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Volume 25 | Issue 1 Article 7

3-1-2021

Rejection: How Bankruptcy Courts' Treatment of Midstream Gathering Agreements Affects Underwriting and Restructuring

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Rejection: How Bankruptcy Courts' Treatment of Midstream Gathering Agreements Affects Underwriting and Restructuring[*]

JOHN J. KANE, GORDON B. RUSSELL, S. KYLE WOODARD, AND KATHLEEN THOMPSON[**]

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[*] Disclosure: The authors actively participated in the bankruptcy proceedings of Southland Royalty Company, LLC, which is discussed in this article. The authors represented a member of the Southland Royalty Company's first lien reserve-based lender and Debtor-in-Possession lending syndicates and were actively involved in the Southland litigation on behalf of the intervening lenders, which sought the rejection of Southland's gathering agreement.

[**] The authors—John Kane, Gordon Russell, Kyle Woodard, and Kathleen Thompson—owe thanks to many people for assisting with this article. Mr. Kane would like to thank his wife, Katharine Kane, for her support, patience, and editorial insights. Mr. Russell would like to thank his wife Cobie Russell, whose wit, love, and support is always appreciated. Mr. Woodard would like to thank his wife, Paige Woodard, for her inspiration, motivation, and support. Ms. Thompson would like to thank her parents, Kevin and Vickie Thompson, for their kindness, love, and assistance. The authors also thank their banking clients for trusting them with representations in some of the largest, most interesting, and occasionally challenging, oil and gas bankruptcy cases filed in 2019-2020. The authors would especially like to thank Mr. L. Johnston for his depth of knowledge, insights, and commentary on the state of all things related to oil and gas lending.

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I. INTRODUCTION: 2020—AN UGLY YEAR FOR OIL & GAS

To put it simply, 2020 was an exceptionally trying year for the United States' oil and gas industry and, as a result, for energy lenders. As 2020 began, West Texas Intermediate ("WTI") crude oil futures traded at approximately $61 per barrel.[1] On January 21, 2020, the United States Energy Information Association projected moderately declining prices through the first half of 2020, predicated in part on unrest in the Middle East and other geopolitical factors.[2] Unfortunately, WTI prices declined at a considerably steeper rate than expected. By February 1, 2020, WTI traded at approximately $50 per barrel.[3] Things would only get worse.

By then, the COVID-19 pandemic was wreaking havoc on the economies of China and several other nations, causing a dramatic decline in international demand for crude oil.[4] In its February Oil Market Report, the International Energy Association predicted a massive contraction in global demand for oil resulting from the COVID-19 pandemic.[5] At or around that same time, members of the Organization of the Petroleum Exporting Countries ("OPEC") and other non-member oil exporting

1. *Crude Oil Prices: West Texas Intermediate (WTI) – Cushing, Oklahoma 1Y*, U.S. ENERGY INFO. ADMIN., https://fred.stlouisfed.org/graph/?g=NPX [https://perma.cc/ZBX8-X9Q2] [hereinafter *Crude Oil Prices*] (last visited Dec. 16, 2020).

2. Matt French, *EIA Forecasts Crude Oil Prices Will Fall in the First Half of 2020, Then Rise Through 2021*, U.S. ENERGY INFO. ADMIN. (Jan. 21, 2020), https://www.eia.gov/todayinenergy/detail.php?id=42535 [https://perma.cc/W3EB-TCCN].

3. *Crude Oil Prices*, *supra* note 1.

4. INT'L ENERGY AGENCY, OIL MARKET REPORT - FEBRUARY 2020 1 (2020), https://www.iea.org/reports/oil-market-report-february-2020 [https://perma.cc/GAM2-QGAP].

5. *Id.* (projecting "the first quarterly contraction in more than 10 years.").

nations, led in large part by Russia,[6] engaged in discussions of additional production cuts to manage long-term pricing.[7] On Friday, March 6, 2020, those discussions collapsed when Russia refused to join in OPEC's proposed production cuts, sparking a dangerous production and pricing war between Saudi Arabia and Russia.[8] Saudi Arabia returned fire by offering dramatic discounts on the price of its oil and announcing plans to ramp up its production. The effects of that price war manifested immediately. On Monday, March 9, 2020, oil prices saw their greatest single-day decline since 1991.[9]

As COVID-19 spread, many nations, including the United States, implemented shutdowns or other "containment measures"[10] in an effort to mitigate the spread of the pandemic.[11] The combined effects of reduced global demand, the Saudi-Russia price war, and excess supply were devastating. On March 5, 2020, WTI traded at $45.90.[12] By March

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6. OPEC's member-nations and 10 non-member nations led by Russia are collectively known as "OPEC+". *See* David Hodari et al., *Oil Prices Plunge After Russia-Saudi Split*, WALL STREET J. (Mar. 6, 2020, 4:10 PM), https://www.wsj.com/articles/saudi-russian-deadlock-pushes-brent-crude-to-2-year-low-11583500044?page=53 [https://perma.cc/WR2P-RH3M].

7. Stanley Reed, *Oil Prices Nose-Dive as OPEC and Russia Fail to Reach a Deal*, N.Y. TIMES (Mar. 6, 2020), https://www.nytimes.com/2020/03/06/business/opec-oil-prices-russia.html [https://perma.cc/8ZAM-Y8AN]; *see also* Will Kennedy, *Why the OPEC-Russia Blowup Sparked All-Out Oil Price War*, BLOOMBERG (Mar. 9, 2020, 12:28 PM), https://www.bloomberg.com/news/articles/2020-03-09/why-opec-russia-blowup-sparked-all-out-oil-price-war-quicktake [https://perma.cc/W22X-L3AX].

8. Ariel Cohen, *OPEC+ Talks Collapse Sending Crude Prices to 2017 Lows*, FORBES (Mar. 6, 2020, 5:04 PM), https://www.forbes.com/sites/arielcohen/2020/03/06/opec-talks-collapse-sending-crude-prices-to-2017-lows/?sh=a644d38431d6 [https://perma.cc/AZW8-VGJK].

9. Natasha Turak, *Oil Nose-Dives as Saudi Arabia and Russia Set Off 'Scorched Earth' Price War*, CNBC (Mar. 8, 2020, 9:01 AM), https://www.cnbc.com/2020/03/08/opec-deal-collapse-sparks-price-war-20-oil-in-2020-is-coming.html [https://perma.cc/8FVF-FEPS].

10. In the U.S., these measures included, among other things, government-mandated shutdowns of non-essential businesses (*e.g.*, bars and restaurants), restrictions on international travel, and banning large public gatherings (*e.g.*, concerts, sporting events, etc.). Many state and local governments issued "stay-at-home" or "shelter-in-place" orders in attempt to limit public interaction, and many businesses required employees to work from home. *See, e.g.*, AJMC Staff, *A Timeline of COVID-19 Developments in 2020*, AM. J. MANAGED CARE (Jan. 1, 2021), https://www.ajmc.com/view/a-timeline-of-covid19-developments-in-2020 [https://perma.cc/B4DM-D7PZ]; Elvia Limon, *Here's How the COVID-19 Pandemic Has Unfolded in Texas Since March*, TEXAS TRIB. (July 31, 2020), https://www.texastribune.org/2020/07/31/coronavirus-timeline-texas/ [https://perma.cc/94FB-ECGT].

11. INT'L ENERGY AGENCY, *supra* note 4.

12. *Crude Oil Prices, supra* note 1.

30, 2020, WTI traded at $14.10.[13] WTI prices continued to collapse in April, due to concerns over a scarcity of available storage and low demand for oil.[14] Infamously, on April 20, 2020, WTI futures fell to the lowest price in United States history at -$36.98.[15] While prices improved to nearly $50 by year-end 2020, price volatility and downward demand trends proved catastrophic, resulting in roughly $145 billion in write downs among United States and European exploration and production companies.[16]

To make matters worse, natural gas fared little better than oil in 2020. As the U.S. Energy Information Administration ("EIA") explained in a July 13, 2020 report:

> In the first half of 2020, natural gas prices at the U.S. Henry Hub benchmark reached record lows. The average monthly Henry Hub spot price in the first six months of the year was $1.81 per million British thermal units (MMBtu). Monthly prices reached a low of $1.63/MMBtu in June, the lowest monthly inflation-adjusted (real) price since at least 1989. Prices started the year low because of mild winter weather, which resulted in less natural gas demand for space heating. Beginning in March, spring weather and the economic slowdown induced by mitigation efforts for the coronavirus disease 2019 (COVID-19) contributed to lower demand, further lowering prices. [17]

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13. *Id.*

14. COMMODITY FUTURES TRADING COMM'N, INTERIM STAFF REPORT, TRADING IN NYMEX WTI CRUDE OIL FUTURES CONTRACT LEADING UP TO, ON, AND AROUND APRIL 20, 2020, at 2–3 (2020), https://www.cftc.gov/media/5296/InterimStaffReportNYMEX_WTICrudeOil/download [https://perma.cc/GN2P-PMUG].

15. Catherine Ngai et al., *Oil Plunges Below Zero for First Time in Unprecedented Wipeout*, BLOOMBERG (Apr. 19, 2020, 6:28 PM), https://www.bloomberg.com/news/articles/2020-04-19/oil-drops-to-18-year-low-on-global-demand-crunch-storage-woes [https://perma.cc/N4VP-5AAY].

16. Collin Eaton & Sarah McFarlane, *2020 Was One of the Worst-Ever Years for Oil Write-Downs*, WALL ST. J. (Dec. 27, 2020, 9:00 AM), https://www.wsj.com/articles/2020-was-one-of-the-worst-ever-years-for-oil-write-downs-11609077600 [https://perma.cc/X5T2-DTU8].

17. Kristen Tsai & Stephen York, *U.S. Henry Hub Natural Gas Spot Prices Reached Record Lows in First Half of 2020*, U.S. ENERGY INFO. ADMIN. (July 13, 2020), https://www.eia.gov/todayinenergy/detail.php?id=44337 [https://perma.cc/F65F-XAVK].

Unsurprisingly, these compounding adverse market forces precipitated a flood of oil and gas related bankruptcy filings. By October 22, 2020, at least 84 oil and gas producers and oil field services companies had filed for bankruptcy relief, seeking to administer a staggering $89 billion in cumulative debt.[18]

Typically, when oil and gas prices plummet, oil and gas producers face dramatic adjustments to their borrowing bases under reserve-based loans.[19] As prices fall, borrowers' collateral—chiefly their mineral reserves—dramatically decrease in value.[20] Availability of credit under reserve-based loans is typically tied to the value of the reserves securing the loan, known as the borrowing base.[21] When the value of reserves declines, the borrowing base similarly declines, restricting a borrower's available credit.[22] Oil and gas producers therefore often file for relief to address liquidity concerns caused by borrowing base reductions.[23]

Recently, oil and gas borrowers have also used bankruptcy as a means of restructuring or disposing of disadvantageous contracts. Those efforts have led to a series of hotly contested and extensively litigated challenges involving midstream gathering agreements, and whether those gathering agreements granted midstream partners' real property interests in upstream debtors' minerals.[24] The implications of the rulings of those

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18. Artem Abramaov & Lefteris Karaagiannopoulos, *North American Oil and Gas Bankruptcy Debt Reached an All Time High in 2020 and Is Set to Grow*, RYSTAD ENERGY (Oct. 22, 2020), https://www.rystadenergy.com/newsevents/news/press-releases/north-american-oil-and-gas-bankruptcy-debt-reached-an-all-time-high-in-2020-and-is-set-to-grow/ [https://perma.cc/37F8-F4DB].

19. Paul J O'Donnell & Carin Dehne-Kiley, *Spring Reserve-Based Lending Redeterminations Result in a Liquidity Squeeze for Speculative-Grade E&P Companies*, S&P GLOBAL RATINGS (June 22, 2020, 1:09 PM), https://www.spglobal.com/ratings/en/research/articles/200622-spring-reserve-based-lending-redeterminations-result-in-a-liquidity-squeeze-for-speculative-grade-e-p-compani-11539901 [https://perma.cc/F4VT-MS54].

20. *Id.* A simple hypothetical proves this concept. If a borrower has 1,000 barrels of oil reserves in the ground and can realize $100 per barrel, the borrower's reserves are worth $100,000. If prices fall to $50 per barrel, the borrower's reserves are worth only $50,000.

21. *Id.*

22. *Id.*

23. *See id.* (at least two of the entities identified in Table 1, Extraction Oil & Gas Inc. and Chesapeake Energy Corp., filed for bankruptcy relief and are subjects of this article).

24. In the context of oil and gas operations, "upstream" refers to the production of hydrocarbons from the ground—these companies are often referred to as "exploration and production" or "E&P" companies; "midstream" refers to the transportation, storage and processing of hydrocarbons from the site of production to refineries and processing facilities;

cases are expansive. As illustrated in recent decisions, a debtor's ability to reorganize may hinge on whether it can reject uneconomic gathering agreements. Further, a court's determination of whether a midstream gathering agreement creates a real property interest can materially affect whether an upstream debtor's lender can recover fair value for its collateral. In some instances, a gathering agreement may create a real property interest so burdensome that the encumbered mineral estate may have value only the midstream gatherer, regardless of whether a senior secured lender has a lien against those assets. As one equally troubling case shows, even a debtor's successful rejection of a burdensome midstream gathering agreement may leave lenders with few options for repayment.

This article addresses, in detail, potential disputes between upstream debtors and their midstream counterparties, key cases discussing whether a debtor can reject economically disadvantageous contracts, how the risks associated with midstream contracts affect underwriting loans to upstream exploration and production companies, and recent developments in case law affecting debtors' and lenders' rights against midstream parties.

Because this article involves complex issues related to oil and gas and bankruptcy law, Part II of this article of this article provides a brief primer on the oil and gas industry, interests in minerals under state laws, gathering agreements, and how executory contracts and other claims are treated under bankruptcy law.[25] Part III of this article addresses one of the most influential recent cases concerning gathering agreements in bankruptcy—*In re Sabine Oil & Gas Corporation*[26]—and why it was

and "downstream" refers to the refining and marketing of hydrocarbons for sale to consumers. Adam Muspratt, *Introduction to Oil and Gas Industry*, OIL & GAS IQ (May 1, 2019), https://www.oilandgasiq.com/strategy-management-and-information/articles/oil-gas-industry-an-introduction [https://perma.cc/3ZEL-7V77].

25. *See infra* Part II.

26. *In re* Sabine Oil & Gas Corp., 547 B.R. 66 (Bankr. S.D.N.Y. 2016); *In re* Sabine Oil & Gas Corp., 550 B.R. 59 (Bankr. S.D.N.Y. 2016). *Sabine* involved two rulings of the bankruptcy court. In the first ruling, the court authorized Sabine to reject its midstream gathering agreements Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holdings, LLC, but the court declined to make any final determination as to whether those gathering agreements formed covenants running with the land. *Sabine*, 547 B.R. at 79–80. Sabine then filed adversary proceedings against Nordheim and HPIP seeking a declaratory ruling that the covenants did not run with the land. *Sabine*, 550 B.R. at 62. On appeal, both opinions were affirmed by the district court, *see In re* Sabine Oil & Gas Corp., 567 B.R. 869 (S.D.N.Y.

beneficial to both upstream debtors and their lenders.[27] Part IV addresses midstream companies' attempts to avoid the *Sabine* ruling, and two important decisions—*In re Alta Mesa Resources, Inc.*[28] and *In re Badlands Energy, Inc.*[29]—that contradicted and declined to follow *Sabine.*[30] Part V addresses three decisions from 2020,[31] two of which evidence a return to *Sabine* even despite the best efforts of midstream gatherers to create real property interests in their upstream counterparties' minerals.[32] Part VI addresses the *In re Southland Royalty Company*[33] conundrum, explains why an upstream debtor's ability to reject a gathering agreement is not a cure-all that enables a successful restructuring, and proposes a financing alternative that could cure some of the uncertainty associated with gathering agreements and their effects on senior encumbrances.[34] Part VII summarizes and concludes this article.[35]

II. BACKGROUND INFORMATION

A. *Oil and Gas Basics: From Geology to Gasoline—Upstream, Midstream, and Downstream Sectors*

The oil and gas industry represents a full chain of businesses that, together, locate, extract, refine, and sell petrochemical products to businesses and consumers. Generally speaking, the oil and gas industry can be broken into three discrete sectors: upstream; midstream; and downstream. The Library of Congress provides a succinct description of each of these sectors:

2017), and ultimately by the Second Circuit U.S. Court of Appeals, *see In re* Sabine Oil & Gas Corp., 734 F. App'x 64 (2d Cir. 2018).

27. *See infra* Part III.

28. 613 B.R. 90 (Bankr. S.D. Tex. 2019).

29. 608 B.R. 854 (Bankr. D. Colo. 2019).

30. *See infra* Part IV.

31. *In re* Southland Royalty Co. LLC, 623 B.R. 64, 98 (Bankr. D. Del. 2020); *In re* Chesapeake Energy Corp., 622 B.R. 274 (Bankr. S.D. Tex. 2020); *In re* Extraction Oil & Gas Inc., 622 B.R. 581 (Bankr. D. Del. 2020).

32. *See infra* Part V

33. 623 B.R. at 64.

34. *See infra* Part VI.

35. *See infra* Part VII.

> The upstream segment of the oil and gas industry contains exploration activities, which include creating geological surveys and obtaining land rights, and production activities, which include onshore and offshore drilling.[36]
>
> The midstream sector covers transportation, storage, and trading of crude oil, natural gas, and refined products . . . . [O]nce the oil has been extracted and separated from natural gas, pipelines transport the products to another carrier or directly to a refinery.[37]
>
> The downstream sector covers refining and marketing . . . . [M]arketing is the wholesale and retail distribution of refined petroleum products to business, industry, government, and public consumers.[38]

Each of the sectors is heavily reliant on each other. An upstream exploration and production company may locate, drill, and extract oil and gas from a basin in Utah but if it does so, it needs both a purchaser and a means to get its petrochemicals to a refinery, which may be in Texas or some other faraway place. As a result, it is likely to enter into what is commonly referred to as a "gathering agreement" with a midstream partner.[39] Under that gathering agreement, the midstream partner gathers extracted petrochemicals at storage tanks or at gas wellheads and transports them to a downstream partner, collecting transportation fees from the producer or purchasing and reselling the production downstream at a profit (or both).[40] The downstream partner may then refine the

36. *Upstream Production and Exploration*, LIBR. OF CONGRESS, https://guides.loc.gov/oil-and-gas-industry/upstream [https://perma.cc/CH8E-2X6P].

37. *Midstream: Transportation*, LIBR. OF CONGRESS, https://guides.loc.gov/oil-and-gas-industry/midstream [https://perma.cc/VD92-G868].

38. *Downstream: Refining and Marketing*, LIBR. OF CONGRESS, https://guides.loc.gov/oil-and-gas-industry/downstream [https://perma.cc/R6QR-8G5E].

39. *Energy Infrastructure Primer: A Guide for Both New and Experienced Investors*, ALERIAN (May 2019), https://www.alerian.com/wp-content/uploads/EI-Primer-May-2019.pdf [https://perma.cc/8LEB-XGBW]; Daniel M. Kennedy, *A Primer on Gathering and Processing Agreements and Their Impact on Asset Value*, NEWSL. (North Houston Ass'n of Prof'l Landmen, Hou., Tex.), Spring 2017, at 3, https://nhapl.org/resources/Documents/2017%20NHAPL%20Spring%20Newsletter.pdf [https://perma.cc/NUQ9-LYMS].

40. LIBR. OF CONGRESS, *supra* note 37.

petrochemicals into clean natural gas and gasoline and sell them through retail channels, including gas stations.

