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# Midstream Agreements in Bankruptcy – Storm Clouds Gathering

# Webinar Presenters

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# Key Issues

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**Recent cases are examining issues as to the survival of midstream agreements in bankruptcy.**



Bankruptcy process as to rejection under §365(a)



Pipeline transportation agreements with no dedication of acreage



Gathering and processing agreement where there is dedicated acreage: do the dedications create “covenants running with the land”?

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# Potential Treatment of Midstream Agreements in Bankruptcy

## Classification of Agreements: Implications for Bankruptcy

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- Whether an agreement creates a covenant that “runs with the land” (as opposed to a contract right) has implications for how the agreement may be treated in bankruptcy.
  - ***If the agreement creates a contract right, the debtor may be able to reject the contract as “executory.”***
  - ***If the agreement creates a covenant running with the land, the debtor may not be able to reject the obligation as “executory” and such covenant may survive a §363 sale.***

## Potential Treatment of Midstream Agreements in Bankruptcy

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### Rejection of “Executory Contracts”

#### Bankruptcy Code Section 365(a)

- Under **Section 365(a)** of the Code, a debtor has the right to reject an executory contract (subject to court approval).
- The Code does not define “executory contract.”
  - Most courts follow the well-known Countryman definition, which provides that a contract is executory “[i]f at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract, thereby excusing the performance of the other party.”
- If the debtor rejects, rather than assumes, an executory contract, the counterparty may be limited to a **pre-petition unsecured claim** for damages caused by rejection.
- Debtor’s decision to reject a contract is subject to low threshold of review – deferential **“business judgment”** standard.

## Potential Treatment of Midstream Agreements in Bankruptcy

- **Examples of rights and obligations outside the scope of §365(a) include:**

- Contracts breached pre-petition
- Contracts that are no longer “executory”
- Right of possession under real property leases, even if lease is rejected (§365(h))
- Licensed intellectual property rights even if the debtor has rejected the executory contract, provided licensee continues to make license payments for remainder of term (§365(n))
- **“Interests in property”** (not defined in the Code) (§363(f))
  - Includes “in rem” interests such as liens, mortgages, security interests, and money judgments lodged against specific property
  - In the Fifth Circuit, **“covenants running with the land”** (See *In re Energytec*) (courts vary)
  - Easements and restrictive covenants affecting real property



## Potential Treatment of Midstream Agreements in Bankruptcy

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Sale of Estate  
Property  
“Free and  
Clear” of  
“Interests”

### Bankruptcy Code Section 363(f)

- Addresses the ability of debtor to sell estate property **“free and clear”** of **“interests”** in the property. Under Section 363(f), a sale may be approved “free and clear” of “interests” **only** if
  - applicable non-bankruptcy law permits sale of such property free and clear of such interest; ***or***
  - the “interest” holder consents; ***or***
  - 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; ***or***
  - such interest is in bona fide dispute; ***or***
  - such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.



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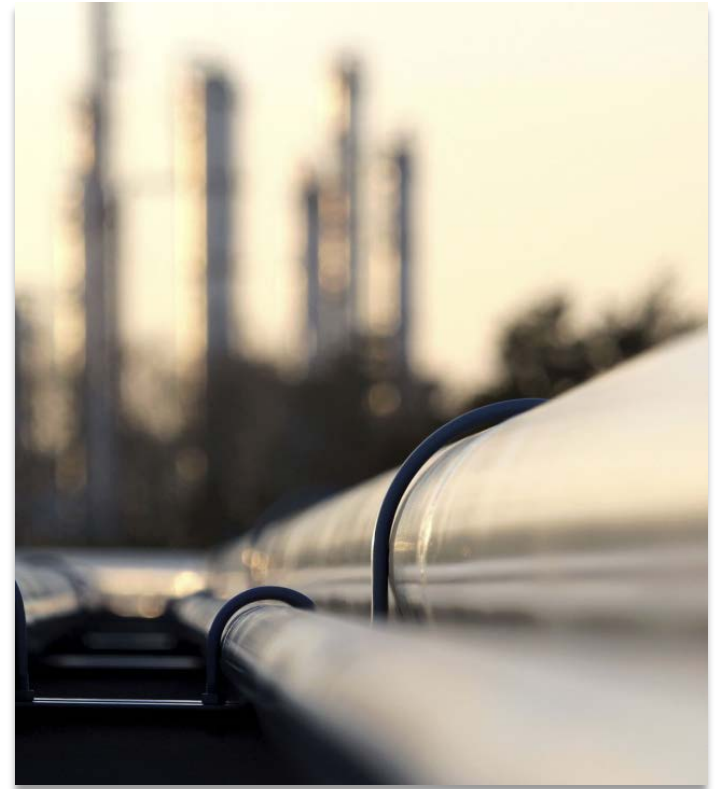


# Transportation Agreements

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- Unlike Gathering Agreements, Transportation Agreements typically **do not contain a dedication**.
- Without a dedication, Transportation Agreements are even more likely to be classified as **executory contracts** in bankruptcy.

