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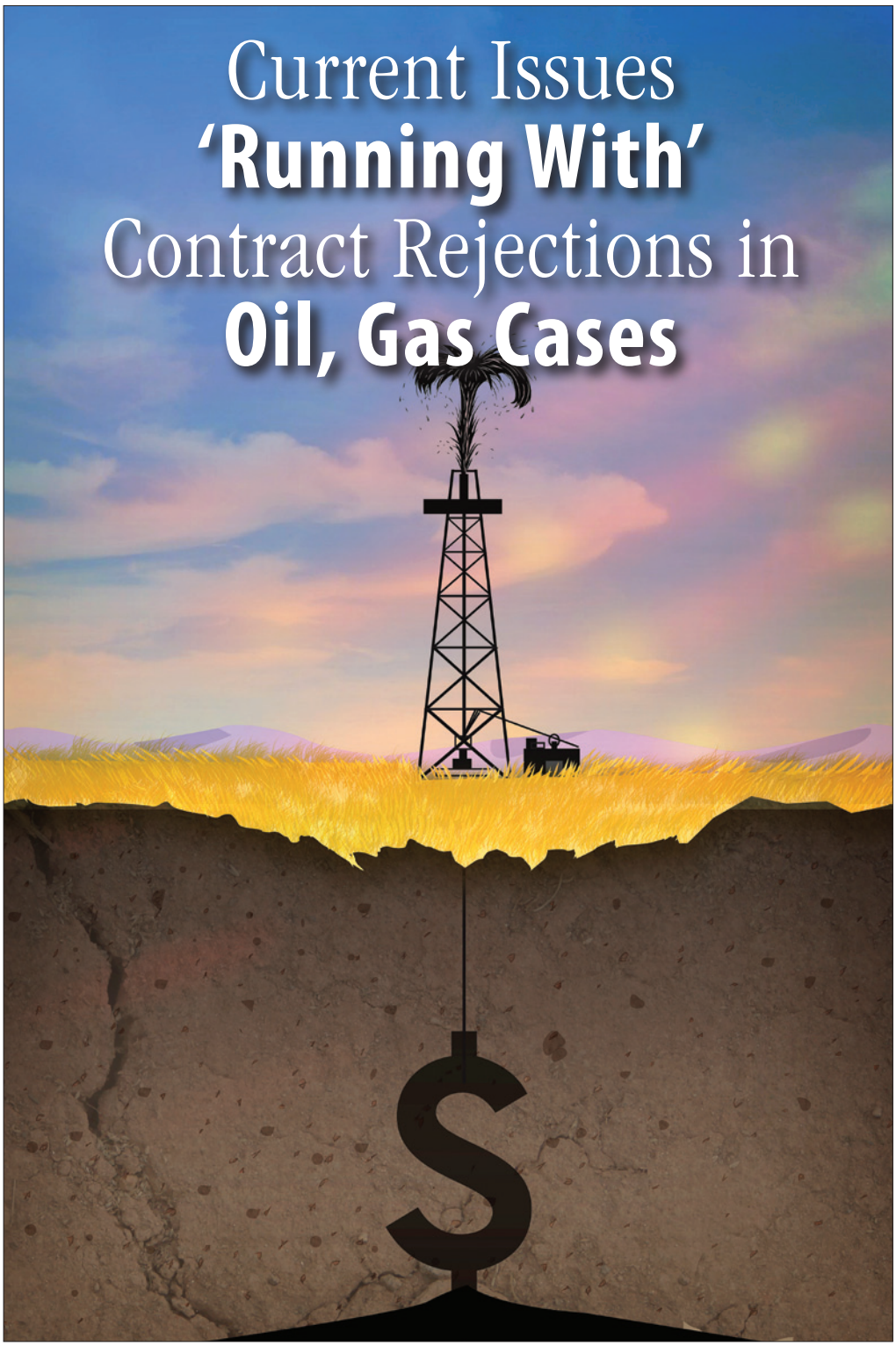
Current Issues 'Running With' Contract Rejections in Oil, Gas Cases



BIGSTOCK

BY MELANIE McLAUGHLIN KOTLER AND TIMOTHY S. SPRINGER

The prolonged downturn of oil prices has begun to take its toll. Over 27 oil and gas bankruptcy cases have filed in 2016, and over 69 since 2015,[1] as companies seek to access powerful protections under the U.S. Bankruptcy Code (the Code).

One such protection at the forefront of the trend is the ability to escape certain burdensome contracts. Rejecting these contracts under §365 of the Code can create substantial bargaining power for a going concern enterprise or increase the value of assets sold through a bankruptcy.

This article analyzes a hiccup in this strategy presented in three recent cases—one that promises to recur. The outcome in these cases will signal a trend that broadly affects similar agreements across the industry.

