

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

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On the Edge

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Dedication Wars: The Midstream Companies Strike Back



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A covenant running with the land, or an executory contract? Prior to 2015, few courts considered the characterization of dedications in gathering, processing and transportation agreements between oil and gas producers and their midstream counterparties.² *In re Sabine Oil & Gas Corp.*³ has since brought the issue to the forefront of oil and gas bankruptcies. The *Sabine* courts held that the gathering agreements under consideration were not covenants running with the land and could therefore be rejected as executory contacts pursuant to § 365.⁴ Since then, producers and midstream companies have continued to square off over this issue, with producers having the benefit of *Sabine* on their side as the only reported opinion.

However, in the last six months, two bankruptcy courts declined to follow *Sabine* and found that the gathering agreements before them were covenants running with the land and could not be rejected or otherwise stripped from the underlying assets by a § 363 sale.⁵ These cases — *In re Badlands Energy Inc.* and *In re Alta Mesa Resources Inc.* — even the score for midstream companies and provide compelling authority that agreements containing appropriate dedications of oil and gas reserves and otherwise

meeting the relevant legal requirements should ride through bankruptcy unaffected.

Covenants Running with the Land and *In re Sabine Oil & Gas Corp.*

When a dispute exists as to a debtor's real property, bankruptcy courts apply the law of the state where the real property is located.⁶ Although the law of real covenants varies from state to state, for a covenant to run with the land it generally must meet the following requirements: (1) the covenant must touch and concern the land; (2) the original parties must intend the covenant to run with the land; and (3) privity of estate, or horizontal privity, exists between the parties.⁷ The elements primarily at issue in *Sabine*, *Badlands* and *Alta Mesa* were touch and concern, and horizontal privity.

To determine whether a covenant touches and concerns real property, the dedication must impact the use, value or enjoyment of the burdened real property interest.⁸ In *Sabine*, gatherers received a dedication of the producer's gas "produced and saved" from dedicated wells and/or leases.⁹ The U.S. Bankruptcy Court for the Southern District of New York applied Texas law and held that the dedication of gas "produced and saved" failed to touch and concern the real property sought to be burdened — the producer's interest in the underlying fee mineral estate — because it only concerned gas severed from the fee mineral estate, which is a

1 The authors thank their colleague Jonathan M. Hyman for his contributions to this article, as well as this area of law.

2 Midstream companies gather, transport and process oil and gas for producers. To build out the necessary infrastructure, midstream companies invest hundreds of millions of dollars in gathering lines, processing plants and other systems. To generate a return of and on their capital, midstream companies contract with producers to "gather" the hydrocarbons, "transport" the hydrocarbons from the well head to a processing plant, storage facility or an end user — through pipelines, trucks or rail — and sometimes, to "process" natural gas (through compression, removal of certain elements and/or dehydrating the gas to remove water). A "dedication" grants the midstream provider the exclusive right to gather, transport and/or process all hydrocarbons owned by the producer within a specified geographic area throughout the life of the midstream agreement.

3 550 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).

4 *Id.* at 65.

5 See *Monarch Midstream LLC v. Badlands Prod. Co., et al.* (*In re Badlands Energy Inc.*), 608 B.R. 854 (Bankr. D. Colo. 2019) (applying Utah law); *Alta Mesa Holdings LP v. Kingfisher Midstream LLC* (*In re Alta Mesa Res. Inc.*), Adv. No. 19-03609, 2019 WL 7580122 (Bankr. S.D. Tex. Dec. 20, 2019) (applying Oklahoma law).

6 *Butner v. United States*, 440 U.S. 48, 54 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.")

7 See, e.g., *Beattie v. State ex rel. Grand River Dam Auth.*, 41 P.3d 377, 387 (Okla. 2002) (Opala, J., concurring); *Flying Diamond Oil v. Newton Sheep Co.*, 776 P.2d 618, 623 (Utah 1989); *Inwood N. Homeowners' Ass'n Inc. v. Harris*, 736 S.W.2d 632, 636 (Texas 1987).

