Rejecting Midstream Contracts in Chapter 11: Understanding the Jurisdictional and Procedural Issues

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Almost 15 years ago, new shale and fracking technology opened areas like North Dakota and Appalachia to significant oil and gas exploration and development, but the advances also created the need for construction of pipelines and related facilities (e.g., gathering, storage, and/or transportation systems) to ensure that oil and gas could be economically moved by interstate transport to markets vital to the U.S. economy. By then, the Federal Power Act (1938) (FPA) and the Natural Gas Act (1938) (NGA) had appointed FERC (and its predecessor, the Federal Power Commission) to serve as the regulator and protector of the public interest in the face of potential utility and pipeline monopolies. FERC performs its task by reviewing and approving rates and other contract terms for pipeline transportation and storage of natural gas and the transmission and sale for resale of electricity in interstate commerce.

The simple cost-based, cost-plus rate structure in place for so many years was modified in 1996 to permit pipeline ("midstream") companies to privately negotiate rates and terms for transportation of natural gas by pipeline with their shippers, such as E&P ("upstream") companies, utilities and others, subject to FERC approval. These privately negotiated contracts permit upstream and midstream entities to finance the significant capital costs of construction of pipelines. FERC standards for approval of such privately negotiated contracts have remained the same for years, i.e., that the filed rates, terms, and conditions are just and reasonable and not unduly discriminatory or preferential. Most FERC-jurisdictional negotiated natural gas transportation agreements are filed and go into effect without substantive review by FERC.

FERC also regulates the transportation of oil by pipeline companies under the Interstate Commerce Act (ICA) and the wholesale sale of electricity through the FPA. FERC often pre-approves the form of oil transportation agreements through a declaratory order process. Shortly prior to the effective date of such agreements, the pipeline company files a tariff setting forth the rates for service but does not file the actual agreement with FERC. FERC permits sellers of wholesale electricity, or "public utilities," to enter into negotiated agreements if they can demonstrate that they do not possess market power in the relevant geographic region or regions. Such agreements are deemed to be on file with FERC through after-the-fact quarterly informational filings.

An E&P company or other customer of a FERC-regulated midstream company or public utility may petition FERC for modification of previously approved rates and/or contract terms.[2] The burden of proof required to obtain modification, however, is a very heavy one.[3]

Before the most recent "crash" in 2020 of oil and gas prices, federal bankruptcy law (the "Bankruptcy Code"), the FPA, the NGA, the ICA, and their rules and regulations were tested by utility debtors seeking to reject their interstate power purchase

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[2] Many of the transportation agreements also contain provisions requiring minimum monthly volumes, dedications of produced gas and/or reserves and surface easements, and language regarding covenants running with the land.

[3] Oil transportation agreements under the ICA are not subject to public interest review under the standard that applies to agreements filed under the NGA and FPA. FERC has indicated that rates set forth in oil transportation agreements (as opposed to rates set forth solely in a tariff) are subject to challenge but has not articulated any standard other than the ordinary "just and reasonable" standard under the ICA. *See, e.g., Nexen Marketing U.S.A., Inc. v. Belle Fourche Pipeline Co.*, 121 FERC ¶ 61,235 at P 52 (2007).

agreements under Section 365 of the Bankruptcy Code.[4] These cases focused on the jurisdictional interplay that arises when a dispute requires consideration of federal statutes other than (or in addition to) the Bankruptcy Code and whether such disputes must be determined by FERC, can be decided by bankruptcy courts with FERC's approval, must be removed to the district court, or can be decided solely by the bankruptcy courts pursuant to an adjusted standard (i.e., supplemental to the business judgment standard). To date, only two circuit-level courts of appeal have issued opinions on the rejection issue (*Mirant* in the Fifth Circuit and *First Energy* in the Sixth Circuit).[5] Both opinions denied FERC exclusive jurisdiction over power purchase agreements during a Chapter 11 case but made clear that the courts, in exercising their own exclusive jurisdiction over rejection, must conduct more than just a "summary" consideration of the debtor's business judgment; they must also consider and balance the public interest, though neither opinion articulated a specific standard or provided guidance for use in connection with such consideration. As the Fifth Circuit said in *Mirant*, "when considering these [rejection] issues, the courts should carefully scrutinize the impact of rejection on the public interest and should, *inter alia*, ensure that rejection does not cause any disruption in the supply of electricity to other public utilities or consumers."[6]

