

WHEN DOES A GAS DEDICATION CREATE A REAL
PROPERTY INTEREST?
A POST-SABINE ANALYSIS OF COVENANTS RUNNING
WITH THE LAND*

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I. OLD LAW, NEW CONTROVERSY

Covenants running with the land or executory contracts? A mere two years ago, few pondered the legal characterization of dedications contained in the thousands of gathering, processing, and transportation contracts between oil and gas producers and their midstream counterparties. Today, this issue is of profound importance to the U.S. energy industry. Since the beginning of 2015, more than 85 U.S. oil and

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gas producers have sought bankruptcy protection in the wake of plummeting commodity prices.¹ At the forefront of these bankruptcy proceedings—most notably *In re Sabine Oil & Gas Corp.*² and *In re Quicksilver Resources, Inc.*³—producers and midstream companies have squared off over whether the dedications in gathering and processing agreements are real property interests, and therefore immune from the reach of the bankruptcy court, or executory contracts that may be jettisoned through the restructuring process.⁴

The domestic shale boom has resulted in markedly increased domestic oil and gas production and a surge in the associated oil and gas infrastructure. Over the last decade and a half, midstream companies have collectively invested billions of dollars in developing the infrastructure necessary to gather, process, and transport domestic oil and gas.⁵ In exchange, these midstream companies contract with producers for a promise of payment based on the volume of oil and gas gathered, processed, or transported, and dedications of the underlying oil and gas interests/mineral interests and associated acreage. The fees charged to producers under the gathering and processing contracts are designed to provide midstream companies, over a period of time, a return of and on their capital investment.

In *Sabine*, the only case thus far where a bankruptcy court has ruled on the characterization of dedications, Sabine sought court approval to reject⁶ four of its contracts—a gas gathering agreement with Nordheim

1. See Nicole Friedman, *U.S. Oil Prices Hit Fresh Six-Year Low, Dipping Below \$40 a Barrel*, WALL STREET J., Aug. 21, 2015, <http://www.wsj.com/articles/oil-prices-fall-in-asia-after-weak-chinese-manufacturing-data-1440132261>; see also Haynes and Boones *Oil Patch Bankruptcy Monitor*, HAYNES AND BOONE (June 30, 2016), http://www.haynesboone.com/~media/files/attorney%20publications/2016/energy_bankruptcy_monitor/oil_patch_bankruptcy_20160106.ashx.

2. *In re Sabine Oil & Gas Corp.*, 562 B.R. 211, 211 (Bankr. S.D.N.Y. 2015).

3. *In re Quicksilver Resources Inc.*, et al, 544 B.R. 781 (Bankr. D. Del. 2016).

4. Other bankruptcy proceedings where parties have sought to reject allegedly out-of-market gathering, processing, and transportation agreements include *In re Magnum Hunter Resources*, 616 Fed. Appx. 442 (Bankr. D. Del. 2015); *In re Swift Energy, Co.*, WL 3566962 (Bankr. D. Del. 2015); *In re Emerald Oil, Inc.*, et al, 807 F.2d 1234 (5th Cir. 1987); *In re Tristream East Tex., LLC*, Case No. 16-31521 (Bankr. S.D. Tex. 2016); *In re Triangle USA Petroleum Corp.*, Case No. 16-11566 (Bankr. D. Del. 2016).

5. For the period from 1998 through 2013, interstate pipeline capacity expenditures totaled more than \$63 billion, and nearly 127 Bcf/d of pipeline capacity was added. U.S. DEP'T OF ENERGY, OFFICE OF ENERGY POLICY AND SYSTEMS ANALYSIS, NATURAL GAS INFRASTRUCTURE IMPLICATIONS OF INCREASED DEMAND FROM THE ELECTRIC SECTOR, (2015), <http://energy.gov/epsa/qer-document-library>; From 2004–2014, companies made an average of \$10 billion annual investment in midstream natural gas infrastructure, including major pipeline projects. U.S. DEP'T OF ENERGY, OFFICE OF ENERGY POLICY AND SYSTEMS ANALYSIS, ENERGY TRANSMISSION, STORAGE, AND DISTRIBUTION INFRASTRUCTURE, APPENDIX B NATURAL GAS NG-5 (2015), http://energy.gov/sites/prod/files/2015/09/f26/QER_AppendixB_NaturalGas.pdf.

6. Courts apply the “business judgment” test to a debtor’s decision to assume or reject an executory contract or unexpired lease. *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1309 (5th Cir. 1985); *Orion Pictures Corp. v. Showtime Networks, Inc.*, 4 F.3d 1095, 1099 (2d Cir. 1993). Under the business judgment test, a bankruptcy court examines the

Eagle Ford Gathering, LLC (“Nordheim”); a condensate gathering agreement with Nordheim; a gathering, treating and processing agreement with HPIP Gonzales Holding, LLC (“HPIP”); and a water and acid gas holding agreement with HPIP—in conjunction with its restructuring efforts.⁷ In a landmark ruling, United States Bankruptcy Judge Shelley Chapman determined the gathering and processing contracts between Sabine and its midstream counterparties were executory contracts—not real property interests—and could therefore be rejected.⁸ The judicially authorized rejection of the four gathering and processing agreements, which has been affirmed by the United States District Court for the Southern District of New York,⁹ is estimated to have saved Sabine as much as \$115 million.¹⁰

In *Quicksilver*, producer-debtor Quicksilver Resources opted to sell its Barnett Shale assets to BlueStone Natural Resources II (“BlueStone”) for \$245 million. BlueStone, however, conditioned its obligation to close the sale on the United States Bankruptcy Court for the District of Delaware issuing a final order rejecting three gas gathering and processing agreements and a joint operating agreement between Quicksilver and Crestwood Midstream Partners (“Crestwood”). Prior to a ruling on Quicksilver’s motion to reject the agreements, Crestwood and BlueStone agreed to new, long-term gathering and processing agreements, obviating the need for a ruling on Quicksilver’s motion to reject.

