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How Midstream Providers Must Respond to Latest Exploration and Production Bankruptcies

By Keith N. Sambur, Seth R. Belzley, and Andrew Thomas Gillespie*

In the bankruptcy case of Extraction Oil & Gas, the U.S. Bankruptcy Court for the District of Delaware issued an opinion that, according to the authors of this article, undermines the framework for how the midstream industry operates and obtains financing. The authors discuss the decision, which they say calls into question bedrock principles on which midstream companies rely in constructing, investing, and financing midstream infrastructure.

The dual impact of a COVID-19 demand slump and market pricing pressures has lead to a host of bankruptcy filings by exploration and production ("E&P") companies. This distress led producers to seek rejection of midstream agreements that producers viewed as burdensome or whose minimum financial commitments restrained the financial flexibility that producers would seek in a period of a "new normal."

Recently, in the bankruptcy case of Colorado-based Extraction Oil & Gas, the U.S. Bankruptcy Court for the District of Delaware—one of the most influential bankruptcy courts in the country—issued an opinion under Colorado law that undermines the framework for how the midstream industry operates and obtains financing.

BACKGROUND

By way of background, one of the tools the U.S. Bankruptcy Code generally provides debtors is the ability to (1) reject any executory contract under Code Section 365, and (2) treat the damages arising from rejection as an unsecured claim. This tool is often necessary to restructure feasibly or sell assets for higher value.

This powerful tool has a critical limitation: debtors can use Section 365 to terminate a contract but not unwind a conveyance of a real property interest.

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As midstream agreements typically include contractual payment and performance provisions as well as dedications (or conveyances) of oil and gas mineral rights (or real property interests), midstream companies and their financing sources believe that midstream agreements constitute a real property conveyance that a debtor could not reject.

If the midstream agreement burdens the mineral estate, the E&P company could not get out from its burdensome effects, and the midstream company and its financing sources have little reason to fear an E&P bankruptcy. It is the belief that midstream agreements burden the mineral estate that allow midstream companies to efficiently finance themselves.

THE COURT'S RULING

In the Extraction bankruptcy, the Delaware court ruled that three sets of midstream transportation and gathering agreements did not create "covenants running with the land" under Colorado law. The ruling cleared the way for Extraction to reject the agreements to the significant economic detriment of the midstream counterparties.[1]

The court ruled that under Colorado law for a covenant to run with the land—and therefore create a real property estate or interest:

(1) Parties must intend to create a covenant running with the land;

(2) The covenant must touch and concern the land with which it runs; and

(3) There must be privity of estate between the original covenanting parties at the time of the covenant's creation.

Failure to satisfy any of these elements is fatal.

Somewhat remarkably, the court found that the gathering and dedication commitments did not touch and concern the land, because they only concern "personal property and do not affect the physical use of real property or closely relate to real property."

In other words, because the agreements related primarily to the delivery of as-extracted minerals, those minerals became severed from the real estate and no longer constituted a real property interest or touch and concern the land.

The court also noted that the agreements allowed Extraction to satisfy its obligations under the agreements not by delivering minerals extracted from the

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[1] In order to reject the agreements, Extraction must still demonstrate that rejection is in its proper business judgment, including that other means exist for transportation of the minerals. With that said, facing the prospect of unused infrastructure is likely to cause the midstream counterparties to renegotiate their agreements with Extraction.

land, but simply by paying money, which further distanced the agreements from one that would touch and concern the land.

The court further ruled that the parties cannot make agreements touch and concern the land if, as a matter of law, the agreement does not involve a real property interest.

Accordingly, any statement in the midstream agreements that the contracts touch and concern the land is self-serving at best.

Because the court concluded that the dedications do not "touch and concern" a real property interest, the court was also able to conclude that there was no privity of estate as between the parties. Privity of estate—according to the court—does not entail mere contractual privity but a conveyance of the real property estate in question and at issue. As the severed mineral interests were not a real property interest, there was no privity of estate.

Although the midstream agreements did provide the midstream companies with surface easements, the court reasoned that those surface easements again related only to as extracted minerals and therefore could not be used to show privity as it related to the minerals themselves.

CONCLUSION

This decision calls into question bedrock principles on which midstream companies (and their financing sources) rely in constructing, investing, and financing midstream infrastructure.

This wave of E&P restructurings has again demonstrated the need for midstream companies and their financing sources to creatively rethink their legal documentation.

As the industry braces for more restructurings and consolidation, proactive midstream companies and their financing sources should use this ruling as a roadmap for strengthening their documents and rethinking their approach.

Fortunately, such tools exist.