By 2016, following the crash of oil prices in late 2014, courts were forced to wrestle with the interplay of certain additional jurisdictional and procedural issues that arose from E&P companies' efforts to reject their privately negotiated natural gas and/or transportation agreements. These jurisdictional issues also involved the extent, procedures, and conditions[7] pursuant to which a bankruptcy court, in the context of a rejection motion, could issue a final order determining whether, under state law, covenants running with the land had been created by the parties to the such agreements and, if so, whether such agreements could nevertheless be rejected. Unfortunately, to date, the decisions of bankruptcy courts in different circuits addressing some of these underlying jurisdictional issues have been contradictory in their analysis and conclusions, notwithstanding efforts to distinguish the cases factually, and leave debtors and non-debtors with little or no clarity on the issues of competing jurisdiction, procedure, and timing that affect these disputes. In some instances, these decisions have been made by bankruptcy courts in the context of an adversary proceeding, even though the litigants have expressly withheld consent to the bankruptcy court's authority to issue final orders. In other instances, the bankruptcy courts have decided the state law issue in the context of adjudicating the Section 365 rejection motion, without an adversary proceeding having been commenced. These procedural issues are important, but often overlooked, elements of the tug-of-war between FERC and/or midstream companies, on the one hand, and the Bankruptcy Courts and Chapter 11 debtors, on the other hand.

Adjudication of various appeals and motions to withdraw the reference pending as of today may soon provide clarity and guidance (e.g., (i) debtors' request for direct appeal to the Fifth Circuit in *Ultra Resources* regarding whether the Bankruptcy Court misapplied *Mirant* in approving rejection of the REX gas transportation agreement, (ii) midstream counterparties' motions to withdraw the reference in *Gulfport Energy*, (iii) joint request for direct appeal to the Fifth Circuit in *Chesapeake*

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[4] There are only two provisions in the Bankruptcy Code that expressly address energy and gas contracts and/or FERC regulations: (i) Section 363(h)(4) prohibits the sale of a non-debtor's undivided interest in the debtor's property if the property is used for the production, transmission, or distribution of electric energy or gas for heat, light, or power and (ii) Section 1129(a)(6) permits confirmation of a plan only if changes to any governmentally regulated rates have been approved by the relevant government agency or the effectiveness of the plan is conditioned on such approval.

[5] *Official Committee of Unsecured Creditors of Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.)*, 378 F.3d 511 (5th Cir. 2004); *FERC v. FirstEnergy Sols. Corp. (In re FirstEnergy Sols. Corp.)*, 945 F.3d 431 (6th Cir. 2019). Though the Ninth Circuit was also set to address the issue on appeal in *PG&E*, the appeal became moot upon confirmation of the PG&E plan of reorganization pursuant to which all power purchase agreements were assumed.

[6] *Official Committee of Unsecured Creditors of Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.)*, 378 F.3d 511, 525 (5th Cir. 2004).

[7] It is beyond the scope of this alert to discuss the tortured history, numerous appellate court decisions, and Congress's responses thereto arising from a bankruptcy court's limited jurisdiction as an Article I court. *See, e.g., Northern Pipeline v. Marathon Pipe Line,* 458 U.S. 50 (1982); *Stern v. Marshall*, 564 U.S. 452 (2011); *Wellness Int'l Network Ltd., et al. v. Sharif*, 575 U.S. 665 (2015); Rule 7008(a) of the Fed. R. Bankr. Pro.

