Midstream Gathering Agreements in Bankruptcy

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In this article, the authors explain that recent decisions have deepened the split among bankruptcy courts on whether midstream gathering agreements may be rejected as executory contracts or whether the assets in the underlying agreements could be sold free and clear without the covenants.

The surge in bankruptcy filings by upstream companies caused by the global pandemic, volatile energy prices, and weak economic activity has resulted in numerous litigations in bankruptcy courts over the ability of an upstream company to reject agreements with midstream counterparties. The focus of the litigation has been whether such agreements contain covenants running with the land and, if so, are such agreements subject to rejection under the Bankruptcy Code or property interests that cannot be extinguished through a bankruptcy proceeding.

THE INDUSTRY

The oil and gas industry is comprised of three business segments: upstream, midstream, and downstream.

Upstream companies consist of oil producers; midstream companies serve as an intermediary between upstream companies and downstream companies; and downstream companies directly serve the consumer market. Upstream activities relate to the exploration, recovery, production and development of hydrocarbons and natural gas.

Midstream activities relate to the gathering, processing, and transmission of hydrocarbons and natural gas through pipelines to gathering facilities.

Downstream activities relate to the process, transport, and sale of refined products to commercial, industrial, and retail oil and gas consumers.

Upstream and midstream companies generally enter into "gathering agreements." Under these agreements, the upstream company agrees to dedicate and deliver a minimum production volume of oil and gas to the midstream company and pay a fee, or a deficiency payment insofar as it is unable to deliver the minimum volume.

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In return, the midstream company agrees to build and maintain a system of pipelines and gathering facilities to render the agreed upon services. Midstream companies invest substantial capital in infrastructure in connection with the gathering agreements, with the expectation that they remain in place and bind successors-to-title. In recent years, such expectation has transformed into concerns about the fate of midstream gathering agreements in bankruptcy.

In re Sabine Oil & Gas Corp.[1] sparked a debate after the bankruptcy court found that two midstream gathering agreements did not contain covenants running with the land and thus such agreements could be rejected.

Two bankruptcy courts, *In re Badlands Energy, Inc.*,[2] and *In re Alta Mesa Resources, Inc.*,[3] found *Sabine* distinguishable and sided with the midstream company. But recently, bankruptcy courts in Delaware and Texas have held that midstream gathering agreements can be rejected because they do not contain covenants running with the land.

These recent decisions have deepened the split among bankruptcy courts on whether midstream gathering agreements may be rejected as executory contracts or whether the assets in the underlying agreements could be sold free and clear without the covenants. And they could strengthen rejection or sale efforts by upstream companies in future bankruptcy filings.

REJECTION OF EXECUTORY CONTRACTS

Section 365 of the Bankruptcy Code allows a debtor to assume or reject any executory contract.[4] An executory contract is a contract wherein unperformed obligations remain by two contracting parties, and the failure of either party to perform constitutes a material breach. The object of assumption or rejection is to allow a debtor to assess which contracts are beneficial or burdensome to the estate.

Courts usually defer to the debtor's business judgment "unless the decision to reject is the product of bad faith, whim, or caprice."[5] Rejection allows a debtor to cease performance of burdensome contracts, reduce the non-debtor counterparty's damages to a general unsecured claim that is paid *pro rata* with other general unsecured creditors under a confirmed plan, and possibly enter into new contracts with terms/rates comparable to current market conditions.

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

[2] *In re Badlands Energy, Inc.*, 608 B.R. 854 (Bankr. D. Colo. 2019).

[3] *In re Alta Mesa Resources, Inc.*, 613 B.R. 90 (Bankr. S.D. Tx. 2019).

[4] *See* 11 U.S.C. § 365.

[5] *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 71 (Bankr. S.D.N.Y. 2016) (citing *In re Bradlees Stores, Inc.*, 194 B.R. 555, 558 n.1 (Bankr. S.D.N.Y. 1996)).

ASSET SALES

Section 363 of the Bankruptcy Code allows a debtor to sell estate assets in bankruptcy.[6] An asset may be sold free and clear of all liens, claims and interests if the debtor establishes any of the enumerated requirements:

(i) Applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(ii) Such entity consents;

(iii) Such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(iv) Such interest is in bona fide dispute; or

(v) Such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[7]

In the decisions discussed below, the debtors, except in *Badlands*, sought to reject midstream gathering agreements because they were burdensome and did not contain covenants running with the land. Their counterparties objected, arguing that rejection was improper, and that the contracts contained covenants running with the land. Each agreement discussed is governed by different state laws, but each state law commonly provides that a covenant runs with the land if:

(i) It touches and concerns land;

(ii) The covenanting parties intended for the covenant to run with the land;

(iii) There is privity of estate;

(iv) It relates to a thing in existence;

(v) Successors to the contract have notice; and

(vi) It is in writing.[8]

Each element must be satisfied to establish that a covenant runs with the land.

It is generally undisputed among the parties that the covenants are in writing, relate to a thing in existence, either oil, gas or water, and successors have notice of the covenant via recordation of the contracts. What is disputed, however, is whether a covenant touches and concerns land, the covenanting parties

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[6] *See* 11 U.S.C. § 363(b).

[7] 11 U.S.C. § 363(f).

[8] *In re Badlands Energy, Inc.*, 608 B.R. 854, 867 (Bankr. D. Colo. 2019).

intended for such covenant to run with land, and privity of estate (horizontal, mutual, and vertical) exists. These elements are discussed below.

