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SELECTED DRAFTING ISSUES IN MIDSTREAM CONTRACTS

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TABLE OF CONTENTS

Page

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By Michael Pearson[1]

I. INTRODUCTION

I will share a small secret – or perhaps, it is not a secret at all. As CLE presentations go, "drafting tip" presentations tend to be very practical in their orientation and are, therefore, more enjoyable and less stressful to prepare than, say, a comprehensive conceptual survey of a complex legal issue (I am currently working on one of those for a program later this fall). And so, when the Planning Committee for the Gas and Power Institute invited me to give this presentation, I was pleased to accept.

Fortunately, in recent times, my practice has given me an opportunity to think about the best way to address many different contract drafting issues that have particular applicability to midstream contracts. For purposes of this presentation, four such issues have been selected. Each section of this paper will identify a particular drafting issue, provide as concise a legal analysis of the issue as possible, and conclude with suggested contract language. Except where expressly indicated otherwise, the discussion will focus on Texas law.

II. ACREAGE COMMITMENTS

Many midstream transactions with oil and gas producers that are performed at the wellhead – i.e., gas purchase, gathering, processing, and similar agreements (collectively, "<u>Wellhead Contracts</u>") – are structured so that the gas purchaser, gatherer, or processor (each, a "<u>Midstream Company</u>") 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 capacity on or at the Midstream Company's gathering system or processing plant that the Midstream Company has agreed to make available to the producer. In consideration for this commitment by the Midstream Company, Wellhead Contracts customarily provide for the commitment by the oil and gas producer to the performance of 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 "<u>Acreage Commitment</u>").

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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 (2014).

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 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.

For purposes of clarity, it is important to note that the quoted Acreage Commitment is a purely contractual commitment by the oil and gas producer to deliver to the Midstream Company, for sale, gathering, or processing, gas produced from described leases or lands. It does NOT effect a dedication of the described leases or lands that survives either the expiration or termination of the Wellhead Contract or the underlying oil and gas lease(s) (or any renewals, extensions, or replacements thereof).[3] As such, it differs from the utility-style dedication of leases and lands pursuant to a Federal Power Commission certificate of public convenience and necessity once (but no longer) required under the Natural Gas Act[4] for wellhead sales of gas in the "interstate" market that would survive the expiration of the original gas purchase contract and the underlying leases and continue to burden the land covered thereby until formally abandoned.[5]

Against this background, we will consider two issues with respect to Acreage Commitments:

1) Does the Acreage Commitment in a conventional Wellhead Contract create a covenant running with the land? If so, what actions should a Midstream Company take

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[3] *See, e.g., Northern Natural Gas Co. v. Conoco, Inc.*, 939 S.W.2d 676, 678 (Tex. App.—El Paso 1996), *aff'd*, 986 S.W.2d 603 (Tex. 1998).

[4] 15 U.S.C. § 717, *et seq*. (West 2013).

[5] *See, e.g., California v. Southland Royalty Co.*, 436 U.S. 519 (1978).

to maximize the likelihood that such an Acreage Commitment will be characterized as a covenant running with the land?

2) If the Acreage Commitment in a conventional Wellhead Contract is characterized as a covenant running with the land, what are the consequences of this characterization to the Midstream Company in the event of the producer's bankruptcy?

A. Acreage Commitment as Covenant Running with the Land.

As a general matter, under Texas law, a covenant will be deemed to run with the land when: (i) it touches and concerns the land; (ii) it relates to a thing in existence or specifically binds the parties and their assigns; (iii) the original parties to the covenant intend it to run with the land; and (iv) the successor in interest to the burdened land has notice of the covenant.[6] In addition, the parties must be in privity of estate when the covenant is made.[7] 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.)*,[8] 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.

1. The *Energytec* Case. 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.[9] 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.[10]

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

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6 *Inwood North Homeowners' Ass'n v. Harris*, 736 S.W.2d 632 (Tex. 1987); *Veterans Land Bd. v. Leslie*, 281 S.W.3d 602 (Tex. App. – Eastland 2009), *jdgmt aff'd in part, rev'd in part on other grounds*, 352 S.W.3d 479 (Tex. 2011); *Raman Chandler Properties, L.C. v. Caldwell's Creek Homeowners Ass'n, Inc.*, 178 S.W.3d 384 (Tex. App. – Fort Worth, *pet. denied*).

7 *Lyle v. Jane Guinn Revocable Trust*, 365 S.W.3d 341 (Tex. App. – Houston [1st Dist.] 2010, *no pet.*).

8 739 F.3d 215 (5th Cir. 2013).

9 *Id.* at 217.

10 *Id.*

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.[11] Newco objected to the sale, 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).[12]

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.[13]

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.[14] After stating the tests for a covenant running with the land, [15] listed above in the first paragraph of <u>Section II.A</u>,[16] the court concluded that the tests listed in items (ii), (iii), and (iv) above were satisfied by the language and subject matter of the 1999 Letter Agreement and the associated assignment and bill of sale.[17] 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.[18] 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".[19] The court then concluded that Newco's rights under the 1999 Letter Agreement to receive the transportation fee and to

[11] 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]" subject to certain exceptions.

[12] 739 F.3d at 218.

[13] *Id.*

[14] *Id.* at 226.

[15] *Id.* at 221.

[16] *See* text accompanying notes 6 and 7, *supra*.

[17] *Id.* at 221.

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

[19] *Id.* at 224, citing *El Paso Refinery, 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).

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 the land" test.[20]

The court's privity of estate analysis is more complex. The court first identified two possible categories of privity of estate: (i) "vertical privity" – *i.e.*, privity among the successive owners of the property burdened with the covenant; and (ii) "horizontal privity" – *i.e.*, privity between the original parties to the covenant as owners of mutual or successive interests in the same land.[21] The court then criticized both the doctrine of horizontal privity, noting that it was a minority view that was rejected in the 2000 edition of the Restatement of Property,[22] and a 1997 Texas Court of Appeals decision that appears to have applied the doctrine,[23] 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.[24] 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.[25]

2. Application to Acreage Commitment. Applying the *Energytec* analysis to the Acreage Commitment in a Wellhead Contract, it seems clear that the Acreage Commitment, if properly drafted, satisfies: (i) the "touch and concern" test – the covenant directly affects how and to whom the oil and gas producer's gas production from the dedicated oil and gas leases and lands will be marketed; and (ii) the test requiring the covenant to be binding on the parties and their successors and assigns and to burden a thing in existence – in this case, the described oil and gas leases and lands. The "intent of the parties" test can easily be satisfied by including in the Acreage Commitment specific language characterizing the Acreage Commitment as a covenant running with the land. The test requiring that successors to the burden of the Acreage

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20 739 F.3d at 224-225.

21 *Id.* at 222, citing R. POWELL, POWELL ON REAL PROPERTY § 60.04[3][c][ii]-[iv] (2013).

22 739 F.3d at 222, citing RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 2.4 (2000).

23 739 F.3d at 222, citing *Wayne Harrell Props. v. Pan Am Logistics Ctr., Inc.*, 945 SW.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 transferee's 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*.)

24 739 F.3d at 222.

25 *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.

Commitment (in this case, successors in interest to the oil and gas producer with respect to the dedicated oil and gas leases and lands) have notice of the covenant can be satisfied by placing of record a memorandum of the Wellhead Contract that describes the dedicated oil and gas leases and lands and repeats, or at least refers to the existence of, the Acreage Commitment.

