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ATTORNEYS FOR AD HOC ROYALTY INTEREST OWNERS
GROUP

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION**

In re:	§	
	§	Chapter 11
	§	
SCANROCK OIL & GAS, INC. <i>et al.</i>	§	Case No. 25-90001-MXM-11
	§	
Debtors.¹	§	Jointly Administered
	§	
	§	

**AD HOC ROYALTY INTEREST OWNERS GROUP'S OBJECTION AND
RESERVATION OF RIGHTS TO DEBTORS' EMERGENCY MOTION FOR ENTRY
OF INTERIM AND FINAL ORDERS (I) AUTHORIZING THE DEBTORS TO USE
CASH COLLATERAL; (II) GRANTING ADEQUATE PROTECTION;
(III) MODIFYING THE AUTOMATIC STAY; (IV) SCHEDULING A
FINAL HEARING; AND (V) GRANTING RELATED RELIEF**

¹ The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, if any, are: O'Ryan Family Limited Partnership (1913); O'Ryan Production & Exploration Ltd. (9950); O'Ryan Ranches, Ltd. (7184); Ryan C. Hoerauf, Inc. (0493); Scanrock Oil & Gas, Inc. (0380); Smackover Oil Treaters, Ltd. (9529); O'Ryan Ponderosa, LLC (1476); Eon Production, LLC (0136). The location of the Debtors' service address is 8180 Lakeview Center, Ste. 300, Odessa, TX 79765.

The Ad Hoc Royalty Interest Owners Group,² by and through its undersigned counsel, submits this Objection (this “Objection”) to the *Debtors’ Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to Use Cash Collateral; (II) Granting Adequate Protection; (III) Modifying the Automatic Stay; (IV) Scheduling a Final Hearing; and (V) Granting Related Relief* [Docket No. 26] (the “Motion”).³ In support of the Objection, the Ad Hoc Royalty Interest Owners Group respectfully states as follows:

PRELIMINARY STATEMENT

1. Photos of ranchland. Organizational charts. Wordy discussions of unsuccessful sale efforts. All of these topics touched on in the First Day Declaration⁴ distract from what should be the headline: **A)** the Debtors extracted minerals belonging to others, **B)** the Debtors sold these minerals, and **C)** the Debtors used the cash to fund operations or other business costs *instead of paying the royalty owners*. As a result, (and as the First Day Declaration rather matter-of-factly put it) the Debtors “may owe in excess of \$6 million in unpaid prepetition royalty interests.” *See* First Day Decl. at ¶ 20. The Debtors owe meaningful portion of the \$6 million arrearage to the members of the Ad Hoc Royalty Interest Owners Group.

2. The members of the Ad Hoc Royalty Interest Owners Group own undivided royalty interests and net revenue interests in certain wells operated by the Debtors. The Proceeds from sale of hydrocarbons attributable to the Ad Hoc Royalty Interests Owners Group’s interests are not property of the Debtor, nor property of the estate (and the same is true of the hydrocarbons

² As set forth in the Rule 2019 Statement [Docket No. 85] (the “Verified Statement”), the Ad Hoc Royalty Interest Owners Group holds undivided royalty interests pursuant to recorded leases by and between such owner and Debtor(s).

³ Capitalized terms used but not defined in this Objection have the meanings ascribed to such terms in the Motion.

⁴ The “First Day Declaration” means that certain *Declaration of Brad Walker in Support of the Debtors’ Chapter 11 Petitions and Requests for First Day Relief* [Docket No. 28].

themselves).⁵ As such, proceeds generated from the Debtors' extraction of minerals are held in trust for the benefit of and to the extent of divisional interests of each of the underlying royalty owners—such as the members of the Ad Hoc Royalty Interest Owners Group. The Debtors violated that trust, looted the royalty owners' hydrocarbons and cash proceeds thereof, and then distributed the royalty owners' cash to prolong the Debtors' downtrodden operations. By the Motion, the Debtors appear to continue to perpetrate this falsity by suggesting that the cash belonging to royalty owners first belongs to the Debtors. It does not.