Sabine

Sabine executed two agreements with Nordheim Eagle Ford Gathering, LLC ("Nordheim")—a Gas Gathering Agreement and a Condensate Gathering Agreement ("Nordheim Agreements"). Both agreements contained the same terms and required Sabine to dedicate and deliver a minimum volume of gas produced from a geographic area to Nordheim.

In return, Nordheim agreed to gather, process and re-deliver the gas to Sabine, as well as build and maintain gathering systems to render the agreed upon services. Nordheim was entitled to a deficiency payment if Sabine failed to deliver the minimum volume. Each Nordheim Agreement declared that the agreement is a covenant running with the land and would bind successors-to-title.

Sabine separately entered into two agreements with HPIP Gonzales Holdings, LLC ("HPIP")—a Production Gathering, Treating and Processing Agreement and an HPIP Gathering Agreement ("HPIP Agreements"). Each HPIP Agreement contained the same terms as the Nordheim Agreements, except the HPIP Agreements did not provide for a deficiency fee. Both the Nordheim and HPIP Agreements ("Agreements") were governed by Texas law.

The bankruptcy court initially determined that sound business reasons existed to reject the Agreements. In a non-binding analysis,[9] Bankruptcy Judge Chapman found that the Agreements did not contain covenants running with the land and thus could be rejected. The Agreements contained covenants that Sabine would dedicate produced oil, gas and water from its mineral estates to Nordheim and HPIP, pay a gathering fee, and make a deficiency payment if it failed to deliver the minimum volume. Another covenant required Nordheim and HPIP to build and maintain gathering systems to facilitate the transport of produced oil, gas and water.

On the touch and concern element, decisions by Texas courts have created two tests: (i) "whether the covenant 'affected the nature, quality or value of the thing demised, independently of collateral consequences, or if it affected the mode of enjoying it' . . . and (ii) 'whether the promisor's legal relations in respect of the land in question are lessened . . . [and] of the promisee's legal

[9] The analysis was non-binding because real covenants concern "substantive legal disputes" that must be adjudicated via adversary proceeding, rather than as a contested matter. *Id.* at 73 (citing *In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993)).

relations in respect to the land are increased.' "[10] Some courts have also required that there be "horizontal privity"[11] between the parties.

Neither test was present because the covenants did not affect Sabine's mineral estates. In Texas, minerals cease to be real property once extracted from the ground and become personal property. The dedication covenant concerned Sabine's interests in produced products, meaning Sabine was obligated to dedicate oil, gas, and water to Nordheim and HPIP only after minerals were extracted from the ground.

As to fees, Judge Chapman found that they were triggered by receipt of gas from Sabine to Nordheim and HPIP's gathering facilities or upon Sabine's failure to deliver the minimum volume. The fees had no connection to or impact on Sabine's mineral estates. Accordingly, the dedication and fee covenants did not touch and concern land because obligations attached to the minerals only when it leaves the ground.

Turning to the privity element, Nordheim and HPIP relied on the *Energytec* case to support their argument that horizontal privity existed. *Energytec* involved an agreement that contained a covenant running with the land after the owner of a pipeline system assigned property rights to another party, but reserved for its subsidiary the right to receive a transportation fee on the pipeline property and a right to consent to the assignment of such property.

Judge Chapman found that *Energytec* was distinguishable because Sabine did not "reserve any interest for Nordheim or HPIP; rather, they simply engaged Nordheim and HPIP to perform certain services related to the hydrocarbon products produced by Sabine from its property."[12] The covenants outlined "the contractual rights and obligations with respect to the services to be provided,"[13] but they did not reserve an interest to Nordheim and HPIP in the dedicated area where Sabine produced oil, gas and water before it delivered produced products to Nordheim and HPIP.

Finally, Nordheim asserted that an equitable servitude existed, but the court found that it did not apply because the covenants did not concern land or its use. While equitable servitude does not require privity between the contracting

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[10] *Id.* at 77.

[11] Horizontal privity refers to " 'simultaneous existing interests or mutual privity' between the original covenanting parties as either landlord or tenant or grantor or grantee." *Id.* at 76 (citing *In re Energytec, Inc.* 739 F.3d 215, 222 (5th Cir. 2013)). The "traditional paradigm of [horizontal privity of estate] involves a property owner reserving by covenant, either for itself or another beneficiary, a certain interest out of the conveyance of the property burdened by the covenant."

[12] *Id.*

[13] *Id.*

parties "at the time of conveyance and [when] a subsequent party purchases the land with notice of the restriction' "[14] it must still touch and concern land. Judge Chapman held that it did not.

Sabine II[15]

Because the bankruptcy court rendered a non-binding analysis on real covenants, Sabine commenced an adversary proceeding to obtain a declaratory judgment that the Agreements did not contain covenants running with the land. The bankruptcy court incorporated its analysis in *Sabine* and addressed additional arguments.

