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CLIENT ALERT

Key Considerations for Midstream Companies Facing Distressed Producers

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Recent weeks have witnessed seismic shifts in the oil and gas industry because of crashing oil prices, demand destruction associated with the COVID-19 pandemic, and crude oil storage reaching record capacity levels. Upstream producers are especially vulnerable to these market pressures and have begun shutting in wells, asserting *force majeure* and cutting costs. As counterparties to distressed producers, midstream players face new challenges in navigating contractual relationships and mitigating risk. This briefing outlines what midstream companies need to consider in the coming discussions with producers.

Shut-in Considerations: Historically low oil prices and dwindling storage capacity have led producers to start shutting-in wells, which could have considerable impacts on midstream companies.

- Producers do not shut-in wells lightly. These decisions are made based on a number of considerations including operational concerns, potential reservoir damage, and contractual obligations found in gathering agreements, joint operating agreements, credit agreements, and other financial instruments.
- The impact of shut-ins on midstream providers will depend on existing agreements with counterparty producers. Agreements requiring the midstream provider to simply redeliver hydrocarbons at a certain point may be less impacted by market disruptions. However, in agreements requiring the midstream provider to market hydrocarbons downstream or redeliver to third parties, a midstream company may need to consider invoking *force majeure*.

Force Majeure: The current environment has all oil and gas parties reviewing *force majeure* provisions for relief from onerous obligations.

- Whether or not a *force majeure* claim is viable requires fact-specific analysis of current circumstances, contract language, and governing law. Courts generally construe *force majeure* clauses narrowly, and for contracts with governing law of New York or Texas, require the specific event underlying a *force majeure* claim to be expressly described in such provisions (although general catch-all clauses may hold water as well). A *force majeure* claim resulting from COVID-19 is more likely to be available if a contract explicitly lists “diseases,” “epidemics,” “pandemics,” “quarantines,” or “acts of government.”

- If a contract does not include a *force majeure* provision, other provisions of the contract may still provide a party an argument that its performance is excused due to the COVID-19 outbreak. For example, agreements often contain a "Compliance with Laws and Regulations" provision whereby such agreements are "subject to all valid laws, rules, regulations, orders, permits or licenses of any duly constituted federal, state or local authority or regulatory body having jurisdiction." Many jurisdictions across the country have issued guidelines or orders to mitigate the spread COVID-19, including "stay-at-home" orders. Note that certain regulatory authorities deem the oil and gas sector as critical and may exclude the industry from being subject to such orders.
- A *force majeure* clause might not apply if other related (but nevertheless avoidable) factors contributed to a party's nonperformance. For example, if a party decides of its own volition (rather than being specifically required by an order of a governmental authority) to let workers stay home rather than continue operations, its ability to perform would not be prevented due to the pandemic itself, and its failure to perform would not be excused due to *force majeure*. However, if a party's business remains operational but its workers refuse to come into work or strike in response to being expected to work during the coronavirus outbreak, such refusal to work or strike could be classified as a *force majeure* event due to "strikes, lockouts or other industrial disturbances," which may be outside the party's control and are often expressly contemplated in the definition of *force majeure* under midstream commercial agreements.

Evaluating and Responding to a Force Majeure Claim:

- If faced with a customer claiming *force majeure*, ensure that any notice conforms to the relevant provisions of the agreement. Without such provisions, counterparties may attempt to assert *force majeure* with insufficient or vague descriptions of the circumstances rendering such party unable to perform and the impact of such events. When presented with such insufficient notices, the non-*force majeure* party should reply requesting the following information:
  - A full description and all available documentation of the event and circumstances constituting a *force majeure*;
  - A full explanation of why such party's performance is not possible (not simply impracticable or costly);
  - The specific contracts under which such party is claiming *force majeure* with references to the applicable provisions of those contracts;
  - If the counterparty references any governmental orders, an explanation of why the counterparty is not excluded as part of the energy sector;
  - A description of the steps such party is taking or plans to take to mitigate the impact of the *force majeure* event on its performance;
  - The date on which the *force majeure* event began and the anticipated duration; and
  - Regular updates regarding such party's attempt to resume performance under the agreement.
- Each response by the non-*force majeure* party should include a deadline to provide this information and a statement that the *force majeure* notice is not effective until sufficient information has been provided. If the counterparty is unable to provide satisfactory information, the non-*force majeure* party should promptly respond in writing that such non-*force majeure* party does not agree with the *force majeure* characterization and expects the counterparty to continue performance in the ordinary course.
- As an attempt to mitigate the impact of a counterparty claiming *force majeure* on the non-*force majeure* party's business, such non-*force majeure* party might also offer to assist its counterparty in navigating the *force majeure* event to minimize the duration of the *force majeure* event and thus the suspension of its performance under the agreement, including coordinating to assist in reallocating and deploying resources.

Commercial Considerations for Dealing with Distressed Counterparties:

- Proactive Relationship Management: In the present environment, midstream providers should proactively engage in open dialogue with producers to ensure they have the best information on their needs and situation and to carefully review agreements for a clear understanding of the commercial and legal leverage points.