8 See, e.g., *Flying Diamond Oil*, 776 P.2d at 623-25; *Westland Oil Devel. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

9 *Sabine Oil & Gas Corp.*, 550 B.R. at 66.

personal property interest under Texas law.¹⁰ Because the gatherers' obligations under the agreement were triggered by the receipt of gas, not by the extraction of gas from the mineral estate itself, the dedications did not affect the use, value or enjoyment of the real property sought to be burdened.¹¹

Likewise, the *Sabine* courts found that horizontal privity had not been satisfied. Horizontal privity is a remnant of ancient property law and historically only existed if the covenant was created in connection with a conveyance of an estate from covenantor to covenantee.¹² It ensures that a covenant "inures to the benefit of, or must be fulfilled by, whatever party holds the land at the time when fulfillment is due."¹³ In all three cases addressed in this article, the courts recognized the debate over whether horizontal privity is still a requirement for a covenant to run with the land, but ultimately conducted the horizontal privity analysis anyway.

In *Sabine*, the bankruptcy court construed Texas law as requiring a "conveyance of an interest in property that itself is being burdened with the relevant covenant" to satisfy horizontal privity.¹⁴ Thus, the court rejected the argument that the producer's conveyance of a surface easement to the gatherer established privity because the easement was property separate and distinct (if related) from the property being burdened by the covenant at issue: the underlying mineral estate.¹⁵

In re Badlands Energy Inc.

Almost three and a half years after *Sabine*, faced with a similar situation in *In re Badlands Energy Inc.*, the U.S. Bankruptcy Court for the District of Colorado reached a different conclusion than the *Sabine* court. Badlands Production Co. sought to sell certain of its Utah oil and gas assets pursuant to § 363 of the Bankruptcy Code.¹⁶ Monarch Midstream LLC was party to a gas gathering and processing agreement and a saltwater disposal agreement with the debtor.¹⁷ Monarch objected to the sale of the assets free and clear of its agreements with the debtor, arguing that the dedications contained therein were covenants running with the land.¹⁸ The Colorado court agreed.

At the outset, the court found *Sabine* to be inapplicable because "it involved the application of Texas law to a very different dedication" than the one at issue.¹⁹ Unlike *Sabine*, the *Badlands* dedications burdened the producers' "interest ... in all Gas reserves *in and under*, and ... produced or delivered" from oil and gas leases, not the underlying fee mineral estate.²⁰ Applying Utah law, the court held that these dedications satisfied the "touch and concern" element because the "burdens imposed under the Agreements directly affect the Producers' use and enjoyment of its interests in the Leases."²¹ The "in and under" language in the dedication affects minerals in the ground, which are real property interests under Utah law.²² Although Utah has a slightly broader definition of

"touch and concern" than Texas, the *Badlands* court seemed to imply that a dedication of oil and gas reserves, leases and related lands would satisfy the touch-and-concern analysis under *Sabine*.

The *Badlands* court also found horizontal privity to be satisfied. Horizontal privity exists under Utah law when the original parties "create a covenant in conjunction with a simultaneous conveyance of an estate."²³ In the gathering agreement, the producers granted the gatherer a right of way and surface easement across the leases and adjoining land for the purposes of installing and operating the gathering system.²⁴ While this did not fit within the traditional paradigm for horizontal privity adopted by *Sabine*, the *Badlands* court held that the grant of a surface easement satisfied privity to the extent it was a requirement under Utah law.²⁵ The *Badlands* court held that to the extent the *Sabine* analysis applied, the dedication itself — although not a fee estate — constituted a conveyance that burdened the producers' real property interest (the leases and oil and gas reserves).²⁶

In re Alta Mesa Resources Inc.

Less than three months after *Badlands*, the U.S. Bankruptcy Court for the Southern District of Texas found that a gathering agreement constituted a covenant running with the land under Oklahoma law in *In re Alta Mesa Resources Inc.* Alta Mesa Holdings LP contracted with Kingfisher Midstream LLC (an affiliated entity) to build a gathering system and transport Alta Mesa's oil and gas.²⁷ On the day after it filed for bankruptcy, Alta Mesa filed an adversary proceeding seeking a declaration that its gathering agreement with Kingfisher did not constitute a covenant running with the land under Oklahoma law and, thus, was subject to rejection under § 365 of the Bankruptcy Code.²⁸ The parties filed cross-motions for summary judgment on the issue, which resulted in the court holding that the mid-stream dedication was a covenant running with the land as a matter of law.