Nordheim and HPIP claimed that the dedicated oil and gas "produced and saved" by Sabine conveyed a royalty interest in Sabine's mineral estates because, in Texas, a conveyance of oil and gas "produced and saved" creates a royalty interest and thus qualifies as a real property interest. Judge Chapman disagreed. According to the judge, merely because conveyance of oil and gas "produced and saved" is considered a royalty interest "does not lead to conclusion that the burdening of oil and gas 'produced and saved' burdens oil and gas in the ground."[16] Plus, "a royalty interest is *per* se a mineral interest . . . [and] a mineral estate include[s] the right to receive royalty payments."[17]

But the facts were devoid of any obligation to pay royalty payments "or any other obligation deemed a real property interest under Texas law." The Agreements required Sabine to dedicate to Nordheim and HPIP oil, gas and water extracted from the ground, which constitutes "personal property, not real property under Texas law."[18]

The court dismissed Nordheim and HPIP's contention that horizontal privity is not required in Texas. Although there is skepticism among Texas courts about whether horizontal privity is required, the court observed that Texas has not categorically rejected horizontal privity as part a real covenant analysis. It also dismissed claims that horizontal privity was satisfied via conveyance of a parcel to Nordheim to construct a gathering facility ("Nordheim Parcel"), creation of a pipeline easement, and Nordheim's right to take minerals from Sabine's mineral estates.

The creation of a pipeline easement did not establish horizontal privity, and the Nordheim Parcel was "not burdened property." Indeed, a non-burdened

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[14] *Id.* at 79 (quoting *In re EL Paso Refinery, LP*, 302 F.3d 343, 358 (5th Cir. 2002)).

[15] *In re Sabine Oil & Gas Corp.*, 550 B.R. 59 (Bankr. S.D.N.Y 2016).

[16] *Id.* at 66.

[17] *Id.* n.34 (citing *Altman v. Blake*, 712 S.W.2d 117, 118 (Tex. 1986)).

[18] *Id.*

property is contrary to the horizontal privity requirement, which serves "to ensure that a covenant that binds successors is formally recorded in connection with the real property that is being *burdened* by the covenant."[19]

Finally, Nordheim's suggestion that it was permitted to take minerals from Sabine's mineral estates was found to be a gross mischaracterization of the Agreements. The Agreements required Sabine to connect its wellheads to receipt points and Nordheim and HPIP to construct gathering systems that connected to the receipt points. "Under this framework, none of Nordheim or HPIP's structures connect[ed] to Sabine's wells themselves, and neither Nordheim nor HPIP ha[d] the right to connect its pipelines to [Sabine's] wells."[20] Again, Judge Chapman held that the failure of privity permitted rejection of the gathering agreement.

Sabine III[21]

Dissatisfied with the bankruptcy court's decisions, Nordheim and HPIP appealed.

The federal district court rejected Nordheim and HPIP's contentions that the covenants in the Agreements touched and concerned land or contained equitable servitudes.

As noted, Texas employs two tests to determine whether a covenant touches and concerns land. Either test is enough to satisfy the touch and concern requirement. According to Judge Jed Rakoff, neither test applied.

The first test did not apply because the Agreements did not reduce Sabine's right to use or alienate its real property interests.

The second test also did not apply because Sabine did not convey real property interests to Nordheim and HPIP, and neither party identified what interests they obtained in Sabine's mineral estates. Sabine was free to produce oil, gas and water without any restriction, and its dedication duties were triggered only *after* oil and gas was produced, "at which point those substances [became] personal, rather than real."[22]

Further, any deficiency payment for failure to deliver the minimum volume was "merely contractual"[23] and had no connection to real property interests.

Finally, the district court agreed with the bankruptcy court that Nordheim and HPIP had no right to receive royalty interests. Rather, they only accepted

[19] *Id.* at 69.

[20] *Id.*

[21] *In re Sabine Oil & Gas Corp.*, 567 B.R. 869 (S.D.N.Y. 2017).

[22] *Id.* at 876.

[23] *Id.*

a right to process minerals from receipt points for a fee and were obligated to re-deliver such minerals to Sabine. Hence, the district court affirmed the bankruptcy court's decisions.

Sabine IV[24]

Nordheim and HPIP appealed again, but the U.S. Court of Appeals for the Second Circuit affirmed the lower courts' rulings. It focused solely on the issue of horizontal privity and agreed that horizontal privity had not been satisfied because the Agreements did not convey "a property interest in subject land (in this case, the mineral estate)."[25]

Following the *Sabine* saga, the debate about midstream gathering agreements in bankruptcy shifted west, with decisions by the bankruptcy courts in *Badlands* and *Alta Mesa*. Unlike *Sabine*, the courts in *Badlands* and *Alta Mesa* found the opposite that (on those facts) the respective midstream gathering agreements *did* contain dedication covenants running with the land.

As the courts held in those cases, the respective gathering agreements could not be rejected under Section 365, nor could the assets under the agreements be sold free and clear under Section 363 without the dedication covenants attached to the realty.

Badlands[26]

The *Badlands* case involved the sale of assets pursuant to Section 363 of the Bankruptcy Code free and clear of any liens, claims, encumbrances, and interests, including gas and gathering agreements. Badlands' predecessor executed a Gas and Gathering Agreement ("GPA") and a Disposal of Salt Water Agreement (together with the GPA, "Agreements") with Monarch Midstream, LLC ("Monarch"). Badlands, as successor-in-interest, and Wapiti Oil and Gas II, LLC (together with Badlands, the "Producers"), which acquired a 50 percent interest in Badlands, later became bound to the terms and conditions of the Agreements.

