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Post-Kingfisher Guidelines for Gathering, Transportation Agreements

By **Harve Truskett** and **Parker Lee,** Attorneys, **Hunton Andrews Kurth**

A recent ruling in *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC, (In re Alta Mesa Res., Inc.), 613 B.R. 90* (Bankr. S.D. Tex. 2019) ("Kingfisher") provides midstream companies with a set of guidelines for evaluating their agreements.

The COVID-19 pandemic has dramatically reduced the demand for crude oil and a mid-April deal between Russia, Saudi Arabia, and other OPEC producers to cut production has done little to alleviate the resulting downward pressure on crude oil prices. Upstream exploration and production companies, particularly those carrying a lot of debt, are especially vulnerable to this downturn in prices.

The financial strain on these upstream exploration and production companies poses a direct threat to the midstream companies that have material commercial agreements with them. Due to the counterparty risk stemming from the threat of bankruptcy and probable industry consolidation in the upstream sector (which will likely take the form of both corporate M&A and asset level A&D activity), midstream companies should review the material contracts with their upstream counterparties to assess and mitigate their risks.

This article focuses on a set of agreements that drives the commercial arrangement between midstream companies and their producer customers: gathering and transportation agreements. The recent Kingfisher case provides guidelines that midstream companies should address when evaluating their existing contracts or entering into new ones.

Kingfisher Decision

In recent years, a split has developed amongst bankruptcy courts regarding how to treat gathering and transportation agreements pursuant to which oil and gas production from specified leasehold acreage in a geographic area is dedicated to the gathering and transportation services under the agreements.

When such agreements are treated as "covenants running with the land," they cannot be rejected in bankruptcy, providing certainty for the midstream company in its existing commercial arrangement with its producer.[1] In these cases, the language of a gathering and transportation agreement can have a major influence on whether the agreement constitutes a "covenant running with the land" in which case the producer cannot reject it in bankruptcy – or an "executory contract" – in which case the producer can reject it.

Prior to *In re Sabine Oil & Gas Corp., 547 B.R. 66 (Bankr. S.D.N.Y. 2016)* ("Sabine"), the long-held belief in the oil and gas industry was that gathering and transportation agreements with acreage dedications would generally be treated as contracts forming real property covenants running with the land and therefore cannot be rejected in bankruptcy. However, the Sabine Court held that a particular gathering and transportation agreement did not constitute a covenant running with the land, deciding instead that it was an executory contract and therefore could be rejected in bankruptcy.

The Kingfisher case at the end of 2019 came to a different conclusion with an analogous, albeit different, set of facts.[2] Unlike Sabine, the Kingfisher Court held that the gathering and transportation agreement in question constituted a covenant running with the land that could not be rejected by the debtor. Therefore, the debtor was required to continue to comply with the terms and obligations under the gathering and transportation agreement and was not excused from further performance.

The Kingfisher case was decided by the United States Bankruptcy Court for the Southern District of Texas (Judge Marvin Isgur presiding) applying Oklahoma real property law versus Sabine, which was decided by the United States Bankruptcy Court for the Southern District of New York applying Texas real property law. Given that the requirements to form real property covenants under Oklahoma law mirror those in Texas, and Judge Isgur's experience in presiding over complex oil and gas bankruptcies,[3] we believe the Kingfisher decision will be an authoritative guideline in assessing whether gathering and transportation agreements may be rejected in states with similar real property laws.

The Kingfisher Court reiterated the prin-

ciple that a "covenant running with the land," a real property interest, cannot be rejected in bankruptcy. ("Bankruptcy Code does not allow for the rejection of real property covenants.")[4] In its analysis, the Kingfisher Court also specified language from the agreement it considered important in reaching its decision, which can serve as a guidepost for a midstream company's review.

Real Property Interest

For the midstream company, having a gathering and transportation agreement with their upstream counterparty that qualifies as a real property interest confers important rights and obligations outside of a bankruptcy context. A subsequent owner or assignee of the upstream asset, following a sale or assignment of the asset, will take the real property interest with notice of the "covenant running with the land" – i.e., they will be bound by the agreement and be responsible for delivering product to the midstream company for gathering and transportation. For example, if an upstream producer sells the property to a third party, that third party takes the property on notice that it is subject to the burden of the covenant and will be obligated to meet the obligations set out in the agreement.

Of course, this aspect of the agreement works both ways. The midstream company, or a successor, will also be bound by the agreement to the upstream company or a successor.

