COVENANTS RUNNING WITH THE LAND

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Biography

Michael P. Pearson is a partner in and co-chairman of the Energy Practice Group of Jackson Walker. He has practiced in the areas of oil and gas and energy law since 1978, representing numerous Texas-based, national, and international energy companies and financial institutions in a broad range of transactional matters relating to the upstream, midstream, finance, and marketing sectors of the oil and gas industry.

Education

Mr. Pearson earned his B.A., with high honors, from The University of Texas at Austin in 1975 and his J.D. from The University of Texas School of Law in 1978, where he was an Associate Editor of *The Texas Law Review*.

Memberships

Mr. Pearson is a member of the State Bar of Texas, the Houston Bar Association, the International Bar Association, and the American Bar Association. Mr. Pearson is a Past Chair of the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas.

Awards

Mr. Pearson has been listed in *The Best Lawyers in America* under Natural Resources Law and Oil & Gas Law since 2004 and has been named a "Texas Super Lawyer" by Thomson Reuters since 2007. Mr. Pearson has also been listed in "Who's Who in Energy" by The Houston Business Journal since 2012 and was listed by Legal Media Group among the "World's Leading Energy & Natural Resources Lawyers" in 2008, 2010, 2013, and 2015. In 2005, *Lawdragon Magazine* selected Mr. Pearson as one of the "500 Best Lawyers in America", in 2007 as one of the "500 Top Deal Makers in America", and in 2010 as one of the "Lawdragon Top 3000."

Publication & Speaking Engagements

Mr. Pearson has authored a number of articles relating to finance and oil and gas matters and has also been a frequent speaker at continuing legal education programs and seminars. Most recently, Mr. Pearson delivered a paper entitled "Selected Drafting Issues in Midstream Contracts" at the 2015 Gas and Power Institute sponsored by The University of Texas School of Law, the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, and the Energy Bar Association, and a paper entitled "Gas Royalty Calculation 2015 – An Update" at the 2015 State Bar of Texas Advanced Oil, Gas and Energy Resources Law Course.

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COVENANTS RUNNING WITH THE LAND

by Michael P. Pearson[1]

I. INTRODUCTION

If one practices law long enough, he or she will experience a new twist on an old legal issue about which it seemed that the last words had been written. Depending on how extreme the "twist" is and the amount of money involved, the reaction can range from mildly intriguing ("Well, now, that's an interesting position. Let's think about that.") to shocking and bet-the-company serious ("That position cannot possibly be the law. If a court agrees with that position, it will be disastrous for the [choose one] industry."). And yet, here we are confronting such a circumstance today, in the wake of the large number of oil and gas producer bankruptcies that followed the collapse of crude oil prices at the end of 2014, with respect to our old real property law friend, the real covenant, better known as the covenant running with the land.

A bit of background is useful at this point. Many midstream transactions with oil and gas producers that are performed at the wellhead – i.e., gas purchase, gathering, processing, and similar agreements (collectively, "Wellhead Contracts") – are structured so that the gas purchaser, gatherer, or processor (each, a "Midstream Company") purchases, gathers, or processes all of the gas produced from certain oil and gas leases or lands that are owned or controlled by the oil or gas producer. In most cases, the Midstream Company's obligation to receive and purchase, gather, or process the producer's gas on a daily basis is firm[2] up to the maximum daily capacity made available to the producer at the Midstream Company's facilities. In consideration for this commitment by the Midstream Company, Wellhead Contracts customarily provide for the producer's commitment to the contract of all gas produced from or attributable to its interests in the relevant oil and gas leases or lands (in each case, an "Acreage Commitment").

A typical Acreage Commitment provides, in pertinent part:

> Subject to the terms of this Agreement, Producer commits and dedicates to the performance of this Agreement, during the Contract Term, all of the Gas now or hereafter Owned or Controlled by Producer that is produced from all current and future wells located on the lands covered by the oil and gas leases described on **Exhibit A,** including any extensions or renewals of such oil and gas leases and any new oil and gas leases taken in replacement thereof prior to or within six (6) months after the expiration of any such oil and gas lease (collectively, the "Dedicated Leases"). For purposes of this Agreement, Gas is "Owned or Controlled" by Producer if Producer has title, whether by virtue of its ownership of a Dedicated Lease or otherwise, or, if Producer does not have title to such Gas, Producer has the right, under

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[2] "Firm" sales service is a higher class of service for gas that is continuous without curtailment except upon the occurrence of force majeure or other occasional, extraordinary circumstances. 8 Patrick H. Martin & Bruce M. Kramer, WILLIAMS & MEYERS OIL & GAS LAW, *Manual of Terms*, at 381 (2016).

> any joint operating agreement, unit operating agreement, or other contractual arrangement or arising by operation of Law, to commit and dedicate such Gas to the performance of this Agreement.

There are, of course, many other variations of this type of provision.

When entering into such a Wellhead Contract, Midstream Companies frequently agree to construct and install a gas gathering system, a gas processing or fractionation plant, or other facilities for use in the performance of the contract. Since the oil and gas producer rarely contributes to the costs of these facilities, Wellhead Contracts frequently obligate the producer to deliver to the Midstream Company the minimum annual volume of hydrocarbons (in each case, the "MAQ") over the period of time that is required to permit the Midstream Company to recover its capital investment and achieve its targeted rate of return. If the producer fails to deliver the MAQ during a contract year, the producer must pay the Midstream Company a deficiency. In many Wellhead Contracts, the MAQ increases and then declines over the term of the contract to reflect the ramp up in production expected to result from the producer's development plan for the Dedicated Leases and the subsequent decline in production after development is complete. In this way, the parties seek to match the MAQ to the producer's anticipated production over the contract term.

As energy commodity prices declined and then collapsed in 2014 and thereafter remained at historically low levels throughout 2015 and much of 2016, many producers were forced to reduce or even suspend entirely their oil and gas drilling programs. This circumstance resulted in a disconnect between the agreed upon MAQ in the affected Wellhead Contracts and the producers' actual production, which did not ramp up and actually began to decline faster than anticipated by the parties. Many producers thus were faced with the obligation to make increasingly large, potentially crippling deficiency payments In an effort to avoid bankruptcy, many producers entered into negotiations with their Midstream Companies to restructure the relevant Wellhead Contracts to reduce or eliminate the economic burden of deficiency payments in the near term. Many other producers, faced with defaults to their lenders and an inability to pay their debts as they came due, were forced to seek protection under the United States Bankruptcy Code.

Once in bankruptcy, several producers have elected, as part of their restructuring strategy, to "reject" the most onerous of their Wellhead Contracts. Midstream Companies, faced with the prospect of material unrecouped capital investments and the loss of significant hydrocarbon throughput on their systems, have, in most cases, contested the right of the producer/debtor to reject its Wellhead Contracts. In this regard, the central argument posited by the Midstream Companies is that their Wellhead Contracts may not be rejected because the contracts contain express covenants – usually, the Acreage Commitment – that run with the land and are, therefore, property interests that cannot be terminated by the producer's bankruptcy.

Thus, one of the most hotly debated issues in current oil and gas and bankruptcy circles is the nature and character of the humble covenant running with land. In this paper, we will (a) discuss the general law of real covenants and equitable servitudes in Texas, (b) review the recent treatment of that subject in different bankruptcy contexts

by the United States court of Appeals for the Fifth Circuit and the United States Bankruptcy Court for the Southern District of New York, (c) analyze what those decisions got right and what they got wrong, (d) attempt to extrapolate these decisions to predict certain bankruptcy-related outcomes, and (e) finally, suggest contract drafting approaches that may benefit Midstream Companies in the future.

II. REAL COVENANTS – EXISTING LAW

A. Servitudes – Generally.

As a general matter, English and American real property law have long recognized the concept of the servitude. The term "servitude" is defined in the Restatement (Third) of Property as "a right or an obligation that runs with land or an interest in land."[3] A right – called a "benefit" – or an obligation – called a "burden" – is said to "run with the land" when the benefit or the burden of the covenant passes automatically to the subsequent owners of the land or interest in land to which the benefit or burden applies.[4] For purposes of this discussion, the land or interest in land either benefited or burdened by the servitude will be referred to as the "burdened land".

Among the most common types of servitudes recognized in the common law are the easement, the real covenant, and the equitable servitude.[5] Recognizing the limitations of this paper and acknowledging that its audience is likely already to have in-depth familiarity with the easement, we will focus our discussion on real covenants and equitable servitudes.

B. Real Covenants.

1. Historical Background. A "covenant" is an agreement or promise of two or more persons "that something is done, or will be done, or will not be done."[6] If the covenant obligates a person to maintain the status quo or perform some act in the future, the covenant is said to be affirmative; if the covenant prohibits a person from performing an act, it is said to be negative.[7] If the parties do not intend the benefits or burdens – of the covenant to bind, or devolve to, their remote successors in interest in the burdened land, the covenant will be treated as a "personal" covenant.[8]

If, on the other hand, the parties intended either the benefit or the burden of the covenant to devolve to their remote successors in interest in the burdened land, the English courts, by the late 1500's, began to recognize the covenant, if it met certain other requirements, as being a "real covenant" that binds remote successors in interest and, therefore, "runs with the land."[9] The famous English decision, *Spencer's Case*,[10] established as the early tests for a

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[3] RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES §1.1 (2000) (hereinafter, "RESTATEMENT (THIRD)").

[4] *Id.* at §1.1, Comment b.

[5] *See* Thomas, *How Far Does the Covenant Run? Covenants that Run With the Land in Oil and Gas Transactions*, 53 ROCKY MT. MIN. L. INST. §19.02[1], [2] (2007) (hereinafter, "Thomas").

[6] A.R. POWELL, POWELL ON REAL PROPERTY §60.02 [2] (2015) (hereinafter, "POWELL").

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] 5 Co. 16a. 77 Eng. Rep. 72 (Q.B. 1583). In this case, the plaintiffs leased a house and lands to Spencer for a term of 21 years, in consideration for Spencer's covenant, for himself and his successors, that a brick wall would be built on the land. The wall was never built, and the plaintiffs brought an action of covenant against Spencer's successor. The court

real covenant the requirements that (i) the covenant may not merely be collateral to the land, but must "touch and concern the thing demised"; (ii) the covenant must relate to something in existence, or "in esse", or alternatively, must expressly bind the assigns of the parties; and (iii) the covenanting parties must also have a common interest in the burdened land, a concept referred to as "privity of estate."[11]

The evolution of real covenants in the United States is a long, complex, and ultimately muddy story that varies from state to state, and a complete discussion of this story is beyond the scope of this paper.[12] Against this historical background, however, it is appropriate to consider the tests for a real covenant under Texas law.

2. "CRWTL Test" in Texas. An attempt to identify the proper tests for identifying a covenant running with the land under Texas law (the "CRWTL Test") quickly shows the difficulty in finding a consistent thread in this area of the law. For example, in *Panhandle & S.F. Ry. Co. v. Wiggins*,[13] the Amarillo Court of Civil Appeals described a real covenant as "one having for its object something annexed to, inherent in, or connected with, land or real property – one which relates to, touches or concerns the land granted or demised and the occupation or enjoyment thereof."[14] A covenant runs with the land, the court stated, "when a liability to perform duties or the right receive advantages thereof passes to a vender or other assignee" of the burdened land.[15] The court also stated that, in order for a covenant to run with the land, there must be privity of estate between the covenanting parties, and the covenant "must be contained in a grant of the land or of some interest or estate therein and, where the assigns of the grantee are not specified, it must be a thing in esse."[16]

The notion of a CRWTL Test emphasizing the concepts of "touching and concerning the land" and privity of estate was endorsed by the Texas Supreme Court in its 1982 decision, *Westland Oil Development Corporation v. Gulf Oil Corporation*.[17]

In *Westland*, the supreme court held that an area of mutual interest created in favor of the plaintiff in an assignment of an oil and gas farmout agreement from Mobil constituted a covenant running with the land that was binding on the parties to a subsequent farmout agreement from Mobil covering the same land based on the fact that the assignment creating the area of mutual interest was referred to in a joint operating agreement to which the second farmout agreement was expressly made subject. In so holding, the court, paraphrasing but not citing *Wiggins*, stated:

> In order for a covenant to run with the land there must be privity of estate between the

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denied recovery, concluding that since the brick wall as not "in esse", and the transfer document to the defendant did not purport to bind "assigns", the covenant to build the wall did not run with the land. *See* POWELL, *supra* note 6, at §60.01 [3].

11 *See* POWELL, *supra* note 6, at §60.01 [3].

12 *See generally* RESTATEMENT (THIRD), *supra* note 3, at §§1.1 – 1.4; POWELL, *supra* note 6, at §60.01; Thomas, *supra* note 5, at §§19.02, 19.03; Williams, *Restrictions on the Use of Land; Covenants Running with the Land at Law*, 27 TEXAS L. REV. 419 (1949) (hereinafter, "Williams").

13 161 S.W.2d 501 (Tex. Civ. App. – Amarillo 1942, *writ ref'd w.o.m.*).

14 *Id.* at 504.

15 *Id.*

16 *Id.* at 505.

17 637 S.W.2d 903 (Tex. 1982).

> parties to the agreement. This means there must be mutual or successive relationship to the same rights of property.[18]

The court also discussed at length its analysis of why the plaintiff's area of mutual interest touched and concerned the farmout acreage.[19] We will discuss that analysis in more depth in Section II.B.2.c.i of this paper.[20]

Although Westland continues regularly to be cited for its description of the privity of estate test,[21] the most frequently cited description of the CRWTL Test over the last thirty years is found in *Inwood North Homeowners' Association, Inc. v. Harris*,[22] a suit between a homeowners' association and homeowners in the affected subdivision who were delinquent in the payment of their neighborhood assessments. The declaration of covenants and restrictions for the subdivision was recorded in the applicable real property records, identified certain covenants and restrictions intended to be binding on homeowners in the subdivision, and provided that such covenants and restrictions would run with the land and be binding on all persons acquiring rights to any property in the subdivision.[23] In holding that the covenants regarding payment of neighborhood assessments were enforceable as covenants running with the land, the Texas Supreme Court stated.