After filing for bankruptcy, Badlands moved to sell its oil and gas assets ("Riverbend Assets") to Wapiti Utah, LLC ("Wapiti Utah") under Section 363. The sale agreement did not provide for Wapiti Utah to assume any contracts with Monarch in connection with the purchase of the Riverbend Assets, including the Agreements. Monarch objected to the sale and commenced an adversary proceeding seeking a declaratory judgment that Wapiti Utah could

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[24] *In re Sabine Oil & Gas Corp.*, 734 Fed.Appx. 64 (2d Cir. 2018).

[25] *Id.* at 67.

[26] *In re Badlands Energy, Inc.*, 608 B.R. 854 (Bankr. D. Colo. 2019).

not purchase the Riverbend Assets without the Agreements because they contained covenants running with the land.

Under the GPA, the Producers agreed to exclusively dedicate produced oil and gas ("Dedicated Reserves") to Monarch. Dedicated Reserves referred to an "interest of Producer in *all Gas reserves in and under*, and all Gas owned by Producer and produced or delivered from: (i) Leases and (ii) other lands within the AMI."[27] AMI means "area of mutual interest," a term of art for the geographical area covered in a gathering or development agreement.

The GPA required the Producers to deliver produced gas to receipt points and for Monarch to build gathering systems and accept the produced gas at the receipt points. Monarch was entitled to a payment if the Producers failed to deliver the minimum volume required. It was also granted an easement across the Producers' leases to install, use, inspect, operate, replace, and remove the gathering facilities. The Producers agreed to commit water extracted from oil and gas operations to Monarch's salt and water disposal facilities. They also agreed to pay a fee in exchange for Monarch's disposal and treatment of water produced from the Producers' oil and gas wellheads.

While the Agreements were governed by Colorado law, Bankruptcy Judge Tyson applied Utah law because the Riverbend Assets were located in Utah. Utah applies a broad test to decide whether a covenant touches and concerns land. The scope of touch and concern "does not require a physical effect upon the land, but rather, requires a court to evaluate whether a covenant 'enhances the land's value [on the benefit side], and for the burden side, whether it diminishes the land's value.' "[28] Thus, "all that must be shown for a covenant to run with the land is that it 'be of such character that performance or nonperformance will so affect the use, value or enjoyment of the land itself that it must be regarded as an integral part of the property.' "[29]

The touch and concern requirement was satisfied because the Agreements reduced the Producers' interests and use and enjoyment of their interests in the oil and gas leases. Particularly, the Agreements required the Producers to pay "Monarch for the burdens associated with acquiring and operating the Gathering System, which [was] connected to the Producer's Wells located on the Leases via the Receipt Points."[30]

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[27] *Id.* at 865.

[28] *Id.* at 868 (quoting *Flying Diamond Oil v. Newton Sheep Co.*, 776 P.2d 618, 624 (Utah 1989) [other citation omitted]).

[29] *Id.* at 870 (quoting *Id.* at 624 [other citation omitted]).

[30] *Id.* at 868.

Wapiti Utah relied on *Sabine* as support for lack of touch and concern, but Judge Tyson determined that *Sabine* did not apply. As discussed, the producer in *Sabine* agreed to dedicate all minerals "produced and saved" from its wellheads in a dedicated area to the midstream provider at a delivery point. The *Sabine* court ruled that this dedication did not create a covenant running with the land because it concerned only minerals extracted from the ground, which constitute personal property, rather than real property. Unlike *Sabine*, Judge Tyson read "*the interest of Producer in all Gas reserves in and under*,"[31] language to encompass real property, which "includes non-extracted minerals."[32]

Further, of concern to Judge Tyson was "not *what* [wa]s conveyed by the covenant, but . . . does the performance or nonperformance of [a covenant] affect the use, value or enjoyment of the land itself."[33] It did because "by requiring [the] Producers to dedicate their interest in oil and gas reserves, leases and all other lands within the AMI, the Agreements affect[ed] the use, value or enjoyment of their interest in the Leases by limiting the right to possess, develop, and dispose of the minerals and salt water."[34]

The bankruptcy court then addressed whether there was privity among the parties. It noted that there are generally three types under Utah law: vertical, mutual, and horizontal. Vertical privity relates to the relationship between the original covenanting parties and their successors in interest. "Mutual privity exists when the parties have a continuing and simultaneous interest in the same property.' "[35] Horizontal privity relates to the relationship between "the original covenanting parties to create a covenant in connection to create a simultaneous conveyance of an estate."

Judge Tyson found that all three types of privity were satisfied. Vertical privity existed between Badlands and Wapiti Utah by virtue of Wapiti Utah's acquisition of the Riverbend Assets. Mutual and horizontal privity were also satisfied because the parties simultaneously owned property interests in the gathering systems, easements, leases, and the Dedicated Reserves in the area of mutual interests.

The court next turned to the application of Section 363(f) of the Bankruptcy Code. That section says a debtor may sell assets free and clear of all liens, claims and interests in the underlying assets. In Utah, a covenant that runs with the

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[31] *Id.* at 869 (emphasis in original).

[32] *Id.*

[33] *Id.*

[34] *Id.* at 870.

[35] *Id.* at 871 (quoting *Flying Diamond*, 776 P.2d at 628 [other citation omitted]).

land is "an integral part of the property"[36] and binds successors-to-title. Considering Utah law and that the covenants in the Agreements run with the land, the court ruled that the Riverbend Assets could not be sold free and clear without the covenants in the Agreements.

Accordingly, because privity existed under Utah law and the dedication touched and concerned the real property, the bankruptcy court prohibited rejection of the gathering agreement.

