⁴ When the debtor is the lessee of an unexpired lease of nonresidential real property, the trustee must assume or reject the lease within sixty days after the order for relief or such additional time as the court may order for cause.⁶⁵ The lease is otherwise deemed rejected, and the

59. *Chattanooga Memorial Park v. Still (In re Jolly)*, 574 F.2d 349, 351 (6th Cir.), *cert. denied*, 439 U.S. 929 (1978).

60. *Id.* at 350-51.

61. *Id.* at 351.

62. 11 U.S.C. § 365(a) (1982 & Supp. III 1985).

63. Section 365 provides in pertinent part:

(d)(1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

(2) In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

....

(4) Notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor.

Id.

64. *Id.* § 365(d)(2).

65. *Id.* § 365(d)(4).

trustee must surrender the property to the lessor.⁶⁶

Section 365 provides some protection to the non-debtor party to an executory contract or unexpired lease. If the debtor has defaulted on the contract or lease, the trustee cannot reject or assume the contract or lease without curing the default, compensating the non-debtor for any loss, and providing adequate assurance of future performance.⁶⁷ When the debtor is the lessor, and the trustee rejects an unexpired lease of real property, the lessee has the option of treating the lease as terminated by the rejection or remaining in possession for the balance of the term and any renewal period that would be enforceable under non-bankruptcy law.⁶⁸ When a debtor has contracted to sell real property and the trustee rejects that contract, the purchaser has two remedies under section 365: if in possession, the purchaser can obtain specific performance;⁶⁹ if not in possession, the purchaser can obtain the equivalent of a vendee's lien on the property for that portion of the purchase price paid.⁷⁰

66. *Id.*

67. *See supra* note 43 for text of § 365(b)(1).

68. Section 365 provides in pertinent part:

(h)(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, . . . the lessee . . . under such lease . . . may treat such lease . . . as terminated by such rejection, where the disaffirmance by the trustee amounts to such a breach as would entitle the lessee . . . to treat such lease as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreements the lessee . . . has made with other parties; or, in the alternative, the lessee . . . may remain in possession of the leasehold . . . under any lease . . . the term of which has commenced for the balance of such term and for any renewal or extension of such term that is enforceable by such lessee . . . under applicable nonbankruptcy law.

Id.

69. 11 U.S.C. § 365(i) (1982 & Supp. II 1984) provides in pertinent part:

(i)(1) If the trustee rejects an executory contract of the debtor for the sale of real property . . . under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property

(2) If such purchaser remains in possession—

(A) such purchaser shall continue to make all payments due under such contract, but may, offset against such payments any damages occurring after the date of the rejection of such contract caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and

(B) the trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.

Id.

70. *Id.* § 365(j) provides:

A purchaser that treats an executory contract as terminated under subsection (i) of this section, or a party whose executory contract to purchase real property from the debtor is rejected and under which such party is not in possession, has a lien on the interest of the debtor in such property for the recovery of any portion of the purchase price that such purchaser or party has paid.

Id.

How then are oil and gas leases in Oklahoma affected by section 365 of the Bankruptcy Code? Are they executory contracts or unexpired leases of nonresidential real property within the meaning of section 365? The above-described characterization of oil and gas leases in Oklahoma was developed for non-bankruptcy purposes. Only a few recent decisions have applied section 365 to Oklahoma oil and gas leases.⁷¹

In *In re Trans-Western Exploration, Inc.*,⁷² a bankruptcy court in Texas addressed the question of whether section 365 is applicable to Oklahoma oil and gas leases. The debtor/lessee in *Trans-Western* was in default on royalty payments but wanted to transfer the leases. If section 365 applied, the debtor would have to cure the default first in order to assume the leases and then transfer them. If section 365 did not apply, the debtor could transfer the leases without curing the default and without the court's approval. This would leave the creditor/lessor in the status of an unsecured creditor without the protection of section 365.

The debtor in *Trans-Western* argued that the contract was not executory because there was not performance due on both sides. Once the lessee pays the lessor for the primary term of the lease and the lessor executes the lease conveying to the lessee the right to explore for oil and gas for the primary term, both have fully performed their duties under the lease contract. Even when production is established, only the lessee continues to have a duty to perform.⁷³

Without stating the reasons for its decision, the *Trans-Western* court expressly held that "oil and gas leases in Oklahoma are neither executory contracts nor unexpired leases pursuant to section 365 of the Bankruptcy Code."⁷⁴ In ruling for the debtor, the court would seem to have accepted its arguments.