1. The Importance of Gathering Agreements

Upstream exploration and production companies may extract minerals from the ground in a relatively isolated place, far from developed infrastructure.[41] After petrochemicals are produced, they are generally separated into oil, gas, and water, and must be further refined before they are sold to their end users.[42] But how do they get to a refinery and to market? Produced crude oil is typically stored in large tanks near the wellhead and can be moved by truck, rail, or pipeline thereafter.[43] Natural gas, on the other hand, is typically collected at the wellhead and moved almost exclusively by pipeline either to a compression station or other area where gas is aggregated and then moved through larger pipelines to downstream partners.[44]

Developing pipelines for the transmission of petrochemicals is costly and requires considerable planning and permitting to ensure the efficient gathering, processing, pressurization, and pumping of petrochemicals through the larger interstate pipeline system.[45] As a result, midstream companies typically require upstream companies to enter into long-term gathering agreements before they will begin to develop pipeline infrastructure to the upstream companies' well heads.[46]

Gathering agreements establish the terms and conditions under which the midstream company will purchase, process, and transport the upstream company's petrochemicals. Most gathering agreements contain a "dedication" in which the upstream company promises that all of its minerals from certain geographic areas will be sold to the midstream

41. Jad Mouawad, *Oil Explorers Searching Ever More Remote Areas*, N.Y. TIMES (Sept. 9, 2004), https://www.nytimes.com/2004/09/09/business/worldbusiness/oil-explorers-searching-ever-more-remote-areas.html [https://perma.cc/27T5-ZCYY].

42. *Energy Infrastructure Primer: A Guide for Both New and Experienced Investors*, *supra* note 39.

43. *Id.*

44. Kennedy, *supra* note 39.

45. *Id.*

46. *Energy Infrastructure Primer: A Guide for Both New and Experienced Investors*, *supra* note 39.

company and transported by the midstream company during the term of the gathering agreement, which may be as long as twenty to thirty years.[47]

A dedication in a gathering agreement essentially grants the midstream company a monopoly to process, trade, and transport all of the upstream company's petrochemicals from a specific area for a slated period of time. This does two things: (1) it ensures the upstream company will always have a buyer for extracted petrochemicals; and (2) ensures the midstream company will have a revenue stream from all of the petrochemicals extracted by the upstream company. The midstream company can generally determine the volume of petrochemicals that the upstream company is likely to extract during the term by analyzing the upstream company's reserve reports and other pertinent data, and so have a reasonable idea of the likely profits it might earn during the term of the gathering agreement. Those profits are used to offset the cost of constructing the pipeline infrastructure and linking the upstream company's wells to the midstream company's pipeline system. The monopolistic dedication is central to the business arrangement between upstream and midstream entities and is used to mitigate risks of nonpayment and to preclude competition from other midstream companies.[48]

2. Interests in Minerals

Below is an actual example of a dedication from a gathering agreement between an upstream exploration and production company and its midstream partner:

> Shipper dedicates to the performance of this Agreement the Dedicated Properties and Dedicated Gas and grants to Williams the exclusive right to Gather, Process, Dehydrate and Treat the Produced Dedicated Gas ("Dedication"). This Dedication shall be a covenant running with the land under applicable law and binding on the respective successors and assigns of the interests of Shipper and its Affiliates in and to the Dedicated Properties and Dedicated Gas. If applicable law requires

47. *Id*; Kennedy, *supra* note 39.
48. Kennedy, *supra* note 39.

> any amendment or modification to this Agreement for this Dedication to be treated as an enforceable covenant running with the land, the parties will promptly enter into any such addendum or modification. Gatherer may file memoranda of this Agreement substantially in the form of Exhibit "J" in local land records from time to time in its discretion, and Shipper will promptly enter into any such memoranda upon request.[49]

The dedication includes a pledge of all of the upstream company's minerals associated with certain leases or geographic areas. The monopolistic pledge combined with the thirty-year term found in this gathering agreement mitigates the midstream company's risk of loss associated with developing its pipeline infrastructure to the upstream company's wells.

Even so, the midstream company is not without risk. While the dedication purports to convey an interest in minerals to the midstream company, parties to this and similar gathering agreements have hotly litigated just what type of interest in minerals was *actually* conveyed to the midstream gatherer.[50] As detailed in cases like *Alta Mesa* and *Extraction*, addressed below, the nature of the interest conveyed in a gathering agreement can materially affect the contract parties' rights in bankruptcy.

There are two types of interests that can be conveyed by dedications in gathering agreements: (1) real property interests or (2) personal property interests. Rules differ by state for classifying oil and gas interests as either real or personal property. Therefore, whether an oil and gas leasehold interest constitutes a real or personal property interest hinges on the case law of the particular state where the oil and gas property is located. Under Texas law, for instance, an oil and gas

49. First Amended Complaint for Avoidance and Related Declaratory Relief, Exhibit B, Gas Gathering, Processing, Dehydrating and Treating Agreement between Wamsutter LLC and Southland Royalty Company LLC (the "Wamsutter L63 Agreement") at § 1.1(a), *In re* Southland Royalty Company, LLC Adv. Proc. No. 20-50551 (KBO) (Bankr. D. Del. Nov. 13, 2020), Adv. D.I. 28.

50. *See, e.g.*, *In re* Sabine Oil & Gas Corp., 550 B.R. 59, 62 (Bankr. S.D.N.Y. 2016); *In re* Alta Mesa Res., Inc., 613 B.R. 90 (Bankr. S.D. Tex. 2019);*In re* Badlands Energy, Inc., 608 B.R. 854 (Bankr. D. Colo. 2019); *In re* Southland Royalty Co. LLC, 623 B.R. 64, 79 (Bankr. D. Del. 2020); *In re* Chesapeake Energy Corp., 622 B.R. 274 (Bankr. S.D. Tex. 2020); *In re* Extraction Oil & Gas Inc., 622 B.R. 581 (Bankr. D. Del. 2020).

lease creates a determinable fee interest that vests the lessee with title to the hydrocarbons thereunder. As explained by the Texas Supreme Court:

> The term "lease," when used in an oil and gas context, is a misnomer. The estate created by the oil and gas lease is not the same as those interests created under a "lease" governed by the law of landlord and tenant.
>
> The common oil and gas lease creates a determinable fee. It vests the lessee with title to oil and gas in place. It logically follows, and has long been held by this court, that an oil and gas lease is a sale of an interest in land.[51]

Under Texas law, conveyances of minerals in the ground through a mineral lease generally constitute conveyances of real property interests, which typically cannot be rejected by a debtor in bankruptcy.[52] Kansas law, however, is entirely different and "an oil and gas lease does not create any present vested estate in the nature of title to the land which it covers or to the oil and gas in place."[53] In other words, oil and gas leases do not convey any interest in real property under Kansas law. Rather, the lease "merely conveys a license to enter upon the land and explore for such minerals and if they are discovered to produce and sever them."[54] Consequently, Kansas oil and gas leases are considered executory contracts that may be rejected under section 365 of the Bankruptcy Code.[55]

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51. Cherokee Water Co. v. Forderhause, 641 S.W.2d 522, 525 (Tex. 1982) (citations omitted); *see also* Anadarko Petroleum Corp. v. Thompson, 94 S.W.3d 550, 554 (Tex. 2002) ("A Texas mineral lease grants a fee simple determinable to the lessee.").

52. *In re* Topco, Inc., 894 F.2d 727, 739 n. 17 (5th Cir. 1990) ("While we interpret the Bankruptcy Code as a matter of federal law, state law determines whether these contracts constitute unexpired leases subject to Section 365. In Texas, they do not. Instead, they convey interests in real property. The term "oil and gas lease" is a misnomer because the interest created by an oil and gas lease is not the same as an interest created by a lease governed by landlord and tenant law. As the district court noted, the so-called leaseholds at issue in this case actually constitute determinable fee interests." (citations omitted)).

53. *In re* J. H. Land & Cattle Co., 8 B.R. 237, 239 (Bankr. W.D. Okla. 1981) (quoting Ingram v. Ingram, *214 Kan. 415, 521 P.2d 254, 257 (1974)*).

54. *Id.*

55. *Id.* The "Bankruptcy Code" refers to title 11 of the United States Code. 11 U.S.C. §§ 101, et seq.

Oil and gas interests are also affected by the distinction drawn between hydrocarbons in the ground and those that have been extracted or produced. As for the cases concerned herein, Texas, Utah, Oklahoma, Colorado, and Wyoming all consider oil and gas hydrocarbons to be real property while remaining in the ground, but personal property once extracted from the ground.[56] This distinction proved to be instrumental in bankruptcy disputes over midstream gathering agreements.

The central question to this article is whether language that purports to grant a midstream gatherer an interest in the upstream debtor's in-ground minerals *actually* results in the conveyance of a real property interest in those minerals. Generally speaking, it is much easier to convey a personal property interest in minerals through a midstream dedication than a real property interest, because midstream companies typically deal only with personal property—*i.e.*, extracted hydrocarbons.[57] An upstream debtor's pledge to run all of its extracted minerals through the midstream counterparty's pipeline creates contractual interests in the upstream party's personal property—the extracted minerals—and creates

56. Texas: *In re* Sabine Oil & Gas Corp., 547 B.R. 66, 77 (Bankr. S.D.N.Y. 2016). ("Under Texas law, once minerals are extracted from the ground, such minerals cease to be real property and instead become personal property.") (citing *Sabine Prod. Co. v. Frost Nat. Bank of San Antonio,* 596 S.W.2d 271, 276 (Tex. Civ. App. 1980); *Colorado Interstate Gas Co. v. Hunt Energy Corp.,* 47 S.W.3d 1, 10 (Tex. App. 2000), *pet. denied*; *Riley v. Riley,* 972 S.W.2d 149, 155 (Tex. App. 1998); *Phillips Petroleum Co. v. Adams,* 513 F.2d 355, 363 (5th Cir.1975); *see also In re* Estate of Ethridge, 594 S.W.3d 611, 616 (Tex. App. 2019).

Utah: *In re* Badlands Energy, Inc., 608 B.R. 854, 869 (Bankr. D. Colo. 2019) ("Under Utah law, 'real property' includes non-extracted minerals."); UTAH CODE ANN. § 57-1-1(3) ("'Real property' or 'real estate' means any right, title, estate, or interest in land, including all nonextracted minerals located in, on, or under the land . . . .").

Oklahoma: *In re* Alta Mesa Res., Inc., 613 B.R. 90, 99 (Bankr. S.D. Tex. 2019). ("Oklahoma draws a distinction between hydrocarbons resting beneath the ground and those that have been extracted. Oil and gas is considered real property while it remains in the ground. After the oil and gas is severed from the ground, it becomes personal property.") (citing Local Fed. Sav. & Loan Ass'n of Okla. City v. Eckroat, 186 Okla. 660, 100 P.2d 261, 263 (1940)).

Colorado: Bill Barrett Corp. v. Lembke, 2018 COA 134, ¶ 26, *aff'd on other grounds*, 2020 CO 73, ¶ 26, 474 P.3d 46 ("'[W]hile in place, minerals are real property.'") (quoting Smith v. El Paso Gold Mines, Inc., 720 P.2d 608, 609 (Colo. App. 1985)).

Wyoming: Denver Joint Stock Land Bank of Denver v. Dixon, 57 Wyo. 523, 122 P.2d 842, 845 (1942) ("It is true, of course, that when oil and gas have been brought to the surface, they become personal property.").

57. *See, e.g.,* Findings of Fact and Conclusions of Law on Plaintiff's Motion for Summary Judgment against Defendant, Grand Mesa Pipeline, LLC; And Defendant's Motion For Permissive Abstention, at 17, *In re* Sabine Oil & Gas Corp., 567 B.R. 869, 876 (S.D.N.Y. 2017); *In re* Extraction Oil & Gas, Inc., Case No. 20-11548 (CSS) (Bankr. D. Del. Oct. 14, 2020), D.I. 834.

what is, in essence, a services contract for a set term.[58] Dedicating minerals in a way that creates a real property interest is more complicated. For example, in Wyoming and many other states,[59] a dedication of minerals can create a covenant that runs with the land only if four elements are met: (1) the original covenant must be enforceable; (2) the parties to the original covenant must have intended that the covenant run with the land; (3) the covenant must "touch and concern" the land; and (4) there must be privity of estate between the parties to the dispute.[60]

3. Why it Matters

The distinction between real and personal property interests in minerals can be critical for an upstream debtor in bankruptcy and for a midstream company as its creditor. While section 365 of the Bankruptcy Code entitles bankrupt debtors to assume or reject executory contracts, it does not enable a debtor to reject or otherwise avoid obligations arising under a covenant that runs with the land. Covenants that run with the land are not executory contracts and cannot be rejected.[61]

If a gathering agreement's dedication does not grant the midstream company a real property interest in the upstream debtor's minerals, the upstream debtor may reject the contract and seek to negotiate more favorable terms with its midstream counterparty, or even a new midstream competitor. If, however, the gathering agreement grants the midstream company a real property interest, the upstream debtor is bound to the gathering agreement even if its terms are so economically penal due to changes in market conditions that the agreement will preclude the debtor from successfully reorganizing or even selling its interests in bankruptcy.

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58. *In re* Southland Royalty Co. LLC, 623 B.R. 64, 79 (Bankr. D. Del. 2020).

59. *See, e.g.*, Noyes v. McDonnell, 1965 OK 16, 398 P.2d 838 (Okla. 1965) (applying same elements under Oklahoma law); Flying Diamond Oil Corp. v. Newton Sheep Co., 776 P.2d 618, 623 (Utah 1989) (applying same elements under Utah law); *see also* LuMac Dev. Corp. v. Buck Point Ltd. Partnership, 61 Ohio App. 3d 558, 562, 573 N.E.2d 681 (1988) (applying same elements under Ohio law).

60. Jacobs Ranch Coal Co. v. Thunder Basin Coal Co., LLC, 2008 WY 101, ¶ 9, 191 P.3d 125, 129 (Wyo. 2008) (citing elements for creation of covenant running with land).

61. *See, e.g.*, *Alta Mesa*, 613 B.R. 90, 95.

B. Restructuring and Gathering Agreements in Bankruptcy Cases

1. Bankruptcy Basics

In the United States, bankruptcy proceedings are governed by what is commonly referred to as the Bankruptcy Code, codified under Title 11 of the United States Code.[62] A debtor initiates a bankruptcy case by filing a petition for bankruptcy relief with the bankruptcy court.[63] The date on which a debtor files a petition for bankruptcy relief is known as the "petition date".[64] Claims are treated differently under the Bankruptcy Code depending on whether they arose prior to or after the petition date.[65]

This article focuses on bankruptcy cases in which upstream debtors attempt to restructure their debts or reorganize their business operations. Corporate reorganizations typically take place under Chapter 11 of the Bankruptcy Code.[66] A corporate debtor who files a petition for relief under Chapter 11 of the Bankruptcy Code continues to operate its business after the petition date as a "debtor-in-possession."[67] In a Chapter 11 bankruptcy case, a debtor may attempt to restructure debts and exit bankruptcy as a going concern through a plan of reorganization,[68] or it may liquidate its assets through a bankruptcy sale commonly known as a "363 sale".[69]

2. Executory Contracts in Bankruptcy

To facilitate reorganizations, the Bankruptcy Code allows debtors to assume or reject economically disadvantageous executory contracts and unexpired leases.[70] While the term "executory contract" is not

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62. 11 U.S.C. § 101 *et seq.* (2018).

63. *Id.* § 301(a) ("A voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter.").

64. *See generally id.* § 101.

65. *See generally* 11 U.S.C. §§ 1101, 1116.

66. *Id.* § 1121.

67. *Id.* § 1107.

68. *See generally, id.* § 1129.

69. *See generally, id.* § 363.

70. *See generally*, *id.* § 365; *see also* PRACTICAL LAW BNKR. & RESTRUCTURING & PRACTICAL LAW FIN., EXECUTORY CONTRACTS AND LEASES: OVERVIEW (2020), Thompson Reuters Practical Law 8-381-2672.

defined under the Bankruptcy Code, it has been oft described by bankruptcy courts as "a contract under which the obligation of both the bankrupt [debtor] and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[71] In its simplest form, an executory contract is a contract pursuant to which both parties have continuing duties and obligations.

Certain categories of contracts may not be assumed or rejected under the Bankruptcy Code, either because they are not executory or because they create some type of non-extinguishable interest. For example, at least one court has ruled that a contract that conveys an interest in real property, or that creates a covenant running with the land, cannot be rejected in bankruptcy[72]—a concept particularly relevant to this article. Additionally, loans or other financing arrangements are generally not executory contracts subject to assumption or rejection because the lender has no substantial performance obligations remaining.[73] Financing agreements are not executory contracts if the only performance that remains is repayment.[74] Security agreements are likewise not executory where the security interest thereunder has fully vested.[75]

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71. U.S. DEP'T OF JUSTICE, JUSTICE MANUAL, CIVIL RESOURCES MANUAL ch. 59, ¶ II, https://www.justice.gov/jm/civil-resource-manual-59-executory-contracts-bankruptcy [https://perma.cc/D35V-LL98] (last visited Feb. 3, 2021) (citing Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. R. 439, 460 (1973)); *In re* Murexco Petroleum, Inc., 15 F.3d 60 (5th Cir. 1994); *In re* Texscan Corp., 976 F.2d 1269 (9th Cir. 1992); United States v. Floyd, 882 F.2d 233, 235 (7th Cir. 1989); Sharon Steel Corp. v. National Fuel Gas Distrib. Corp., 872 F.2d 36, 39 (3d Cir. 1989); *In re* Speck, 798 F.2d 279, 279-80 (8th Cir. 1986); Gloria Mfg. Corp. v. International Ladies Garment Workers' Union, 734 F.2d 1020, 1021 (4th Cir. 1984); *In re* Chateaugay Corp., 130 B.R. 162, 164 (S.D.N.Y 1991).

72. *In re* Badlands Energy, Inc., 608 B.R. 854, 875 (Bankr. D. Colo. 2019) ("Because the Agreements are covenants that run with the land under Utah law, Section 365 is simply not available."); *Sabine*, 567 B.R. 869, 874 ("[I]t is not possible for a debtor to reject a covenant that "runs with the land," since such a covenant creates a property interest that is not extinguished through bankruptcy.").

73. *In re* Cox, 179 B.R. 495, 498 (Bankr. N.D. Tex. 1995) ("Under the SmartBuy Contract, the parties do not have substantial obligations outstanding because the only performance remaining is the repayment of GMAC under the Contract.").

74. *Id.* ("A note is not an executory contract if the only performance that remains is repayment."); *In re* Texstone Venture, Ltd., 54 B.R. 54, 56 (Bankr. S.D. Tex. 1985) ("The legislative history of § 365 indicates that a note is not an executory contract if the only performance that remains is repayment.").

75. Leasing Serv. Corp. v. First Tennessee Bank Nat. Ass'n, 826 F.2d 434, 437 (6th Cir. 1987) ("[I]n the present case, the security interest granted to LSC to secure Metler's obligation under the leases was fully vested. The consideration for the grant of the security interest was the lessor agreeing to lease the cranes to Metler and LSC agreeing to take an assignment of

While there are exceptions to a debtor's ability to assume an executory contract like those mentioned above, a debtor may typically assume an executory contract by (1) curing any outstanding defaults and (2) providing the counterparty adequate assurance of future performance.[76] In other words, the debtor must pay what it owes, and prove that it can pay obligations under the contract as they come due in the future. Importantly, if a debtor is going to assume a contract, it must assume all of the terms of the contract.[77] A debtor cannot assume only beneficial provisions of an executory contract or reject adverse provisions. It must assume or reject the contract in its entirety.

Alternatively, a debtor can reject the executory contract. Rejection is treated as a statutory breach of contract and gives rise to a claim for rejection damages.[78] A creditor's rejection damages claim is treated as a pre-petition general unsecured claim and is paid near the very bottom of the bankruptcy claims payment hierarchy detailed below.[79]

A debtor's ability to assume or reject executory contracts is, therefore, a powerful weapon.[80] It can, in effect, convert costly future

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the leases. Thus, the security interest was non-executory and therefore not subject to the rejection power of the trustee.").

