Uncertainty Rises for Energy Sector Bankruptcies

In recent years, the energy sector has struggled with low commodity prices, oversupply, and logistical constraints—challenges which are poised to continue in the months ahead. These issues are putting a significant strain on the capital-intensive oil and gas sector, and a segment of the industry will labor to balance operating costs with profitability (or survival). Eventually, the financial constraints will require some operators to seek relief, either through an out-of-court restructuring, a reorganization, or liquidation under bankruptcy laws. As this wave of distressed enterprises progresses, there will be a residual impact on all facets of the infrastructure and supply chain supporting the oil and gas sector.

One segment of the industry infrastructure recently in the headlines is the pipeline companies that provide assets and/or transport services to the oil and gas industry. There are a number of variants on how these relationships are formed; the type at issue in the case discussed below generally provides for the pipeline company to construct or own pipeline systems to service an operator's well fields. The capital costs are recouped by a fee charged to transport oil and gas through the pipeline from the well head to a downstream sale point. The pipeline company generally requires a committed dedication of oil and gas by the operator (e.g., all of the gas generated by its Marcellus operators in Pennsylvania) and a minimum daily volume. This ensures that the pipeline company receives a threshold rate of return on its invested capital. While those costs can be more easily borne by the operator when times are good, there is some uncertainty as to the economics of these arrangements in the current market (i.e., when times are tough).

One of the ways pipeline operators have attempted to protect their investment and revenue stream is to provide that the covenants to dedicate a committed volume "run with the land" and are binding on successors. The assumption that such "real covenants" provided bankruptcy protection took a significant blow from a recent opinion of a bankruptcy court in New York. In *In re Sabine Oil & Gas Corporation,* No. 15-11835 (SCC), 2016 WL 890299 (Bankr. S.D.N.Y. March 8, 2016), the bankruptcy court permitted an operator to "reject" as executory contracts two pipeline gathering contracts that the debtor/operator had with two midstream providers. Both of the pipeline operators strenuously objected to the rejection on the ground that the covenants to dedicate a minimum volume and pay certain minimum fees constituted "covenants running with the land."

The bankruptcy court agreed that if the covenants truly constituted "real covenants," they would be considered property interests that could not be rejected in bankruptcy. For technical jurisdictional reasons, the court did not officially rule that the contracts were not covenants running with the land. Rather, it reserved that decision for a subsequent, more in-depth proceeding (which has not yet occurred). But, the court went on to provide a lengthy analysis, albeit in non-binding dicta, concluding that the covenants were not real covenants running with the land (under Texas law), because they did not burden the land conveyed with the pipeline easement or the gathering agreements. At best, the covenants burdened the debtor/operator's interests in the minerals (oil, gas, and other condensates), which once severed from the realty are considered personal property under the applicable state law. Therefore, the covenants to exclusively use the pipeline operators' pipeline, to provide a minimum volume through the pipeline and to pay a minimum annual fee did not burden the debtor's real property interests.

The lesson from the case is clear: if a midstream operator or any other party is counting on its property interests, as opposed to its contractual rights, to protect it from a future bankruptcy, the transaction must be carefully structured to make sure it complies with applicable state property law. Existing contracts also should be reviewed to make sure they comply with property law.

Although not raised by the pipeline operators in their initial objections, the case raises another more subtle issue. The court indicated that rejection of the contracts would relieve the debtor of all of its obligations that could be rejected in bankruptcy. The court indicated that the covenants in question did not run with the land; however, the court further opined that even if there were covenants that run with the land, the contracts could still be rejected. If that principle prevails, covenants running with the land could preclude the debtor from rejecting an integrated contract containing such covenants. It is unclear if the result would have been different if the contracts clearly provided that the intent of the parties was to treat valid covenants "running with the land" and all other contractual provisions as a single, integrated transaction or contract (even if set forth in multiple documents). That could have presented the court with a conflict with numerous cases that hold an executory contract must either be assumed or rejected as a whole. For example, in Pennsylvania, a debtor/landowner's oil and gas lease could not be rejected because once oil or gas is produced, it constitutes a conveyance of a property interest. *See Chesapeake Appalachia, LLC v. Powell* (In re Powell), No. 3:13-cv-00035-RDM, 2015 WL 6964549 (M.D.Pa. Nov. 10, 2015).

Careful drafting and planning to anticipate those bankruptcy issues can significantly enhance a counterparty's rights in the event of a bankruptcy. With the energy industry under financial distress, these issues (and others) should be considered and anticipated before future bankruptcy cases arise.

Cohen & Grigsby's Energy and Bankruptcy & Creditors' Rights practice groups will continue to monitor these cases as the outcomes will significantly impact upstream operators and midstream entities during the current commodity cycle. Please contact us if you have any questions.

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