Two recent bankruptcy decisions from the Northern District of Oklahoma, *In re Heston Oil Co.*⁷⁵ and *In re Clark Resources, Inc.*,⁷⁶ combined the *Workman* and *Countryman* definitions to find that oil and gas leases in Oklahoma are not "executory contracts." In each case the creditor/lessor asked the bankruptcy court to set a time for assumption

71. For an extensive discussion of these recent cases, see Note, *supra* note 12, at 99-100 (focusing on "the protection afforded the landowner/lessor when a lessee defaults on royalty payments owed to the landowner/lessor and subsequently seeks bankruptcy protection.").

72. No. 385-31045-A-11 (Bankr. N.D. Tex. Aug. 15, 1986) (order granting default judgment). See Note, *supra* note 12, at 103-10 for a discussion of this case.

73. See Note, *supra* note 12, at 103-04.

74. *Trans-Western*, No. 385-31045-A-11, slip op. at 2.

75. 69 Bankr. 34 (Bankr. N.D. Okla. 1986).

76. 68 Bankr. 358 (Bankr. N.D. Okla. 1986).

or rejection of an oil and gas lease by the debtor/lessee. In both cases the requests were denied.

In *Heston*, District Judge Brett quoted the *Workman* definition and stated the essence of the Countryman definition: "Breach of contractual obligations by one party would excuse performance by the other party."⁷⁷ The court focused on the fact that under the oil and gas lease the debtor's only obligation was "to defend her title to the leased land and not to interfere with the lessees' drilling operation. Breach of these duties would not excuse performance by [the lessee], but would merely abate [the lessee's] obligation for so long as [the debtor] was in breach."⁷⁸ Similarly in *Clark Resources*, Judge Wilson of the bankruptcy court applied both definitions as well as the reasoning of *Heston* to the facts presented and found that "[w]here a party's only remaining obligation is the payment of money, as is the case here for Clark Resources, the contract is not executory."⁷⁹

In finding that oil and gas leases are not within the reach of section 365, Judge Brett relied on the Oklahoma Supreme Court's position that an oil and gas lease is not a "true lease" but rather an "estate[] in real property having the nature of a fee."⁸⁰ Judge Brett found unpersuasive and specifically rejected the reasoning of *In re J.H. Land & Cattle Co.*,⁸¹ the only case cited as authority by the appellant for the proposition that an oil and gas lease is subject to section 365.

The court in *Clark Resources* followed *Heston* in looking at Oklahoma case law to determine that an oil and gas lease is "merely a license to explore, not an interest in real property."⁸² As such, the court found that the lease was "not within the scope of section 365 generally, or more particularly section 365(d)(4)."⁸³ The court opined that the legislative history of section 365(d)(4) evidenced a Congressional intent to limit the scope of that section to "traditional leases of shopping centers and leases of other 'nonresidential structures.'"⁸⁴

Both courts expressed certainty that the traditional oil and gas lease

77. *Heston*, 69 Bankr. at 36.

78. *Id.* (citations omitted).

79. *Clark Resources*, 68 Bankr. at 359-60.

80. *Heston*, 69 Bankr. at 36 (citing *Shields v. Moffitt*, 683 P.2d 530, 532-33 (Okla. 1984)).

81. 8 Bankr. 237 (Bankr. W.D. Okla. 1981) (applying Kansas law which specifically characterizes oil and gas leases as personal property).

82. *In re Clark Resources, Inc.*, 68 Bankr. 358, 358-59 (Bankr. N.D. Okla. 1986) (citing *Mitchell v. Probst*, 52 Okla. 10, 12, 152 P. 597, 599 (1915)).

83. *Id.* at 358.

84. *Id.* at 358-59 (referring to statements of Senator Hatch, 130 CONG. REC. S8891-95 (1984), reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 590, 598).

under Oklahoma law is not encompassed by section 365, either as an "executory contract" or as a "lease."⁸⁵ However in neither opinion was there any consideration of section 365(m), which provides that any rental agreement to use real property is a lease of real property for the purposes of section 365.⁸⁶ One bankruptcy court has recently declared that by enacting 365(m) Congress intended that rental interests in real property "be covered by section 365 no matter what their nature under state law."⁸⁷

Although an Oklahoma oil and gas agreement clearly does not convey a leasehold, a surface use easement is conveyed.⁸⁸ Whether that right to use the land is within the scope of section 365(m) is a question that has not yet been addressed by a court applying Oklahoma law.⁸⁹

C. Section 541

Under section 541, the commencement of a bankruptcy case creates an estate comprised of all legal or equitable interests of the debtor in property, wherever located and by whomever held.⁹⁰ When a debtor holds only legal title to a property, subsection 541(d) limits the inclusion of that property in the estate to the extent of the debtor's legal interest.⁹¹ The legislative history of subsection 541(d) indicates that Congress intended "to protect parties in the secondary mortgage market."⁹²

85. *In re Heston Oil Co.*, 69 Bankr. 34, 36 (Bankr. N.D. Okla. 1986); *Clark Resources*, 68 Bankr. at 359-60 ("Oklahoma law clearly rejects the contention that an oil and gas lease, such as the one [here] should come within the reach of section 365.").

