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Fraudulent Transfer Risks in Oil and Gas Transactions

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Over the past few months, the economics of the oil and gas industry have changed dramatically. As oil and gas prices have fallen, so too have profit margins and working capital. Many companies will weather this storm. A fortunate few will expand their positions and acquire additional assets, some of which will be purchased from distressed companies. In dealing with these distressed companies and their assets, landmen and other oil and gas industry professionals will need to have a working-knowledge of select bankruptcy-related laws and concepts to protect their company's assets. In this article, we will discuss one aspect of relevant bankruptcy law: fraudulent transfers and how they may affect property transactions.[1]

What is a fraudulent transfer?

When a company files for bankruptcy, the bankruptcy trustee may avoid any fraudulent transfer of property made within four years of filing in most states, if certain conditions are met. Fraudulent transfers occur when: (1) there was an intent to hinder, delay, or defraud creditors; or (2) the debtor transfers property without receiving "reasonably equivalent value" in exchange for the transfer and is insolvent at the time of the transfer, becomes insolvent as a result of the transfer, or is left with an unreasonably small amount of capital to operate its business as a result of the transfer.[2] If a transaction is deemed to be a fraudulent transfer, the bankruptcy trustee can recover the property or obtain a judgment for the value of the property.

The first type of fraudulent transfer involves an actual intent to defraud and is more easily identified. For example, in *In re Tronox*, a court found that a debtor transferred property with environmental liabilities with an intent to hinder, delay, or defraud creditors through a spinoff.[3] In another case, *In re ASARCO*, a court found that the debtor hindered and delayed creditors by directing all of the consideration from a sale of a majority of a mining entity to one of the Debtor's creditors, to the detriment of other creditors.[4] These situations usually involve related parties.

The second type of fraudulent transfer, commonly referred to as a constructively fraudulent transfer, occurs when a company purchases an asset without paying reasonably equivalent value. This can occur when purchasing assets from a third party or, more commonly, when buying-out a partner to resolve a debt or other obligation. If the seller files for bankruptcy subsequent to the transaction, there is a risk that the bankruptcy trustee could seek to have the transaction declared to be a fraudulent transfer.

In determining “reasonably equivalent value” a bankruptcy court looks at

the totality of the circumstances. Fraudulent transfer laws are designed to preserve the assets of the debtor for the benefit of creditors. When carrying out this intent, courts disregard the form of a transaction and look "instead to its substance."[5] Fraudulent conveyance law is "designed to protect creditors' rights" and looks at transactions from "the perspective of creditors." [6] Whether a purchaser paid reasonably equivalent value is a subjective question that depends on the facts of each individual situation.

What does this mean for landmen?

Oil and gas professionals should be aware of the risks of acquiring property from distressed companies. To avoid constructively fraudulent transfers, a purchaser should ensure that they are giving "reasonably equivalent value" for the asset. This can be difficult. Under certain circumstances, when the value of the property is enhanced by the buyer after the sale closes (through drilling or other development) the debtor may later contend that the buyer failed to pay reasonably equivalent value.

The best way to determine "reasonably equivalent value" when dealing with a distressed company is to obtain an appraisal from an independent third party. If an appraisal is not cost-effective or is impractical, the risk of a fraudulent transfer can be mitigated by conducting proper due diligence.

An awareness of the financial health of the companies you are doing business with is as important as ever. By evaluating the transaction now, you can avoid problems down the road.

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[1]There are many tools that an oil and gas company can use to mitigate its exposure to bankruptcy risks. A full discussion of all the tools is beyond the scope of this article. If you have questions on how to mitigate bankruptcy risks, or if a business partner files for bankruptcy, we advise you to contact a bankruptcy expert immediately to protect your assets.
[2] *See* 11 U.S.C. § 548.
[3] *In re Tronox Inc.*, 429 B.R. 73 (Bankr. S.D.N.Y. 2010).
[4] *See In re ASARCO, L.L.C*, 702 F.3d 250 (5th Cir. 2012).
[5] *In re HBE Leasing Corp. v. Frank*, 48 F.3d 623, 638 (2d Cir.1995) (construing the New York's fraudulent conveyance statute).
[6]*In re Crowthers McCall Pattern, Inc.*, 129 B.R. 992, 998 (S.D.N.Y.1991).

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