3. In addition, Texas law is clear on the priority of royalty owners' liens on the Debtors' cash: as royalty interest owners, each member of the Ad Hoc Royalty Interest Owners Group has an automatically-perfected first-priority security interest in its minerals and the proceeds from the sale of its production, without the need of filing a financing statement. *See* TEX. PROP. CODE § 67.004 (“Except for a permitted lien, an oil and gas lien takes priority over any other lien, whether arising by contract, law, equity, or otherwise, or any security interest.”); *see also* TEX. PROP. CODE § 67.001 *et seq.* Accordingly, the Ad Hoc Royalty Interests Owners Group is entitled to adequate protection of their interests in the Debtors' cash collateral. Furthermore, the adequate protection proposed to be afforded to the Lender impermissibly

⁵ *See* Dahlberg v. ConocoPhillips Co. (In re Reichmann Petroleum Corp.), 434 B.R. 790, 797-98 (Bankr. S.D. Tex. 2010) (“Under Texas law and controlling bankruptcy authority, property held in constructive trust by the debtor is not the property of the debtor's estate and may not be disposed of by the debtor.”); *see also* *In re Southmark*, 49 F.3d 1111, 1117 (5th Cir. 1995); *and In re Matter of Haber Oil, Inc.*, 12 F.3d 426, 435-36 (5th Cir. 1994) (holding that because Section 541(d) excludes property subject to a constructive trust from the bankruptcy estate, Section 541(d) prevails against the trustee's strong-arm powers); *see also In re Tri-Union Dev. Corp.*, 253 B.R. 808, 815 (Bankr. S.D. Tex. 2000) (holding that “the debtor cannot use the cash [from sale of hydrocarbons] for any other purpose [other than distribution to royalty owners] without court order and without affording adequate protection for the interests of the royalty and working interest owners.”); *In re MCZ, Inc.*, 82 B.R. 40, 41 (Bankr. S.D. Tex. 1987) (finding, in the context of a royalty proceeds dispute, that, where a debtor merely holds bare legal title to property as agent or bailee for another, the debtor's bare legal title is of no value to the estate, and the debtor should convey the property to its rightful owner).

undermines the statutorily senior liens of each of the royalty owners—including the members of the Ad Hoc Royalty Interest Owners Group.

4. The Debtors' insistence on labeling royalty owners' cash as their own is particularly offensive given the lackluster commitment made by them in the Royalty Motion (as defined in the First Day Declaration). In the Royalty Motion, the Debtors (a) seek authority to segregate a mere 2% of the \$6,000,000 in unpaid prepetition royalties, and (b) request authority (without any requirement) to pay postpetition royalties in the ordinary course of business. In other words, the Debtors *might*, but are not required to pay postpetition royalty obligations to royalty owners. Of course, this means that the Debtors might—and absent Court intervention, likely would—continue to fund other postpetition obligations instead.

5. The Court must deny the relief requested in the Motion and modify the terms of the Debtors' use of cash collateral by, at minimum: (1) removing from the Budget cash that is not property of the Debtors' respective chapter 11 estates (and is instead, held in trust for the benefit of royalty owners); (2) providing members of the Ad Hoc Royalty Interests Owners Group adequate protection of the Ad Hoc Royalty Interest Owners Group's statutorily-senior interests in the Debtors' cash.

BUDGET

6. The Budget forecasts two sources of cash: (1) \$568,000 from *Oil & Gas Production*, and (2) \$140,000 from *Other*. The Budget also forecasts negative Net Cash Flow without any accounting of payments or reserving for payments to royalty owners.⁶ Most or all of this cash belongs to the royalty interest owners and is subject to liens in their favor. The Ad Hoc Royalty Interests Owners Group now files this Objection and Reservation of Rights to ensure that

⁶ The \$120,000 payment listed as being for royalty and working interest holders appears to be the reservation of prepetition amounts pursuant to the Royalty Motion, not for postpetition payments.

the Debtors are prohibited from using this cash unless the Debtors are able to adequately protect the royalty interest holders' superior interest therein.

OBJECTION

A. Royalty Owners Have a Senior Lien on Proceeds from the Sale of Minerals

7. Royalty owners such as the members of the Ad Hoc Royalty Interest Owners Group have a statutory lien in their minerals and proceeds from of their minerals (the "Statutory Liens").

8. Texas Property Code section 67.002 provides, in relevant part:

(a) To secure the obligations of a first purchaser to pay the sales price, each interest owner has an oil and gas lien to the extent of the interest owner's interest in oil and gas rights. The oil and gas lien exists as part of and incident to the ownership of oil and gas rights.