***Alta Mesa*[37]**

Shortly after filing for bankruptcy, subsidiaries of Alta Mesa Resources ("Alta Mesa") commenced an adversary proceeding against non-Debtor affiliate Kingfisher Midstream, LLC ("Kingfisher") and certain other parties. Alta Mesa alleged that a common owner caused Alta Mesa to execute above market long-term crude oil, gas, and produced water gathering agreements (collectively, the "Gathering Agreements") with Kingfisher and then subsequently amend certain of the Gathering Agreements to benefit Kingfisher.

Alta Mesa also sought a declaration that the dedication provisions of the Gathering Agreements did not "run with the land" and therefore were subject to rejection, and that the Alta Mesa's assets could be sold free and clear of such dedication provisions. Bankruptcy Judge Isgur held that certain covenants for dedication under the Gathering Agreements "run with the land" and thus could not be rejected under Sections 365(a) and 363(f) of the Bankruptcy Code.

In the Gathering Agreements, Alta Mesa agreed to dedicate and deliver oil and gas within a dedicated area to certain receipt points in exchange for Kingfisher's obligation to deliver such oil and gas to market. The Gathering Agreements did not contain minimum volume requirements, but provided for fixed gathering fees and granted Kingfisher an easement to construct, own, operate and maintain gathering systems, and the agreements themselves claimed that the dedication was a covenant running with the land.

The court applied Oklahoma law since the real property related to the Gathering Agreements was located there. In Oklahoma, a covenant touches and concerns land if there is " 'a logical connection between the benefit to be derived from enforcement of the covenant and the property.' "[38] Moreover, "[a] covenant touches and concerns land when it requires performance of a physical

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[36] *Id.* at 874 (quoting *Lundeberg v. Dastrup*, 497 P.2d 648, 650 (Utah 1972)).

[37] *In re Alta Mesa Resources, Inc.*, 613 B.R. 90 (Bankr. S.D. Tex. 2019).

[38] *Id.* at 102 (quoting *Beattie v. State ex rel. Grand River Dam Auth.*, 41 P.3d 377, 388 (Okla. 2002)).

act upon the land which directly benefits the landowner,"[39] and "[i]f the value of owner's interest in the land itself is affected by the covenant, either positively or negatively."[40]

Judge Isgur initially identified real property interests held by Alta Mesa. He noted that oil and gas leases created an interest in land and allowed a lessee to search for and capture minerals beneath the ground. An implied surface easement springs from an oil and gas lease and "extends to such parts of the leased premises as are reasonably necessary for the purpose of exploration or production."[41] Under Texas law, oil and gas leases are distinct from fee simple mineral estate. "Ownership of a fee simple mineral estate includes the power to lease, the right to receive bonuses, the right to receive delay rentals, and the right to receive royalties,"[42] whereas "with a lease, title to [minerals] on the estate is not acquired until the [minerals] are reduced to possession."[43] Considering all this, the court found that the Gathering Agreements dedicated to Kingfisher oil and gas from Alta Mesa's oil and gas leases, rather than fee mineral estates.

Having found that Alta Mesa's real property interests stemmed from its oil and gas leases, the court next identified four covenants in the Gathering Agreements that touch and concern land. One covenant provided that Alta Mesa would "dedicate and deliver" all oil and gas produced to Kingfisher. Another required recordation transferee affirmation to the Gathering Agreements. A third granted surface easements to Kingfisher to build and maintain gathering systems. A final covenant provided for fixed gathering fees. Judge Isgur held that each covenant touched and concerned land because both the benefits and burdens of the Gathering Agreements were "logically connected to Alta Mesa's leasehold interests in real property."[44]

In Judge Isgur's view, Alta Mesa burdened its leasehold interests in the oil and gas leases by dedicating all its produced minerals to Kingfisher and restricting its right to build a gathering system and determine what happens to the minerals after they were captured. The surface easement to Kingfisher similarly burdened Alta Mesa's leasehold interests because it restricted Alta Mesa's use of the surface land for drilling and exploration.

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[39] *Id.* (citing *Id.* at 389).

[40] *Id.* (citing *Id.* at n.31).

[41] *Id.* (quoting *Hinds v. Phillips Petroleum Co.*, 591 P.2d 697, 698 (Okla. 1979)).

[42] *Id.* at 103 (*Sharp v. Gayler*, 737 P.2d 120, 122 (Okla. Civ. App. 1987)).

[43] *Id.* (citing *Atlantic Richfield Co. v. Tomlinson*, 859 P.2d 1088, 1095 (Okla. 1993)).

[44] *Id.*

Interestingly, Judge Isgur acknowledged that gathering fees were triggered after the minerals became personal property, yet determined that because the fee arrangement affected "Alta Mesa's drilling schedules and use of its leaseholds,"[45] the mineral reserves were affected and devalued "because if they were extracted, Alta Mesa [would be obligated] to pay above market gathering fees."[46]

As to the privity element, Judge Isgur found that vertical privity existed because the original covenanting parties agreed that successors would be charged with notice of the gathering agreements via recordation. On horizontal privity, the court found a simultaneous relationship between the parties existed because Alta Mesa's surface easement was "integrally tied to the purpose of an oil and gas lease"[47] and "spring[ed] directly from its leasehold mineral interests."[48]

On the facts before the *Alta Mesa* court, as applied to the specific gathering agreement and Texas law, the court found Alta Mesa could not reject the agreement.