Regarding the issue of privity of estate, vertical privity appears to exist in the case of the Acreage Commitment in a Wellhead Contract in the same way that the Fifth Circuit found it to exist in *Energytec.* The issue of horizontal privity is more difficult. Although Newco's rights under the 1999 Letter Agreement were clearly contractual in nature, they arose in the context of a conveyance involving interests in real property from Mescalero to Producers Pipeline. They were also secured by a mortgage granted by Producers Pipeline to Newco covering the pipeline assets. In the case of a conventional Wellhead Contract, however, no sale of an interest in real property ordinarily occurs; at no point will both the oil and gas producer and the Midstream Company own direct interests in the dedicated oil and gas leases or the underlying gas reserves in place; Wellhead Contracts are not ordinarily executed as part of or to effectuate a conveyance of an interest in real property; and it is certainly not customary for the rights of Midstream Companies to be secured by liens and security interests covering the producer's interests in the dedicated oil and gas leases.

If the characterization of the Acreage Commitment as a covenant running with the land fails because of the inability to satisfy the horizontal privity test, then assuming that a transferee of all or a portion of the interests of the oil and gas producer in the dedicated oil and gas leases does not otherwise have notice of the existence of the relevant Wellhead Contract and its Acreage Commitment, it appears that the transferee would be able to acquire its interests in the dedicated oil and gas leases free and clear of the burden of the Wellhead Contract and its Acreage Commitment.[26] Such a transfer of interests in the burdened oil and gas leases does not, of course, relieve the original oil and gas producer of its obligations under the Wellhead Contract (unless the Wellhead Contract specifically releases the producer from such obligations),[27] and to the extent that gas produced from the dedicated oil and gas leases and lands is ultimately sold to a person other than the Midstream Company, the Midstream Company would still have a cause of action for damages against the original producer.[28]

3. <u>Protecting the Midstream Company's Interests</u>. The Fifth Circuit in *Energytec* seems to have been willing to stretch to find a rationale supporting the characterization of Newco's rights under the 1999 Letter Agreement as covenants running with the land, rather than to permit those rights to fall victim to a strict application of the horizontal privity doctrine. It seems clear, however, that after *Energytec,* an element of doubt about the future of the

[26] *E.g., Wayne Harrell Props. v. Pan Am Logistics Ctr., Inc.,* 945 S.W.2d 216 (Tex. App. – San Antonio 1997, *writ denied*).

[27] *See* text accompanying notes 84 through 112, *infra*.

[28] *See, e.g.,* TEX. BUS. & COM. CODE ANN. §§ 2.210(a), (f) (UCC) (2014) (An assignment of a contract or rights under a contract constitutes an assignment of rights and a delegation of performance of duties; no delegation of performance relieves the party delegating of any duty to perform or liability for breach).

horizontal privity doctrine under Texas law has been introduced. With that in mind, we suggest that Midstream Companies take steps to enhance their position regarding the characterization of the Acreage Commitments in their Wellhead Contracts as covenants running with the land by (a) including additional language in the Acreage Commitments that specifically addresses the individual covenant tests and (b) recording in the public records of the relevant counties or parishes a memorandum of the Wellhead Contract, executed by both the oil and gas producer and the Midstream Company, [29] that contains a legally sufficient description of the oil and gas leases and lands committed to the Wellhead Contract[30] and quotes the Acreage Commitment provision. The following is a suggested provision that addresses these matters:

> The dedication by Producer of the Gas production described in the preceding paragraph to the performance of this Agreement shall be a covenant running with the land with respect to the Dedicated Leases, shall be deemed to convey to Midstream Company interests in property with respect to the Dedicated Leases, and shall be binding upon all of Producer's permitted successors and assigns. To that end, counterparts of a recording memorandum for this Agreement, a form of which is attached hereto as Exhibit B, shall be filed of record in all counties/parishes in which the lands covered by the Dedicated Leases are located. If, at any time during the Contract Term, Producer sells, transfers, conveys, assigns, or otherwise disposes of all or any portion of its interests in the Dedicated Leases, any such sale, transfer, conveyance, assignment, or other disposition shall expressly be made subject to the terms of this Agreement.

Alternatively, such language may provide that the producer may not transfer its interests in the dedicated oil and gas leases without the Midstream Company's consent, unless the transferee expressly agrees to take the transferred interests subject to the terms of the relevant Wellhead Contract and/or to assume and to pay, perform, and discharge the obligations of the producer under the contract.

Even if the Acreage Commitment in a Wellhead Contract is not characterized as a covenant running with the land, following these procedures will place third parties on constructive notice of the existence of the Wellhead Contract and its Acreage Commitment.[31]

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[29] TEX. PROP. CODE ANN. § 12.001(a) (2014) ("An instrument concerning real or personal property may be recorded if it has been acknowledged ..."); TEX. PROP. CODE ANN. § 13.002 (2014) ("An instrument that is properly recorded in the proper county is ... (1) notice to all persons of the existence of the instrument and (2) subject to inspection by the public.").

[30] To be legally sufficient, a description of real property in a deed or other instrument affecting real property must furnish, within itself or by reference to "other existing writing," the means by which the property can be identified with reasonable certainty. *E.g., Broaddus v. Grout*, 258 S.W.2d 308 (Tex. 1953).

[31] *Westland Oil Development Corp. v. Gulf Oil Corp.,* 637 S.W.2d 903, 908 (Tex. 1982) (Regarding references to documents appearing in a chain of title, "a purchaser is bound by every recital, reference and reservation

In most cases, that notice will result in the agreement of potential transferees of the dedicated oil and gas leases to ratify the Wellhead Contract or reach some other accommodation.

B. Wellhead Contracts as Executory Contracts; Bankruptcy Consequences of Covenant Running with the Land.

1. Property of Debtor's Estate. Section 541(a) of the Bankruptcy Code provides that the commencement of a bankruptcy case creates an estate comprised of all property subject to the jurisdiction of the bankruptcy court. Under Section 541(a), with only a few exceptions, the bankruptcy estate consists of all of the debtor's legal and equitable property that existed as of the filing of the bankruptcy petition and is broad in scope.[32] Conventional Wellhead Contracts do not constitute conveyances of interests in real property in the oil and gas leases covered thereby.[33] None of the other exceptions to Section 541(a) that are contained in Section 541(b) or Section 541(c)(2) appear to apply. Accordingly, language that creates a covenant running with the land would not prevent the Wellhead Contract from constituting part of the producer's estate in the event of a bankruptcy.

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contained in or fairly disclosed by any instrument which forms an essential link in the chain of title, under which he claims."); *Loomis v. Cobb*, 159 S.W. 305, 307 (Tex. Civ. App. – El Paso 1913, *writ ref'd*) ("The rationale for the rule is that any description, recital of fact, or reference to other documents puts the purchaser on inquiry, step by step, from one discovery to another and from one instrument to another, until the whole series of title deeds is exhausted and a complete knowledge of all the matters referred to and affecting the estate is obtained.")

32 *See* 11 U.S.C. § 541; *United States v. Whiting Pools, Inc.*, 103 S. Ct. 2309 (1983).

33 To the extent a gas gathering agreement or a gas processing agreement contemplates only the provision of gathering and processing services by the Midstream Company and does not provide for the sale or purchase of gas, such agreements are clearly property of the debtor's estate. In the case of gas purchase agreements, based on the language of Article 2 of the Uniform Commercial Code, it is clear that conventional gas purchase contracts, regardless of whether they contain Acreage Commitments, do not constitute deeds or conveyances to the gas purchaser of direct interests, in the nature of interests in real property, in the oil and gas leases or lands, or the underlying oil and gas reserves, committed and dedicated to the performance of the contract. *See* White, *"Gas Sale Contracts Under the Uniform Commercial Code"*, 47th ANN. INST. ON OIL & GAS LAW & TAXATION 9-1(1996). Section 2.107(1) of the UCC 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) (2014). 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*). *See also Anadarko Petroleum Corp. v. Alaska Petroleum, Inc.*, 2013 U.S. App. LEXIS 16262, at 2 (5th Cir. August 6, 2013); *JN Exploration Production v. Western Gas Resources*, 153 F.3d 906 (8th Cir. 1998).

