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Preparing for a Joint Venture Partner's Bankruptcy

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- **Lien Perfection – Memorandum/Recording Supplement of JOA and UCC Financing Statement**. Generally, joint operating agreements (JOA) include a grant of reciprocal liens and security interests among operators and nonoperators to secure the performance of the parties' respective payment and other obligations under the JOA. The effort to perfect these interests is important to provide the secured partners with priority over later creditors. Liens and security interests that are not properly perfected can generally be avoided by the debtor in bankruptcy under the "strong-arm" provisions of the Bankruptcy Code. In order to perfect the lien on the real property interests of the debtor (such as oil and gas leases, fixtures and reserves in the ground), either the JOA itself or a legally sufficient memorandum or recording supplement thereof must be recorded in the mortgage records of the counties (and/or parishes) in which the properties are situated. To perfect a lien against as-extracted oil and gas or other personal property, a uniform commercial code (UCC) financing statement is generally filed. To be effective, such statement must, among other things, name the proper secured party and debtor, reasonably identify the proper collateral, be recorded in the proper recording office and otherwise comply with the UCC in the applicable jurisdiction. To perfect a security interest in as-extracted collateral, a nondebtor can also record a mortgage filed as a financing statement covering as-extracted collateral. However, the validity of a financing statement or mortgage filed to perfect interests in as-extracted oil and gas interests rests upon the UCC adopted in the applicable jurisdiction, and, in certain oil and gas producing states, the applicable UCC requires that such documents be renewed every five years during the six-month period prior to the expiration of each succeeding fiveyear period. In our experience, not all E&P producers are filing continuation statements in a timely manner, and, thus, in those cases, financing statements are lapsing, and joint venture partners' claims are no longer secured.

- **Advance Payments**. Operators concerned about a nonoperator's financial viability should take steps well in advance of any bankruptcy filing by such nonoperator to exercise applicable cash call rights. In these circumstances, operators should also consider cash calling all estimated expenses (not just the next month's expenses) to the extent that the underlying documents permit such request. Operators should also pay close attention to the applicable funding deadlines and make certain to exercise remedies, such as suspension of rights, if these payment deadlines are missed by a failing joint venture partner.
- **Direct Payments**. In the case of nonoperators concerned about a restructuring involving an operator, direct payment to vendors by the nonoperators (versus allowing the operator to make payment) could provide protection. The funds that are used to pay joint venture expenses would go directly from the nondebtor partner to the applicable third-party vendors and would never reside in any account over which the debtor has ownership rights. This would mitigate any risk that prefunded amounts held in a debtor-operator's account would become property of its bankruptcy estate and would likely cut off any arguments to the contrary.
- **Escrow or Segregated Account**. To the extent that direct payments are not an option, prefunding joint venture project funds to an escrow account is the next most preferable outcome. Generally, the cash held in an escrow account of this type would not become property of the debtor's bankruptcy estate. Rather, only the debtor's rights under the escrow agreement would become part of its bankruptcy estate. For example, if the debtor is entitled to a release of the funds in the escrow account under certain circumstances specified in the escrow agreement, that right would become part of its bankruptcy estate. There is some degree of litigation risk if the debtor asserts that it is entitled to a release of funds, but much of this risk can be ameliorated with carefully crafted escrow instructions regarding the release of project funds. An alternative to setting up an escrow account is to establish a segregated joint account requiring countersignatures from both the operator and nonoperator(s) on all checks. Note that, while this option is not without risks, it still has a substantially better outcome than funding project funds into a commingled account.

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