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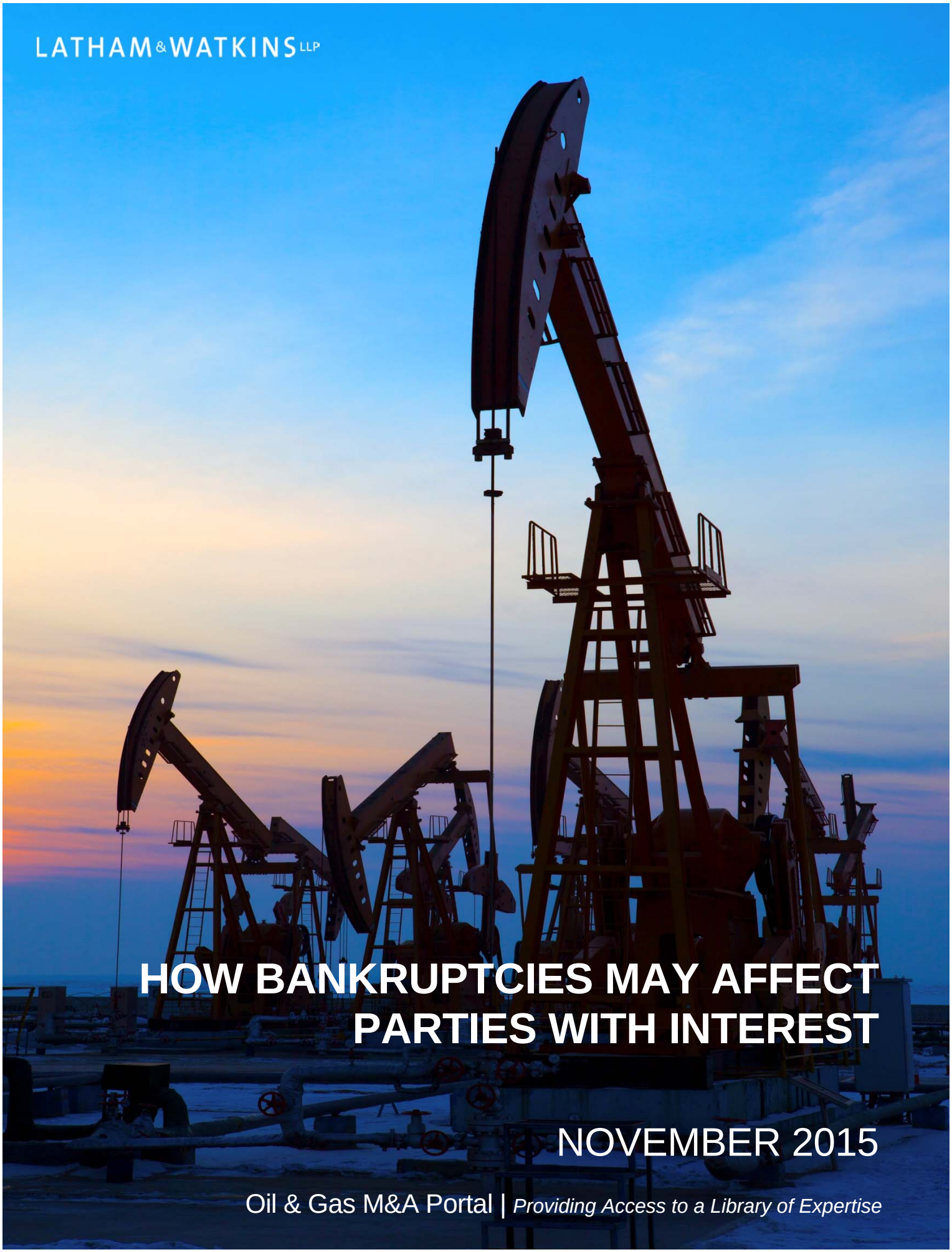

HOW BANKRUPTCIES MAY AFFECT PARTIES WITH INTEREST

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HOW BANKRUPTCIES MAY AFFECT PARTIES WITH INTEREST

With the increasing financial instability in the oil and gas industry, it has become essential for parties in interest to understand how their rights may be affected by a counterparty's bankruptcy.