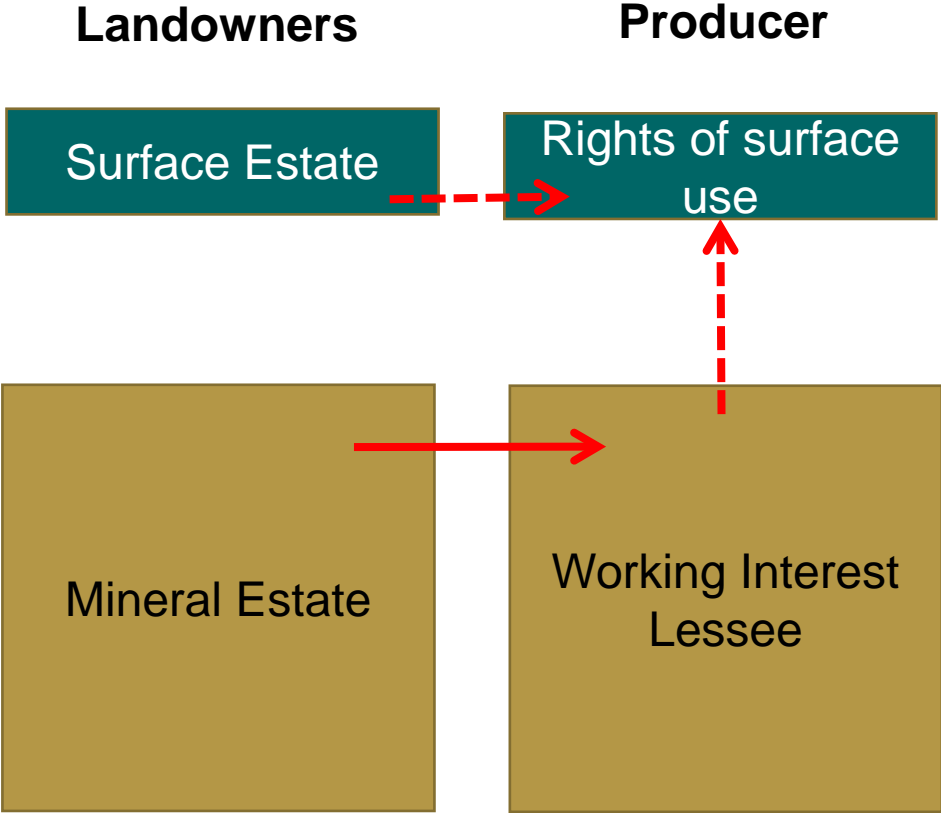


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# Gathering Agreements

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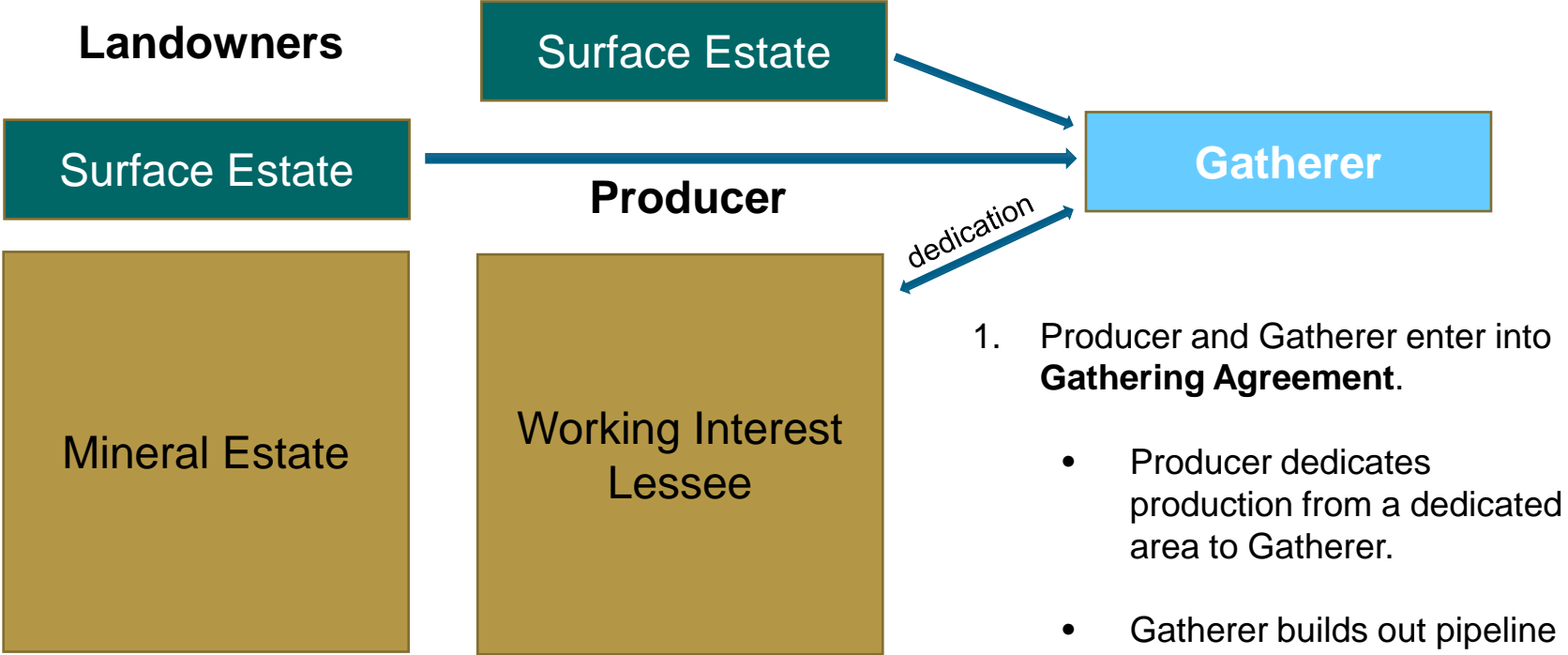


