

ReoStar Energy CORP  
Form 10-Q  
February 18, 2011

**Table of Contents**

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

X Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2010

O Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number **000-52316**

**REOSTAR ENERGY CORPORATION**

(Exact name of registrant as specified in its charter)

**Nevada**

(State or other jurisdiction  
of incorporation or organization)

**20-8428738**

(I.R.S. Employer Identification No.)

**3880 Hulen Street, Suite 500, Fort Worth, Texas 76107**

(Address of principal executive offices)

**(817) 989-7367**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o

Accelerated filer o

Edgar Filing: ReoStar Energy CORP - Form 10-Q

Non-accelerated filer o (Do not check if a smaller reporting company)

Smaller reporting company x

---

Edgar Filing: ReoStar Energy CORP - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| <u>Class</u>                              | <u>Outstanding at February 14, 2010</u> |
|---|---|
| Common Stock, par value \$0.001 per share | 80,743,912                              |

---

TABLE OF CONTENTS

|   | <u>Page</u> |
|---|-------------|
| <b>PART I - FINANCIAL INFORMATION</b>   |             |
| <u>ITEM 1-- FINANCIAL STATEMENTS</u>  | 1           |
| <u>ITEM 2-- MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> | 8           |
| <u>ITEM 3-- QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>                            | 14          |
| <u>ITEM 4T-- CONTROLS AND PROCEDURES</u>  | 14          |
| <br>  |             |
| <b>PART II - OTHER INFORMATION</b>  |             |
| <u>ITEM 1-- LEGAL PROCEEDINGS</u>   | 15          |
| <u>ITEM 1A-- RISK FACTORS</u>   | 15          |
| <u>ITEM 2-- UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>                           | 15          |
| <u>ITEM 3-- DEFAULTS UPON SENIOR SECURITIES</u>   | 15          |
| <u>ITEM 4--(REMOVED AND RESERVED)</u>   | 15          |
| <u>ITEM 5-- OTHER INFORMATION</u>   | 15          |
| <u>ITEM 6-- EXHIBITS</u>  | 15          |
| <u>SIGNATURES</u>   | 16          |

---

Table of Contents

## PART I - FINANCIAL INFORMATION

ReoStar Energy Corporation  
Consolidated Balance Sheets

|  | December 31, 2010<br>(unaudited) | March 31, 2010 |
|--|----------------------------------|----------------|
| <b>ASSETS</b>                                      |                                  |                |
| Current Assets:                                    |                                  |                |
| Cash   | \$ 305,887                       | \$ 277,307     |
| Accounts Receivable:                               |                                  |                |
| Oil & Gas - Related Party                          | 401,470                          | 639,738        |
| Related Party                                      | 1,088,405                        | 561,169        |
| Other  | 2,000                            | -              |
| Inventory  | 116,346                          | 130,886        |
| Other Current Assets                               | -                                | 248,759        |
| Total Current Assets                               | 1,914,108                        | 1,857,859      |
| Notes Receivable                                   | 205,863                          | 213,619        |
| Oil and Gas Properties - successful efforts method | 26,750,382                       | 26,847,329     |
| Less Accumulated Depletion and Depreciation        | (10,850,023)                     | (9,034,348)    |
| Oil & Gas Properties (net)                         | 15,900,359                       | 17,812,981     |
| Other Depreciable Assets:                          | 2,028,487                        | 2,028,487      |
| Less Accumulated Depreciation                      | (570,065)                        | (427,013)      |
| Other Depreciable Assets (net)                     | 1,458,422                        | 1,601,474      |
| Total Assets                                       | \$ 19,478,752                    | \$ 21,485,933  |
| <b>LIABILITIES</b>                                 |                                  |                |
| Current Liabilities:                               |                                  |                |
| Accounts Payable                                   | \$ 494,953                       | \$ 278,233     |
| Revenue Payable                                    | 18,504                           | 20,912         |
| Payable to Related Parties                         | 240,550                          | 148,550        |
| Other Current Liabilities                          | -                                | 93,923         |
| Accrued Expenses                                   | 594,004                          | 140,390        |
| Accrued Expenses - Related Party                   | 185,868                          | 88,458         |
| Current Portion of Long-Term Debt                  | 10,529,442                       | 10,283,339     |
| Total Current Liabilities                          | 12,063,321                       | 11,053,805     |
| Notes Payable - Related Parties                    | 3,518,924                        | 3,518,924      |
| Total Long-Term Debt                               | 3,518,924                        | 3,518,924      |
| Asset Retirement Obligation                        | 355,195                          | 324,773        |
| Deferred Tax Liability                             | -                                | 639,034        |
| Total Liabilities                                  | 15,937,440                       | 15,536,536     |

Edgar Filing: ReoStar Energy CORP - Form 10-Q

**Stockholders' Equity**

|  |               |               |
|--|---------------|---------------|
| Common Stock, \$.001 par, 200,000,000 shares authorized and<br>80,743,912 shares outstanding on December 31, 2010<br>and 80,743,912 shares outstanding on March 31, 2010 | 80,743        | 80,743        |
| Additional Paid-In-Capital   | 11,510,020    | 11,460,893    |
| Treasury Stock, at cost  | (12,240)      | (12,240)      |
| Retained Deficit   | (8,037,211)   | (5,579,999)   |
| Total Stockholders' Equity   | 3,541,312     | 5,949,397     |
| Total Liabilities & Stockholders' Equity   | \$ 19,478,752 | \$ 21,485,933 |

