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Alert

Distressed Energy: Midstream Agreements — 10 Questions After *Sabine*'s 'Unspeakable Quagmire'

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While a recent federal bankruptcy court ruling provides some clarity as to how midstream gathering agreements may be treated in Chapter 11 cases involving oil and gas exploration and production companies ("E&Ps"), there are still many questions that remain. This *Alert* analyzes and answers 10 important questions raised by the *In re Sabine Oil & Gas Corporation* decision of March 8, 2016.[1]

1. **Does the *Sabine* decision apply to all midstream contracts?**
   No. Judge Shelley Chapman's holding in *Sabine* is very fact-specific and applies only to the gathering agreements with Nordheim and HPIP (the midstream counterparties in *Sabine*) that contain dedications of production. Judge Chapman did not articulate a blanket rule of law for all midstream contracts —though her ruling is instructive for analyzing the provisions of gathering agreements with production dedications.

2. **What impact will this have for *Quicksilver*?**
   Quicksilver[2] varies from *Sabine* in that the *Quicksilver* gathering agreements, unlike those at issue in *Sabine*, do not contain express language to the effect that the dedications create covenants running with the land. Additionally, the *Quicksilver* debtors have a final "free and clear" sale order that has already been entered for the sale of substantially all of their assets to BlueStone Natural Resources II. While Crestwood Midstream Partners (the *Quicksilver* midstream counterparty) has a reservation of rights in the sale order to object to the rejection of its agreements, U.S. Bankruptcy Judge Laurie Silverstein questioned at oral argument whether Crestwood's failure to object to the sale constituted a waiver or consent. Crestwood is also grappling with many of the same issues that midstream gatherers Nordheim and HPIP did (albeit unsuccessfully) in *Sabine*. In summary, Crestwood is likely fighting an uphill legal battle, especially after the *Sabine* decision.

3. **Do other courts need to follow Judge Chapman's decision?**
   No. A bankruptcy court's decisions are not binding on other bankruptcy courts, though they may be given some precedential value. Even other bankruptcy judges in the Southern District of New York are not bound by Judge Chapman's decision because bankruptcy courts are only bound by the decisions of higher federal courts (i.e., district and circuit courts). That said, this is a "white hot"

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[1] (Case No. 15-11835) (Bankr. S.D.N.Y.) (Dkt. 872). For an overview of the legal issues that may arise with respect to midstream gathering agreements in an E&P's bankruptcy, please refer to our recent publication, co-authored with Tudor, Pickering, Holt & Co., *Distressed Energy: Midstream Agreements — Impact on E&P Creditor Recovery*.

[2] *In re Quicksilver Resources Inc.* (Case No. 15-10585) (Bankr. D. Del.).

issue for which there is very little case law. Judge Chapman's *Sabine* decision thus will likely inform the decisions of other courts examining similar issues.

4. How will this play out in situations in which the midstream contracts are governed by the laws of a state other than Texas?

It depends on how similar the state's laws are to those of Texas. A bankruptcy court must analyze contractual issues in accordance with applicable state law, and the laws applicable to midstream contract disputes vary from state to state. The *Sabine* decision was based on an analysis of Texas law, and the laws of many other oil- and gas-producing states (e.g., Oklahoma) are similar to Texas law regarding covenants running with the land and mineral estates. For example, Oklahoma also requires that for a covenant to run with the land, there must be privity and the covenant must "touch and concern" the land. An Oklahoma mineral estate also contains four "distinct incidents" that are nearly identical to the "sticks" in the bundle of rights that compose a Texas mineral estate: (1) the power to lease; (2) the right to receive bonuses; (3) the right to receive delay rentals; and (4) the right to receive royalties (Texas has a fifth stick: the right to develop).

Accordingly, one might expect bankruptcy judges applying Oklahoma law to find, as Judge Chapman did in applying Texas law, that dedications of produced oil and gas are not covenants running with the land. On the other hand, the laws of other states, such as North Dakota, are less similar to Texas with respect to these issues. Under North Dakota law, covenants running with the land are generally defined by statute rather than by common law (as in Texas and Oklahoma), and a "mineral interest" in North Dakota typically includes: (1) the right to sell all or part of the estate; (2) the right to explore and develop the estate; (3) the right to execute oil and gas leases; and (4) the right to create fractional shares of the mineral estate. As a result of these variations in state law, a bankruptcy court's disposition of a midstream contract and any dedication therein will be highly state-specific, making it difficult to generalize regarding future outcomes.