The bottom line is that the marketability of the midstream assets is reinforced by having strong covenants. The "covenant running with the land" status affects the risk profile of the midstream asset, usually making the asset more valuable and more marketable. The status of a covenant running with the land may also benefit the upstream company, depending on the economic terms of the contract.

Land Analysis

In determining that the agreements were covenants running with the land, the Kingfisher Court focused on the following three elements required to create a real property covenant running with the land under Oklahoma law.

1. The agreement contains a covenant that touches and concerns the land. "Touches and concerns the land" is a legal term of art which means that there is "a logical connection between the benefit to be derived from enforcement of the covenant and the property."[5] In essence, if the landowner's value in the land is affected, positively or negatively, by the covenant, then it likely touches and concerns the land. The Kingfisher Court begins by describing the nature of the producer's interest: an oil and gas lease. The original Kingfisher gathering agreement contained the following four relevant covenants:
   - A dedication of all the produced hydrocarbons with respect to certain defined properties for delivery to Kingfisher for gathering services;
   - Specific sections entitled "covenants running with the land" requiring recordation and express affirmation of the agreements by any transferee;
   - A grant of surface easements allowing Kingfisher to build and maintain the gathering system; and
   - Fixed gathering fees.[6]

   The Kingfisher Court concluded that these covenants established that the gathering agreement touched and concerned the land. Pursuant to the agreement, Kingfisher created an oil and gas gathering system that provided benefits to the producer's property – e.g., facilitating the collection of hydrocarbons from the dedicated property.

   The agreement also imposed burdens on the producer's property – e.g., the dedication of the reserves to Kingfisher and the limitation on the producer's midstream services options. The Kingfisher Court noted that while Kingfisher's right to gather hydrocarbons springs into action upon extraction, Kingfisher's interest touches and concerns the producer's mineral interests.
2. There is privity of estate between the parties. "Privity of estate" is another legal term of art. While it is defined somewhat differently in different states, "privity of estate" generally means that the parties to the agreement have both vertical privity and horizontal privity.

   Vertical privity exists when each party is a successor in interest to one of the original covenanting parties. As Alta Mesa and Kingfisher were the original parties to the gathering agreement, the Kingfisher Court found that vertical privity was irrelevant, but to the extent they happened to be successors of interests, the fact that a memorandum of the agreements was recorded would satisfy vertical privity.

   Horizontal privity exists when a covenant is created in connection with a transfer of an interest in real property from one party to another. The Kingfisher Court found that the conveyance of the surface easements by the producer to Kingfisher for purposes of constructing and maintaining the gathering system constituted a conveyance of real property (specifically, a possessory interest in the producer's oil and gas lease), and that the related covenants in the gathering agreement therefore satisfied the requirement for horizontal privity.[7]
3. The agreement contains evidence of intent between the parties to create a covenant running with the land. The simplest way to convey such an intent is for the parties to include a provision stating they intend for the agreement to be "a covenant running with land." This, of course, won't make it so if the other elements are not satisfied. A provision stating that the agreement binds successors and assigns is further evidence that the parties intended the covenant to run with land. This can be accomplished by having a covenant requiring an assignee of the producer's leasehold estate to sign a subsequent agreement to uphold the original agreement's obligations. Finally, a covenant requiring recording a memorandum of the agreement in the applicable real property records provides evidence of an intent to create a covenant running with land. The act of recording puts third parties (potential purchasers of the acreage) on notice that the acreage is burdened by the dedication to the gathering agreement. A covenant requiring such a recording shows that intent. The agreements in question in Kingfisher included all of these provisions and were cited as evidence of the intent to create covenants running with the land.

Thus, a midstream company should evaluate its gathering and transportation agreements with acreage dedications for the following attributes:

- Dedication language containing words of "grant" (e.g., grants, transfers, assigns) with respect to the producer's interests in specified areas of mutual interest with the midstream company to the gathering and transportation services under the agreement (touch and concern and privity of estate).
- A covenant requiring a memorandum of the agreement to be recorded (intent to create a covenant running with

land).

- Actual recordation of a memorandum in the real property records of the county or analogous jurisdiction in which the acreage is located (vertical privity of estate).
- The grant of a surface easement from the producer to the midstream company with respect to the area of mutual interest for purposes of constructing and maintaining the gathering and/or transportation systems (horizontal privity of estate).
- Language that the agreement is to be binding on successors and assigns (intent to create a covenant running with land).
- A covenant requiring an assignee of acreage to sign a written agreement to be bound by the original agreement (intent to create a covenant running with land and vertical privity).