- Requests for Fee Reductions: Producers are almost universally seeking fee reductions from their suppliers and vendors – particularly their midstream providers, as gathering, transportation, processing, marketing, storage, and other midstream costs can be significant. When you receive a request for fee reductions, consider what other contract terms could be improved to mitigate the impact of a fee reduction. Midstream companies often insist on limiting fee reductions to a specific time period, tying the reduction to the price of oil and/or requiring other changes to the agreement such as increased volume commitments, inserting adequate assurance provisions, shoring up dedication language, or extending the term of the agreement. Below are several considerations when fielding requests for fee reductions.
- Negotiating Leverage: The most important consideration at the outset is who has the leverage. In particular, from the midstream perspective, what is the likelihood of a third-party midstream company being able to offer similar or better terms and service based on the contract rates, service level, available capacity, capital flexibility, asset locations, and other key commercial and operational concerns?
  - Capacity: Consider capacity in the area (third-party and any in-house capacity the counterparty may have).
  - Available Alternatives: Determine how close and feasible alternative gathering systems are for the producers, including the cost and timing of connections, the capital available to other potential providers, and the cost of trucking, shut-in, or other interim solutions.
  - Rates: Compare your current rates against the current and expected rates of alternative providers.
  - Impact of Bankruptcy: Understand the potential impacts of bankruptcy on the producer's customers and the associated timeline and whether their agreements may be subject to rejection. Contract terms that would present hurdles to the producer terminating outside of bankruptcy, including liquidated damages, minimum volume commitments (MVCs), conditions on termination rights, and other similar terms are generally less effective deterrents in bankruptcy.
- Options for Midstream Companies*:* Depending on negotiating leverage, certain actions may be taken ahead of potential bankruptcy to strengthen financial and operational certainty.
  - Carrier/Statutory Liens: The ability to obtain liens could provide a secured position to a carrier of a customer's product and if product being transported is owned by the customer and has value. A secured position is always preferable.
  - Adequate Assurance: Contractual entitlements to letters of credit, deposits, or shortened payment timeframes favor midstream service providers with distressed counterparties. Security options provided by a financially sound third party are most preferable as they may be drawn after bankruptcy is filed. Such protections should be obtained as soon as possible to mitigate potential preference claims (lookback period is generally 90 days prior to bankruptcy filing). Also consider including standard ISDA adequate assurance language allowing demands based on "reasonable grounds for insecurity."
  - Dedication/MVC: Agreements should be reviewed to ensure that covenants properly run with the land and can avoid rejection in bankruptcy based on applicable law. With lower production levels, MVCs will be one of the first things that producers seek to eliminate, so consider other contract modifications that mitigate the impact of removing MVCs.
  - Increased Volume: Negotiating fee reductions may also be an opportunity to secure increased volume commitments and similar concessions to better capitalize on the eventual recovery.

Understand your agreements and bargaining position: Midstream agreements with dedications that comprise covenants running with the land may be protected from rejection in bankruptcy. A close look at your agreements will reveal the viability of a customer's threat of potential rejection in bankruptcy.

Dedication as Covenant Running with the Land:

- Gathering agreements deemed executory contracts under Section 365 of the *Bankruptcy Code* may be rejected by a debtor in most circumstances, leaving a counterparty with an unsecured claim against the debtor for prepetition breach of contract damages. Producers commonly use the threat of rejection to renegotiate existing midstream contracts.

- Depending on the terms of gathering agreements, midstream companies may argue that the agreements contain dedications of underlying mineral rights and acreage interests that "run with the land" and as a result are protected from being discharged in bankruptcy or used as leverage by a producer threatening to reject the agreement.
- In order to form a real property covenant that runs with the land, three factors must be satisfied. First, the covenant must touch and concern real property. Second, there must be privity of estate. Third, the original parties to the covenant must have intended to bind successors." *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)* (Bankr. S.D. Tex. Dec. 20, 2019).
- State law governs in satisfying these three factors. As a reference, we can look to the recent *Alta Mesa* opinion by Judge Isgur (interpreting Oklahoma law).
  - Must touch and concern the land: There must be a logical connection between the benefit to be derived from enforcement of the covenant and the property; for example, agreements dedicating all produced hydrocarbons for delivery to the gatherer. Other favorable factors include granting a surface easement to build a gathering system for the dedicated wells (which enhances the value of the leases) and fixed-fee arrangements. Furthermore, covenants requiring recordation and affirmation of subsequent transferees also indicate that gathering agreements touch and concern the land.
  - Privity of estate must exist between the parties: Vertical privity is usually achieved if the parties are the originally contracting entities to the agreements or a successor to the estate of the original person. Horizontal privity (if required) is created in conjunction with a conveyance of an estate in property. For example, this element can be satisfied if a surface easement is granted by the producer to the midstream provider to construct and maintain a gathering system.
  - Intent to bind successors: The original parties to the agreement must have intended for the real property covenant to run with the land. Courts will typically look to the language in the agreement to demonstrate this intent. Agreements that state that the covenant runs with the land or that require that the dedication be recorded will more likely meet the standard. Recording puts subsequent purchasers on notice of real property covenants.

Producer bankruptcies are difficult and complicated, but also frequently provide substantial opportunities for well-positioned midstream providers to incentivize producers to reject other midstream agreements, allowing the well-positioned midstream companies to increase volumes, solidify their positions in the event of subsequent insolvency or sale, and expand their footprint with larger dedications.

The negotiating tips provided here are aimed at assisting entities in the midstream space when facing distressed counterparties. Once counterparties become insolvent, many other considerations arise when forced to navigate a complex bankruptcy process. For additional guidance on such matters we recommend our recent presentation on the topic, available here.

Winston & Strawn's COVID-19 Task Force brings a comprehensive approach to the complex legal and strategic challenges presented by the pandemic. View all of our COVID-19 perspectives here. Contact a member of our COVID-19 Legal Task Force here.

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