1. Mineral owner and Producer enter into **Oil & Gas Lease**. Mineral owner conveys fee simple determinable in the Mineral Estate and grants rights of use (e.g., easements) of Surface Estate.

2. Producer's right to use the surface comes from:

- If surface and mineral estate owned by same party, the Lease
- A separate surface use agreement signed by the surface owner
- The inherent superiority of the rights of the mineral estate

# Gathering Agreements



1. **Producer and Gatherer enter into Gathering Agreement.**
  - Producer dedicates production from a dedicated area to Gatherer.
  - Gatherer builds out pipeline system on easements and rights of way – sometimes relying on surface use rights in the Oil & Gas Lease, but more likely through easements from other landowners.

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# Covenants Running with the Land

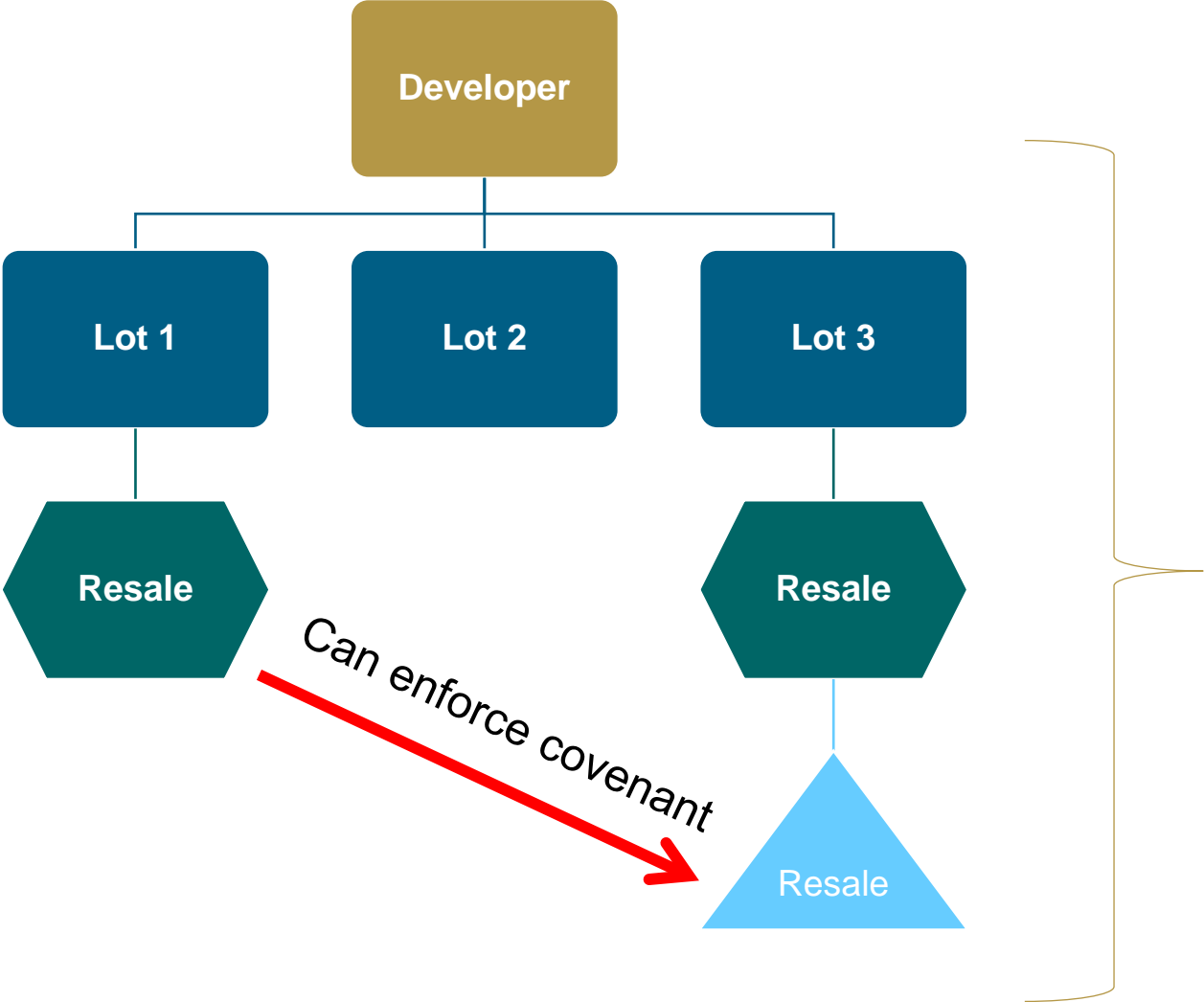
## Overview: Bankruptcy Implications for Covenants Running with the Land