76. 11 U.S.C. § 365(b) (2018).

77. N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 531–32 (1984) ("Should the debtor-in-possession elect to assume the executory contract, however, it assumes the contract *cum onere* . . . ."); *In re* Texstone Venture, Ltd., 54 B.R. 54, 56 (Bankr. S.D. Tex. 1985) ("It is elementary that if a contract is to be rejected, it must be rejected in whole and not in part. Thus, the Debtor cannot retain those aspects of the contract to his benefit while rejecting the burdensome aspects of the contract. 'It is axiomatic that an assumed contract under Section 365 is accompanied by all of its provisions and conditions . . . a debtor may not retreat to this provision, derived from the inherent equitable powers of the bankruptcy courts to avoid an obligation while it enjoys a benefit which arises in conjunction with that obligation.'") (quoting *In re* Holland Enterprises, Inc., 25 B.R. 301, 303 (E.D.N.C., 1982)).

78. 11 U.S.C. § 365(g) ("Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease . . . ."); *In re* FBI Distribution Corp., 330 F.3d 36, 42 (1st Cir. 2003) ("If the contract is rejected, . . . the contract is deemed breached on the date 'immediately before the date of the filing of the petition . . . .'").

79. 11 U.S.C. § 502(g); Bildisco, 465 U.S. 513, 531 (citing 11 U.S.C. §§ 502(g), 507) ("Damages on the contract that result from the rejection of an executory contract … must be administered through bankruptcy and receive the priority provided general unsecured creditors."); *FBI Distribution Corp.*, 330 F.3d 36, 42 (citing to 11 U.S.C. § 365(g)(1) regarding rejection damages) ("[T]he nondebtor party has a prepetition general unsecured claim for breach of contract damages, one not entitled to administrative priority.").

80. *See, e.g.*, Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1310 (5th Cir. 1985) ("[Section 365 of the Bankruptcy Code] provides a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so.").

obligations into pre-petition general unsecured claims likely to be paid pennies on the dollar.[81] As a result, debtors often threaten rejection in order to obtain contractual concessions, price improvements, and favorable lease amendments before agreeing to assume the contract.[82] If those threats fail, debtors may simply reject uneconomical executory contracts and move on.

3. Claim Payment Hierarchy: The Waterfall of Funds[83]

In most Chapter 11 reorganizations, there are insufficient funds to pay all creditors in full. Whether a creditor is paid in full, pennies on the dollar, or not at all, generally depends on what type of claim the creditor has. Claims are paid according to a statutory hierarchy under the Bankruptcy Code often referred to as the "absolute priority rule."[84] The absolute priority rule provides that all creditors holding a claim of a type higher up the claim hierarchy must be paid in full before any creditor holding a claim of a type lower on the hierarchy is paid anything.[85]

Atop the claim hierarchy are claims secured by collateral that were properly perfected as of the petition date.[86] The Bankruptcy Code provides that such claims must be paid up to the value of the collateral.[87] If, however, an alleged secured claim was not perfected on the petition date, a debtor or trustee may be able to avoid any alleged lien,[88] thus

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81. For example, as further discussed herein, Southland Royalty Company's ability to reorganize in Chapter 11 hinged almost exclusively on rejected its burdensome midstream gathering agreements in order to generate any interest in its assets from potential buyers.

82. *See, e.g.*, Debtors' Omnibus Reply to Objections to the Third Amended Joint Plan of Reorganization of Triangle USA Petroleum Corporation and its Subsidiary Debtors, at ¶ 14-17, *In re* Triangle USA Petroleum Corporation, Case No. 16-11566 (MFW) (Bankr. D. Del. Mar. 8, 2017), D.I. 807 (discussing debtors' alleged "'high stakes strategy' of threatening rejection to bring about negotiations" to revise their midstream agreements).

83. Author John Kane thanks his former partner Jason Binford for his assistance preparing this synopsis of the claim payment hierarchy in bankruptcy cases.

84. *See* 11 U.S.C. § 1129(b)(2).

85. *See* Bank of Am. Nat'l Trust & Savs. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 442 (1999); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 115–16 (1939), *superseded by statute as stated in In re* Greystone III Joint Venture, 95 F.2d 1274 (5th Cir. 1991) (citing Louisville Trust Co. v. Louisville N.A. & C. Ry. Co., 174 U.S. 552 (1889)).

86. *See* 11 U.S.C. § 1129(b)(2).

87. *See id.* § 506(a)(1) (providing that a creditor's claim is secured up to the value of the underlying collateral); *id.* § 1129(b)(2)(A) (discussing how secured claims must be treated in a plan of reorganization). Generally speaking, secured creditors are not entitled to full payment for the amount of their claim in excess of the collateral's value. *See id.* § 506.

88. *See* 11 U.S.C. § 544(a).

sending the creditor plummeting down the hierarchy to join the ranks of the unsecured creditors.

Administrative expense claims sit just below secured claims on the claim hierarchy.[89] Administrative expense claims arise out of the administration of the debtor's business post-petition, and include professional fees, post-petition rent, and post-petition operational expenses.[90] Payment of administrative expense claims is critical to a successful reorganization and must, by statute, be paid in full upon confirmation of a plan of reorganization.[91] If a debtor cannot pay its administrative expense claims, it is deemed administratively insolvent, and cause exists to convert a reorganization into a Chapter 7 liquidation.[92]

Immediately junior to administrative expense claims are priority claims.[93] Priority claims are unsecured claims that Congress decided that debtors should pay before other types of unsecured claims.[94] These include certain wage claims payable to the debtor's employees, certain taxes, and claims payable for public policy reasons, such as alimony and child support.[95]

Unsecured claims that do not fall into any of priority categories are known as "general unsecured claims."[96] General unsecured claims may consist of things like unpaid pre-petition trade debt, unpaid pre-petition rent, or rejection damages claims.[97] General unsecured claims typically make up a large portion of the debts owed by a bankrupt debtor but, because they are junior to nearly all other classes of claims, they are typically paid only pennies on the dollar, if anything at all.[98]

89. *See* 11 U.S.C. § 503(b).

90. *See id.* (administrative expenses include "the actual, necessary costs and expenses of preserving the estate" including certain post-petition costs and expenses, and professional fees awarded under 11 U.S.C. § 330, among others).

91. *See id.* § 1129(a)(9).

92. *See id.* § 1112(b)(4)(A). Cause includes "substantial or continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation." A debtor cannot "rehabilitate" or reorganize if it cannot pay all allowed administrative expense claims on the effective date of a plan of reorganization. 11 U.S.C. § 1129(a)(9).

93. *Id.* § 507(a); *see also id.* § 503.

94. *See id.* § 507.

95. *Id.*

96. *See id.* §§ 506–507 (referred to as "general" unsecured claims to differentiate them from "priority" unsecured claims because they receive no special treatment under the Bankruptcy Code.)

97. *See* § 502(g).

98. *See id.* § 1129(b); and *see* Baird, Bris & Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study*, AM. BANKR. INST. (Nov. 2005) (discussing

Finally, at the very bottom of the claim hierarchy are the debtor's equity interest holders.[99] Equity interest holders receive distributions from the estate only in the rare event that all other creditors are paid in full, plus post-petition interest.[100]

4. The Executory Contract Battleground

As noted above, if a gathering agreement grants a midstream company a real property interest in the upstream debtor's minerals, the debtor cannot reject the gathering agreement.[101] As a result, the debtor must continue post-petition performance under the gathering agreement. The upstream debtor's post-petition obligations under the gathering agreement are administrative expenses[102] which must be paid in full for the debtor to effectuate a reorganization.[103] Moreover, if the midstream party to the gathering agreement is a beneficiary of a covenant running with the land, its interests attach to minerals in the ground. As a result, it must receive those minerals once extracted as required by the gathering agreement, thereby securing a future revenue stream. Midstream parties to gathering agreements therefore have a vested interest in obtaining a real property interest in the upstream debtor's minerals and vigorously contesting whether their gathering agreement is subject to rejection.

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distribution percentages to unsecured creditors in chapter 11 reorganizations) http://commission.abi.org/sites/default/files/priority.pdf [https://perma.cc/PHB4-DMPM].

99. *Id.* § 726(a)(6).

100. *See id.*; *see also In re* La. Indus. Coatings, Inc., 31 B.R. 688, 697 (Bankr. E.D. La. 1983).

101. *See In re* Badlands Energy, Inc., 608 B.R. 854, 875 (Bankr. D. Colo. 2019) ("Because the Agreements are covenants that run with the land under Utah law, Section 365 is simply not available."); *see also In re* Sabine Oil & Gas Corp., 567 B.R. 869, 874 (S.D.N.Y. 2017) ("[I]t is not possible for a debtor to reject a covenant that "runs with the land," since such a covenant creates a property interest that is not extinguished through bankruptcy.").

102. *In re* Applied Theory Corp., 312 B.R. 225, 237 (Bankr. S.D.N.Y. 2004) ("Section 503(b) allows administrative expense treatment for 'the actual, necessary costs and expenses of preserving the estate. . . for services rendered after the commencement of the case.' . . . [A]n expense is administrative only if it arises out of a transaction between the creditor and the bankrupt's trustee or debtor in possession, and 'only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business.'") (citation omitted).

103. *See* 11 U.S.C. § 1129(a)(9)(A) (requiring claims under Bankruptcy Code sections 507(a)(2)—i.e., administrative claims under section 503(b)—to be paid in full on the effective date of the plan in order for the plan to be confirmed); 11 U.S.C. § 507(a)(2).

By contrast, upstream debtors in bankruptcy benefit greatly if they have the flexibility to reject a gathering agreement as an executory contract.[104] If the terms of the gathering agreement become financially punitive due to market volatility or pricing issues, as they did in 2020, debtors may wish to reject the contract and either seek a new midstream partner or negotiate an updated "market" gathering agreement that offers reduced volume requirements and economic terms that account for depressed prices.[105] While rejection of a gathering agreement may give rise to a massive rejection damages claim in favor of the midstream party, that claim is treated as a general unsecured claim and may receive only a small fraction of its face value, if anything at all.[106]

Unsurprisingly, as oil and gas prices precipitously declined in 2020, some upstream debtors' gathering agreements grew increasingly financially onerous. Multiple upstream debtors were left with little choice but to file for bankruptcy relief and sue to reject those gathering agreements as executory contracts.[107] In three recent decisions,[108] the debtors' ability to restructure hinged on whether gathering agreements

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104. *See supra* note 81 regarding Southland's need to reject its gathering agreements in order for its reserve to be marketable.

105. *See* Debtors' Omnibus Reply to Objections to the Third Amended Joint Plan of Reorganization of Triangle USA Petroleum Corporation and its Subsidiary Debtors, *supra* note 82, at ¶ 3 ("The Debtors are saddled with substantially higher lease operating expenses . . . because much of their oil and gas production is "dedicated" to Caliber at above-market rates pursuant to the Specified Caliber Contracts. The Debtors negotiated the Specified Caliber Contracts during a period of strong commodity prices and rapid production growth . . . . The Specified Caliber Contracts . . . do not reflect the precipitous decline in commodity prices . . ., [placing] the Debtors at a systematic competitive disadvantage. The rejection or renegotiation of the Specified Caliber Contracts therefore remains an important restructuring objective.").

106. *See, e.g.*, Order Confirming Fifth Amended Joint Chapter 11 Plan of Reorganization of Chesapeake Energy Corporation and its Debtor Affiliates at Exhibit A, Fifth Amended Joint Chapter 11 Plan of Reorganization of Chesapeake Energy Corporation and its Debtor Affiliates, *In re* Chesapeake Energy Corp., 622 B.R. 274 (Bankr. S.D. Tex. Jan. 16, 2020) Case No. 20-33233. D. I. 2915. Chesapeake's confirmed chapter 11 plan provided for a maximum five percent (5%) recover to holders of unsecured claims (in addition to equity interest in the reorganized entity). *Id.*

107. Allison Good, *As Upstream Bankruptcies Loom, Oil and Gas Pipelines Brace for Contract Disputes*, S&P GLOBAL MKT. INTEL. (June 17, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/as-upstream-bankruptcies-loom-oil-and-gas-pipelines-brace-for-contract-disputes-58985313 [https://perma.cc/5GVW-H9ZR].

108. *In re* Extraction Oil & Gas, Inc., 622 B.R. 581 (Bankr. D. Del. 2020); *In re* Southland Royalty Co. LLC, 623 B.R. 64 (Bankr. D. Del. 2020); *In re* Chesapeake Energy Corp., 622 B.R. 274 (Bankr. S.D. Tex. Jan. 16, 2020).

were executory contracts subject to rejection, or were instead real property covenants burdening the debtors' mineral interests. Before analyzing those cases, it is important to first understand the progression of both case law and dedication language in gathering agreements that led to such hotly contested litigation and three significant rulings in 2020.

III. *IN RE SABINE OIL & GAS CORPORATION*: GATHERING AGREEMENTS AS EXECUTORY CONTRACTS

From approximately 2011 through mid-2014, United States crude oil prices were favorable, and often exceeded $100 per barrel.[109] Towards the end of 2014, however, prices precipitously dropped as global production exceeded demand due in part to considerably increased production by United States' shale oil producers.[110] As prices declined, many upstream entities filed for bankruptcy relief as production became unprofitable.[111] One such entity was Sabine Oil & Gas Corporation ("Sabine").[112]

A. Sabine's Contractual Dedications

Prior to filing for bankruptcy relief, Sabine, an upstream exploration and production company, entered into gathering agreements with HPIP Gonzales Holdings, LLC ("HPIP") and Nordheim Eagle Ford Gathering, LLC ("Nordheim"), its midstream counterparties, for the collection, processing, and transportation of oil, gas, gas condensate, and water produced from Sabine's wells.[113] Sabine's gathering agreements with HPIP and Nordheim were very similar. In each Nordheim gathering agreement Sabine "dedicate[d] for gathering and dehydration … all [gas and condensate] produced and saved … from wells … located within the

109. Hanna Breul, *Crude Oil Prices Down Sharply in Fourth Quarter of 2014*, U.S. ENERGY INFO. ADMIN. (Jan. 6, 2015), https://www.eia.gov/todayinenergy/detail.php?id=19451 [https://perma.cc/4TM3-NLY5].

110. *Id.*

111. Matt Egan, *U.S. Oil Bankruptcies Spike 379%*, CNN BUSINESS (Feb. 11, 2016, 10:59 AM), https://money.cnn.com/2016/02/11/investing/oil-prices-bankruptcies-spike/index.html [https://perma.cc/ZQN6-7YUK].

112. *In re* Sabine Oil & Gas Corp., 550 B.R. 59, 62 (Bankr. S.D.N.Y. 2016), *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017), *aff'd*, 734 F. App'x 64 (2d Cir. 2018).

113. *In re* Sabine Oil & Gas Corp., 567 B.R. 869, 872 (S.D.N.Y. 2017), *aff'd,* 734 F. App'x 64 (2d Cir. 2018).

Dedicated Area…"[114] As summarized by the court, the Nordheim gathering agreements obligated Sabine to deliver "all of the gas and condensate it produced from a particular area to Nordheim."[115] In addition, the Nordheim agreements contemplated an additional conveyance of land from Sabine to Nordheim on which Norheim would construct its gathering facilities and pipelines.[116]

Under the HPIP agreements, "HPIP agreed to perform gathering services with respect to all of the oil, gas, and water produced by Sabine from a 'Dedicated Area' over which Sabine held certain leases, and to construct the facilities required for those services."[117] As a key part of those agreements, Sabine "dedicate[d] and commit[ted] to the performance of this Agreement and the Leases and all of [Sabine]'s owned or controlled Production *produced and saved* from [Sabine]'s operated Wells located on the Leases" and "covenant[ed] to deliver the same to [HPIP]."[118]

Under the Nordheim and HPIP agreements, the parties agreed that Sabine would retain title to the mineral leases in question, but that each gathering agreement established a "real right and covenant running with the lands and the leasehold interests" covered by the dedication, and that the gathering agreements would be "binding on the parties' successors."[119]

B. The Rejection Battleground: Covenant Running with the Land or Executory Contract?

Two months after filing for bankruptcy relief, Sabine moved to reject the Nordheim gathering agreements as economically disadvantageous executory contracts.[120] After preliminary hearings, Sabine's motion was converted into an adversary proceeding—a full-fledged lawsuit in bankruptcy court—to litigate whether the gathering

114. *Id.*
115. *See id.*
116. *Id.*
117. *Id.*
118. *Id.* (emphasis added).
119. *Id.*
120. *Id.* at 873; *In re* Sabine Oil & Gas Corp., 550 B.R. 59, 61–62 (Bankr. S.D.N.Y. 2016).

agreements were executory contracts subject to rejection, or covenants running with the land binding on the debtor and its successors.[121]

As explained by the court in *Sabine*, the distinction between whether dedication language in a gathering agreement establishes a real or personal property interest "is significant, because if the agreements constitute real covenants that run with the land they are not 'executory contracts' and the Bankruptcy Court does not have authority to approve their rejection under 11 U.S.C. § 365(a)."[122] The *Sabine* courts recognized that determining whether an agreement created real property interest was a matter of state law.[123] As a result, the New York courts complied with the choice of law provisions of each of the gathering agreements and applied Texas law.[124]

Under Texas law, a covenant, like a dedication in a gathering agreement, runs with the land if: (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.[125] In *Sabine*, the parties agreed that the gathering agreements satisfied the second, third, and fourth elements of the Texas "running with the land" test.[126] As a result, the *Sabine* courts focused on the first element, and whether, while not expressly enumerated, the Texas test also requires "horizontal privity" between the parties to the purported covenant running with the land.[127]

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121. *Sabine*, 550 B.R. at 61–62.

122. *In re* Sabine Oil & Gas Corp., 734 F. App'x 64, 65 (2d Cir. 2018).

123. *Id.* at 65–66 ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.") (citing Butner v. United States, 440 U.S. 48, 55 (1979)).

124. *Id.*

125. *Id.* at 66 (citing Inwood N. Homeowners' Ass'n, Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987)).

126. *Id.*

127. *Id.*

1. Horizontal Privity

Horizontal privity is an element required to establish that a covenant runs with the land in many states.[128] In *Sabine*, the Second Circuit explains horizontal privity as follows:

> In order for the parties to the original agreement to have been in horizontal privity with one another, there must have been some common interest in the land other than the purported covenant itself at the time it was executed. Horizontal privity typically exists when the original covenanting parties make their covenant in connection with the conveyance of an estate in fee from one of the parties to the other. The covenant and the conveyance must be made at the same time, although no continuing mutual relationship to the affected land is needed. [129]

In other words, a conveyance of the property subject to the encumbrance must occur at the time of the creation of the encumbrance, or the encumbrance—the covenant—does not run with the land.[130]

HPIP and Nordheim vehemently argued that two leading Texas Supreme Court cases failed to list horizontal privity as an element of the "running with the land" test.[131] Though recognizing a growing trend "towards the abolition of the horizontal privity requirement," the Second Circuit found Texas authority requiring horizontal privity, and that no later Texas case eliminated the requirement.[132]

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128. *See, e.g.*, *In re* Murray Energy Holdings Co., Case No. 19-56885, 2020 WL 4037248, at * 11 (S.D. Ohio July 14, 2020) (applying West Virginia law); Flying Diamond Oil Corp. v. Newton Sheep Co., 776 P.2d 618, 623 (Utah 1989)) (applying Utah law); Noyles v. McDonnell, 398 P.2d 838 (Okla. 1965) (applying Oklahoma law); Jackson Hole Racquet Club Resort v. Teton Pines Ltd. P'ship, 839 P.2d 951, 958 (applying Wyoming law); Taylor v. Melton, 274 P.2d 977, 988–89 (Colo. 1954) (applying Colorado law).