2. Executory Contract. Section 365 of the Bankruptcy Code[34] provides that the debtor or the bankruptcy trustee may assume or reject any executory contract of the debtor. Subject to the requirements of the Bankruptcy Code, upon the cure of any prior defaults and adequate assurance of future performance, a debtor may assume and assign an executory contract. Alternatively, the debtor can reject an executory contract. 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."[35] Unperformed Wellhead Contracts should constitute executory contracts under the Bankruptcy Code, and accordingly, come under the purview of Section 365.[36] During the bankruptcy process, the debtor or the bankruptcy trustee will generally have the ability to reject such executory contracts, if, in the exercise of business judgment, it is in the best interest of the debtor and its estate.

3. Bankruptcy Treatment of Covenants Running With the Land. In *In re Beeter*,[37] 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 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."[38] 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."[39] 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." If an Acreage Commitment in a Wellhead Contract is characterized as a covenant running with the land, the holding in *Beeter* suggests that such a covenant should not be characterized as executory and, therefore, may not be rejected in bankruptcy.

In *Energytec*,[40] 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

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34 11. U.S.C. § 365.

35 *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).

36 *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).

37 173 B.R. 108 (Bankr. W.D. Tex. 1994).

38 *Id*.

39 *Id*. at 115.

40 *Newco Energy v. Energytec, Inc. (In the Matter of Energytec, Inc.)*, 739 F.2d 215 (5th Cir. 2013).

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.[41] 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."[42] 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.[43] 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.[44] 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.[45]

Subsequent to remand, the parties stipulated to the dismissal of the matter in the bankruptcy court.[46] Since the Fifth 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.

III. GAS PURCHASE CONTRACT AS FORWARD CONTRACT.

In the event of the bankruptcy of an oil and gas producer who is a party to a conventional gas purchase contract, the Bankruptcy Code provides several protections for the gas purchaser if the contract qualifies as a "forward contract" entered into by a "forward contract merchant." In light of the anticipated increase in producer bankruptcies in the current economic environment in the oil and gas industry, the second issues to be considered are:

1) What tests must be met for a conventional gas purchase contract to be characterized as a "forward contract" as defined in Section 101(25) of the Bankruptcy Code?

2) What are the consequences to the gas purchaser of such a characterization?

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41 *Id.* at 221.

42 *Id.* at 225.

43 *Id.*

44 *Id.*

45 *Id.* at 225-226.

46 *See* Stipulation of Dismissal of Contested Matter, *In re Energytech, Inc.,* Case No. 09-41477 (Bankr. E.D. Tex. October 1, 2014) [Docket. No. 792].

A. Qualification as a "Forward Contract".

The Bankruptcy Code defines the term "forward contract" as follows:

> (A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement" as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any similar agreement. (emphasis supplied). [47]

Looking at the quoted definition, courts have noted that, in general terms, "forward contracts" are contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade.[48]

In addition, the Bankruptcy Court defines "forward contract merchant" as follows:

> [A] Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.[49]

In determining whether a particular contract constitutes a "forward contract," some bankruptcy and appellate courts have required a contract to have "financial characteristics" in

[47] 11. U.S.C. § 101(25).

[48] *Superior Livestock Auction, Inc. v. E. Livestock Co., LLC (In re E. Livestock Co., LLC),* No. 10-93904, 2012 Bankr. LEXIS 1469 (Bankr S.D. Ind. Apr. 5, 2012) (holding that contracts for the purchase and sale of cattle for future delivery were forward contracts); *Williams v. Morgan Stanley Capital Grp., Inc. (In re Olympic Natural Gas Co.)*, 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff'd* 294 F.3d 737 (5th Cir. 2002) (holding that contracts for the purchase and sale of a certain, specified quantity of natural gas to be delivered physically at some certain, specified future date constituted forward contracts).

[49] 11. U.S.C. § 101(26).

order to achieve that characterization,[50] while other courts, including the Fifth Circuit, have not considered a contract's financial character.[51]

With respect to the particular characteristics required of a contract for it to constitute a forward contract under the Bankruptcy Code, courts have reached differing results. For example, in *Nagel v. ADM Investor Services, Inc.,*[52] the Seventh Circuit set forth a "totality of the circumstances" analysis, stating that the following factors are indicative of a forward contract: (i) the contract specifies specific terms regarding place of delivery, quantity, or other terms; (ii) the contract is between industry participants, such as farmers and grain merchants; and (iii) delivery cannot be deferred forever.[53] Recently, the Fifth Circuit, in *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs., Inc.),*[54] ruled that a contract that contained no fixed quantity or delivery dates qualified as a forward contract. In addition, the bankruptcy court in *Liquidating LLC v. Brideline Gas Mkgt., LLC (In re Borden Chems. & Plastics Operating Ltd. P'ship),*[55] held that a natural gas supply contract was a forward contract even though it contemplated actual delivery of the gas, and did so based upon the plain language in Section 101(25).

Two Fifth Circuit cases are of particular interest in this regard. In *Olympic Natural Gas Company*,[56] the Fifth Circuit construed a contract for the purchase and sale of natural gas to constitute a "forward contract" between "forward contract merchants." In *Olympic,* Morgan Stanley entered into contracts with Olympic to purchase and sell natural gas. The contracts provided that by the 15th day of the month, Olympic was required to invoice Morgan Stanley for the gas provided, and by the 25th day of the month, Morgan Stanley was to pay the total amount due[57]. An involuntary bankruptcy petition was filed against Olympic, and the bankruptcy trustee brought a suit to avoid transfers made to Morgan Stanley as being preferential and fraudulent. Morgan Stanley asserted that the payments could not be avoided pursuant to Section 546(e) of the Bankruptcy Code, which shelters settlement payments made

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50 *See, e.g., Lachmund v. ADM Investor Services, Inc.,* 191 F.3d 777, 786 (7th Cir. 1999); *Buchwald v. Williams Energy Mktg. & Trading Co. (In re Magnesium Corp. of Am.),* 460 B.R. 360 (Bankr. S.D.N.Y. 2011) (remarking that several courts have considered a contract's financial character). *See also* H.R. Rep. No. 101-484, at 3 (1990) ("The primary purpose of a forward contract is to hedge against possible fluctuations in the price of a commodity. This purpose is financial and risk-shifting in nature, as opposed to the primary purpose of an ordinary commodity contract, which is to arrange for the purchase and sale of the commodity.").

51 *See, e.g., Williams v. Morgan Stanley Capital Group (In re Olympic Natural Gas Co.),* 294 F.3d 737 (5th Cir. 2002); *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs.)*, 690 F.3d 352 (5th Cir. 2012) (rejecting argument that "ordinary supply contracts' cannot qualify as forward contracts under the statute).

52 217 F.3d 436, 441 (7th Cir. 2000).

53 *Id.*

54 690 F. 3d 352 (5th Cir. 2012).

55 336 B.R. 214 (Bankr. D. Del. 2006).

56 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff'd*, 294 F.3d 737 (5th Cir. 2002).

