

A Clear Path To Section 363 Sale Challenges

Law360, New York (February 06, 2014, 2:58 PM ET) -- On Dec. 31, 2013, in *Newco Energy v. Energytec Inc. (In re Energytec Inc.)*,^[1] the Fifth Circuit ruled that certain rights connected to a gas pipeline — in particular, the right to receive a "transportation fee" based on gas throughput and the requirement that the recipient of the transportation fee consent to any assignment of interests in the pipeline — were covenants running with the land under Texas law.

Because a covenant running with the land can survive a sale in bankruptcy and cannot be "rejected" in bankruptcy, the ruling indicates that covenants such as those addressed in the *Energytec* case may survive the bankruptcy of the party bound by them, and may limit the party's ability to sell the relevant assets free and clear of all liens.

Background

Energytec Inc. filed for bankruptcy in 2009, and at the time, held property including a pipeline system acquired from *Producers Pipeline Corp.* This pipeline system, in turn, had been acquired by *Producers* from its original owner pursuant to an agreement requiring that *Producers* pay *Newco Energy Inc.* a transportation fee based on gas throughput and that *Newco* consent to any assignment of *Producers'* interests in the pipeline.

The agreement specified that *Newco's* rights were to "run with the land" and gave *Newco* a security interest and lien on the pipeline system to secure payment of the transportation fee. *Energytec* expressly assumed the obligation to pay the transportation fee when it acquired the pipeline system from *Producers*.

As part of *Energytec's* bankruptcy proceedings, *Energytec* sold a substantial portion of its assets to a third-party buyer in a sale under Section 363 of the Bankruptcy Code, and it requested (with limited exceptions) that the sale be free and clear of any liens, claims or encumbrances, including *Newco's*.

The sale was approved and consummated, but the parties reserved for later determination the issue of whether the sale was in fact free and clear of *Newco's* rights related to the pipeline. *Newco* later moved to resolve the issue, arguing that its rights to the transportation fee and to consent ran with the land and, therefore, that the pipeline could not be sold free and clear of such interests.

The bankruptcy court ruled that *Newco's* interest in the transportation fee was not a covenant running with the land without addressing *Newco's* consent right.^[2] The district court affirmed.^[3]

The Fifth Circuit Analysis

The Fifth Circuit, analyzing on appeal whether Newco's rights were a covenant running with the land, generally accepted the test set forth in *Inwood N. Homeowners' Association Inc. v. Harris*[4] as controlling in Texas.

Accordingly, the Fifth Circuit accepted that "a covenant runs with the land when it (1) touches and concerns the land; (2) relates to a thing in existence or specifically binds the parties and their assigns; (3) is intended by the original parties to run with the land; and (4) when the successor to the burden has notice." [5]

In addition, the Fifth Circuit noted that *Inwood* "referred to a requirement of privity but did not detail it." [6] Concluding that the other elements were met, and after addressing ambiguous Texas case law on the requirements of privity, the Fifth Circuit turned to whether the covenants to Newco "touched and concerned the land."

The Fifth Circuit noted that the Texas Supreme Court had considered several tests in determining whether an agreement to convey interests in oil and gas leases ran with the land in *Westland Oil Development Corp. v. Gulf Oil Corp.* [7] One test assessed whether the applicable covenant "affected the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it." [8] The other considered the covenant's effect on the value of the burdened property:

If the promisor's legal relations in respect to the land in question are lessened — his legal interest as owner rendered less valuable by the promise — the burden of the covenant touches or concerns that land; if the promisee's legal relations in respect to that land are increased — his legal interest as owner rendered more value by the promise — the benefit of the covenant touches or concerns the land. [9]

Applying these tests, the Fifth Circuit found that Newco's rights to a transportation fee and to consent to assignments of interest in the pipeline touched and concerned the land, and therefore constituted covenants running with the land.

It noted that the real property at issue was the gas pipeline system and the rights-of-way required for its placement, and that Newco's transportation fees were for the use of that real property. The Fifth Circuit described the pipeline as a "subsurface road for natural gas," the transportation fee as a fee for the use of such road, and the consent right as a restriction on the use of such road. [10] Each of Newco's rights affected the owner's interest in the pipeline and the value of the pipeline to prospective buyers.

Effect of the Ruling

The categorization of the transportation fee and consent right, and by implication, the categorization of similar fees for the use of and rights concerning oil and gas pipelines, as covenants running with the land can have a significant effect on how such rights are treated in bankruptcy.