129. *In re* Sabine Oil & Gas Corp., 734 F. App'x 64, 66 (2d Cir. 2018).

130. *See id.*

131. *In re* Sabine Oil & Gas Corp., 550 B.R. 59, 68 (Bankr. S.D.N.Y. 2016) (recognizing that HPIP and Nordheim's argued that neither *Inwood* nor *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982), among others, expressly include horizontal privity as an element necessary to establish a covenant running with the land).

132. *Sabine*, 734 Fed. App'x. at 66–67 ("It would be improper for us to read a traditional requirement of real covenants out of Texas state law when there is no Texas law instructing courts to do so. Accordingly, we agree with the bankruptcy court and find that horizontal privity remains a requirement of Texas real covenants.") (citation omitted).

The *Sabine* courts then analyzed whether there was evidence of horizontal privity in the HPIP and Nordheim gathering agreements. When analyzing those agreements, the *Sabine* court noted that the agreements dedicated interests in minerals that were "produced and saved."[133] The court further observed that the term "produced and saved" referred only to "minerals extracted from the ground."[134] Moreover, the terms of each gathering agreement expressly disclaimed the sale, transfer, or assignment of Sabine's interest in its mineral leases.[135] The court in *Sabine* ruled that, as a result, there was no conveyance of an interest in Sabine's minerals in the gathering agreement to go along with the pledges in the dedication.[136] With no concurrent conveyance of any real property interest purportedly burdened by the covenant, the covenant could not run with the land.[137]

2. Touch and Concern the Land

Having determined that horizontal privity is a necessary element for a covenant running with the land under Texas law, and that the gatherers failed to prove it, the Second Circuit did not address the first element of Texas's "running with the land" test.[138] The lower courts did, however, and determined that the HPIP and Nordheim agreements did not touch and concern the land.[139] The district court noted that Texas courts apply two tests when determining whether a covenant touches and concerns the land:

> First, a covenant touches and concerns the land if it affects the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affects the mode of enjoying it. Second, a covenant touches and concerns the land either if the promisor's legal relations in respect to the land in question are lessened or if the

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133. *Sabine*, 550 B.R. at 66.
134. *Id.*
135. *Id.* at 70 and n.53.
136. *Sabine*, 734 Fed. Appx. at 66 (adopting bankruptcy court's analysis).
137. *Id.* at 67.
138. *Id.*
139. *In re* Sabine Oil & Gas Corp., 567 B.R. 869, 877 (S.D.N.Y. 2017).

> promisee's legal relations in respect to that land are increased.[140]

Meeting either of the tests satisfies the "touches and concerns the land" element of the "running with the land" test.[141]

In finding that the agreements did not "touch and concern the land" the district court again noted that the dedications in the gathering agreements pertained only to extracted minerals, and that nothing in the agreements would enable HPIP or Nordheim to interfere in any way with Sabine's in-ground minerals.[142] Moreover, the district court noted that even if the agreements made Sabine's mineral interests "more or less valuable, depending on the price of hydrocarbons and the market rates for gather …those factors are clearly collateral …and would affect the value of any oil-producing land."[143] The agreements therefore failed the first "touches and concerns" test.

The district court similarly rejected HPIP and Nordheim's contention that the agreements lessened Sabine's "legal relations in respect to the land in question" or increased the gatherer's "legal relations in respect to" the land in question.[144] While the court issued a detailed ruling addressing each of HPIP and Nordheim's legal arguments, its reasoning is straightforward and simple: the agreements dedicated only extracted minerals, which is personal property and, as a result, there is no land—or any other real property interest—in question.[145] The agreements, as written, could not therefore affect the parties' legal interests in Sabine's in-ground minerals.[146] Thus, even if the *Sabine* courts did not apply horizontal privity, the gatherers could still not establish that the agreements were covenants running with the land under Texas law.

140. *Id.* at 874.
141. *Id.*
142. *Id.* at 876–77.
143. *Id.* at 877.
144. *Id.* at 876.
145. *Id.* at 874–75.
146. *See id.*

C. *Sabine Takeaway: The Importance of Extracted Minerals*

Fundamentally, the *Sabine* decisions all hinged on the fact that the gathering agreements in question pledged only minerals that were "produced and saved" from dedicated leases.[147] The gatherers could not establish horizontal privity because Sabine never conveyed any interests in its in-ground minerals.[148] Moreover, the gathering agreements contained express language stating that Sabine was *not* transferring any title to its mineral leases or in-ground minerals.[149] Further, the gathering agreements did not bestow on HPIP or Nordheim any ability to extract minerals from Sabine's wells or to affect Sabine's production volume.[150] Taken as a whole, Sabine merely promised that it would allow HPIP and Nordheim to process and transport its extracted minerals for a contractual fee. The agreements did not give rise to any covenant running with any land or other real property interest.

IV. CLOSING THE LOOPHOLE: *IN RE BADLANDS ENERGY, INC.* & *IN RE ALTA MESA RESOURCES, INC.*

A. *Drafting Dynamics: "Curing" the Personal Property Problem*

In the aftermath of *Sabine*, midstream gatherers took affirmative steps to protect their interests by drafting around the "produced and saved" language that led to Sabine's rejection of the HPIP and Nordheim agreements.[151] Wamsutter LLC, a midstream gatherer referred to as "Williams" in its agreements, presents a prime example because its gathering agreements were later the subject of litigation in the *In re*

147. *In re* Sabine Oil & Gas Corp., 550 B.R. 59, 66–68 (Bankr. S.D.N.Y. 2016).

148. *Id.* at 68–70.

149. *Id.* at 66–68.

150. *In re* Sabine Oil & Gas Corp., 567 B.R. 869, 876 (S.D.N.Y. 2017).

151. Mark L. Jones et al., *Bankruptcy Courts Contemplate Debtors' Rejection of Real Property Covenants in Midstream Contracts*, LEXOLOGY (Dec. 3, 2020), https://www.lexology.com/library/detail.aspx?g=353cd8c2-6720-424c-ad4b-756fac28d575 [https://perma.cc/4YU9-E5Y4] ("Over the past four years, midstream firms have struggled to adapt their long-standing practices and adjust their long-held expectations, which were fundamentally disrupted by the outcome of the landmark bankruptcy case, *In re Sabine Oil & Gas*. Midstream providers have since developed and relied on certain mechanisms and carefully drafted contract language in order to bind upstream companies and their successors in interest to obligations and restrictions contained of midstream agreements.").

Southland Royalty Company LLC bankruptcy case.[152] Wamsutter's first agreement, known as the L60 gathering agreement, is dated June 1, 2016 and likely drafted before the issuance of the *Sabine* bankruptcy court's ruling just weeks prior.[153] The "Shipper's Dedication" contained in the L60 gathering agreement simply states: "Shipper dedicates Shipper's Gas within the Area of Interest described in Exhibit B to Williams for Gathering, Processing, Dehydrating and Treating."[154] Given the simplicity of the language, it would be hard to imagine the *Sabine* court determining that the dedication or agreement established a covenant running with the land.

The second gathering agreement, known as the L63 gathering agreement, became effective November 1, 2018, months after the Second Circuit affirmed *Sabine*'s rejection of the HPIP and Nordheim agreements.[155] The "Shipper's Dedication" contained in the L63 is considerably more expansive, and states, in pertinent part:

> Shipper dedicates to the performance of this Agreement the Dedicated Properties and Dedicated Gas and grants to Williams the exclusive right to Gather, Process, Dehydrate and Treat the Produced Dedicated Gas ("Dedication"). *This Dedication shall be a covenant running with the land* under applicable law and binding on the respective successors and assigns of the interests of Shipper and its Affiliates in and to the Dedicated Properties and Dedicated Gas. If applicable law requires any amendment or modification to this Agreement for this Dedication to be treated as an enforceable covenant running with the land, the parties will promptly enter into any such addendum or modification. Gatherer may file memoranda of this Agreement substantially in the form of Exhibit "J" in local land records from time to time in

152. *In re* Southland Royalty Co. LLC, 623 B.R. 64, 71–72 (Bankr. D. Del. 2020).

153. *See* First Amended Complaint for Avoidance and Related Declaratory Relief at Exhibit A Gas Gathering, Processing, Dehydrating and Treating Agreement dated June 1, 2016 between Wamsutter LLC and Anadarko E&P Onshore, LLC, *In re* Southland Royalty Co. LLC 623 B.R. 64 (Bankr. D. Del. Nov. 13, 2020) [hereinafter "Wamsutter L60 Agreement"].

154. *Id.* at Ex. A § 1.1.

155. *See id.* at Ex. B.

> its discretion, and Shipper will promptly enter into any such memoranda upon request.[156]

It is abundantly clear from the plain language of the L63 dedication that Wamsutter, the gatherer, intended the agreement to be a covenant running with the land.

The definitions of "Dedicated Properties" and "Dedicated Gas" further illustrate Wamsutter's efforts to concretely establish a covenant running with the land after *Sabine*. Dedicated Properties "means all interests owned or Controlled by Shipper …during the term of this Agreement in oil, Gas or mineral leases covering lands …within the Dedication Area."[157] The term Dedicated Gas means "all Gas owned or Controlled by Shipper …in and under the Dedicated Properties *before it has been produced* …."[158] Wamsutter makes clear that Southland is agreeing to dedicate Wamsutter an interest in its minerals *that are in the ground* in an effort to "touch and concern" the land, that both parties intend to create a covenant running with the land, and that the covenant is binding on all successors and assigns.

Like Wamsutter, other midstream companies similarly amended gathering agreements in an effort to ensure they established covenants running with the land.[159] Those efforts were, at least for a while, vindicated. In the years following *Sabine*, courts issued two impactful rulings suggesting that with careful drafting, gathering agreements could indeed establish real property interests in favor of midstream gatherers.[160]

B. *In re Alta Mesa Resources: Covenant Running with Land*[161]

On September 11, 2019, Alta Mesa Holdings, LP and Oklahoma Energy Acquisitions, LP (collectively "Alta Mesa") filed petitions for bankruptcy relief under Chapter 11 of the Bankruptcy Code.[162] Alta

156. *Id.* at Ex. B § 1.1(a) (emphasis added).
157. *Id.* at Ex. J § 1(g).
158. *Id.* at Ex. J § 1(f) (emphasis added).
159. Jones et al., *supra* note 151.
160. *In re* Badlands Energy, Inc., 608 B.R. 854 (Bankr. D. Colo. 2019); *In re* Alta Mesa Resources, Inc., 613 B.R. 90 (Bankr. S.D. Tex. 2019).
161. Unless otherwise noted herein, the definitions and meanings of terms provided in this section IV.C. shall not apply to other sections of this article.
162. *Alta Mesa*, 613 B.R. at 90, 95.

Mesa was an upstream oil and gas exploration and production company.[163] In 2015, Alta Mesa entered into oil and gas gathering agreements with a midstream counterparty, Kingfisher Midstream, LLC ("Kingfisher"), to ensure it could take its produced minerals to market.[164]

In each of the Kingfisher gathering agreements, Alta Mesa dedicated to Kingfisher "all Interests within the Dedicated Area" which, in context, meant all of Alta Mesa's "produced hydrocarbons."[165] The agreements also (1) conveyed to Kingfisher "any easement or rights-of-way for purposes of constructing, owning, operating, repairing, replacing and maintaining" any portion of the gathering systems, (2) declared that the agreements were "covenants running with the land," and (3) required the parties to cause any successors to acknowledge the dedications and agreements in writing.[166]

On December 1, 2016—months after *Sabine*—Alta Mesa and Kingfisher entered into amendments to the gathering system.[167] The amendments expanded the gathering agreements to include additional interests and the development of the Kingfisher gathering agreement.[168] Significantly, the amendments also incorporated a "Conveyance of Transportation Right, which the parties intended to be a conveyance of a portion of [Alta Mesa's] real property interests."[169] That right constituted "the sole and exclusive right to transport [oil and gas] produced from" Alta Mesa's dedicated interests.[170]

Unfortunately for Alta Mesa, the Kingfisher gathering agreements required payment of what Alta Mesa described as exorbitant fees.[171] After filing for bankruptcy relief, Alta Mesa promptly moved to reject the Kingfisher gathering agreements as executory contracts,

163. *Id.* at 95.
164. *Id.* at 95-96.
165. *Id.* at 96, 103.
166. *Id.* at 96.
167. *Id.*
168. *Id.*
169. *Id.* at 97 (internal quotations omitted).
170. *Id.*
171. *See id*. at 98 ("At the heart of this dispute is Alta Mesa's belief that its owners, sitting on both sides of the negotiation table, agreed to pay Kingfisher exorbitant gathering fees. According to Alta Mesa, its value as a going concern will increase if it is able to renegotiate its gathering arrangements, either with Kingfisher or a third party.").

determining that doing so would improve its prospects of reorganization.[172]

The Kingfisher gathering agreements each related to operations in Oklahoma, and, as a result, the *Alta Mesa* court applied Oklahoma law to determine whether the gathering agreements were covenants running with the land.[173] As the *Alta Mesa* court detailed, three factors are required to create a real property covenant that runs with the land under Oklahoma law: (1) the burden or benefit must "touch and concern" the land; (2) there must be privity of estate between the party claiming the benefit and the party upon whom the burden rests; and (3) the original covenanting parties must have intended to bind successors.[174] The court notes that in Oklahoma, "[r]eal property covenants are those that are so connected to the underlying land that the benefit and burden pass to successors by operation of law."[175] Oklahoma law does not require any "magic words" to create a real property covenant but instead focuses on the intent of the covenanting parties.[176]

It is important to note that the court in *Alta Mesa* recognized repeatedly that, like *Sabine*, the dedications in the Kingfisher gathering agreements involved only "produced" minerals.[177] Further, the court recognized that the test for determining whether a covenant runs with the land in Oklahoma mirrors the Texas test applied in *Sabine*.[178] Even so, in a scathing review of *Sabine*, the *Alta Mesa* court distinguished the facts between the cases and ruled that the Kingfisher gathering agreements were covenants running the with land and not subject to rejection.[179]

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172. *Id.*

173. *Id.* at 99.

174. *Id.* at 99–100.

175. *Id.* at 100.

176. *Id.*

177. *See id.* at 96–97, 103–04.

178. *Id.* at 101.

179. *See id.* at 102 ("The Court assumes that unique facts in Sabine led to that court's conclusions. To the extent that the pronouncements in Sabine were intended to be generalized, this Court must reject them."); *see also id.* at 103 ("An oil and gas lease is distinguishable from a fee simple mineral estate. Although over-lapping in many respects, a fee mineral estate contains a separate collection of rights. . . . Unlike in *Sabine*, where that court focused its inquiry on a fee mineral estate, the relevant starting point here is Alta Mesa's leasehold interest. . . . *Sabine* drew a distinction between covenants concerning the surface estate and those that concern the mineral estate. That distinction is far from semantic. An oil and gas lease contemplates extraction of hydrocarbons for profit. All of the property interests associated with an oil and gas lease are necessary for the lessee to successfully explore and

1. Diverging from *Sabine*: Privity of Estate

The court in *Alta Mesa* recognized that in Oklahoma, as in Texas, "privity requires that a covenant be made in conjunction with a conveyance of property."[180] Instead of applying *Sabine's* privity analysis, however, the court in *Alta Mesa* rejected it. In *Sabine*, the court refused to find privity even though Sabine conveyed surface rights and easements to HPIP and Nordheim at the time it pledged its produced and saved minerals.[181] The court reasoned that because the surface and mineral estates are separate under Texas law, the conveyance of surface rights was inadequately tied to Sabine's mineral interests.[182]

In *Alta Mesa*, the court reached the opposite result. As detailed by Judge Isgur, a surface interest arising out of a mineral lease is integral to the mineral interests arising out of the lease:

> [T]he easements conveyed to Kingfisher a possessory interest in the leasehold estate. The surface easement is integrally tied to the purpose of an oil and gas lease. The conveyance of the easements to Kingfisher is enough to show horizontal privity . . . . Alta Mesa's surface easements spring directly from its leasehold mineral interest. Because a surface easement is crucial component of an oil and gas lease, the Court does not view the conveyance as creating privity only with respect to the surface estate.[183]

In short, because surface and mineral estates under a mineral lease are so interconnected, the conveyance of a surface interest was sufficient to satisfy the privity element with regard to the mineral interest.[184] In so ruling, Judge Isgur reframed the "produced and saved" issue of *Sabine*; dedicating only produced minerals could still create a covenant running

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produce his reserves. Those lease-hold interests, targeted at the production of hydrocarbons, are the real property interests which the Alta Mesa gathering agreements involve.").

180. *Id.* at 101.

181. *In re* Sabine Oil & Gas Corp., 550 B.R. 59, 69 (Bankr. S.D.N.Y. 2016).

182. *Id.*

183. *Alta Mesa*, 613 B.R. at 106.

184. *See id.*

with the land when there was a concurrent conveyance of a real property interest in the surface estate tied to the produce minerals.

2. Diverging from *Sabine*: Touch and Concern

In addition to finding privity, the *Alta Mesa* court also held that the gathering agreements touched and concerned Alta Mesa's mineral interests.[185] For a covenant to touch and concern real property, there must be "a logical connection between the benefit to be derived from enforcement of the covenant and the property."[186] According to Judge Isgur, "a covenant touches and concerns the land when it requires performance of a physical act upon the land which directly benefits the landowner …. If the value of the owner's interest in the land itself is affected by the covenant, either positively or negatively, the covenant touches and concerns the land."[187]

Applying that analysis, the court noted that on the one hand, Kingfisher used the surface easement Alta Mesa conveyed in order to build a gathering system that enhanced the value of Alta Mesa's leases by facilitating delivery of its minerals to market.[188] On the other hand, the court recognized that the gathering agreements imposed "costs and delivery restrictions on produced hydrocarbons, which diminish the value of Alta Mesa's unproduced reserves."[189] Moreover, the agreements materially affected Alta Mesa's rights to its minerals. While it could choose when and if to drill, it had no choice but to deliver its produced minerals to Kingfisher.[190]

As in its "privity" analysis, the *Alta Mesa* court also focused on the interconnectedness of surface and mineral rights under a mineral lease.[191] According to the court, a mineral lease consists of surface and mineral interests, and "[a]ll of the property interests associated with an oil and gas lease are necessary for the lessee to successfully explore and produce his reserves. Those leasehold interests, targeted at the production of hydrocarbons, are the real property interests which the Alta

185. *Id.* at 102.
186. *Id.*
187. *Id.* (internal citations omitted).
188. *Id.* at 103–04.
189. *Id.* at 102.
190. *Id.* at 104.
191. *Id.* at 103.

Mesa gathering agreements involve."[192] Accordingly, a conveyance from Alta Mesa to Kingfisher of surface rights for the construction of a gathering system inherently burdened and related to Alta Mesa's mineral interests under affected mineral leases. After all, the court reasoned, "[w]ithout the surface easement, [a] [mineral] lessee cannot capture reserve hydrocarbons."[193] Development of the surface for a gathering system therefore inherently touched and concerned Alta Mesa's mineral interests under related mineral leases, satisfying the second element of the "runs with the land" test.[194]

3. Intent to Bind Successors

None of the substantive cases addressing whether a debtor can reject a gathering agreement in bankruptcy turn on the issue of whether parties to a gathering agreement intend to bind successors. In almost every case, the issue of intent is either agreed or determined by the express terms of the agreement.[195] As a result, this article focuses on whether the gathering agreements addressed in each key decision touch and concern the land and whether privity exists between the parties to the gathering agreements

4. Diverging from *Sabine*: Liberal Creation of Covenants Running with the Land

The *Alta Mesa* court's "privity" and "touch and concern" analyses presented a major departure from *Sabine*. As illustrated in the Wamsutter dedications provided above and by Kingfisher's effort to establish a conveyance of an interest in Alta Mesa's minerals in the gathering agreement amendments, midstream gatherers focused on curing the "produced and saved" language in the aftermath of *Sabine*.[196] The court in *Alta Mesa*, however, rendered that largely unnecessary.