> In Texas, a covenant runs with the land when it touches and concerns the land; relates to a thing in existence or specifically binds the parties and their assigns; is intended by the original parties to run with the land; and when the successor to the burden has notice.[24]

This statement of the CRWTL Test has been cited as controlling in numerous appellate decisions by the Texas courts[25] and by federal courts[26] applying Texas law since the *Inwood North* case was decided.

Interestingly, the four-pronged CRWTL Test announced in *Inwood North* made no mention of the requirement of privity of estate between the covenanting

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[18] *Id.* at 910-911.

[19] *Id.* at 911.

[20] *See* notes 64 through 72 and accompanying text, *infra*.

[21] *E.g.*, *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. – Tyler 2013, *no pet.*); *Lyle v. Jane Guinn Revocable Trust*, 365 S.W.3d 341, 353 (Tex. App. – Houston [1st Dist.] 2010, *no pet.*); *Wayne Harwell Props. v. Pan Am. Logistics Ctr., Inc.*, 945 S.W.2d 216, 218 (Tex. App. – San Antonio 1997, *writ denied*).

[22] 736 S.W.2d 632 (Tex. 1987).

[23] *Id.* at 633.

[24] *Id.* at 635. The Texas Supreme Court cited *Westland* and Professor Williams' Texas Law Review article as authority for this proposition. *See* Williams, *supra* note 12, at 423. Interestingly, the four-pronged test established in *Inwood North* does not, in fact, appear in the *Westland* opinion.

[25] *E.g.*, *Montfort v. Trek Res., Inc.*, 198 S.W.3d 344, 355 (Tex. App. – Eastland 2006, *no pet.*); *TX Far West, Ltd. v. Texas Investments Management, Inc.*, 127 S.W.3d 295, 302 (Tex. App. – Austin 2004, *no pet.*); *Rolling Lands Investments, L.C. v. Northwest Airport Management, L.P.*, 111 S.W.3d 187 (Tex. App. – Texarkana 2003, *pet. denied*); *718 Associates, Ltd. v. Sunwest N.O.P., Inc.*, 1 S.W.3d 355, 364 (Waco 1999, *pet. denied*); *Musgrave v. Brookhaven Lake Prop. Owners Ass'n*, 990 S.W.2d 386, 396 (Tex. App. – Texarkana 1999, *pet. denied*)); *Wayne Harwell Props. v. Pan Am. Logistics Ctr, Inc.*, 945 S.W.2d 216, 218 (Tex. App. – San Antonio 1997, *writ denied*).

[26] *E.g. Newco Energy v. Energytec, Inc. (In the Matter of Energytec, Inc.*), 739 F.3d 215, 221 (5th Cir. 2013); *Refinery Holding Co., LP v. TRMI Holdings, Inc.* (In the Matter of El Paso Refinery, LP), 302 F.3d 343, 355 (5th Cir. 2002).

parties, although the supreme court noted that *Westland's* requirement of privity of estate was, in fact, satisfied since the persons seeking to enforce the subdivision covenants and restrictions at issue all were successors in interest to the original property owners in the subdivision.[27]

Since *Inwood North* was decided, the majority of the Texas decisions addressing real covenant issues that we have identified in our research cite the four-pronged CRWTL Test of *Inwood North* as the controlling test for determining whether a covenant running with the land exists, without reference to the privity of estate requirement.[28] As will be discussed in Section II.B.2.b. of this paper, the privity of estate requirement has received heavy criticism from some commentators and courts in recent years.[29] No Texas case has ever expressly disapproved the privity of estate requirement, however, and for the reasons discussed in Section II.B.2.b. below, we believe that the best view of the current Texas authority is that the CRWTL Test is five-pronged, based on showings that:

- the covenant in question touches and concerns the land;
- the covenant relates to something in existence or is expressly made binding on the parties and their assigns;
- the covenant was intended by the covenanting parties to run with the land;
- successors to the burden of the covenant have notice of its existence; and
- there was privity of estate between the original covenanting parties with respect to the burdened land.

Please note that we have not included in this description of the CRWTL Test the requirement from *Wiggins* that the covenant must be "contained in a grant of land or of some interest or estate therein."[30] No Texas court has expressly rejected such requirement; indeed, a handful of subsequent decisions have carried it forward.[31] Based on our research, however, the vast majority of the real covenant decisions since *Westland* and *Inwood North* do not require a real covenant to be created in a conveyance or otherwise in conjunction with a "grant of land." As a result, we have treated the "grant of land" requirement as

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[27] 736 S.W.2d at 635.

[28] *E.g.*, *Refinery Holding Co., LP v. TRMI Holdings, Inc. (In the Matter of El Paso Refinery, LP)*, 302 F.3d 345, 355 (5th Cir. 2002); *Montfort v. Trek Res., Inc.*, 198 S.W.3d 344, 355 (Tex. App. – Eastland 2006, *no pet.*); *Wimberly v. Lone Star Gas Co.*, 818 S.W.2d 868, 871 (Tex. App. – Fort Worth 1991, *writ denied*); *TX Far West, Ltd. v. Texas Investments Management, Inc.*, 127 S.W.3d 295, 302 (Tex. App. – Austin 2004, *no pet.*); *Musgrave v. Brookhaven Lake Prop. Owners Ass'n*, 990 S.W.2d 386, 396 (Tex. App. – Texarkana 1999, *pet. denied*); *718 Associates, Ltd. v. Sunwest N.O.P., Inc.*, 1 S.W.3d 355, 364 (Tex. App. – Waco 1999, *pet. denied*); *Fallis v. River Mt. Ranch Prop. Owners Ass'n*, No. 04-09-00256-CV, 2010 WL 2679997, at 11-12 (Tex. App. – San Antonio 2010, *no pet.*); *Supkis v. Madison Place Homeowners' Ass'n*, No. 01-07-00573-CV, 2008 WL 2465788 (Tex. App. – Houston [1st Dist.] 2008, *pet. denied*).

[29] *See* notes 54 through 63 and accompanying text, *infra*.

[30] *Panhandle & S.F. Ry. Co. v. Wiggins*, 161 S.W.2d 501, 505 (Tex. Civ. App. – Amarillo 1942, *writ ref'd w.o.m.*).

[31] *E.g.*, *Mobil Oil Corp. v. Brennan*, 385 F.2d 951, 953 (5th Cir. 1967); *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. – Tyler 2013, *no pet.*); *Lyle v. Jane Guinn Revocable Trust*, 365 S.W.3d 341, 353 (Tex. App. – Houston [1st Dist.] 2010, *no pet.*); *Wayne v. Harwell Props. v. Pan Am Logistics Ctr, Inc.*, 945 S.W.2d 216, 218 (Tex. App. – San Antonio 1997, *writ denied).*

not representing the majority position of the Texas courts.

Experienced contract draftspersons are able to address fairly easily the requirements that a purported real covenant bind the parties and their assigns and that the parties express their interest that a covenant run with the land. The requirement that successors in interest to the covenanting parties must have notice of the covenant can be satisfied, in the context of a Wellhead Contract, by placing of record a memorandum of the Wellhead Contract that describes the dedicated oil and gas leases and lands and sets forth, or at least makes reference to, the Acreage Commitment or other covenant that the parties intend to run with the land. The more difficult conceptual issues relate to determining whether the covenant touches and concerns the burdened land and whether privity of estate exists. We now turn attention to those issues.

a. "Touch and Concern" Requirement. As discussed above in Section II.A.1 of this paper, *Spencer's Case*[32] is the source of the critically important "touch and concern" element of the CRWTL Test. As one distinguished commentator has written, "It has been impossible to state any absolute tests to determine what covenants touch and concern land and what do not. The question is one for the court to determine in the exercise of its best judgment upon the facts of each case."[33]

For example, in *Panhandle & S.F. Ry. Co. v. Wiggins*,[34] the Amarillo Court of Civil Appeals described a real covenant as "one having for its object something annexed to, inherent in, or connected with land or real property – one which relates to, touches or concerns the land granted or demised and the occupation or enjoyment thereof."[35]

In *Blasser v. Cass*,[36] the Texas Supreme Court held that covenants to pay incremental broker commissions upon the renewal of certain real estate leases were personal covenants and not covenants running with the land. In so holding, the court, citing the first Restatement of the Law of Property, articulated a test grounded in a policy favoring the ready sale or lease of property and against permitting personal covenants to "hamper and impede real estate transactions." According to the court:

> The successor in title to land respecting the use of which the owner has made a promise can be bound as promisors only if (a) the performance of the promise will benefit the promisee or other beneficiary of the promise in the physical use or enjoyment of the land possessed by him, or (b) the consummation of the transaction of which the promise is part will operate to benefit and is for the benefit of the promisor in the physical use or enjoyment of land possessed by him, and the burden on the land of the promisor bears a reasonable relation to the benefit received by the person benefited.[37]

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32 5 Co. 16a, 77 Eng. Rep. 72 (Q.B. 1583).

33 Williams, *supra* note 12, at 429, quoting Clark, *Real Covenants and Other Interests Which Run With Land* 96 (2d ed. 1947) (hereinafter, "Clark").

34 161 S.W.2d 501 (Tex. Civ. App. – Amarillo 1942, *writ ref'd n.r.e.*).

35 *Id.* at 504.

36 158 Tex. 560, 314 S.W.2d 807, 809 (1958).

37 314 S.W.2d at 809.

Somewhat later, in *Prochemco, Inc. v. Clajon Gas Co.,*[38] the El Paso Court of Civil Appeals, in determining whether a contract under which the owner of a ranch purchased from a gas pipeline all of the gas required by the ranch owner to power the lifting of water from the burdened land for irrigation purposes constituted a covenant running with the land binding on the ranch owner's successors, articulated a different test:

> The chief consideration in deciding whether a covenant runs with the land is whether it is so related to the land as to enhance its value and confer a benefit on it ...[39]

Over time, however, the "touch and concern" test articulated in a venerable real property treatise and adopted by the Texas Supreme Court in *Westland* appears to have received the most acceptance by courts and commentators:

> One of the two often cited statements of the requirement is that a covenant will run "if it affected the nature, quality or value of the thing demised, independently of collateral circumstances, or it affected the mode of enjoying it" …. It has also been said,
>
> "If the promisor's legal relations in respect to the land in question are lessened – his legal interest as owner rendered less valuable by the promise – the burden of the covenant touches or concerns that land; if the promisee's legal relations in respect to that land are increased – his legal interest as owner rendered more value [*sic*] by the promise – the benefit of the covenant touches or concerns the land."[40]

There is a line of older Texas cases holding that, for a covenant to "touch and concern" land, it must confer a benefit to the burdened land.[41] More recent cases, however, have dispensed with the benefit requirement and have enforced covenants that only establish a burden or obligation on the burdened land.[42] As stated by the Fifth Circuit, "Although the case law is somewhat unclear, it is at least arguable that the benefit requirement has been abandoned by the Texas courts.[43]

b. Privity of Estate. As stated by the Texas Supreme Court in *Westland*, for a

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[38] 555 S.W.2d 189 (Tex. Civ. App. – El Paso 1977, *writ ref'd n.r.e.*).

[39] *Id*. at 191. *Accord*, *Homsey v. University Gardens Racquet Club*, 730 S.W.2d 763, 764 (Tex. App. – El Paso 1987, *writ ref'd n.r.e.*).

[40] *Westland Oil Dev. Corp. v. Gulf Oil Corp*., 637 S.W.2d 903, 911 (Tex. 1982), *citing* Bigelow, *The Content of Covenants in Leases*, 12 MICH. L. REV. 639 (1914) (hereinafter, "Bigelow"), and Williams, *supra* note 12, at 429. *See* also POWELL, *supra* note 6, §60.04[3][a].

[41] *E.g., Davis v. Skipper*, 125 Tex. 364, 83 S.W.2d 318, 321-22 (Tex. Comm'n App. 1935) ("In the absence of proof that a restriction was imposed for the benefit of other land, it is construed as a personal covenant merely with the grantor."); *McCart v. Cain*, 416 S.W.2d 463, 465 (Tex. Civ. App. – Fort Worth 1967, *writ ref'd n.r.e.*).

[42] *E.g., Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982) (covenant touches and concerns land because it burdens the promisor's estate and renders it less valuable); *Wimberley v. Lone Star Gas Co.*, 818 S.W.2d 868, 871 (Tex. App. – Fort Worth 1991, *writ denied*) (covenant need not confer a benefit in order to run with the land; it need only touch upon the land).

[43] *Refinery Holding Co., LP v. TRMI Holdings, Inc. (In the Matter of El Paso Refinery, LP)*, 302 F.3d 343, 356 (5th Cir. 2002).

covenant to run with the land, there must be "privity of estate between the parties to the agreement" – that is, "a mutual or successive relationship to the same rights of property."[44] Under Texas law, this requirement may be satisfied by either simultaneous or successive interests in the same land.[45] Privity of estate must exist between the covenanting parties at the time when the covenant is made.[46]

That is essentially all the Texas cases tell us about the privity of estate requirement. What, then, is a "mutual or successive" relationship in the same property for purposes of this analysis? The concept of a mutual relationship between the covenanting parties at the time when the covenant is made appears to contemplate what is generally referred to as "horizontal" privity of estate. The term "horizontal" derives from the teacher's illustration on a blackboard of the covenanting parties standing side-by-side or adjacent to one another when the covenant is made. The notion underlying the horizontal privity requirement is that, for a real covenant to be created, there must be some additional transactional element to the relationship between the covenanting parties, rather than merely two persons seeking to make a contract.[47]

Under the English common law, this "additional transactional element" could only be satisfied if there was a relationship of "tenure", or landlord and tenant, between the covenanting parties.[48] In the United States, the version of horizontal privity adopted in Massachusetts required that the covenanting parties must be left with continuing interests in the burdened land, such as that of landlord and tenant or the dominant and servient owners of land burdened by an easement.[49] Because of the restrictive nature of the so-called "Massachusetts rule," most American jurisdictions that have adopted the requirement of horizontal privity require there to be a real property transaction of some kind – whether a landlord-tenant arrangement, or the conveyance of an estate in land, or the grant of an easement, or the existence of a co-tenancy relationship – between the parties.[50]

The concept of a "successive" relationship between the covenanting parties appears to refer to "vertical" privity of estate – that is, the relationships (i) between the person making the promise and his successors in interest and (ii) between the person to whom the promise is made and her successors in interest.[51] Vertical privity becomes relevant when the successor in interest to the party to whom the promise is made seeks to enforce the covenant against the original party who made the promise or his or her successors in interest. In some

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[44] 637 S.W.2d at 910-911. The identical formulation of this rule appeared in *Panhandle & S.F. Ry. v. Wiggins*, 161 S.W.2d 501, 505 (Tex. Civ. App. – Amarillo 1942, *writ ref'd w.o.m.*).