See Accompanying Notes to Consolidated Financial Statements

Table of Contents

**ReoStar Energy Corporation**  
**Consolidated Statements of Operations**

|   | Three Months Ended                  |                                     | Nine Months Ended                |                                  |
|---|-------------------------------------|-------------------------------------|----------------------------------|----------------------------------|
|   | December<br>31, 2010<br>(unaudited) | December<br>31, 2009<br>(unaudited) | December 31, 2010<br>(unaudited) | December 31, 2009<br>(unaudited) |
| <b>Revenues</b>   |                                     |                                     |                                  |                                  |
| Oil & Gas Sales   | \$ 834,532                          | \$ 975,933                          | \$ 2,504,693                     | \$ 2,150,145                     |
| Sale of Leases  | -                                   | 173,420                             | -                                | 311,097                          |
| Other Income  | 20,661                              | 79,856                              | 93,454                           | 253,438                          |
|   | 855,193                             | 1,229,209                           | 2,598,147                        | 2,714,680                        |
| <b>Costs and Expenses</b>   |                                     |                                     |                                  |                                  |
| Oil & Gas Lease Operating Expenses  | 340,743                             | 436,640                             | 1,122,597                        | 1,480,038                        |
| Workover Expenses   | -                                   | 27,830                              | 13,680                           | 71,828                           |
| Severance & Ad Valorem Taxes  | 94,004                              | 121,486                             | 194,695                          | 186,681                          |
| Geologic & Geophysical  | -                                   | -                                   | 38,494                           | -                                |
| Plugging and Abandonments   | 86,617                              | 45,348                              | 104,404                          | 45,348                           |
| Depletion & Depreciation  | 695,969                             | 827,021                             | 2,204,829                        | 2,222,948                        |
| ARO Accretion   | 10,140                              | 10,222                              | 30,422                           | 32,003                           |
| General & Administrative:   |                                     |                                     |                                  |                                  |
| Salaries & Benefits   | 76,882                              | 261,056                             | 509,819                          | 664,551                          |
| Legal & Professional  | 199,630                             | 120,921                             | 543,471                          | 897,751                          |
| Other General & Administrative  | 129,856                             | 106,019                             | 285,726                          | 378,390                          |
| Interest, net of capitalized interest of \$0 and \$129,357 for the three months ended 12/31/10 and 12/31/09, respectively and \$0 and \$383,630 for the nine months ended 12/31/10 and 12/31/09, respectively | 210,532                             | -                                   | 630,487                          | -                                |
|   | 1,844,373                           | 1,956,543                           | 5,678,624                        | 5,979,538                        |
| <b>Other Income (Expense)</b>   |                                     |                                     |                                  |                                  |
| Interest Income   | 11                                  | (9,467)                             | 31                               | 18,437                           |
| Hedging Gain (Loss)   | -                                   | (7,307)                             | (15,800)                         | (110,950)                        |
| Income (Loss) from continuing operations before income taxes  | (989,169)                           | (744,108)                           | (3,096,246)                      | (3,357,371)                      |
| Income Tax Benefit (Expense)  | -                                   | 307,324                             | 639,034                          | 999,312                          |
| Net Income (Loss)   | \$ (989,169)                        | \$ (436,784)                        | \$ (2,457,212)                   | \$ (2,358,059)                   |
| <b>Basic &amp; Diluted Loss per Common Share</b>  | \$ (0.01)                           | \$ (0.01)                           | \$ (0.03)                        | \$ (0.03)                        |
| <b>Weighted Average Common Shares Outstanding</b>   | 80,743,912                          | 80,181,310                          | 80,743,912                       | 80,998,912                       |