The ongoing litigation in *Sabine* and commercial resolution in *Quicksilver* underscores the high degree of uncertainty surrounding the

circumstances to determine whether assumption or rejection is prudent and will benefit the estate. *Orion Pictures Corp.*, 4 F.3d at 1099. In applying the test, some courts presume that the debtor “acted prudently, on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the bankruptcy estate,” and that rejection should be approved unless the “conclusion that rejection would be advantageous is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice.” *In re Pomona Valley Medical Group*, 476 F.3d 665, 670 (9th Cir. 2007). In contrast, at least one bankruptcy court in Texas has noted that it “is unwilling to presume Congress, by providing that authority to bankruptcy courts, intended a bankruptcy court, as opposed to exercising actual oversight of determinations of how to deal with contracts, to serve as no more than a rubber stamp for the trustee or debtor in possession.” *In re Pilgrim’s Pride Corp.*, 403 B.R. 413, 424, 426 n.31 (Bankr. N.D. Tex. 2009).

7. *In re Sabine Oil & Gas Corp.*, No. 15-11835, 2016 WL 1320279 (Bankr. S.D.N.Y. Mar. 31, 2016).

8. *In re Sabine Oil & Gas Corp.*, No. 15-11835, 2016 WL 890299 ((Bankr. S.D.N.Y. Mar. 8, 2016) (holding that Sabine would be allowed to reject its executory gathering contracts); *In re Sabine Oil & Gas Corp.*, No. 15-11835, 2016 WL 2603203 (Bankr. S.D.N.Y. May 3, 2016) (holding that covenants did not run with the land as real covenants nor did the covenants run with the land as equitable servitudes under Texas law) (collectively these two opinions will be referred to as the “Sabine Opinions.”).

9. *In re Sabine Oil & Gas Corp.*, No., 16-CV-4127 (JSR), 2017 WL 1093290 (S.D.N.Y. Mar. 10, 2017) (the “District Court Opinion”).

10. Tom Hals, *As U.S. shale sinks, pipeline fight sends woes downstream*, REUTERS (Feb. 22, 2016), <http://www.reuters.com/article/usa-oil-lawsuits-idUSL2N1610NC>.

characterization of dedications. This paper will address the importance of this issue to both the upstream and midstream sectors, provide a survey of Texas law on covenants that run with the land and equitable servitudes, analyze the landmark Sabine Opinions, and address drafting considerations for both upstream and midstream market participants.

A. An Issue of Vital Importance to the Energy Industry

Sabine's rejection of the Nordheim and HPIP contracts has enhanced its prospects of a successful restructuring; the specter of rejecting the Crestwood gathering and processing agreements aided Quicksilver's efforts to consummate the sale of its assets to BlueStone; and other financially strapped producers will undoubtedly seek to leverage this uncertainty into more favorable commercial arrangements with their midstream counterparties.

However, *In re Tristream East Texas, LLC*,¹¹ a bankruptcy pending in the United States Bankruptcy Court for the Southern District of Texas, demonstrates that producers are also vulnerable to the characterization of gathering and processing agreements as executory contracts that may be rejected in bankruptcy. Tristream is a midstream operating company that provides gas gathering and processing services to producers in East Texas. Tristream sought to reject its gathering and processing agreements with certain producers, including Eagle Rock Acquisition Partnership, LP.¹² Eagle Rock filed an objection, contending that such agreements contain dedication language that constitute covenants running with the land that burden Tristream's property interests (i.e., the gatherer's real property interest in the pipeline easements and rights of way), and Tristream used the wrong procedural vehicle to raise rejection of these agreements.¹³ The *Tristream* litigation was ultimately resolved without an adjudication on the characterization of the gathering and processing agreements at issue.

Additionally, financially solvent producers can expect new challenges in their commercial negotiations with midstream service providers. With the enforceability of dedications in question, midstream companies are more likely to seek additional assurances in their contracts, such as minimum volume commitments, reservation charges, secured collateral, or other financial commitments.

11. *In re Tristream East Texas, LLC*, Case No. 16-31521 (Bankr. S.D. Tex. 2016).

12. *Id.* at Docket No. 118.

13. *Id.* at Docket No. 139. Fed. R. Bankr. P. 7001(2) requires that a debtor file an adversary proceeding to determine the extent of any interest in its property. The *Sabine* court recognized that an adversary proceeding is the proper procedural vehicle to address whether agreements constitute covenants running with the land. See *In re Sabine Oil & Gas Corp.*, No. 15-11835 (Bankr. S.D.N.Y. March 8, 2016) [Docket No. 872].

From the midstream perspective, the dedications operate as security by burdening the oil and gas interests, thereby binding all successors to the terms of the original bargain. Midstream companies have historically undertaken large capital investments, and their lenders have financed these midstream projects, with the understanding that these dedications are real property interests that bind successors to the mineral interests. That is, regardless of any change to the leasehold ownership, any hydrocarbons produced from the subject acreage remain dedicated to the midstream company and subject to the terms of the gathering and processing contracts. Midstream companies have traditionally filed memoranda of the agreements in the real property records to put potential transferees on notice of the dedication. This is because producers routinely transfer or otherwise divest themselves of all or a portion of their mineral interests after granting the dedication to the midstream company.

The midstream sector has posited that judicial determinations that dedications are not covenants running with the land or equitable servitudes, and therefore subject to rejection in a bankruptcy proceeding, will have negative consequences to producers and consumers.¹⁴ The Gas Processing Association, a midstream trade association, has stated that such “a determination would threaten the sanctity of thousands of bargained-for agreements between midstream companies and their producer counterparties; would undermine investor confidence in midstream companies, raising the cost of capital to invest in infrastructure; would force midstream companies and producers to include more costly assurances in their contracts, such as reservation charges, secured collateral, or other guarantees; and would undermine the market in which mineral interests are transferred by threatening the dedications that underpin midstream investments.”¹⁵

II. SUMMARY OF TEXAS CASE LAW

Under Texas law, a covenant runs with the land when (i) it touches and concerns the land; (ii) it relates to a thing in existence or specifically binds the parties and their assigns; (iii) the original parties intended it to run with the land; and (iv) the successor to the burden has notice.¹⁶ In addition, courts typically examine whether privity of estate (vertical

14. Brief of Amicus Curiae Gas Processors Association in Opposition to Debtors’ Motion for Order Authorizing and Approving Rejection of Certain Executory Contracts with Affiliates of Crestwood Midstream Partners, LP at 6; In re Quicksilver Resources Inc., et al, No. 15-10585 (Bankr. D. Del. March 1, 2016) [Docket No. 1210].

