Westlaw Today
powered by Reuters

Treatment of midstream agreements in bankruptcy remains unsettled, but limited consensus may be emerging

By Carl T. Tullson, Esq., Joseph O. Larkin, Esq., Jackie Dakin, Esq., and Christopher M. Dressel, Esq., Skadden, Arps, Slate, Meagher & Flom LLP*

FEBRUARY 4, 2022

Takeaways

- Pipeline companies have opposed efforts by oil and gas producers to reject midstream gathering agreements in bankruptcy, claiming that the exclusive "dedication" provisions in such agreements "run with the land" under state law and preclude rejection.
- Bankruptcy and appellate courts have reached different conclusions about the validity of these dedication clauses under state law.
- But more recent cases suggest an emerging consensus that a debtor can reject a midstream gathering contract even if its dedication clause runs with the land under state law.

Volatile and generally depressed oil and gas prices drove over 250 North American exploration and production (E&P) operators into bankruptcy from 2015 to 2021. Although this wave of energy restructurings has subsided with the recent rise in commodity prices, the legal issues left in its wake remain relevant.

More recent cases suggest an emerging consensus that a debtor can reject a midstream gathering contract even if its dedication clause runs with the land under state law.

Among these issues, few have attracted greater interest than the ability of an E&P debtor to reject burdensome midstream agreements in bankruptcy. That question, which lies at the intersection of federal bankruptcy and state oil and gas law, has played a pivotal role in numerous E&P restructurings since 2015.

Surprisingly, this issue generated little case law until recently. A spate of decisions, beginning in late 2019, has yielded an emerging consensus that midstream agreements are not wholly immune from rejection in bankruptcy. But a definitive answer remains elusive.

Typical midstream agreements include a 'dedication' clause

E&P debtors have used bankruptcy not only to restructure their balance sheets, but also to recalibrate their cost structures. Midstream gathering agreements — long-term contracts to transport oil and gas from the wellhead to central facilities by pipeline — are a popular target. Many producers have sought to reject these agreements as uneconomical, typically over the vigorous opposition of their counterparties.

In most contexts, a debtor seeking to reject an executory contract in bankruptcy need only show that it has a good business reason to do so. But midstream companies have a unique defense. Most gathering agreements contain a "dedication" clause that designates the midstream party as the exclusive provider of gathering, transportation and processing services for hydrocarbons produced from leases and wells in a specified area. The contracts typically characterize the provision as a covenant that "runs with the land."

These clauses raise two pivotal questions:

(1) Do these dedication clauses actually create enforceable covenants that run with the land under state law?

(2) If so, does the running covenant preclude rejection or just create an *in rem* interest that survives it?

Do 'dedication' clauses in midstream agreements 'run with the land'?

A threshold question is whether dedication clauses are what they purport to be: real covenants or equitable servitudes that "run with the land."

A running covenant is an agreement among real property owners that is deemed to attach to, and "run" with, the land, binding later owners, even if contractual privity is lost. Such covenants originate in contract but acquire *in rem* character only if they satisfy certain requirements prescribed by state law.

These vary from state to state, but at common law there are two fundamental elements: The covenant (1) is an element of a contemporaneous real property conveyance between the covenanting parties (denoted "horizontal privity"); and (2) "touches and concerns" the land, meaning, roughly, that it benefits or burdens it.

This threshold question proved fertile ground for litigation during the initial wave of E&P bankruptcies that began in early 2015, but surprisingly yielded only one reported decision until 2019. In that case, the U.S. Court of Appeals for the Second Circuit held that dedication clauses in debtor *Sabine* Oil & Gas Corp.'s midstream gathering contracts did not create valid running covenants under Texas law. *Sabine* and its midstream counterparties lacked horizontal privity of estate because the purported covenants were not part of a conveyance of real property. Moreover, the dedication clauses conferred merely a personal benefit on the pipeline operators, without benefitting the land.

Recent decisions provide some guidance, but leave ample grounds for further dispute

Since late 2019, at least eight similar disputes have been litigated to judgment. These cases reveal no consensus on whether dedication clauses constitute valid running covenants. Some courts have construed the legal prerequisites for such covenants liberally, holding, for instance, that (1) (whether or not part of a conveyance) contractual easements created to facilitate oil and gas gathering create horizontal privity, and (2) a gathering agreement touches and concerns the land by facilitating the production of hydrocarbons and restricting the E&P debtor's ability to procure alternative gathering services.

A threshold question is whether dedication clauses are what they purport to be: real covenants or equitable servitudes that "run with the land."

Other courts, following *Sabine*, have declined to construe the dedication clauses as running covenants. Several have dismissed the relevance of surface easements as proof of horizontal privity, emphasizing that the surface estate and subsurface mineral estate constitute distinct fee simple estates.

Likewise, the same courts have carefully distinguished produced hydrocarbons from unproduced reserves, holding that a gathering agreement concerns only the former, which are personal property under state law.

Recent cases have addressed not just the state law nature of the dedications, but the scope of the rejection power in bankruptcy.

Some of these courts have questioned the premise (assumed, but not discussed, in *Sabine*) that a valid running covenant precludes rejection. They emphasize that the dedication clause is but one provision of a larger contract; that the dedication clause runs with the land does not necessarily mean all of the debtor's obligations do.

On this view, the question is not whether the debtor can reject its gathering agreement, but whether the contract encompasses any *in rem* interests that survive rejection. On this basis, a bankruptcy court in the Southern District of Texas recently authorized a debtor to reject midstream agreements despite concluding that its dedication clauses ran with the land under state law and thus would survive rejection.

Recent cases have addressed not just the state law nature of the dedications, but the scope of the rejection power in bankruptcy.

Two recent decisions of bankruptcy judges in the District of Delaware go further, concluding not only that a gathering contract containing a valid running covenant is susceptible to rejection, but that the running covenant itself can be rejected. These decisions reason that, because running covenants arise by contract and are reducible to claims for money damages, they merit no different treatment in bankruptcy than other contractual obligations.

A consensus that running covenants might survive but not preclude rejection?

Given the recovery in oil and gas prices, it may be some time before courts take up these issues again. But those planning for the next cycle of distress in the energy sector can draw several tentative conclusions from recent cases.

On one hand, these cases leave important facets of this issue unresolved — in particular, the validity of purported running covenants in midstream gathering agreements under state law.

On the other hand, the cases suggest an emerging consensus that a valid running covenant in a midstream gathering agreement does not preclude its rejection, but instead creates a real property interest that survives rejection.

To be sure, the far-reaching conclusion that a valid running covenant can be reduced to a claim for damages and discharged fits uneasily with longstanding case law distinguishing *in personem* claims and *in rem* interests in bankruptcy. This conclusion therefore may not attract widespread support.

But the more modest proposition that a valid running covenant in a midstream agreement survives, but does not preclude, rejection may represent a point of consensus among courts that diverge on other aspects of this controversy.

About the authors

  

Carl T. Tullson (L) is a corporate restructuring partner in **Skadden, Arps, Slate, Meagher & Flom LLP**'s office in Wilmington, Delaware. He represents clients in complex debt restructurings, troubled company mergers and acquisitions, and financing transactions. **Joseph O. Larkin** (C) is a litigation partner in the Wilmington office. He represents a broad range of clients in disputes involving mergers and acquisitions, commercial contracts, antitrust matters, securities class actions and corporate control challenges. **Jackie Dakin** (not pictured) is a corporate restructuring associate in the Wilmington office. **Christopher M. Dressel** (R) is a corporate restructuring associate in the Wilmington office. This article was originally published Jan. 19, 2022, on the firm's website. Republished with permission.

This article was published on Westlaw Today on February 4, 2022.