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- **Covenants Running with the Land**

- Gathering and processing agreements often include a provision stating the parties intend the agreement to be a **“covenant running with the land”** under applicable state law.
- A covenant running with the land is a covenant that is so connected with the underlying realty that the benefit, burden, or both to enforce the covenant passes to the heirs or grantees of one or both of the original covenanting parties **by operation of law**, even without express assignment or delegation.
- The requirements for determining whether an agreement creates a covenant running with the land differ from state to state.

# Covenant Running with the Land: Subdivision Example





# Elements of a Covenant Running with the Land (Texas)

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- In Texas, a **covenant runs with the land** when it:
  1. touches and concerns the land;
  2. relates to a thing in existence or specifically binds the parties and their assigns;
  3. is intended by the original parties to run with the land; **and**
  4. when the successor to the burden has notice that the land is so burdened.

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

- Additionally, in order for a covenant to run with the land, there may be a requirement of privity of estate between the parties to the agreement creating the covenant.

*In re Energytec, Inc.*, 739 F.3d 215 (5th Cir. 2013)

# Elements of Covenants Running with the Land (Texas)

## Touch and Concern

- Does covenant affect “nature, quality or value” or the “mode of enjoying” the thing demised?
- Does the covenant impact the value of the burdened real property?

## Thing in Existence/Binding on Assigns

- Covenant must affect a “thing in existence” or “specifically bind the parties and their assigns”
  - *Contract typically includes language that agreement will be binding on “successors and assigns”*

## Intent

- Original parties must intend for covenant to run with the land
  - *Contract typically includes language that parties intend covenant to run with the land*

# Elements of Covenants Running with the Land (Texas)

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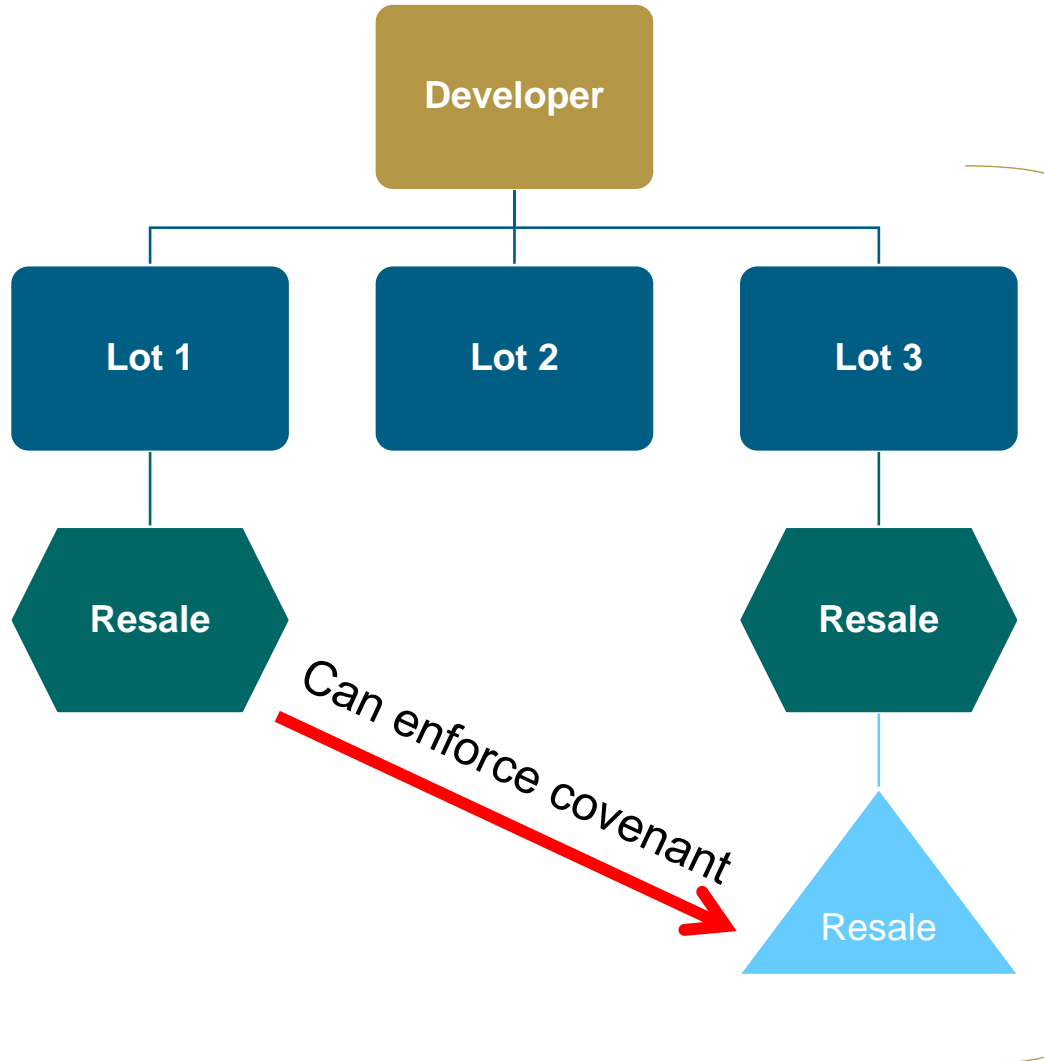
## Notice