15. *Id.* at 5–6.

16. Inwood N. Homeowners’ Ass’n Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987).

privity) existed between the parties when the covenant was made.¹⁷ Below is a discussion of case law with respect to the elements which have been at issue with respect to midstream agreements.

A. *Touches and Concerns the Land*

In general, a covenant touches and concerns the land when it affects the “nature, quality or value of the thing demised, independently of collateral circumstances, or if it affect[s] the mode of enjoying it.”¹⁸ A covenant must only burden the land to meet the touch and concern requirement – it need not convey a benefit.¹⁹ Any burden created by the covenant must have a direct impact upon the land itself and its value, not just the parties personally.²⁰

The Fifth Circuit recently examined whether a gas gathering agreement touched and concerned the land in *Newco Energy v. Energytec, Inc.* In *Energytec*, the real property at issue was a gas pipeline system.²¹ The party entitled to the transportation fees (Newco) did not own the gas pipeline system.²² The Fifth Circuit held that Newco’s interest in the transportation fee was for the use of real property, *i.e.*, the traveling of natural gas from a starting point along the length of the pipeline to an endpoint.²³ “The pipeline is a subsurface road for natural gas . . . [and Newco’s] rights impact the owner’s interest in the pipeline.”²⁴ The transportation fee, along with Newco’s right to consent to assignment of the pipeline, were burdens upon the property, as they would likely impact the pipeline’s value in the eyes of prospective buyers.²⁵ The Fifth Circuit held that the touch and concern requirement was met.²⁶

17. *Id.*; *Ehler v. B.T. Suppenas Ltd.*, 74 S.W.3d 515, 521 (Tex. App.—Amarillo 2002, *no pet.*). Vertical privity is discussed in greater depth *infra*.

18. *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982). A personal covenant, in contrast, does not touch and concern the land, because such a covenant affects the grantor personally and is unrelated to the use of the land. *Id.* at 910.

19. *In re El Paso Refinery, LP*, 302 F.3d 343, 356 (5th Cir. 2002) (“Although the caselaw is somewhat unclear, it is at least arguable that the benefit requirement has been abandoned by the Texas courts.”); *Wimberly v. Lone Star Gas Co.*, 818 S.W.2d 868, 871 (Tex. App.—Fort Worth 1991, *pet. denied*) (rejecting requirement that covenant must benefit land in order to fulfill touch and concern requirement).

20. *See, e.g. Westland Oil*, 637 S.W.2d at 911 (holding that promise to convey interests in oil and gas leases burdened the land by potentially rendering it less valuable); *Wimberly*, 818 S.W.2d at 870–71 (holding that contract permitting gas company to purchase water from wells on owner’s land was contract running with the land); *El Paso Refinery*, 302 F.3d at 357–58 (holding that covenant allocating liability for environmental cleanup costs did not touch and concern land because covenant only benefitted original owner).

21. *Newco Energy v. Energytec, Inc.*, 739 F.3d 215, 224 (5th Cir. 2013).

22. *Id.* at 217.

23. *Id.* at 224.

24. *Id.*

25. *Id.*

26. *Id.* at 225.

Prior to *Energytec*, the Fifth Circuit considered the touch and concern element in *In re El Paso Refinery, LP*.²⁷ In *El Paso Refinery*, the covenant at issue sought to prevent the owner of a refinery from seeking contribution or indemnity from the prior owner for any environmental cleanup costs.²⁸ When determining whether the covenant touched and concerned the land, the Fifth Circuit remarked the covenant affected only the prior owner personally and had “no direct impact on the land itself.”²⁹ Because the covenant was a personal contractual arrangement that did nothing more than shield the prior owner of the refinery from the possibility of a contribution suit by a future owner, it did not run with the land.³⁰ The prior owner, in reliance on the Texas Supreme Court’s decision in *Westland Oil*,³¹ argued that the impact on the value of the underlying land caused by the payment of environmental cleanup costs was enough to meet the touch and concern requirement of a covenant running with the land.³² The Fifth Circuit held that “even when a covenant impacts the value of land, it must still affect the owner’s interest in the property of its use in order to be a real covenant.”³³ Because the covenant in question was personal in nature and had no impact on the owner’s interest in or use of the land, the touch and concern requirement was not met.³⁴

In *Energytec*, the producer argued the obligation to pay transportation costs was unrelated to the use of the land because it was based solely on the volume of gas moving through the pipeline and had no direct impact on the land.³⁵ The Fifth Circuit rejected this argument, holding the gatherer’s “interest in transportation fees is for the use of real property, *i.e.*, the traveling of natural gas from a starting point along the length of the pipeline to an endpoint.”³⁶ Such rights “impact [producer’s] interest

27. *El Paso Refinery*, 302 F.3d at 357.

28. *Id.* at 355.

29. *Id.* at 356. “The Refinery’s owner may, in accordance with the deed’s provisions, take remedial action or not take remedial action, pollute or not pollute, as long as contribution is not sought from [the prior owner]. The covenant does not compel nor preclude the promisor or any subsequent owner from doing anything on the land itself. . . . Nor does it permit . . . the promisee, to enter or utilize the land for any purpose.” *Id.* at 356–57.

30. *Id.* at 357.

