AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Problems in the Code

By Mark Pfeiffer

Will the Pipeline Continue to Flow After *Sabine*?

Oil and Gas Bankruptcies Expose Limitations in § 365

Mark Pfeiffer
Buchanan Ingersoll & Rooney PC
Philadelphia

Mark Pfeiffer is counsel with Buchanan Ingersoll & Rooney PC in Philadelphia.

A wave of oil and gas bankruptcies is in progress as commodity prices are near their lowest points in 20 years and supply exceeds demand. Oil and gas producers are using bankruptcy to reject and renegotiate "midstream" pipeline, processing and gathering contracts. This is problematic for midstream companies because their own debt service may be dependent on legacy contract revenue levels, and they could default if that revenue is curtailed.

Billions of dollars in investments might be affected with the potential for cascading fallout for lenders to the industry. From the producer's perspective, contract rejection may be a high-stakes bluff because the oil and gas leases usually terminate if production stops for an extended period, and the producers need the pipelines in order to continue production.

These bankruptcies raise fundamental and unresolved questions about the interplay between rejection under § 365 of the Bankruptcy Code and covenants running with the land that expose a gap in § 365. Bankruptcy Judge **Shelley C. Chapman** (S.D.N.Y.) recently issued the first opinions addressing some of the issues in *In re Sabine Oil & Gas Corp*.[1] The *Sabine* decisions do not resolve anything other than to point out that a rejection proceeding under § 365 is probably not the appropriate method of divesting a restrictive covenant. Debtors will likely look for alternatives, and future battles may be waged in § 363(f) sales.

Industry Structure

The oil and gas industry is structured vertically with landowners at the top. The landowners and producers enter into oil and gas leases, which grant surface rights to the producers and permit drilling and exploration. These leases also give the producers mineral rights that are usually considered real property interests under local law. The owner is compensated partly with a royalty for the minerals produced by the well.

Pipelines and processing plants are required to convert the raw minerals to finished products and transport them from the well to market. This infrastructure is usually owned by separate "midstream" companies, which build the facilities based on exclusive gathering, pipeline and processing agreements with the producer. These agreements typically "dedicate"[2] all of the minerals from the leases to the midstream companies' facilities in exchange for a fee. Debtors are trying to use rejection under § 365 to renegotiate or terminate these midstream agreements.

Financing Structure

Production and exploration costs are financed with leasehold mortgages and other liens on the producer's interest in the surface and mineral rights. If the producer enters into a development joint venture, the operating agreement[3] may also create liens in favor of the operator over the nonoperator's mineral interest to secure the nonoperator's obligations under the agreement. The senior liens against the real property and mineral rights frequently leave the midstream companies to rely on the dedication as a means of protecting their investments. There is little industry standardiza-

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

2 As discussed herein, "dedications" in the oil and gas context are not well defined in the law.

3 An operating agreement is an agreement between two producers, which provides for one of them to drill and operate wells for the benefit of both. If the operating agreement meets the definition of "farmout" agreement in § 101(21A) of the Bankruptcy Code, then the hydrocarbons of the "farmee" are not property of the estate. 11 U.S.C. § 541(b)(4).

tion for midstream contracts, and the dedications are not always recorded in the real property records or Uniform Commercial Code (UCC) filings.

Rejection of Midstream Agreements

To date, midstream companies facing rejection motions have opposed them, saying that the dedication is a covenant running with the land that cannot be rejected. Section 365(a) was designed to deal with contractual rights and not property interests,[4] and as a result, the key issue for rejection is whether a dedication creates a property interest or merely a contractual right.

Courts are struggling to determine the meaning of "dedications."[5] There is little (if any) case law dealing with dedications or what (if any) property interests are created. A dedication may create a lien, a real property interest or merely a contractual right without any property interest. The issues are complicated by the transformative nature of the property, making the identification of any property interest difficult.