- Successor to the burden of the covenant must have notice
- *Typically satisfied by recordation in real property records*

## Privity of Estate

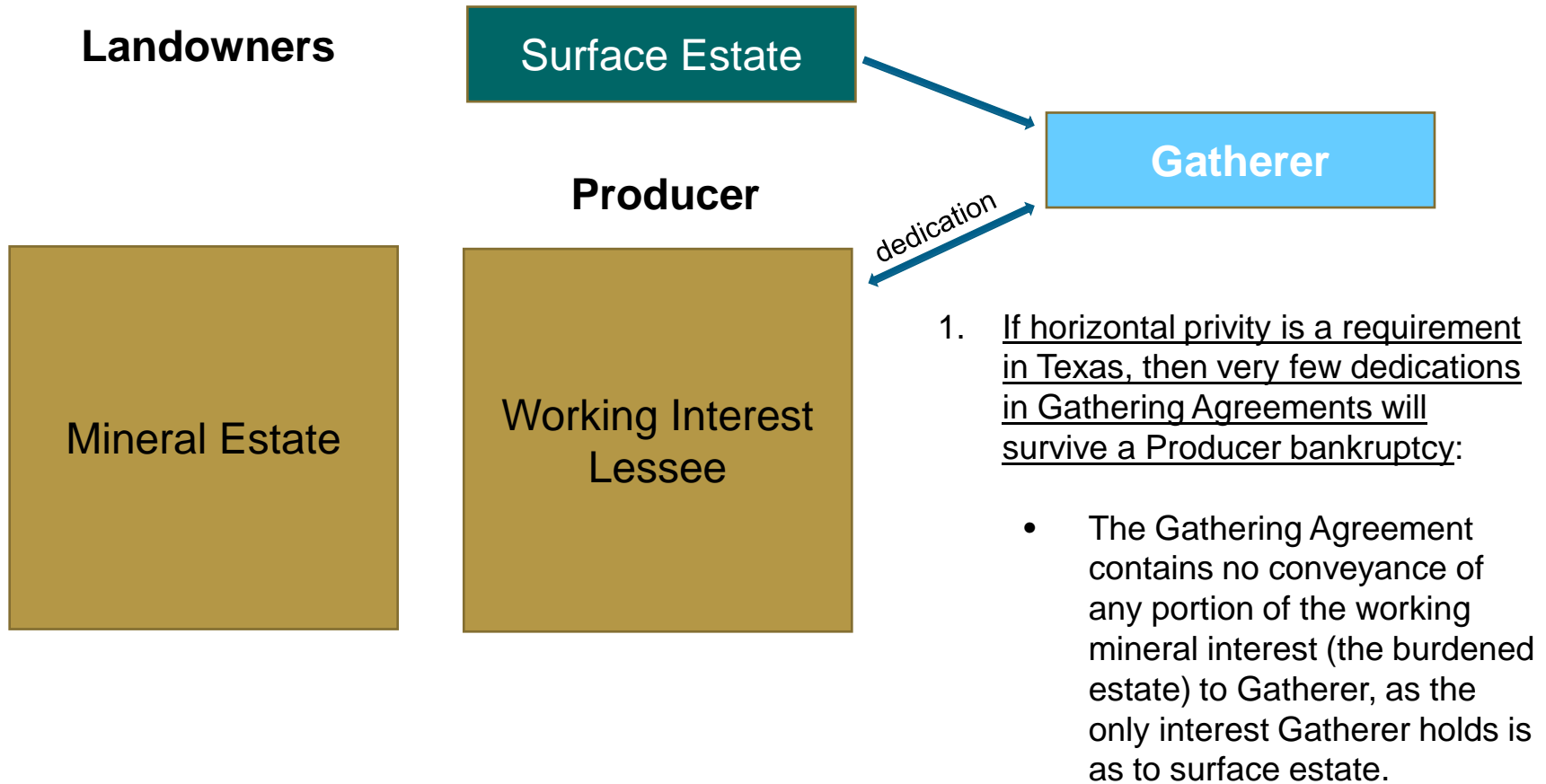
- Privity requirements under Texas law are unclear (horizontal vs. vertical privity)
- Parties seeking to reject gathering agreements point to lack of “**horizontal privity**”
- **Horizontal privity** is meant to capture a mutual relationship between the original covenanting parties and the land (as opposed to the “successive” relationship represented by “vertical privity”)

