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Beatty & Wozniak Secures Ruling Distinguishing the Landmark Bankruptcy Decision, In re Sabine Oil & Gas Corp.

By Tyler L. Weidlich

The U.S. Bankruptcy Court for the District of Colorado, on September 30, 2019, issued a long-awaited decision that limits the ability of production companies to reject midstream contracts in bankruptcy. The court found that dedications in a gas gathering and processing agreement and a saltwater disposal agreement constitute "covenants running with the land." Based on this finding, the court concluded that neither contract could be rejected in bankruptcy and both had to be assumed by the purchaser of the debtor's oil and gas assets. The decision is *Monarch Midstream, LLC v. Badlands Production Company, et al.* (*In re Badlands Energy, Inc.*), Adversary No. 17-01429 KHT, D. Colo. Bankr. Sept. 30, 2019) and the Court's Order can be found here.

Monarch is a notable departure from *In re Sabine Oil & Gas Corp.*, in which three landmark (and rather controversial) decisions were rendered in 2016-2018 by the U.S. District Court for the Southern District of New York and the Court of Appeals for the Second Circuit. *See In re Sabine Oil & Gas Corp.*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016); *In re Sabine Oil & Gas Corp.*, No. 16-CV-4127, 2017 WL 1093290 (S.D.N.Y. Mar. 10, 2017); *In re Sabine Oil & Gas Corporation*, 734 Fed. Appx. 64 (2d Cir. 2018).

In re Sabine Oil & Gas Corp.

In *Sabine*, a well operator and bankruptcy debtor, Sabine Oil & Gas Corp. ("Sabine"), sought to reject three gathering contracts and a water/acid gas holding agreement in the course of its reorganization efforts under Chapter 11. Applying Texas real property law in conjunction with Section 365 of the Bankruptcy Code, the court concluded the contracts were "executory"—not real covenants running with the land—and could therefore be rejected in bankruptcy. The judicially authorized rejection of Sabine's midstream contracts is estimated to have saved the debtor as much as $115 million.

Sabine primarily addressed the "touch and concern" and "horizontal privity" requirements for a covenant to run with the land. Under Texas law, a covenant "touches and concerns" land if "it affects the nature, quality, or value of the subject of the covenant or affects the mode of enjoying it." Horizontal privity requires "some interest in the land other than the purported covenant itself at the time it was executed," which in turn typically exists when the covenanting parties establish the covenant in connection with a simultaneous conveyance of real property interests.

The bankruptcy court in *Sabine* held that the mineral dedications at issue did not "touch and concern" Sabine's oil and gas assets. "By the plain terms of the agreements," the court ruled,

"the mineral dedications concern only minerals extracted from the ground, which indisputably constitute personal property, not real property, under Texas law." The court also found horizontal privity was lacking because there was no original conveyance of a property interest between Sabine and the midstream companies that itself was burdened by the mineral dedications. In rendering this holding, the *Sabine* court rejected a midstream company's contention that the simultaneous conveyance of an easement on property not covered by the dedication created horizontal privity.

The bankruptcy court's ruling was affirmed by the U.S. District Court for the Southern District of New York and the Court of Appeals for the Second Circuit.

Monarch Midstream, LLC v. Badlands Production Company, et al. (In re Badlands Energy, Inc.)

Monarch is the first decision since *Sabine* addressing whether mineral dedications in midstream contracts constitute covenants running with the land in the context of an asset sale in bankruptcy. Contrasted to *Sabine*, the *Monarch* court found that both the "touch and concern" and "horizontal privity" elements were met under Utah law and concluded that the dedications in the midstream contracts constituted covenants running with the land. As a result, the purchaser of the debtor's assets in bankruptcy was bound by and required to assume the contracts.

In *Monarch*, a well operator and Chapter 11 debtor, Badlands Production Company ("Badlands"), sought to reject gathering and saltwater disposal contracts on the same theory espoused in *Sabine*—i.e., that the mineral dedications were "merely a promise by Badlands to use Monarch's gathering and processing services" and were thus "contractual" as opposed to "real" covenants. A critical distinction in *Monarch*, however, was that the mineral dedications covered Badlands' interests not only in produced gas (i.e., personal property) but in "oil and gas reserves, leases and all other lands within an Area of Mutual Interest (AMI)." Under Utah law, as in most jurisdictions, non-extracted minerals constitute real property, and the *Monarch* court classified Badlands' interests subject to the dedications as such.

With regard to the "touch and concern" element, the *Monarch* court further held that "under Utah law, all that must be shown for a covenant to run with the land is it be of such character that its performance will so affect the use, value or enjoyment of the land…." The court appropriately held that the dedication of Badlands' interests in mineral reserves, leases and AMI lands to Monarch's gathering and disposal facilities met this standard.

With regard to "horizontal privity," the court noted two additional distinctions between *Monarch* and *Sabine*: (1) Badlands' midstream contracts were executed—and the mineral dedications were granted—in conjunction with and as a condition to Monarch's acquisition of Badlands' midstream assets, which were located within the same AMI subject to the dedications; and (2) the gathering and processing contract granted a "floating easement" across the AMI lands. "Here, unlike *Sabine*," the court concluded, "the covenants burden Badlands' real property interests…in the context of a simultaneous conveyance of real property interests…." The *Monarch* court appropriately found that the horizontal privity and touch and concern elements were met, and that the midstream contracts ultimately run with the land.

Initial Observations

Mineral dedications, like those in *Sabine* and *Monarch*, are intended to bind a producer's successors to the underlying midstream contracts—either in context of a producer's ordinary

divestment of assets, in bankruptcy, or in foreclosure. Midstream companies, as well as their lenders, have historically relied on these dedications as a form of security in undertaking large capital investments. Thus, it comes as little surprise that *Sabine* garnered considerable attention from the industry and legal commentators. *See, e.g.,* Sabine Decision Puts Midstream Pipeline Contracts in Jeopardy.

Monarch and *Sabine* involved differing dedication language and other facts relevant to horizontal privity. Nevertheless, at the very least, *Monarch* should ease concerns that a broad application of *Sabine* will be adopted nationwide, particularly, the theory that midstream contracts inherently do not constitute real covenants insofar as they "concern only minerals extracted from the ground." *Monarch* dispels such a theory and demonstrates that properly drafted dedication language in midstream contracts will bind successors and survive bankruptcy.

Tyler L. Weidlich and Karen L. Spaulding of Beatty & Wozniak represented Monarch Midstream, LLC in the bankruptcy adversary proceeding. Gina L. Matero of Beatty & Wozniak authored the gathering and processing agreement in question.

Beatty & Wozniak's experienced litigation and transactional attorneys regularly work with clients on issues related to midstream contracts and others impacting the industry.