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# 8th Circ. Ruling May Provide Relief For Bakken Debtors

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Recently, the COVID-19 pandemic and depressed commodity prices have spurred a wave of bankruptcies throughout the U.S. energy sector. In these cases, parties commonly question whether the debtor must remain bound by its contracts through bankruptcy—especially when those contracts purport to create covenants running with the land. Parties often dispute these alleged covenants because they can significantly affect a reorganization.

Several recent bankruptcy court decisions have addressed this issue in different states and basins, including the Permian and Eagle Ford Basins, applying Texas law; the Uinta Basin, applying Utah law; and the Anadarko Basin, SCOOP and STACK, applying Oklahoma law.

Last month, *Slawson Exploration Co. v. Nine Point Energy LLC*, an opinion from the U.S. Court of Appeals for the Eighth Circuit added the Williston Basin, Bakken, in North Dakota to this list. This guidance is particularly important given recent drilling declines in that region, which are prompting parties to restructure and renegotiate contracts both in and out of court. At the same time, the status of many alleged covenants—in the Bakken and elsewhere—has not yet been definitively resolved, as further discussed below.

## Exploration and Production Contract Covenants and Why It Matters Whether They Run with the Land

Most of the prior bankruptcy court decisions on whether covenants run with the land have involved contracts that include a dedication of oil and gas interests between upstream and midstream companies.

This latest case is different because it involves a second type of alleged covenant, called a promote obligation, which is common in contracts with Bakken producers. These provisions appear in contracts among working interest owners and require parties to contribute additional funds when electing to participate in drilling a well.

Whether an alleged covenant runs with the land is often significant in bankruptcy cases because of a debtor's right to reject certain types of contracts. On their face, gathering agreements and contracts containing promote obligations are typically eligible for rejection, but a debtor cannot reject a covenant running with the land.

Rejection rights, or the lack thereof, can significantly impact the outcome of a reorganization. For example, when a debtor chooses to sell assets, the purchase price may improve if the debtor will be able to reject contracts that the buyer perceives as unfavorable. In contrast, the purchase price may drop when a contract creates a covenant running with the land, precluding the debtor from renegotiating terms or seeking a better deal.

Understanding whether these types of provisions will run with the land is significant outside of bankruptcy as well. Whether an obligation will remain binding in a hypothetical future bankruptcy is an important risk management tool when parties enter into a new deal or renegotiate an existing contract—especially during periods of financial difficulty. For example, if one party seeks pricing concessions, the other side may desire new or revised language to increase the likelihood of a binding covenant running with the land.

## When the Stakes Are High, Parties Often Dispute Whether Alleged Covenants Touch and Concern the Land

Whether a covenant runs with the land is a matter of state law, and many states use relatively similar standards to determine whether a covenant runs with the land. For example, many states require courts to assess whether there is privity of estate and whether the parties intended to create a covenant running with the land.

One requirement that is frequently disputed in the bankruptcy context is whether an alleged covenant touches and concerns the land. Essentially, this involves examining how closely the alleged covenant relates to the underlying real estate interests—in this context, usually either a mineral interest or an oil and gas leasehold.

The "touch and concern" element is ripe for dispute because it is often fact-specific and nuanced. For example, parties defending alleged covenants have cited the impact of a gathering system on the development of oil and gas reserves. As discussed below, courts have reached different results depending on the contract provisions and other facts involved in each dispute.

## *Slawson Exploration v. Nine Point Energy*

Until recently, no court had directly addressed whether promote obligations—which, again, are common among Bakken producers—are covenants running with the land under North Dakota law. Last month, however, the Eighth Circuit ruled that they are not.

In Slawson Exploration v. Nine Point Energy,[1] two parties to an oil and gas exploration and production agreement disputed the status of their promote obligation, which applied to oil and gas leaseholds that either party acquired in a designated area of mutual interest. Under the contract, Slawson was entitled to receive additional payments whenever its counterparty elected to participate in a particular well in that area.[2]

Unlike some other bankruptcy court decisions on alleged covenants, this case arose after the relevant bankruptcy proceedings had concluded. The defendant, Nine Point Energy, had emerged from Chapter 11 proceedings in Delaware.[3] Slawson had filed a proof of claim in that case, seeking payments under the promote obligation.[4] The parties disputed whether the confirmed Chapter 11 plan discharged this obligation.[5]

Slawson's main argument was that the promote obligation survived confirmation because it was a covenant running with the land. But the Eighth Circuit disagreed and ultimately concluded that Slawson's claim had been discharged.[6]

The opinion focused on whether the promote obligation was "made for the direct benefit of the property or some part of it then in existence."[7]

The court concluded that the promote obligation did not meet this requirement because, even if the promote obligation provided some benefit to the property by encouraging the development of oil and gas reserves, its benefit was indirect. Instead, the promote obligation provided more of a personal benefit to Slawson and thus did not run with the land.[8]

## Earlier Bankruptcy Decisions Addressing the Touch-and-Concern Requirement

Prior bankruptcy court decisions have reached differing results on whether alleged covenants touch and concern the associated real property interests.

In *Sabine Oil & Gas Corp. v. HPIP Gonzalez Holdings LLC*, the U.S. Bankruptcy Court for the Southern District of New York determined that a series of contracts, including oil and gas gathering agreements, did not create covenants running with the land under Texas law.[9]

In *Monarch Midstream LLC v. Badlands Production Co.*, the U.S. Bankruptcy Court for the District of Colorado determined that gas gathering and saltwater disposal contracts created covenants running with the land under Utah law.[10]

In *Alta Mesa Holdings LP v. Kingfisher Midstream LLC*, the U.S. Bankruptcy Court for the Southern District of Texas determined that oil and gas gathering agreements created covenants running with the land under Oklahoma law.[11]

Of course, these cases are by no means identical; each arose under a different state's law and involved different facts. But some of the results are difficult to reconcile. For example, one court expressly rejected the argument that a covenant's impact on property value could satisfy the touch-and-concern requirement, while two others reached the opposite conclusion.[12]

While the opinions attempt to justify their differing results,[13] parties navigating energy bankruptcies are still left with a patchwork of nonbinding decisions, which may not provide the clearest guidance in future disputes and transactions.

## Slawson Fills a Gap, Leaves Uncertainty in its Wake

Slawson fills in one more spot on the map of active production regions in the U.S., providing the first piece of guidance to Bakken producers and their counterparties with similar contracts. Moreover, because drilling activity in the Bakken has dropped significantly over the last several months—as much as 80% since January—more bankruptcies can be expected from Bakken producers, and as a result, more promote obligations may be disputed in the future.

At the same time, all the decisions discussed in this article, including Slawson, still leave significant uncertainty for parties to similar contracts. In most bankruptcy cases, these decisions will only be persuasive authority, at best, and they will remain so until the underlying issues are definitively addressed under state law. This lack of clarity creates an opportunity for court disputes. As a result, parties may be faced with the difficult choice to pursue expensive litigation or accept a negotiated resolution that is less than ideal.

Parties negotiating, or renegotiating, contracts in the current distressed market face similar difficulties. Piecemeal, nonbinding decisions can make it difficult to deliberately craft language that will survive a future challenge in bankruptcy court. And particularly when new decisions reject alleged covenants, parties may need to explore different types of negotiating leverage, which can be challenging in a tough environment.

In the meantime, until the law becomes more settled, it is critical for parties to these agreements, in the Bakken and elsewhere, to stay informed on the ever-changing legal landscape around this issue.

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