Similar to *Badlands*, the *Alta Mesa* court recognized that *Sabine* was based on unique facts, and "[t]o the extent that the pronouncements in *Sabine* were intended to be generalized, this Court must reject them."²⁹ The *Alta Mesa* gathering agreement dedicated "all Interests within the Dedicated Area," and interests were defined as a producer's interest in, among other things, its oil and gas leases.³⁰

The court held that the *Alta Mesa* dedications touched and concerned the producer's oil and gas leases because "both the benefits and the burdens of the covenants affect the value of Alta Mesa's real property interests."³¹ The dedicated gathering system increased the value of the producer's leases, while the costs and restrictions imposed by the gathering agreement simultaneously diminished the value of the unproduced reserves.³² The court stated, "This simple fact

10 *Id.*

11 *Id.* at 67.

12 *Beattie*, 41 P.3d at 387 (citing *Flying Diamond*, 776 P.2d at 628).

13 See, e.g., *Lingle Water Users' Ass'n v. Occidental Bldg. & Loan Ass'n*, 43 Wyo. 41, 297 P. 385, 387 (Wyo. 1931).

14 *Id.* at 69.

15 *Id.* at 68-69.

16 *Badlands Energy Inc.*, 608 B.R. at 860.

17 *Id.*

18 *Id.*

19 *Id.* at 869.

20 *Id.* at 871 (emphasis added).

21 *Id.* at 868.

22 *Id.* at 869.

23 *Id.* at 871.

24 *Id.* at 865.

25 *Id.* at 874.

26 *Id.* at 873.

27 *Alta Mesa Res. Inc.*, 2019 WL 7580122, at *1.

28 *Id.* at *5.

29 *Id.* at *7.

30 *Id.* at *2.

31 *Id.* at *7.

32 *Id.*

persists even through Kingfisher is not entitled to possession until after the hydrocarbons become personal property.”³³ The court distinguished the touch-and-concern analysis in *Sabine*, which focused on a fee mineral estate: the right to lease and otherwise profit from the unproduced oil and gas in place.³⁴ In contrast, the real property interests burdened in *Alta Mesa* were oil and gas leases, which explicitly contemplated the extraction of oil and gas for profit.³⁵ Because the purpose of the gathering agreement (transporting extracted hydrocarbons for profit) was logically connected to the burdened real property (the oil and gas leases), the touch-and-concern requirement had been met.³⁶

Finally, the *Alta Mesa* court found that the parties were in privity of the estate. Declining to follow *Sabine*, the court found that the producer’s conveyance of a surface easement to the gatherer satisfied horizontal privity. The court stated, “While a conveyance of a fee simple estate satisfies horizontal privity, conveyances of lesser estates [like a surface easement] have also been found sufficient.”³⁷ The easements conveyed to the gatherer sprung directly from the producer’s oil and gas leases — the real property burdened by the dedication. Because the dedication was created in connection with the conveyance of a property interest in the burdened oil and gas leases, horizontal privity was satisfied.³⁸

Conclusion

Badlands and *Alta Mesa* mark a significant departure from *Sabine* and arm midstream companies with additional arguments in the event that their gathering-and-processing agreements face the prospect of rejection, or an attempted free-and-clear sale, in bankruptcy. The moral of the story is that the language used in any gathering-and-processing agreement matters will be the focal point of any dispute. The impact of *Sabine*, *Badlands* and *Alta Mesa* needs to be considered on the front end so that gathering and processing agreements are drafted to insulate the agreement in question to the greatest extent possible from subsequent attacks in the bankruptcy courts. **abi**

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³³ *Id.*

³⁴ *Id.* at *8.

³⁵ *Id.*

³⁶ *Id.* at *10.

³⁷ *Id.*

³⁸ *Id.*