First, Section 365(a) of the Bankruptcy Code generally permits a debtor in bankruptcy or its trustee to reject so-called "executory contracts" — contracts "under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." [11]

Many oil and gas contracts can be considered to be executory contracts, such as gas gathering contracts

where a producer is obligated to deliver and pay a processing fee to a gatherer who must collect, treat and process, and deliver the gas.[12]

It is not uncommon in these agreements to dedicate and commit gas to a certain gathering system and to declare such dedication and commitment to be a covenant running with the land. Under the rule set forth in *Energytec*, the agreements may create interests in property that could survive rejection in bankruptcy.[13]

In addition, Section 363 of the Bankruptcy Code permits a trustee or a debtor-in-possession, with approval of the bankruptcy court, to sell assets of the estate. Although some courts have applied additional safeguards, the power to effectuate a Section 363 sale free and clear of interests, including covenants running with the land, is limited by Section 363(f). That subsection sets out five conditions that must be met in order to sell property free and clear.[14]

By categorizing the transportation fee and consent right as a covenant running with the land, the Fifth Circuit held that such rights constitute "interests in property" that can only be shed if the requirements of Section 363(f) are satisfied. Although in *Energytec* the court remanded to the bankruptcy court for consideration of whether one of the five conditions of Section 363(f) was met on the facts of the case, the Fifth Circuit provided a clear path for any holder of similar interests to challenge a proposed Section 363 sale.

Conclusion

By setting forth a framework for evaluating whether a covenant is a covenant that runs with the land, the Fifth Circuit's decision in *Energytec* will permit parties to oil and gas contracts to better assess the risks associated with a counterparty's bankruptcy.

In other words, a party entitled to a transportation fee, consent right, or similar interest can point to *Energytec* to argue that its rights should remain intact notwithstanding a bankruptcy of the obligor under the covenants, and purchasers of oil and gas assets in bankruptcy may be required to take the assets subject to such covenants or to negotiate a fee for the release of them.

—By Michael A. Rosenthal, Robert Little, Chris Babcock and Jeremy Graves, Gibson Dunn & Crutcher LLP

Michael A. Rosenthal is a partner in Gibson Dunn's New York office and co-chairman of the firm's Business Reorganization & Restructuring practice.

Robert Little is a partner and Chris Babcock is an associate attorney in the firm's Dallas office.

Jeremy Graves is an associate attorney in the firm's Denver office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Case No. 12-41162, 2013 U.S. App. LEXIS 25872, 2013 WL 6868618 (5th Cir. Dec. 31, 2013).

[2] *In re Energytec, Inc.*, 2011 Bankr. LEXIS 5530 (Bankr. E.D. Tex. Sept. 2, 2011).

[3] *Newco Energy v. Energytec, Inc. (In re Energytec, Inc)*, 2012 U.S. Dist. LEXIS 141984, 2012 WL 4627028 (E.D. Tex. Sept. 30, 2012).

[4] 736 S.W.2d 632 (Tex. 1987).

[5] *Energytec*, 2013 U.S. App. LEXIS 25872 at *14 (quoting *Inwood*, 736 S.W.2d at 635).

[6] *Id.*

[7] 637 S.W.2d 903 (Tex. 1982).

[8] *Id.* at 911 (quotations omitted).

[9] *Id.*

[10] *Energytec*, 2013 U.S. App. LEXIS 25872 at *24.

[11] *Vern Countryman, Executory Contracts in Bankruptcy*, 57 *Minn. L. Rev.* 439, 460 (1973).

[12] See, e.g., *In re R&C Petroleum, Inc.*, 247 B.R. 203, 205 (Bankr. E.D. Tex 2000) ("R&C was party to an executory contract, a Gas Gathering Agreement . . . by and between R&C and Bayou.").

[13] See, e.g., *Stewart Title Guar. Co. v. Old Republic Nat. Title Ins. Co.*, 83 F.3d 735, 742 (5th Cir. 1996) ("Rather, the executed portions of the contracts remain intact, and property rights acquired under the contracts prior to [rejection are not rejected] despite the trustee's rejection of unperformed obligations of the contracts.") (quotations and citations omitted).

[14] Section 363(f) provides that property may be sold free and clear of interests only if "(1) applicable nonbankruptcy law permits sale of [the applicable] property free and clear of [the] interest; (2) [the holder of the interest] consents; (3) [the] interest is a lien and the price at which [the applicable] property is to be sold is greater than the aggregate value of all liens on [the] property; (4) [the] interest is in bona fide dispute; or (5) [the holder of the interest] could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of [the] interest." 11 U.S.C. § 363(f).

For examples of other, court applied safeguards to sales under Section 363, see *In re Gulf Coast Oil Corporation*, 404 B.R. 407 (S.D. Tex 2009) (if creditors' rights are denied under a sale under Section 363, "the bankruptcy court can only approve the transaction if it fashions an appropriate protective measure modeled on those which would attend a reorganization plan"); *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452 (2d Cir. 2007) (suggesting a list of factors to consider in determining whether it is appropriate to permit a sale under Section 363 that violates absolute priority).