See Accompanying Notes to Consolidated Financial Statements

Table of Contents

**ReoStar Energy Corporation**  
**Consolidated Statements of Cash Flows**

|   | <b>Nine Months Ended</b> |                          |
|---|--------------------------|--------------------------|
|   | <b>December 31, 2010</b> | <b>December 31, 2009</b> |
|   | <b>(unaudited)</b>       | <b>(unaudited)</b>       |
| <b>Operating Activities:</b>  |                          |                          |
| Net (Loss) Income   | \$ (2,457,212)           | \$ (2,358,059)           |
| Adjustments to reconcile net (loss) income to cash from operating activities: |                          |                          |
| Income Tax (Benefit) Expense  | (639,034)                | (999,312)                |
| Depletion, Depreciation, & Amortization                                       | 2,204,829                | 2,222,948                |
| Stock based compensation  | 49,127                   | 273,475                  |
| Non-employee stock based compensation   | -                        | 580,500                  |
| ARO Accretion   | 30,422                   | 32,003                   |
| Changes in Operating Assets and Liabilities                                   |                          |                          |
| Changes in Accrued Liabilities  | 551,024                  | 8,095                    |
| Change in Inventory   | 14,540                   | 4,117                    |
| Change in Related Party Receivables/Payables                                  | (527,235)                | 105,781                  |
| Changes in Other Receivables  | (2,000)                  | 9,353                    |
| Changes in Hedging Activity   | 154,836                  | 130,958                  |
| Changes in Revenue Payable  | (2,408)                  | -                        |
| Change in Revenue Receivables   | 238,268                  | (334,781)                |
| Changes in Accounts Payable   | 216,720                  | 110,284                  |
| Net Cash provided (used) from operating activities                            | (168,123)                | (214,638)                |
| <b>Investing Activities:</b>  |                          |                          |
| Oil & Gas Drilling, Completing and Leasehold Acquisition Costs                | 96,947                   | (1,441,647)              |
| ARO on Properties Acquired or Drilled   | -                        | 25,335                   |
| ARO on Sold Properties  | -                        | (32,607)                 |
| Change in Related Party Payable related to drilling                           | -                        | 597,768                  |
| Investment in Other Depreciable Assets  | -                        | (181,201)                |
| Note Receivable (Advances)  | -                        | (112,991)                |
| Note Receivable Collections   | 7,756                    | 553,537                  |
| Net Cash used in investing activities   | 104,703                  | (591,806)                |
| <b>Financing Activities</b>   |                          |                          |
| Advances from Related Parties   | 92,000                   | 200,000                  |
| Related Party Note (Payments)   | -                        | (200,000)                |
| Notes Payable (Payments) Advances   | -                        | 1,000,000                |
| Net Cash provided from financing activities.                                  | 92,000                   | 1,000,000                |
| Net Increase in cash  | 28,580                   | 193,556                  |
| Cash - Beginning of the period  | 277,307                  | 426,430                  |
| Cash - End of the period  | \$ 305,887               | \$ 619,986               |

See Accompanying Notes to Consolidated Financial Statements





Table of Contents

**ReoStar Energy Corporation**  
**Consolidated Statements of Cash Flows**  
**(Continued)**

|   | <b>Nine Months Ended</b> |                          |
|---|--------------------------|--------------------------|
|   | <b>December 31, 2010</b> | <b>December 31, 2009</b> |
|   | <b>(unaudited)</b>       | <b>(unaudited)</b>       |
| <b>Supplemental Disclosure of Cash Flow Information</b> |                          |                          |
| Cash paid during period for:                            |                          |                          |
| Interest  | \$ 64,609                | \$ 423,959               |
| Income Taxes-   | \$ -                     | \$ -                     |
| <b>Non Cash Investing and Financing Activities</b>      |                          |                          |
| Stock Based Compensation                                | \$ 49,127                | \$ 273,475               |
| Stock Based Consulting Fees                             | \$ -                     | \$ 580,500               |

See Accompanying Notes to Consolidated Financial Statements

**Table of Contents**

**REOSTAR ENERGY CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the United States Securities and Exchange Commission. They do not include all information and notes required by generally accepted accounting principles for complete financial statements. However, except as disclosed, there has been no material change in the information disclosed in the notes to the consolidated financial statements included in the Annual Report on Form 10-K of ReoStar Energy Corporation for the year ended March 31, 2010. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended December 31, 2010 are not necessarily indicative of the results that may be expected for the year ending March 31, 2011. The consolidated financial statements and notes are representations of the Company's management who are responsible for their integrity and objectivity. The Company's accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of these consolidated financial statements.

**Going Concern**

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America with the assumption that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. The Company has a working capital deficit of \$10,149,213. This working capital deficit was precipitated because the Company could not meet its covenant or borrowing base requirements of their lender due in part to a reduction in their borrowing base. Therefore the note payable to BT & MK Energy and Commodities LLC was classified as current. A complete discussion regarding the transactions leading to the default is more fully discussed in Note 3. On November 1, 2010, the Company filed for bankruptcy protection under Chapter 11. A reorganization plan has not yet been filed. The Company's ability to continue as a going concern is contingent upon successfully completing a reorganization which may include restructuring the company's long-term debt. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments to the amounts and classifications of assets and liabilities that might be necessary should the Company be unable to continue as a going concern.

**(2) CAPITAL STOCK**

We have authorized capital stock of 200 million shares of common stock. There were 80,743,912 shares of common stock issued and outstanding at December 31, 2010.

On July 25, 2008, the Board of Directors approved the 2008 Long-Term Incentive Plan whereby the Company reserved 8,000,000 shares of stock for issuance under the plan. The Board also approved the grant of 2,500,000 options to certain officers under the plan. The options have a strike price of \$0.35 per share, which was the closing price on July 24, 2008, and expire on July 25, 2018. The options vest over a three year period, with the first third vesting on March 31, 2009. The options were valued at \$679,992 using the Black-Scholes model with a volatility of 194%. During the year ended March 31, 2010, one of the officers resigned. In lieu of severance, the officer and the company agreed that the balance of the unvested options would vest immediately. Salaries and Benefits included stock option related compensation costs of \$49,127 and \$268,861 for the nine months ended December 31, 2010 and 2009, respectively.

On April 1, 2007, ReoStar also entered into a stock option arrangement with two outside members of its board of directors. Both board members received stock options of 50,000 shares with a strike price of \$1.11, one-third of which vested annually on March 31 2008, 2009, and 2010. For the six months ended December 31, 2010 and 2009 Salaries and Benefits expense included stock option costs of \$0 and \$4,614, respectively.

