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Texas Bankruptcy Court Denies Rejection of Certain Production Dedication Midstream Agreements

*By Jim Prince and Scott Looper**

The Houston bankruptcy court in Alta Mesa Resources held that a midstream service provider's rights under its agreements to gather and transport production in the Oklahoma STACK formation could not be rejected in bankruptcy because those rights were covenants running with the land under Oklahoma law.

Many midstream companies (some of which are organized as master limited partnership (“MLPs”)) rely on dedications¹ of oil and gas leases, wells and the production therefrom as a form of credit support from producers to assure the future cash flows necessary to recover the significant capital expenditures incurred by such companies to construct and maintain the gathering, transportation and processing assets built for such producers.

In 2016, the viability of such dedications was drawn into question when a New York bankruptcy court in *In re Sabine Oil & Gas Corporation*,² held that under Texas law the “dedications” that were before the court failed to qualify as covenants running with the land and thus the gathering agreements secured by such dedications were simply executory contracts that could be rejected by the bankrupt producer under Section 365 of the Bankruptcy Code.³

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¹ A dedication is a common provision in a midstream contract that grants the exclusive right to gather, process or transport all hydrocarbons produced from leases and wells located within an agreed geographic area. These provisions are called “dedications” because they dedicate all hydrocarbon production from identified upstream assets (namely, leases and wells) to a particular midstream asset.

² *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC (In re Sabine Oil & Gas Corp.)*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016); *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017); *aff'd*, 734 Fed. Appx. 64 (2nd Cir. 2018) (summary order).

³ In bankruptcy, a burdensome unperformed contract may be rejected, thereby effectively replacing future performance obligations with a general unsecured claim for damages. Because unsecured claims share *pro rata* with other unsecured claims after all secured lender claims are satisfied, where the cash flows of upstream companies have dropped due to low commodity

A bankruptcy court in Colorado reached an opposite result, finding that certain gathering agreements servicing upstream assets in the Uinta Basin ran with the land under Utah law and thus could not be rejected as executory contracts.⁴ The Houston bankruptcy court in *Alta Mesa Resources*, also differed with the analysis of the New York courts, holding that a midstream service provider's rights under its agreements to gather and transport production in the Oklahoma STACK formation could not be rejected in bankruptcy because those rights were covenants running with the land under Oklahoma law.⁵

IN RE ALTA MESA RESOURCES

After Alta Mesa became a Chapter 11 debtor-in-possession, it sued Kingfisher Midstream, former officers and directors and its parent companies, seeking to invalidate two gathering agreements on various grounds. The crux of the lawsuit was “Alta Mesa’s belief that its owners, sitting on both sides of the negotiation table, agreed to pay Kingfisher exorbitant gathering fees.” Alta Mesa asserted claims to avoid the gathering agreements as fraudulent transfers and preferences, to rescind the agreements as breaches of fiduciary duty and to reject them as executory contracts. The Kingfisher defendants moved for partial summary judgment, asserting that the gathering agreements formed real property running covenants under Oklahoma law that could not be rejected as executory contracts as a matter of law.

The court held that under Oklahoma law, which the court described as mirroring Texas law, a covenant runs with the land if all of the following are true:

- The covenant touches and concerns real property;
- There is privity of estate; and
- The original parties to the covenant intended to bind successors.

Only the first two issues were in meaningful dispute.

The Dedicated Agreements Touched and Concerned Real Property; Namely, Alta Mesa’s Oil and Gas Leases

For the touch and concern prong, which required the court to evaluate

prices, such unsecured claims may receive substantially less than the face value of their claims in bankruptcy. In contrast, many courts have ruled that covenants running with the land cannot be rejected in bankruptcy because they constitute interests in real property rather than future contract performance obligations.

⁴ *Midlands Midstream, LLC v. Badlands Energy, Inc. (In re Badlands Energy, Inc.)*, 608 B.R. 854 (Bankr. D. Colo. 2019).

