King & Spalding
Client Alert

DECEMBER 20, 2019

For more information, contact:

Matthew Warren
+1 312 764 6921
mwarren@kslaw.com

Thad Wilson
+1 404 572 4842
thadwilson@kslaw.com

Lindsey Henrikson
+1 312 764 6924
lhenrikson@kslaw.com

Jake Jumbeck
+1 312 706 8569
jjumbeck@kslaw.com

King & Spalding

Houston
1100 Louisiana Street
Suite 4000
Houston, Texas 77002-5213
Tel: +1 713 751 3200

Chicago
353 N Clark Street
12th Floor
Chicago, IL 60654
Tel: +1 312 995 6333

Bankruptcy Court Rules that Dedications Within Gathering Agreements "Run with the Land"

On December 20, 2019, the Bankruptcy Court for the Southern District of Texas in *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Resources, Inc.)*[1] held that dedications in gathering agreements create covenants that run with the land that cannot be rejected in bankruptcy, contrary to the holding in *In re Sabine Oil & Gas Corp.*[2] Although the dispute in *Alta Mesa* involved Oklahoma law, whereas *Sabine* involved Texas law, the court stated that the "requirements to form a real property covenant in Texas mirror those in Oklahoma." In addition, the Court's decision is in accord with another recent decision under Utah law, *Monarch Midstream, LLC v. Badlands Production Co. (In re Badlands Energy, Inc.).*[3] While the decision provides protection for midstream service providers in structuring transactions, the jurisdictional split in the case law leaves continued uncertainty.

BACKGROUND

Section 365 of the Bankruptcy Code allows a debtor in possession, "subject to the court's approval," to "assume or reject any executory contract."[4] In most situations, rejecting an executory contract (i) relieves a debtor from future performance obligations; and (ii) leaves the contractual counterparty with a prepetition, unsecured claim against the debtor for breach of contract.

Energy debtors can use the prospect for rejection as leverage to renegotiate their existing midstream services contracts, which typically require the producing company to either deliver a minimum production volume or pay a deficiency payment to the service providers. But midstream providers object, arguing the agreements are real property interests—e.g., dedications of underlying oil and gas mineral rights and associated acreage interests—that "run with the land."

This distinction is critical. If a midstream services contract does not contain covenants that run with the land, then an energy debtor could reject the contract. If, however, the agreement contains covenants that run

with the land, a debtor will not practically be able to reject the midstream services contract. Ultimately, whether a contract contains real property covenants that "run with the land" is an issue of state law.[5]

ALTA MESA: COVENANTS RAN WITH THE LAND UNDER OKLAHOMA LAW

In *Alta Mesa*, the Bankruptcy Court for the Southern District of Texas determined that the debtors' gathering agreements contained covenants that ran with the land under Oklahoma law.[6] There, the debtors and a midstream servicer executed two gathering agreements pre-petition, which the debtors attempted to invalidate, seeking a declaration that the gathering agreements did not create real property covenants under Oklahoma law and were therefore subject to rejection under section 365 of the Bankruptcy Code.

The bankruptcy court disagreed for three reasons. *First*, the court found that the gathering agreements touched and concerned the land. The court focused on the nature of Alta Mesa's leasehold interest in the underlying minerals and not the interest in the minerals themselves. Through that framework, the court concluded that the covenants in the parties' agreements touched and concerned those interests because the agreements: (i) dedicated all of Alta Mesa's produced hydrocarbons for delivery to the servicer; (ii) required recordation and required transferees to affirm the agreements; (iii) created surface easements so the servicer could maintain its gathering facilities; and (iv) set out fixed gathering fees.[7]

Second, the court determined the parties were in privity with each other. Because the parties agreed they were in vertical privity with each other (i.e., they were the original contracting parties), the court only examined horizontal privity closely. In concluding horizontal privity existed, the court explained that "conveyance of the easements to [the servicer] is enough to show horizontal privity with respect to the gathering agreements" because Alta Mesa's surface easements "spring directly from its leasehold mineral interests."[8] And since a surface easement is a "crucial component on an oil and gas lease," the court found horizontal privity existed.