**Table of Contents**

**(3) NOTES PAYABLE**

On October 30, 2008, we entered into a \$25 million senior secured credit facility with lenders led by Union Bank, N.A. ("UB"), as administrative agent and as issuing lender. Pursuant to the terms of the senior credit facility, the initial borrowing base was set at \$14 million and is subject to re-determination every six months with one optional re-determination allowed between scheduled re-determinations. During the fiscal year ended March 31, 2010, the borrowing base was adjusted downward to \$7.6 million leaving an over-advance of \$3.2 million. The Company lacks the liquidity to repay the over-advance.

The credit facility is secured by all of the Company's assets and is senior to all other long-term debt. The outstanding principal is due October 30, 2011. However, if, pursuant to the terms of the senior credit facility, specific events of default occur, the due date of all outstanding principal and accrued interest may be accelerated. Specific events of default include, but are not limited to: payment defaults; breaches of representations and warranties; breaches of covenants; insolvency; a "change of control" in our ownership as described in the senior credit agreement; and a "material adverse change" as described in the senior credit agreement.

The senior credit facility requires us to comply with certain credit metrics, such as the maintenance of minimum working capital, certain ratios of debt to EBITDA (as defined in the senior credit facility), maintenance of a minimum EBITDA to interest, and places a cap on Capital Expenditures each year. Each metric is further defined below.

Working capital, defined as consolidated current assets less consolidated current liabilities is required to be at least \$1.5 million as of the last day of each fiscal quarter. Current assets includes the unused amount available under the senior credit facility. We were not in compliance with the working capital requirement as of December 31, 2010.

The leverage ratio is as follows: (a) for each fiscal quarter, the ratio of (i) Funded Debt (as defined in the senior credit facility) to (ii) consolidated EBITDA for the four fiscal quarter periods then ended must not be greater than 3.50 to 1.00. For the purposes of calculating the leverage ratio, the definition of "Funded Debt" does not include Notes Payable to Shareholders that has been subordinated to the senior credit facility. EBITDA is defined as Consolidated Net Income adjusted plus, to the extent deducted in determining net income, interest expense, income taxes, depletion, depreciation, amortization, and other non-cash charges for the period. We were not in compliance with the leverage ratio as of December 31, 2010.

The interest coverage ratio is the ratio of our consolidated EBITDA for the four fiscal quarter periods then ended to our consolidated Interest Expense for the four fiscal quarters then ended must be at least 3.00 to 1.00. We were not in compliance with the interest coverage ratio as of December 31, 2010.

In February, Union Bank formally notified the Company of non-compliance under the above covenants and the over-advance resulting from the revision of the borrowing base. See the Form 8-K filed on February 17, 2010.

The senior credit agreement imposes certain restrictions on us and our subsidiaries, subject to specific exceptions, including, but not limited to, the following: (i) incurring additional liens; (ii) incurring additional debt; (iii) merging or consolidating or selling, transferring, assigning, farming-out, conveying or otherwise disposing of any property; (iv) making certain payments, including cash dividends to our stockholders; (v) making any loans, advances or capital contributions to, or making any investment in, or purchasing or committing to purchase any stock or other securities or interests in any person or any oil and natural gas properties or activities related to oil and natural gas properties unless with regard to new oil and natural gas properties, such properties are mortgaged to UB, as administrative agent, or with regard to new subsidiaries, such subsidiaries execute a guaranty, pledge agreement, security agreement and mortgage in favor of UB, as administrative agent; and (vi) entering into affiliate transactions on terms that are not at least as favorable to us as comparable arm's length transactions.

**Table of Contents**

On June 30, 2010, an interest payment of \$155,416 became due. The Company did not make the interest payment.

In August 2010, Union Bank sold the note under the credit facility to BT & MK Energy and Commodities LLC ("BTMK"). Consequently all amounts due to Union Bank in connection with the credit facility, including accrued interest were assigned to BTMK.

On September 30, 2010, an interest payment of \$156,526 became due. The Company did not make the interest payment.

On October 12, 2010 BTMK provided notice that it was accelerating the note due to the interest payment default and that BTMK intended to foreclose on the assets of the Company if payment in full was not made by November 2, 2010. See the 8-K filed October 22, 2010.

On November 1, 2010, the Company filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code in order to prevent the foreclosure.

**(4) DERIVATIVE INSTRUMENTS AND PRICE RISK MANAGEMENT**

The Company does not engage in speculative derivative activities or derivative trading activities, nor does it use derivatives with leverage features. The Company uses derivative instruments from time to time to manage market risks resulting from the fluctuations in the prices of crude oil and natural gas. The gains and losses resulting from changes in the fair value of derivatives are recorded in operations.

The Company may periodically enter into derivative contracts, including price swaps and costless collars utilizing put and call options, which require payments to (or receipts from) counterparties based upon the differential between a fixed price and a variable price for a fixed quantity of crude oil or natural gas without delivering the physical product. The notional amount of the financial instruments is based upon production forecasts from existing wells.

On August 2, 2010, in accordance with the terms of the senior secured credit facility, Union Bank elected to terminate all outstanding derivative contracts with the Company. The termination of the outstanding derivative contracts resulting in proceeds of \$32,900, which were applied to amounts due Union Bank.

**(5) SUBSEQUENT EVENTS**

None

Table of Contents

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**CAUTIONARY STATEMENT**

You should read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto contained elsewhere in this report. The information contained in this quarterly report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our annual report on Form 10-K for the year ended March 31, 2010 and subsequent reports on Form 8-K, which discuss our business in greater detail.