57 258 B.R. at 163.

to a forward contract merchant.[58] The Fifth Circuit concluded that, because the transactions were contracts for the purchase and sale of a certain, specified quantity of natural gas to be delivered at a certain, specified future date, they qualified as forward contracts.[59] Further, because Morgan Stanley's business consisted in whole or in part of entering into forward contracts, the Fifth Circuit found that Morgan Stanley constituted a forward contract merchant. The Fifth Circuit then concluded that the payments made to Morgan Stanley by Olympic constituted settlement payments within the meaning of Section 101(51A) of the Bankruptcy Code because they were payments that could be characterized as "a similar payment commonly used in the forward contracts trade" and were therefore eligible for protection under Section 546(e).[60]

In *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs.)*,[61] the most recent opinion on the issue by the Fifth Circuit, the court examined an agreement in which MBS agreed to purchase from MX the full electric requirements for specified apartment complexes for two years at a set price based on actual usage.[62] After MBS filed a bankruptcy case, the bankruptcy trustee sought to recover payments made to MX as preferential transfers under Section 547 of the Bankruptcy Code.[63] MX argued that avoidance should not be permitted under Section 546(e), but the bankruptcy trustee disagreed, arguing that the contract was not a forward contract because it did not provide for a specific quantity of electricity to be purchased or a specific delivery date, and also that MX did not qualify as a "forward contract merchant."[64] The Fifth Circuit disagreed, noting that if the bankruptcy trustee were correct, many natural gas, fuel, and electricity requirements contracts would be excluded from Section 546(e).[65] Instead, the Fifth Circuit ruled that the statutory text encompassed the type of futures contract arranged between the debtor and MX, and clarified that forward contracts that are in the nature of supply contracts may be protected by Section 546(e).[66]

Based on the foregoing decisions, the gas purchase contracts commonly entered into by Midstream Companies with oil and producers appear to qualify as forward contracts. First, the agreements are contracts for the future purchase of gas from certain oil and gas leases or lands, and ordinarily these contracts are not subject to the rules of a contract market or board of trade.[67] Consistent with *Nagel v. ADM Investor Services,*[68] these contracts contain specific

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58 *Id.* at 164.

59 294 F.3d at 740-741.

60 *Id.* at 742.

61 690 F.3d 352 (5th Cir. 2012).

62 *Id.* at 354.

63 *Id.*

64 *Id.* at 355.

65 *Id.*

66 *Id.* at 356-357.

67 *See In re Olympic Natural Gas Co.,* 258 B.R. 161, 165 (Bankr. S.D. Tex. 2001), *aff'd*, 294 F.3d 737 (5th Cir. 2002).

terms regarding price and quantity (all gas produced, subject to a maximum daily quantity). Most Midstream Companies should be able to show that they are industry participants that, as part of their business, enter into forward contracts. In most cases, Midstream Companies are not end-users of the gas purchased under these contracts. Rather, they resell the gas or the residue gas and the products extracted by processing, or they use the gas for system supply, favorable facts under *Superior Livestock Auction, Inc. v. E. Livestock Co., LLC, (In re E. Livestock Co., LLC).*[69] Delivery occurs on specified dates and is not deferred forever. Finally, settlement of the account under the gas purchase contracts occurs each month, and outside the two-day time period in Section 101(25).

B. Rights/Consequences of Forward Contract Characterization.

1. Settlement Payments. A finding that its gas purchase contracts are forward contracts qualifies a Midstream Company for certain "safe harbor" provisions of the Bankruptcy Code. Among these is the "safe harbor" protection for "settlement payments" afforded by virtue of Section 546(e).[70] Section 546(e) protects the Midstream Company from a bankruptcy trustee's ability to recover and avoid settlement payments as preferential or constructively fraudulent transfers under Sections 544, 547, and 548(a)(1)(B) of the Bankruptcy Code, although it would not shelter a Midstream Company from a suit for recovery of an actually fraudulent transfer under Section 548(a)(1)(A).[71]

Under the Bankruptcy Code, a "settlement payment" is defined as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade."[72] In *Olympic Natural Gas Co.,* the Fifth Circuit decided that the monthly payments paid pursuant to the natural gas sales contract in controversy to settle each month's trading constituted "settlement payments" under Section 101(51A).[73] In reaching its conclusion, the court stated that the term "settlement payment" should be interpreted very broadly," rejecting the trustee's argument that to be exempt from avoidance, a settlement payment must be made on a financial derivative contract and be cleared through a centralized system.[74] Accordingly, in the event of the bankruptcy of

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68 217 F. 3d 436, 441 (7th Cir. 2000).

69 No. 10-93904, 2012 Bankr. LEXIS 1469 (Bankr. S.D. Ind. April 5, 2012).

70 11 U.S.C. § 546(e). *See Williams v. Morgan Stanley Capital Grp., Inc. (In re Olympic Natural Gas Co.)*, 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff'd* 294 F.3d 737 (5th Cir. 2002).

71 *GPR Holdings, L.L.C. v. Duke Energy Trading and Mktg, L.L.C. (In re GPR Holdings),* 316 B.R. 477 (Bankr. N.D. Tex. 2004).

72 *See* 11 U.S.C. § 101(51)(A).

73 *See Olympic Natural Gas Co,* 294 F.3d at 742.

74 *Id.; GPR Holdings, L.L.C. v. Duke Energy Trading and Mktg, L.L.C. (In re GPR Holdings),* 316 B.R. 477 (Bankr. N.D. Tex. 2004) (observing that a "settlement payment' is broadly defined to include any payment commonly used in the forward contract trade.").

the oil and gas producer/seller under a gas purchase contract with a Midstream Company, payments made to the Midstream Company by the producer under the gas purchase contract prior to the bankruptcy filing should be protected from avoidance actions of the bankruptcy trustee.

2. Setoff. In addition, a party to a forward contract may immediately set off or net amounts owed to it in respect of a claim against the debtor for a settlement payment, notwithstanding the imposition of the automatic stay.[75] Section 362(b)(6) of the Bankruptcy Code provides that the automatic stay will not apply to a setoff by a commodity broker or forward contract merchant of any mutual debt and claim under or in connection with any forward contract.[76] A motion for relief from the automatic stay is thus not required, although it otherwise would be required in order to exercise a right to setoff.[77]

3. Liquidation. An final advantage provided by the Bankruptcy Code to parties to a forward contract is that forward contracts are an exception to the "*ipso facto*" clause prohibition. An *ipso facto* clause refers to a contractual provision that allows a party to terminate and liquidate a contract upon the filing of a bankruptcy by a counterparty.[78] The bankruptcy safe harbor provisions allow a non-defaulting party to a forward contract to terminate a contract based upon the counterparty's act of filing a bankruptcy petition. Ordinarily, such contractual right would be unenforceable against a debtor pursuant to Section 365(e)(1) of the Bankruptcy Code. But, Section 556 of the Bankruptcy Code provides as follows:

> The *contractual right* of a commodity broker or *forward contract merchant to cause the liquidation of* a commodity contract, as defined in § 761(4), or *forward contract* because of a condition of the kind specified in § 365(e)(1) of this title and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forwarded contracts, *shall not be stayed, avoided or otherwise limited by operation of any provision of this title* or by the order of a court in any proceeding under this title.[79]

Thus, Section 556 permits a "forward contract merchant" to liquidate a forward contract without court approval if the liquidation is based upon a contractual provision providing for default upon a counterparty becoming a debtor in bankruptcy. If a gas purchase contract is

[75] *See* 11 U.S.C. § 362(b)(6).

[76] *GPR Holdings, L.L.C. v. Duke Energy Trading and Mktg, L.L.C (In re GPR Holdings),* 316 B.R. 477 (Bankr. N.D. Tex. 2004).

[77] *See* 11 U.S.C. § 362(a)(7) (providing that the stay applies to the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor).

[78] *See Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings, Inc.),* 452 B.R. 31, 38 (Bankr. S.D.N.Y. 2011).

[79] 11. U.S.C. § 556 (emphasis added).

thus liquidated as a forward contract upon the bankruptcy of the gas seller, the Midstream Company will have a pre-petition, general unsecured claim for damages in the bankruptcy pursuant to Section 502(g)(2) of the Bankruptcy Code.[80]

C. Drafting Suggestions.

1. Settlement Payments. The invoicing and payment provisions contained in a conventional gas purchase contract should be adequate to provide to a Midstream Company the "safe harbor" protection for settlement payments by virtue of Section 546(e) of the Bankruptcy Code.[81] Because of the routine nature of these provisions, we will not include a sample of such a provision here.