# Vertical vs. Horizontal Privity: Subdivision Example



1. Developer places restrictive covenant in deeds of Lots 1 - 3
  - **Horizontal Privity** exists between Developer and first purchasers by virtue of the conveyance
2. Purchaser of Lot 1 can enforce restrictive covenant against third purchaser of Lot 3
  - **Vertical Privity** exists between Developer, purchasers and re-purchasers

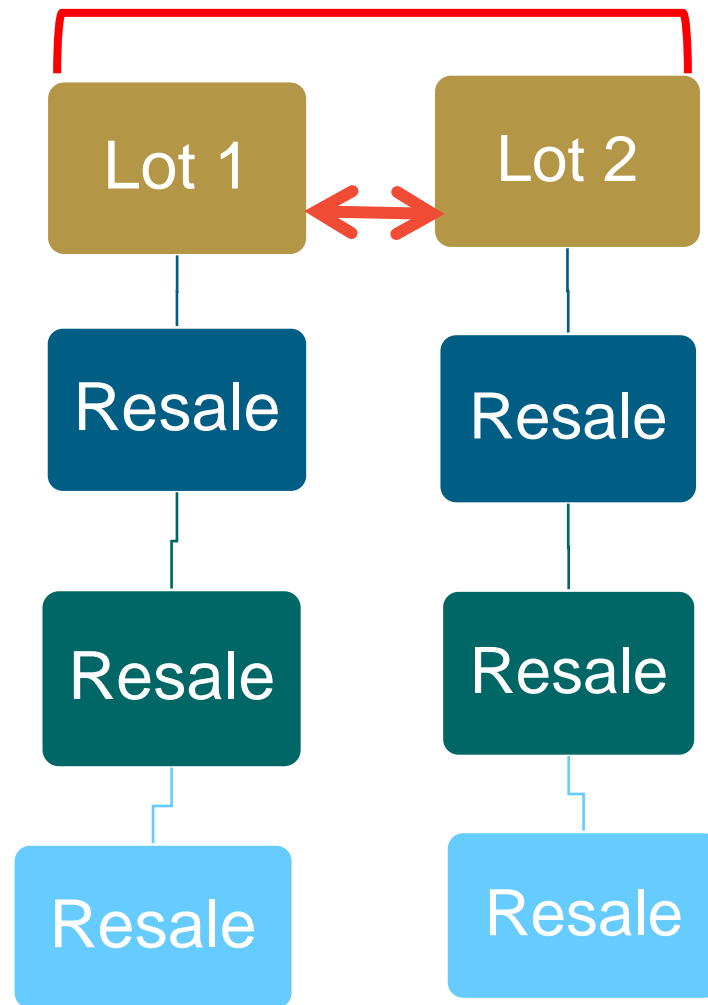
# Horizontal Privity in Gathering Agreements



# Equitable Servitudes and Restrictive Covenants

Even if not enforceable as a covenant running with the land, there has been a recognized class of restrictions traditionally enforceable by injunction known as equitable servitudes. Issues in using this doctrine could be:

- Not what parties intended.
- Limitations on injunctive relief.