In this report we make, and from time to time we otherwise make, written and oral statements regarding our business and prospects, such as projections of future performance, statements of management's plans and objectives, forecasts of market trends, and other matters that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Statements containing the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimates," "projects," "believes," "expects," "anticipates," "intends," "target," "goal," "plans," "objective," "should" or similar expressions identify forward-looking statements, which may appear in documents, reports, filings with the Securities and Exchange Commission, news releases, written or oral presentations made by officers or other representatives made by us to analysts, stockholders, investors, news organizations and others, and discussions with management and other of our representatives. For such statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Our future results, including results related to forward-looking statements, involve a number of risks and uncertainties. Such risks and uncertainties include, but are not limited to, changes in local, regional, and national economic and political conditions, the effect of governmental regulation, competitive market conditions, our ability to obtain additional financing, and other risks detailed herein and from time to time in our SEC reports. No assurance can be given that the results reflected in any forward-looking statements will be achieved. Any forward-looking statement speaks only as of the date on which such statement is made.

**Overview of Our Business**

We are engaged in the exploration, development and acquisition of oil and gas properties, primarily located in the state of Texas. We seek to increase oil and gas reserves and production through internally generated drilling projects, coupled with complementary acquisitions.

We own approximately 9,000 acres of leasehold, which include 5,000 acres of exploratory and developmental prospects as well as 4,000 acres of enhanced oil recovery prospects. We have built a multi-year inventory of drilling projects and drilling locations and currently have enough acreage to sustain several years of drilling.

Our corporate offices are located at 3880 Hulen Street, Suite 500, Fort Worth, Texas 76107. Our telephone number is (817) 989-7367.

**Table of Contents**

**Business Strategy**

Our objective is to build shareholder value by establishing and consistently growing our production and reserves with a strong emphasis on cost control and risk mitigation. Our strategy is (1) to control operations of all our leases via our affiliated operating companies, (2) to acquire and develop leasehold in key regional resource development plays while utilizing existing infrastructure and engaging in long-term drilling and development programs, and (3) to acquire leasehold in mature fields and implement enhanced oil recovery programs.

**Industry Environment**

The globalization of the world's economy, the rapid development of the emerging markets, and increased commodity speculation have recently resulted in unprecedented commodity pricing and volatility. Oil prices peaked at unprecedented highs in July 2008 before contracting significantly. At their low in January 2009, oil prices were down more than 75% from the July highs. Prices have since doubled to approximately \$85 per barrel.

While natural gas is also a fungible commodity, it is more regional in nature than oil. Constant changes in regional supplies and demand have resulted in significant pricing volatility in the natural gas market as well. Natural gas prices (the Houston Ship Channel index) peaked at \$13 per MMBTU in early July 2008 and have since then dropped by more than 75%. Natural gas prices remain weak with current pricing of approximately \$4.00 per MMBTU.

The rapid run up in commodity prices encouraged substantial drilling, which resulted in upward pressure on finding and development costs. For example, during last fiscal year, a shortage of pipe caused casing and tubing prices to dramatically increase, which resulted in a material increase in total completion costs.

The commodity pricing volatility accompanied with cost volatility has significantly reduced operating margins and has negatively impacted our ability to accurately forecast cash flows.

The reduction in commodity pricing for natural gas has helped ease drilling and service costs pressures. However, we expect them to remain at a high level relative to past pricing. In addition, we expect lease operating expenses to continue to rise as producers are forced to make operational enhancements to maintain production in more mature fields.

We believe that in order for an independent oil and gas producer to be successful, the producer must either operate its leases effectively or have significant operational control over its oil and gas properties. As commodity prices fluctuate, controlling costs through operations will make the difference between turning a profit and incurring a financial loss.

**Table of Contents**

**Principal Components of Our Cost Structure**

*Direct Operating Expenses.* These are day-to-day costs incurred to bring hydrocarbons out of the ground and to the market together with the daily costs incurred to maintain our producing properties. Such costs also include work-over repairs to our oil and gas properties not covered by insurance. To minimize and help control our costs, we acquired a work-over drilling rig and a swab rig in June of 2007. In 2009 we purchased and refurbished a shallow well oil drilling rig which is used to drill our Corsicana Nacatoch and Pecan Gap wells.

*Production and Ad Valorem Taxes.* These costs are primarily paid based on a percentage of market prices or at fixed rates established by federal, state or local taxing authorities.

*Exploration Expense.* The costs include geological and geophysical costs, seismic costs, delay rentals and the costs of unsuccessful wells or dry holes. While our current asset mix requires a minimum of geological and geophysical costs and seismic costs, it is possible this component of our cost structure could sharply increase depending upon future property acquisitions.

*Plugging Costs.* The Corsicana field is over one hundred years old and has hundreds of abandoned well bores scattered throughout the properties. In order to properly execute our enhanced oil recovery projects, we need to plug these abandoned, worn out well bores. Since the wells are fairly shallow, we are able to cement in the entire well bore at a cost of less than \$1,500 per well. To date, we have plugged over 200 well bores in this field.

*General and Administrative Expenses.* Overhead, including payroll and benefits for our corporate staff, costs of maintaining our headquarters, costs of finding our working interest partners, costs of managing our production and development operations, audit and other professional fees and legal compliance are included in general and administrative expense. General and administrative expense includes stock-based compensation expense (non-cash), amortization of restricted stock grants as part of employee compensation.

