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Midstream Oil & Gas Contracts Seeing Changes Following Bankruptcy Court Scrutiny

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Between every producer of oil and gas and the end users of their output there is a vast infrastructure without which the efficient distribution of natural gas and petroleum products would be impossible. Midstream oil and gas companies, as a critical piece of this infrastructure, provide transportation, storage, processing and other logistical services to upstream exploration and production (*"E&P"*) companies. The services agreements under which midstream companies operate are routinely structured as long-term contracts requiring a large initial expenditure by the midstream service providers to build infrastructure in the form of, among other things, pipes, storage, or processing facilities necessary to provide upstream customers the contracted-for services. In these cases, the midstream service providers' initial investment is only recouped over the life of the services agreement. Early termination or rejection of such agreements can therefore be devastating, particularly given that the infrastructure is often built to customer specifications and may not be transferable or otherwise usable for substitute arrangements with other customers.

Section 365 of the Bankruptcy Code provides debtors with the right to reject executory contracts or unexpired leases, but not contracts that are non-executory. Specifically, section 365(a) provides that "[e]xcept as [otherwise provided], the trustee [or debtor in possession], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." While the word "executory" is not defined in the Bankruptcy Code, most courts hold a contract to be executory if "the obligations of both parties are so far underperformed that the failure

of either party to complete performance would constitute a material breach and thus excuse the performance of the other." Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439 (1973). Courts will approve a debtor's decision to reject an executory contract unless the decision fails a highly deferential "business judgment" standard of review.

Negative easements and covenants do not create reciprocal obligations that may be excused by failure of performance and, as such, agreements that create them generally will not be subject to rejection pursuant to section 365. Covenants that are said to "run with the land" are treated as being so intrinsically linked to a particular parcel of land that the benefits and burdens arising from the covenant will apply to any owner of the given parcel and will not be treated as constituting mere contract rights between the original covenanting parties.[1]

To, among other things, mitigate the risk of having their services agreements rejected in the bankruptcy of an upstream counterparty and to protect their considerable up-front infrastructure investments, midstream service providers historically have included provisions in their services agreements purporting to convert the mutual obligations arising under such agreements into covenants running with land, with an eye to immunizing them from the risk of rejection pursuant to section 365.

Those provisions, however, largely went untested by legal challenge until the recent surfeit of E&P company bankruptcies. Those bankruptcy proceedings finally brought scrutiny to midstream services agreements and, in particular, the esoteric and largely untested provisions of these agreements that purport to convert the mutual obligations of parties to the agreements into un-rejectable covenants.

Earlier this year, the court overseeing the bankruptcy cases of Sabine Oil & Gas Corp. ("*Sabine*") and its subsidiaries refused to give effect to several such covenant provisions in midstream services agreements that Sabine had with two midstream service providers. Sabine, a Texas-based E&P company filed for bankruptcy protection in July of 2015 in the Southern District of New York. Sabine was party to pre-petition midstream services agreements with midstream service providers Nordheim Eagle Ford Gathering, LLC ("*Nordheim*") and HPIP Gonzales Holdings, LLC ("*HPIP*"). These companies provided, among other things, gas gathering and transportation services to the debtors. In September 2015, Sabine filed a motion seeking to reject its midstream services agreements with Nordheim and HPIP, which agreements expressly provided that the parties thereto intended for the agreements to create covenants that would run with the land. Under the relevant agreements, Sabine agreed to "dedicate" to the "performance" of the agreement certain leases owned by Sabine and the oil and gas produced from the wells located on the land subject to the leases. In exchange, Nordheim and HPIP agreed to construct, operate, and maintain gathering facilities for the respective leases and perform such other midstream services set out in the agreements.

The requirements for creation of a covenant that runs with the land vary from state-to-state and are not always well settled. Citing *Inwood North Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987), the *Sabine* court found that under Texas law (the applicable law governing the midstream services agreements in that case, and a jurisdiction with some of the more developed law on this topic), a covenant runs with the land when: (1) it touches and concerns the land; (2) it relates to a thing in existence or

specifically binds the parties and their assigns; (3) it is intended by the original parties to run with the land; and (4) the successor to the burden has notice." *Bench Decision on Debtors' Omnibus Motion to Authorize Rejection of Certain Executory Contracts*, *In re Sabine Oil & Gas Corp.,* No. 15-11835 (Bankr. S.D.N.Y., March 8, 2016). Further, citing *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 910-11 (Tex. 1982), the *Sabine* court noted that "[m]any courts have also required that the parties have horizontal privity of estate."[2] *Id.*

After describing the law of covenants as an "unspeakable quagmire" in an earlier non-binding opinion, the court held in its subsequent, binding opinion, that the Nordheim and HPIP contracts neither contain nor include covenants running with the land. *Mem. Decision on Motions of Nordheim Eagle Ford Gathering, LLC et al.*, *In re Sabine Oil & Gas Corp.*, No. 15-11835 (Bankr. S.D.N.Y., May 3, 2016) (Chapman, J.). The court's ruling allowed Sabine to reject the midstream services agreements at issue under section 365, with the result that the resulting breach of contract claims under those agreements were relegated to prepetition, general unsecured status. *Id.*