The above requirements outlined in Kingfisher are common in many oil and gas producing states (e.g., Oklahoma, Texas, Utah). Therefore, we believe these guidelines are a good starting point for evaluating gathering and transportation agreements with acreage dedications.

However, the real property law in the state in which the underlying real property is located (the area of mutual interest for the acreage dedication) will govern the analysis as to whether a real property covenant running with the land is created. Therefore, the specific state law should be researched to determine the relevant requirements and how they are applied.

What Should Companies Do?

First, midstream companies should review their gathering and transportation agreements and strength-test them against the guidelines listed above.

If a gathering and transportation agreement falls short of the Kingfisher guidelines for establishing a covenant running with the land, the midstream company should consider whether it's worth approaching the upstream company to amend the contract. We suggest starting by identifying matters that are easy to correct and focusing on those.

For example, if a memorandum has not been recorded in the real property records of the relevant county, the corrective action – recording the memorandum – is relatively simple. Assuming the agreement does not prohibit filing a memorandum of the agreement, or if the step of recording was contemplated in the agreement but simply omitted, the midstream company can reach out to the upstream counterparty and ask them to agree to execute and record the memorandum in the appropriate county courthouse.

More extensive, substantive changes to the terms and conditions of the gathering and transportation agreement may be harder to acquire. The producer counterparty may decline requests for changes or ask for consideration in return.

Decisions about whether to approach a producer counterparty to make changes, what changes to request, and how hard to push depend on many business and economic factors, including the severity of the contract's deficiency, the parties' relative strengths in negotiations, the likelihood of the producer declaring bankruptcy, and the parties' existing business relationship – e.g., do the parties' have a long-standing cordial relationship or is there a history of disputes? If there is a current amendment being negotiated to revise the agreement's commercial terms (particularly terms the producer wants), it is a good opportunity for the midstream company to negotiate for stronger dedication language in the amendment.

For a new contract, both parties should seek clarity on their intentions as to whether or not they want to create a covenant running with the land. If they do, they should look to the Kingfisher line of cases for guidance and use specific language in the contract to show those intentions. It is in both parties' interests to review the contract, especially in light of current market conditions.

Ultimately, it is important to make these agreements as strong as you can make them – before they are put to the test. ***P&GJ***

References:

1. The Bankruptcy Code allows a debtor to assume or reject certain types of contracts during a bankruptcy. Rejection of a contract excuses the debtor from further performance under the contract and gives the counterparty an unsecured claim for breach of contract damages.
2. It is worth noting that Kingfisher also cites a September 2019 case, Midlands Midstream, LLC v. Badlands Energy, Inc. (In re Badlands Energy, Inc.), 2019 WL 5549463, No. 17-01429 (Bankr. D. Colo. Sept. 30, 2019) ("Badlands"). Badlands, applying Utah real property law, held a gas gathering and processing agreement was not subject to rejection by the Bankruptcy Code using similar reasoning.
3. https://www.law360.com/articles/818457/texas-bankruptcy-courts-boom-with-commodities-bust
4. "Alta Mesa seeks a declaratory judgment that the gathering agreements did not form real property covenants under Oklahoma law, and may therefore be rejected as executory contracts. The parties (and the Court) agree that the Bankruptcy Code does not allow for the rejection of real property covenants. In order to form a real property covenant, three factors must be satisfied. First, the covenant must touch and concern real property. Second, there must be privity of estate. Third, the original parties to the covenant must have intended to bind successors. For the reasons that follow, the gathering agreements satisfy all three requirements. Alta Mesa cannot reject the agreements." Alta Mesa, 613 B.R. at 99.
5. Id., at 102.
6. Note that two additional relevant covenants were established in the amended gathering agreements: transportation conveyances and reduced gathering fees.
7. It bears noting that the Sabine Court found that granting a surface easement to the midstream company did not create horizontal privity with the producer, but the Sabine Court's conclusion centered on its characterization of the producer's interest as a fee mineral estate. We believe the Kingfisher finding (as well as the Badlands finding) is more authoritative on this point as it correctly characterizes the producer's rights to the surface estate under an oil and gas lease for the production and exploration of the producer's underlying interest in the fee mineral estate as being integral to the realization of the value of such interest.

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ANDREWS KURTH