[45] *Wayne Harwell Prop. v. Pan Am. Logistics Ctr, Inc.*, 945 S.W.2d 216, 218 (Tex. App. – San Antonio 1997, *writ denied*). *See* Williams, *supra* note 12, at 446.

[46] *Wayne Harwell Prop. v. Pan Am. Logistics Ctr, Inc.*, 945 S.W.2d 216, 218 (Tex. App. – San Antonio 1997, *writ denied*); *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. – Tyler, *no pet.).*

[47] *See* Thomas, *supra* note 5, § 19.04 [5][b][i] at 19-17.

[48] *See id.*, § 19.03 at 19-7, 19-8; Williams, *supra* note 12, at 440-441.

[49] *See* Williams, *supra* note 12, at 441; Thomas, *supra* note 5, § 19.04 [5][b][ii] at 19-18; RESTATEMENT (THIRD), *supra* note 12, § 2.4, Comment a at 96.

[50] *See id.*

[51] *See* Thomas, *supra* note 5, § 19.04 [5][b][ii] at 19-18.

jurisdictions, a higher standard of vertical privity – usually that the successor in interest to the promisor must have succeeded to the same estate in land as owned by the original promisor – is required if the promisee seeks to enforce the covenant.[52] That does not appear to be the case in Texas. As stated by Professor Williams, "The Texas cases do not indicate that there is any difference in the nature of the privity required for the running of the burden than is required for the running of the benefit thereof.[53]

In particular, the RESTATEMENT (THIRD) is extremely critical of the horizontal privity requirement:

> In American law, the horizontal-privity requirement serves no function beyond insuring that most covenants intended to run with the land will be created in conveyances. Formal creation of covenants is desirable because it tends to assure that they will be recorded. However, the horizontal-privity requirement is no longer needed for this purpose. In modern law, the Statute of Frauds and the recording acts perform that function.[54]

Based on the foregoing analysis, the RESTATEMENT (THIRD) no longer requires a showing of horizontal privity in order to create a real covenant or other servitude obligation.[55]

That position does not appear to have been adopted in Texas, however. As discussed in Section II.B.2 of this paper,[56] the Texas Supreme Court in *Inwood North*[57] did not expressly disapprove or overrule prior Texas decisions that required a showing of horizontal privity of estate at the time when the contract was made in order to create a covenant running with the land. Although the court did not include horizontal privity in its four-pronged CRWTL Test, the court noted that privity of estate was, in fact present, on the facts of the case.[58] As will be discussed in Section III.A of this paper,[59] the United States Court of Appeals for the Fifth Circuit, in *Energytec*, adopted the criticism of the horizontal privity requirement by the RESTATEMENT (THIRD), although the court also made a finding regarding the presence of horizontal privity as part of its holding.[60]

No other Texas case (or case applying Texas law) has ever expressly disapproved or overruled the horizontal privity of estate requirement, and there have been several cases since *Inwood North*, in addition to *Energytec*, that either cite *Inwood North's* four-pronged CRWTL Test and the privity

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[52] *See id*.; Williams, *supra* note 12, at 443.

[53] *See* Williams, *supra* note 12, at 446. *Accord*, Aigler, *The Running with the Land of Agreements to Pay for a Portion of the Cost of Party-Walls*, 10 MICH. L. REV. 187, 191 (1912) ("There seems no good reason why the same sort of privity that carries a benefit should not be sufficient to allow a burden to run in the case of fee estates.").

[54] RESTATEMENT (THIRD), *supra* note 12, § 2.4, Comment b at 97.

[55] *Id*.

[56] *See* notes 27 and 28 and accompanying text, *supra*.

[57] *Inwood North Homeowners' Ass'n v. Harris*, 736 S.W.2d 632 (Tex. 1987).

[58] *Id.* at 635.

[59] *See* notes 130 through 134 and accompanying text, *infra.*

[60] *Newco Energy v. Energytec, Inc.* (*In the Matter of Energytec, Inc.*), 739 F.3d 215, 222-223 (5th Cir. 2013).

of estate requirement from *Westland*[61] or that, based primarily on *Wiggins*, focus on privity of estate as the critical element in determining the existence of a real covenant.[62] For these reasons, as stated above in Section II.B.2 hereof,[63] we think that the best view of current Texas law is that the privity of estate requirement remains a part of the real covenant analysis.

c. Examples. Having completed our discussion of the basic principles applicable to the creation of a covenant running with the land, it is appropriate to consider the fact patterns in several cases to sue how these principles are applied. In this regard, we will avoid the numerous cases dealing with affirmative and negative or restrictive covenants in a real estate context and focus on oil and gas related cases.

i. Farmout Agreement and Area of Mutual Interest. In *Westland*,[64] Westland entered into a drill-to-earn farmout agreement with Mobil, covering Sections 23 and 24, Block 49, and Section 19, Block 48 (the "Mobil-Westland Farmout"). Subsequently, Westland and C&K entered into a letter agreement (the "Westland-C&K Agreement") under which C&K (i) assumed Westland's obligations under the Mobil-Westland Farmout, (ii) paid Westland $50,000 in cash, and (iii) agreed to assign to Westland a $^{1}/_{16}$ overriding royalty interest in any acreage earned under the Mobil-Westland Farmout, $^{1}/_{32}$ of the working interest received from Mobil thereunder, and a production payment. The Westland-C&K Agreement also created an area of mutual interest ("AMI") in which Westland and C&K were entitled to share in future leases within the AMI.[65]

C&K obtained additional participants for the initial well under the Mobil-Westland Farmout. The well was drilled, and Mobil delivered assignments to C&K and its participants (including Westland). The assignments were expressly made subject to a 1968 joint operating agreement among Mobil, C&K, and the other participants (the "1968 Operating Agreement"), which, in turn, was expressly made subject to the Mobil-Westland Farmout and the Westland-C&K Agreement (which contained the AMI provision).[66]

Several years later, Mobil entered into a second, drill-to-earn farmout agreement with Hanson (the "Mobil-Hanson Farmout"), covering a number of sections, including those covered by the Mobil-Westland Farmout. The Mobil-Hanson Farmout was expressly made subject to the 1968 Operating Agreement. Hanson also obtained farmouts from C&K and its participants (the "C&K–Hanson Farmouts") covering the same sections as the Mobil-Westland Farmout, which farmouts were expressly made subject to the Mobil-

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[61] *E.g.*, *Rolling Lands Investments, L.C. v. Northwest Airport Management, L.P.*, 111 S.W.3d 187, 200 (Tex. App. – Texarkana 2003, *pet. denied*); *Wayne Harwell Prop. v. Pan Am. Logistics Ctr, Inc.*, 945 S.W.2d 216, 218 (Tex. App. – San Antonio 1997, *writ denied*); *MPH Prod. Co. v. Smith*, Cause No. 06-11-00085-CV, 2012 WL 1813467 (Tex. App. – Texarkana 2012, *no pet.*); *First Permian, L.L.C. v. Graham*, 212 S.W.3d 368, 370-371 (Tex. App. – Amarillo 2006, *pet. denied*)..

[62] *Wasson Interests, Ltd. v. Adams*, 405 S.W.3d 971, 973 (Tex. App. – Tyler 2013, *no pet.*); *Lyle v. Jane Guinn Revocable Trust*, 365 S.W.3d 341, 353 (Tex. App. – Houston [1st Dist.] 2010, *no pet.*); *Tarrant Appraisal Dist. v. Colonial Country Club*, 767 S.W.2d 230, 235 (Tex. App. – Fort Worth 1989, *writ denied*).

[63] *See* text following note 29, *supra*.

[64] *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982).

[65] *Id*. at 905-906.

[66] *Id*.

Westland Farmout and the Westland-C&K Agreement. Hanson ultimately assigned all of its rights under the Mobil-Hanson Farmout and the C&K-Hanson Farmouts to Gulf and Superior. Subsequently, Westland sought to enforce its AMI rights against Gulf and Superior with respect to the acreage earned by Gulf and Superior under the Mobil-Hanson Farmout and the C&K-Hanson Farmout.[67]

The Texas Supreme Court held in favor of Westland, concluding that its AMI rights under the C&K-Westland Agreement were covenants running with the land that were enforceable against Gulf and Superior with respect to the lands covered by the Mobil-Westland Farmout.[68] In so holding, the court concluded that the promise by C&K embodied in the AMI provision to convey to Westland subsequently acquired interests in the affected lands "clearly affected the nature and value of the estate conveyed to C&K" and "could be considered to have rendered [the promisor's estate] less valuable."[69] As such, the court concluded that the AMI provision touched and concerned the land burdened by the AMI.[70]

With respect to the issue of privity of estate, the court stated simply that, "Privity of estate exists in this case by virtue of the assignment of [the burdened lands] to Gulf and Superior."[71] The privity of estate the court was referring to is the vertical privity of estate that existed between Westland, the promisee under the AMI provision and the owner of overriding royalty interests and working interests in the burdened land, and Gulf and Superior, as the assignees of C&K, the original promisor under the AMI provision. Gulf and Superior obtained notice of Westland's rights under the AMI provision by references to the C&K-Westland Agreement contained in the C&K-Hanson Farmouts and the 1968 Operating Agreement.[72]

ii. Preferential Right to Purchase. In *First Permian, L.L.C. v. Graham*,[73] the Grahams, in 1963, conveyed oil and gas leases located in Cochran County to Pan American, reserving to the assignors a production payment and a preferential right to match any bona fide offer to purchase the leases received from Pan American. The production payment paid out in 1975. Title to the leases ultimately passed to First Permian through multiple assignments, prior to each of which the Graham family was given the right to exercise their preferential right. In connection with a bid from Energen to purchase the leases, however, First Permian, based on advice of counsel, determined that the Grahams' preferential right had expired upon the discharge in full of the production payment. The Grahams filed suit alleging breach of their preferential right in connection with the Energen sale.[74]

The Amarillo Court of Appeals concluded that although the preferential purchase right is clearly a covenant running with the land,[75] it terminated when the Grahams no longer owned an interest in the

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67 *Id.* at 907.

68 *Id.* at 911.

69 *Id*.

70 *Id*.

71 *Id*.

72 *Id.* at 908.

73 212 S.W.3d 368 (Tex. App. – Amarillo 2006, *pet. denied*).

74 *Id.* at 369-370.

75 *Id.* at 370-31. *See Sanchez v. Dickinson*, 551 S.W.2d 481, 485 (Tex. Civ. App. – San Antonio 1977, *no writ*); *Stone v. Tigner*, 165 S.W.2d 124, 127 (Tex. Civ. App. – Galveston 1942, *writ ref'd*).

burdened oil and gas leases.[76] The court stated that, under Texas law, a real covenant endures only so long as the interest in the land to which it is appended,[77] and that only the owner of an interest in the land intended to be benefitted by a real covenant is entitled to enforce the covenant.[78] The only interest in the burdened leases retained by the Grahams when they conveyed the leases to Pan American was the production payment. When the production payment was discharged, the Grahams no longer had an interest in the burdened land that supported the preferential right as a real covenant.[79]

iii. Gas Supply in Support of Agricultural Activities. In *Prochemco, Inc. v. Clajon Gas Co.*,[80] a farm and ranch company, the wholly-owned subsidiary of Prochemco, entered into a gas sales contract with Clajon Gas as the pipeline/gas seller, under which the farm and ranch company agreed to purchase from Clajon all of the natural gas required "for utilization as the total power requirements (particularly, but without limitation, for the operation of internal combustion engines) necessary for the lifting of water for use in the irrigation of" certain lands in Pecos County.[81] The contract was for a term of five (5) years and provided that its terms were covenants running with the land. The contract also contained an option, exercisable solely to Prochemco to extend the term of the contract for an additional five years.[82]

Subsequently, the farm and ranch company sold all of the Pecos County land. Thereafter, Prochemco exercised its option to extend the term of the gas sales contract, but Clajon refused to honor the exercise because Prochemco no longer owned any interest in the Pecos County land.[83]

Concluding that the gas sale contract was "so related to the land as to enhance its value and confer a benefit on it,"[84] and citing cases from other jurisdictions in support of the proposition that contracts to furnish gas may run with the land, the El Paso Court of Civil Appeals held that the gas sale contract did, in fact, create a covenant running with the land that resulted in the passage to the purchaser of the Pecos County land of the right to purchase gas from Clajon under the terms of such contract.[85] The court rejected, however, Clajon's argument that the sale of the Pecos County land extinguished Prochemco's option to extend the contract, concluding that the option was a personal covenant properly exercised by Prochemco that was not tied to the ownership of the Pecos County land.[86]

For purposes of this paper, the most interesting aspect of this case is the court's finding that the gas sale contract was a covenant running with the land, even

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[76] 212 S.W.3d at 370-371.

[77] 212 S.W.3d at 372, *citing Talley v. Howsley*, 170 S.W.2d 240, 243 (Tex. Civ. App. – Eastland 1943), *aff'd*, 142 Tex. 81, 176 S.W.2d 158 (1943).

[78] 212 S.W.3d at 372, citing *Davis v. Skipper*, 125 Tex. 364, 83 S.W.2d 318, 321 (1935).