In reaching its decision, the court mainly focused on the "touch and concern" prong of the test for covenants running with the land under Texas law: prong (1) above. The court held that "the mineral dedications [that are covered by the applicable contracts] concern only minerals *extracted from the ground*, which indisputably constitute personal property, not real property, under Texas law." *Id.* (emphasis added). The court also held that, to the extent that horizontal privity is required for a covenant to run with the land under Texas law, no such privity existed. *Id.* The *Sabine* court found rather that the parties merely conveyed interests in, but distinct from, the property burdened by the alleged covenant, even while admitting that the interests conveyed and and the property itself were closely related. *Id.*

Legal commentators and analysts in the oil and gas industry predicted that this decision would materially affect the drafting of future midstream services agreements. This is because, prior to the *Sabine* ruling (and prior to similar challenges that were raised and settled in the bankruptcy cases of Magnum Hunter Resources Corp. and Quicksilver Resources Inc.), midstream service providers were confident that their midstream services agreements were immune from bankruptcy rejection. Since the *Sabine* ruling, midstream service providers have scrambled to assess the risk that existing midstream service agreements may also be subject to rejection in a bankruptcy proceeding of an upstream counterpart and have sought to develop new agreement language that, they hope, will stand up to future scrutiny.

Recently, another bankrupt E&P company, Warren Resources, Inc., seeking to leverage the *Sabine* decision, negotiated improved economic terms in one of its existing pre-petition midstream services agreements in exchange for agreeing to add language proposed by the midstream service provider aiming to strengthen and "clarify" the covenant provisions of the existing agreement, and to execute a new dedication instrument in an apparent attempt to remedy deficiencies identified by the *Sabine* court.

On June 2, 2016, Warren Resources and five affiliated companies had each filed a petition in the United States Bankruptcy Court for the Southern District of Texas seeking bankruptcy protection. Warren Resources is party to a midstream services agreement (styled a "Gathering Agreement") with UGI Energy Services, LLC ("*UGI*"), which provides for the transportation of natural gas and related services by UGI for the debtor. On

August 24, 2016, Warren Resources disclosed in an assumption and amendment motion (the "*Motion*") that it and various other parties in interest had been "negotiating and discussing potential amendments to the Gathering Agreement since before the Petition Date to provide the Debtors... relief from certain minimum monthly demand charges as part of the Debtors' overall restructuring efforts." *Expedited Motion for Entry of an Order (i) Authorizing the Debtors to Assume Gas Gathering Agreement, as Amended and Restated, with UGI Energy Services, LLC; (ii) Authorizing the Debtors to Enter into Related Agreements; and (iii) Granting Related Relief, Warren Resources, Inc.,* No. 16-32760 (Bankr. S.D. Tex., Aug. 24, 2016). Those negotiations reportedly resulted in an agreement for the debtors to assume the Gathering Agreement, with certain amendments.

As the debtors noted in the Motion, "UGI has asserted that it believes the Gathering Agreement, prior to amendment, contains an acreage dedication that runs with the land and therefore is not subject to assumption or rejection under section 365. Assuming the Gathering Agreement, as amended by the Restated Gathering Agreement, and entering the transactions contemplated thereby avoids what could be protracted and expensive litigation over whether the Gathering Agreement could be assumed or rejected in the first instance." *Id.*

The headline amendments to the Gathering Agreement are economic and benefit the debtor (including, among other things, a reduction of the minimum commitment of gas under the restated Gathering Agreement by 25% for a three year period, reportedly resulting in savings to the Debtors of approximately $11,169,000 during the three year period), but also include, as a concession to UGI, (i) a revision of existing language in the Gathering Agreement to "clarify" that the agreement unambiguously creates a covenant running with the land and that the parties intend for the agreement to do so, and (ii) the execution of an independent "instrument of dedication" that further acknowledges that Warren Resources agrees to dedicate and convey its "right, title and interest in and to the Produced Gas . . . from the Committed Acreage" to UGI, closely tracking the language added to the agreement itself. The stated purpose of the dedication instrument is to evidence "the existence of the [a]greement and the [d]edication [contained in the agreement]." *Id.*

The Warren Resources court approved the Gather Agreement's assumption on September 7, 2016. *Order Granting Motion to Assume/Reject, Warren Resources, Inc.,* No. 16-32760 (Bankr. S.D. Tex., Sept. 7, 2016). The new language and dedication instrument incorporated into the the Warren Resources agreement may serve as a template for future midstream agreements, although whether even those features will survive judicial scrutiny under section 365 remains to be seen.

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1. Whether a given agreement creates a covenant is a question governed by applicable state law; a representative set of factors is identified below.
2. Horizontal privity generally exists when a covenant is created in the same agreement or other instrument by which the burdened property is transferred or that the covenanting parties both share some other contemporaneous interest in the relevant property when the covenant is created.

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