Restrictive covenants between owners of adjacent tracts

Vertical privity

# Texas Law on Horizontal Privity is Inconsistent and Unclear

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- ***Westland Oil Dev. Corp. v. Gulf Oil Corp.*** 637 S.W.2d 903, 910-11 (Tex. 1982): “In order for the covenant to run with the land **there must be privity of estate between the parties to the agreement**. This means there must be a **mutual or successive** relationship to the same rights of property.” (citing *Blasser v. Cass*, 314 S.W.2d 807 (Tex.1958)) (emphasis added)
- ***Wayne Harwell Properties v. Pan Am. Logistics Center***, 945 S.W.3d 216 (Tex. App. San Antonio 1997): “For a covenant to run with the land at law, and so be enforceable at law so as to bind successors in title, the covenant must be made between **parties who are in privity of estate at the time the covenant is made**, and must be **contained in a grant of land or in a grant of some property interest** in land.”
- ***In re Energytec, Inc.***, 739 F.3d 215 (5th Cir. 2013): “Energytec relies strongly on a Texas case addressing **horizontal privity**. . . [which] **is a much-criticized doctrine** that has been rejected by th[e] latest Restatement. . . . We must also be wary because the cited decision is not one from the Texas Supreme Court. . . . We conclude that ***if horizontal privity is a requirement of Texas law*** in determining whether a covenant runs with the land, it was satisfied.” (discussing Energytec’s reliance on *Wayne Harwell*) (emphasis added)

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A grayscale photograph of an industrial facility, likely a refinery or chemical plant. The image shows a complex network of pipes, walkways, and structural elements. In the background, a person is visible standing on a walkway. The overall scene is hazy and desaturated.

# Status Update: Recent Cases



## ***In re Energytec, Inc.*, 739 F.3d 215 (5th Cir. 2013)**

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- **Facts/Background**: Energytec, Inc. (“Energytec”) filed for bankruptcy in 2009, and at the time held property including a pipeline system acquired from Producers Pipeline Corporation (“Producers”). The pipeline had been acquired by Producers from its original owner “subject to” a transportation fee and a consent right in favor of an affiliate of the transferring owner, Newco (“Newco”). Payment of the transportation fee was also secured by a perfected lien in the pipeline system assets. Could Energytec could sell its assets pursuant to §363 “free and clear” of any liens, claims or encumbrances, including Newco’s transportation fee and consent right? The bankruptcy court determined that the transportation fee was not a covenant running with the land, and accordingly was discharged in the §363 sale.
- **Fifth Circuit Holding**: The Fifth Circuit held that the transportation **fee and consent right were covenants running with the land under Texas law**. The court explained that the real property at issue was a gas pipeline system and the rights-of-way required for its placement. The transportation fee and consent right sufficiently impacted the use and value of the real property, so as to “touch and concern” the land, and privity was established. However, the court remanded for determination of whether one of the five conditions in §363(f) had been satisfied, allowing for a sale “free and clear” of Newco’s interests.
- **Limited applicability**: The *Energytec* holding is **limited to its facts** – it involved a fee payment obligation and consent right preserved with the sale of a pipeline. The court did, however, clarify that a covenant running with the land is an “interest” for purposes of §363(f).

## *In re Sabine Oil & Gas Corp., Case No. 15-11835 (Bankr. S.D.N.Y)*

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- **Sabine’s §365(a) Motion**: Sabine filed a motion (the “Rejection Motion”) in its bankruptcy proceeding seeking approval to reject, pursuant to Section 365, certain prepetition (i) gas and condensate gathering agreements with Nordheim Eagle Ford Gathering, LLC (“Nordheim”), and (ii) production gathering and handling agreements with HPIP Gonzales Holdings, LLC (“HPIP”). The Nordheim and HPIP agreements included “**dedications**” providing that Nordheim and HPIP had the exclusive right to, among other things, gather product from Sabine’s oil and gas properties in specific identified areas in Texas.
  - **Nordheim and HPIP Objections**: Nordheim and HPIP each objected to the Rejection Motion on the basis that the **dedications gave rise to real property covenants that run with the land**. They argued that although the agreements may technically be rejected pursuant to Section 365, the covenants would continue to encumber the land and thus rejection would not benefit Sabine’s estate.
  - **Sabine’s Reply**: Sabine argued that under Texas law, the Nordheim and HPIP agreements did not establish covenants running with the land because there was **no privity of estate** between Sabine and either Nordheim or HPIP. Sabine urged that to demonstrate privity of estate under Texas law, one party must convey an interest in property to which a covenant attaches. A valid conveyance requires both (1) **clear language evidencing an actual grant** of such interest, and (2) the **intent** of the grantor to convey an interest in property. Sabine argued that the dedications in the Nordheim and HPIP agreements were not sufficient to grant interests in real property because they did not include the words “grant,” “sale,” or “assignment” of any “interest in” property.