[79] 212 S.W.3d at 373. In so holding, the court distinguished *McMillan v. Dooley*, 144 S.W.3d 159 (Tex. App. – Eastland 2004, *pet denied*), on its facts, concluding that the preferential purchase right in that case was intended to be enforced as a personal covenant.

[80] 555 S.W.2d 189 (Tex. Civ. App. – El Paso 1977, *writ ref'd n.r.e*).

[81] *Id.* at 190.

[82] *Id.*

[83] *Id.*

[84] *Id.* at 191.

[85] *Id.*

[86] *Id.* at 192.

though there existed no privity of estate between Clajon and the owner of the Pecos County land.

iv. Casinghead Gas Contract. In *American Refining Co. v. Tidal Western Oil Corporation*,[87] IXL, the operator of oil and gas leases owned by IXL and Williamson, entered into a casinghead gas sale contract with Snedden, as gas purchaser. Subsequently, the oil and gas leases were assigned, first, to Breman and then to American Refining, and Snedden assigned the casinghead gas sale contract to Tidal Western.[88]

Under the cashinghead gas sale contract, the seller agreed to sell and deliver to the gas buyer "all of the casinghead gas … which may be produced from oil wells now or hereafter to be located or drilled" on the described lands – an early form of Acreage Commitment.[89] The casinghead gas sale contract also provided that it was binding on the successors and assigns of the parties and constituted a covenant running with the land burdening the oil and gas leases of IXL and Williamson. In addition, Tidal Western entered into division orders with Breman that were expressly made subject to the casinghead gas sale contract.[90]

After acquiring the IXL-Williamson oil and gas leases from Breman, however, American Refining disconnected Tidal Western's pipeline from its wells and began to receive the casinghead gas through its own lines and gasoline manufacturing plants, asserting that it had not assumed or taken subject to the casinghead gas sale contract and that the casinghead gas sale contract was not a covenant running with the land.[91]

In a somewhat rambling and occasionally imprecise opinion, the Amarillo Court of Civil Appeals rejected American Refining's argument and held that the casinghead gas sale contract constituted a covenant running with the land with respect to the IXL-Williamson oil and gas leases that was enforceable against American Refining.[92] Focusing great attention on then-recent Texas Supreme Court decisions characterizing the fee mineral and oil and gas leasehold estates as interests in real property, the court stated:

> … the covenants contained in the [contract] are real rather than personal covenants, because at the time the contract was made it had for its object gas which was then inherent in and a part of the land itself. Moreover, both the grantor and the grantee, in virtue of the contract, obtained certain advantages and incurred certain liabilities which bound their assigns … and the value of the lease to both was greatly enhanced thereby … [A] fair construction of the contract shows that they referred to and that the parties were dealing with gas in place.[93]

As was the case in *Petrochemco*, the court ignored the absence of privity of estate between the lease owners, as gas sellers, and

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87 264 S.W. 335 (Tex. Civ. App. – Amarillo 1924, *writ ref'd*).

88 *Id.* at 335.

89 *Id.* at 336.

90 *Id.* at 337.

91 *Id.*

92 *Id.* at 338.

93 *Id.* at 338-339.

the gas purchaser.[94] Although the opinion is far from perfect,[95] *American Trading* is an important case from the perspective of a Midstream Company seeking to characterize its Wellhead Contract as a covenant running with the land.[96]

C. Equitable Servitudes.

The concept of "the equitable servitude" developed in the English courts of equity in the early 19th century in response to decisions in the courts of law that narrowed the enforceability of real covenants.[97] An "equitable servitude" is a promise relating to the use of land that cannot be enforced against the remote successors in interest of the burdened land as a real covenant because of the failure of the promise to meet one or more of the tests of a real covenant. The traditional English model of an equitable servitude did not require a showing of privity of estate, but required that (i) the original covenanting parties must intend the promise to run with the burdened land, (ii) the promise must touch and concern the burdened land, and (iii) the person against whom the promise is to be enforced must have actual or constructive notice of the promise.[98]

The RESTATEMENT (THIRD) has dropped the distinctions drawn in previous RESTATEMENTS OF PROPERTY between real covenants and equitable servitudes because continued use of such terms "perpetuates the idea that there is a difference between covenants at law and in equity, which at best tends to generate confusion, and at worst may lead lawyers and judges to focus on irrelevant questions or reach erroneous results."[99] As was the case with the concept of horizontal privity of estate, however, the Texas courts have not adopted the views of

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[94] The only reference in the court's opinion to the concept of privity of estate is found in a lengthy quote from *Spencer's Case*, in which the English court stated that if "the covenant is intended to be and is annexed to the estate, … the rights and liabilities of those who take the estate and possess the land during the term flow from a privity of estate and not from any assignment of right or contract." 264 S.W. at 340.

[95] Of particular concern is the court's characterization of produced oil and gas as realty. 264 S.W. at 340. This is certainly not the modern view in Texas. Section 2.107(1) of the Uniform Commercial Code draws a distinct line between oil and gas leases, deeds, and other conveyances of interests in minerals in place, on the one hand, and sales of the minerals by the producer after their production, on the other hand, providing, in pertinent part:

> A contract for the sale of minerals or the like (including oil and gas) ... is a contract for the sale of goods within this chapter if they are to be severed by the seller but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell.

TEX. BUS. & COM. CODE ANN. § 2.107(1) (2016). In reliance on the quoted language, Texas courts, as well as courts in other jurisdictions, have consistently held that contracts for the sale of oil, gas, and other mineral commodities are sales of goods governed by Article 2 of the UCC. *E.g., Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 577 (Tex. 1996) (Phillips, C.J., dissenting in part and concurring in part); *Keyes Helium Co. v. Regency Gas Services, LP*, 393 S.W.3d 858 (Tex. App. – Dallas 2012, *no pet.*); *Gasmark, Ltd. v. Kimbell Energy Corp.*, 868 S.W.2d 925, 928 (Tex. App. – Fort Worth 1994, *no writ*).

[96] Indeed, the bankruptcy court in the *Sabine* cases went to considerable, and strained, lengths to distinguish *American Trading* from the facts in controversy in those cases. *See* notes 169 through 170 and accompanying text, *infra*.

[97] *See* POWELL, *supra* note 6, §60.01[4], citing *Tulk v. Moxhay*, 2 Phillips 774, 41 Eng. Rep. 1143 (1848).

[98] *See* Thomas, *supra* note 5, §19.02[2] at 19-5, 19-6.

[99] RESTATEMENT (THIRD), *supra* note, 3 §1.4 and Comment a, at 28-30.

the RESTATEMENT (THIRD) on equitable servitudes, and the equitable servitude remains an inconsistently defined, but key, component of Texas real property law.[100]

In *Wayne Harwell Properties v. Pan American Logistics Center, Inc.*,[101] a case involving whether a party's right of first refusal to be general contractor on any improvements on the land and its right to receive a percentage of the "net cash flow" from the land were covenants running with the land, the San Antonio Court of Appeals stated that equitable covenants or servitudes

> … do not, strictly speaking run with the land, but are binding against subsequent purchasers who acquire the land with notice of the restriction. If no privity of estate existed between the original parties, it must be shown that the restriction is imposed for the benefit of adjacent land; absent this showing, the covenant will be construed as a personal covenant of the grantor.[102]

The court held that the covenants in controversy did not constitute either real covenants or equitable servitudes because the covenants did not touch and concern the land.[103]

A similar description of the equitable servitude concept is found in *Reagan National Advertising of Austin, Inc. v. Capital Outdoors, Inc.*,[104] a case concerning whether a billboard lease contract prohibited the lessor from executing a new billboard lease with a third person within five years after the lease's termination. In holding that the billboard lease did not constitute either real covenant or an equitable servitude, the Austin Court of Appeals stated:

> But a covenant that does not technically run with the land can still bind successors to the burdened land as an equitable servitude if: (1) the successor to the burdened land took its interest with notice of the restriction, (2) the covenant limits the use of the burdened land, and (3) the covenant benefits the land of the party seeking to enforce it.[105]

A generally consistent line of Texas cases regarding the characteristics of an equitable servitude was disrupted, however, by *Refinery Holding Co., L.P. v. TRMI Holdings, Inc. (In the Matter of El Paso Refinery, LP)*,[106] a case concerning, in part, whether a provision in a purchase and sale agreement governing the sale of a refinery purporting to bar the purchaser and its successors in interest from seeking contribution or indemnity from the seller for environmental cleanup costs was

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[100] Indeed, a significant line of Texas cases dealing with restrictive covenants in a real estate context deal with the establishment of equitable servitudes based on a general plan or common scheme of property development. *E.g.*, *Selected Lands Corp. v. Speich*, 702 S.W.2d 197, 198 (Tex. App. – Houston [1st Dist.] 1985, *no writ*); *Ramsey v. Lewis*, 874 S.W.2d 320, 324 (Tex. App. – El Paso 1994, *no writ)*; *Collum v. Neuhoff*, 507 S.W.2d 920, 922 (Tex. Civ. App. – Dallas 1974, *no writ)*.

[101] 945 S.W.2d 216 (Tex. App. – San Antonio 1997, *writ denied*).

[102] *Id.* at 218.

[103] *Id.* at 218-219.

[104] 96 S.W.3d 490 (Tex. App. – Austin 2002, *pet. granted, judgm't vacated w.r.m.*)

[105] *Id.* at 495.

[106] 302 F.2d 343 (5th Cir. 2002).

enforceable by the seller against a subsequent purchaser at a foreclosure sale. In concluding that the referenced contract provision did not touch and concern the land and, therefore, was not enforceable as either a real covenant or an equitable servitude, the United States Court of Appeals for the Fifth Circuit stated:

> An equitable servitude is enforceable when the contracting parties are in privity of estate at the time of the conveyance, and subsequent purchases of the land are with notice of the restriction. However, the restriction sought to be enforced must still concern the land or its use or enjoyment ….[107]

El Paso Refinery is the only equitable servitude case applying Texas law discovered in our research that requires a showing of privity of estate. Indeed, the notion seems completely at odds with the rationale underlying the development by English courts of equity of the concept of the equitable servitude in the first place.[108] In support of its holding, the Fifth Circuit cited *Tarrant Appraisal District v. Colonial Country Club*,[109] but, in fact, *Tarrant Appraisal District* does not address equitable servitudes. It holds only that, "In order to run with the land, a covenant must be made by parties in privity of estate at the time the conveyance is made."[110]

El Paso Refinery is clearly an "outlier" relative to other Texas cases dealing with equitable servitudes. Because it is a Fifth Circuit case decided in the context of an adversary proceeding in a bankruptcy, however, *El Paso Refinery* establishes unfortunate precedent for any party trying to establish the existence of an equitable servitude in a bankruptcy or other federal court proceeding.[111]

III. REAL COVENANTS IN BANKRUPTCY

A covenant running with the land is an interest in real property – not a freehold estate like the surface or mineral fee or the oil and gas leasehold estate, but a right or obligation that is primarily attached to the land, rather than being contractual in nature.[112] As such, a covenant running with the land should not constitute an executory contract under Section 365 of the Bankruptcy Code, nor should, in most cases, a debtor in bankruptcy be able to sell his property free and clear of such a covenant under Section 363 of the Bankruptcy Code.[113]

Thus, for example, in *In re Beeter*,[114] the United States Bankruptcy Court for the Western District of Texas held that an agreement relating to a condominium association "contained in the deed and

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[107] *Id.* at 358.

[108] *See* notes 97 through 98 and accompanying text, *supra*.

[109] 767 S.W.2d 230 (Tex. App. – Fort Worth 1989, *writ denied*).

[110] *Id.* at 235.

[111] *See* notes 194 through 195 and accompanying text, *infra*.

[112] *E.g., Gouveia v. Tazbir*, 37 F.3d 295, 299-300 (7th Cir. 1994); *City of Houston v. McCarthy*, 464 S.W.2d 381, 385-386 (Tex. Civ. App. – Houston [1st Dist.] 1971, *writ ref'd n.r.e.*). *See* Thomas, *supra* note 5, §19.04[1][a] at 19-9; Sims, *The Law of Real Covenants: Exceptions to the Restatement of the Subject by the American Law Institute*, 30 CORNELL L. REV. 1 (1944); POWELL, *supra* note 6, §60.02.

[113] 11 U.S.C. §§ 365, 363(f).

[114] 173 B.R. 108 (Bankr. W.D. Tex. 1994).

declaration is actually not an executory contract at all, but a covenant running with the land, an equitable restriction with its roots not in contract law but in real property law."[115] The court went on to observe that such interests could not be rejected because they are not "executory' at all. They are not even truly contracts."[116] The court supported this conclusion by noting that the covenants did not serve to benefit only the parties to the contract, but instead benefit all owners. More explicitly stated, the court provided that such agreements "are a square real estate 'peg' that sensibly should not be 'forced' into the 'round hole' of the law of contracts."[117] Against this background, we will now review two recent decisions that address the treatment in bankruptcy of real covenants in the context of midstream transactions.

A. The Energytec Case.

A 2013 decision of the United States Court of Appeals for the Fifth Circuit in *Newco Energy v. Energytec, Inc. (In the Matter of Energytec, Inc.)*,[118] addressed in detail the application of the tests for determining the existence of a covenant running with the land in the context of a bankruptcy sale of assets.