⁵ *Alta Mesa Holdings, LP, v. Kingfisher Midstream, LLC (In re Alta Mesa Resources, Inc.)*, 613 B.R. 90 (Bankr. S.D. Tex. 2019), The Honorable Marvin Isgur presiding (hereinafter, the “Memorandum Opinion”).

whether the gathering agreements made Alta Mesa's real property interests more or less valuable, the court first had to identify the real property interest that Alta Mesa holds.

Distinguishing the New York courts in *In re Sabine*, which opinions had focused on the fee simple mineral estate as the relevant real property, the court in *Alta Mesa* instead focused on Alta Mesa's interests in its oil and gas leases, which the court found distinguishable from the fee simple mineral estate, noting that each are overlapping but that each contain a separate bundle of rights.

The court found that the gathering agreements both burdened and benefited Alta Mesa's leasehold interests by four relevant provisions:

First, the agreements carved out surface easements from easements granted to Alta Mesa under its oil and gas leases, which enabled Kingfisher to build and maintain the system—the surface easements thus burdened Alta Mesa's possessory interest in its leases, “[reduced] Alta Mesa's real property interest under the leases [and] contrary to the holding in *Sabine*, the surface easements directly affect the lessee's underlying mineral interest”;

Second, the agreements dedicated all of Alta Mesa's production from the dedicated leases and wells, which restricted Alta Mesa's use of its reserves. The gathering system also enhanced the value of such reserves;

Third, the agreements required recordation and the affirmation by subsequent transferees; and

Finally, the agreements provided for fixed gathering fees, which during periods of low commodity prices diminished the value of Alta Mesa's reserves and impacted Alta Mesa's drilling schedule and use of its leases.

The Parties Were in Privity of Estate

For a covenant to run with the land in Oklahoma, privity of estate must exist between the party claiming the benefit of the covenant and the party burdened by the covenant. The court noted that common law recognizes two types of privity of estate: vertical and horizontal. Vertical privity, which relates to the present owner of the land and the original parties to the covenant, was not relevant under the facts before the court. Neither party had transferred its interests. And the gathering agreements had been recorded, which would charge any subsequent transferee with knowledge of the gathering agreements.

The parties disputed whether horizontal privity is required under Oklahoma law. Horizontal privity arises when the covenant—the dedication at issue in *Alta Mesa*—is created in conjunction with a conveyance or reservation of a real

property interest. The court concluded that it need not decide that issue because even if Oklahoma required horizontal privity, it was nevertheless present. The court found that the gathering agreements conveyed surface easements, a possessory interest in Alta Mesa's leasehold estate, to Kingfisher, which was enough to show horizontal privity. In so holding, the court again distinguished *Sabine's* analysis of fee mineral estates, not oil and gas leases, reasoning that:

Alta Mesa's surface easements spring directly from its leasehold mineral interests. Because a surface easement is a crucial component [of] an oil and gas lease, the court does not view this conveyance as creating privity only with respect to the surface estate Instead, it supports a finding that the covenants were created alongside the conveyance of a property interest in Alta Mesa's leasehold estates.⁶

KEY TAKEAWAYS

The opinions in *Alta Mesa* and *Badlands* reinforce that the parties' intent as evidenced by their writings will continue to be critical and in many cases outcome determinative. So too is a careful analysis of the state law supplying the rule on running covenants. The granting and structure of surface easements, an important part of both decisions in *Alta Mesa* and *Badlands* and a common provision in most modern gathering agreements providing for the construction or future expansion of a gathering system, will continue to be important if not mandatory going forward in states like Oklahoma and Texas that treat oil and gas leases as real property. While the recent opinions in *Alta Mesa* and *Badlands* may reasonably be viewed as alleviating some of the uncertainty around the viability of dedications, the issues nevertheless remain complex, fact specific and largely unsettled in most states. Credit support and the impact of bankruptcy are expected to remain key issues as producers and their midstream counterparties continue their navigation of a prolonged commodity price downturn.

⁶ Memorandum Opinion, pp. 21-22 (citing, *Badlands*, *supra* note 4). *But see Sabine*, 550 B.R. at 69.