One of a debtor's most powerful tools is its ability to reject burdensome executory contracts under Section 365 of the Bankruptcy Code. Generally speaking, a contract is executory when reciprocal duties are owed by both parties. Where a debtor grants a covenant running with the land, such covenant will likely be considered a property interest of the grantee rather than an executory agreement subject to rejection. However, where such a covenant is incorporated as part of a larger executory contract, issues arise with respect to the treatment of the covenant upon rejection of the contract.

In this situation, parties should be aware that rejection merely constitutes a breach by the debtor of the contract immediately prior to the commencement of the bankruptcy case. Rejection is not the same as rescission— it does not render the contract void or require that the parties be put back in the positions they were in before the contract was formed. In other words, a debtor who has already conveyed a property interest, such as a covenant running with the land, cannot later undo such conveyance through rejection of the broader contract.

Whether a covenant is considered to constitute a property interest running with the land can be particularly important in the oil and gas industry, as oil and gas assets are often subject to several agreements essential to the assets' development and operation, as well as the transporting and marketing of the resulting production (e.g., joint operating agreements, participation agreements, gathering and transportation agreements, area of mutual interest agreements, etc.). Many of these contracts will expressly provide that certain covenants run with the land, and/ or that any assignment of the underlying assets will be subject to the agreement. However, such language itself may be insufficient to shield a counterparty from the effects of Section 365.

Interested parties should keep in mind that the Bankruptcy Code does not create or define property interests— the nature of property rights is generally a matter of state law. Accordingly, bankruptcy courts look to state law to determine whether a covenant runs with the land. In most states, is not enough that an agreement expressly state that a covenant runs with the land. For example, in Texas, courts have held that a covenant runs with the land when it (i) touches and concerns the land, (ii) relates to a thing in existence or specifically binds the parties and their assigns, (iii) is intended by the parties to run with the land, and (iv) where the successor to the burden has notice. The parties also must be in privity of estate at the time the covenant is made.

With respect to the first element, if the promisor's interests in the affected property are burdened (i.e. rendered less valuable) by the covenant, the covenant "touches and concerns the land." While traditionally Texas cases have required that the covenant result in both a benefit to one party and a burden to the other, recent Texas cases have dispensed with the benefit requirement.

The second element requires that the covenant relate to a thing in existence, such as a tangible piece of property, or that the covenant specifically bind the parties and their assigns. This element is rarely in dispute in the oil and gas industry because it is common for agreements to expressly state that the covenant binds successors and assigns.

Likewise, the intent requirement is often satisfied in the oil and gas industry, where agreements typically expressly provide that certain rights run with the land (i.e., dedications of acreage, consent rights, restrictions on use, etc.). Intent to create a

HOW BANKRUPTCIES MAY AFFECT PARTIES WITH INTEREST continued

covenant running with the land is also suggested when an agreement states that it inures to the benefit of the parties' successors and assigns. When determining intent, Texas courts will harmonize all parts of the underlying agreement so as to give effect to all of the provisions.

With respect to the last element, notice is most typically provided through recordation. In Texas, a purchaser is presumed to have notice of all properly recorded instruments in the chain of title and all instruments referred to in the recorded documents. Many types of oil and gas agreements provide for the recording of a memorandum of agreement, and assignments of oil and gas assets are often specifically made subject to these types of agreements. Parties should be careful to ensure that all documents are properly recorded.

In addition to the factors above, Texas law also requires that the parties be in privity of estate at the time the covenant is made. There are two types of privity. Horizontal privity is privity between the parties who agree to a covenant and requires that the parties must have shared some level of ownership or control of the land. Vertical privity, on the other hand, is privity between the parties who made the covenant and the parties to whom they are transferring the property. While vertical privity is undoubtedly required for a covenant to run with the land, the law in Texas is unsettled as to whether horizontal privity is necessary as well.

The test for whether a covenant runs with the land varies from state to state and bankruptcy courts have broad discretion in determining whether a covenant constitutes a property interest outside the reach of Section 365. Parties in the oil and gas industry should look beyond the language in their agreements and be proactive in analyzing applicable state law in order to best protect their interests in the event of a counter-party's bankruptcy.