In *Energytec*, Mescalero entered into a letter agreement (the "1999 Letter Agreement") with Producers Pipeline pursuant to which Mescalero agreed to sell to Producers Pipeline all of Mescalero's interests in a gas pipeline, associated rights-of-way, and a processing plant. In the 1999 Letter Agreement, Producers Pipeline agreed, as part of the consideration for the sale, to pay to Newco, an affiliate of Mescalero, a monthly "transportation fee" based on the pipeline's throughput. This obligation was secured by a mortgage lien and security interest on the pipeline assets being sold, and Newco's right to receive the transportation fees was expressly characterized as "running with the land." The 1999 Letter Agreement also required Producers Pipeline to obtain Newco's consent prior to any assignment of the pipeline assets.[119] The pipeline assets were actually conveyed by Mescalero to Producers Pipeline pursuant to an assignment and bill of sale dated as of the same date as the letter agreement. Both the 1999 Letter Agreement and the assignment and bill of sale were filed for record in the relevant counties.[120]

Subsequently, as part of a settlement of litigation, Producers Pipeline conveyed the pipeline assets to Energytec, subject to Energytec's express agreement to assume the obligation to pay transportation fees to Newco. Thereafter, Energytec filed a voluntary petition in bankruptcy. During the pendency of Energytec's bankruptcy, Energytec requested the bankruptcy court to approve Energytec's sale of the pipeline assets to Red Water under Section 363(f) of the Bankruptcy Code, free and clear of any liens, claims, or encumbrances, including Newco's rights under the 1999 Letter Agreement.[121] Newco objected to the sale,

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115 *Id*.

116 *Id*. at 115.

117 *Id. See Gouveia v. Tazbir*, 37 F.3d 395 (7th Cir. 1994).

118 739 F.3d 215 (5th Cir. 2013).

119 *Id.* at 217.

120 *Id.*

121 11 U.S.C. § 363(f). Section 363(f) of the Bankruptcy Code provides the authority for a debtor or bankruptcy trustee to sell property of the estate "free and clear of any interest in such property of an entity other than [the debtor]" only if "(1) applicable nonbankruptcy law permits sale of [the applicable] property free and clear of [the] interest; (2) [the holder of the interest] consents; (3) [the] interest is a lien and the price at which [the applicable] property

asserting that its rights under the 1999 Letter Agreement to the transportation fee and to consent to future assignments were covenants running with the land and, thus, could not be cut off by a sale of the pipeline assets under Section 363(f).[122]

The bankruptcy court approved the sale, reserving Newco's objection for later determination. More than one year after the bankruptcy court approved the sale, it ruled that Newco's right to the transportation fee was not a covenant running with the land, so that the sale of the pipeline assets to Red Water was free and clear of Newco's claims. The district court affirmed the decision of the bankruptcy court.[123]

On appeal, the Fifth Circuit reversed the judgment of the district court and held that Newco's rights under the 1999 Letter Agreement were covenants running with the land.[124]

1. Covenant Running With the Land Analysis. After stating the four-pronged CRWTL Test from *Inwood North*, and the additional requirement of privity of estate,[125] the court concluded that the tests related to intent, notice, and binding successors were satisfied by the language and subject matter of the 1999 Letter Agreement and the associated assignment and bill of sale.[126] The court then focused on whether Newco's rights "touched and concerned the land" and whether privity of estate existed. The court stated that the tests for whether a covenant "touches and concerns" land are whether the covenant "affects the nature, quality, or value of the thing demised, independently of collateral circumstances, or if it affects the mode of enjoying it" and whether the benefit of the covenant increases the value of the promisor's interest in the land or the burden thereof reduces the value of its interest.[127] The court also noted that a covenant merely to pay an encumbrance does not run with the land, and that even when a covenant affects the value of land, it must also affect the owner's interest in the land or its use in order to "run with the land".[128] The court then concluded that Newco's rights under the 1999 Letter Agreement to receive the transportation fee and to consent to future assignments both impacted the rights and interests of the owner of the pipeline assets and clearly impacted the value and the use of the pipeline assets in the eyes of prospective purchasers. As such, the court held that Newco's rights under the 1999 Letter Agreement satisfied the "touch and concern" test.[129]

The court's privity of estate analysis is more complex. The court first reviewed the concepts of vertical privity and horizontal privity"[130] The court then criticized both the doctrine of horizontal privity, noting that it

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is to be sold is greater than the aggregate value of all liens on [the] property; (4) [the] interest is in bona fide dispute; or (5) [the holder of the interest] could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of [the] interest".

[122] 739 F.3d at 218.

[123] *Id.*

[124] *Id.* at 226.

[125] *Id.* at 221. The court cited *Ehler v. B.T. Suppenas Ltd.*, 74 S.W.3d 515, 521 (Tex. App. – Amarillo 2002, *no pet.*), as the source of the privity of estate requirement.

[126] 739 F.3d at 221.

[127] *Id.* at 223-224, citing *Westland Oil Development Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

[128] *Id.* at 224, citing *Refinery Holding Co., LP v. TRMI Holdings, Inc. (In re El Paso Refinery, LP)*, 302 F.3d 343, 357 (5th Cir. 2002) (covenant allocating liability for environmental costs does not "touch and concern" the land).

[129] 739 F.3d at 224-225.

[130] *Id.* at 222, citing POWELL, *supra* note 6, § 60.04[3][c][ii]-[iv].

was a minority view that was rejected in RESTATEMENT (THIRD),[131] and the decision in *Wayne Harrell Properties*, which applied the doctrine,[132] concluding that since the case was not a decision of the Texas Supreme Court, the Fifth Circuit would be "guided but not controlled by" the decision.[133] The Fifth Circuit then concluded that, because the rights of Newco under the 1999 Letter Agreement were created at the time of a conveyance of real property (the sale from Mescalero to Producers Pipelines), and the 1999 Letter Agreement was recorded in the land records of the relevant county, the requirements for vertical privity of estate and, if applicable under Texas law, horizontal privity had been satisfied.[134]

2. Bankruptcy Analysis. The Fifth Circuit addressed several issues relating to the effect on a covenant running with the land of a sale in bankruptcy of assets burdened by the covenant. After concluding that Newco's rights under the 1999 Letter Agreement to the transportation fee and to consent to future assignments constituted covenants running with the land, the Fifth Circuit proceeded to determine whether Energytec's pipeline assets could be sold under Section 363 of the Bankruptcy Code free and clear of Newco's interests.[135] Energytec argued that Section 363(f)(5) applied, which provides that the debtor or bankruptcy trustee may sell property free and clear of any interest "only if ... such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[136] On this point, Newco asserted that because it was impossible to estimate the monetary value of its right to future transportation fees, monetization of its interest in transportation fees was impossible.[137] The Fifth Circuit held that it could not address the valuation issue further because it had not been resolved by the lower courts, and thus remand for further proceedings on valuation was proper.[138] The Fifth Circuit also stated, however, that what constitutes "a qualifying legal or equitable proceeding for the purposes of Section 363(f)(5)" remains an open issue in the Fifth Circuit. It thus remanded the proceeding to the district court to determine whether a qualifying proceeding would enable Energytec to sell the pipeline assets free and clear of Newco's interests.[139]

Subsequent to remand, the parties stipulated to the dismissal of the matter in the bankruptcy court.[140] Since the Fifth

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[131] 739 F.3d at 222, citing RESTATEMENT (THIRD), *supra* note 3, § 2.4.

[132] 739 F.3d at 222, citing *Wayne Harrell Props. v. Pan Am Logistics Ctr., Inc.*, 945 S.W.2d 216, 217-18 (Tex. App. – San Antonio 1997, *writ denied*) (a right of first refusal and an assignment of an interest in net cash flows granted by a landowner to a real estate developer held not to constitute a covenant running with the land binding on transferees from the landowner, because the covenants were purely contractual and did not arise out of a conveyance of a real property interest, so that no privity of estate existed between the parties). For similar holdings, *see Mobil Oil Corp. v. Brennan*, 385 F.2d 951 (5th Cir. 1967); *Panhandle & S.F. Ry. Co. v. Wiggins*, 161 S.W.2d 501 (Tex. Civ. App. – Amarillo 1942, *writ ref'd w.o.m.*)

[133] 739 F.3d at 222. Apparently, the court did not read the entire opinion in *Westland*.

[134] *Id.* at 223. Interestingly, the court did not cite the fact that Newco's rights under the 1999 Letter Agreement were secured by a mortgage granted to Newco by Producers Pipeline covering the pipeline assets as a decisive factor in its holding.

[135] 739 F.3d at 221.

[136] *Id.* at 225.

[137] *Id.*

[138] *Id.*

[139] *Id.* at 225-226.

[140] *See* Stipulation of Dismissal of Contested Matter, *In re Energytec, Inc.*, Case No. 09-41477

Circuit's issuance of its opinion in *Energytec*, no other court has addressed these issues. Because the matter was dismissed by stipulation of the parties at the bankruptcy court level following the Fifth Circuit's remand, these issues remain open, and it is uncertain whether a sale could occur in a bankruptcy case free and clear of such interests.

B. The Sabine Case.

More recently, the issue of covenants running with the land received extensive consideration in two opinions issued by Judge Shelley C. Chapman of the United States Bankruptcy Court for the Southern District of New York in the bankruptcy case of Sabine Oil & Gas Corporation ("Sabine"). In this discussion, the first decision, *In re Sabine Oil & Gas Corporation*,[141] issued on March 8, 2016, will be referred to as "*Sabine I*", and the second decision, *Sabine Oil & Gas Corporation v. HPIP Gonzales Holdings, LLC*,[142] issued on May 3, 2016, will be referred to as "*Sabine II*."

1. Facts. Sabine, an oil and gas producer, filed its petition or relief under Chapter 11 of the United States Bankruptcy Code on July 15, 2015.[143] As the result of an earlier business combination with Forest Oil Corporation, Sabine became a party to (a) a Gas Gathering Agreement and a Condensate Gathering Agreement, each dated January 23, 2014, with Nordheim Eagle Ford Gathering, LLC ("Nordheim"; such agreements, collectively, the "Nordheim Agreements"), and (b) a Production Gathering, Treating and Processing Agreement dated May 3, 2014, and a Water and Acid Gas Handling Agreement dated "May __, 2014", with HPIP Gonzales Holdings, LLC ("HPIP"; such agreements, collectively, the "HPIP Agreements").[144]

The Nordheim Agreements, both of which were for ten-year terms, contained Acreage Commitments that were similar to that quoted earlier in this paper.[145] Nordheim also agreed to construct, at its sole expense, a gas gathering system and treatment facilities to handle Sabine's gas, and Sabine agreed to, and subsequently did, in fact, convey to Nordheim a surface tract and a pipeline and electrical easement for Nordheim's use in such construction activities.[146] The Nordheim gathering agreement also (w) provided for the delivery of Sabine's gas into Nordheim's system at multiple central "Receipt Points" in the field identified in the gathering agreement,[147] (x) obligated Sabine to pay a gathering fee on gas actually delivered into Nordheim's system, (y) established a MAQ for Sabine under the gathering agreement, and (z) obligated Sabine to make a deficiency payment to Nordheim if Sabine failed to deliver the MAQ in any contract year. Both Nordheim Agreements were governed by Texas law, specifically characterized themselves as covenants running with the land, and were expressly made enforceable

(Bankr. E.D. Tex. October 1, 2014) [Docket. No. 792].

141 547 B.R. 66 (Bankr. S.D.N.Y. 2016).

142 550 B.R. 59 (Bankr. S.D.N.Y. 2016).

143 *Sabine I*, 547 B.R. at 69.

144 *Id.* at 70-71.

145 Nordheim's Objection to Debtors' Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Contracts, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835, Dkt. 387 (Bankr. S.D.N.Y. October 8, 2015) ("Nordheim's Objection to Debtors' Motion to Reject"), Exhibit A at 1-2.

146 *Sabine I*, 547 B.R. at 70.

147 *Sabine II*, 550 B.R. at 69.

by Nordheim against Sabine, its affiliates, and their successors and assigns.[148]

The HPIP Agreements also contained Acreage Commitments as well as a commitment by HPIP to construct and maintain gas gathering and water disposal facilities to handle the gas and produced water delivered by Sabine under such agreements.[149] Delivery of Sabine's gas into HPIP's facilities was to be made at "Central Delivery Points" in the field identified in the HPIP gathering agreement.[150] The HPIP gathering agreement also obligated Sabine to drill at least one well per year on the dedicated leases to avoid triggering an obligation to purchase HPIP's gathering facilities at a price calculated as specified in the gathering agreement.[151] As was the case with the Nordheim Agreements, both HPIP Agreements were governed by Texas law, specifically characterized themselves as covenants running with the land, and were expressly made binding on the parties and their "successors, assigns, heirs, administrators and/or executors".[152]

On September 30, 2015, Sabine filed a motion in the bankruptcy court seeking to reject the Nordheim Agreements and the HPIP Agreements under Section 365(a) of the Bankruptcy Code.[153] According to

[148] *Sabine I*, 547 B.R. at 70.

[149] Objection of HPIP Gonzales Holdings, LLC, to Debtors' Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Executory Contracts, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835, Dkt 386 (Bankr. S.D.N.Y. October 8, 2015), at 3.

[150] *Id.*, Ex. 3, Section 3.1 at 2.

[151] *Id.*, Section 8.2.1 at 11-12.

[152] *Sabine I*, 547 B.R. at 70-71.

[153] Debtor's Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Executory Contracts, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835, Dkt. 371 (Bankr. S.D.N.Y. September 30, 2015) ("Debtors' Omnibus Rejection Motion"). Section 365 of the Bankruptcy Code, 11 U.S.C. §365, provides that the debtor or the bankruptcy trustee may assume or reject any executory contract of the debtor. Although the term "executory contract" is not defined under the Bankruptcy Code, courts have accepted the definition that an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." *Sharon Steel Corp. v. National Fuel Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989); *In re Kendall Grove Joint Venture*, 59 B.R. 407, 408 (Bankr. S.D. Fla. 1986). During the bankruptcy process, the debtor or the bankruptcy trustee will generally have the ability to reject executory contracts, if, in the exercise of its business judgment, it is in the best interest of the debtor and its estate. *See In the Matter of Tilco, Inc.*, 408 F. Supp. 389 (D. Kan. 1976), *rev'd and remanded on other grounds*, 558 F.2d 1369 (10th Cir. 1977). Rejection of a contract in bankruptcy pursuant to Section 365 constitutes a breach of the contract immediately before the filing date of the bankruptcy petition. *Aslan v. Sycamore Inv. Co.*, 909 F.2d 367 (9th Cir. 1990); *In re Continental Airlines, Inc.*, 146 B.R. 520, 531 (Bankr. D. Del. 1992) (rejection of lease) Such a rejection does not, however, terminate, rescind, or undo the contract. *Matter of Austin Development Co.*, 19 F.3d 1077 (5th Cir. 1994) (noting that rejection does not equate termination.) Instead, rejection simply constitutes a breach of the contract that relieves the debtor from future performance under the contract. *Taylor-Wharton Int'l LLC v. Blasingame (In re Taylor-Wharton Int'l LLC)*, Adv. Pr. No. 10-52792 (Bankr. Del. Nov. 23, 2010) at 6-7. The non-debtor party to a rejected contract becomes an unsecured creditor, *NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (1984), with (i) a general unsecured claim against the debtor for damages for breach of contract, which claim is deemed to have arisen immediately before the filing of the petition, and (ii) an expense of administration claim for any benefits received by the debtor in possession prior to rejection. *See* 11 U.S.C. §§ 365(g)(1) & 502(g).