Extraction Oil[49]

Bankruptcy Judge Sontchi in the *Extraction Oil & Gas, Inc.* case meticulously outlined several reasons why most of the covenants in the gathering agreements at issue did not run with the land. *Extraction Oil* was a three-part decision involving other midstream parties. For brevity sake, however, this article discusses only the decision related to Extraction Oil and Elevation Midstream, LLC.

Extraction Oil and Elevation entered into three agreements—Oil, Gas, and Water Agreements ("Agreements"). Each agreement contained substantially the same terms and conditions, provided that they shall bind successors-to-title, and was governed by Colorado law. Extraction agreed to dedicate and deliver to receipt points all oil, gas and water produced from its mineral estates ("Dedication and Delivery Obligations") to Elevation.

The Dedication and Delivery Obligations were stated in the Agreements to be "covenants running with (and touching and concerning) all Dedicated Interests."[50] Dedicated Interests referred to all interests owned or later acquired "in lands, mineral interest, easements, leases, wells" and oil, gas and water

[45] *Id.* at 105.

[46] *Id.*

[47] *Id.* at 106.

[48] *Id.*

[49] *In re Extraction Oil & Gas, Inc.*, 2020 Bankr. LEXIS 2855 (Bankr. D. Del. 2020).

[50] *Id.* at *10, *19, *29, *38 (altered).

"therein and thereunder" the dedicated area operated by Extraction. The Agreements facilitated Elevation's provision of gathering services to Extraction and granted Elevation a non-exclusive surface easement in dedicated areas.

The Agreements required Extraction to drill a certain number of wells into its mineral estates within a specified time period. Subject to the drilling commitment, Extraction had discretion to determine when, where and how "to drill new wells, to repair and rework wells, temporarily shut-in wells, to renew or extend, in whole or in part, any oil and gas lease covering any of the Dedicated Interests, and cease production from or abandon any well or surrender any such oil and gas lease, in whole or in part[.]"[51] The parties ratified the Agreements to confirm the Dedication and Delivery Obligations. Ratification did not alter pre-existing terms.

Judge Sontchi initially found that privity was lacking because the Agreements did not convey any interest of Extraction's mineral estates to Elevation. Moreover, Elevation's suggestion that the conveyance of surface easements satisfied the privity requirement was unpersuasive.

Notably, "[t]he surface estate and mineral estate, once severed, are separate and distinct estates in real property."[52] Easements across a surface estate are easements in gross. "An easement in gross does not belong to an individual by virtue of her ownership in land, but rather is a personal right to use another's property."[53]

Judge Sontchi concluded that the surface easements conveyed to Elevation were easements in gross, and "[b]ecause easements in gross are personal rights in the use of (and interests in) the surface estate, they are not interests in a severed mineral estate."[54]

Further, the dedications and commitments did not satisfy privity either because the terms "conveyance" and "dedication" are not synonymous, and the dedications and the commitments merely identified particular produced minerals that were "pledged or committed to the parties' contractual obligations under the service contracts."[55] Extraction, retained its rights, title, and interest in the Dedicated Interests at all times, subject to the drilling commitment. Therefore, the covenanting parties lacked privity of estate at the time covenants were created.

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[51] *Id.* at *9.

[52] *Id.* at *56 (citing *Notch Mountain Corp. v. Elliott*, 898 P.2d 550, 556 (Colo. 1995)).

[53] *Id.* (quoting *Lobato v. Taylor*, 71 P.3d 938, 945 (Colo. 2002)).

[54] *Id.* (citing *Id.* at 945).

[55] *Id.* at *59.

On touch and concern, the court initially found that the drilling commitment touched and concerned land. The drilling commitment required Extraction to drill wells into its mineral estates within a certain timeframe. In the court's view, this commitment directly affected the parties' use and enjoyment "because the obligation to drill a certain number of wells on a certain schedule affects Extraction's drilling and development of its mineral estates."[56]

Judge Sontchi, however, found that the dedication obligation did not touch and concern land because "the obligations and services for which they were made concern only personal property [i.e., the produced minerals]"[57] and do not relate to Extraction's mineral estates. The delivery obligation also concerned personal property, not real property, because "[r]eference to the Delivery Points confirms gas, oil, and water have been reduced to possession and are personal property when the obligation to deliver to Elevation for services accrues."[58] Thus, both the dedication and delivery obligations did not diminish Extraction's right to use and enjoy its mineral estates.

The assignment provisions and facilities obligation also did not touch and concern land. The assignment provisions purported to bind successors-to-title, which is purely a contractual issue, and the facilities obligation required Elevation to build and operate gathering facilities to "facilitate services to personal property,"[59] that is, the produced minerals. The assignment provisions and facilities obligation did not affect Extraction's use or enjoyment of its mineral estates.

The fixed fee provisions and exclusive nature of the Agreements also failed to meet the touch and concern requirement. The fixed fee provisions were payments for services to personal property, that is, the produced minerals. The fee did not restrict or limit Extraction's right to "produce from or develop its mineral estates[,]"[60] and neither did the exclusive nature of the Agreements. Exclusivity merely restricted Extraction's right to contract with other midstream suppliers. However, Extraction was free to "produce from its mineral estates as it [saw] fit, and Elevation [could] not compel any action in the use or enjoyment of Extraction's mineral estates."[61]

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[56] *Id.* at *70 (citing *Reishus v. Bullmasters, LLC*, 409 P.3d 435, 440 (Colo. 2016)).