2. Setoff. Most invoicing and payment provisions in gas purchase contracts contain language that, on a monthly basis, permits amounts owed by the seller to the buyer and by the buyer to the seller to be aggregated and netted, so that only one net payment is due under the contract each month. Particularly if there are multiple contracts between the same parties involved in a midstream transaction – a gas purchase contract or a gas gathering agreement and a gas processing contract, for example –, however, it may be appropriate to include in the transaction agreements a provision for contractual setoff that reads as follows:

> Each Party reserves to itself all rights, setoffs, counterclaims, and other remedies and defenses that such Party has or may be entitled to arising from or out of this Agreement. Upon the occurrence of a Default, all outstanding transactions between the Parties and the obligations to make payment in connection therewith, whether arising under this Agreement, the [Gas Gathering Agreement], or other agreement between the Parties, may be offset against each other, set off, or recouped therefrom upon notice to the defaulting Party detailing the amounts set off and the obligations for which such setoff has occurred.

3. Liquidation. To assure that a gas purchase contract characterized as a forward contract may take advantage of the exception under Section 556 of the Bankruptcy Code to the "ipso facto" clause prohibition set forth in Section 365(e)(i) thereof, the contract should, obviously, contain an "ipso facto" clause. A typical "ipso facto" clause provides as follows:

> If either Party shall (a) make an assignment or any general arrangement for the benefit of creditors; (b) fail to make, when

[80] 11 U.S.C. §§ 502(g)(2) ("A claim for damages calculated in accordance with Section 562 shall be allowed . . . or disallowed . . . as if such claim had arisen before the date of the filing of the petition."), and 562(a) (Damages from the rejection or termination of a "swap agreement, . . . forward contract, . . . or master netting agreement shall be measured from the earlier of (1) the date of such rejection or (2) the date or dates of such liquidation, termination, or acceleration.") *See, e.g., Conway Hosp., Inc. v. Lehman Bros. Holdings, Inc.*, 531 B.R. 339 (S.D.N.Y. 2015).

[81] 11 U.S.C. § 546(e).

> due, any payment required herein (which failure is not cured within five (5) Days after the defaulting Party's receipt of written notice thereof); (c) otherwise fail to perform any covenant herein when such performance is due (which failure is not excused by Force Majeure or remedied within sixty (60) Days after the defaulting Party's receipt of written notice thereof); (d) file a petition or otherwise commence, authorize, or acquiesce in the commencement of a proceeding or cause under any bankruptcy or similar Law for the protection of creditors or have such petition filed or proceeding commenced against it; (e) otherwise become bankrupt or insolvent (however evidenced); (f) be unable to pay its debts as they fall due; or (g) fail to give adequate assurance as provided under Section [x] of its ability to perform its obligations under this Agreement within forty-eight (48) hours of a reasonable request by the non-defaulting Party (each, a "Default"), then in addition to any and all other remedies available hereunder, at law, and in equity, the non-defaulting Party shall have the right to terminate this Agreement and/or any or all transactions hereunder, (1) immediately and without notice in the case of a Default described in clause (a), clause (d), clause (e), or clause (f), or (2) upon the expiration of the applicable cure period in the case of a Default described in clause (b), clause (c), or clause (g).

The Bankruptcy Code does not specify the elements for a liquidation provision in a gas purchase contract characterized as a forward contract that will pass muster under Section 556, nor does it even require such a gas purchase contract to contain a procedure spelling how the liquidation value of the contract will be calculated.[82] Nevertheless, our firm's bankruptcy practice group believes that it is a "best practice" for all contracts that are likely to be characterized as forward contracts to contain a liquidation provision. The following is a familiar example of such a provision:

> 10.3.1. As of the Early Termination Date, the Non-Defaulting Party shall determine, in good faith and in a commercially reasonable manner, (i) the amount owed (whether or not then due) by each Party with respect to all Gas delivered and received between the Parties under Terminated Transactions on and before the Early Termination Date and all other applicable charges relating to such deliveries and receipts, for which payment has not yet been made by the Party that owes such payment under this Contract and (ii)

[82] For a discussion of the enforceability of different contract methodologies for conducting the liquidation of a swap agreement, *see Michigan State Housing Development Authority v. Lehman Bros. Derivative Products (In re Lehman Brothers Holdings)*, 2013 Bankr. LEXIS 5317 (Bankr. S.D.N.Y. Dec. 19, 2013).

the Market Value, as defined below, of each Terminated Transaction. The Non-Defaulting Party shall (x) liquidate and accelerate each Terminated Transaction at its Market Value, so that each amount equal to the difference between such Market Value and the Contract Value, as defined below, of such Terminated Transaction(s) shall be due to Buyer under the Terminated Transaction(s) if such Market Value exceeds the Contract Value and to Seller if the opposite is the case; and (y) where appropriate, discount each amount then due under clause (x) above to present value in a commercially reasonable manner as of the Early Termination Date (to take account of the period between the date of liquidation and the date on which such amount would have otherwise been due pursuant to the relevant Terminated Transactions).

For purposes of this Section 10.3.1, "Contract Value" means the amount of Gas remaining to be delivered or purchased under a transaction, multiplied by the Contract Price; and "Market Value" means the amount of Gas remaining to be delivered or purchased under a transaction, multiplied by the market price for a similar transaction at the Delivery Point determined by the Non-Defaulting Party in a commercially reasonable manner. To ascertain the Market Value, the Non-Defaulting Party may consider, among other valuations, any or all of the settlement prices of NYMEX Gas futures contracts, quotations from leading dealers in energy swap contracts or physical gas trading markets, similar sales or purchases, and any other bona fide third-party offers, all adjusted for the length of the term and differences in transportation costs. A Party shall not be required to enter into a replacement transaction(s) in order to determine the Market Value. Any extension(s) of the term of a transaction to which the Parties are not bound as of the Early Termination Date (including but not limited to "evergreen provisions") shall not be considered in determining Contract Values and Market Values. For the avoidance of doubt, any option pursuant to which one Party has the right to extend the term of a transaction shall be considered in determining Contract Values and Market Values. The rate of interest used in calculating net present value shall be determined by the Non-Defaulting Party in a commercially reasonable manner.[83]

[83] North American Energy Standards Board, *Base Contract for Purchase and Sale of Natural Gas*, NAESB Standard 6.3.1 (September 5, 2006).

IV. CONTINUING LIABILITY OF THE ASSIGNOR OF A CONTRACT

When a producer and a Midstream Company enter into a contract with a counterparty, in most cases, there are at least some negotiations regarding the "assignment" clause – i.e., the contract provision that ordinarily sets out any agreed upon restrictions on the transferability of the rights and interests of the parties to the contract. In many cases, however, the parties pay little attention to the delegation of the assigning party's obligations and responsibilities under the contract, much less the continuing liability of the assigning party for such obligations and responsibilities after the assignment. The latter circumstance often produces unexpected consequences for the assigning party.

Section IV of this paper will, therefore, consider the nature and extent of the continuing liability under a contract of a party that assigns its rights and interests under the contract.

A. Assignment and Delegation of Contract Rights and Duties.

1. General Rule. The general rule of law applicable to this issue appears to be the blackest of black-letter law. Contractual rights may be assigned unless the assignment would materially change the duty of the obligor, is prohibited by statute, or is validly prevented by the terms of the contract. In like manner, contractual obligations may be delegated unless prevented by the terms of the contract, but neither such a delegation of obligations nor the assumption of such obligations by the transferee will relieve the assigning party of continuing liability for the delegated obligations absent a release of the assigning party from such continuing liability by the party to whom the obligations are owed.[84] To use a simple example, a lessee of real property is not relieved of liability on his covenant to pay rent by an assignment of the lessee's rights under the lease unless the lessor expressly releases the lessee from such obligation.[85]

An early Texas case applying these principles in an oil and gas contract is *Western Oil Sales Corporation v. Bliss & Wetherbee*.[86] In that case, an oil and gas producer contracted to sell crude oil produced from certain oil and gas leases to a crude oil purchaser at an agreed upon price for a six-month term. The crude oil purchaser ("Purchaser 1") subsequently assigned the contract to a second purchaser ("Purchaser 2"), which assumed all of Purchaser 1's obligations under the contract. Thereafter, Purchaser 1 notified the producer of the assignment, instructed the producer to look to Purchaser 2 for future payments under the contract, and "disclaimed and renounced" all liability for future performance under the contract.[87] Purchaser 2 also notified the producer of the assignment and demanded that the

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[84] RESTATEMENT (SECOND) OF CONTRACTS §§ 317(2), 318(3). For a statutory example of this rule, *see* TEX. BUS. & COM. CODE ANN. § 2.210(a) (UCC) (2014) ("No delegation of performance relieves the party delegating of any duty to perform or any liability for breach."). *See* Phillip R. Clark, 41st ANN. INST. ON OIL & GAS LAW & TAX'N § 502[1] at 5.3 (1990).