31. *Westland Oil*, 637 S.W.2d at 911. The definition of “touch and concern” cited by the Texas Supreme Court states that a covenant will run “if it affected the *nature, quality or value* of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it.” *Id.* (emphasis added). The court held that the promise to convey interests in oil and gas leases predicated on the drilling of a test well on the land affected both the nature and value of the land, so the touch and concern requirement was met. *Id.*

32. *El Paso Refinery*, 302 F.3d at 357.

33. *Id.*

34. *Id.*

35. *Energytec, Inc.*, 739 F.3d at 224.

36. *Id.*

in the pipeline,” and as a result, the dedication of transportation fees touched and concerned the land.³⁷

In *Wimberly v. Lone Star Gas Co.*, landowner and operator entered into a contract for the purchase of water from landowner’s well for operator’s use in its gas compressor station plant, “so long as [operator] operated the plant.”³⁸ Landowner subsequently sold the property to new owners, and the new owners brought suit against the operator.³⁹ The new owners argued they were not bound by the water contract because such contract only impacted the operator’s gas plant, which was personal property.⁴⁰ The court rejected this argument and held that the promise to provide water from landowner’s well clearly touched and concerned real property because the landowner was required to deliver water to the gas plant.⁴¹

In *Prochemco*, Coyanosa Land & Cattle Company, a subsidiary of Prochemco, contracted to purchase natural gas from Clajon as the total power requirements for lifting water for use in the irrigation of its over 1,500 acres of farmland in Pecos County, Texas.⁴² The gas sales contract provided that its terms “are and shall be deemed covenants running with the described land and shall extend to all wells utilized in irrigating said land.”⁴³ The gas sales contract bound not only Coyanosa, but also its heirs, successors, and assigns.⁴⁴ The court held that the gas sales contract was a covenant running with the land, so that when Coyanosa assigned its interest in the farmland, the agreement passed with the land.⁴⁵

B. *Intended by the Original Parties to Run with the Land*

In many cases where courts have found covenants running with the land (including *Energytec*), the agreements explicitly state that they “run

37. “Whenever the owner of the ‘land,’ i.e., the pipeline and the rights-of-way, wants to transport natural gas along its length, the fee to [gatherer] is to be paid. If the ‘land’ owner decides no longer to do so, then [gatherer’s] rights are dormant, subject to revival should the natural gas ever again flow.” *Id.* at 225.

38. 818 S.W.2d 868, 870 (Tex. App.—Fort Worth 1991, writ denied).

39. *Id.*

40. *Id.*

41. See also *Montfort v. Trek Res., Inc.*, 198 S.W.3d 344, 355 (Tex. App.—Eastland 2006) (citing *Wimberly* to support its holding that covenant regarding water gathering system touched and concerned the land). “Although no Texas case has stated a general rule with respect to covenants to supply or furnish water, case law from other jurisdictions establishes that covenants to supply or furnish water generally run with the land.” *Id.* (citing *Camenisch v. City of Stanford*, 140 S.W.3d 1, 5 (Ky. Ct. App. 2003)); 20 Am. Jur. 2d *Covenants, Conditions, and Restrictions* (1995).

42. *Prochemco, Inc. v. Clajon Gas Co.*, 555 S.W.2d 189, 190 (Tex. Civ. App.—El Paso 1977, writ ref’d n.r.e.).

43. *Id.*

44. *Id.*

45. *Id.* at 191; see also *Wimberly*, 818 S.W.2d at 871 (contract permitting gas company to purchase water from wells on owner’s land for as long as gas company operated plant was contract running with the land binding upon all heirs, successors, and assigns).

with the land.”⁴⁶ This statement alone is sufficient evidence to satisfy the element of intent (although intent alone is not dispositive of whether a covenant exists).⁴⁷

When an agreement does not contain an express statement that a provision shall run with the land, courts look at the contract to determine if the parties intended to bind successive purchasers to the agreement.⁴⁸ Language that the contract is binding upon the parties’ “successors and assigns” is evidence that the original parties to a contract intended the agreement to run with the land.⁴⁹ Evidence of intent can also be inferred from whether the agreement was filed in the county deed records.⁵⁰

C. Vertical Privity

For a covenant to run with the land, the covenant must be made between parties who are in privity of estate.⁵¹ “Privity of estate,” or vertical privity between covenanting parties, means a mutual or successive relationship exists to the same rights in the property.⁵² The classic example of vertical privity is of a producer that sells its leasehold interest to another producer. The midstream operator and new producer are in vertical privity with one another.

In *Energytec*, the transportation fee was created in a letter agreement at the time of a real property conveyance between Mescalero and Producer’s Pipeline.⁵³ As part of a purchase agreement, Energytec (successor to Producer’s Pipeline) expressly agreed to assume the burden to pay transportation fees to Newco (successor to Mescalero).⁵⁴ Newco was either the original owner of the benefit of the covenant (i.e., the transportation fees) or the clear successor. The Fifth Circuit found that vertical privity existed as to both Newco (the holder of the benefit of the covenant) and Energytec (the holder of the burden of the covenant).⁵⁵

46. See, e.g. *Energytec*, 739 F.3d at 217; *Gouveia*, 37 F.3d at 297 (covenant restricting lots to single-story, residential property); *In re Beeter*, 173 B.R. 108, 111 (Bankr. W.D. Tex. 1994) (condominium declaration covenant).

47. See, e.g. *Energytec*, 739 F.3d at 217 (intent element was not at issue, given explicit statement in letter agreement that transportation fee was to run with the land).

48. *Montfort v. Trek Resources, Inc.*, 198 S.W.3d 344, 355 (Tex. App.—Eastland 2006, no pet.) (use of terminology such as “successors and assigns” is helpful, but not dispositive, in determining intent); *Musgrave v. Brookhaven Lake Prop. Owners Ass’n*, 990 S.W.2d 386, 395 (Tex. App.—Texarkana 1999, pet. denied) (“Intent may be implied from the fact that the benefit of the covenant was intended to be of more than a transitory nature”).