If a debtor wishes to assume a contract in its bankruptcy case, it must cure any defaults under the contract and provide adequate assurance of future performance. *See* 11 U.S.C. § 365(b)(1). In connection with a sale of the debtor's assets, the debtor may seek to assume and assign the contract to a third-party purchaser. In that circumstance,

Sabine, the rejection of such agreements was a reasonable exercise of its business judgment and in the best interests of its estate in bankruptcy because the agreements were unnecessarily burdensome. If rejection was granted, Sabine stated that it would enter into new gathering agreements with other Midstream Companies on terms more favorable to Sabine.[154]

Nordheim argued that Sabine's decision to reject the Nordheim Agreements did not satisfy the business judgment rule because its Acreage Commitment and agreement to pay gathering fees are covenants that run with the land and would therefore survive rejection. If Sabine remained obligated on its Acreage Commitment and to pay gathering fees, Nordheim argued, rejection of the Nordheim Agreements would be of little or no benefit to Sabine's bankruptcy estate.[155] HPIP, on the other hand, did not object to Sabine's rejection of the HPIP Agreements. Rather, it objected only to Sabine's attempt to reject the Acreage Commitments in the HPIP Agreements which, HPIP argued, constitute covenants running with the land.[156]

2. Rejection of Contracts – *Sabine I*. On March 8, 2016, Judge Cashman issued the decision in *Sabine I*. The court concluded that it was precluded from making a final decision regarding whether the covenants at issue run with the land because the issue was raised in the context of a motion to reject that was not accompanied by a simultaneous adversary proceeding or contested matter to determine the merits of that issue.[157] Nonetheless, the court held that Sabine was authorized to reject the Nordheim Agreements and the HPIP Agreements, concluding that Sabine's decision to reject such agreements was a reasonable exercise of the business judgment rule.[158]

Even though the court was unable to make a final determination on the covenant issue, however, *Sabine I* included the court's "non-binding analysis" of whether the relevant covenants run with the land under Texas law and stated its "preliminary finding" that none of the covenants runs with the land either as a real covenant or an equitable servitude.[159] We will consider *Sabine I's* "preliminary finding" on the covenant issue in the following discussion of *Sabine II*.

3. *Sabine II*. After *Sabine I*, Sabine commenced adversary proceedings against Nordheim and HPIP seeking a declaratory judgment that the covenants in controversy in the Nordheim Agreements and the HPIP Agreements do not constitute covenants running with the land, and Nordheim and

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counterparties to the contract can demand adequate assurance that the third-party purchaser has the ability to perform under the contract prior to the court's approval of the sale transaction. *Id*. at § 365(b)(1)(C).

154 Rejection Motion, *supra* note 153 at 6-8.

155 *Sabine I*, 547 B.R. at 72.

156 *Id.*

157 *Id.* at 73.

158 *Id.* at 73-74. According to the bankruptcy court:

> If it is ultimately determined that the covenants at issue in the Agreements do not run with the land, … the Debtors will be free to negotiate new gas gathering agreements with any party, likely obtaining better terms than the existing agreements provide. If, however, the covenants are ultimately determined to run with the land, the Debtors will likely need to pursue alternative arrangements with Nordheim and HPIP consistent with the covenants by which the Debtors would remain bound. In either scenario, the Debtors' conclusion that they are better off rejecting the Nordheim and HPIP Agreements is a reasonable exercise of their business judgment.

Id.

159 *Id*. at 74-80.

HPIP filed motions for judgment on the pleadings in response to Sabine's declaratory judgment motion.[160] On May 3, 2016, the bankruptcy court, in *Sabine II*, granted Sabine's motions and denied those of Nordheim and HPIP, holding that neither the Acreage Commitment or the agreement to pay gathering fees in the Nordheim Agreements, nor the Acreage Commitment in the HPIP Agreements, constitute covenants running with the land as either real covenants or equitable servitudes under Texas law.[161]

In so holding, the court expressly incorporated by reference its preliminary analysis and findings from *Sabine I* and then addressed additional arguments raised by Nordheim and HPIP in their responsive motions.[162] At the core of the decision in *Sabine II* are the bankruptcy court's conclusions that (i) the covenants in issue do not satisfy the "touch and concern" element of the CRWTL Test under Texas law, and (ii) assuming that horizontal privity of estate is a required element of the CRWTL Test in Texas, horizontal privity is not present with respect to either the Nordheim Agreements or the HPIP Agreements.[163]

a. "Touch and Concern" Analysis. In *Sabine I*, after quoting the tests for determining whether a covenant satisfies the "touch and concern" element of the CRWTL Test,[164] the bankruptcy court stated that the covenants at issue neither "impact the value of the land 'independent of collateral circumstances'" nor do they "affect any interest in the real property of, or its use by, the owner [Sabine]".[165]

(1) Produced Minerals as Personal Property. In a key point, the court in *Sabine I* noted that, under Texas law, minerals once produced are no longer real property and become personal property.[166] The court then concluded that the Acreage Commitments in the Nordheim Agreements and the HPIP Agreements "do not have a direct impact upon the real property from which the [minerals] were produced …", but rather "concern only the [minerals] produced from real property and affect only Sabine's personal property rights."[167]

(2) "Produced and Saved" Argument. In *Sabine II*, Nordheim and HPIP argued that (i) Texas law deems a conveyance of oil and gas "produced and saved" to create a royalty

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160 *Sabine II*, 550 B.R. at 61-62.

161 *Id.* at 62.

162 *Id*. at 66.

163 *Id.* at 67-68, 70.

164 According to the bankruptcy court:

> The first test considers whether the covenant "affected the nature, quality, or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it" [citing *El Paso Refinery, LP v. TRMI Holdings, Inc. (In re El Paso Refinery, LP*), 302 F.3d 343, 356 (5th Cir. 2002)]. The second test evaluates whether "the promisor's legal relations in respect of the land in question are lessened – his legal interest as owner rendered less valuable by the promise … [and] if the promisee's legal relations in respect of the land are increased – his legal interest rendered more valuable by the promise" [*citing Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982)]. … [I]t is not enough that a covenant affect the value of the land; it must still affect the owner's interest in the property or its use in order to be a real covenant [*citing El Paso Refinery*, 302 F.3d at 357].

Sabine I, 547 B.R. at 77.

165 *Id.*

166 *Id., citing Sabine Prod. Co. v. Frost Nat. Bank of San Antonio*, 596 S.W.2d 271, 276 (Tex. App. – Corpus Christi 1980, *writ dism'd*); *Colorado Interstate Gas Co. v. Hunt Energy Corp.*, 47 S.W.3d 1, 10 (Tex. App. –Amarillo 2000, *pet. denied*).

167 *Sabine I*, 547 B.R. at 78.

interest, which under Texas law is an interest in real property, and (ii) therefore, Sabine's dedication of minerals "produced and saved" is a dedication of minerals in place that "touches and concerns" the dedicated acreage and leases. The bankruptcy court rejected this argument, stating that Sabine did not owe a royalty obligation to either Nordheim or HPIP and that Texas law does not hold that all rights and obligations relating to "minerals yet to be produced create rights and obligations relating to real property."[168]

In so holding, the court distinguished the *American Refining* case[169] – authority that, to this author, appears to provide compelling support for the positions of Nordheim and HPIP – based on several differences between the contracts in issue in *American Refining* and the Nordheim Agreements and the HPIP Agreements. Chief among these were: (i) Sabine's reservation of rights to operate its oil and gas properties without interference from Nordheim or HPIP; (ii) the fact that the receipt points under the Nordheim and HPIP gathering agreements were at central points in the field and not at the wellheads of Sabine's wells; and (iii) Sabine became obligated to pay gathering fees under both gathering agreements upon the receipt of gas into Nordheim's and HPIP's facilities and not upon the production of the gas.[170]

(3) Triggering Event for Covenants. Finally, the court in *Sabine I* looked to whether "the action triggering the covenant is one that affects the land."[171] According to the court, the Acreage Commitments in the Nordheim Agreements and the HPIP Agreements are triggered by "production and saving" of minerals from the dedicated acreage and leases, and the obligation to pay the Nordheim gathering fee is triggered by Nordheim's receipt of minerals into its facilities. Somewhat remarkably, particularly with respect to the Acreage Commitments, the court stated that only produced minerals are affected by these triggering events and that "none of those triggers affects the land from which [the minerals] have been produced.[172] In reaching this conclusion, the court contrasted the Nordheim gathering fee with the transportation fee in *Energytec* that was payable by Producers Pipeline (the pipeline purchaser) to Newco (the affiliate of the pipeline seller). According to the court, the obligation to pay the *Energytec* transportation fee was triggered simply by the flow of gas through the pipeline, while the obligation to pay the Nordheim gathering fee was triggered by Nordheim's receipt of Sabine's gas into Nordheim's facilities. The Nordheim gathering fee was "thus not as directly tied to the promisor's land as was the case in *Energytec*".[173]

(4) Consents to Assignment and Lien Issues. In *Sabine I*, the court additionally distinguished the letter agreement in *Energytec* from the Nordheim Agreements and the HPIP Agreements based on (i) the presence in the *Energytec* letter agreement of an obligation on the part of Producers Pipeline (the pipeline purchaser) to obtain the consent of Newco (the pipeline seller's affiliate and the recipient of the transportation fee) to any future assignment of the pipeline system and (ii) the fact that the obligation of Producers Pipeline to pay

168 *Sabine II*, 550 B.R. at 66.

169 *See American Ref'g Co. v. Tidal Western Oil Corp.*, 264 S.W. 335, 336 (Tex. Civ. App. – Amarillo 1924, *writ ref'd*).

170 *Sabine II*, 550 B.R. at 67.

171 *Sabine I*, 547 B.R. at 78.

172 *Id.*

173 *Id.* at 79.

the transportation fee to Newco was secured by a lien against the pipeline system purchased by Producers Pipeline. The court characterized the consent-to-assignment requirement as "a clear burden on the land because it restricted the landowner's right of alienation of his property."[174]

Regarding the lien issue, the court pointed out that not only was the obligation to pay the Nordheim gathering fee not secured, but also that Sabine's dedicated acreage and leases were subject to pre-existing liens in favor of Sabine's lenders that were not subordinated to the Nordheim Agreements. Rejecting Nordheim's argument that the priority of the Acreage Commitments in the Nordheim Agreements relative to the liens of Sabine's lenders was an issue to be resolved by Sabine and its lenders, the court summarily stated that the existence of the pre-existing, unsubordinated liens "strongly militate[s] against a finding that the covenants at issue burden the property and thus touch and concern the land."[175]

In *Sabine II*, Nordheim and HPIP argued that the Acreage Commitments constituted "excepted liens" within the meaning of Sabine's credit agreement, such that Sabine was permitted to enter into the Acreage Commitments without lender approval. The court rejected this argument, noting that the "excepted lien" definition in Sabine's credit agreement required that the relevant interest not "materially impair the use of the Property" or "materially impair the value of the Property subject thereto."[176] The court then stated that if the Acreage Commitments satisfy the "touch and concern" prong of the CRWTL Test as expressed in *El Paso Refinery – i.e.*, that the legal interest of the promisor is rendered "less valuable by the promise" or the legal interest of the promisee is made "more valuable by the promise"[177] – they would likely not qualify as "excepted liens" under Sabine's credit agreement and would therefore constitute a default thereunder.[178]

b. "Privity of Estate" Analysis. Consistent with the discussion in Section II.B.2.b. of this paper,[179] the court in *Sabine II* noted the lack of uniformity among the Texas cases regarding whether a showing of horizontal privity of estate is, in fact, an element of the CRWTL Test.[180] In the absence of definitive Texas authority rejecting horizontal privity of estate as an element of the CRWTL Test, the court addressed whether horizontal privity of estate existed between Sabine and Nordheim or HPIP.[181]

(1) "Traditional Paradigm." In *Sabine I*, the court, citing *Energytec*, described horizontal privity as being present where there exists "'simultaneous existing interests or mutual privity' between the original covenanting parties as either landlord and tenant or grantor and grantee."[182] According to the court,

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174 *Id.* at 78.

175 *Id.* at 79.

176 *Sabine II*, 550 B.R. at 67.

177 *Id. See* note 40 and accompanying text, *supra*.

178 *Sabine II*, 550 B.R. at 67-68.

179 *See* notes 54 through 60 and accompanying text, *supra*.

180 *Sabine II*, 550 B.R. at 68. *See Sabine I*, 547 B.R. at 76, citing *Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 910-11 (Tex. 1982), in support of the proposition that a showing of horizontal privity of estate is part of the CRWTL Test.

181 *Sabine I*, 547 B.R. at 76; *Sabine II*, 550 B.R. at 68.