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192. *Id.*

193. *Id.* at 104.

194. *Id.*

195. *See In re* Badlands Energy, Inc., 608 B.R. 854, 870–71 (Bankr. D. Colo. 2019); *Alta Mesa*, 613 B.R. at 106–07; *In re* Chesapeake Energy Corp., 622 B.R. 282 (Bankr. S.D. Tex. Jan. 16, 2020); *In re* Southland Royalty Co. LLC 623 B.R. 81 (Bankr. D. Del. Nov. 13, 2020); *In re* Extraction Oil & Gas, Inc., 622 B.R. 620 n.32 (Bankr. D. Del. 2020).

196. *See supra* notes 157–60, 166–71, and the text associated therewith.

By focusing on the nature of mineral leases and the connection between surface and mineral estates under a mineral lease, the court in *Alta Mesa* promoted an exceptionally liberal analysis of the "privity" and "touch and concern" elements of the "runs with the land" test. Applying *Alta Mesa*, a gathering agreement will be a covenant running with the land so long as: (1) the upstream party conveys an interest in the surface estate of pertinent mineral leases to the midstream party; (2) the upstream party dedicates the minerals from the mineral estates of those pertinent mineral leases to the midstream party; (3) the midstream party agrees to develop a gathering system on the conveyed surface interests; and (4) the parties intend the covenant to be binding on successors-in-interest. It is abundantly clear from Judge Isgur's ruling that if he applied his reasoning to *Sabine*, the HPIP and Nordheim gathering agreements would be covenants running with the land.[197]

The liberal creation of covenants running with the land set forth in *Alta Mesa* creates potential underwriting issues for energy lenders. A reserve-based lender, for instance, may have loaned money to an upstream company based on its mineral reserves.[198] As a practical matter, most reserve-based loans prohibit upstream borrowers from granting non-lender parties liens or other encumbrances on the lender's collateral—the borrower's mineral interests.[199] In *Sabine*, for example, the bankruptcy court noted that Sabine's Second Amended and Restated Credit Agreement precluded Sabine from granting Nordheim and HPIP liens on Sabine's mineral interests.[200] An upstream borrower's entry into a gathering agreement that conveyed a midstream counterparty a lien or other encumbrance on the borrower's minerals would almost certainly breach any applicable credit agreement and trigger a default.[201]

Moreover, because a covenant running with the land cannot be rejected in bankruptcy, an upstream debtor saddled with a seriously disadvantageous gathering agreement is less likely to successfully

197. *See generally In re* Sabine Oil & Gas Corp., 550 B.R. 59, 66–68 (Bankr. S.D.N.Y. 2016).

198. *See, e.g.*, *Southland*, 623 B.R. at 97 n.134.

199. *See supra* note 49, Adv. D.I. 238-1, *Lenders' Post-Trial Memorandum of Law* at ¶ 8–13.

200. *Sabine*, 550 B.R. at 67–68 n.41.

201. *See, e.g.*, *id.* (noting that under the applicable credit agreement, if Sabine *had* conveyed a real property interest in its minerals to Nordheim and HPIP, it would have triggered an Event of Default under Sabine's credit agreement).

reorganize. If the upstream debtor cannot reject a financially adverse gathering agreement, and its midstream counterparty refuses to restructure the terms of the agreement, the debtor may be forced to simply liquidate its assets. Liquidation in a depressed oil and gas market may result in huge write downs for the lenders to an upstream borrower who has become undersecured due to market conditions.[202]

Liquidation, however, may not even be a viable means of shedding a disadvantageous gathering agreement. As another leading 2019 energy lending case revealed, in some instances, even a sale free and clear of all liens, claims, and encumbrances under section 363 of the Bankruptcy Code might not extinguish a covenant running with the land.[203]

C. In re Badlands: Covenant Running With Land[204]

Badlands Energy, Inc. and its debtor subsidiaries (collectively, "Badlands")[205] filed Chapter 11 bankruptcy proceedings on August 11, 2017, in the United States Bankruptcy Court for the District of Colorado.[206] The *Badlands* opinion arose from an adversary proceeding filed by Monarch Midstream, LLC, f/k/a Monarch Natural Gas, LLC, ("Monarch") concerning Badlands' ability to (1) reject its gas gathering agreement (the "GPA") and saltwater disposal agreement (the "SWDA") with Monarch and (2) sell certain oil and gas assets free and clear of those agreements.[207]

Prior to bankruptcy, Badlands was a consolidated natural gas and petroleum exploration and production company that operated oil and gas

202. *See, e.g.* Becky Yerak, *Texas-Based Driller Arena Energy Files for Bankruptcy: The Gulf of Mexico Operator, Looking to Restructure More Than $1 Billion in Debt, Has a $64 Million Deal to Sell Virtually All of Its Assets*, WALL ST. J. (Aug. 21, 2020), https://www.wsj.com/articles/texas-based-driller-arena-energy-files-for-bankruptcy-11598036183 [https://perma.cc/G6BY-PHXU]; 11 U.S.C. § 506(a) (2018) (bifurcating claims of undersecured creditor into secured claim up to value of collateral, and undersecured claim for any remaining amount due and owing).

203. *See In re* Badlands Energy, Inc., 608 B.R. 854 (Bankr. D. Colo. 2019).

204. Unless otherwise noted herein, the definitions and meanings of terms provided in this section IV.B. shall not apply to other sections of this article.

205. The Badlands debtors included Badlands Energy, Inc., f/k/a Gasco Energy, Inc.; Badlands Production Company, f/k/a Gasco Production Company; Badlands Energy-Utah, LLC; and Myton Oilfield Rentals, LLC.

206. *Badlands*, 608 B.R. at 862.

207. *Id.* at 860.

leasehold interests in Utah's Uinta Basin.[208] In 2010, Badlands sold certain gas gathering and saltwater disposal facilities to Monarch, pursuant to an asset purchase agreement (the "Facilities APA").[209] The GPA and SWDA were executed contemporaneously with the Facilities APA—and amended from time to time thereafter—to establish terms of Badlands' continued use of the gathering and disposal facilities following the asset sale to Monarch.[210] Monarch's obligation to close on the sale was conditioned on Badlands' execution of the GPA and SWDA.[211]

In the GPA, Badlands dedicated its interests in certain gas reserves to Monarch and agreed that all gas produced from those reserves would be delivered exclusively through Monarch's gathering facilities.[212] The GPA dedication further stated that "[t]he dedication and commitment under this Agreement is a covenant running with the land."[213] The GPA also (1) contained a minimum volume commitment requiring Badlands to pay a fee to Monarch if a minimum volume of gas was not delivered to the gathering system each calendar quarter; (2) granted Monarch a right-of-way and easement across the GPA Leases and adjoining lands for the purpose of installing and maintaining the gathering systems; (3) granted Monarch an irrevocable option to purchase a certain 50 acres of land; (4) included an anti-assignability provision; and (5) stated that the GPA bound and injured to the benefit of each party's successors and assigns.[214]

Under the SWDA, Badlands committed to dispose all water produced from certain production areas through Monarch's saltwater disposal system and to pay fees to Monarch for the disposal and treatment

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208. *Id.*

209. *Id.* at 861.

210. *Id.* at 864–66.

211. *Id.* at 866.

212. *Id.* at 864. The GPA dedication was of the "Dedicated Reserves," which the GPA defined as "the interest of Producer in all Gas reserves in and under, and all Gas owned by Producer and produced or delivered from (i) the Leases and (ii) other lands within the AMI, whether now owned or hereafter acquired, along with the processing rights, subject to certain volume exclusions as described herein, and any and all additional right, title, interest, or claim of every kind and character of Producer or its Affiliates in (x) the Leases or (y) lands within the AMI, and Gas production therefrom, and all interests in any wells, whether now existing or drilled hereafter, on, or completed on, lands covered by a Lease or within the AMI . . . ." GPA, § 1.1, p. 2; *see also Badlands,* 608 B.R. at 864–65.

213. *Badlands,* 608 B.R. at 864–65.

214. *Id.* at 865–66.

of its produced water.[215] Like the GPA, the SWDA stated that "[t]he commitment made by [Badlands] hereunder is a covenant running with the land."[216]

Three days into the bankruptcy case, Badlands filed a motion to sell certain oil and gas assets (the "Riverbend Assets") to Wapiti Utah, LLC ("Wapiti Utah") free and clear of the GPA and SWDA pursuant to section 363(f) of the Bankruptcy Code.[217] Exhibit A to the Wapiti Utah Purchase and Sale Agreement expressly provided that "Wapiti Utah shall not assume any contracts with Monarch in connection with the purchase of the Riverbend Assets, including the GPA and SWDA."[218] In conjunction with the sale, Badlands sought to reject both the GPA and SWDA under section 365 of the Bankruptcy Code.[219]

On October 23, 2017, two days before the sale hearing, Monarch filed its adversary complaint asserting that the GPA and SWDA were covenants running with the land and that, as a result, the Riverbend Assets could not be sold free and clear of those agreements.[220] Oddly, Monarch also sought to have Wapiti Utah cure all prepetition monetary defaults under the Agreements, totaling $1.2 million, pursuant to section 365 of the Bankruptcy Code.[221] Given the timing of Monarch's adversary proceeding, the court approved the Sale Motion and Wapiti Utah's Purchase and Sale Agreement subject to a later ruling as to whether the GPA and SWDA were covenants running with the land.[222]

Wapiti Utah moved for a judgment on the pleadings in the adversary proceeding.[223] In doing so, Wapiti Utah argued that: (1) the GPA and SWDA were rejected executory contracts; (2) neither the GPA

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215. *Id.* at 866.

216. *Id.*

217. *Id.* at 862–63.

218. *Id.* at 863.

219. *Id.*

220. *Id.*

221. *Id.* The authors find Monarch's cure demand very odd given the circumstances. Monarch would not be entitled to any cure payment under section 365 of the Bankruptcy Code unless the GPA and SWDA were executory contracts *and assumed* by Badlands and assigned to Wapiti Utah. *See* 11 U.S.C. § 365(b) (2018). If they were executory contracts, however, Badlands could simply reject the GPA and SWDA as intended. Simply put, the authors are unaware of any scenario under the Bankruptcy Code pursuant to which a claimant could receive a cure payment under section 365 for something other than an executory contract otherwise subject to rejection.

222. *Badlands*, 608 B.R. at 863.

223. *Id.*

nor SWDA satisfied the elements necessary to be covenants running with the land; and (3) even if the agreements were covenants running with the land, they were stripped from the Riverbend Assets as a result of Badlands' "free and clear" sale under section 363(f) of the Bankruptcy Code.[224]

In response, Monarch filed a motion for summary judgment seeking a determination that the GPA and SWDA were covenants running with the land and that such covenants were not "interests" that could be stripped from the Riverbend Assets through a sale under section 363(f) of the Bankruptcy Code.[225]

Although the GPA and SWDA were both governed by Colorado law, the court in *Badlands* applied Utah law because "property interests are created and defined by state law, and the Riverbend assets are located in Utah."[226] Utah law applies substantially the same test as Texas and Oklahoma to determine whether a covenant runs with the land. Covenants running with the land must (1) "touch and concern" the land; (2) the parties must have intended that the covenant run with the land; and (3) and there must be privity of estate between the parties.[227]

1. *Badlands*: Touch and Concern

Utah's "touch and concern" test is similar to the Texas test applied in *Sabine* and the Oklahoma test applied in *Alta Mesa*. The court provides the following summary of the touch and concern inquiry under Utah Law:

> In *Flying Diamond*, the Utah Supreme Court recognized a broad test for touch-and-concern that does not require a physical effect upon the land but rather, requires a court to evaluate whether a covenant "enhances the land's value [on the benefit side], and for the burden side, whether it diminishes the land's value." … "[A]ll that must be shown

224. *Id*. at 863–64; *see also* 11 U.S.C. § 363(f) (debtor "may sell property . . . free and clear of *any interest* in such property of an entity other than the estate . . ." if any provision of (f)(1-5) is satisfied) (emphasis added).

225. *Badlands*, 608 B.R. at 864.

226. *Id.* at 867.

227. *Id.* (citing Flying Diamond Oil Corp. v. Newton Sheep Co., 776 P.2d 618, 623 (Utah 1989)). Under Utah law, because a covenant running with the land concerns real property, it must also be in writing and satisfy the statute of frauds. *Id.*

> for a covenant to run with the land is that it 'be of such character that its performance or nonperformance will so affect the use, value or enjoyment of the land itself that it must be regarded as an integral part of the property.'"[228]

Put another way, "to touch and concern the land, a covenant must bear upon the use and enjoyment of the land and be of the kind that the owner of an estate or interest in land may make because of his ownership right."[229] The Utah "touch and concern" test is objective and should be conducted "without reference to the subjective mindset of original covenantors."[230]

Here, as in *Alta Mesa*, the court took a generally holistic analysis of whether the GPA and SWDA touched and concerned the land:

> Here, [Badlands'] interests in the Leases are diminished by the [gathering agreements]. The burdens imposed under the [gathering agreements] directly affect [Badlands'] use and enjoyment of its interests in the Leases in the [dedicated area]…the purpose of the [gathering agreements] is to compensate Monarch for the burdens associated with acquiring and operating the Gathering System, which is connected to [Badlands'] Wells located on the Leases via the Receipt Points.[231]

The character of the covenant was therefore such "that its performance or nonperformance will so affect the use value or enjoyment of the land itself that it must be regarded as an integral party of the property."[232] It did not matter to the court that one of the objectives of the gathering agreements was to process and dispose of "produced gas." Instead, the court noted that, as a whole, the covenants affected the use and value of the mineral estates by connecting Badlands' minerals to gathering systems that would enable them to be gathered and processed.[233]

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228. *Id.* at 868 (citing *Flying Diamond*, 776 P.2d at 624).
229. *Id.* at 867.
230. *Id.* at 867 (citing Stern v. Metro. Water Dist. of Salt Lake & Sandy, 274 P.3d 935, 946 (Utah 2012)).
231. *Id.* at 868.
232. *Id.* at 870.
233. *Id.* at 869.

Moreover, while the court disagreed with the *Sabine* ruling, it also factually distinguished *Sabine* in that Badlands' dedications included real property interests in minerals "in and under" the surface estate.[234] As a result, the court held that the covenants touched and concerned the land.

2. *Badlands*: Privity of Estate

The *Badlands* decision is unique in part because it analyzes three potential types of privity under Utah law: vertical; mutual; and horizontal.[235] According to the court, vertical privity exists between an original party and its successor.[236] Wapiti Utah did not dispute its vertical privity with Badlands; it purchased Badlands' assets.[237]

The court then held that mutual privity exists among parties with a continuing or simultaneous interest in the same property.[238] In *Badlands*, the court established mutual privity for two key reasons. First, the gathering agreements dedicated *in ground minerals*, not just produced minerals, to Monarch.[239] While the dedication did not give Monarch a "fee estate" to the dedicated reserves, the court determined it was sufficiently based on an interest Monarch had in real property.[240] Second, Monarch owned gathering and saltwater disposal systems and easements on the same lands burdened by Badlands/Wapiti Utah's mineral leases and dedicated reserves.[241] Together, the substance of the parties' overlapping interests was sufficient to establish mutual privity.[242]

The court next stated that horizontal privity exists under Utah law when original covenanting parties create a covenant in connection with a simultaneous conveyance of an estate.[243] The facts in *Badlands* relating to horizontal privity are relatively unique because, in 2010, Badlands and Monarch entered into the Facilities APA pursuant to which Badlands conveyed a gathering system to Monarch concurrently with the parties'

234. *Id.*
235. *Id.* at 871 (citing *Flying Diamond*, 776 P.2d at 628).
236. *Id.*
237. *Id.*
238. *Id.*
239. *Id.* at 873.
240. *Id.*
241. *Id.*
242. *Id.*
243. *Id.* at 871.

execution of the GPA and SWDA, which contained the dedications in question.[244] Citing the parties' 2010 conveyance and dedications, the *Badlands* court found horizontal privity between Badlands and Monarch.[245]

Citing *Sabine*, Wapiti Utah argued that Monarch could not establish horizontal privity because (1) the GPA and SWDA did not actually convey real property interests, but merely pledged to deliver extracted minerals, (2) Monarch's surface easements did not burden Badlands' mineral interests.[246] Rejecting Wapiti Utah's argument, the court reiterated that unlike *Sabine*, the dedications in question included *in-ground* minerals, not produced and saved minerals.[247] While the court noted that the dedications therefore burdened the mineral estate, it did not go so far as to say that the dedication constituted a conveyance of an interest in the in-ground minerals.[248] Even so, taken in conjunction with Badlands' conveyance of the gathering system and surface easements, the net effect was sufficient to establish horizontal privity.[249]

3. *Badlands*: Intent

As in *Sabine* and *Alta Mesa*, the court spent little time analyzing the intent of the parties to create a covenant running with the land. Both the GPA and SWDA explicitly stated that the "Dedication" and "Commitment" in those agreements were covenants running with the land.[250] Wapiti Utah argued, however, that Monarch's failure to record the GPA's memorandum demonstrated a genuine dispute over the intent of the parties to create a covenant running with the land binding on successors.[251] The court again rejected Wapiti Utah's argument, however, holding that "the failure to record implicates notice, not intent."[252] The court then ruled "[i]n light of the intent clearly expressed in the

244. *Id.* at 861–62.
245. *Id.* at 873.
246. *Id.* at 874.
247. *Id.*
248. *Id.*
249. *Id.*
250. *Id.* at 870.
251. *Id.* at 870–71.
252. *Id.*

Agreements themselves, the Court concludes Monarch and [Badlands] intended the Agreements to run with the land. . . ."[253]

4. *Badlands*: No Free and Clear Sale? An Underwriting Nightmare

Having determined that the Agreements constituted real property covenants, one issue of relevance to this article remained before the court: whether a sale of assets subject to a covenant running with the land under section 363(f) of the Bankruptcy Code would be "free and clear" of the covenant.[254] Section 363(f) of the Bankruptcy Code allows a debtor in possession "can only sell property of an estate free and clear of *any interest* under one" of five circumstances,[255] two of which were at issue in *Badlands*: (i) "applicable nonbankruptcy law permits sale of such property free and clear of such interest; … or [(ii)] such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[256]

The court in *Badlands* ruled that Wapiti Utah could not satisfy any element for a sale free and clear of Monarch's covenant running with the land for one simple reason: under Utah law, a covenant running with the land is not an "interest" that can be extinguished under section 363(f) of the Bankruptcy Code.[257] In Utah, the court explained, a covenant

253. *Id.* at 870.

254. The issue of whether Wapiti Utah was obligated to cure Badlands' prepetition defaults under section 365(b) of the Bankruptcy Code, a remedy owed only to parties to an executory contract, was resolved as expected. *See supra* note 221. The court noted that if the covenants ran with the land, Monarch would not be party to any executory contract and so would be ineligible as a matter of law to receive cure payments under section 365(b). As a result, Monarch would simply have a pre-petition unsecured claim against Badlands for the default and no recourse against Wapiti Utah. *Id.* at 875–76.

255. *See* 11 U.S.C. § 363(f) (2018).

256. *Badlands*, 608 B.R. at 874 (citing 11 U.S.C. § 363(f)(1)–(5)).

