CLIENT ALERT

Monarch Midstream and *Alta Mesa* Hold Gathering Contracts Are Not Subject to Rejection in Bankruptcy

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Two bankruptcy courts, one applying Utah law and the other applying Oklahoma law, have recently held that contracts providing for the gathering of hydrocarbons constitute covenants running with the land, and thus cannot be rejected in bankruptcy as executory contracts. These decisions come nearly three and a half years after the *Sabine*[1] case, which featured a controversial holding that certain midstream contracts governed by Texas law did not constitute covenants running with the land and could be rejected in bankruptcy. The cases are of critical importance for oil and gas production companies and midstream companies analyzing potential challenges to midstream contracts in bankruptcy, and for dealmakers drafting and structuring new contracts that are intended to survive industry downturns.

Alta Mesa

In *Alta Mesa Resources, Inc. v. Kingfisher Midstream, LLC*,[2] Judge Marvin Isgur of the United States Bankruptcy Court for the Southern District of Texas (Houston Division) ruled as matter of summary judgment that, under Oklahoma law, a gathering agreement between Alta Mesa and Kingfisher formed a real property covenant. Because real property covenants are not executory, the gathering agreement could not be rejected under 11 U.S.C. section 365(a). In the case, the debtor, Alta Mesa Resources, Inc. ("Alta Mesa"), sought to invalidate two gathering agreements with its affiliated

1 *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 69 (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).

2 *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Resources, Inc.)*, No. 19-03609 (Bankr. S.D. Tex. Dec. 20, 2019) [ECF No. 236].

company, Kingfisher Midstream, LLC ("Kingfisher") – one for oil gathering and one for gas gathering – in part because the fixed fees under the agreements had become uneconomic. The court, applying a three-part test under Oklahoma law, found that:

(i) the agreements "touched and concerned" the leasehold interests of Alta Mesa because the covenants contained in those agreements both enhanced the value of the leasehold estate (and the underlying reserves) through the creation of a modern gathering system for the dedicated wells, together with the provision of gathering services, and burdened the estate by restricting to whom the hydrocarbons could be dedicated and delivered;

(ii) vertical privity of estate existed (as there had been no transfer of ownership by Alta Mesa or Kingfisher[3]) and "horizontal" privity of estate was established through Alta Mesa's conveyance to Kingfisher of surface easements (that were derivative of Alta Mesa's leasehold interests) in order to enable Kingfisher to build a new gathering system; and

(iii) the agreements contained provisions obligating transferees of the original parties to remain bound by the covenants, thereby evidencing an intent of the parties for the agreement to apply to their respective successors.

The court sought to distinguish its analysis from *Sabine*. The court noted that Alta Mesa dedicated to Kingfisher "the products of oil and gas leases, not the products of fee mineral estates . . . [u]nlike in *Sabine*, where that court focused its inquiry on a fee mineral estate, the relevant starting point here is Alta Mesa's leasehold interest."[4] In focusing on Alta Mesa's leasehold interest, the court found that a conveyance of surface easements to Kingfisher "reduces Alta Mesa's real property interest under the leases…[c]ontrary to the holding in *Sabine*, the surface easements directly affect the lessee's underlying mineral interest."[5] Accordingly, under *Alta Mesa*, a new gathering agreement's provision granting easements to the midstream company in order to build a system should clearly stipulate that such easements burden the leasehold interests, as well as any interests in hydrocarbons produced therefrom or attributable thereto. Importantly, the *Sabine* court did not recognize that a surface pipeline easement between the producer and the gathering company created privity of estate or burdened the mineral estate (the easement was "distinct from (even if somewhat related to) the property burdened by the covenant").[6] *Sabine* cited the "traditional paradigm" for horizontal privity from the Fifth Circuit's decision in *Newco Energy v. Energytec*,[7] where a company sold a pipeline and its attendant easements (comprising real

3 The *Alta Mesa* court also suggested that, in the event there had been ownership transfers, vertical privity would have been established based on the fact that the agreements were recorded, and would have charged any transferee with notice thereof. *See Id.*

4 Page 16 of *Alta Mesa*.

5 Page 18 of *Alta Mesa*.

6 Page 12 of *Sabine*.

7 739 F.3d 215 (5th Cir. 2013).

property) to a third party subject to a transportation fee payable to the seller's affiliate as a covenant that "touched and concerned the land." Judge Isgur noted that "the requirements to form a real property covenant in Texas mirror those in Oklahoma," which, together with other relevant dicta from the decision, could signal that bankruptcy courts interpreting Texas law and Texas State Courts will consider this case as persuasive authority.

Monarch Midstream

In *Monarch Midstream, LLC v. Badlands Prod. Co.*,[8] Badlands Prod. Co. ("Badlands") attempted, as part of a chapter 11 restructuring, to sell its oil and gas assets free and clear of a gas gathering and processing agreement and a salt water disposal agreement (collectively, the "Badlands Agreements"). Monarch Midstream, LLC ("Monarch") objected to the sale on the basis that the Badlands Agreements were real property covenants that could not be rejected as executory contracts under Bankruptcy Code section 365. Although the Badlands Agreements were governed by Colorado law, the court applied Utah law to analyze whether they comprised a real property covenant because the assets were located in Utah and property interests are created under the law of the state where the real property is located. The court cited Utah law's four-part test for a covenant to run with the land: (i) the covenant must touch and concern the land; (ii) the covenanting parties must intend for the covenant to run with the land; (iii) there must be privity of estate; and (iv) the covenant must be in writing.

The court, in finding that the four-part test was met, distinguished its decision from *Sabine* in at least two significant ways. First, the covenants in the Badlands Agreements "touched and concerned the land" because the covenants applied to "Dedicated Reserves," which were defined to mean unproduced oil and gas. In *Sabine*, the court found the covenant applied only to natural gas and condensate as extracted, which constitute personal property under Texas law (as opposed to minerals in an unproduced state, which constitute real property under Texas law). Second, the court found that "horizontal privity of estate" existed in the Badlands Agreements because Badlands granted Monarch an easement across the oil and gas leases, as well as the lands, in which Badlands had an interest. As the leases themselves were subject to the easement and the dedication, the same real property interests (the leasehold interests) were burdened by the easement and the dedication.

Conclusion

The rulings in *Monarch* and *Alta Mesa* confirm the advice many practitioners have been providing clients since *Sabine*: the *Sabine* decision was a fact-specific application by a federal bankruptcy court of state property law, and given the great variety of midstream contract structures, other courts could reach different conclusions with respect to the enforcement of covenants in midstream contracts in bankruptcy. Similarly, the *Monarch* and *Alta Mesa* decisions are fact specific; neither set of agreements appears to contain minimum volume commitments, conflicts with lender covenants (in *Sabine* the

[8] *Monarch Midstream, LLC v. Badlands Prod. Co. (In re Badlands Energy, Inc.)*, No. 17-01429-KHT (Bankr. D. Colo. Sept. 30, 2019) [ECF No. 61].

granting of material easements was not permitted under a credit agreement) or addresses dedication of "downstream" services. Ultimately, these new decisions underscore the importance of drafting easement grants in new midstream contracts in an effort to establish privity of estate – the easement should burden the same property interests, preferably stipulated oil and gas leases (listed on an exhibit), that are the subject of the dedication. Practitioners should continue to monitor the jurisprudence in this area as further producer and midstream bankruptcies will undoubtedly impact both the structuring and drafting of new midstream contracts and the analysis and potential renegotiation of existing ones.

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