*Interest.* We increased our levels of debt during fiscal year 2009, and in the future, we may finance a larger portion of our working capital requirements and acquisitions with borrowings under a credit facility or with longer-term public traded debt securities. As a result, interest expense has become a much more prevalent component of our cost structure.

*Depreciation, Depletion and Amortization.* As a successful efforts company, we capitalize all costs associated with our acquisition and all successful development and exploration efforts, and apportion these costs to each unit of production through depreciation, depletion and amortization expense. This also includes the systematic, monthly depreciation of our oilfield equipment assets.

*Changes in Estimates.* Changes in estimates of proved reserves significantly impact the depletion expense we record each year. When proved reserves increase, our depletion rate decreases, resulting in a lower depletion expense and higher net income. Conversely, as proved reserves decrease, our depletion rate increases, resulting in a higher depletion expense and lower net income. Changes in estimates of proved reserves are frequently the result of changes in commodity prices, changes in operating costs, and reservoir performance history. While depletion is a non-cash expense, volatility in commodity prices and the resulting volatility in depletion can have a material impact on our profitability and on certain leverage ratios.

*Income Taxes.* We are subject to federal income taxes but are currently not in a tax paying position for regular federal income taxes, primarily due to the current deductibility of intangible drilling costs ("IDC"). Currently, we are not subject to state income taxes. Virtually all of our Federal taxes are deferred; however, at some point, we will utilize all of our net operating loss carry-forwards and we will recognize current income tax expense and continue to recognize current tax expense as long as we are generating taxable income.



**Table of Contents**

**Results and Analysis of Financial Condition, Cash Flows and Liquidity**

During the quarter ended December 31, 2010, we sold approximately 3,775 barrels of oil compared with approximately 7,107 barrels of oil for the quarter ended December 31, 2009. The average price for oil sold during the quarter ended December 31, 2010 was \$80.54 per barrel compared with the average price for the quarter ended December 31, 2009 of \$73.60 per barrel.

We sold approximately 78,212 mcf of gas for the quarter ended December 31, 2010 compared with approximately 100,561 mcf of gas for the same period a year earlier. The average price for natural gas sold during the quarter ended December 31, 2010 was \$6.33 per mcf (net of transportation, compression and CO2 charges) compared with \$4.50 per mcf for the quarter ended December 31, 2009.

Oil and gas revenues for the quarter ended December 31, 2010 were \$834,532 compared with \$975,933 for the three months ended December 31, 2009, an decrease of approximately 14.5%. Oil and gas revenues for the nine months ended December 31, 2010 were \$2,504,693, compared with \$2,150,145 for the nine months ended December 31, 2009, an increase of approximately 16.5%.

During the three months ended December 31, 2010, no drilling and completion costs were incurred.

On December 31, 2010, we had \$305,000 in cash and total assets of \$19.48 million. Debt consisted of accounts and notes payables to non-related parties of \$11.6 million, all of which is classified as current. We also had accounts and notes payables to related parties of \$3.9 million.

During the quarter, we did not draw on the credit facility secured by our assets. The material terms of the credit facility were reported on our Form 8-K filed on November 4, 2008. We are currently in default under the terms of the credit facility.

***Cash Flow***

Our principal sources of cash are operating cash flow, the sale of a portion of the working interest in our drilling projects, the credit facility and other financing options, including debt and equity, which may be available to us from time to time. Our operating cash flow is highly dependent on oil and gas prices.

Our 2010 capital program has been suspended.

***Capital Requirements***

Our primary needs for cash are to cure the borrowing base deficiency default under the terms of the senior secured credit facility. Due to the bankruptcy filing, continued tight credit and equity markets, the increased costs, and the recent volatility in commodity pricing, we have suspended our development drilling program in the Barnett Shale and have deferred planned expansion of the enhanced oil recover project in Corsicana. Management has reduced the capital expenditure budget to \$0 for the balance of fiscal year 2011.

***Future Commitments***

In addition to our capital expenditure program, we are committed to making cash payments in the future on two types of contracts: note agreements and operating leases. As of December 31, 2010, we have no capital leases nor have we entered into any material long-term contracts for equipment, nor do we have any off-balance sheet debt or other such unrecorded obligations.

**Table of Contents**

The table below provides estimates of the timing of future payments that we are obligated to make based on agreements in place at December 31, 2010. In addition to the contractual obligations listed on the table below, our balance sheet at December 31, 2010 reflects accrued interest payable on our debt of \$654,336.

|                                 | Fiscal Years Ending March 31, |      |              |            | Total         |
|---------------------------------|-------------------------------|------|--------------|------------|---------------|
|                                 | 2011                          | 2012 | 2013         | Thereafter |               |
| Office Lease Payments           | \$ 14,928                     | \$ - | \$ -         | \$ -       | \$ 14,928     |
| Notes Payable - Related Parties | -                             | -    | 3,518,924    | -          | 3,518,924     |
| Senior Secured Note Payable     | 10,800,000                    | -    | -            | -          | 10,800,000    |
|                                 | \$ 10,814,928                 | \$ - | \$ 3,518,924 | \$ -       | \$ 14,333,852 |

**Off-Balance Sheet Arrangements**

We do not currently utilize any off-balance sheet arrangements to enhance liquidity and capital resource position, or for any other purpose.