49. *Barnes S.W. Plaza, LLC v. WF Retail Investments LLC*, No. 02-11-00244-CV, 2012 WL 3758086, at *4 (Tex. App.—Fort Worth Aug. 30, 2012) (intent may be evidenced by language in the covenant agreement stating the covenants bind the drafters’ “successors and assigns”).

50. *Harris County Flood Control Dist. v. Glenbrook Patiohome Owners Ass’n*, 933 S.W.2d 570, 575 (Tex. App.—Houston [1st Dist.] 1996, writ denied).

51. *Westland Oil*, 637 S.W.2d at 910–11.

52. *Id.*

53. *Energytec*, 739 F.3d at 221, 223.

54. *Id.* at 217.

55. *Id.* at 222.

D. Horizontal Privity

Some Texas courts have determined whether a covenant runs with the land by analyzing the four requirements set forth by the Texas Supreme Court in *Inwood*. However, other Texas courts have required the additional element of horizontal privity; that is, there must be a simultaneous existing interest between the original parties as either landlord and tenant or grantor and grantee.⁵⁶ In other words, horizontal privity requires that the covenant be created in conjunction with a conveyance of an estate in land.⁵⁷ Therefore, current Texas law appears to be unsettled with respect to whether the additional horizontal privity element is required for a covenant to run with the land.

1. Cases Requiring Horizontal Privity

Perhaps the strongest argument that horizontal privity is a requirement under Texas law arises out of a 1997 decision by the San Antonio Court of Appeals.⁵⁸ In *Wayne Harwell*, the issue was whether a contract between a landowner and developer which granted the developer a right of first refusal and percentage of cash flow generated from the land created a covenant running with the land. Two different agreements between a landowner and developer, Wayne Harwell Properties, Inc. and Wayne N. Harwell, granted Harwell a right of first refusal to be general contractor on improvements to the landowner's property and a 20 year assignment of 15 percent of the net cash flow interest generated from the landowner's property. The landowner later sold the property and filed suit seeking a declaration that the development agreements were not enforceable against the landowner's successor—even though the development agreements were recorded in the Bexar County real property records. The court held that the development agreements were not covenants running with the land for the following reason:

[f]or a covenant to run with the land. . .the covenant must be made between parties who are in privity of estate at the time the covenant was made, and must be contained in a grant of the land or in a grant of some property interest in the land.⁵⁹

56. *Energystec*, 739 F.3d at 222. In *Energystec*, the Fifth Circuit noted that horizontal privity was not a requirement set forth by the Texas Supreme Court and that it is a "much-criticized doctrine that has been explicitly rejected by this latest Restatement [of Property]." *Id.* The Fifth Circuit, nevertheless, performed the horizontal privity analysis and determined that in the event horizontal privity was required, it was satisfied. *Id.* at 223.

57. *Id.* (citing *Wayne Harwell Prop. v. Pan Am. Logistics Ctr., Inc.*, 945 S.W.2d 216, 218 (Tex. App.—San Antonio 1997, writ denied)); *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App.—Tyler 2013, no pet.).

58. *Wayne Harwell Prop.*, 945 S.W.2d at 218.

59. *Id.*

A similar case out of the Houston Court of Appeals in 1976 also held that a covenant must be part of a conveyance of an interest in the land burdened by the covenant.⁶⁰ In *Clear Lake*, it was held that services contracts between a utility company and landowner did not create covenants running with the land. The North Clear Lake Development Corporation owned an eight acre tract of land and entered into various agreements with the Clear Lake Utilities Company. The agreements gave Clear Lake Utilities the exclusive right to furnish water and sewer services to North Clear Lake Development's land. North Clear Lake Development sold the property to Clear Lake Apartments, Inc. and Clear Lake Apartments later notified Clear Lake Utilities that it intended to terminate the service contracts. Clear Lake Utilities brought suit to enforce its rights under the service contracts. Although the service contracts contained language stating that the contracts would bind "successors and assigns," the Houston Court of Appeals held that the service contracts did not create a covenant running with the eight acre tract because the contracts were "not part of any transaction conveying the land involved."⁶¹

2. Cases That Do Not Appear to Require Horizontal Privity

Although covenants are typically created in conjunction with a conveyance of land, many courts, including the Texas Supreme Court, have analyzed covenants that were not created in conjunction with a conveyance of land and have held they nevertheless run with the land.⁶²

In *Wimberly v. Lone Star Gas Co.*, landowner and operator entered into a contract for the purchase of water from landowner's well for operator's use in its gas compressor station plant, "so long as [operator]

60. *Clear Lake Apartments, Inc. v. Clear Lake Util. Co.*, 537 S.W.2d 48, 51 (Tex. App. 1976).

61. *Id.*

62. *Inwood N. Homeowners' Ass'n, Inc.*, 736 S.W.2d at 635 (characterizing the duty of a landowner to pay assessment fees to a community association pursuant to a covenant running with the land as a property interest) (declaration of covenants filed years before ultimate conveyance of real property to homeowners; no mention of horizontal privity requirement); *Westland Oil*, 637 S.W.2d at 910-11 (promise to convey interests in oil and gas leases contained in letter agreement executed in connection with farmout agreement was covenant running with land; no mention of horizontal privity requirement); 718 *Assoc., Ltd. v. Sunwest N.O.P., Inc.*, 1 S.W.3d 355, 365 (Tex. App.—Waco 1999) (options provision in commercial lease allowing for extension of lease meets the requirements of a covenant running with the land) (no mention of horizontal privity requirement; dedication not made in conjunction with a conveyance of land); *Wimberly*, 818 S.W.2d at 871 (contract permitting gas company to purchase water from wells on owner's land for as long as gas company operated plant was contract running with the land binding upon all heirs, successors, and assigns) (declaration of covenant made in water contract, not in conjunction with a conveyance of land; no mention of horizontal privity requirement); *Prochemco, Inc. v. Clajon Gas Co.*, 555 S.W.2d 189 (Tex. Civ. App.—El Paso 1977, writ ref'd n.r.e.) (contract to buy and sell natural gas for irrigation purposes constituted a covenant that ran with the land) (declaration of covenant made in gas sales contract, not in conjunction with a conveyance of land; no mention of horizontal privity requirement).

operated the plant.”⁶³ Landowner did not convey any real property to operator in connection with the water contract—only the right to access the property and use its water. Landowner subsequently sold the property to new owners.⁶⁴ New owners argued they were not bound by the water contract because such contract was personal and did not run with the land.⁶⁵ The court rejected this argument, holding that the promise to provide water from the landowners’ well touches and concerns the land, and stated that “[w]e see nothing in the contract that is inconsistent with the Supreme Court’s definition of a contract running with the land.”⁶⁶ Absent from the opinion is any mention of a horizontal privity requirement for a covenant to run with the land.