Before extraction, the mineral rights are generally considered real property interests. Once the minerals pass the wellhead,[6] they become personal property and the midstream company may acquire an interest in them through a sale or the pledge of a security interest under Articles 2 and 9 of the UCC. Even after extraction, it might be difficult to determine who owns the minerals. The midstream contracts are sometimes structured as sales, service agreements or hybrids of both, thus making it difficult to distinguish sales transactions covered by the UCC and service transactions covered by general contract law. The contracts are governed by state laws, which may vary by jurisdiction.

In *Sabine*, Judge Chapman authorized the debtor to reject the agreements that were "subject to rejection."[7] However, she declined to make a final determination on whether the dedications were covenants running with the land because there were contested factual issues that could not be decided in a summary rejection proceeding.[8] After receiving an incomplete remedy in the rejection proceeding, the debtor filed an adversary proceeding seeking a binding determination that there was no covenant running with the land. In a subsequent opinion in the adversary proceeding, Judge Chapman ruled that the dedications did not run with the land[9] and do not "touch and concern" the land because they relate to extracted gas, which is considered to be personal property under Texas law. The court also concluded that there was no "horizontal privity of the estate," which is arguably required under Texas law.[10]

The *Sabine* opinions may not universally resolve the critical issues facing the industry because of the lack of uniformity in the documentation of midstream contracts and potential variance of state laws. However, two practical points may be derived from *Sabine*. First, it is unlikely that a covenant running with the land can be rejected in a summary rejection proceeding, and an adversary proceeding is probably required to adjudicate the property rights. Second, the rejection/adversary proceeding approach used in *Sabine* only provides debtors with a complete remedy if the court makes a final determination that there is no covenant running with the land.[11] A debtor's goal is not to obtain an academic determination about the nature of a dedication; the point is to terminate the dedication, whether or not it runs with the land, and debtors will try to find more sure-fire ways to do it.

> **The *Sabine* decisions do not resolve much, although they do point out the limitations to terminating oil and gas dedications using § 365.... Until the Bankruptcy Code is amended or the law is more firmly established, parties to midstream contracts will face uncertainty concerning their rights.**

Is § 363(f) an Option for Debtors?

Section 363(f) of the Bankruptcy Code might be a tool available to debtors to accomplish the divestiture, either through a standalone third-party sale or a sale conducted in connection with a confirmed plan.[12] So far, none of the oil and gas cases have addressed whether a restrictive covenant dedication can be divested in a § 363(f) sale.[13] Generally, the Code permits sales free and clear of "interests" in the property being sold, provided that the sale satisfies the requirements of § 363(f).[14] The threshold question is whether a dedication is an "interest" that may be divested by § 363(f). Some courts define "interests" narrowly to include only *in rem* property rights, while others employ a broader definition that includes other obligations flowing from ownership of the property.[15]

If a dedication is a covenant running with the land, it probably falls within either of the definitions and could be divested in a sale. If it is only a contractual right, it is not an

4 *See* discussion in *CASC Corp. v. Milner (In re Locke)*, 180 B.R. 245 (Bankr. C.D. Cal. 1995).

5 During a recent oral argument on a rejection motion in the *Quicksilver Resources Inc.* bankruptcy, Judge **Laurie Selber Silverstein** asked, "What does 'dedication' mean? ... I'm not sure either party told me." None of the parties were able to provide an answer in the oil and gas context. *In re Quicksilver Res. Inc.*, No. 15-10585, Doc. 1233 (Bankr. D. Del. March 7, 2016).

6 *See* comment to 13 Pa.C.S.A. § 9102(a); *RPITA LLC v. Mfrs. & Traders Trust Co.*, 122 A.3d 441 (Pa. Super. Ct. 2015).

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

8 *Id.* at 73 (discussing *Orion Pictures Corp. v. Showtime Network*, 4 F.3d 1095 (3d Cir. 1993)). *Orion* appears to represent the prevailing view nationwide.

9 *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings LLC (In re Sabine Oil & Gas Corp.)*, Adv. Pro. No. 15-11835, Doc. 22 (Bankr. S.D.N.Y. May 3, 2016).