(b) An oil and gas lien:

(1) exists in and attaches to all oil and gas before severance;

(2) continues uninterrupted and without lapse in all oil and gas on and after severance; and

(3) continues uninterrupted and without lapse in and to all proceeds from the sale of the oil or gas.

Additionally, "Except for a permitted lien, an oil and gas lien takes priority over any other lien, whether arising by contract, law, equity, or otherwise, or any security interest." *See* TEX. PROP. CODE § 67.004.

9. Accordingly, the Statutory Liens held by royalty owners, such as the members of the Ad Hoc Royalty Interest Owners Group, are entitled to first lien priority, and are secured to the extent that any of the Debtors' cash constitute proceeds from the sale of the oil or gas derived from such royalty owners' interests in oil and gas rights.

10. Here, approximately 80% of the Debtors' forecasted cash generation is derived from oil and gas production (*i.e.*, \$568,000 of the \$708,000 in cash generation forecasted in the

Budget), and therefore, holders of statutory liens have interests in such cash to the extent of their respective liens. Furthermore, to the extent that any of the Debtors' existing cash balance as of the Petition Date was generated as proceeds from the sale of oil and gas to which royalty owners have rights, then such existing cash as of the Petition Date is likewise subject to the Statutory Liens of royalty owners entitled to first lien priority. In short, the Debtors' cash constitutes the cash collateral of the royalty owners such as the members of the Ad Hoc Royalty Interest Owners Group.

B. Under Bankruptcy Code Section 363, the Debtors are Prohibited from Using the Royalty Owners' Cash Collateral Absent Consent or the Grant of Adequate Protection

11. Although Bankruptcy Code section 363 contemplates the Debtors' use, sale, or lease of lienholders' collateral, the Bankruptcy Code permits the Debtors to do so only where (a) the lienholder consents, or (b) the court so orders. Bankruptcy Code section 363(c)(2)(B) provides that the Court may authorize the use of cash collateral only in conformance with the other provisions of section 363—namely, that the lienholder's interest be adequately protected.

12. Here, the Ad Hoc Royalty Interest Owners Group has not consented to the use of their respective cash collateral. Accordingly, the Debtors must provide adequate protection of their interests. No such adequate protection has been provided.

13. *First*, the relief provided by the Interim Royalty Order (and requested in the Royalty Motion) is woefully deficient in that it falls short of requiring the Debtors actually do anything at all—merely authorizing the Debtors to pay royalty obligations or segregate royalty obligation funds. Accordingly, the Interim Royalty Order does not constitute adequate protection.

14. *Second*, here, the use of cash collateral does not serve as adequate protection in and of itself by “preserv[ing] the base that generates the income stream.” *See* Mot. at ¶ 19. Courts that have “generally found that using cash collateral to preserve the value of secured creditors’

collateral is a form of adequate protection in itself” do so in circumstances where lenders’ collateral packages encompass more than cash (lenders such as Prosperity, for example). *See* Mot. at ¶ 19. Where, as with royalty owners, the principal collateral package *is the cash*, such rationale falls apart. Accordingly, the mere use of cash collateral to preserve other assets (which may not be royalty owners’ collateral) is insufficient to adequately protect royalty owners’ interests.

15. *Third*, the Budget forecasts negative cashflow week-to-week. Accordingly, the royalty owners’ interest in cash collateral will be depleted with the erosion of the Debtors’ cash.

16. *Fourth*, the adequate protection granted to Prosperity further erodes royalty owners’ interests in the cash collateral by prioritizing Lender’s postpetition liens and superpriority administrative expense claims over comparable liens and interests of royalty owners. To the extent that royalty owners’ cash collateral is being used, the Ad Hoc Royalty Interest Owners Group requires the following issues to be remedied:

- a. *Amendments to Budget*. Modifications of the Budget should require approval from this Court or the Ad Hoc Royalty Interest Owners Group. *See* Interim Ord. at ¶ J (permitting modifications to the Budget with agreement between Debtors and Lender only and permitting expenditures in excess of 110% of the Budget with approval from only the Lender).
- b. *Superpriority Administrative Expense Claims*. Royalty owners should be entitled to superpriority administrative expense claims ahead of the Lender given that the Lender’s prepetition interest in cash collateral is inferior to that of royalty owners.
- c. *Challenge Budget*. The Interim Order denies a statutorily-appointed committee any budget whatsoever to investigate or pursue a Challenge. *See*

Interim Ord. at ¶¶ L, P. Sufficient investigation and Challenge budget must be provided.