Rejection Analysis in Chapter 11 Bankruptcy

Some brief background on the Chapter 11 bankruptcy process helps illustrate the problem. Immediately upon filing, the "automatic stay" takes effect, which means a blanket injunction protects the debtor and its assets

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from most forms of attack.[2] The automatic stay and other protections give debtors a "breathing spell" to soften the blow of a bankruptcy filing.[3]

During this breathing spell, a debtor[4] is able to analyze its options under §365, which permits a debtor to "assume" or "reject" certain "executory" contracts and unexpired leases.[5] Rejection is deemed a material breach and generally converts any damages into a prepetition, general unsecured claim.[6] The decision to reject a contract is reviewed under the relatively lenient business judgment standard.[7]

The Code does not define "executory," creating fertile ground for debate. The commonly accepted view defines "executory" to mean when each side continues to owe material, unfulfilled duties of performance under the contract.[8] For instance, a contract between a supplier (who is obligated to provide goods) and a buyer (who is obligated to pay) is executory. But a fully funded loan where only the buyer's payment obligation remains is not executory.

In comparison, a *property interest* is not an executory contract susceptible to rejection under §365. State law defines property interests, which the Code imports into the federal-law rejection analysis.[9] But other Code provisions allow a debtor to sell property of the bankruptcy estate "free and clear" of interests in certain situations.[10] So a debtor may be able to escape property interests, even if not accomplished through §365.

Covenants Running With Land

One particular property interest has created a wrinkle in the typical rejection analysis: covenants running with land. Texas law requires five elements for a covenant to run: (1) the covenant must "touch and concern" the land; (2) the covenant must "relate to a thing in existence" or specifically bind successors/assigns; (3) the parties must intend for covenant to run with the land; (4) the successor to the burden must have notice of covenant; and (5) privity of estate must exist.[11] Privity means some connection must exist between original and enforcing parties.[12] The Texas Supreme Court has not squarely addressed what level of privity is required, and other courts have muddied the waters.[13]

Problem Presented in Recent Oil, Gas Cases

The analysis of covenants running with the land in connection with a §365 rejection analysis has presented in three recent cases—*In re Sabine Oil & Gas*, No. 15–11835 (Bankr. S.D.N.Y.); *In re Quicksilver Resources*, No. 15-10585 (Bankr. D. Del.); and *In re Magnum Hunter Resources*, No. 15-2533 (Bankr. D. Del.). In each case, the respective debtors are exploration and production companies and party to gas gathering and dedication agreements with midstream pipeline companies.

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Each of the relevant agreements are governed by Texas law and generally contain terms common to the industry. For example, in *Sabine*, the debtor agreed to dedicate all gas produced in a designated area and deliver that gas to the pipeline company. Failure to deliver contractual minimums would trigger deficiency payments. In exchange, the pipeline companies agreed to construct systems of gathering stations to transport the gas, and the contracts coincided with separate conveyances of land for the stations. The contracts were all recorded in the real property records of the respective counties and explicitly stated that the contracts were "covenants running with land" enforceable against affiliates, successors, and assigns.

Each of the debtors in *Sabine*, *Quicksilver*, and *Magnum Hunter* sought to reject several of these agreements pursuant to §365. Rejection of such contracts would allow the debtors to convert significant rejection damages into prepetition claims and to either (1) renegotiate lower contract rates or (2) sell substantially all of the debtors' assets, as in *Quicksilver*, to a buyer who intended to use its own pipeline systems.

But a covenant running with land is a property interest under Texas law.[14] As a result, if such covenants existed, either (1) the debtors could not reject the contracts under §365 or (2) the rejections would be ineffective to destroy the counterparties' property interests. In either circumstance, the debtors would remain liable for the post-petition deficiency payments, which would potentially derail a proposed sale or reorganization plan.

The arguments in the three cases followed similar logic, with some notable deviations. The pipeline companies argued that the contracts (1) demonstrated an "intent to run" through clear language binding successors and assigns, and (2) touched and concerned the land due to the gathering stations and the transportation of gas. Additionally, they argued that only "vertical" privity (unity of

contract with former owners) was required and was satisfied by identifiable chains of title.

In reply, the debtors in each case argued the "touch and concern" element was not satisfied because gas in a pipeline is personal property and not real property, as is gas in the ground.[15] Likewise, the debtors argued "horizontal" privity (unity of estate when the interest was created) was required and not satisfied.