III. EQUITABLE SERVITUDES

An alternative way that a covenant can bind successors to burdens on land is as an equitable servitude.⁶⁷ Equitable servitudes may be binding upon a successor in interest even though the traditional legal test (and specifically horizontal privity) for a covenant running with the land is not met.⁶⁸

The distinction between a covenant running with the land and an equitable servitude was recognized by *Anderson v. Rowland*, 18 Tex. Civ. App. 460, 463, 44 S.W. 911, 912–13 (1898):⁶⁹

The contract was good between the original parties, and it should, in equity, at least, bind whoever takes title with notice of such covenant. By reason of it, the vendor received less for his land; and the plain and expressed intention of the parties would be defeated if the covenant could not be enforced as well against a purchaser with notice as against the original covenantor. In order to uphold the liability of the successor in title, it is not necessary that the covenant should be one technically attaching to and concerning the land, and so running with the title. It is enough that a purchaser has notice of

63. *Wimberly*, 818 S.W.2d at 870.

64. *Id.*

65. *Id.*

66. *Id.* at 871.

67. *TX Far West, Ltd. v. Tex. Inv. Mgmt., Inc.*, 127 S.W.3d 295, 302 (Tex. App.—Austin 2004, no pet.); *Collum v. Neuhoff*, 507 S.W.2d 920, 922 (Tex. Civ. App.—Dallas 1974, no writ).

68. *See Collum*, 507 S.W.2d at 922.

69. Developments over time have made the distinction between “real covenants” and “equitable servitudes” all but extinct. *See* Restatement (Third) of Prop.: Servitudes § 1.4 (2000). Historically, the differences between real covenants and equitable servitudes were that a real conveyance required horizontal privity and a written instrument under seal. Notice was all that was required for the creation of an equitable servitude. *Id.* “In American law, the horizontal-privity requirement serves no function beyond insuring that most covenants intended to run with the land will be created in conveyances. Formal creation of covenants is desirable because it tends to assure that they will be recorded. However, the horizontal privity requirement is no longer needed for this purpose. In modern law, the Statute of Frauds and recording acts perform that function.” *See* Restatement (Third) of Prop.: Servitudes § 2.4 (2000).

it; the question in equity being (as is said in *Tulk v. Moxhay*, 11 Beav. 571; *Id.*, 2 Phil. Ch. 774) not whether the covenant ran with the land, but whether a party shall be permitted to use the land inconsistently with the contract entered into by his vendor, and with notice of which he purchased. This principle was applied in *Tallmadge v. Bank*, 26 N. Y. 105, where the equity in regard to the manner of improvement and occupation of certain land grew out of a parol contract made by the owner with the purchaser, and was held binding upon a subsequent purchaser with notice, although his legal title was absolute and unrestricted.

More specifically, a conveyance that does not technically run with the land can still bind successors to the burdened land as an equitable servitude if: (1) the successor to the burdened land took its interest with notice of the restriction,⁷⁰ (2) the covenant limits the use of the burdened land,⁷¹ and (3) the covenant benefits the land of the party seeking to enforce it.⁷² Equitable servitudes “do not, strictly speaking, run with the land, but are binding against subsequent purchasers who acquire the land with notice of the restriction.”⁷³ It is well established that the benefit, as well as the burden, of an equitable servitude can run to successors in title.⁷⁴ Like covenants running with the land, equitable servitudes are considered real property rights under Texas law, not contractual rights.⁷⁵

IV. ANALYSIS OF THE SABINE OPINIONS

A. *Horizontal Privity*

The United States Bankruptcy Court for the Southern District of New York said the following about horizontal privity in its *Sabine* decision:

The parties disagree as to whether horizontal privity of estate is also required between the covenanting parties inasmuch as some Texas courts have not expressly addressed the horizontal privity requirement in determining whether a covenant runs with the land. In light of the fact that numerous Texas courts have expressly included horizontal privity in their analyses, the Court is not

70. *Collum*, 507 S.W.2d at 922–23.

71. *Clear Lake City Water Auth. v. Clear Lake Util.*, 549 S.W.2d 385, 388 (Tex. 1977).

72. *Davis v. Skipper*, 125 Tex. 364, 365, 83 S.W.2d 318, 321–22 (Comm'n App. 1935); *Reagan Nat. Advert. of Austin, Inc. v. Capital Outdoors, Inc.*, 96 S.W.3d 490, 496 (Tex. App.—Austin 2002), judgment vacated, cause dismissed (Dec. 9, 2003).

73. *Wayne Harwell Properties v. Pan Am. Logistics Ctr., Inc.*, 945 S.W.2d 216, 218 (Tex. App.—San Antonio 1997, writ denied) (citing 18 Tex. Jur. 3d *Covenants, Conditions, and Restrictions* § 15 (1981)).

74. *See Ortiz v. Jeter*, 479 S.W.2d 752, 759 (Tex. Civ. App.—San Antonio 1972, writ ref'd n.r.e.).