257. Stating:

> Under Utah law, the nature of a covenant that runs with the land is such "that it must be regarded as an integral part of the property." Lundeberg v. Dastrup, 28 Utah 2d 28, 497 P.2d 648, 650 (1972). Therefore, the Agreements are part of the bundle of sticks Wapiti Utah acquired when it purchased the Riverbend Assets, and they are not subject to elimination utilizing Section 363(f). Similarly, this Court has previously held restrictions that run with the land are not "interests" to which Section 363 applies: Restrictions that run with the land "create equitable interests that do not compel a person to accept a monetary interest; thus, when restrictive covenants are involved, there is nothing that can force those

running with the land is something that, by its very nature "must be regarded as an integral part of the property."[258] As a result, Monarch's covenants running with the land were inherently "part of the bundle of sticks Wapiti Utah acquired when it purchased the Riverbend Assets, and they are not subject to elimination under Section 363(f)."[259]

In any event, even if section 363(f) did apply to Monarch's covenants, the court reasoned, neither sections 363(f)(1) nor (f)(5) would apply.[260] Quoting its own prior opinion, the *Badlands* court held that "restrictions that run with the land create equitable interests that do not compel a person to accept a monetary interest; thus, when restrictive covenants are involved, there is nothing that can force those who benefit from restrictive covenants to forego equitable relief in favor of a cash award."[261] Finally, quoting *Sabine*, the court issued a broad statement that "it is not possible for a debtor to reject a covenant that 'runs with the land' [under section 365], since such a covenant creates a property interest that is not extinguished in bankruptcy."[262]

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who benefit from restrictive covenants to 'forego [sic] equitable relief in favor of a cash award.'" *In re* Lonesome Pine Holdings, LLC, Case No. 10-34560 HRT (Bankr. D. Colo. Sept. 9, 2011), citing Skyline Woods Homeowners Ass'n, Inc. v. Broekemeier, 276 Neb. 792, 758 N.W.2d 376, 393 (2008) (property sold in bankruptcy subject to implied restrictive covenant running with the land requiring property only be used as a golf course) (further citations omitted); *see also* Gouveia v. Tazbir, 37 F.3d 295, 299 (7th Cir. 1994); *In re* Banning Lewis Ranch Co., LLC), 532 B.R. 335, 345–46 (Bankr. D. Colo. 2015); *In re* Oyster Bay Cove, Ltd., 161 B.R. 338 (Bankr. E.D.N.Y. 1993), *aff'd*, 196 B.R. 251 (E.D.N.Y. 1996); *In re* 523 E. Fifth St. Housing Pres. Dev. Fund Corp., 79 B.R. 568 (Bankr. S.D.N.Y. 1987).

Id. at 874–75.

258. *Id.*

259. *Id.*

260. *Id.* at 875 ("Even if the real covenants at issue were subject to Section 363(f), neither Section 363(f)(1) nor (f)(5) serve to strip the Riverbend Assets of the Agreements. Under applicable nonbankruptcy law, covenants that run with the land in Utah 'bind successive owners of the burdened or benefited land.' *Stern v. Metro. Water Dist. of Salt Lake & Sandy*, 274 P.3d 935, 945 (Utah 2012) (citing *Flying Diamond*, 776 P.2d at 623). In other words, Section 363(f)(1) cannot be satisfied because Utah law does not permit sale of property free and clear of the covenants that run with it. Under Section 363(f)(5), Monarch could not be 'compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest' because the interests of Monarch are part of the Riverbend Assets themselves.").

261. *Id.* at 874 (quoting *In re* Lonesome Pine Holdings, LLC, 2011 Bankr. LEXIS 5775, *1).

262. *Id*. at 875 (quoting *In re* Sabine Oil & Gas Corp., 567 B.R. 869, 874 (S.D.N.Y. 2017), *aff'd*, 734 F. App'x 64 (2d Cir. 2018)).

As a result of the court's ruling, Wapiti Utah purchased the Riverbend Assets subject to the preexisting terms and conditions of the GPA and SWDA. The ruling's effects, however, are far broader.

5. A Liberal Application of the "Runs with the Land" Test Creates Uncertainty and Underwriting Nightmares

The *Badlands* and *Alta Mesa* courts' ruling broadly expanded the *Sabine* court's application of the "runs with the land" test. Courts following *Badlands* and *Alta Mesa* can go so far as to disregard whether dedications in gathering agreements address minerals in the ground or extracted minerals so long as there are other burdens on the upstream party's interest in its mineral estate. As a result, a dedication of produced minerals from the leases of certain mineral estates and a concurrent grant of surface rights and easements on the surface estates of the leases would, under *Alta Mesa*, create a covenant running with the land. That covenant, under *Badlands* would not be subject to elimination through a "free and clear" sale under section 363(f) of the Bankruptcy Code.

In the context of underwriting reserve-based loans to upstream exploration and production companies, the *Badlands* decision is a disaster. In a typical reserve-based lending scenario like the one discussed above, an upstream exploration and production company borrows money and, in exchange, grants the lender a first priority lien on all of its mineral reserves, whether currently owned or acquired in the future.[263] Later encumbrances are generally junior to the lender's interest.[264] As a result, a lender must be made whole before any junior lienholder is paid anything. If the upstream borrower defaults, its lender may typically foreclose and take possession of its collateral free and clear of junior encumbrances.[265] Similarly, in bankruptcy, a lender would

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263. *See, e.g.*, *In re* Southland Royalty Co. LLC, 623 B.R. 64, 97 (Bankr. D. Del. 2020) ("With respect to section 363(f)(1), Wyoming law allows a preexisting mortgage with priority over a later-created real property covenant to extinguish the covenant through foreclosure. The purpose is to protect the mortgagee by ensuring that upon foreclosure, the mortgagee acquires exactly such title as the mortgagor owned at the time the mortgage was executed. Wamsutter does not dispute Wyoming state law on this matter or the priority of the RBL Lenders' credit facilities or their foreclosure rights.").

264. *Id.*

265. *See, e.g.*, Burning Rock Energy LLC v. Pinnacle Gas Resources, Inc., 2007 WL 9706009, at *4 (D. Wyo. Mar. 6, 2007) (applying Wyoming law).

typically have the right to credit bid its lien and purchase its collateral in bankruptcy free and clear of all objecting junior lienholders under section 363(f)(1) or (f)(5) of the Bankruptcy Code.[266]

After *Badlands*, however, lenders have little certainty of their ability to foreclose out and extinguish later-in-time encumbrances arising from gathering agreements. That creates a real underwriting concern. When debtors seek to avoid gathering agreements in bankruptcy, it is typically because the terms are economically disadvantageous. In *Alta Mesa*, for example, the gathering agreements saddled the debtor with excessive fees.[267] If unavoidable, those fees may make the production of minerals infeasible. Put simply, despite owning vast reserves, the terms of a gathering agreement may be so penal as to ensure that production results in net losses to the upstream counterparty. An unavoidable adverse gathering agreement may therefore so detrimentally burden an upstream party's mineral interests as to render them worthless. That, of course, jeopardizes a senior secured reserve-based lender's ability to recover in the event of a default by the upstream borrower.[268]

In application, *Badlands* weakens an earlier-in-time secured lender's ability to recover against its collateral, because any foreclosure or similar sale process must remain subject to the economically disadvantageous gathering agreement. If operating under such an agreement would result in a loss, the only party who may benefit from

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266. *See* 11 U.S.C. § 363(k) (2018); *In re* Spanish Peaks Holdings II, LLC, 872 F.3d 892, 900 (9th Cir. 2017) (applying 363(f)(1) where state foreclosure law allows elimination of junior encumbrances); *In re* Southland Royalty Co. LLC, 623 B.R. 64, 97–98 (Bankr. D. Del. 2020)

(citing *Pinnacle* for applicability of 363(f)(1) where state foreclosure law would allow elimination of junior encumbrance, noting 363(f)(5) is applicable where state law allows satisfaction of a claim through a money judgment, and citing *Desert Palace, Inc. v. Costa*, 539 U.S. 90, 98, 123 S.Ct. 2148, 156 L.Ed.2d 84 (2003) in support of interpretation of bankruptcy code); s*ee, e.g.*, *In re* Gulf States Steel, Inc. of Ala., 285 B.R. 497, 508 (Bankr. N.D. Ala. 2002) (interpreting section 363(f)(5) to authorize sales of property free and clear of liens if trustee can point to other legal mechanisms that would extinguish liens). *But see* Dishi & Sons v. Bay Condos LLC, 510 B.R. 696, 710 (S.D.N.Y. 2014) (minority view holding that § 363(f)(1) is only eligible if the property owner could bring an appropriate action under nonbankruptcy law) (citing *In re Jaussi*, 488 B.R. 456, 458 (Bankr. D.Colo.2013)).

267. *In re* Alta Mesa Res., Inc., 613 B.R. 90, 95 (Bankr. S.D. Tex. 2019).

268. *See* Jesse S. Lotay & Yenmi Tang, Address at 46th Annual Ernest E. Smith Oil, Gas and Mineral Law Fundamentals and Institute: A Primer on Understanding Oil and Gas Transportation Agreements and Identifying Key Issues 1 (Mar. 26–27, 2020), https://www.jw.com/wp-content/uploads/2020/04/Jesse-Lotay-Yenmi-Tang-UT-CLE-A-Primer-on-Understanding-Oil-and-Gas-Transportation-Agreements-Mar.-2020.pdf [https://perma.cc/7SL5-AUX7].

the underlying reserves is the later-in-time gatherer, not the earlier-in-time lender whose collateral must flow through the gatherer. As discussed in detail below, this hypothetical is not idle speculation, but a harsh reality.

V. THE BACKLASH: REVISITING *SABINE* AND A CLOSER ANALYSES OF COVENANTS RUNNING WITH THE LAND

Many economic and practical factors precipitated a wave of oil and gas bankruptcy filings in 2020. Three of those bankruptcy cases involved struggling upstream companies that were parties to economically disadvantageous gathering agreements.[269] As discussed below, two of the three cases rejected *Alta Mesa* and *Badlands*, determined that the gathering agreements were executory contracts, and enabled the bankrupt debtors to reject the gathering agreements under section 365 of the Bankruptcy Code.[270] While that may be cause for celebration to upstream companies and their lenders, the uncertainty arising from *Badlands* remains, and one court's ruling rejecting a gathering agreement suggests *Alta Mesa* remains alive and well.

A. *In re Extraction Oil & Gas, Inc.: Turning the Tide*

Extraction Oil & Gas, Inc. (and with its affiliates, "Extraction") is an upstream exploration and production company that produces oil and related hydrocarbons from wells located in Colorado.[271] In 2017, Extraction entered into a series of transportation agreements ("Transportation Agreements") with various midstream counterparties (the "Gatherers").[272]

The Transportation Agreements generally contained expansive dedications that included "all interests that [Extraction] . . . now or

269. *In re* Southland Royalty Co. LLC, 623 B.R. 64 (Bankr. D. Del. 2020); *In re* Chesapeake Energy Corp., 622 B.R. 274, 276 (Bankr. S.D. Tex. 2020); *In re* Extraction Oil & Gas, 622 B.R. 608, 614 (Bankr. D. Del. 2020).

270. *See infra* sections V.A., V.B., and V.C.

271. *In re* Extraction Oil & Gas, Inc., 622 B.R. 581, 584–86 (Bankr. D. Del. 2020) (providing detailed factual background regarding the debtor's operations and gathering agreements, along with detailed legal analysis of covenant running with the land test); *see also In re* Extraction Oil & Gas, Inc., 622 B.R. 608 (Bankr. D. Del. 2020) (providing additional legal analysis on potential rejection of covenants even if they do run with the land).

272. *Extraction,* 622 B.R. at 585–86.

hereafter owns, controls, acquires or has the right to market in Crude Petroleum of all formations in, under or attributable to the Dedication Area, and all interests in any wells, whether now existing or drilled hereafter . . . ."[273] Certain of the Transportation Agreements made clear that the parties intended the dedications to run with the land. For example, one Transportation Agreement expressly stated that "the dedication and commitment . . . shall be deemed an interest that runs with the land in the dedication Area . . . [Extraction] agrees to execute and deliver a memorandum . . . for each of [the applicable countries] to [Gatherer] for recording in the real property records of each such country . . . ."[274] The Transportation Agreements also contained express provisions stating that they would inure to the benefit of the parties' successors-in-interest.[275]

The Transportation Agreements did note, however, that Extraction retained title to all minerals delivered to Gatherers, and that Extraction's minerals were free and clear of all liens, claims, and encumbrances other than Extraction's lender's liens.[276] Further, Extraction did not grant any easement or rights-of-way to the Gatherers contemporaneously with the Transportation Agreements.[277]

On August 14, 2020, Extraction filed for bankruptcy relief under Chapter 11 of the Bankruptcy Code.[278] Less than two months later, Extraction moved to reject the Transportation Agreements as executory contracts under section 365 of the Bankruptcy Code and, shortly thereafter, filed an adversary proceeding seeking a declaratory judgment ruling that the Transportation Agreements were, in fact, executory contracts subject to rejection.[279]

As the assets purportedly subject to the Gatherers' covenant were located in Colorado, the *Extraction* court applied Colorado law.[280] The court noted that Colorado law "disfavors the creation of covenants running with the land as a derogation of the common law's preference for

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273. *Id.* at 587–88.

274. *Id.* at 588 (citing to Adv. D.I. 5-2 (filed under seal), Notice of Filing of Exhibits to Brief in Support of Plaintiff's Motion for Summary Judgment, Exhibit B at § 2.5).

275. *Id.* at 593–94.

276. *Id.* at 590–91.

277. *Id.* at 586.

278. *Id.*

279. *Id.*

280. *Id.* at 595.

free alienability of land."[281] As a result, the court determined that "any ambiguity concerning whether the terms of the Transportation Agreements created covenants running with the land would be resolved in favor of the unrestricted use of the land."[282]

To create a covenant running with the land under Colorado law, a party must prove three elements: (1) the covenant must touch and concern the land; (2) there must be privity of estate between the original covenanting parties; and (3) the parties must intend to create a covenant running with the land.[283] In *Extraction*, the court ruled that the Gatherers failed to prove any of the three requisite elements and that, as a result, the Transportation Agreements could be rejected.[284]

1. *Extraction*: Touch and Concern

For a covenant to touch and concern land under Colorado law, it must be "closely related to the estate in real property with which it is intended to run, its use, or enjoyment."[285] In this case, that "real property with which" the covenants purportedly ran was "Extraction's mineral estate."[286] The question was therefore whether the dedications and commitments in the Transportation Agreements touched and concerned Extraction's mineral interests.[287]

The Gatherers, citing *Badlands*, argued that the dedication of in-ground minerals in the Transportation Agreements necessarily touched and concerned the land.[288] The court disagreed. The court analyzed the Transportation Agreements and noted that they were, in their fundamental essence, a contract for the transportation of produced minerals.[289] Reference to minerals in the ground simply identified the minerals that, once extracted, would flow through the Gatherers' pipelines for a fee.[290] A dedication is, therefore, just a pledge that

281. *Id.* at 596 (citing Nelson v. Farr, 354 P.2d 163, 166 (Colo. 1960)).
282. *Id.* at 595 (citing B.B. & C. P'ship v. Edelweiss Condo. Ass'n, 218 P.3d 310, 315 (Colo. 2009)).
283. *Id.* at 596.
284. *Id.* at 608.
285. *Id.* at 598 (internal parenthetical omitted).
286. *Id.*
287. *See id.* at 599–600.
288. *Id.*
289. *See id.*
290. *Id.*

identifies the minerals that, once extracted, will be subjected to the services identified in the Transportation Agreements.[291] As a result, a dedication identifying pledged minerals does not inherently burden those minerals.[292]

While the Transportation Agreements contractually obligated Extraction to deliver to Gatherers its pledged minerals, once extracted, the Transportation Agreements did not grant any right to the Gatherers to affect Extraction's in-ground minerals.[293] As stressed by the court, "Extraction retains exclusive control and possession of all minerals from severance from the ground through delivery into the pipeline systems … Extraction retains title to the crude petroleum throughout the entire transportation process, and the [Gatherers] never obtain title to the crude petroleum at any point."[294] Fundamentally, the Transportation Agreements did not affect Extraction's use or enjoyment of oil in place or the use of the mineral estate. It only affected what Extraction could do with its extracted minerals.[295] As a result, the Transportation Agreements did not touch and concern the land—in this case, Extraction's mineral estate.

2. *Extraction*: Privity of Estate

Under Colorado law, "[p]rivity of estate requires that the covenants that allegedly run with the land be accompanied by a contemporaneous conveyance of some interest in the land with which the covenant runs."[296] A later-in-time conveyance cannot establish privity for an earlier-in-time covenant.[297] The court continued, noting that once a surface and mineral estate are severed, they remain separate and distinct estates in real property.[298] As a result, the conveyance of an interest in a

291. *Id.* at 600–01.
292. *Id.*
293. *Id.* at 601–02.
294. *Id.*
295. *Id.*
296. *Id.* at 605 (citing Taylor v. Melton, 274 P.2d 977, 988-89 (Colo. 1954)).
297. *Id.* at 606–07 (holding that a conveyance of rights-of-way two years after entry into the Transportation Agreements could not satisfy privity of estate *even if* it affected Extraction's mineral estate, because it was not "*contemporaneous* with the creation of the covenant intended to run.") (emphasis in original).
298. *Id.* at 605 (citing Notch Mountain Corp. v. Elliot, 898 P.2d 550, 556 (Colo. 1995)).

severed surface estate will not satisfy the privity test for a covenant burdening the severed mineral estate.[299]

None of the conveyances asserted by the Gatherers, which included "purported easements or rights-of-way on Extraction's surface estate" and "the Transportation Agreements' dedications," satisfied Colorado's privity of estate test because none of them involved a conveyance of Extraction's *mineral estate*.[300] The court reasoned that the dedication granted personal rights for the use of the surface estate, but that those rights were inherently severed from the mineral estate.[301] Just because a gatherer is entitled to access or develop the surface does not actually give it any interest in the mineral estate. Moreover, the dedication of surface rights could not by itself be a covenant running with the land. As the court reasoned, the surface estate dedications "cannot be both the real covenant and the element that satisfies privity of estate to create a real covenant."[302] Without some other contemporaneous conveyance, the Gatherers could not satisfy the privity element of the "runs with the land" test.[303] The Extraction gathering agreement was not, therefore, a covenant running with the land.

3. *Extraction*: A Return to *Sabine*?

The *Extraction* decision is important for several reasons. First, it is one of the only widely publicized decisions[304] addressing gathering agreements that stresses a common law disfavor for the creation of covenants running with the land. Second, it returns to *Sabine*'s focus on the separation of the surface and mineral estate and treats each as largely independent real property interests. Doing so raises the burden of proving

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299. *Id.*

300. *Id.* at 607.

301. *Id.* at 607–08 (citing Lobato v. Taylor, 71 P.3d 938, 945 (Colo. 2002)).

302. *Id.* at 608–09.

303. *Id.* at 605.

304. *See, e.g.*, Allison Good, *Extraction Oil & Gas can Reject Midstream Contracts, Bankruptcy Court Says*, S&P GLOBAL MKT. INTELLIGENCE, (Oct. 15, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/extraction-oil-gas-can-reject-midstream-contracts-bankruptcy-court-says-60747959 [https://perma.cc/4QAS-DRE9]; Greg Avery, *Colorado Oil Company Wins Pipeline Ruling from Bankruptcy Court*, DENVER BUS. J. (Oct. 15, 2020, 8:33 AM) https://www.bizjournals.com/denver/news/2020/10/15/extraction-midstream-chapter-11-bankruptcy-court.html [https://perma.cc/A4QJ-URAG].

the existence of a covenant running with the land. Third, the court in *Extraction* arguably disagreed with *Badlands*' ruling that a covenant running with the land is not an "interest" for the purposes of section 363 of the Bankruptcy Code. In dicta, the court in *Extraction* noted that a "covenant running with the land, creates 'an equitable property *interest* in the burdened land'" and cited a quotation stating "covenants running with the land, are not a lien or executory contract but rather, 'an *interest* in land . . . .'"[305]

B. In re Chesapeake Energy Corporation: Houston, Do We Have a Contradiction?

On June 28, 2020, energy giant Chesapeake Energy Corporation and its affiliates (collectively "Chesapeake") filed for bankruptcy relief and immediately moved to reject a natural gas purchase agreement with its pipeline counterparty ("ETC").[306] Chesapeake entered into the agreements with ETC more than four years before Chesapeake's bankruptcy filing.[307] Under the ETC agreements, Chesapeake agreed to sell and ETC agreed to purchase all of Chesapeake's gas from dedicated leases, subject to certain allowed uses by Chesapeake, up to certain agreed volume limits.[308]

As part of the agreements, Chesapeake dedicated "for sale and delivery hereunder all of the Gas owned or controlled by [Chesapeake] that is produced from the oil and gas leases described" in an exhibit to the agreement.[309] The dedication expressly stated that it was "a covenant running with the land, and [ETC] and [Chesapeake] shall sign, and [ETC] shall file in the property records of the applicable county or counties, a Memorandum of this Transaction Confirmation . . . ."[310] Despite the purported covenant running with the land in Chesapeake's gas, ETC's exclusive remedy for Chesapeake's breach under the agreements was a right to money damages.[311]

305. *In re* Extraction Oil & Gas, Inc., 622 B.R. 581, 596 (Bankr. D. Del. 2020) (emphasis added).