182 *Sabine I*, 547 B.R. at 76, citing *Newco Energy v. Energytec, Inc. (In the Matter of Energytec, Inc.*),

> … the original covenanting parties … need to have some additional transactional element to their relationship, and not merely be two parties seeking to covenant with one another. The traditional paradigm involves a property owner reserving by covenant, either for itself or another beneficiary, a certain interest out of the conveyance of the property burdened by the covenant.[183]

(2) No Direct Interest in the Mineral Estate. In *Sabine I*, the court concluded that neither the Nordheim Agreements nor the HPIP Agreements fit the "traditional paradigm" of the horizontal privity analysis. The court noted that Sabine did not reserve any interest in its oil and gas leases for either Nordheim or HPIP in such agreements; rather, it simply engaged Nordheim and HPIP to perform certain services with respect to hydrocarbon production from such leases.[184]

The court also stated that neither the Nordheim Agreements nor the HPIP Agreements granted to Nordheim or HPIP a real property interest in Sabine's "mineral estate," which, according to the court, is comprised of the five real property rights incident to the ownership of a fee mineral estate in land commonly referred to in oil and gas parlance as the "bundle of sticks."[185] Failing to note the distinctions between a fee estate in minerals and the oil and gas leasehold estate[186] – the estate actually owned by Sabine – the court stated that "a right to transport or gather produced gas is clearly not one of [the bundle of] sticks."[187]

In *Sabine II*, Nordheim argued that its right to "take minerals out of Sabine's mineral estate" constituted an interest in real property that satisfied the horizontal privity requirement. In support of this argument, Nordheim cited several cases that characterized the right of a party "to go upon the land and place there the necessary structures to connect the wells" to such party's pipeline as a real property right.[188] The court rejected this argument, stating that since Nordheim received gas under the Nordheim Agreements at "Receipt Points" described therein, rather than at the wellheads of Sabine's wells, Nordheim's facilities were not connected to Sabine's wells, so that the cases cited by Nordheim were inapposite.[189]

HPIP also argued that the "dedication" of Sabine's leases in the HPIP Agreements was, by definition, a conveyance of real property. The court also rejected this argument because the HPIP Agreements do

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739 F.3d 215, 222 (5th Cir. 2013), and Thomas, *supra* note 5, at §19.03.

183 *Sabine I*, 547 B.R. at 76.

184 *Id.*

185 *Id.* According to the bankruptcy court, the mineral estate is comprised of "five real property rights, or 'sticks', under Texas law: '(1) the right to develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, [and] (5) the right to receive royalty payments …", citing *Lesley v. Veterans Land Bd.*, 352 S.W.3d 479, 481 n. 1 (Tex. 2011), quoting *Altman v. Blake*, 712 S.W.2d 117, 118 (Tex. 1986).

186 For a discussion of the incidents of ownership associated with an oil and gas leasehold estate, *see* notes 208 through 210 and accompanying text, *infra*.

187 *Sabine I*, 547 B.R. 77-78.

188 *Sabine II*, 550 B.R. at 69-70. In support of its argument, Nordheim cited *Guffey v. Utex Exploration Co.*, 376 S.W.2d 1, 5 (Tex. Civ. App. – San Antonio 1964, writ ref'd n.r.e.); *Southwest Pipe Line Co. v .Empire Nat. Gas Co.*, 33 F.2d 248, 252 (8th Cir. 1929).

189 *Sabine II*, 550 B.R. at 69-70.

not contain words of grant and such agreements expressly disclaim any conveyance of an interest in the dedicated leases.[190]

(3) Which Land Does the Covenant Burden? Finally, in *Sabine II*, Nordheim argued that the horizontal privity of estate element of the CRWTL Test was satisfied by Sabine's agreement to convey to Nordheim, and subsequent conveyance of, a surface tract and a pipeline and electrical easement for Nordheim's use in the construction of its facilities. According to Nordheim, horizontal privity of estate is created through the conveyance of any land "involved" in the covenants at issue.[191] The court flatly rejected this argument, concluding that it failed to fit within the "traditional paradigm":

> … [T]he model for the creation of horizontal privity of estate is the conveyance of an interest in property that itself is being burdened with the relevant covenant, not the conveyance of an interest in property that is distinct from (even if somewhat related to) the property burdened by the covenant.[192]

The court also stated that a covenant to make a conveyance of an interest in property does not create horizontal privity of estate until the actual conveyance is executed and delivered.[193]

c. Equitable Servitude Analysis. In both Sabine I and Sabine II, the bankruptcy court rejected, without extensive discussion, Nordheim's argument that even if the covenants at issue are personal, and not real, covenants, such covenants still constitute equitable servitudes that may not be rejected under the Bankruptcy Code. Citing *El Paso Refinery*, Judge Cashman stated that, for a covenant to be enforceable as an equitable servitude, (i) horizontal privity of estate must exist between the covenanting parties when the covenant is made, and (iii) subsequent purchasers must have notice of the restriction.[194] Since the court had concluded that the Acreage Commitment and agreement to pay gathering fees in the Nordheim Agreements did not touch and concern the dedicated acreage under such agreements, and that no horizontal privity of estate existed between Sabine and Nordheim, it held that the covenants were also unenforceable as equitable servitudes.[195]

4. Subsequent History. Following its decision in *Sabine II*, the bankruptcy court, on May 11, 2016, issued (i) its final order granting Sabine's motion to reject the Nordheim Agreements (*Sabine I*) and decreed that such agreements were rejected effective as of December 31, 2015 (the "Rejection Order")[196] and (ii) its final order in the adversary proceedings memorializing

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190 *Id.* at 70.

191 *Sabine II*, 550 B.R. at 68-69.

192 *Id.*, citing *El Paso Nat. Gas Co. v. Amoco Prod. Co.*, Civ. A. No. 12083, 1992 WL 43925 (Del. Ch. March 4, 1992).

193 *Sabine II*, 550 B.R. at 69.

194 *Sabine I*, 547 B.R. at 79, and *Sabine II*, 550 B.R. at 83, citing, in both cases, *El Paso Refinery, LP v. TRMI Holdings, Inc.* (*In re El Paso Refinery, LP*), 302 F.3d 343, 358 (5th Cir. 2002).

195 *Sabine I*, 547 B.R. at 79; *Sabine II*, 550 B.R. at 83.

196 Order Authorizing Rejection of Certain Executory Contracts, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (Bankr. S.D.N.Y. May 11, 2016), [Docket No. 1082].

the holdings in *Sabine II* (the "Summary Judgment Order").[197]

On May 13, 2016, Nordheim filed with the bankruptcy court (x) notices of appeal with respect to both the Rejection Order and the Summary Judgment Order,[198] (y) motions to certify the Rejection Order[199] and the Summary Judgment Order[200] for direct appeal to the United States Court of Appeals for the Second Circuit (the "Certification Requests"), and (z) motions seeking stays of the Rejection Order[201] and the Summary Judgment Order[202] pending a decision in Nordheim's appeal of such orders. Central to Nordheim's motion seeking a stay of the Rejection Order pending its appeal was the argument that "there was a serious likelihood that a reviewing court could disagree with the Rejection Order" and conclude that the Nordheim Agreements "create covenants that run with the land or are equitable servitudes, and, accordingly, not subject to rejection . . ."[203] On May 24, 2016, HPIP filed a joinder to Nordheim's Certification Request.[204]

On June 15, 2016, Judge Chapman issued a memorandum decision and order on Nordheim's motion for stay pending appeal and the Certification Request in which the bankruptcy court denied both the Certification Requests and Nordheim's motions for stay.[205] Of particular interest for purposes of this paper was the court's conclusion, in the context of its denial of Nordheim's motions for stay pending appeal, that although "there is more than a trivial possibility that some portion of the Summary Judgment [Order] may be reversed or modified on appeal", Nordheim had failed to demonstrate "a substantial possibility of success" on its appeal of either the Rejection Order or the Summary Judgment Order.[206]

5. Analysis of Sabine Decisions. The *Sabine I* and *Sabine II* opinions both cover a lot of ground, and a complete discussion of all of the nuances of such decisions is beyond the scope of this paper. Plus, the author's bankruptcy partners have asked that we hold back a little something for the briefs

[197] Order on Debtor's Motion for Summary Judgment and Nordheim's Motion for Judgment on the Pleadings, *In re Sabine Oil & Gas Corp.*, Adv. Pro. No. 16-01043 (Bankr. S.D.N.Y. May 11, 2016) [Adv. Pro. Docket No. 22].

[198] Notice of Appeal, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (Bankr. S.D.N.Y. May 13, 2016) [Docket No. 1098].

[199] Nordheim's Expedited Request for Certification of Rejection Order for Direct Appeal, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (Bankr. S.D.N.Y. May 13, 2016) [Docket No. 1100].

[200] Nordheim's Expedited Request for Certification of Summary Judgment Order, *In re Sabine Oil & Gas Corp.*, Adv. Pro. No. 16-01043 (Bankr. S.D.N.Y. May 13, 2016) [Adv. Pro. Docket No. 25].

[201] Nordheim's Motion for Stay Pending Appeal of Rejection Order, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (Bankr. S.D.N.Y. May 13, 2016) [Docket No. 1099] (the "Rejection Order Stay Motion").

[202] Nordheim's Motion for Stay Pending Appeal of Summary Judgment Order, *In re Sabine Oil & Gas Corp.*, Adv. Pro. 16-1043 (Bankr. S.D.N.Y. May 13, 2016) [Adv. Pro. Docket No. 29].

[203] Rejection Order Stay Motion, *supra* note 201, at 7.

[204] Joinder of HPIP Gonzales Holdings, LLC, to Nordheim's Expedited Request for Certification of Rejection Order, *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (Bankr. S.D.N.Y. May 24, 2016) [Docket No. 1143].

[205] Memorandum Decision and Order on (I) Motions for Stay Pending Appeal and (II) Expedited Requests for Certification of Orders for Direct Appeal, *In re Sabine Oil & Gas Corp.*, Adv. Pro. Nos. 16-01042 and 16-01043 (Bankr. S.D.N.Y. June 15, 2016) [Adv. Pro. Docket No. 1267].

[206] *Id.* at 19.

in the adversary proceeding relating to real covenants in our next producer bankruptcy.

With those limitations in mind, it is the author's view, speaking for no one but himself, that (i) the *Sabine* court's analysis of the "touch and concern" requirement of the CRWTL Test in the context of the Nordheim Agreements and the HPIP Agreements is seriously flawed and, in all likelihood, incorrect, but (ii) the court's analysis of the privity of estate requirement as applied to those agreements, although flawed in many of its details, is correct in its result. If this view is correct, then the court was, in all likelihood, correct in permitting Sabine to reject the Nordheim Agreements and the HPIP Agreements, subject to the satisfaction of the business judgment test under Section 365 of the Bankruptcy Code.

With respect to the "touch and concern" analysis, we will offer the author's view about how such analysis should have proceeded. Among the most fundamental of the flaws in the *Sabine* opinions is using the fee mineral estate's "bundle of sticks" as the starting point for analyzing the relationship of the Nordheim Agreements and the HPIP Agreements to the dedicated lands and oil and gas leases.[207]

An oil and gas leasehold estate is the estate granted to and owned by the lessee under an oil and gas lease. Such interest arises as the result of the mineral owner's exercise of the executive right and vests in the lessee the right to develop the leased premises for oil and gas, subject to the obligations to pay to the lessor/mineral owner (i) the lease bonus payable as consideration for the granting of the lease, (ii) any delay rentals, shut-in well payments, and other payments necessary to maintain the lease in effect in the absence of production or operations, and (iii) royalty on production from the leased premises.[208] An oil and gas lease is a conveyance of an interest in minerals.[209] The oil and gas lessee receives a corporeal estate in land in the nature of a fee simple determinable interest in all of the oil and gas in place owned by the lessor.[210] The notion of "development" is far broader than its sounds. As stated by Professors Smith and Weaver, "Exploration, drilling, producing, transporting, storing, and marketing are all part of development."[211]

In the parlance of *American Refining*, since it would be impossible for the lessee to enjoy the benefits of the oil and gas leasehold estate without removing and transporting the oil and gas produced therefrom, obligations entered into prior to such production to receive, gather, transport, and redeliver such oil and gas appear to "refer to" and "deal with" the oil and gas when it was "inherent in and part of the land itself."[212] In the parlance of *Westland*, we would argue that the producer's obligation to deliver oil and gas production from the

[207] *See* notes 155 through 157 and accompanying text, *supra*.

[208] *See* P. Martin and B. Kramer, 8 WILLIAMS & MEYERS OIL AND GAS LAW, MANUAL OF TERMS, at 549 (LexisNexis Matthew Bender 2015); E. Smith and J. Weaver, TEXAS LAW OF OIL AND GAS, § 2.1[A][1][b] at 2-10 (LexisNexis Matthew Bender 2015) (hereinafter, "SMITH & WEAVER").

[209] *Retamco Operating, Inc. v. Republic Drilling Co.*, 278 S.W.3d 333 (Tex. 2009); *Cherokee Water Co. v. Forderhouse* 641 S.W.2d 522 (Tex. 1982).

[210] *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S.W. 290 (1923). *See* P. Martin and B. Kramer, 1 WILLIAMS & MEYERS OIL AND GAS LAW, §§ 209, 212 (LexisNexis Matthew Bender 2015); SMITH & WEAVER, *supra* note 208, §2.2.

[211] *See* SMITH & WEAVER, *supra* note 208 §2.1[A][1][b] at 2-10.

[212] *See American Refining Co. v. Tidal Western Oil Corporation*, 264 S.W. 335, 338-339 (Tex. Civ. App. – Amarillo 1924, *writ ref'd*).

dedicated leases and lands to the Midstream Company for sale, gathering, or transportation (i) "affects the nature, quality, or value of" the producer's oil and gas leasehold estate, (ii) "affects [the producer's] mode of enjoying it", and (iii) either enhances or reduces, depending on the terms of the Wellhead Contract, the value of the producer's oil and gas leasehold estate.[213] As such, the covenants of the Wellhead Contract appear clearly to "touch or concern" the producer's oil and gas leasehold estate.

On the other hand, if privity of estate is a requirement of the CRWTL Test in Texas (and based on the analysis set forth above,[214] we believe the best view is that it does), we have no answer for a Midstream Company in the position of Nordheim or HPIP in this regard because at no point does the Midstream Company own "a mutual or successive interest" in the oil and gas leasehold estates of the producer in the dedicated leases and lands.