## *In re Sabine Oil & Gas Corp., (Cont'd)*

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- **Granting Language**: Sabine argued that the dedications in the Nordheim and HPIP agreements were not sufficient to grant interests in real property because they did not include the words “grant,” “sale,” or “assignment” of any “interest in” property.
- **Other Gathering Agreements with Proper Language Not Rejected**: At a hearing in the bankruptcy proceeding, Sabine’s counsel noted that Sabine has not yet attempted to reject gathering agreements with other parties that contain “stronger” granting language.
- **Hearing on the §365(a) Motion**: At the hearing on the Rejection Motion, the judge stated she is “inclin[ed] toward a ruling that [the dedications are] not covenants running with the land,” noting: (i) the dedication language in the agreements was “**not a conveyance**”; (ii) in *Energytec*, the fee under the relevant agreements burdened the land because if it was not paid it would have resulted in a loss of ownership and use of the pipeline through foreclosure, which was **not applicable here**; and (iii) the Nordheim and HPIP agreements related to “oil, gas and water produced by Sabine. Those are . . . **personal property items . . . not real property.**”
- **Note**: Regardless of the outcome of the Sabine case, gathering agreements should include proper granting language, the owner of the burdened property should be a party to any such agreement, and such agreements should convey recognized property interests to the extent possible. Midstream service providers will also seek forms of security to mitigate the risks of contract rejection.

## *In re Quicksilver Resources, Inc.* Case No. 15-10585 (Bankr. Del.)

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- **BlueStone APA**: Debtors announced BlueStone Natural Resources II, LLC (“BlueStone”) as the successful bidder of Debtors’ assets. Debtors and BlueStone executed an Asset Purchase Agreement (the “APA”), pursuant to which **a condition precedent to BlueStone’s obligation to close is entry of a final order rejecting a significant number of Crestwood midstream agreements** listed on Schedule 7.4(d) of the APA. Further, Section 11.1(a)(iii) of the APA provides that either party may terminate the APA if the sale has not closed by March 31, 2016.
- **Sale Order “Free and Clear” of “Interests”**: The judge entered a sale order (the “Sale Order”) which, among other things, approved the BlueStone APA. The Sale Order includes findings and determinations that BlueStone would not have entered into the APA if the sale was not, pursuant to Bankruptcy Code §363(f), free and clear of any **“Interests”** in the Oil and Gas Assets, including **“any dedication under any gathering agreement, transportation, treating, purchasing [sic] or similar agreement that relates solely to any Contract set forth on Schedule 7.4(d) to the APA and any other such contract that is not assumed by or assigned to [BlueStone] . . . .”** The Sale Order also provides that Debtors may sell the assets free and clear of all Interests because, “in each case, one or more of the standards set forth in Bankruptcy Code [§]363(f)(1)-(5) has been satisfied.” The Sale Order does not provide explanation as to which provision of §363(f) applies to the midstream contracts.
- **§365(a) Motion**: On February 5, 2016, Debtors filed a motion and proposed order to reject the Crestwood midstream contracts pursuant to §365(a). The motion is set for hearing on February 26, 2016.
- **Note**: The court in *Quicksilver* treats the **dedications as “Interests”** subject to §363(f), while treating the **contracts that contain the dedications as “executory”** and subject to rejection pursuant to §365(a).

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# Path Forward

# Path Forward: Negotiating Midstream Agreements

- As to existing agreements, parties should carefully review the language in their existing contracts.
- Moving forward, both upstream and midstream players have an interest in creating obligations that will be respected for the duration of the agreement and will survive in the event of counterparty insolvency.
- Strategic drafting should address such issues as:
  - “Intent” to run with the land
  - “Grant or conveyance” (horizontal privity)
  - Recordation
  - Inadequacy of money damages (specific performance)
  - Choice of governing law?
- For parties re-negotiating midstream agreements, questions of leverage if midstream agreements do not survive:
  - Do upstream players have viable alternatives for bringing product to the market?
  - Do midstream players have alternative uses for the pipeline system?



# Path Forward: Key Players and Concerns



## Bankruptcy Courts

- *Reconciling incompatible legal frameworks*
- *Interpreting state law requirements for covenants “running with land”*
- *Determining applicability of §365(a), §363(f) or both*

## Upstream Players

- *Understanding the status of burdensome midstream agreements in bankruptcy context*
- *Analyzing midstream agreements as a potential “covenant running with land” (horizontal privity, etc.)*
- *Moving product to market following rejection*

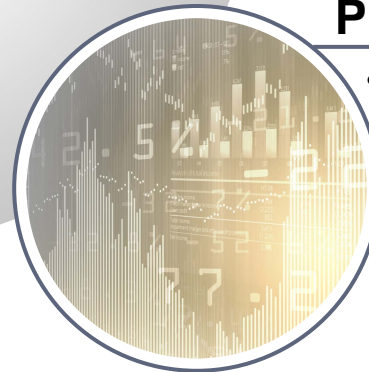
## Midstream Players

- *Creating enforceable agreements*
- *Horizontal privity exists, or is not required*



## Private Equity and Other Capital Providers

- *Receiving clarity as to treatment of midstream agreements to assess and manage risk*



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