[85] *E.g., Cauble v. Hanson*, 249 S.W. 175 (Tex. Comm'n App. 1923, *jdgmt adopted*).

[86] 299 S.W. 637 (Tex. Comm'n App. 1927, *jdgmt aff'd*).

[87] *Id*.

producer continue to make deliveries of oil under the contract to Purchaser 2, which the producer refused to do unless Purchaser 1 recognized its continuing liability under the contract. The producer treated the contract as terminated and later sold its interests in the underlying oil and gas leases to a second producer ("Producer 2"), which filed suit to recover damages against Purchaser 1 based on its alleged repudiation of the contract.[88]

The Texas Commission of Appeals affirmed the judgments of the district court and the court of civil appeals in favor of Producer 2, holding that Purchaser 1 had committed an anticipatory breach of the contract entitling Producer 2 to damages. In so holding., the commission of appeals stated:

> When a contract is assignable, a party may assign the benefits of his contract to another, and delegate to his assignee the performance of his obligations under the contract; but he remains liable for the proper performance of those obligations, unless the other party to the contract consents for the assignment to have the effect of releasing him."[89]

The court also stated that the presence of "successors and assigns" language in the contract was not sufficient to release Purchaser 1 from its continuing liability.[90]

2. *Seagull* and Subsequent Cases. The leading modern case on this issue in the oil and gas context is *Seagull Energy E&P, Inc. v. Eland Energy, Inc.*,[91] a 2006 Texas Supreme Court decision that produced great consternation among upstream oil and gas acquisition/disposition lawyers. In *Seagull*, a non-operating working interest owner ("Non-Operator 1") sold its interest in an oil and gas lease, including its rights and interests under the governing joint operating agreement, to another oil and gas producer ("Non-Operator 2"). Thereafter, Non-Operator 2 failed to reimburse the operator (the "Operator") of the lease for operating expenses incurred after the lease and contract assignment to Non-Operator 2. The Operator made demand for such expenses on Non-Operator 1, but Non-Operator 1 refused to pay. The Operator then filed suit against Non-Operator 1 and Non-Operator 2.[92]

The joint operating agreement contained a number of provisions that defined the obligations of the non-operators to pay the costs and expenses of joint operations by reference to the non-operators' ownership interests – defined as "Participating Interests" –in the contract area. Non-Operator 1 argued that, under the terms of the joint operating agreement, it was obligated to reimburse the Operator for operating expenses only so long as it owned a

88 *Id*. at 638.

89 *Id*.

90 *Id*.

91 207 S.W.3d 342 (Tex. 2006).

92 *Id*. at 344.

Participating Interest in the contract area, so that its assignment of the lease and the joint operating agreement to Non-Operator 2 was effective to release Non-Operator 1 from any continuing obligation to the Operator for future costs.[93] The district court rejected Non-Operator 1's argument and entered judgment in favor of the Operator, but the court of appeals reversed.[94] The Texas Supreme Court, however, reversed the judgment of the court of appeals and held that Non-Operator 1 remained liable to the Operator for the payment of post-assignment operating expenses.[95]

The supreme court reiterated the general rule of continuing liability for assignors of a contract, stating:

> ... [A]s a general rule, a party who assigns its contractual rights and duties to a third party remains liable unless expressly or impliedly released by the other party to the contract.[96]

The court then concluded that neither the provisions of the joint operating agreement obligating the owners of Participating Interests to pay the costs and expenses of operations on the contract area, nor the "successors and assigns" language in the assignment clause in such agreement, address the consequences of an assignment of the joint operating agreement or evidence an intent that an assigning party be released from continuing liability.[97]

The court continued, stating that, "[e]ven when the contract does not expressly provide for the consequences resulting from the assignment of one's interest, the contract's subject or other circumstances may indicate that obligations were not intended to survive assignment."[98] To illustrate the point, the court used an example from the Restatement of Property, in which it is suggested that a promise to maintain a dam on one's property to provide a certain level of water for his downhill neighbor would cease upon the conveyance of the land.[99] After noting that Non-Operator 1 did not base its arguments on the subject matter or circumstances of the joint operating agreement, the court noted that:

> Even if it were to argue this, it is not apparent why [Non-Operator 1] would not have been able to fulfill its obligations under the

93 *Id*. at 345-346.

94 *Id*. at 344.

95 *Id*. at 347

96 *Id*.

97 *Id*. at 346.

98 *Id*. at 347.

99 *Id*., citing RESTATEMENT OF PROPERTY: SERVITUDES § 538, Comment a.

> operating agreement even after the transfer of its interest in the underlying lease.[100]

A similar result was reached in *GOM Shelf, LLC v. Sun Operating Limited Partnership*.[101] In that case, the operator of a federal oil and gas lease covering lands located on the Outer Continental Shelf ("OCS") in the Gulf of Mexico sought to recover from prior owners of record title interests in the OCS lease the share of well plugging and abandonment costs owed by the current non-operator (the successor interest to such prior owners) who defaulted on its obligation to pay such costs.[102] The governing joint operating agreement provided that an assignment by a party of all or a part of its rights and interests under the operating agreement would not relieve the assignor of responsibilities or liabilities that "accrued" prior to the execution, delivery, and approval of the assignment, but that the assignor would be relieved "of all obligations hereunder which accrue subsequent to" the assignment.[103]

The federal district court held that, under then-effective federal regulations,[104] the obligation of the prior owners to pay plugging and abandonment costs "accrued" before they assigned their interests in the affected OCS lease, with result that the prior owners remained liable for such costs by operation of the express terms of the joint operating agreement.[105] Applying the principles of *Seagull*, the court continued, however, by stating that, even if the obligation to pay abandonment costs did not accrue until the operator actually incurred the costs of such operations, which occurred after the prior owners had assigned their interests in the affected OCS lease, the language of the joint operating agreement did not contain an express release of liability and, therefore, was not effective to release the prior owners from continuing liability for such obligations.[106] As was the case in *Seagull*, the district court also failed to identify anything about the contract's "subject or other circumstances" that indicated that the prior owners' obligations "were not intended to survive assignment."[107]

B. Bankruptcy Considerations.

Assume that: (i) the counterparty to a contract ("Counterparty") with a Midstream Company assigns its rights and interests under the contract to another person ("Assignee"); (ii) the contract does not contain language effective to release Counterparty from continuing

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[100] 207 S.W.3d at 347.

[101] 2008 WL 901482 (S.D. Tex. 2008) (not released for publication).

[102] *Id*. at 4.

[103] *Id*. at 6-7.

[104] *Id*. at 7, citing 30 C.F.R. § 250.1702, which provides that, "You accrue decommissioning obligations when you … (d) are or become a lessee or the owner of operating rights of a lease on which there is a well that has not been permanently plugged and abandoned according to this subpart, a platform, a lease pipeline, or other facility …"

[105] 2008 WL 901482 at 7.

[106] *Id*.