C. Moving on From Sabine.

When viewed logically, *Sabine I* and *Sabine II* have had a more wide-ranging impact than they should have, as decisions by a bankruptcy court sitting in New York interpreting Texas law. Because *Sabine I* and *Sabine II* were the first and, to date, only adversary proceedings in a producer bankruptcy to address, and to proceed to judgment on, the issue whether the Acreage Commitments and related covenants in a Wellhead Contract constitute real covenants that survive the producer's bankruptcy, the cases have generated an enormous amount of interest and commentary.

A comprehensive update of the status of these issues in the numerous other pending producer bankruptcies is beyond the scope of this paper. It is sufficient to say that, in virtually every other producer bankruptcy where a material Wellhead Contract containing an Acreage Commitment or a MAQ concept is in controversy, the producer/debtors and the Midstream Companies are in negotiations to restructure the relevant contracts so that they will be assumed by the debtor or the purchaser of the debtor's assets.

Sabine I and *Sabine II* have not stopped producers and Midstream Companies from doing new business, however, but the cases have prompted virtually all Midstream Companies to reassess their best practices for Wellhead Contracts to address as many of the issues raised in the *Sabine* cases as possible to reduce their future bankruptcy exposure under such contracts. In this regard, Midstream Companies should consider the following points.

1. Address the "Touch and Concern" Issue.

Attached to this paper as Appendix I is a draft of proposed dedication language for a gas gathering agreement that attempts to bolster the argument that the dedication of lands, leases, and gas under the gathering agreement constitutes a servitude in the nature of a real covenant under Texas law. In this regard, please note the following features:

a. In Appendix I, the producer purports to "grant and convey" the servitude to the gatherer. Under Texas law (as well as the RESTATEMENT (THIRD)), there are no "words of art" applicable to the creation of a servitude. To address the *Sabine* court's issue with the concept of "dedication", and

[213] *See Westland Oil Dev. Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903, 911 (Tex. 1982).

[214] *See* notes 60 through 65 and accompanying text, *supra*.

since a servitude is a right in or with respect to real property, Appendix I uses conventional "words of grant" to create the servitude.

b. Appendix I specifically characterizes the right being granted as "a servitude in the nature of a real covenant." If one is to create an interest in real property, the interest granted must be an interest in real property recognized at law. We would argue that this language satisfies that test.

c. Appendix I provides that the servitude burdens the "Dedicated Area", the "Dedicated Leases", and all gas "on, in, and under the Dedicated Area and the Dedicated Leases" and "that may be produced therefrom…" This language carries forward concepts from *American Refining* and is an attempt to respond to the *Sabine* court's bifurcation, in the "touch and concern" portion of the opinions, of the concepts of ownership of gas in place (i.e., in the ground, prior to production, which is recognized as an interest in real property) and the UCC's characterization of produced gas as a "good" and, therefore, personal property. The attached language is intended to satisfy the "touch and concern" test because the servitude burdens not only produced gas, but also the Dedicated Area, the Dedicated Leases (covering the Dedicated Area), and the gas in place underlying the Dedicated Area and the Dedicated Leases prior to its production.

d. Rather than speaking about the "dedication" of gas, Appendix I describes the servitude being granted as "the exclusive right to receive from Producer, gather, and redeliver to Producer…. all Gas on, in, under, and that may be produced, during the Term, from the Dedicated Acreage and the Dedicated Leases by means of the Dedicated Wells and that is owned or Controlled…." by the producer. The "on, in, and under" language is intended to make clear that the servitude granted attaches to lands, oil and gas leases, and gas in place – all real property concepts – as well as produced gas.

e. Clauses (i) and (ii) of Appendix I are designed to meet the "intent" and "binding on assigns" tests for a real covenant.

2. Bolstering the Case of Horizontal Privity. Even with an Acreage Commitment that addresses all of the issues in *Sabine I* and *Sabine II* regarding the "touch and concern" requirement of the CRWTL Test, Midstream Companies must still address the issue of horizontal privity.

a. Learn from *Energytec*. Particularly when the midstream transaction involves the conveyance by the producer to the Midstream Company of existing, producer-constructed pipeline and/or other midstream facilities, *Energytec* provides a blue print for a transaction that creates horizontal privity of estate between the producer and the Midstream Company that is not present when a Wellhead Contract is executed without conveyances of infrastructure.

i. Although it is certainly appropriate to include an Acreage Commitment in the new Wellhead Contract between the producer and Midstream Company (these are, after all, contracts governing a business transaction, not just vehicles to limit bankruptcy exposure), consider treating the easements and rights-of-way conveyed by the producer to the Midstream Company, and not the dedicated leases and lands, as the burdened land for purposes of any covenants the parties desire to run with the land. In this circumstance, the producer and the Midstream Company would appear to be in horizontal privity of estate with respect to the easements and rights-of-way as long as the conveyances of the easements and rights-of-way and the creation of the

covenant take place relatively simultaneously.

ii. Consider treating the producer's obligation to pay fees (particularly deficiency payments) to the Midstream Company as the covenant to run with the land.

iii. Consider securing the producer's obligation to pay fees under the Wellhead Contract with a lien against the producer's interests in the dedicated oil and gas leases and wells. Additional discussion of the concept a "Midstream Lien" appears below in Section III.C.3 of this paper.

b. Make Use of Overriding Royalty Interests. In order to bolster additionally the Midstream Company's argument that the Wellhead Contract is a covenant running with the land, the Midstream Company should consider requesting the producer to convey to the Midstream Company, as part of the consideration for the midstream services provided to the producer, an overriding royalty interest ("ORRI") that burdens the dedicated leases and wells. Presumably, the ORRI would be relatively small (i.e., 1%) because the ORRI reduces the producer's net revenue interest in the dedicated leases and the dedicated wells (even 1% of production from good wells can generate "real" money). Producers would likely not accept the concept of an ORRI if it is too large because of the ORRI's impact on the profitability of the dedicated leases and wells. When considering the use of an ORRI for this purpose, keep in mind the following points:

i. The ORRI could be structured in several ways. It could simply represent consideration to the Midstream Company in addition to the fees otherwise charged by the Midstream Company under the Wellhead Contract. Alternatively, and more appealingly to most producers, the Midstream Company may agree to allow the ORRI to reduce the fees separately charged under the Wellhead Contract if the Midstream Company is willing to assume the reserve risk associated with recovering a portion of its fees out of production. Language describing how the ORRI fits into the consideration received by the Midstream Company for providing midstream services under the Wellhead Contract would be included in the Wellhead Contract itself. The ORRI would be effectuated, or "granted", pursuant to the execution of a conventional form of conveyance of overriding royalty interest.

ii. Under Texas law, an ORRI is characterized as an interest in real property.[215] The primary benefit of incorporating an ORRI concept into a Wellhead Contract is that it essentially converts the Wellhead Contract from (in most cases) a pure service contract to a contract for the sale of an interest in real property. The inclusion in a Wellhead Contract of an agreement to convey an ORRI answers one of the *Sabine* court's principal objections; the covenant to convey the overriding royalty is clearly a "real" covenant and could be expected to run with the land with respect to the dedicated leases.

iii. Whether the presence in the Wellhead Contract of a covenant to convey the ORRI is enough to cause a bankruptcy court to characterize the entire Wellhead Contract as a covenant running with the land still has not been finally determined by the courts. Even if a bankruptcy court were to conclude that only the covenant to convey the ORRI is a

[215] *E.g., Frost v. Standard Oil Co. of Kansas*, 107 S.W.2d 1037, 1039 (Tex. Civ. App. – Galveston 1937, *no writ*); *Kelly Oil Co., Inc. v. Svetlik*, 975 S.W.2d 762, 764 (Tex. App. – Corpus Christi 1998, *writ denied*).

"real" covenant and that the rest of the Wellhead Contract is an executory contract that can be assumed or rejected at the option of the producer/debtor, the ORRI, if properly conveyed, would, in most states, give the Midstream Company an interest in real property that should not constitute "property of the debtor's estate" under Section 541 of the Bankruptcy Code[216] and, therefore, a continuing source of cash flow (at least as long as the dedicated leases continue to produce) that is not subject to the jurisdiction of the bankruptcy court.

iv. Finally, it should be kept in mind that, for an ORRI to be properly granted, it must comply with the statute of frauds. That means that the conveyance of the ORRI must contain a legally sufficient description of the Dedicated Leases. A plat of the Dedicated Area will, in most cases, not be sufficient for this purpose. Presumably, if a producer is willing to grant an ORRI, it will be willing to give the Midstream Company a good description of the burdened leases.

3. Use of "Midstream Lien." Finally, Midstream Companies should consider attempting to negotiate the inclusion in the Wellhead Contract of a lien and UCC security interest granted by the producer to the Midstream Company covering the producer's interest in the dedicated area, dedicated leases, dedicated wells, and the dedicated gas (both in place and once produced) to secure the obligations of the Producer to pay the amounts it owes to the Midstream Company under the terms of the Wellhead Contract. These amounts would include any fees, fuel charges, deficiency payments if the Producer fails to satisfy its MAQ, and damages (including damages resulting from the rejection of the Wellhead Contract in the producer's bankruptcy). The inclusion of such a "Midstream Lien" has a number of advantages for the Midstream Company:

a. The inclusion of a "Midstream Lien" would arguably bolster the Midstream Company's "touch and concern" and "horizontal privity" arguments in favor of characterizing the Wellhead Contract as a "covenant running with the land." Such a Midstream Lien should constitute a recognized encumbrance against real property that, at least with respect to the lien itself, appears clearly to "touch and concern" the real property rights encumbered thereby. Also, since the grant of the lien constitutes the transfer of rights in the dedicated leases and lands from the producer to the Midstream Company, it arguably satisfies the "horizontal privity" test.

b. The existence of a debtor/secured party relationship resulting from the grant of a lien on the pipeline assets sold in the *Energytec* case was viewed as a positive fact by the Fifth Circuit in *Energytec*, although the court did not specifically rely on the existence of such lien in concluding that the agreements in controversy constituted covenants running with the land.[217] In *Sabine*, no liens were present, but in *Sabine I*, the bankruptcy court cited the existence of a lien like that in *Energytec* as factor that, had it been present, would have impacted its analysis.[218] In our view, the proposed "Midstream Lien" is "better" than the lien on pipeline assets in *Energytec* because it attaches to the dedicated area, dedicated leases, and dedicated gas and, therefore, appears directly to "touch and concern" the

[216] 11 U.S.C. § 541(a).

[217] *Newco Energy v. Energytec, Inc.* (*In the Matter of Energytec, Inc.*), 739 F.3d 215, 217 (5th Cir. 2013).

[218] *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 78-79 (Bankr. S.D.N.Y. 2016).

subject matter of the Acreage Commitment in the Wellhead Contract.

c. There may be issues under the producer's credit facilities with the granting of such a Midstream Lien. There are almost always negative covenants in the producer's credit documents that limit the right of the producer/borrower to create liens against its properties in addition to its lenders' mortgage liens. There is generally an exception to this covenant for "operator's and similar liens" to the extent that such liens do not secure indebtedness that is past due. A Midstream Lien like that described herein should fit within most such exceptions, although that determination will ultimately be made by the producer and its lenders. A second issue is the issue of priority of the Midstream Lien. From the Midstream Company's perspective, it is most desirable for the Midstream Lien to have first priority with respect to the burdened properties. If the operator of the producer's oil and gas leases or the producer's lenders already have liens in place, however, first priority status can only be obtained if the relevant operators and/or lenders agree to subordinate their liens to the Midstream Lien. That will be an issue to be negotiated on a case-by-case basis.

d. Even if a bankruptcy court concludes that the Wellhead Contract does not constitute a covenant running with the land, the Midstream Lien would still be a positive from the Midstream Company's perspective because it gives the Midstream Company secured creditor status with respect to the Producer's obligations under the Wellhead Contract in the event of the Producer's bankruptcy. In the oil and gas joint operating agreement context (where "operator's liens" similar to the Midstream Lien are common), even when the operating agreements have been rejected as executory contracts, the operator's liens created thereunder, if properly perfected, have been enforced. It is clear that it is better to be a secured creditor in a producer bankruptcy, even if in a second lien status, than it is to be an unsecured creditor.

IV. CONCLUSION

The large number of currently pending producer bankruptcies, not to mention those yet to be filed, have brought the ancient and confusing world of real covenant law into the sunlight for the first time in many years. As can be seen from the foregoing discussions, for many of the questions being asked about real covenants, the available case law more than occasionally provides conflicting answers. From a scholarly standpoint, it would be interesting to see rulings from bankruptcy courts sitting in Texas on the issues addressed in *Sabine I* and *Sabine II*. Practically speaking, it is almost always better not to leave arcane state law interpretations in the hands of bankruptcy judges.

APPENDIX I

One suggestion for a restructured acreage commitment:

"Dedicated Acreage. Except for the exclusions and reservations set forth in Section ___, and subject to the other terms and conditions of this Agreement, during the Term, Producer grants and conveys to Gatherer, as a servitude in the nature of a real covenant burdening all of the rights, titles, and interests of Producer, its Affiliates, and its and their respective successors and assigns in and to the Dedicated Area, the Dedicated Leases, all Gas on, in, and under the Dedicated Area and the Dedicated Leases, and all such Gas that may be produced therefrom, the exclusive right to receive from Producer, gather, and redeliver to Producer, in accordance with the terms of this Agreement, all Gas on, in, under, and that may be produced during the Term from the Dedicated Area and the Dedicated Leases by means of the Dedicated Wells and that is owned or Controlled by Producer, its Affiliates, and its or their successors or assigns, save and except Gas reserved and excepted as provided in Section ___ ("Dedicated Gas"). It is the intent of the Parties that all of the terms, covenants, provisions, and conditions of this Agreement, including specifically, but without limitation, the grant of the servitude described in this Section ___, shall be (i) deemed to be covenants running with the land with respect to the Dedicated Area and the Dedicated Leases, and (ii) binding on the respective successors and assigns of the interests of Producer and its Affiliates in and to the Dedicated Area, Dedicated Leases, Dedicated Wells, and the Dedicated Gas."