86. *See supra* notes 50-51 and accompanying text.

87. *In re Gasoil, Inc.*, 59 Bankr. 804, 809 (Bankr. N.D. Ohio 1986) (holding that oil and gas leases are covered by § 365(d)(4)).

88. *See supra* notes 13-15 and accompanying text.

89. *See Note, supra* note 12, at 109-10 (arguing that section 365 would not apply to an Oklahoma oil and gas lease as it "is not a mere leasehold estate . . . and is more than a rental agreement to use real property as in section 365(m).").

90. 11 U.S.C. § 541 (1982 & Supp. III 1985).

91. *Id.* § 541(d). Section 541(d) provides:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

Id.

92. Baker & Schiffman, *Effect of Bankruptcy Law on Specific Oil and Gas Insolvency Problems*, 35 INST. ON OIL & GAS L. & TAX'N 187, 200 (1984).

In an unreported case, *In re Partners Oil Co.*,⁹³ a Texas court applied section 541(d) to unrecorded oil and gas interests. The debtor made numerous assignments of working and royalty interests which were unrecorded at the time the bankruptcy petition was filed.⁹⁴ The assignees had paid for or earned the working and royalty interests before the bankruptcy case commenced. The court held that under section 541(d) the equitable interests of the assignees "are not and shall not become, pursuant to section 544 or otherwise property of the estate of the debtor."⁹⁵ Because this was a hearing on a request for a preliminary injunction, the decision indicates only the court's concern with equity and does not provide precedential authority that would protect the holders of unrecorded oil and gas interests.

In a case applying Oklahoma law, *Reserve Oil, Inc. v. Dixon*,⁹⁶ the Tenth Circuit Court of Appeals held that an operating agreement "created a trustee type relationship . . . between the operator and the non-operator owners . . ."⁹⁷ There the operator failed to distribute the production revenues as provided by the operating agreement. The court in effect imposed a constructive trust on the production revenues for the benefit of the nonoperating working interest owners. Thus the equitable interests of the working interest owners were kept out of the bankruptcy estate.

This approach was followed in *In re Mahan & Rowsey, Inc.*,⁹⁸ where an operating working interest owner had paid more than his share of the operating expenses. The court found that there was a "fiduciary-beneficiary relationship"⁹⁹ which supported the imposition of a constructive trust on the overpayments to the debtor. This decision was later overturned because the plaintiff was unable to specifically trace his funds into the debtor's estate. On similar facts, the court in *In re Heston Oil Co.*¹⁰⁰ would have imposed a constructive trust but for the claimant's inability

93. No. 83-01577-83-5 (Bankr. S.D. Tex. Dec. 13, 1983). This case is the subject of much commentary. See, e.g., Gandy, *Recent Developments in Oil and Gas Bankruptcy Law*, 38 INST. ON OIL & GAS L. & TAX'N 2 (1987); Davis, *supra* note 25, at 330-31; Baker & Schiffman, *supra* note 92, at 200-01.

94. *Partners*, No. 83-01577-83-5, slip op. at 1-5.

95. *Id.* at 3.

96. 711 F.2d 951 (10th Cir. 1983).

97. *Id.* at 953.

98. 35 Bankr. 898 (Bankr. W.D. Okla. 1983), *aff'd in part, rev'd in part*, 62 Bankr. 46 (W.D. Okla. 1985).

99. *Id.* at 903.

100. 63 Bankr. 711 (Bankr. N.D. Okla. 1986).

to trace its funds into the debtor's estate.¹⁰¹

D. Section 544(a)

While section 541 includes in the estate all the property in which a debtor has a legal or equitable interest, section 544(a)¹⁰² gives the trustee the "strong arm power" to bring back into the estate property already transferred out of the estate. Section 544 gives the trustee explicit authority to avoid transfers and liens because the trustee is given the priority status of a hypothetical judicial lienholder, a creditor with an unsatisfied execution, and a bona fide purchaser of real property as of the petition date.

Of special significance to the oil and gas industry is section 544(a)(3), which gives the trustee the status of a hypothetical bona fide purchaser of real property. As such the trustee has the same power as a bona fide purchaser under state law to nullify unrecorded interests in the debtor's real property.

The question to be addressed is whether an Oklahoma oil and gas lease can be considered real property for the purposes of section 544(a)(3). As previously discussed, Oklahoma treats oil and gas leases as real or personal property depending upon the purpose of the particular statute.¹⁰³ Under Oklahoma law transfers of interests in oil and gas leases are treated like real property in that they must be recorded in order to defeat bona fide purchasers.¹⁰⁴ Consequently an oil and gas lease

101. See Gandy, *supra* note 93 § 2.02[1] for a discussion of the federal requirement of tracing.

102. 11 U.S.C. § 544(a)(1982 & Supp. III 1985) provides:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

Id.