**Inflation and Changes in Prices**

Our revenues, the value of our assets, and our ability to obtain bank loans or additional capital on attractive terms have been and will continue to be affected by changes in oil and gas prices and the costs to produce our reserves. Oil and gas prices are subject to significant fluctuations that are beyond our ability to control or predict. The hedges put in place in the prior year have all expired.

In July 2009, the Company placed hedges on a portion of our future production. The hedging contracts we had in place at June 30, 2010 collared prices for 2,000 barrels of oil per month for the balance of calendar year 2010 with a floor of \$65 per barrel and a ceiling of \$85 per barrel. For natural gas, we collared natural gas prices for 20,000 MMBTU per month for the balance of calendar 2010 at a floor of \$5.50 per MMBTU and a ceiling of \$6.50 per MMBTU.

On August 2, 2010, under the terms of the senior secured credit facility the remaining hedging contracts were terminated and the net proceeds of \$32,900 were applied against outstanding amounts due related to the senior secured credit facility.

Although certain of our costs and expenses are affected by general inflation, inflation does not normally have a significant effect on our business. In a trend that began in 2004 commodity prices for oil and gas have increased significantly. The higher prices led to increased activity in the industry and, consequently, rising costs. These cost trends have put pressure not only on our operating costs but also on our capital costs. Industry capital costs have nearly doubled during the last five years. Industry analysts expect the trend to continue during the next fiscal year.

**Critical Accounting Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at year-end and the reported amounts of revenues and expenses during the year. We base our estimates on historical experience and various other assumptions that we believe are reasonable; however, actual results may differ.

Certain accounting estimates are considered to be critical if (a) the nature of the estimates and assumptions is material due to the level of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to changes; and (b) the impact of the estimates and assumptions on financial condition or operating performance is material.

**Table of Contents**

***Successful Efforts Method of Accounting***

We account for our exploration and development activities utilizing the successful efforts method of accounting. Under this method, costs of productive exploratory wells, development dry holes and productive wells and undeveloped leases are capitalized. Oil and natural gas lease acquisition costs are also capitalized. Exploration costs, including personnel costs, certain geological and geophysical expenses and delay rentals for oil and natural gas leases, are charged to expense as incurred. Exploratory drilling costs are initially capitalized, but charged to expense if and when the well is determined not to have found reserves in commercial quantities. The sale of a partial interest in a proved property is accounted for as a cost recovery and no gain or loss is recognized as long as this treatment does not significantly affect the unit-of-production amortization rate. A gain or loss is recognized for all other sales of producing properties.

The application of the successful efforts method of accounting requires managerial judgment to determine the proper classification of wells designated as developmental or exploratory which will ultimately determine the proper accounting treatment of the costs incurred. The results from a drilling operation can take considerable time to analyze and the determination that commercial reserves have been discovered requires both judgment and industry experience. Wells may be completed that are assumed to be productive and actually deliver oil and natural gas in quantities insufficient to be economic, which may result in the abandonment of the wells at a later date. The evaluation of oil and natural gas leasehold acquisition costs requires managerial judgment to estimate the fair value of these costs with reference to drilling activity in a given area.

The successful efforts method of accounting can have a significant impact on the operational results reported when we enter a new exploratory area in hopes of finding an oil and natural gas field that will be the focus of future developmental drilling activity. The initial exploratory wells may be unsuccessful and will be expensed. Seismic costs can be substantial which will result in additional exploration expenses when incurred.

To ensure the reliability of our reserve estimates, we engage independent petroleum consultants to prepare an estimate of proved reserves. The SEC defines proved reserves as those volumes of crude oil, condensate, natural gas liquids and natural gas that geological and engineering data demonstrate with reasonable certainty are recoverable from known reservoirs under existing economic and operating conditions. Proved developed reserves are volumes expected to be recovered through existing wells with existing equipment and operating methods. Although our engineers are knowledgeable of and follow the guidelines for reserves established by the SEC, the estimation of reserves requires engineers to make a significant number of assumptions based on professional judgment. Reserve estimates are updated at least annually and consider recent production levels and other technical information. Estimated reserves are often subject to future revisions, which could be substantial, based on the availability of additional information, including: reservoir performance, new geological and geophysical data, additional drilling, technological advancements, price and cost changes and other economic factors. Changes in oil and gas prices can lead to a decision to start-up or shut-in production, which can lead to revisions to reserve quantities. Reserve revisions in turn cause adjustments in the depletion rates utilized by us. We cannot predict what reserve revisions may be required in future periods.

We monitor our long-lived assets recorded in property, plant and equipment in our consolidated balance sheet to ensure they are fairly presented. We must evaluate our properties for potential impairment when circumstances indicate that the carrying value of an asset could exceed its fair value. A significant amount of judgment is involved in performing these evaluations since the results are based on estimated future events. Such events include a projection of future oil and natural gas sales prices, an estimate of the ultimate amount of recoverable oil and gas reserves that will be produced from a field, the timing of future production, future production costs, future abandonment costs, and future inflation. The need to test a property for impairment can be based on several factors, including a significant reduction in sales prices for oil and/or gas, unfavorable adjustment to reserves, physical damage to production equipment and facilities, a change in costs, or other changes to contracts, environmental regulations or tax laws. All of these factors must be considered when testing a property's carrying value for impairment. We cannot predict whether impairment charges may be required in the future. We are required to develop estimates of fair value to allocate purchase prices paid to acquire businesses to the assets acquired and liabilities assumed under the purchase method of accounting. The purchase price paid to acquire a business is allocated to its assets and liabilities based on the estimated fair values of the assets acquired and liabilities assumed as of the date of acquisition. We use all available information to make these fair value determinations.