75. *Davis*, 83 S.W.2d at 321 (The existence of an “easement” or “equity” in a tract of land growing out of restrictive covenant as to use can hardly be conceived except in connection with another tract of land, which may be said to be the dominant estate and for which the easement or equity is created).

persuaded that the requirement of horizontal privity has been abandoned under Texas law, and therefore, as it did in the Rejection Decision, the Court shall consider the issue of horizontal privity.⁷⁶

The defendants in *Sabine* cited to many of the same decisions referenced herein for the proposition that horizontal privity is not a requirement under Texas law.⁷⁷ And while the court expressly acknowledged that there is some “ambiguity under Texas law as to whether horizontal privity remains a requirement for a covenant to run with the land,” the court was not persuaded that horizontal privity was no longer a requirement under Texas law.⁷⁸

In *Sabine*, the midstream agreements at issue arose in the “normal” context insofar as the gathering agreements were negotiated between the parties and were not part of a broader conveyance of real property. Specifically, the court rejected any notion that a “dedication” amounts to an actual conveyance as is required under the doctrine of horizontal privity.⁷⁹

The *Sabine* Opinions do not establish precedent under Texas law on the necessity of horizontal privity to create a covenant running with the land. However, until such time as the Texas Supreme Court resolves the issue, the *Sabine* Opinions are certainly instructive with respect to how bankruptcy courts might construe the horizontal privity issue. To the extent horizontal privity is required to create a covenant running with the land, it is undoubtedly more difficult to establish the covenant.

Midstream agreements typically do not arise out of the sale of real property. Most often, midstream agreements are the result of a negotiated transaction between a midstream operator that has pipeline (or other) infrastructure in or near a field, and an upstream operator that needs to connect to such pipeline (or other) infrastructure in order to move its hydrocarbons (most often gas) to market. This takes the form of a gas gathering agreement but the same legal principals apply to any number of midstream agreements such as processing agreements, simple transport agreements, disposal agreements and the like. Because these are often negotiated agreements between the parties with no transfer of real property, satisfaction of any horizontal privity requirement will be difficult or impossible in most instances.

Although there is currently no Texas case law specifically on point, the authors of this paper believe that there is at least one fairly common instance in which horizontal privity might be present. Horizontal privity

76. *In re Sabine Oil & Gas Corporation*, 550 B.R. 59, 65 (Bankr. S.D.N.Y. 2016).

77. *See e.g.*, *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982); *Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632 (Tex. 1987); *Wimberly v. Lone Star Gas Co.*, 818 S.W.2d 868 (Tex. App.—Fort Worth 1991, writ denied).

78. *Sabine*, 550 B.R. at 68.

79. *Id.* at 81.

may exist when the upstream operator has installed pipeline infrastructure in order to move its own hydrocarbons to market and has decided to sell such pipeline infrastructure to a third party midstream operator. Quite often, as part of such a sale of pipeline infrastructure, the upstream operator and midstream operator will enter into a gas gathering agreement whereby the producer dedicates its acreage to the services under the gas gathering agreement. The authors believe horizontal privity may be present in this scenario because the dedication in the gathering agreement was part and parcel of a conveyance of real property, the rights-of-way, easements and other real property rights sold by the producer to the midstream operator.

B. *Touch and Concern*

The Sabine Opinions largely focused on the critical “touch and concern” element of the real covenant test under Texas law. As noted, the dueling “touch and concern” standards are replete with references to arcane verbiage such as whether the covenant “affects the nature, quality or value of the thing demised”⁸⁰ and whether the “promisor’s legal relations in respect of the land in question are lessened.”⁸¹ The Sabine Opinions concluded the covenants at issue failed to satisfy either applicable test⁸² and largely boiled the “touch and concern” analysis down to a single inquiry: whether the dedications in the Nordheim and HPIP midstream contracts created a real or personal property interest.⁸³

The *Sabine* court determined the covenants merely created a personal property interest, not a real property interest. Under Texas law, once minerals are extracted (*i.e.*, *produced*) from the ground, they are no longer real property, but are instead personal property.⁸⁴ The dedication language in the Nordheim and HPIP agreements referenced hydrocarbons *produced* from the designated areas.⁸⁵ Thus, the court concluded (1) the Debtors “simply engaged Nordheim and HPIP to perform certain services related to the hydrocarbon products *produced* by Sabine from its property;” (2) “the covenants at issue are properly viewed as identifying and delineating the contractual rights and obligations with respect to the services to be provided;” and (3) because the covenants

80. *Id.* at 80 n.39.

81. *Id.* at 80 n.40.

82. *Id.* at 81.

83. *Id.* at 66–68.

84. See, e.g., *Sabine Prod. Co. v. Frost Nat. Bank of San Antonio*, 596 S.W.2d 271, 276 (Tex. Civ. App.—Corpus Christi 1980, writ *dism’d*); *Colorado Interstate Gas Co. v. Hunt Energy Corp.*, 47 S.W.3d 1, 10 (Tex. App.—Amarillo 2000, *pet. denied*); *Riley v. Riley*, 972 S.W.2d 149, 155 (Tex. App.—Texarkana 1998, *no pet.*); *Phillips Petroleum Co. v. Adams*, 513 F.2d 355, 363 (5th Cir. 1975).

85. *Sabine*, 550 B.R. at 73–74.