Outcomes

Sabine ruled first, although the timing of the issue in all three cases overlapped. The *Sabine* court issued a "non-binding" decision, telegraphing that the contracts were not, and did not contain, covenants running with land.[16] The ruling was non-binding because the court also ruled the issue was not properly before the court. Determination of a property interest requires commencement of an adversary proceeding (a civil proceeding conducted in bankruptcy court) and not a contested matter (an evidentiary hearing in connection with a bankruptcy case).[17] So the *Sabine* court granted the motion to reject the contracts and left open the possibility of an adversary proceeding to determine the property interest.[18]

The *Quicksilver* court did not rule on the issue because the parties settled shortly after the *Sabine* court announced its non-binding decision. But *Quicksilver* involved a twist that made for a closer decision. There, the court had already approved a sale under §363(f) of the debtors' assets free and clear of all interests. The order approving the sale—to which the counterparties did not object—defined "interest" to include "any dedication under any gathering, transportation, treating, purchasing or similar agreements that relates solely to any" contracts to which debtor is counterparty.[19] In other words, the court may have already dealt with the issue even assuming the agreements did constitute or include property interests by virtue of covenants running with land.

Finally, in *Magnum Hunter*, the debtors heeded the *Sabine* ruling and filed both a motion to reject the contracts and an adversary proceeding to avoid an interest in property.[20] Although the parties settled, *Magnum Hunter* presented another situation likely to repeat—the "dual debtor" problem. There, both the party seeking to reject the contract *and* the counterparty opposing rejection were debtors in pending Chapter 11 cases. In that situation, a debtor may file a motion to reject without seeking permission in the counterparty's bankruptcy,[21] although the standard of review may shift from business judgment to a balancing of the equities.[22]

Conclusion

Contracts negotiated before the recent downturn in oil and gas are often ripe for rejection upon a Chapter 11 filing. Arguing that such contracts include covenants running with land is one of the few retorts to a debtor's ability to wield §365. Look for future cases to build on the arguments (and ample briefing) set forth in *Sabine*, *Quicksilver*, and *Magnum Hunter*, and possibly even certify a question to the Texas Supreme Court on the issue.

1. Haynes & Boone, Oil Patch Bankruptcy Monitor (May 1, 2016). These numbers do not include a rash of filings in May that included Penn Virginia and Linn Energy.

2. 11 U.S.C. §362(a) (2012).

3. *In re Siciliano*, 13 F.3d 748, 750 (3d Cir. 1994).

4. In most cases, the debtor functions as a "debtor in possession" and continues to operate the business. 11 U.S.C. §§1107, 1108. The distinction is immaterial in this article, so we refer only to "debtors."

5. 11 U.S.C. §365(a).

6. Id. §365(g).

7. See, e.g., *Orion Pictures v. Showtime Networks (In re Orion Pictures)*, 4 F.3d 1095, 1099 (2d Cir. 1993); *Byrd v. Gardinier (In re Gardinier)*, 831 F.2d 974, 975 n.2 (11th Cir. 1987).

8. Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 Minn. L. R. 439, 460 (1973). Prof. Countryman's definition has been widely-adopted, including in the Second, Third, and Fifth Circuits. *Phx. Exploration v. Yaquinto (In re Murexco Petroleum)*, 15 F.3d 60, 62-63 & n.8 (5th Cir. 1994); *Sharon Steel v. Nat'l Fuel Gas Distrib.*, 872 F.2d 36, 39 (3d Cir. 1989); *S. Chi. Disposal v. LTV Steel Co. (In re Chateaugay*, 130 B.R. 162, 164 (S.D.N.Y. 1991).

9. *Butner v. United States*, 440 U.S. 48, 55 (1979).

10. 11 U.S.C. §365(f).

11. *Inwood N. Homeowners' Ass'n v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987).

12. *In re Sabine Oil & Gas*, 547 B.R. 66, 76 (Bankr. S.D.N.Y. 2016) (citing 53 Rocky Mtn. Min. L. Inst. §19.03 (2007)).

13. See *Newco Energy v. Energytec (In re Energytec)*, 739 F.3d 215, 222-23 (5th Cir. 2013).

14. *Harris*, 736 S.W.2d at 635-36.

15. See *Sabine Oil & Gas*, 547 B.R. at 78 & n.44.

16. Id. at 74.

17. See Fed. R. Bankr. P. 7001(2).

18. *Sabine Oil & Gas*, 547 B.R. at 74.

19. *In re Quicksilver Res.*, No. 15-10585 (Bankr. D. Del. Jan. 1, 2016), ECF No. 1095.

20. *Magnum Hunter Res. v. Oneok Rockies Midstream, LLC (In re Magnum Hunter Res.)*, Adv. No. 16-50376 (Bankr. D. Del. Filed March 18, 2016) (adversary proceeding); *In re Magnum Hunter Res.*, No. 15-2533 (Bankr. D. Del. March 4, 2016), ECF No. 738 (rejection motion).

21. E.g., *In re Old Carco*, 406 B.R. 180, 211-12 (Bankr. S.D.N.Y. 2009).

22. E.g., *In re Midwest Polychem*, 61 B.R. 559, 562 (Bankr. N.D. Ill. 1986).