[107] *Id*. at 8.

liability under the contract upon its assignment to Assignee; and (iii) Assignee subsequently becomes bankrupt and rejects the contract as an executory contract under Section 365 of the Bankruptcy Code.[108] Does Assignee's bankruptcy affect or impair any rights the Midstream Company may have to pursue Counterparty for Assignee's breach of the contract (i.e., its rejection) based on Counterparty's continuing liability thereunder?

As a general matter, the commencement of a case in bankruptcy by or against a debtor does not prevent another party from pursuing other entities for liability, including sureties, guarantors, co-obligors, or others.[109] There are exceptions to every rule, of course, and the bankruptcy courts in different federal circuits have prevented litigation against a co-obligor of the debtor from going forward on a number of grounds: (i) in the Second Circuit, if the bankruptcy court determines that the co-obligor's participation was essential to the debtor's reorganization efforts;[110] (ii) in the Third Circuit, if the bankruptcy court determines the presence of "unusual circumstances", which include (a) a danger of imminent, irreparable harm to the estate or the debtor's ability to reorganize; (b) a reasonable likelihood of a successful reorganization; (c) the balancing of the relevant harm as between the debtor and the creditor who would be restrained weighs in favor of the injunction; and (d) consideration of the public interest, including a balancing of the public interest in successful bankruptcy reorganizations with other competing societal interests;[111] and (iii) in the Fifth Circuit, if the bankruptcy court determines the presence of "unusual circumstances", which exist when (a) there exists such an identity between the debtor and the non-debtor co-obligor that the suit against the non-debtor is essentially a suit against the debtor, or (b) litigation against the non-debtor co-obligor will have an adverse impact on the debtor's ability to accomplish reorganization.[112]

In the hypothetical posed above, we have not posited any facts that suggest the presence of the kinds of "unusual circumstances" based on which bankruptcy courts have enjoined suits against co-obligors of a debtor. As such, the bankruptcy of Assignee should not prevent the Midstream Company from pursuing Counterparty as Assignee's co-obligor under the rejected contract based on Counterparty's continuing liability thereunder.

C. Drafting Suggestions.

The lesson of *Seagull* and the related cases is that the parties to a contract should be careful to address specifically the consequences of an assignment of the contract with respect to liability under the contract after the assignment. The following sample assignment clause releases the party that assigns its rights and interests from continuing liability under the contract after the assignment:

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[108] 11 U.S.C. § 365.

[109] *E.g., Queenie Ltd. v. Nygard International*, 321 F.3d 282, 287 (2d Cir. 2003).

[110] *See, .e.g., In re Lazarus Burman Associates*, 161 B.R. 891, 899-900 (Bankr. E.D.N.Y. 1993).

[111] *Union Trust Phila., LLC v. Singer Equip. Co. (In re Union Trust Phila.)*, 465 B.R. 765, 771 (Bankr. E.D. Penn. 2011).

[112] *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 761 (5th Cir. 1995).

> Neither Seller nor Buyer shall assign this Agreement, except to an Affiliate of the assigning Party (whether by direct assignment, transfer of equity, merger, reorganization, or consolidation), without the prior written consent of the non-assigning Party, which consent shall not be unreasonably withheld, delayed, or conditioned. Any such assignment of rights shall provide for the assumption by the transferee of the obligations of the assigning Party under this Agreement. No assignment of any rights hereunder shall relieve the assigning Party of any obligations or responsibilities hereunder that accrued prior to the assignment. Upon the assumption by such a transferee of the obligations of the assigning Party under this Agreement, such transferee shall become primarily liable for all such obligations that accrue on and after the effective date of the assignment, and the non-assigning party shall be deemed to have released and discharged the assigning Party from all liability for the performance of all such post-assignment obligations and responsibilities. Subject to the foregoing, this Agreement shall be binding upon and inure to the benefit of the Parties and their respective successors and assigns.

The following sample assignment clause does <u>not</u> release the assigning party from such continuing liability:

> Neither Seller nor Buyer shall assign this Agreement, except to an Affiliate of the assigning Party (whether by direct assignment, transfer of equity, merger, reorganization, or consolidation), without the prior written consent of the non-assigning Party, which consent shall not be unreasonably withheld, delayed, or conditioned. Any such assignment of rights shall provide for the assumption by the transferee of the obligations of the assigning Party under this Agreement. No assignment of any rights hereunder shall relieve the assigning Party of any obligations or responsibilities hereunder, whether accruing before, on, or after the effective date of the assignment. Upon the assumption by such a transferee of the obligations of the assigning Party under this Agreement, such transferee shall become primarily liable for all such obligations assumed. Notwithstanding any such assumption, however, if such a transferee fails to perform any of the obligations thus assumed, the assigning Party shall remain liable for the performance thereof. Subject to the foregoing, this Agreement shall be binding upon and inure to the benefit of the Parties and their respective successors and assigns.

V. AVOIDING QUITCLAIM CHARACTERIZATION OF CONVEYANCES

Particularly in the context of an acquisition of oil and gas assets, it has been common, over the years, for sellers to convey to buyers the real property assets involved in the transaction – whether oil and gas leases, easements, rights-of-way, surface leases, fee interests, or the like – pursuant to an instrument conveying "all of Seller's rights, titles, and interests in, to, under, or derived from ..." the described assets. A possible unintended consequence of using this form of conveyance is that the Texas courts, at least, may characterize the conveyance as a quitclaim deed.

Section V of this paper will consider, then, the following questions.

1) Does the quoted grant create a quitclaim under Texas Law?

2) If so, what are the legal characteristics of a quitclaim?

A. Quitclaims – Definition and Historical Precedents.

A quitclaim deed is a deed of conveyance intended to pass the title, interest, or claim of the grantor, but not professing that such title is valid, or containing any warranty or covenant for title.[113] Further, a quitclaim deed is one that does not purport to convey the land in its entirety or a specific interest therein, but rather only the grantor's right, title, and interest in it.[114] In Texas, a quitclaim effectively conveys whatever right, title or interest the grantor owns.

Section 13.001(a) of the Texas Property Code provides that "[A] conveyance of real property . . . is void as to a creditor or to a subsequent purchaser for a valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed for record as required by law."[115] At common law, a "bona fide purchaser" is one who, in good faith, pays valuable consideration without actual, constructive, or inquiry notice of an adverse claim.[116] The principal legal consequence of characterizing a conveyance as a quitclaim is that the grantee under a quitclaim cannot qualify as a bona fide purchaser for a valuable consideration without notice under either the Texas recording statute or the common law bona fide purchaser doctrine.[117] The reasoning underlying this treatment of quitclaims is that the

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113 *Rogers v. Ricane Enterprises., Inc*., 884 S.W.2d 763, 769 (Tex. 1994) (citing BLACK'S LAW DICTIONARY 1126) (5th ed. 1979); *Porter v. Wilson*, 389 S.W.2d 650, 655-56 (Tex. 1965); *Cook v. Smith*, 174 S.W. 1094 (Tex. 1915)).

114 See *Rogers v. Ricane Enterprises, Inc.*, 884 S.W.2d at 763, 769 (Tex. 1994); *see also Richardson v. Levi*, 3 S.W. 444 (Tex. 1887).

115 TEX. PROP. CODE ANN. § 13.001(a) (2014). An unrecorded instrument is "binding on a party to the instrument, on the party's heirs, and on a subsequent purchaser who does not pay a valuable consideration or who has notice of the instrument." TEX. PROP. CODE ANN. § 13.001(b) (2014).

116 *Sparks v. Taylor*, 99 Tex. 411, 90 S.W. 485 (1906).