5. What is the status of *Quicksilver* and *Magnum Hunter*?

The dispute surrounding the *Quicksilver* debtors' motion to reject certain gathering agreements has been fully briefed and was argued before the court on March 4, 2016. Judge Silverstein has not provided a time frame for her ruling.

In *Magnum Hunter*,[3] the debtors filed a motion to reject a specific transaction confirmation under a gathering agreement with Eureka Hunter Pipeline LLC. The *Magnum Hunter* rejection motion raises a new issue that was not addressed in *Sabine* or *Quicksilver* — contract severability. The *Magnum Hunter* debtors are seeking to reject only a specific transaction agreement pertaining to the Eureka gathering agreement. In bankruptcy, a contract may only be assumed or rejected in its entirety. Only if the agreement sought to be rejected is found to constitute a separate contract can it be rejected separately. The *Magnum Hunter* dispute has not yet been briefed or argued.

6. What are the critical dates for *Quicksilver* and *Magnum Hunter*?

As noted above, Judge Silverstein has not provided a time frame for her ruling in *Quicksilver*, but there is a looming March 31 deadline for consummation of the debtors' sale of substantially all of their assets to BlueStone. As to *Magnum Hunter*, the objection deadline with respect to the debtors' rejection motion is March 24, 2016 at 4:00 p.m., and a hearing is scheduled for March 31, 2016 at

[3] *In re Magnum Hunter Resources Corp.* (Case No. 15-12533) (Bankr. D. Del.).

10:00 a.m., though it is impossible to predict whether U.S. Bankruptcy Judge Kevin Gross will rule at that time.

7. **What about the Chesapeake/Williams midstream agreements?**
   The *Sabine* gathering agreements contained dedications limited to oil and gas *produced*. The court, in a non-binding ruling, found that they were dedications of personal property and thus were not covenants running with the land. In contrast, a number of the publicly filed Chesapeake Energy Corporation and Williams agreements contain dedications of interests in oil, gas and/or minerals *in place*. It is likely that these dedications will be interpreted differently because in Texas, as well as various other states, interests in oil and gas in the ground are recognized interests in real property. This does not necessarily mean, however, that the gathering agreements between Chesapeake and Williams could not be rejected (as discussed further below).

8. **If a dedication covers the mineral estate, does that mean the midstream agreement cannot be rejected?**
   No. Under Texas law, a "dedication" is not a recognized means of conveying an interest in the mineral estate because a transfer of an interest in real property cannot be effected via dedication. Even a dedication of a mineral interest (as opposed to a dedication of production) may not qualify as a covenant running with the land because horizontal privity still may not be present. Horizontal privity requires "a property owner reserving by covenant, either for itself or another beneficiary, a certain interest out of the conveyance of the property burdened by the covenant," according to *Sabine*. The presence — or absence — of horizontal privity may be the critical question for a court in evaluating whether a covenant running with the land exists with respect to a dedication covering the mineral estate.

9. **Did Judge Chapman find that the *Sabine* dedications were not covenants running with the land?**
   While approving the debtors' rejection of the Nordheim and HPIP gathering agreements, for procedural reasons, Judge Chapman bifurcated the motion on the legal issue of whether the dedications in the agreements were covenants running with the land — an area of law that she referred to as an "unspeakable quagmire." Nevertheless, Judge Chapman issued a *non-binding* ruling by which she made clear her view that the dedications contained in the agreements are *not* covenants running with the land.

10. **How does *Sabine* apply to equitable servitudes?**
    An equitable servitude operates similarly to a covenant running with the land. Judge Chapman held that the dedications are not equitable servitudes because, similar to covenants running with the land, an equitable servitude requires any such restriction to "concern the land or its use or enjoyment." For the same reason the *Sabine* dedications did not "touch and concern" real property, the court found that they did not contain all of the elements of an equitable servitude.

On March 8, 2016, SRZ and Tudor, Pickering, Holt & Co. co-sponsored the event "Distressed Energy: Midstream Agreements — Impact on E&P Creditor Recovery." Materials from the event are available on SRZ's website. To join SRZ's midstream contract analysis client group, please contact David J. Karp or Lawrence V. Gelber.

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