103. See *supra* notes 19-33 and accompanying text.

104. *Busby v. United States Steel Corp.*, 237 F. Supp. 602 (E.D. Okla. 1965), cited in *Davis*, *supra* note 25, at 328.

would likely be considered real property for the purposes of section 544(a)(3).

The same question concerning Kansas oil and gas leases was addressed in *D & F Petroleum v. Cascade Oil Co. (In re Cascade Oil Co.)*¹⁰⁵ and was answered affirmatively. Under Kansas law an oil and gas lease is considered real property for some purposes and personal property for others.¹⁰⁶ The court found it significant that oil and gas leases must be recorded in the same manner as instruments affecting real estate, and that mortgages and liens on oil and gas leaseholds are to be enforced and foreclosed as those against real estate.¹⁰⁷ The court concluded that "for the purposes of the Bankruptcy Code and specifically for the purposes of section 544(a)(3), the debtor's interest in the working interest of an oil and gas lease is to be treated as real property."¹⁰⁸

E. Sections 541(d) and 544(a)(3): Separate or Related?

There is an inherent tension between Section 541(d) and Section 544(a)(3) of the Code. Section 541(d) provides that certain equitable interests are excluded from the debtor's estate. Section 544(a)(3) allows the trustee to bring "certain tainted property" into the estate.¹⁰⁹ The owners of unrecorded assignments of working and royalty interests in oil and gas leases argue that since the debtor held only legal title to those interests, under section 541(d) those assignments were never part of the debtor's estate. Consequently they could not be brought into the estate under section 544(a)(3).

The disagreement of the courts on whether section 541(d) limits section 544(a)(3) is extensively analyzed in two cases: *In re Cascade Oil Co.*¹¹⁰ and *City National Bank of Miami v. General Coffee Corp. (In re General Coffee Corp.)*¹¹¹ The court in *General Coffee* stated that a majority of courts holds that the sections "operate independently. Thus, property not part of the estate under section 541(d) may come into the estate under section 544(a)."¹¹² As a follower of the majority view, the court in *Cascade* emphasized that the policy of the Code to treat all unsecured

105. 65 Bankr. 35 (Bankr. D. Kan. 1986).

106. *Id.* at 41.

107. *Id.*

108. *Id.*

109. *City Nat'l Bank v. General Coffee Corp. (In re General Coffee Corp.)*, 828 F.2d 699, 704 (11th Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988).

110. 65 Bankr. 35 (Bankr. D. Kan. 1986).

111. 828 F.2d 699 (11th Cir. 1987).

112. *Id.* at 705 (citations omitted).

creditors alike would be adversely affected by giving priority to beneficiaries of constructive trusts.¹¹³ According to the opinion in *General Coffee* the minority courts take the position that "Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own."¹¹⁴

Although Oklahoma courts have not yet spoken directly to this issue, their willingness to impose constructive trusts based on finding a fiduciary type relationship between parties to an operating agreement indicates a leaning toward the minority position.¹¹⁵

IV. CONCLUSION

While it is unlikely that the bankruptcy courts will find oil and gas leases to be executory contracts under Oklahoma law, they may be persuaded to consider the leases to be unexpired leases of nonresidential real property based on the enactment of section 365(m) without characterizing them as real property. Holding section 365 applicable to oil and gas leases would protect the lessor/creditor when a lessee defaults on royalty payments because of the depressed price of oil and then seeks the protection of bankruptcy. The lessee/debtor would first have to cure any default before rejecting or assigning the lease. Similarly under section 365 a nondebtor lessee would be able to remain in possession of the lease for the remainder of the unexpired lease term if the debtor rejects the lease. Thus section 365 would protect holders of recorded interests in oil and gas leases against hopelessly insolvent debtors.

The owners of unrecorded working and royalty interests will continue to remind the courts that oil and gas leases are personal property in Oklahoma and thus not subject to the trustee's avoidance power under section 544(a)(3). They can then use section 541(d) to keep their equitable interests out of the debtor's estate and achieve priority for payout. Such an approach would be consistent with Oklahoma's policy to favor constructive trusts and with the equitable goals of the Bankruptcy Code.

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113. *Cascade*, 65 Bankr. at 40.

114. *General Coffee*, 828 F.2d at 705, (quoting *Vineyard v. McKenzie (In re Quality Holstein Leasing)*, 752 F.2d 1009, 1013 (5th Cir. 1985)).

115. *See supra* notes 94-99 and accompanying text.