117 *Threadgill v. Bickerstaff*, 29 S.W. 757 (Tex. 1895); *Richardson v. Levi*, 3 S.W. 444, 447-48 (Tex. 1887); *Rodgers v. Burchard*, 34 Tex. 442 (Tex. 1870-71).

fact that a quitclaim is used, in and of itself, is evidence of the doubtful nature of the title.[118] As a result, although a quitclaim is effective to convey whatever interest the grantor owns in the described land,[119] the interest received by the grantee will be subject to the claims (if any) of persons under unrecorded instruments and other outstanding equitable interests in existence at the time of the quitclaim, regardless of whether the grantee had notice.[120] Moreover, not only is the grantee under a quitclaim not entitled to the status of a bona fide purchaser, the subsequent purchasers in his claim of title are likewise not entitled to such status with respect to unknown and unrecorded rights and interests existing at the time of the quitclaim.[121] As a result, no title that is dependent on a quitclaim as a link in the chain of title can be marketable title, because it is subject to being defeated at any time by an unknown claimant.[122]

Given the draconian consequences of a conveyance's characterization as a quitclaim, the Texas courts historically appear to have found the existence of quitclaims in only the clearest of circumstances, based on the premise that if the language in a deed, taken as a whole, reasonably demonstrates the intent to convey particular rights or interests in land, the deed will be characterized as a true conveyance of those rights or interests, and not a quitclaim, notwithstanding the presence in the deed of traditional "all right, title, and interest" language or even the word "quitclaim."[123].

The leading decision in this line of cases is *Bryan v. Thomas*.[124] In *Bryan*, the granting clause in the deed in controversy provided that "grantors have granted, sold, conveyed, assigned and delivered and by these presents do grant, sell, convey, assign, and deliver unto the said grantee *all of our undivided interest* in and to all of the oil, gas and other minerals in and under that may be produced from the following described land situated in Hunt County, Texas…." (emphasis added).[125] The deed contained a general warranty of title, but the exact language was unstated in the case. The Texas Supreme Court held that the deed was not a quitclaim, stating unequivocally that, "To remove the question from speculation and doubt, we now hold that the grantee in a deed which purports to convey all of the grantor's undivided interest in a particular tract of land, if otherwise entitled, will be accorded the protection of the bona fide purchaser."[126]

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118 *Richardson v. Levi*, 3 S.W. 444 (Tex. 1887).

119 *Harrison Oil Co. v. Sherman*, 66 S.W.2d 701, 705 (Tex. Civ. App. – Beaumont 1933, *writ ref'd*).

120 *E.g., Woodward v. Ortiz*, 237 S.W.2d 286, 291-92 (Tex. 1951).

121 *Houston Oil Co. v. Niles*, 255 S.W.2d 604, 609-611 (Tex. Comm'n App. 1923, *holding approved*).

122 *See generally* TEXAS TITLE EXAMINATION STANDARDS, TEX. PROP. CODE ANN. Title 2, Standard 4.90, Comment.

123 *E.g., Benton Land Co. v. Jopling*, 300 S.W. 28 (Tex. Comm'n App. 1928, *jdgmt adopted*); *Cook v. Smith*, 174 S.W. 1094 (Tex. 1915).

124 365 S.W.2d 628 (Tex. 1963).

125 *Id.* at 631.

126 *Id.*

B. Recent Decisions.

Two more recent Texas Supreme Court decisions were less reluctant than the *Bryan* court to find the existence of a quitclaim. In *Rogers v. Ricane Enterprises, Inc.*,[127] the court construed an assignment of oil and gas leases that contained the following granting clause:

> "…[Grantor] granted, conveyed, sold, assigned, and transferred to [Grantee] *all of the right, title and interest*…as conveyed to him by Assignments of record including conveyance of all of his right, title, and interest…in the base lease…insofar as said lease covers the…329.3 acres…subject to the exceptions, reservations and provisions…stated, but all without warranty of any kind, either expressed or implied." (emphasis added).[128]

The Texas Supreme Court held that the assignment constituted a quitclaim, concluding that it met the definition of "quitclaim" in Black's Law Dictionary.[129] The court did not address whether the characterization of the assignment as a quitclaim deprived the assignee of the status of a bona fide purchaser.

Similarly, in *Geodyne Energy Income Production Partnership I-E v. Newton Corp*.,[130] the Texas Supreme Court construed another assignment of oil and gas leases that, without anywhere in the document stating the type or quantum of interest being conveyed, granted:

> "…*all of Geodyne's right, title and interest* in the described lease AS IS, AND WHERE IS, WITHOUT WARRANTY OF MERCHANTABILITY, provided that this Assignment hereby conveys to Assignee…*all of Assignor's right, title and interest*…in and to the Property…WITHOUT WARRANTY OF TITLE, EITHER EXPRESS OR IMPLIED." (emphasis added).[131]

The court held this to be a quitclaim deed as a matter of law, reasoning that after looking at the language of the instrument as a whole, the assignment conveyed merely the grantor's rights and not the property itself.[132]

Most recently, in *Enerlex, Inc. v. Amerada Hess, Inc.*,[133] the Eastland Court of Appeals construed a mineral deed that purported to convey to the grantee:

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[127] 884 S.W.2d 763 (Tex. 1994).

[128] *Id.* at 769.

[129] *Id.*

[130] 161 S.W.3d 482 (Tex. 2005).

[131] *Id.* at 487.

[132] *Id.* at 486.

> "*all right, title and interest* in and to all of the Oil, Gas, and any other classification of valuable substance, including any mineral leasehold and royalty interests…in and under that may be produced from the following described lands situated in Gaines County, State of Texas…. (emphasis added). It is the intent of the Grantor to convey all interest in the said county whether or not the sections or surveys are specifically described herein."[134]

The deed also contained a general warranty of title. In an opinion that generated much consternation among upstream oil and gas title attorneys, the court held that the mineral deed constituted a quitclaim, citing primarily *Rodgers* and *Geodyne*.[135] According to the court, neither the deed nor any of its attachments quantified the interest conveyed and, instead, "conveyed the interest broadly."[136] Since the deed contained no statement or representation of the interest conveyed, the court concluded that the general warranty of title did not prevent the deed from being a quitclaim. Finally, since the deed was characterized as a quitclaim, the court held that the grantee could not be a bona fide purchaser.[137]

The absence of warranties of title in *Rogers* and *Geodyne* provides at least a basis for distinguishing their results from the holding in *Bryan*. *Enerlex*, on the other hand, appears to be in direct conflict with *Bryan*, notwithstanding some differences in the granting clauses ("all right, title and interest" v. "all of our undivided interests") that at least this author views as immaterial. Interestingly, the opinion of the court of appeals in *Enerlex* does not even mention *Bryan*, which has not been formally distinguished in any other case discovered by our research or overruled by any subsequent decision of the Texas Supreme Court.

C. Drafting Suggestion.

Unlike conveyances of oil and gas leases in upstream transactions, conveyances of easements, rights-of-way, surface leases, and the like in midstream transactions rarely involve assets owned in undivided interests. Consequently, the difficulties associated with conveying specific undivided interests in oil and gas leases ordinarily are not present in a conveyance of surface rights. For that reason, we recommend that midstream buyers avoid the quagmire of the quitclaim cases by eschewing the "all right, title, and interest" approach, and employing the following approach, to conveyances of surface rights:

> "Grantor grants, bargains, sells, conveys, and assigns to Grantee … the easements, rights-of-way, servitudes, surface leases, fee

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133 302 S.W.3d 351 (Tex. App.-Eastland 2009, *no writ*).

134 *Id.* at 354.

135 *Id.* at 355.

136 *Id.*

137 *Id.*

> surface interests in land, surface use agreements, licenses, franchises, road, railroad, and other surface use permits and agreements, and other rights and interests in real property described more particularly in Exhibit A …"

VI. CONCLUSION

As can be seen from the foregoing discussion, sometimes lack of attention to mundane issues can produce significant unintended consequences. Hopefully, this discussion has provided some insights that will help practitioners avoid the unintended consequences that can flow from the issues discussed in this paper if they are not properly addressed.