10 Horizontal privity requires "simultaneous existing interests or mutual privity between the original covenanting parties as either landlord and tenant or grantor and grantee." *In re Sabine Oil & Gas Corp.*, 547 B.R. at 66 (Bankr. S.D.N.Y. 2016) (internal quotations omitted).

11 *See Banning Lewis Ranch Co. v. City of Colorado Springs (In re Banning Lewis Ranch Co.)*, 532 B.R. 335 (Bankr. D. Colo. 2015) (rejection of executory contract would not terminate covenant running with land); *Beeter v. Tri-City Prop. Mgmt. Servs. Inc. (In re Beeter)*, 173 B.R. 108 (Bankr. W.D. Tex. 1994) ("interests" in property are not contracts that may be rejected). At least one circuit court determined that a restrictive covenant is a property right and may not be rejected under § 365. *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994).

12 There is little (if any) case law dealing with divesting restrictive covenants through a plan pursuant to the free-and-clear language of § 1141 of the Bankruptcy Code. *See In re Eastport Golf Club Inc.*, 373 B.R. 446, 452 at fn.13 (Bankr. D.S.C. 2007).

13 The issue appeared to be lurking in the *Quicksilver Resources Inc.* bankruptcy in Delaware because the bankruptcy court issued an order allowing Quicksilver to sell the wells and the oil and gas leases free and clear of any interests pursuant to § 363(f). The Quicksilver sale was not contested by the midstream companies that reserved their rights with respect to any subsequent rejection motion. However, the rejection motion was withdrawn shortly after the first *Sabine* opinion was issued and was not decided by the court. *In re Quicksilver Res. Inc.*, No. 15-10585, Doc. 1297 (Bankr. D. Del. 2016).

14 To the extent that the sale occurs in connection with a confirmed plan, the debtor may not need to satisfy the § 363(f) requirements. *See In re Nagy*, No. 10-10404-TPA (Bankr. W.D. Pa. Jan. 29, 2013).

15 *See* discussion in *In re Trans World Airlines Inc.*, 322 F.3d 283 (3d Cir. 2003).

"interest" under the narrow view and may not be divested. However, this begs the question of whether a non-interest needs to be divested.[16] If the dedication is only a contractual right that does not follow the land, can the midstream company enforce it against the buyer?[17] The answer is probably analogous to the successor liability risk faced by § 363(f) buyers, who get an order stating that the sale is free and clear of all interests in the property but that this does not necessarily stop claims that could end up being litigated in front of a state court judge who may not respect the free-and-clear language of the sale order.

If the dedication is an interest that could be divested, the likely mechanisms are § 363(f)(1), which authorizes divestment as permitted by nonbankruptcy law, and § 363(f)(4) if there is a *bona fide* dispute.[18] Although § 363(f)(1) is not commonly used in bankruptcy sales, it is possible to terminate a restrictive covenant based on changed circumstances in many jurisdictions, including a number of the key oil and gas-producing states.[19] The depressed prices may provide debtors with a basis to terminate a restrictive covenant based on changed circumstances, particularly if the operation is unprofitable.[20] However, in some jurisdictions, a mere change in economic condition is insufficient to justify abrogating a restrictive covenant, and a debtor may need to show other factors, including frustration of purpose, impossibility or impracticability.[21]

The debtor may not need to sustain the high burden of invalidating the dedication. Section 363(f)(4) permits a sale free and clear of any interest that is in *bona fide* dispute.[22] It may be tantalizing for a debtor to take the position that there is a *bona fide* dispute given the unclear nature of midstream dedications and the possibly changed conditions based on the low commodity prices. There is authority that disputes concerning the validity of the interest are within the scope of § 363(f)(4).[23] However, there is also authority indicating that the dispute cannot concern validity of the interest. Instead, the dispute must involve the validity of debt.[24]

Whether or not a dispute concerning the validity of the interest falls within the scope of § 363(f)(4), debtors may favor § 363 over the adversary proceeding required by *Sabine*. Once a court determines in an adversary proceeding that the dedication runs with the land, there may no longer be a *bona fide* dispute that can be used to divest the interest.