Finally, the court concluded the parties intended that the gathering agreements would run with the land and bind successors. The court highlighted several aspects of the gathering agreements to reach this conclusion: (i) the express language of the agreements, each of which stated that "it is a covenant running with the land"; (ii) the dedications had been recorded in the real property records; and (iii) the parties had to obtain confirmation from transferees that they would uphold the transferor's responsibilities under the agreements.[9] For these reasons, the court determined that the gathering agreements contained real covenants that ran with the land.

As noted above, while this dispute involved Oklahoma law, the court expressly noted, in the course of reviewing precedent decided under Texas law (*Sabine*), that the requirements necessary to form real property covenants under Texas law and under Oklahoma law mirror each other, that Oklahoma law is identical to Texas law on whether covenants run with the land, and the court referenced Texas law throughout its opinion.[10] The next steps that will determine the long-term impact of this ruling under Oklahoma law are whether other courts look to *Alta Mesa* as a leading authority on the issue. But the next major footfall across the U.S. oil and gas industry would be delivery of an opinion with an outcome as loud and as clear as this one by a court in Texas analyzing Texas law. The Houston court clearly set the table for this today.

PREVIOUS DECISIONS

Two recent courts have decided whether midstream services contracts contain covenants that run with the land[11]: (i) *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC (In re Sabine Oil & Gas Corp.)*,[12] decisions we have discussed in prior Client Alerts[13]; and (ii) *Monarch Midstream, LLC v. Badlands Production Co. (In re Badlands Energy, Inc.)*.[14]

a. *Sabine Oil & Gas*: Covenants did not run with the land under Texas law

In *Sabine Oil & Gas*, the Bankruptcy Court for the Southern District of New York held that covenants contained in the debtors' midstream services contracts did not contain covenants that ran with the land under Texas law.[15] There, the debtors sought to reject midstream services agreements with Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holding, LLC, who opposed the debtors' request by arguing that their gathering agreements contained covenants that ran with the land and rejection was thus improper. The court agreed with the debtors for two reasons. *First*, the court found that the covenants did not touch and concern the land because, among other reasons, the covenants only addressed minerals after they were extracted. The court highlighted that under Texas law, minerals once produced are no longer real property and become personal property.[16] Because the agreements only addressed personal property, they did not touch and concern the land.[17]

Second, the court concluded that the parties did not stand in horizontal privity. The court noted that the traditional example "involves a property owner reserving by covenant, . . . a certain interest out of the conveyance of the property burdened by the covenant."[18] The court determined that the parties' contracts did not transfer any portion of their real property interests and only identified the contractual rights and obligations for the services Nordheim and HPIP Gonzales would provide—"clearly not" an interest in mineral rights.[19] The court therefore held that the covenants in the midstream services contracts did not run with the land—a critical ruling as it could essentially require a dedication of mineral interests "in the ground" in the applicable acreage (i.e., the same reserves that typically serve as collateral for upstream companies' funded indebtedness).

The United States District Court for the Southern District of New York and the Second Circuit Court of Appeals subsequently affirmed the bankruptcy court's holding.

b. *Badlands Production*: Covenants ran with the land under Utah law.

In *Badlands Production*, the Bankruptcy Court for the District of Colorado held that obligations imposed under the debtors' gas gathering and processing and salt water disposal agreements "ran with the land" and were not subject the free-and-clear sale provision of Section 363 of the Bankruptcy Code.[20] There, the debtors sought to sell substantially all their assets free and clear under Section 363 of the Bankruptcy Code, including their oil and gas assets, which were subject to midstream gas gathering and processing and saltwater disposal contracts with Monarch Midstream, LLC. Monarch objected, arguing that the assets could not be sold free and clear of the servicing contracts because they contained covenants running with the land.[21]

The court sided with Monarch for two primary reasons. *First*, the court held that the covenants touched and concerned the land and found that the purpose of the agreements was to compensate Monarch "for the burdens associated with acquiring and operating the" gathering systems, which was connected to the debtors' oil and gas wells.[22] The court thus concluded that the covenants touched and concerned the land.