[57] *Id.* at *72.

[58] *Id.* at *81.

[59] *Id. at* *86 (citing *Cloud v. Ass'n of Owners*, 857 P.2d 435, 440 (Colo. App. 1992)).

[60] *Id.* at *90.

[61] *Id.* at *92.

Finally, the easements provision and the ratification agreement did not touch and concern land. Extraction granted easements on its surface estate interests which were distinct from Extraction's mineral estates,[62] and later agreed to a ratification to restate the parties' intent to commit to the Agreements and to create covenants running with the land. The easements provision and the ratification agreement did not affect Extraction's use or enjoyment of its mineral estates.

Accordingly, the bankruptcy court ruled in favor of Extraction because not all the elements of a real covenant were established. The decision is on appeal and is currently pending in the U.S. District Court for the District of Delaware.

Chesapeake Energy[63]

Chesapeake Energy ("Chesapeake") entered into a contract with ETC Texas Pipeline, Ltd. ("ETC") for the sale and purchase of natural gas, which required Chesapeake to exclusively dedicate and deliver all natural gas produced from its oil and gas leases ("Dedicated Leases") to ETC. The contract provided that the parties intended for the Dedicated Leases to constitute a covenant running with the land, will bind successors-to-title and be governed by Texas law. If either party breached the agreement by failing to deliver or receive gas, the sole remedy for each party was limited to a formulaic payment. The parties agreed that the contract constitutes a forward contract, a swap agreement, and a master netting agreement.

As noted above, the commonly applied checklist for a covenant running with the land is:

(i) Touch and concern land;

(ii) Intent for covenant to run with land;

(iii) Privity of estate;

(iv) Obligation relates to a thing in existence or binds successors and assigns; and

(v) Notice.

The parties focused their arguments on factors one and three and agreed that factors four and five were undisputed. Neither party genuinely contested factor three—intent, but Bankruptcy Judge Jones began the analysis there.

While the contract contained an express acknowledgement that the parties intended for the obligation to sell produced gas to run with the land, the court

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[62] *Id.* at *94 (citing *Notch Mountain Corp. v. Elliott*, 898 P.2d 550, 556 (Colo. 1995)).

[63] *In re Chesapeake Energy Corp.*, No. 20-33233 (Bankr. S.D. Tex. 2020).

was not convinced that this expressed the true intent. Rather, Judge Jones believed the exclusive remedy provision better expressed the parties' true intent. The provision specified that failure by each party to deliver or purchase specified quantity of gas would result in *only* a formulaic payment. Other remedies such as "[s]pecific performance, injunctive relief, and other equitable remedies"[64] were excluded.

In the court's view, the exclusive remedy provision was personal "and unrelated to any real property interest held by Chesapeake."[65] It added, "[t]he damages limitation along with the acknowledgement that the [contract] is a two-party forward contract . . . suggests that the added language that 'the parties intended for the obligation to run with the land' was an ill-conceived attempt to portray the [contract] as a horse of a different color."[66]

Judge Jones also found that the Dedicated Leases did not touch and concern land. Chesapeake did not specifically assign to ETC any interest in the oil and gas leases. The Dedicated Leases, which required Chesapeake to dedicate all produced gas to ETC, merely meant "*gas severed from the mineral estate and collected at the wellhead*"[67] would be delivered to ETC at the receipt points. In Texas, "produced gas is personal property,"[68] not real property.

Further, the parties agreed for Chesapeake to deliver produced gas and for ETC to accept the gas at a receipt point, ETC had no access or control over Chesapeake's interests in real property (oil and gas leases), and Chesapeake had an unrestricted right to use and enjoy its real property interests.

Finally, the Dedicated Leases lacked privity because there was no successive and concurrent relationship in existence to establish vertical and horizontal privity. The court observed that the contract was a forward contract and contained ongoing obligations for the "purchase and sale of *personal property*—not the burdening of a real property interest."[69] It also dismissed ETC's assertion that the contract constituted equitable servitudes that could not be rejected because equitable servitudes is immaterial in deciding whether an executory contract can be rejected.

In comparison with similar language interpreted by Judge Isgur in *Alta Mesa*, Judge Jones' analysis concludes that the specific contract in question and

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[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *Id.* (emphasis added).

[68] *Id.*

[69] *Id.* (emphasis added).

dedication of gas did not run with the land and can be rejected. The key takeaway from the different analyses is that each contract is unique, and each state's law is unique. One cannot state generally "gas gathering agreements run with the land." Some do, some do not.

Southland Royalty[70]

In the recent Southland Royalty Company LLC ("Southland") case, Bankruptcy Judge Owens acknowledged the split between courts and contracts concerning gas gathering agreements and their status as real property covenants. Judge Owens noted that some courts tend to interpret the matter narrowly (that is, *Sabine* and *Extraction*) and some broadly (that is, *Alta Mesa* and *Badlands*), depending on each court's interpretation of state law.[71] Judge Owens adopted the "narrow" approach and followed the *Sabine* and *Extraction* cases to require stringent analysis of the legal requirements instead of a more holistic approach.

Southland and Wamsutter LLC ("Wamsutter") executed two gas gathering agreements—the L63 Agreement and the L60 Agreement. This article addresses the L63 Agreement which was the focus of the decision. Southland's made the agreement to develop its horizontal drilling program while Wamsutter enlarged the gathering systems for future horizontal production. Because it was expensive, Wamsutter would receive gathering fees and deficiency fees quarterly if Southland failed to deliver a minimum volume.