“concern only the Products *produced* from real property—[not the real property itself—they] affect only Sabine’s personal property rights.”⁸⁶

The court rejected Nordheim and HPIP’s efforts to analogize Sabine’s dedication of minerals “produced and saved” with Texas law, holding that a conveyance of oil and gas interest “produced and saved” creates a royalty interest and therefore a real property interest.⁸⁷ The court posited that the “characterization under Texas law of a conveyance of oil and gas produced and saved as a royalty interest, however, does not lead to the conclusion that the burdening of oil and gas ‘produced and saved’ burdens oil and gas in the ground.”⁸⁸ Rather, the court concluded the plain language of the Nordheim and HPIP mineral dedications addressed only minerals extracted from the ground, which are personal property under Texas law.⁸⁹

The *Sabine* court also examined the Texas Supreme Court’s opinion in *Westland Oil*,⁹⁰ holding that a covenant obligating a third party to assign interests in oil and gas leases ran with the land because the covenant was triggered by building a test well.⁹¹ The *Sabine* court distinguished the Nordheim and HPIP covenants; it found that the dedication covenants were triggered by Sabine’s production of oil and gas liquids and Nordheim’s receipt of the hydrocarbons, both of which are personal nature.⁹²

Finally, the court distinguished *Sabine* from *Energytec*⁹³—where the Fifth Circuit found a covenant running with the land—on several grounds.⁹⁴ First, the *Sabine* court noted the right to consent to an assignment in *Energytec* constituted a “clear burden on the land” because the burden expressly limited the landowner’s ability to sell or transfer the property.⁹⁵ In *Sabine*, the court noted, no such burden existed.⁹⁶ Second, in *Energytec* the midstream provider’s transportation fee was secured by a lien on the entire pipeline.⁹⁷ In *Sabine*, the Nordheim gathering fee was not secured and the mineral interests were already subject to existing liens by Sabine’s secured lenders.⁹⁸ Lastly, in *Energytec*, the transportation fee was triggered merely by the flow of gas through the pipeline, whereas in *Sabine* the gathering fee was not triggered until

86. *Id.* at 80–81.

87. *Id.* at 66.

88. *Id.*

89. *Id.*

90. *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982).

91. *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 78 (Bankr. S.D.N.Y. 2016).

92. *Id.*

93. *Newco Energy v. Energytec, Inc.*, 739 F.3d 215, 224 (5th Cir. 2013).

94. *Sabine*, 547 B.R. at 78.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.* at 78–79.

Nordheim received the gas into its gathering system.⁹⁹ According to the court, “the Nordheim gathering fee covenant has no direct connection to or impact on the land or on Sabine’s property rights.”¹⁰⁰

In its affirmance, the District Court adopted much of the bankruptcy court’s touch and concern analysis, concluding Nordheim and HPIP failed to show the midstream agreements “increased their legal relations to the real property interests at issue or decreased Sabine’s.”¹⁰¹ Central to the District’s analysis was its conclusion that the dedication of the leases merely granted HPIP and Nordheim a contractual right to provide services, not a property interest in the leases.¹⁰² The District Court further concluded that because Sabine retained the right to “produce as much or as little gas and condensate from the Dedicated Area as it choose,” the midstream agreements did not lessen Sabine’s interest in its leasehold position.¹⁰³

V. DRAFTING CONSIDERATIONS

In light of the Sabine Opinions, practitioners must take careful note in drafting midstream agreements—particularly with respect to the (i) touch and concern and (ii) horizontal privity elements.

A. *Touch and Concern*

When drafting a dedication to satisfy the touch and concern element, it is vital the dedication attach not only to produced gas, but also to the hydrocarbons in place. As noted, once hydrocarbons have been produced, they are personal property. In the ground, those same hydrocarbon molecules are the upstream operator’s real property.¹⁰⁴ In order to draft a dedication that attaches to real property, one must tie the dedication to the underlying oil and gas leases themselves. The lessee’s interest in the oil and gas lease is a fee simple determinable interest in real property.¹⁰⁵ Therefore, the dedication should encompass the producer’s interest in the leases. The following is exemplar lease dedication language:

Producer hereby exclusively dedicates to the services, this contract and to the gathering system, all of its interest in and to the oil and gas leases set forth on Exhibit “A” (the “Leases”) and commits to

99. *Id.* at 79.

100. *Id.*

101. *In re Sabine Oil & Gas Corp.*, 2017 WL 1093290, at *4

102. *Id.* at *5.

103. *Id.*

104. *Phillips Petroleum Co. v. Adams*, 513 F.2d 355, 363 (5th Cir. 1975).

105. *See W.T. Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 509, 19 S.W.2d 27, 28–29 (Tex. 1929).

deliver to the gathering system all gas owned or controlled by Producer which is produced from the Leases.

Although this language does not guarantee satisfaction of the touch and concern real element, it ties more closely to the underlying real property—the oil and gas leases—than verbiage found in many gathering agreements dedicating “gas,” “gas produced and saved,” or “gas produced” from the leases. This type of language is less likely to satisfy the touch and concern element than a dedication expressly tied to the oil and gas leases themselves.

B. Horizontal Privity

Horizontal privity presents a more challenging obstacle for practitioners. Horizontal privity is less tied to contract verbiage and more to the factual circumstances under which the covenant is created. That does not mean, however, practitioners looking to create a covenant running cannot bolster their chances of success through careful drafting.

When a midstream company acquires an existing gathering system from a producer and executes a gathering agreement in conjunction with the transaction, the gathering agreement should specifically reference the transfer of real property from the producer to the midstream operator. Ideally, the gathering agreement would specifically state that the gathering agreement and property transfer comprise one integrated transaction. Such language would evidence the dedication was created in the same transaction, and as part of, a conveyance of real property. Although such verbiage has not been examined by Texas courts, it will aid a party's efforts to establish the existence of horizontal privity.

In circumstances where there is no clear conveyance of a real property interest (i.e., the producer is not selling the midstream operator any existing midstream infrastructure), establishing horizontal privity is more challenging. However, subject to the negotiation of the parties, it *may be* possible for the producer to convey some non-cost bearing beneficial title in the hydrocarbons in place to the midstream operator. Any conveyance would necessarily need to be for the term of the agreement. However, such a conveyance may raise more questions than it answers. Practically, most producers would likely be reluctant to convey any leasehold interest to the midstream operator, whether such a conveyance changed the parties' rights under the oil and gas lease or not. However, if horizontal privity is a true requirement under Texas law, and if the *Sabine* court's analysis were applied, nothing short of such a conveyance would establish horizontal privity. Therefore, for a midstream operator that may be allocating billions of dollars in capital to infrastructure development

based on the revenues to be derived from the dedication in the midstream agreement, such a negotiation may be one worth having.