Second, the court held the parties were in privity with each other. To reach this conclusion, the court noted that both parties shared interests in the "'Dedicated Reserves,' defined broadly as 'the interest of [debtors] in all Gas reserves . . ., and all Gas owned by [the debtors] . . . ."[23] The debtors and Monarch also created the covenants in connection with a simultaneous conveyance of property from one debtor to Monarch.[24] For these reasons, the court held that the covenants ran with the land under Utah law, and the debtors could not sell their assets free and clear of the agreements.

CONCLUSION

While *Alta Mesa* stands in contrast to *Sabine*, uncertainty for debtors and midstream counterparties remains. Absent further clarity from state courts, outcomes likely will be dependent on applicable bankruptcy precedent, including at

the appellate level. Thus, debtors and midstream counterparties may still choose to negotiate an amended gathering agreement when faced with the prospect of contract rejection.

ABOUT KING & SPALDING

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,100 lawyers in 21 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality, and dedication to understanding the business and culture of its clients.

ABU DHABI	BRUSSELS	DUBAI	HOUSTON	MOSCOW	RIYADH	SINGAPORE
ATLANTA	CHARLOTTE	FRANKFURT	LONDON	NEW YORK	SAN FRANCISCO	TOKYO
AUSTIN	CHICAGO	GENEVA	LOS ANGELES	PARIS	SILICON VALLEY	WASHINGTON, D.C.

[1] 19-03609, Dkt. No. 236 (Bankr. S.D. Tex. Dec. 20, 2019).
[2] 547 B.R. 66 (Bankr. S.D.N.Y. 2016); *see also Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC (In re Sabine Oil & Gas Corp.)*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016).
[3] No. 17-17465 KHT, 2019 WL 5549463 (Bankr. D. Colo. Sept. 30, 2019).
[4] 11 U.S.C. § 365(a).
[5] *See Butner v. United States*, 440 U.S. 48, 55 (1979).
[6] 19-03609, Dkt. No. 236, at 8, 23.
[7] *Id.* at 15–16.
[8] *Id.* at 21.
[9] *Id.* at 22.
[10] Oklahoma law is identical to Texas law on whether covenants run with the land. For example, each state's laws require that (a) burden or benefit must "touch and concern" the land; (b) the original parties must have intended for the burden or benefit to pass to successors; and (c) the parties must be in privity of estate. *Compare Beattie v. State ex rel. Grand River Dam Auth.*, 41 P.3d 377, 387 (Okla. 2002) (listing the factors for covenants running with the land under Oklahoma law) (per curiam) (Opala, J., concurring) (citation omitted), *with Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987) (listing overlapping factors).
[11] A third, *Official Committee of Unsecured Creditors v. Bank of New York Mellon Trust Co. N.A. (In re Quicksilver Res. Inc.)*, 544 B.R. 781 (Bankr. D. Del. 2016), was pending when the *Sabine* court issued its opinion. The parties consensually resolved their dispute in the wake of *Sabine* before the court could rule on the issue, though.
[12] 550 B.R. 59 (Bankr. S.D.N.Y. 2016), *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017), *aff'd*, 734 F. App'x 64 (2d Cir. 2018).
[13] Client Alert, "Second Circuit Affirms Debtors' Ability to Reject Gathering Agreements in Bankruptcy Cases," King & Spalding LLP (May 30, 2018); Client Alert, "District Court Upholds Bankruptcy Court's Ruling on Rejection of Gathering Agreements," King & Spalding LLP (Mar. 16, 2017); Client Alert, "Bankruptcy Court Rules Gathering Agreements Can Be Rejected: Potential Significant Impacts on Midstream Companies," King & Spalding LLP (Mar. 8, 2016).
[14] No. 17-17465 KHT, 2019 WL 5549463 (Bankr. D. Colo. Sept. 30, 2019).
[15] 550 B.R. at 62, 70.
[16] *Id.* at 66.
[17] *Id.* at 81.
[18] *Id.* at 79.
[19] *Id.* at 80.
[20] 2019 WL 5549463, at *7.
[21] *Id.* at *1.
[22] *Id.*
[23] *Id.* at *13.
[24] *Id.*