Recent Midstream Contract Developments in Bankruptcy

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I. INTRODUCTION

With downward pressure on energy commodity prices, highlighted by oil going into negative territory in April 2020, domestic energy companies sought bankruptcy relief at an ever-increasing pace in 2020. Energy commodity prices rebounded starting in the Fall of 2020 and the price increases may have been sufficient to allow even highly leveraged producers to avoid plunging into Chapter 11 in 2021. Unless demand for oil and gas sharply decreases or supply of oil and gas materially increases, many overleveraged oil and gas producers may continue to avoid Bankruptcy Court into 2022.

Debtors, creditors and counterparties alike paid close attention to the latest wave of energy company bankruptcies to see whether courts allowed debtors to reject midstream service contracts, power purchase agreements ("***PPAs***"), transportation service agreements ("***TSAs***") and, if so, their reasons why. The goal of this paper is to survey court rulings that have recently addressed the issue and assess the general effect of those rulings on the market for midstream services and the Federal Energy Regulatory Commission's ("***FERC's***") jurisdiction. The issues presented in this paper are fact-intensive, meaning the same judge could rule differently on other contracts in the future. The trend, however, has indicated that bankruptcy courts tend to favor debtors and their power to reject *any* contract, so it is certainly worth keeping up with these issues until more Circuit Courts of Appeal are able to rule on them.

A. Executory Contracts and the Debtor's Power to Reject Them

The Bankruptcy Code gives debtors certain rights to maximize the value of the estate, including the right to reject burdensome contracts. The concept of executory contracts is critical in a typical chapter 11 energy bankruptcy because the nature of the contract and status of performance determines how contracts will be treated in bankruptcy.

When a business debtor files for bankruptcy, contract counterparties will want to know what happens to their contracts and the obligations thereunder. In short, the contracts receive different treatment under the Bankruptcy Code depending on the status of performance on both sides of the contract. Where there are substantial postpetition obligations by each party to a contract where a failure of either party to perform would constitute a material breach, section 365 of the Bankruptcy Code treats such contract as executory.[1]

Section 365 of the Bankruptcy Code specifically states that the debtor ". . . may assume or reject any executory contract or unexpired lease of the debtor."[2] The debtor's power to assume or reject executory contracts and unexpired leases is critical to the success of a complex reorganization. In many cases, performance of an overly burdensome executory contract may be detrimental to the debtor and undermine its ability to successfully reorganize. The Bankruptcy Code recognizes this and addresses it by allowing the debtor to choose between ***rejecting*** (*i.e.*, breaching) the contract, ***assuming*** the contract (*i.e.*, curing defaults and performing its obligations thereunder going forward), or even assuming and assigning the contract to a third-party. If the

[1] While section 365 does not actually define the term executory contract, the Supreme Court has stated: "A contract is executory 'if performance remains due to some extent on both sides.'" *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652, 1658 (2019) (quoting *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984)).
[2] 11 U.S.C. § 365(a).

debtor rejects an executory contract, the breach is treated as having arisen before the bankruptcy petition was filed, and the contract counterparty is entitled to a general unsecured claim for the contract rejection damages—which, in nearly all chapter 11 cases, likely results in pennies on the dollar for the contract counterparty.[3] If the debtor chooses to assume an executory contract, it must cure all defaults and perform its obligations under the contract going forward.

B. The Two Key Arguments Against Rejection to be Analyzed

Midstream service providers and other contract counterparties that do not want debtors to reject prepetition agreements through bankruptcy have asserted two fundamental arguments that have caused courts around the country to evaluate the scope of the debtor's rejection power under section 365 of the Bankruptcy Code. The first argument is that agreements forming or containing covenants that run with the land represent real property rights that cannot be impaired in bankruptcy and, thus, cannot be rejected. The second argument is that debtors cannot reject executory contracts containing filed rates over which FERC has exclusive jurisdiction, including PPAs and transportation agreements, without *also* obtaining FERC's approval. Recent bankruptcy court decisions show a trend toward rejecting both these arguments and, instead, allowing debtors to reject such agreements as executory contracts subject to the exclusive jurisdiction of the bankruptcy courts.

1. Covenants Running with the Land

Oil and gas producers often enter into transportation, treatment, processing, and delivery agreements, such as gas gathering agreements with pipeline and processing plant operators (collectively, "***midstream service agreements***"). Until recently, the rejection of midstream service agreements was generally seen as a matter of state law. Contract counterparties opposing rejection argued that rejection turns on whether the dedications and other covenants contained in oil and gas gathering agreements are ***covenants running with the land***. A covenant that runs with the land is an agreement that both benefits and burdens current and future holders of an interest in real property—it is not tied to one individual interest holder, it is tied to the property itself.[4] For example, a covenant to pay for the maintenance of subdivision facilities both benefits and burdens the property of each individual landowner, so it is a real property interest that runs with the land.[5]

Whether a covenant runs with the land is a question of state law that will vary from state to state, but the dispositive attributes of the covenants may be summarized as follows: (1) the parties *intended* to create a covenant that would run with the land when they entered into the agreement; (2) there was *privity of the estate* between the benefitted party and the burdened party; and (3) the benefit or burden of the agreement *touched and concerned* the land.[6]

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[3] *See id.* § 365(g).
[4] *See, e.g.*, *Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987).
[5] *See id.* (citing 5 R. POWELL, THE LAW OF REAL PROPERTY § 673[2] at 60–46 (15th ed. 1986)).
[6] *See, e.g.*, *In re Sabine Oil & Gas Corp.*, 550 B.R. 59, 65 (Bankr. S.D.N.Y. 2016); *Midlands Midstream, LLC v. Badlands Energy, Inc. (In re Badlands Energy, Inc.)*, 608 B.R. 854, 867 (Bankr. D. Colo. 2019); *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)*, 613 B.R. 90, 99 (Bankr. S.D. Tex. 2019).

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