**Table of Contents**

***Deferred Taxes***

We are subject to income and other taxes in all areas in which we operate. When recording income tax expense, certain estimates are required because income tax returns are generally filed many months after the close of a calendar year, tax returns are subject to audit which can take years to complete and future events often impact the timing of when income tax expenses and benefits are recognized. We have deferred tax assets relating to tax operating loss carry forwards and other deductible differences. We routinely evaluate deferred tax assets to determine the likelihood of realization. A valuation allowance is recognized on deferred tax assets when we believe that certain of these assets are not likely to be realized. In determining deferred tax liabilities, accounting rules require OCI to be considered, even though such income or loss has not yet been earned.

At December 31, 2010, a valuation allowance was recorded that reduced net deferred tax assets in excess of deferred tax liabilities to zero. We may be challenged by taxing authorities over the amount and/or timing of recognition of revenues and deductions in our various income tax returns. Although we believe that we have adequately provided for all taxes, gains or losses could occur in the future due to changes in estimates or resolution of outstanding tax matters.

***Contingent Liabilities***

A provision for legal, environmental and other contingent matters is charged to expense when the loss is probable and the cost or range of costs can be reasonably estimated. Judgment is often required to determine when expenses should be recorded for legal, environmental and contingent matters. In addition, we often must estimate the amount of such losses. In many cases, our judgment is based on the input of our legal advisors and on the interpretation of laws and regulations, which can be interpreted differently by regulators and/or the courts. We monitor known and potential legal, environmental and other contingent matters and make our best estimate of when to record losses for these matters based on available information. We currently have no material accruals for contingent liabilities.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

As a "smaller reporting company" defined in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this item.

**ITEM 4T. CONTROLS AND PROCEDURES.**

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of such period, our disclosure controls and procedures were effective.

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II - OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

On November 1, 2010, the Company filed a voluntary petition for protection under Chapter 11 of the U.S. Bankruptcy Code in the U.S. Bankruptcy Court for the Northern District of Texas. The Company also filed separate voluntary petitions for its operating subsidiaries ReoStar Gathering, ReoStar Leasing, and ReoStar Operating.

The Company filed these petitions to prevent foreclosure on substantially all of the assets of the Company by BT&MK Energy and Commodities LLC, who had acquired the Company's senior credit facility. While the Company has been in default under its senior credit facility, the Company believes that a foreclosure sale would not have yielded a fair value for the sale of the assets. Thus, the Company believed a more orderly bankruptcy process was necessary for the protection of the shareholders and other creditors of the Company.

As of the date of this report, an order confirming a plan of reorganization, arrangement or liquidation has not been adopted or confirmed.

**ITEM 1A. RISK FACTORS.**

As a "smaller reporting company" defined in Item 10(f)(1) of Regulation S-K, we are electing scaled disclosure reporting obligations and therefore are not required to provide the information requested by this item.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

The Company did not make the June 30, 2010 quarterly interest payment of \$155,416 due to Union Bank under the senior secured credit facility. In August, Union Bank sold the note and all amounts due in connection with the senior secured credit facility were assigned to the buyer, BT & MK Energy and Commodities LLC ("BTMK"). On September 30, 2010 another quarterly interest payment of \$156,526 became due. On October 1, 2010, BTMK provided the Company with notice of the default resulting from the failure to make the June 30, 2010 interest payment and its election to accelerate the maturity of the Note under the terms of the Note related to the senior secured credit facility. On November 1, 2010, the Company filed for bankruptcy protection. On December 31, 2010 a quarterly interest payment of approximately \$156,525 became due. To the date of this filing, the Company has not made the June 30, 2010, the September 30, 2010, or December 31, 2010 quarterly interest payments which total approximately \$468,470. The amount of principal outstanding on the date of this filing is \$10,800,000. The total due under the credit facility is approximately \$11,268,470.

**ITEM 4. (REMOVED AND RESERVED).**

Not applicable.

**ITEM 5. OTHER INFORMATION.**

Not applicable.

**ITEM 6. EXHIBITS.**

| <u>EXHIBIT<br/>NUMBER</u> | <u>DESCRIPTION</u>  |
|---------------------------|---|
| <u>31.1</u>               | <u>CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>  |
| <u>31.2</u>               | <u>CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>  |
| <u>32.1</u>               | <u>CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| <u>32.2</u>               | <u>CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |



**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**REOSTAR ENERGY CORPORATION**

February 18, 2011

By  /s/ Scott D. Allen  
Scott D. Allen, Chief Financial Officer  
(Principal Financial Officer and duly authorized signatory)

Table of Contents

**EXHIBITS INDEX**

| <u>EXHIBIT<br/>NUMBER</u> | <u>DESCRIPTION</u>  |
|---------------------------|---|
| <u>31.1</u>               | <u>CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>  |
| <u>31.2</u>               | <u>CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>  |
| <u>32.1</u>               | <u>CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| <u>32.2</u>               | <u>CFO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |