

Midstream Contracts in Chapter 11: Covenants Running with the Land?

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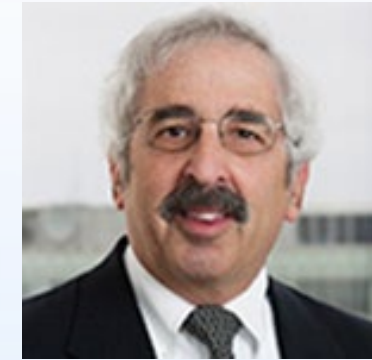
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Contract Rejection in Bankruptcy

- 11 U.S.C. § 365 allows bankrupt debtors to, subject to various conditions, assume, assume and assign, or reject executory contracts and unexpired leases in bankruptcy.
- The debtor is accorded substantial deference with respect to its decision on whether to assume or reject.
- Oil and Gas “leases,” are not subject to rejection

Real Covenants

- **Real Covenants or Covenants That Run With the Land** are covenants that are so connected to an interest in real property that the benefit and burden pass to successors in interest by operation of law.
- The requirements for real covenants vary from state to state but most are based on century-old common law principles. Likewise, states differ on how they may define the various requirements, especially touch and concern.

Elements Of Real Covenants

- Elements:
 - **FORM**
 - **INTENT**
 - **NATURE OF THE PROMISE (TOUCH & CONCERN)**
 - **PRIVITY**
 - Horizontal
 - Vertical

Elements of Real Covenants (Cont.)

- **FORM**

- Written Instrument - Compliance with Statute of Frauds
- Enforceable Between Original Covenantor and Covenantee
- Deeds, Oil and Gas Lease, Gas Purchase Contracts, Gas Gathering Agreements

- **INTENT**

- Use of the term “assigns” is evidence of intent to create a covenant running with the land
- Courts look past the form, and examine the substance. “[W]ithout more ... words do not create a covenant.” *In re Chesapeake*, Case No. 20-33233, Docket No. 1579 at *8 (Bankr. S.D.Tex. October 28, 2020)
- No requirement that the term “assigns” be included

Elements of Real Covenants (Cont.)

- **NATURE OF THE PROMISE (TOUCH & CONCERN)**
 - Affect the nature, quality or value of the THING DEMISED
 - Collateral to the THING DEMISED
 - Legal Relations Test
 - Rights, Privileges or Powers
 - Focuses on the Estate in Land and not the Owner of the Estate in Land
 - Promisor's Legal Relations in Respect to Land Lessened
 - Promisee's Legal Relations in Respect to Land Rendered More Valuable
 - **Historically Courts Have Struggled with Promises to Pay Money**

Elements of Real Covenants (Cont.)

- **PRIVITY**

- Horizontal

- Relationship between the original covenantor and original covenantee. In U.S. a contemporaneous conveyance of real property will satisfy this requirement
 - Some courts question whether horizontal privity is still necessary

- Vertical

- Relationship between original covenanting parties and successors in interest
 - Assignment/Sub-Lease Situation
 - Dovetails with Notion that Real Covenants Attach to the ESTATE IN LAND

In re Sabine Oil and Gas Corp., 547 B.R. 66, 71 (Bankr. S.D.N.Y. 2016)

- The gas gathering agreements did not contain a covenant running with the land and could be rejected.
- The covenant at issue “dedicated” all the produced oil, gas, and water from leases owned by Sabine within a specified area for transportation exclusively through the pipeline systems owned by the gatherer.

In re Sabine Oil and Gas Corp., 547 B.R. 66, 71 (Bankr. S.D.N.Y. 2016) (Cont.)

- Touch and Concern

- It is not enough for the covenant to affect the value of the land—it must affect the owner’s interest in the property or its use. Under Texas law, minerals cease to be real property and instead become personal property once extracted from the ground.
- The dedications spoke to minerals “produced and saved”

- Privity

- The grant included an easement allowing the running of a pipeline over the surface of the leased property, and the outright grant of a certain parcel of surface rights to the pipeline company, but these conveyances do not sufficiently relate to the oil and gas reserves to support a finding of privity of estate.



Monarch Midstream, LLC v. Badlands Production Co., (In re Badlands Energy, Inc.), Adv. Proc. No. 17-01429, (Bankr. Colo., Sept. 30, 2019)

- Gas gathering and salt water disposal agreements did create covenants running with the land and may not be rejected or sold free and clear of liens under 363(f).
- Touch and Concern
 - Under Utah law, the covenant must only affect the use, value, or enjoyment of the land.
 - The covenant to deliver gas produced from reserves on the land to a specific buyer or to pay money in lieu clearly affects the use and value of the land.
 - The court distinguished the contractual language in *Sabine*, holding that since the language in these contracts applied to “all gas reserves in and under” the leased property, and not just “produced” gas, the agreements truly govern real property interests, and are not merely contractual in nature.



Monarch Midstream, LLC v. Badlands Production Co., (In re Badlands Energy, Inc.), Adv. Proc. No. 17-01429, (Bankr. Colo., Sept. 30, 2019) (Cont.)

- Privity

- Horizontal privity is present because the covenants were created as part of a transaction where Badlands sold the gathering and water disposal systems to Monarch. The sale was a conveyance of real property interests that supported a finding a horizontal privity.

- Intent

- Provisions in the agreement that expressly state the intent that the contract create covenants that run with the land are dispositive under Utah law.

- 363 Implications: The property cannot be sold free and clear of the covenants

- The Bankruptcy Courts in Colorado have held that covenants are not “interests” subject to treatment under 363(f), because they create only equitable interests and are not susceptible to being reduced to a money judgment under state law.



Alta Mesa Holdings LP v. Kingfisher Midstream LLC (In re Alta Mesa Res., Inc.), Adv. Proc. No. 19-03609, (Bankr. S.D.Tex., Dec. 20, 2019)

- The gas gathering agreement did create a covenant running with the land and could not be rejected.
- Touch and Concern
 - The gas gathering contracts affect the value of the land and therefore touch and concern the land. The gathering system enhances the value of the leases on the one hand, because the dedication allowed Kingfisher to build a modern gathering system for the dedicated wells, allowing Alta Mesa to market its gas. In exchange, Alta Mesa agreed to burden the land by agreeing to dedicate its reserves to the Kingfisher system and pay agreed transportation fees.



Alta Mesa Holdings LP v. Kingfisher Midstream LLC (In re Alta Mesa Res., Inc.), Adv. Proc. No. 19-03609, (Bankr. S.D.Tex., Dec. 20, 2019) (Cont.)

- Privity

- The surface easements granted in favor of Kingfisher constitute a contemporaneous conveyance of a real property interest, which is sufficient to allow a finding of privity of estate between the contracting parties.

- Intent

- Exhibited by the agreement because there are provisions that bind successors and assigns as well as provisions that require recording the instrument in the land records.
- The contract contained clauses that identified the interests as covenants that run with the land. Although there are no “magic words” that create a covenant under Oklahoma law, this influenced the court’s decision.

In re Chesapeake Energy Corp., No. 20-33222, Docket No. 1579,
(Bankr. S.D.Tex. October 28, 2020)

- The gas purchase agreement does not contain a covenant running with the land, and may be rejected.
- Touch and Concern
 - Because the midstream company had no access to the Chesapeake lands, and their contract only requires a sale of the produced gas at the midstream entity's point of sale, the contractual relationship relates completely to personalty, i.e. the produced gas. Unlike in *Alta Mesa*, there is no right of way or any other physical grant of land.

In re Chesapeake Energy Corp., No. 20-33222, Docket No. 1579,
(Bankr. S.D.Tex. October 28, 2020) (Cont.)

- Intent

- The intent that the covenant run with the land is not present in this case because the contract excludes any relief aside from a formulaic monetary payment based on a liquidated damages provision. Specific performance, injunctive relief, and other equitable remedies are specifically excluded, thus rendering even the “magic words” that the contract intended a covenant to run with the land void.
- The fact that the parties agreed that the contract was a “forward contract” pursuant to the Bankruptcy Code is further support that this was not a real property grant.

- Privity

- The contract language itself designates the contract as a “forward contract” under Section 101 of the Bankruptcy Code which seems to cover continuous or future sales of personal property. Therefore, the contract cannot satisfy the privity concept because it is not the result of a contract that affects any real property interests.

In re Chesapeake Energy Corp., No. 20-33222, Docket No. 1579,
(Bankr. S.D.Tex. October 28, 2020) (Cont.)

- Rejection Judge Jones noted that an executory agreement could contain a covenant running with the land and be subject to rejection under 365.
- Under the Supreme Court's decision in *Mission Products Holdings, Inc. v. Tempnology*, 587 U.S. ___, 139 S. Ct. 1652 (2019), rejection is not a termination and does not void any of the pre-petition rights created by an executory contract, but simply excuses the debtor's performance, and gives rise to claims for damages by the counterparty in the form of pre-petition claims.
- Judge Isgur is also grappling with this issue in the *Sanchez Energy* case, where a decision is pending, and may result in a rejection of contract containing a covenant running with the land.

In re Extraction Oil and Gas, No. 20-11548-CSS, Docket No. 942,
(Bankr. Del. Nov. 2, 2020)

- Transportation services agreements do not contain covenants running with the land.
- Touch and Concern
 - The dedication only concerned produced minerals, i.e. personal property, and did not limit Extraction's rights to the use of its mineral estates. Therefore, because the agreements only govern rights with respect to produced hydrocarbons, and not the real property interests themselves, the covenants do not touch and concern the land.

In re Extraction Oil and Gas, No. 20-11548-CSS, Docket No. 942,
(Bankr. Del. Nov. 2, 2020) (Cont.)

- Privity

- There was no contemporaneous conveyance of any real property interest in the contract separate and apart from the dedication. There were easements granted to the gatherer but they were not granted at the time of the creation of the covenant, and they only concern the surface estate, not the subject of the covenants—the oil and gas reserves.

- Rejection

- However, even if there was a covenant running with the land, this covenant is subject to rejection under § 365.
- Rejection would excuse the debtor's future performance, including with respect to any dedication of any future produced gas, and the gatherer would retain a claim against the estate for the corresponding breach.



Southland Royalty Co. v. Wamsutter LLC, (In re Southland Royalty Co.), Adv. Proc. No. 20-50551-KBO, (Bankr. Del., Nov. 13, 2020)

- Gas gathering contract did not create a covenant running with the land, and a sale free and clear was allowed under 363(f).
- Touch and Concern
 - Southland is free to assign its working interest, Wamsutter has no right to enter the property and cannot access or control the unproduced reserves, and the only property benefited and burdened by the Wamsutter dedication is produced gas. Therefore, there is no touch and concern.



Southland Royalty Co. v. Wamsutter LLC, (In re Southland Royalty Co.), Adv. Proc. No. 20-50551-KBO, (Bankr. Del., Nov. 13, 2020) (Cont.)

- Privity

- In order for there to be privity of estate, the covenant must arise within a grant of a real property interest. Since the surface lands where the easements are granted are not the same as the minerals alleged burdened by the covenant, there is no privity of estate between the parties.

- Rejection

- Similar to *Extraction*, the court held that the contract could be rejected.
- Under Wyoming law, even if the covenant did run with the land, Southland could still reject it, because “real covenants are contractual obligations, albeit exceptional forms that bind landowners regardless of their consent.”
- So long as there remain material unperformed obligations on either side, the contract could be rejected, and the debtor would be subject to only a prepetition damages claim under 365.



Southland Royalty Co. v. Wamsutter LLC, (In re Southland Royalty Co.), Adv. Proc. No. 20-50551-KBO, (Bankr. Del., Nov. 13, 2020) (Cont.)

- 363 Implications

- The 3rd Circuit interprets the language of 363 broadly, thus capturing the covenants as an “interest in property” that may be extinguished in certain circumstances. Under 363(f)(1) a mortgage foreclosure under non-bankruptcy law would extinguish the covenant, therefore where a senior mortgage burdens the applicable property, the trustee may step in the shoes of the mortgage holders, and sell free and clear.
- Courts have wide discretion under Wyoming law to enforce covenants by way of a money judgment. Therefore, the covenant is an interest that “may be compelled ... to accept a money satisfaction,” and thus may also be extinguished by way of 363(f) sale.