306. *In re* Chesapeake Energy Corp., 622 B.R. 274, 276–77 (Bankr. S.D. Tex. 2020).

307. *Id.* at 277.

308. *Id.*

309. *Id.* at 278.

310. *Id.*

311. *Id.* at 279.

1. *Chesapeake*: The Texas Test

When analyzing whether the Chesapeake agreements were covenants running with the land, the court applied a six element test slightly different than that referenced in *Sabine*: (1) did the obligation touch and concern the land; (2) did the obligation relate to a thing in existence or bind the parties and their assigns; (3) did the parties intend for the obligation to run with the land; (4) did the successor to the burden have notice of the obligation; (5) was there privity of estate or vertical privity between the parties at the time the covenant was created; and (6) was there horizontal privity.[312] However, the court noted, while listing those elements, that in *Energytec* the Fifth Circuit questioned whether horizontal privity remains an element of the "runs with the land test."[313]

While the court appears to be skeptical of the necessity of its inclusion, it recognized that, though questioned by the Fifth Circuit, the court in *Energytec* did in fact perform a horizontal privity test as part of its analysis.[314] Moreover, while the court lists six potential elements for inclusion in the Texas test, its analysis focused only on the three standard elements addressed by each of the cases analyzed in this article: (1) did the covenant touch and concern the land; (2) was there privity of estate; and (3) did the parties intend to create a covenant running with the land.[315]

As a preliminary matter, the *Chesapeake* court noted that executory contracts and covenants running with the land are not mutually exclusive.[316] Judge Jones reasoned that nothing in the text of section 365 of the Bankruptcy Code creates mutual exclusivity, and that it is possible to contemplate an executory contract that also contains a covenant that runs with the land.[317] The court stated that, in such an event, the

312. *Id.* at 281 (citing *In re* El Paso Refiner, LP., 302 D.3d 343, 355 (5th Cir. 2002) (cited for first four elements); *In re* Energytex, Inc., 739 F.3d 215, 221 (5th Cir. 2013) (cited for the fifth element and sixth elements)).

313. *Id.* at 281. (citing *Energytex*, 739 F.3d at 221).

314. *Id.*

315. *Id.* at 282–283.

316. *Id.* at 281.

317. *Id.* ("ETC repeatedly asserts that the ETC Purchase Agreement cannot be an executory contract if it contains a covenant that runs with the land. ETC does not cite nor is the Court able to locate any authority for such a proposition. Likewise, § 365 of the Bankruptcy Code contains no such exclusion and no known rule or law prohibits the mutual existence of both concepts within a single document. It does not stretch the imagination to envision a contract that both contains a covenant that runs with the land and is executory. In such a circumstance, the appropriate analysis is what benefit was previously bestowed by the debtor on the non-

"appropriate analysis is what benefit was previously bestowed by the debtor on the non-rejecting party that remains post-rejection and what future performance by the debtor is excused by the rejection."[318] While the court opened the door to a whole new issue—whether a party could reject an executory contract that otherwise created a limited covenant running with the land—it found no need to pursue the analysis in light of the terms of the contract in question.[319]

2. *Chesapeake*: Touch and Concern

Under Texas law, a covenant "touches and concerns the land when the underlying obligations affect the nature, quality or value of the thing demised, independently of collateral circumstances, or it affect[s] the mode of enjoying it."[320] In *Chesapeake*, ETC argued that the agreement touched and concerned Chesapeake's mineral estate because of Chesapeake's dedication of all of its gas[321] produced from specifically identified oil and gas leases. Further, ETC noted that the memorandum recording Chesapeake's purported covenant dedicated all gas owned by Chesapeake "and underlying or produced from the Dedicated Leases . . ." to ETC.[322] As a result, ETC argued, the covenant touched minerals underlying specific leases.[323] The court rejected ETC's argument by applying an analysis similar to that applied in *Sabine*.

First, the court determined that the dedication applied only to produced gas, which necessarily meant gas that had been removed from the ground and was ready for collection at the debtor's wellheads.[324] Under Texas law, gas that has been extracted from the ground is personal

rejecting party that remains post-rejection and what future performance by the debtor is excused by the rejection. Depending on the particular language of the subject agreement, a plethora of outcomes are possible.") (citation omitted).

318. *Id.* (citing Mission Prod. Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652, 1658 (2019) (addressing effects of rejection on licensee's right to continue use of licensed trademark after licensor's rejection of parties' executory contract)).

319. *Id.*

320. *Id.* at 283 (citing *In re* El Paso Refinery, LP, 302 F.3d 343, 356 (5th Cir. 2002)); Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 911 (Tex. 1982); Wimberly v. Lone Star Gas Co., 818 S.W.2d 868, 871 (Tex. App.—Fort Worth 1991) (*writ denied).*

321. Up to certain volume limits referenced in the agreement known as the "SRC".

322. *Id.* at 278 n.2.

323. *See id.*

324. *Id.*

property.[325] Accordingly, although the dedication referenced "Dedicated Leases," the substance actually dedicated to ETC was produced gas in certain volumes.[326] As the court reasoned, "[o]nly after gas is produced and becomes personal property does an obligation regarding the disposition of that gas arise."[327]

Second, the court analyzed whether the purported covenant running with the land actually affected Chesapeake's real property interests.[328] The court determined that under the agreement, ETC had "no right of access to or control over Chesapeake's use of its real property interest."[329] ETC had a right to receive produced gas under the agreement and nothing more. Further, its only remedy was a claim for monetary damages against Chesapeake. Without more, the court reasoned, the agreement did not "touch and concern" Chesapeake's real property mineral interests.[330]

3. *Chesapeake*: Privity

The court's analysis of whether privity existed diverged considerably from that of *Sabine*. While the *Chesapeake* court summarily found a lack of horizontal privity, it focused its privity analysis almost exclusively on vertical privity under Texas law.[331] Vertical privity requires only a "mutual or successive relationship to the same rights of property."[332] The question in *Chesapeake* was therefore whether Chesapeake transferred any interest in its real property to ETC.

ETC asserted that the language of dedication evidenced such a transfer.[333] ETC argued that under the ETC Agreement's express terms, Chesapeake dedicated "such *property rights* arising out of the Dedicated Leases necessary to burden the Dedicated Leases with [Chesapeake's] dedication of the Dedicated Leases and Gas," and that this specific

325. *Id.* (citing Phillips Petroleum Co. v. Adams, 513 F.2d 355, 363 (5th Cir. 1975)).
326. *Id.* at 283.
327. *Id.*
328. *Id.*
329. *Id.*
330. *See id.* at 282–83.
331. *Id.* at 284.
332. *Id.* at 283.
333. *Id*.

reference to "property rights" satisfied vertical privity.[334] Admittedly, that language is difficult to follow. The court, however, translated it to mean "we dedicate whatever is necessary to make sure that the dedication is valid."[335] Chesapeake's agreement with ETC was, in essence, a forward contract for the purchase of gas.[336] While ETC had a contractual right to purchase Chesapeake's produced gas from a dedicated area for a certain fee, no dedication or conveyance of any real property interest was necessary to effectuate any of the terms and conditions of the agreement.[337] Without that corollary, there was no vertical privity in *Chesapeake*.[338] Having failed to prove any of the necessary elements to establish a covenant running with the land, the court ruled against ETC and determined that the contract was executory and subject to rejection.

4. A Disagreement in Houston? Perhaps not.

The *Chesapeake* decision is notable in part because it was rendered by Judge Jones, who is bench mates with Judge Isgur at the United States Bankruptcy Court for the Southern District of Texas,

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334. *Id.* (emphasis added).

335. *Id.*

336. *Id.* at 283–84. Quoting section 101 of the Bankruptcy Code for the definition of a "forward contract," the court explains as follows:

> Under § 101 of the Bankruptcy Code, a forward contract means: [A] contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in this section) [2] consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement . . . . The parties' agreement is indicative that the object of the ETC Purchase Agreement is the ongoing purchase and sale of personal property—not the burdening of a real property interest.

Id. (quoting 11 U.S.C. § 101(25)(A)).

337. *Id.*

338. *Id.* at 284.

Houston Division.[339] Judge Isgur of course decided *Alta Mesa*. Further, it involved a Texas judge applying Texas law and, like *Sabine*, finding that a midstream oil and gas contract masquerading as a covenant running with the land was a rejectable executory contract. On its face, it initially appears that Judge Jones diverges from Judge Isgur's ruling in *Alta Mesa*. A closer reading, however, suggests otherwise.

In his ruling, Judge Jones considers an argument from ETC in which ETC states that *Alta Mesa* unequivocally stands for the proposition that the inclusion of a covenant running with the land in a contract precludes rejection.[340] While Judge Jones perhaps surprisingly challenged ETC's interpretation, he did affirmatively state that the decision in *Alta Mesa* was "proper given the relief requested, the arguments raised by the parties and addressed by the court . . . ."[341]

What is perhaps more surprising is that Judge Jones affirmatively applied Judge Isgur's *Alta Mesa* analysis when issuing his conclusion and ruling.[342] Applying Judge Isgur's analysis appears unnecessary under the circumstances. First, *Alta Mesa* involved Oklahoma law, not Texas law. Judge Isgur's decision in *Alta Mesa* promoted a liberal application of the "runs with the land" test under Oklahoma law as opposed to the considerably more conservative approach in *Sabine*, which applied Texas law. That conflict is noticeable in *Chesapeake*. Although Judge Jones approved Judge Isgur's liberal *Alta Mesa* analysis, he also recognized that Texas Supreme Court case law disfavors covenants running with the land,

339. Judge Jones and Judge Isgur handle the vast majority of complex chapter 11 bankruptcy cases filed in the United States Bankruptcy Court for the Southern District of Texas. Recently, their Houston courtrooms have become among the busiest commercial bankruptcy courts in the nation, and among the most influential courts addressing oil and gas bankruptcy issues in the United States. *See December 2020 Bankruptcy Statistics – Commercial Filings*, AM. BANKR. INST., https://www.abi.org/newsroom/bankruptcy-statistics [https://perma.cc/37UQ-EBCX] (reporting that the United States Bankruptcy Court for the Southern District of Texas received the second-most commercial bankruptcy filings in the United States in 2020 and received nearly 60% more filings than it did in 2019 despite a 16.75% reduction in total commercial filings nationally. For comparison, the United States Bankruptcy Court for the Southern District of New York saw almost no increase in filings in 2020).

340. *In re* Chesapeake Energy Corp., 622 B.R. 274, 281 (Bankr. S.D. Tex. 2020).

341. *Id.* at 281–82.

342. *Id.* at 284 ("Applying Judge Isgur's analysis in *Alta Mesa* and the specific content of the ETC Purchase Agreement, the Court concludes that . . . ."). The authors suspect that Judge Jones included this statement, which was unnecessary considering *Alta Mesa* was determined under a different state's law, to ensure the *Chesapeake* decision is not later used to evidence a shift in the court's reasoning from *Alta Mesa* to something closer to *Sabine*.

and that all ambiguities must be strictly construed against the party seeking to enforce a covenant running with the land under Texas law.[343] Judge Jones's does little to resolve that apparent contradiction.

Second, the distinguishing elements of the *Alta Mesa* decision are absent in *Chesapeake*. *Alta Mesa*, like *Sabine*, included a dedication of produced minerals—a personal property interest—along with certain rights related to the surface estate. Contrary to *Sabine*, Judge Isgur determined that despite dedicating only produced minerals, the conveyance of interests in the *surface* estate resulted in a covenant that ran with the underlying *mineral* estate because of the interconnected nature of those estates in the context of a gathering agreement. *Chesapeake*, however, did not even involve dedications of surface rights or the development of any gathering system. Its analysis is, in relevant part, rather inapplicable to the facts of *Chesapeake*. Regardless, *Chesapeake* denied the existence of a covenant running with the land in a contract that involved a dedication of produced gas; thus, it appears *Alta Mesa* remains superior to *Sabine* in the Southern District of Texas. It is not, however, the favored law of the United States Bankruptcy Court for the District of Delaware.

C. In re Southland Royalty Company: Another Covenant Bites the Dust

Southland Royalty Company LLC ("Southland") is an upstream exploration and production company "focused on the acquisition, development, and exploitation of oil, natural gas, and natural gas liquid reserves in North America."[344] In 2016, Southland acquired its interests in oil and gas wells covering more than 500,000 net working interest acres in the Wamsutter Field of Wyoming through a transaction with Anadarko E&P Onshore, LLC, Anadarko Land Corp., and Kerr-McGee Oil and Gas Onshore, LP (collectively, "Anadarko").[345]

In June, 2016, Southland entered into contracts with Wamsutter LLC ("Wamsutter"), a large midstream pipeline company, for the

343. *See id.* at 281 ("Covenants restricting the unfettered use of one's real property are generally disfavored under Texas law. Any ambiguity is strictly construed against the party seeking to enforce the restriction.") (citing Wilmoth v. Wilcox, 734 S.W.2d 656, 657 (Tex. 1987)).

344. *In re* Southland Royalty Co. LLC*,* 623 B.R. 64, 71 (Bankr. D. Del. 2020).

345. *Id.*

treatment, processing, and transportation of minerals extracted from its interests in the Wamsutter Field.[346] Wamsutter's gathering system is described by the court as "a large highway of pipes, compressors, dehydrators, processing plants, and other facilities that enable Wamsutter to gather, transport, process, and treat the gas produced from Southland's wells so that it can be taken downstream for sale."[347] In total, the Wamsutter gathering system consists of, "among other things, thousands of miles of pipelines, numerous gas compressor stations, and a gas processing plant."[348] Given the size and scope of the gathering system and the Wamsutter Field, Wamsutter's facilities are critical to upstream entities like Southland that want to take their produced minerals to market.

At issue in *Southland* were two gathering agreements.[349] The first gathering agreement between Southland and Wamsutter, dated June 1, 2016 is known as the L60 Agreement.[350] The L60 Agreement expires by its terms on December 31, 2031.[351] The second, dated November 1, 2018, is known as the L63 Agreement (and together, the "Gas Gathering Agreements").[352] The L63 Agreement expires by its terms on October 1, 2038.[353]

Most of Southland's wells under the L60 Agreement were traditional vertical wells.[354] Shortly after acquiring its interest from Anadarko, Southland desired to effectuate a large horizontal drilling program in an effort to dramatically increase production in the Wamsutter Field.[355] To handle the increased production, Southland contracted with Wamsutter for the development of multiple additional compressor

346. *Id.*

347. *Id.*

348. *Id.*

349. *See supra* notes 158–63 and accompanying text.

350. *In re* Southland Royalty Co. LLC*,* 623 B.R. at 71–72.

351. *Id.*

352. *Id.*

353. *Id.* at 73.

354. *Id*. at 72–73 ("Because the then-existing Wamsutter Gathering System was designed to accommodate vertical wells, it was determined that modifications were needed to provide incremental capacity to accommodate Southland's future horizontal wells. *Horizontal wells typically produce gas at a much higher volume than vertical wells. As a result, if not updated, a gathering system servicing vertical wells may be incapable of handling the additional volume from horizontal wells*. The resulting increased pressure on the system could reduce or completely stop production from the vertical wells.") (emphasis added).

355. *Id.*

stations, miles of additional pipeline, and other related equipment.[356] Wamsutter expected the project to cost approximately $350 million to complete.[357] In order to effectuate the expansion, the parties executed the L63 Agreement.[358]

The "Shippers Dedication" found in the L63 Agreement states, in pertinent part:

> Shipper dedicates to the performance of this Agreement the Dedicated Properties and Dedicated Gas and grants to [Wamsutter] the exclusive right to Gather, Process, Dehydrate and Treat the Produced Dedicated Gas ("Dedication"). This Dedication shall be a covenant running with the land under applicable law and binding on the respective successors and assigns of the interests of Shipper and its Affiliates in and to the Dedicated Properties and Dedicated Gas. If applicable law requires any amendment or modification to this Agreement for this Dedication to be treated as an enforceable covenant running with the land, the parties will promptly enter into any such addendum or modification. Gatherer may file memoranda of this Agreement substantially in the form of Exhibit "J" in local land records from time to time in its discretion, and Shipper will promptly enter into any such memoranda upon request.[359]

By contrast, the L60 Agreement's "Shippers Dedication" states, "Shipper dedicates Shipper's Gas within the Area of Interest described in Exhibit B to [Wamsutter] for Gathering, Processing, Dehydrating and Treating."

Following the execution of the L63 Agreement, the parties worked together on the development of the corresponding gathering infrastructure. In late 2019, however, Southland began to experience severe economic hardship and demanded that Wamsutter cease all additional capital expenditures related to the L63 infrastructure

356. *Id.*
357. *Id.*
358. *Id.*
359. *Id.* at 74–75.

improvements.[360] In its notice to Wamsutter, Southland admitted to suffering from diminished drilling economics and limited access to capital caused by the decline in commodity prices, underperforming wells, and unanticipated operational issues.[361]

On January 27, 2020, Southland filed for bankruptcy relief under Chapter 11 of the Bankruptcy Code.[362] Instead of immediately challenging whether the Gas Gathering Agreements were covenants running with the land, Southland pursued a robust, well marketed sale process for substantially all of its assets in the Wamsutter Field.[363] As part of the sale process, Southland worked to facilitate a renegotiation of the L63 agreement between potential purchasers and Wamsutter, who willingly participated in those discussions.[364]

Unfortunately, no potential purchaser was able to reach any meaningful agreement with Wamsutter over the renegotiation of the L63 Agreement and its minimum volume commitments.[365] As a result, Southland's sale process failed and, on March 27, 2020, Southland commenced an adversary proceeding against Wamsutter seeking a declaratory judgment holding, in pertinent part, that the Gas Gathering Agreements were subject to rejection as executory contracts.[366] After a lengthy trial, supplemental briefing, and extensive oral argument, the court ruled that "for many of the same reasons set forth by the courts in *Sabine* and *Extraction*, the L63 Agreement contains no real covenants."[367] Instead, the court ruled, it was merely a services contract for the gathering of Southland's personal property.[368] More surprisingly, the court further ruled that even if the L63 Agreement did contain a "real covenant," it could be rejected under section 365(a) of the Bankruptcy Code.[369]

360. *See id.* at 75.
361. *Id.*
362. *Id.* at 71.
363. *Id.* at 76–77.
364. *Id.*
365. *Id.*
366. *Id.*
367. *Id.* at 79–80.
368. *Id*. at 80.
369. *Id.*

Beginning its analysis, the court in *Southland* noted that covenants running with the land are typically disfavored.[370] As a general rule, under Wyoming law, no one should be held liable for obligations under a contract unless by his express consent by entry into the agreement.[371] As a result, covenants running with the land that automatically burden successive owners should be considered an exception to the general rule and should be disfavored.[372]

To create a covenant running with the land under Wyoming law, four elements are required: (1) the original covenant must be enforceable; (2) the parties must intend the covenant runs with the land; (3) the covenant must touch and concern the land; and (4) there must be privity of estate between the parties.[373] Importantly, because covenants running with the land are disfavored under Wyoming law, they must "be strictly constructed, will not extend by implication, and in case of doubt the restriction will be constructed in favor of the free use of the land."[374] This article focuses on whether the purported covenant touched and concerned the land and whether there was privity estate between the parties, as those two elements are consistently determinative in each of the previous bankruptcy decisions addressing whether a covenant runs with the land.

