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Third Circuit: Unpaid Royalties in Bankruptcy are Subject to Constructive Trust under Colorado Law

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The United States Court of Appeals for the Third Circuit determined that, under Colorado law, unpaid royalties are real property interests and not property of the bankruptcy estate, reversing lower courts in Delaware that classified alleged royalty underpayments as unsecured non-priority claims. The Circuit Court's opinion is available through this link and reported at *In re Ursa Operating Co., LLC*, --- F.3d ---, 2023 U.S. App. LEXIS 31759 (3rd Cir. Dec. 1, 2023).

The Circuit Court characterized its decision as “not precedential” – its holding, nevertheless, may have far-reaching implications for oil and gas producers in bankruptcy cases. Under the opinion, royalty owners have a property interest in unpaid royalties retained by a producer in bankruptcy, and the royalty owners maintain the right to recover those unpaid royalties through a constructive trust under Colorado law. The Circuit Court's decision departs from prior bankruptcy proceedings that have historically viewed royalty underpayment claims as unsecured non-priority claims.

Background

Ursa Operating Co., LLC and its affiliated entities filed their chapter 11 cases in the United States Bankruptcy Court for the District of Delaware. Prior to filing, several of the producer's royalty owners filed both individual and class action lawsuits in Colorado state court alleging underpayment of royalties.

In the bankruptcy case, the royalty owners argued their claims were for the recovery of property (underpaid royalties) that was not property of the bankruptcy estate under 11 U.S.C. § 541. The producer disagreed, arguing that the royalty owners held only general, unsecured non-priority claims against the estate.

The Bankruptcy Court held for the producer, agreeing that the royalty owners could only seek recovery from the estate, and therefore, were general, unsecured non-priority claims. In so holding, the Bankruptcy Court rejected the argument that underpaid royalties are non-estate property. The United States District Court for the District of Delaware affirmed, and the royalty owners appealed.



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Third Circuit Opinion

The Circuit Court reversed, holding that, under Colorado law, royalty owners have a real property interest in unpaid royalties. The Court concluded that, under the Bankruptcy Code and Colorado state law, because the producer did not have an equitable interest in the royalty owners' designated share of natural gas proceeds, those proceeds were never property of the bankruptcy estate.

“The [Bankruptcy Code] contemplates that a debtor in bankruptcy may be holding property that equitably belongs to another and provides that such property should not be disbursed to creditors along with the debtor's own. That is the scenario here.”

The Circuit Court further held that a constructive trust is a remedy available under Colorado law to recover any underpaid royalties held by the producer, provided the royalty owners could satisfy certain requirements which, collectively, set a high bar for the owners. Those requirements are (1) proving that royalties were underpaid by the producer, (2) proving the producer was unjustly enriched by those underpayments, and (3) the funds in the producer's possession were traceable to those claimed by the royalty owners. The Court ultimately remanded the case to the Bankruptcy Court to consider whether the royalty owners could satisfy these requirements.

Takeaway

Although “not precedential,” the Circuit Court's opinion upends the traditional treatment of royalty underpayment claims in bankruptcy cases. If this interpretation is accepted and followed by other courts, oil and gas producers entering bankruptcy will be forced to contend with claims for underpayment that were historically discharged under the Bankruptcy Code. As the Circuit Court noted, producers have argued this outcome would create a “super priority” for royalty owners in bankruptcy proceedings. Just how “super” it is remains to be seen.

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