- d. *Challenge Period.* The Challenge period is deficiently short. It should be at least 60 days following the Petition Date and should be extended further to provide at least 60 days for a statutorily-appointed committee.
- e. *Payment of Ad Hoc Royalty Interest Owners Group Expenses.* Texas Law provides that the royalty owners are entitled to reimbursement and payment of costs and reasonable attorneys' fees when pursuing amount due under Section 91.406 of the Texas Natural Resources Code and lien rights under chapter 67 of the Texas Property Code; accordingly, the Ad Hoc Royalty Interest Owners Group is entitled to payment of fees during the pendency of these Chapter 11 Case.
- f. *Marshalling.* There is no basis for waiving the doctrine of marshalling. Here, by the Debtors' own account, the Lender is significantly ***oversecured*** and, thus, Lender is not entitled to a waiver of marshalling as adequate protection.
- g. *Reporting and Access.* The Ad Hoc Royalty Interest Owners Group should be entitled to all reports produced and access granted pursuant to ¶ JJ and ¶ OO of the Interim Order (or comparable reports under a subsequent order), which reports shall include, for the avoidance of doubt, and

identification of all segregated royalty funds and all reports related to royalty obligations.⁷

C. *Prosperity's Equity Cushion Constitutes Sufficient Adequate Protection*

17. Separately, it is unclear why the Debtors are intent to give the Lender exorbitant adequate protection where the Lender is already adequately protected by a significant equity cushion. According to the First Day Declaration, the Lender has the following collateral securing its \$50.1 million claim:

- a. \$49.2 million on account of the Lender's second lien interest in the Oregon Ranch (as defined in the First Day Declaration); *see* First Day Decl. ¶ 13;⁸
- b. \$25 million on account of the Llano Ranch (as defined in the First Day Declaration); *see* First Day Decl. ¶ 14;
- c. ~\$24.6 million on account of reserves in the Debtors' oil and gas interests; *see* First Day Decl. ¶ 10; and
- d. Other collateral, the values of which has not yet been sworn to by the Debtor.

18. In other words, if the Oregon Ranch, the Llano Ranch, and the oil and gas assets against which the Lender purports to have a lien are sold for half of the value that the Debtors have indicated they are worth, the Lender would be repaid in full. Stated differently, the Lender has an equity cushion in excess of 100% of the value of its claim (i.e., collateral valued at 200% of the amount of the loan)—again, based on the Debtors' own testimony.

⁷ And of course, all of this ignores the fact that it appears that the cash forecasted to be generated by the Debtors is apparently overwhelmingly generated from oil and gas production—meaning that the Debtor entities that do not generate proceeds from oil and gas production are getting a free ride in the bankruptcy off cash generated by the cash-producing oil and gas Debtors.

⁸ As set forth in the First Day Declaration, the value of the Oregon Ranch is approximately \$60 million, and the Lender's lien on the Oregon Ranch is subject to a first lien held by another lender in the amount of \$10.8 million. *See* First Day Decl. ¶ 17 at n. 6.

19. Accordingly, the Lender's interest is adequately protected and the proposed adequate protection package is woefully exorbitant.

RESERVATION OF RIGHTS

20. The Ad Hoc Royalty Interest Owners Group expressly reserves its rights to file, amend, and further object to the Motion as it deems appropriate and to join in and adopt as its own any such objection filed by another party, to seek discovery with respect to same, and to raise any issue or introduce evidence at any interim or final hearing relating to the Motions, whenever such hearings occur.

CONCLUSION

WHEREFORE, the Ad Hoc Royalty Interest Owners Group respectfully requests that the Court deny the Motion and grant such other and further relief as the Court may deem just and proper.

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Dated: February 28, 2025

Respectfully submitted,

/s/ Eric T. Haitz

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that he has transmitted a true and correct copy of the foregoing (a) via the Court's Electronic Case Filing system to all persons participating therein on February 28, 2025; and (b) via electronic mail on February 28, 2025 to counsel for the Debtors (drukavina@munsch.com; tbergman@munsch.com; gsmith@munsch.com; hjobe@jobelawpllc.com).

/s/ Eric T. Haitz

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