Under the L63 Agreement, Southland "dedicated" to Wamsutter produced gas ("L63 Dedication") within an area of interest ("L63 Area of Interest") that overlapped with a geographic area under the L60 Agreement). Wamsutter held exclusive rights to gather and process the produced gas, which was to be delivered and accepted at specific receipt points. The L63 Agreement provided that it was the parties' intent that the L63 Dedication constitute a covenant running with the land that would bind successors-to-title.

After filing for bankruptcy, Southland sought to sell all of its assets. The sale process failed to generate binding offers because of uncertainty about the minimum volume commitments under the L63 Dedication. Southland then launched an adversary proceeding to reject the L63 Agreement, alleging it did not contain real covenants running with the land. Applying Wyoming law, Judge Owens agreed with Southland and ruled that the L63 Agreement could be rejected and Southland may sell its assets free of the L63 Dedication.

Judge Owens held that, while the parties may have intended for the L63 Dedication to serve as a covenant running with the land, the entire L63

[70] *In re Southland Royalty Co. LLC*, No. 20-10158 (Bankr. D. Del. 2020).

[71] *Id.*

Agreement did not. The court found that "[t]he striking omission of similar language from the remaining terms of L63 Agreement suggest[ed] that all other obligations [were] personal."[72] Even if the parties' had intended it, the court found that the L63 Dedication did not touch and concern land because Southland's rights in its mineral estates remained unaltered by the L63 Dedication. The L63 Dedication merely gave Wamsutter exclusive rights to gather and process produced gas (personalty), "i.e., Southland's gas produced in the L63 Area of Interest."[73] The court observed:

> Despite the language of the L63 Dedication that "dedicates" or commits Southland's "Dedicated Properties" and "Dedicated Gas" to Wamsutter, the L63 Dedication does not convey any right, title, or interest in the Dedicated Gas or Dedicated Properties to Wamsutter, and it places no restrictions or any other burden on such property.[74]

Southland was free to decide whether to decrease or cease "further exploration, drilling and production"[75] on its unproduced reserves. Wamsutter could not "enter the L63 Area of Interest and access or control Southland's unproduced reserves, including through its own development."[76]

The L63 Dedication triggered only after Southland produced gas in the L63 Area of Interest, which then required Wamsutter to receive it at receipt points unconnected to the L63 Area of Interest and service such produced gas for a fee. Under the framework of the Agreement, "[t]he only property directly benefited and burdened by the L63 Dedication is Southland's produced gas in the L63 Area of Interest, and in Wyoming such property is personal property[,] rather than realty."[77]

The court also found that the parties lacked privity of estate because the L63 Dedication did not convey a real property interest. In Wyoming, privity of estate relates to a grant of an interest in the land.[78] Further, Southland's surface estates, from which Wamsutter obtained easements and other rights of access,

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[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Id.*(citing *Denver Joint Stock L & Bank of Denver v. Dixon*, 122 P.2d 842, 845 (Wyo. 1942)).

[78] *Id.*

were deemed to be distinct from "the same estate allegedly burdened by the L63 Dedication—Southland's mineral interests."[79]

Wamsutter, like many of the counterparties in the cases discussed, asserted that an equitable servitude existed, which could not be rejected. The court rejected this argument finding that an equitable servitude is enforceable against future landowners "if such parties took the land with notice of the covenants and the seller intended to bind"[80] successors-to-title. Here, the parties agreed to bind successors-to-title as to the L63 Dedication only (a dedication of personalty). Accordingly, the court ruled that Southland could reject the L63 Agreement.

Finally, the court ruled that Southland could sell its assets free and clear pursuant to Bankruptcy Code Section 363(f)(1) because Wyoming permits Southland's lenders to extinguish real property covenants via foreclosure. Also, because remedies are available to enforce covenants in Wyoming, Southland could sell its assets pursuant to 11 U.S.C. § 363(f)(5) and compel Wamsutter to accept money in satisfaction of its interests.[81]

CONCLUSION

There are two key certainties and one large remaining unanswered question. A practitioner can be certain that each contract will be unique and each contract will apply an applicable state law. As a result, one should not expect a categorical declaration that all gathering agreements are (or are not) subject to modification and rejection by operation of the Bankruptcy Code. However, the law remains uncertain on what dedications constitute an intent to "touch and concern" the land with privity.

Because of these divergent applications by various bankruptcy courts, the fate of midstream gathering agreements in bankruptcy generally, will remain an unsettled issue.

Also, the recent decisions make one thing clear—merely tattooing the magic phrase "covenant running with the land" in a dedication clause within a gathering agreement does not end the analysis. In deciding whether a real covenant exists, courts must carefully review the language in the agreement to determine whether a real covenant and privity exist.

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[79] *Id.*

[80] *Id.* (citing *Cash v. Granite Springs Retreat Ass'n, Inc.*, 248 P.3d 614, 619 (Wyo. 2011)).

[81] *Id.*

As Judge Jones stated in *Chesapeake*, "the parties' words matter."[82] A wise practitioner may want to revise existing contracts to carefully describe the status of gas *in situ* and whether the obligations of the purchaser actually do attach to the land.

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[82] *Chesapeake*, *supra*.