1. *Southland*: Touch and Concern

In *Southland*, the court determined that, under Wyoming law, the question of whether a covenant touched and concerned the land depended on whether it substantively affected Southland's "legal rights in its real property."[375] The court ruled with beautiful simplicity that "the L63 Dedication does not alter Southland's legal rights in its real property."[376] In support of its ruling, the court reasoned that:

370. *Id.* at 80–82.
371. *Id.*
372. *Id.*
373. *Id.* at 80.
374. *Id.* at 82 n.65 (citing Kincheloe v. Milatzo, 678 P.2d 855, 859 (Wyo. 1984); Kindler v. Anderson, 433 P.2d 268 (1967); Pennaco Energy Inc. v. KD Co., LLC, 363 P.3d 18, 37 (Wyo. 2015)).
375. *Id*. at 83.
376. *Id.*

> It is undisputed that Southland is free to do what it likes with its unproduced gas reserves, including decreasing or ceasing further exploration, drilling, and production…Wamsutter has no right to enter the L63 Are of Interest and access or control Southland's unproduced reserves, including through its own development. It is only once the gas in the L63 Area of Interest is produced that the L63 Dedication takes affect by requiring the production to be served by Wamsutter and the Wamsutter Gathering System in exchange for the agreed upon fees. At that point, Wamsutter takes title to and control of the produced gas . . . ."[377]

Accordingly, only Southland's *produced* gas from the L63 Area of Interest was affected by the Dedication, and produced gas is a personal property interest under Wyoming law.[378]

Further, the court continued, any benefit to the value of Southland's reserves caused by the Wamsutter gathering system was indirect, or collateral, because they arose only from services associated with Southland's produced gas.[379] As the Dedication only directly affects Southland's legal rights in its produced gas—personal property—it cannot run with the land.

2. *Southland*: Privity of Estate

Under Wyoming law, privity of estate can only be created by a conveyance of the real property that the parties seek to encumber.[380] The court noted that the L63 Dedication was not a conveyance of a real property interest but instead an exclusivity agreement tied to produced gas—personal property.[381] Because the debtor did not convey its mineral estate, the mineral estate could not be burdened by a covenant running

377. *Id.* at 83–84.
378. *Id.* at 84.
379. *Id.* at 85.
380. *Id.* at 86 ("Privity of estate can only be created in the first instance in connection with a grant of the land sought to be charged, or an estate therein, or the equivalent thereof.") (citing Lingle Water Users' Ass'n v. Occidental Bldg. & Loan Ass'n, 297 P. 385, 391 (1931)).
381. *Id.*

with the land.[382] Applying a *Sabine*-like analysis, the court further ruled that any floating easements conveyed in the L63 Agreement or executed between the parties were not tied to Southland's mineral interests because the surface and mineral estates are severed.[383] Accordingly, even a conveyance of a real property interest in Southland's surface estate could not give rise to a covenant burdening Southland's mineral estate. As a result, the court found no privity of estate, and that the L63 Agreement was not a covenant running with the land.

3. *Southland*: Rejecting *Badlands*—Court Precludes Equivalent of Priming Lien in Favor of Midstream Gatherer

Although the court in *Southland* ruled that the L63 Agreement could be rejected as an executory contract, it also held in dicta that Southland could sell its assets free and clear of the L63 Agreement even if it was a covenant running with the land.[384] In doing so, it rejected *Badlands*. First, the court noted that section 363(f) of the Bankruptcy Code should be broadly applied.[385] A covenant running with the land does not constitute something other than an "interest" as that term is used in section 363(f) of the Bankruptcy Code.[386] The question should not be whether a covenant runs with the land is an "interest," but whether there are grounds under section 363(f)(1)–(5) of the Bankruptcy Code to sell the asset free and clear of the covenant.[387]

According to *Southland*, Wyoming foreclosure law allowing a senior lienholder to foreclose out a junior encumbrance, including a covenant running with the land, satisfies section 363(f)(1) of the Bankruptcy code. Accordingly, Southland could sell its assets free and clear of any covenant running with the land arising from the L63 Agreement.[388]

Wyoming law also allows the satisfaction of a covenant running with the land by money judgment. As the court recited, "[u]nder Wyoming law, it is well established that both legal and equitable remedies are available in covenant enforcement actions. Valid

382 .*See id.*
383. *Id.* at 86–87.
384. *Id.* at 96–97.
385. *Id.* at 97 (citing *In re* Trans World Airlines, Inc. 322 F.3d 283, 289 (3d Cir. 2003)).
386. *See id.*
387. *Id.* (citing *In re* Energytec, 739 F.3d 215, 225-26 (5th Cir. 2013)).
388. *Id.* at 97–98.

covenants, like other contracts and property interests, can be enforced and protected by both legal and equitable remedies as appropriate . . . ."[389] As a result, Southland could also sell its assets "free and clear" under section 363(f)(5) of the Bankruptcy Code.[390]

VI. THE *SOUTHLAND* CONUNDRUM: BIG PICTURE APPLICATION OF RECENT RULINGS AND REMAINING UNCERTAINTY

A. Rejecting Gathering Agreements: Far from a Panacea

On December 5, 2019, Wamsutter's Chief Executive Officer, Alan Armstrong, summarily dismissed questions raised at an investor conference about the potential rejection of Wamsutter's gathering agreements in bankruptcy.[391] Armstrong noted his frustration with the question, pointed out that none of Wamsutter's gathering agreements with other producers had ever been rejected, and stated that rejection made no sense because "there is no other feasible way to move the commodity to the market and get paid than to own the gathering system, and so if you think about the opportunity to reject a contract you would have to believe the avoided cost of building a system . . . is better than current pricing."[392]

Armstrong's analysis reflects a harsh reality. Even if an upstream debtor *can* reject its gathering agreement, is there any economically feasible alternative that will enable the upstream debtor to get its produced minerals to market? That is a very real and very difficult question for some bankrupt upstream debtors whose leases are located in isolated areas, areas with minimal pipeline development, or in areas in which one midstream gatherer provides substantially all gathering services to upstream producers.

Southland presents a prime example of this. While Southland successfully rejected the L63 Agreement, the question quickly became "what next?" If Southland will not use Wamsutter, but Wamsutter is the

389. *Id.* at 98 (citing Essex Holding, LLC v. Basic Props., Inc., 427 P.3d 708, 724 (Wyo. 2018)).

390. *Id.* at 98–99.

391. Allison Good, *Gas Gathering Contracts Safe from Customer Credit Woes, Williams CEO Says*, S&P GLOBAL MKT. INTELLIGENCE., (Dec. 6, 2019), https://www.spglobal.com/marketintelligence/en/news-insights/trending/xwBl1l2NUB239xjtFWcQcQ2 [https://perma.cc/46UM-GG7E].

392. *Id.*

only gathering system around, Southland will have to develop its own pipeline at great cost. As noted above, Wamsutter invested hundreds of millions of dollars developing pipeline based on Southland's bullish expectations. Southland lacks capital to develop its own pipeline, and its reserves are already fully encumbered. Southland must, therefore, consider alternatives. Can Southland incentivize a Wamsutter competitor to develop new gathering systems to service its wells? Unfortunately, the answer is "not likely." Further, the cost of development may exceed the value of Southland's reserves, sounding a death knell to Southland's continuing operations.

The Southland conundrum does not end there. If Southland cannot negotiate any economically favorable gathering agreement, it may have no real chance of selling its assets for value. Imagine the following hypothetical: Southland possesses mineral reserves valued at $500,000,000 and successfully rejected Wamsutter's Gas Gathering Agreements in bankruptcy.[393] Due to liquidity issues, Southland cannot afford a new gathering and processing system and has no alternative midstream counterparty with which to enter into a new gathering agreement. Due to depressed mineral prices, Southland's lenders are under-secured and cannot loan Southland more money to develop a gathering system.[394] As a result, Southland cannot produce and sell its minerals. It has no means of monetizing its reserves.

Faced with such a bad situation, Southland may seek to liquidate its assets, but who would buy Southland's assets? A buyer would have to negotiate a new gathering agreement with Wamsutter or spend a huge sum of money developing its own gathering and processing system, which is implausible.[395] Wamsutter may refuse negotiations because of its *own* interest in acquiring Southland's assets. Moreover, without a gathering agreement, there is simply too much risk for any potential purchaser to buy Southland's assets. Accordingly, Southland can neither monetize its reserves through operations nor monetize its assets through a sale to a third-party purchaser. Southland's senior reserve-based lender may therefore decline to foreclose on its collateral for substantially the

393. *See In re* Southland Royalty Co. LLC, 623 B.R. at 96–97.

394. *See supra* Part I (describing the collapse in energy prices during 2020).

395. *See supra* Section II.A.1. (describing the importance of gathering agreements to oil and gas production).

same reasons. Southland's lender would simply step into Southland's shoes with no means of disposing of its collateral in a lucrative manner.

That leaves Wamsutter as the only remaining party that may have an interest in Southland's assets. Wamsutter already owns a gathering and processing system capable of servicing Southland's wells and is familiar with the assets.[396] Regardless, Wamsutter has no real competition to purchase Southland's assets, and so Southland's bargaining power in sale negotiations is limited. Specifically, Wamsutter and Southland know, in this hypothetical, that Southland's assets will enable Wamsutter to mitigate its losses and possibly even make a profit, but Wamsutter has no remaining competitors. As a result, Wamsutter will likely offer, and Southland will likely accept, a heavily discounted purchase price. Wamsutter becomes the only winner in Southland's bankruptcy case in this hypothetical: Wamsutter purchases Southland's assets for a pittance, and then extracts, gathers, and processes the minerals at great profit.

In the *Southland* bankruptcy case, Wamsutter quickly realized the power of its position, regardless of whether its Gas Gathering Agreements were rejected. Months into the bankruptcy case, Wamsutter filed a *Motion for Adequate Protection, or Alternatively, for Relief from the Automatic Stay*.[397] In that motion, Wamsutter pointed out that it was the sole means of monetizing Southland's assets, that Southland had no other means of getting its product to market, and that constructing an alternative system would be complex and could not be completed on any expedited timetable.[398] Wamsutter argued that because it was not getting paid what it was owed by Southland, but was still processing Southland's minerals, it should be able to simply take Southland's gas and process and sell it for Wamsutter's own benefit.[399] After its Gas Gathering Agreements were rejected, Wamsutter only slightly shifted its position and engaged in negotiations to acquire all of Southland's assets at a tremendous discount.

396. *See supra* Section V.C.

397. Wamsutter LLC's Motion for Adequate Protection, or Alternatively, for Relief from the Automatic Stay*, In re* Southland Royalty Co. LLC, No. 20-10158, (2020) (D.I. 843).

398. *Id.* at ¶ 8.

399. *Id.* at ¶ 14.

B. *The Southland Conundrum: Underwriting Considerations*

From an underwriting perspective, banking clients with whom the authors have spoken pointedly raise similar concerns. Is a successful rejection of a gathering agreement really a success? Is rejection the backstop that lenders should rely on to ensure they retain a first-priority lien on their collateral? Are there alternative means for midstream gatherers to finance the construction of gathering systems to eliminate or at least mitigate confusion and risk? If a lender's reserve-based loan is secured by reserves that cannot be brought to market, what is the real value of its collateral? Does it have any value to any party other than the midstream entity that already has a developed pipeline? All are difficult questions, and the *Southland* case evidences just how troubling these issues can be.

Southland's conundrum should not be understated. Regardless of reserve reports or other reserve valuations, the minerals securing Southland's lenders' debts are essentially worth what Wamsutter is willing to pay for them. Accordingly, while *Extraction* and *Southland* appear to be favorable cases to lenders to upstream debtors, they may provide only cold comfort. There is little practical difference between the outcomes in *Southland* and in *Alta Mesa* and *Badlands*. In each case the midstream gatherer's interests dominated the debtor's effort to reorganize and deprived the debtor's lender of value.

One potential solution addresses the nature and construction of gathering agreements. As illustrated above, midstream gatherers often rely on dedications and specific language in gathering agreements to establish a covenant running with the land that encumbers the upstream counterparty's mineral interests.[400] In doing so, the gatherer seeks to ensure that it recoups its costs of construction and perhaps makes a profit. The creation of a later-in-time real property encumbrance is, however, detrimental to the upstream counterparty's lender and may cause an immediate breach of the upstream borrower's credit agreement.[401] Given the conflicts between the parties' interests, one must question whether there is a better way. Based on the authors' experiences in other

400. *See supra* Section II.A.2.
401. *See, e.g., In re* Sabine Oil & Gas Corp., 550 B.R. 59, 67–68 (Bankr. S.D.N.Y. 2016).

industries,[402] we offer that midstream gatherers could accomplish their goals through debt financing and inter-creditor agreements with their upstream counterparty's lender.

First, doing so would promote transparency. Earlier-in-time lenders would not be surprised by later-in-time encumbrances associated with the development of gathering systems that benefitted their borrower's operations. That transparency would help prevent surprise credit agreement defaults like that referenced in *Sabine*.[403] Moreover, recording and providing notice of a gatherer's lien, along with an intercreditor and subordination agreement, would provide certainty to all parties about who has what rights in the borrower's collateral.

Second, a debt instrument with a recorded lien on the upstream borrower's minerals would achieve the gatherer's goal of recouping the costs incurred constructing the gathering system. Through an intercreditor and subordination agreement, the borrower, lender, and gatherer could come to terms on the cost and scope of the development project and agree which party—the lender or the gatherer—should have priority of payments from extracted minerals. The lender and gatherer could even negotiate how proceeds of the sale of the borrower's assets would be remitted to each party in the event of a sale, providing certainty should the borrower later file for bankruptcy and sell its assets under section 363 of the Bankruptcy Code. That certainty of some recovery from the proceeds of a sale should be superior to the chance of possessing nothing but a general unsecured claim if, in the alternative, the gatherer's agreement was rejected. Moreover, possessing a valid secured claim may entitle a gatherer to credit bid its debt under section 363(k) of the Bankruptcy Code should it wish to acquire the upstream borrower's assets in a bankruptcy sale.[404]

Finally, structuring the borrower's repayment obligations as a secured debt instrument eliminates the need for speculative volume-

402. The authors have witnessed the successful use of junior debt financing and intercreditor and subordination agreements to allow borrowers' to successfully expand operations in various industries, including heavy machinery manufacturing, horticulture, automotive services, real estate development, marketing and advertising, science and technology, oilfield services, shipping and trucking, meat packing, ranching, retail, and many more.

403. *See, e.g., Sabine*, 550 B.R. at 67–68.

404. *See* 11 U.S.C. § 363(k) (2018) (allowing a secured creditor to credit big value of its interest in debtor's collateral in section 363 sale).

based repayment obligations like those found in *Southland*, which gave rise to damages claims by Wamsutter greatly exceeding any amount spent to develop the gathering system. As shown above, the Wamsutter Gas Gathering Agreements had approximately thirty-year terms. The authors are unaware of any reason why Wamsutter could not have obtained a secured promissory note from Southland with a similar term and fixed or even floating repayment schedule. With such a note in place, a gatherer could simply agree to gather and process the borrower's extracted minerals for a market fee which, when paid in conjunction with debt service payments, would ensure that the gatherer is repaid *and* earns a healthy profit. That could potentially reduce volatility for the benefit of all parties involved.

VII. CONCLUSION

An upstream debtor's ability to reject a gathering agreement in bankruptcy is, at times, critical to its efforts to reorganize. If a debtor proves that its gathering agreement is an executory contract and rejects it under section 365 of the Bankruptcy Code, the debtor is absolved of any future obligations under the agreement. Moreover, the midstream counterparty to the agreement will receive only a general unsecured claim in the debtor's bankruptcy case, which is likely to receive only partial payment.[405] After rejecting the agreement, the debtor can renegotiate a new agreement, contract with a different midstream company, or develop its own gathering system as part of its restructuring. A debtor's ability to reject a gathering agreement can therefore provide great flexibility in a bankruptcy restructuring.[406]

However, a debtor may not be able to reject a gathering agreement if it is deemed a covenant running with the land.[407] A covenant running with the land is a real property interest and, in most courts, not subject to rejection under the Bankruptcy Code.[408] To qualify as a covenant running with the land, the gathering agreement in question must typically satisfy at least three elements under most states' laws: (1) the

405. *See id.* §§ 506–507 (referred to as "general" unsecured claims to differentiate them from "priority" unsecured claims because they receive no special treatment under the Bankruptcy Code.)

406. *See supra* Section II.B.2.

407. *See supra* Section II.B.2.

408. *See supra* Section III.B.

parties must intend to create a covenant running with the land; (2) the covenant must touch and concern the land it seeks to encumber; and (3) there must be privity between the contracting parties.[409] Specifically, the intent is typically determined by the terms of the agreement and behavior of the parties; and a covenant may touch and concern the land where it affects the legal rights of the interest owner, or directly affects the value or use of the interest the parties seek to encumber. Finally, there may be privity when the owner of the asset the parties seek to encumber actually conveys some right, title, or interest in that asset contemporaneously with the covenant.

The issue of whether gathering agreements are executory contracts subject to rejection or covenants running with the land is an important issue in oil and gas reorganizations and has been litigated to judgment no less than five times in as many years. The earliest case addressing the issue, *Sabine*, applied a narrow test under Texas law and ruled that a gathering agreement that dedicates only produced minerals does not create a covenant running with the land because, under Texas law, produced minerals are personal property.[410] Two cases that followed, *Alta Mesa* and *Badlands*, rejected *Sabine* and ruled that gathering agreements created covenants running with the land where the gathering agreements dedicated real property interests related to the debtor's mineral estate, even if not the mineral estate itself. Moreover, the court's ruling in *Badlands* indicated that covenants running with the land cannot be removed by a bankruptcy sale under section 363 of the Bankruptcy Code. The *Badlands* decisions is particularly concerning for reserve-based lenders because it enables a later-in-time encumbrance to survive the foreclosure of an earlier-in-time lien. The continuing later-in-time encumbrance may preclude the foreclosing lender from recovering any value from its encumbered collateral.

Recently, at least two courts have ruled against *Alta Mesa* and *Badlands* by holding that gathering agreements do not create covenants running with the land unless they materially affect the owner's rights in its minerals. In so ruling, the courts in *Extraction* and *Southland* both recognized that regardless of the language of dedications in gathering agreements, the agreements are fundamentally service agreements related to the gathering and processing of produced gas, which is personal

409. *See supra* Section III.B.
410. *See supra* Section III.B.

property, and a covenant running with the land cannot apply to personal property interests.

While *Extraction* and *Southland* both follow *Sabine*, the court in *Chesapeake* affirmed, in dicta, the court's ruling in *Alta Mesa*. As a result, at least one court recognizes *Alta Mesa* as good law. Even so, the court in *Chesapeake* recognized that covenants running with the land are generally disfavored under Texas law, which supports a more conservative application of the covenant test than that found in *Alta Mesa*.

Regardless, the successful rejection of an upstream debtor's gathering agreement may not ensure the debtor's ability to reorganize. As illustrated in *Southland*, the rejection of a gathering agreement may create additional problems and preclude a market sale of the debtor's assets. Accordingly, debtors should analyze whether rejection is necessary and how it may affect their cases before proceeding. Similarly, lenders should proactively investigate and work to address risks to their collateral associated with gathering agreements both in initial underwriting, documentation, and during the life of their loan.