Conclusion

The *Sabine* decisions do not resolve much, although they do point out the limitations to terminating oil and gas dedications using § 365. These limitations may drive debtors to seek alternative means of terminating the dedications, and § 363(f) might be an attractive option. However, neither Code section clearly identifies what interests may be rejected and divested, and the Code would benefit from amendments that provide more clarity. Until the Bankruptcy Code is amended or the law is more firmly established, parties to midstream contracts will face uncertainty concerning their rights.

However, even if the dedications could be terminated, it may only be an academic exercise because the viability of the wells depends on transporting the hydrocarbons to market, and the most efficient way to do that is to use the existing midstream facilities. As a result, negotiated resolutions are likely to occur, as producers and midstream companies have too much at stake. abi

Reprinted with permission from the ABI Journal, Vol. XXXV, No. 7, July 2016.

16 *See In re Hassen Imps. P'ship*, 502 B.R. 851, 858 (C.D. Cal. 2013) (noting that there would have been no need for bankruptcy court to authorize sale free and clear unless right runs with land).

17 *See In re MidSouth Golf LLC*, No. 13-07906-8-SWH, Doc. 344 (Bankr. E.D.N.C. March 29, 2016) (recognizing distinction between personal covenants enforceable at law between contracting parties and real covenants, which create servitude upon land for benefit of another).

18 *See Silverman v. Ankari (In re Oyster Bay Cove Ltd.)*, 196 B.R. 251 (E.D.N.Y. 1996). Section 363(f)(5) of the Bankruptcy Code authorizes sale free and clear of interests if the holder of the interest could be compelled to accept a money satisfaction of the interest in a legal or equitable proceeding. However, this section may not be a prime candidate to effectuate a divestment of the interest. *See In re Hassen Imps. P'ship*, 502 B.R. 851 (C.D. Cal. 2013); Gouveia v. Tazbir, 37 F.3d 295 (7th Cir. 1994).

19 *See, e.g., TX Far West Ltd. v. Texas Inv. Mgmt. Inc.*, 127 S.W.3d 295 (Tex. App. 2004); *Vernon Twp. Volunteer Fire Dept. Inc. v. Connor*, 855 A.2d 873 (Pa. 2004); *Brown v. Huber*, 88 N.E. 322 (Ohio 1909); *Kytle v. Peck*, 330 P.2d 189 (Okla. 1958); *Winston v. 524 W. End Ave. Inc.*, 233 App. Div. 5, 251 N.Y.S. 96 (App. Div. 1st Dept. 1931).

20 *See, e.g., In re TOUSA Inc.*, 393 B.R. 920 (Bankr. S.D. Fla. 2008) (restrictive covenant setting minimum sale price for real estate is impractical given intervening collapse in real estate market).

21 *See, e.g., Heatherwood Holdings LLC v. First Commercial Bank*, 61 So. 3d 1012 (Ala. 2010); *City of Bowie v. MIE Props. Inc.*, 922 A.2d 509 (Md. 2007); *Old Taunton Colony Club v. Medford Twp. Zoning Bd. of Adjustment*, No. A-5134-11T2, 2013 WL 2420354 (N.J. Super. Ct. App. Div. June 5, 2013).

22 *See In re Daufuskie Island Props. LLC*, 431 B.R. 626 (Bankr. D.S.C. 2010) (court does not need to resolve dispute in connection with sale).

23 *Id.*; *see, e.g., In re Daufuskie Island Props. LLC*, 431 B.R. 626 (Bankr. D.S.C. 2010).

24 *See Baylake Bank v. TCGC LLC*, 2008 WL 4525009 at *9, fn.6; *Bridges Restaurant Assocs. v. The Meadowbrook Mall Co.*, No. 1:06CV53, Doc. 18 (N.D. W.Va. March 28, 2007).