To Reject or Not to Reject: Can Midstream Agreements be Rejected in Bankruptcy?

In the oil and gas industry, producers and midstream operators frequently enter into gathering agreements. As part of the gathering agreement, a producer will dedicate its production to an operator in return for the building and maintaining of a pipeline system for the benefit of both parties. In order to build and maintain a pipeline system, surface easements have become a common feature of gathering agreements.

As previously discussed, in bankruptcy, the United States Bankruptcy Court for the Southern District of Texas ruled in *Alta Mesa* that when gathering agreements "directly touch and concern" the leasehold interest, either by burdening or benefitting it, they are not subject to rejection under Section 365 of the Bankruptcy Code.

However, in a surprising twist, on May 6, 2021, the Bankruptcy Court changed course and held that gathering agreements that "directly touch and concern" the leasehold interest could be rejected, that real property interests that are granted can be retained, and that all is not what it seems in the aftermath of the *Alta Mesa* decision.

A Familiar Situation Involving Gathering Agreements

In *Occidental Petroleum Corp., et al v. Sanchez Energy Corporation et al*, Sanchez (now Mesquite), as the producer, and Occidental, as the midstream operator, entered into gathering and operating agreements collectively called the "Springfield Agreements."

Like most gathering agreements, the Springfield Agreements expressed an intent to form covenants running with the land, including dedications, covenants, and commitments, as well as a floating easement and right-of-way in order to lay pipeline, maintain pipeline, and install other necessary equipment.

The Bankruptcy Court's Surprising Ruling

After filing for bankruptcy, Sanchez sought to reject the Springfield Agreements. After summarily holding that Sanchez's decision to reject the Springfield Agreements was a reasonable exercise of business judgment, the Court turned to explaining how the real property covenants of the Springfield Agreements survive rejection.

Using the same analysis it used in *Alta Mesa*, the Court applied Texas property law in holding that:

(1) the Springfield Agreements touched and concerned the land;

(2) the obligations expressly bound successors and assigns;

(3) the parties intended for the covenants to run with the land;

(4) the parties had notice of the covenants; and

(5) the Springfield Agreements had horizontal privity.

Surprisingly, after applying the same analysis used in *Alta Mesa*, the Bankruptcy Court came to a drastically different conclusion and held that Sanchez could reject the gathering agreements, and that Occidental retained its real property interests granted in the gathering agreements.

Reconciling With *Alta Mesa*

Seeking to reconcile its ruling, the Court acknowledged its previous *Alta Mesa* decision, holding that agreements containing real property covenants could not be rejected in bankruptcy. They went so far as to attempt to clarify that "that point of the *Alta Mesa* decision could lead one to believe that a debtor cannot reject an executory contract which creates a real property covenant which held that a debtor cannot reject an executory contract which creates a real property covenant." Despite acknowledging the potential for confusion, the Court did not offer much in the way of explanation as to why it pivoted.

Given the Bankruptcy Court's change in course, it is more important than ever to have your business' gathering agreements reviewed to determine how Texas property law may impact them in bankruptcy.

For more information, please contact Patrick Kelly.