regarding whether, under Texas law, ETC Pipeline's gas purchase agreement contained covenants running with the land that prohibit rejection, and (iv) FERC's appeal of the confirmation order (of December 23, 2020) in *Extraction*, arguing, among other things, that the Bankruptcy Court cannot retain exclusive jurisdiction over the plan to the extent disputes arise that require FERC's decision-making and that the plan may violate Section 1126(a)(6) of the Bankruptcy Code), but in advance thereof, this alert offers some perspective, analysis, and potential practice points on the most material of these issues. *[Note, on January 21, 2021, the Gulfport Bankruptcy Court entered its report recommending that the District Court deny the motions to withdraw and requesting an expedited hearing on the matter. Unlike in Judge Isgur's Ultra Petroleum opinion, the Court determined that rejection of the midstream contracts was a question of bankruptcy law only and did not require consideration of the NGA at all.]*

Ultra Petroleum, Extraction, Gulfport Energy: Rejection of FERC-Regulated Contracts

On August 21, 2020, in Texas, Bankruptcy Judge Isgur approved rejection of a gas transportation agreement in *Ultra Petroleum* after devoting significant attention in his opinion to the purpose of the NGA and FERC's role in regulating the industry.[8] In November 2020, in Delaware, Chief Bankruptcy Judge Christopher Sontchi explored the ICA before approving rejection of several oil transportation service agreements in *Extraction Oil and Gas*.[9] More recently, in *Gulfport Energy*, three gas transportation service providers have moved to withdraw the reference of the debtors' rejection motions from the Bankruptcy Court to the District Court, arguing that the rejection motions require consideration of non-Title 11 federal statutes and of FERC's regulatory role in the industry.[10]

These cases all raise jurisdictional and procedural issues that appear to require District Court involvement, regardless of the substantive standard used to determine whether rejection is appropriate. As the United States Supreme Court has routinely reminded the bankruptcy bar, questions of jurisdiction matter. If rejection of oil and gas transportation and/or sale agreements requires substantial and material consideration of non-Bankruptcy Code federal statutes, then, under 28 U.S.C. § 157(d), the matter is one for the district courts.

The Bankruptcy Code and FERC: Withdrawal of the Reference

Section 365 of the Bankruptcy Code permits a debtor to file a motion in the bankruptcy court to reject executory contracts and unexpired leases. The purpose is to relieve the debtor of burdensome prepetition contracts in order to aid in the debtor's rehabilitation. Typically, the test for determining whether to approve rejection of an executory contract is whether rejection would be in the best interests of the debtor (i.e., beneficial to efforts to reorganize) according to the debtor's business judgment, which is not a terribly high burden for a debtor to satisfy. The motion is deemed a contested, core matter by most, if not all, jurisdictions, over which the bankruptcy court has final order authority.

If, however, to determine whether a contract may be rejected, the court must undertake substantial and material consideration of a federal statute *other than*, or *in addition to*, the Bankruptcy Code, then mandatory withdrawal of the reference is required, and only the District Court will have final order jurisdiction on the rejection issue.[11] Mandatory withdrawal is only appropriate,

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[8] *In re Ultra Petroleum Corp*, 2020 Bankr. LEXIS 2249 (Bankr. S.D. Tex. Aug. 21, 2020).
[9] *In re Extraction Oil and Gas*, 2020 Bankr. LEXIS 3101 (Bankr. D. Del. Nov. 2, 2020).
[10] *In re Gulfport Energy Corp.*, Case No. 20-35562 (DRJ).
[11] 11 U.S.C. § 157(d). *See In re National Gypsum Co.,* 145 B.R. 539, 541 (N.D. Tex. 1992); *Levine v. M&A Custom Home Builder and Developer LLC*, 400 B.R. 200, 202 (S.D. Tex. 2008); *In re Johns-Manville Corp.*, 63 B.R. 600, 602 (S.D.N.Y. 1986).

however, where interpretation, and not mere application, of non-Title 11 statutes is necessary or where the court must make an analysis of unresolved issues concerning the non-Title 11 statute.[12] The mere presence of non-Title 11 statutes in determining whether to approve rejection does not render the rejection motion subject to mandatory withdrawal.

FERC is the federal agency responsible for supervising the regulation of the interstate wholesale sale of electricity[13] and natural gas[14] and the use of pipelines to transmit oil[15] and gas through interstate commerce.[16] Its authority derives from the FPA, the NGA, and the ICA. It is responsible for maintaining just and reasonable and non-discriminatory rates to consumers, thereby protecting interstate consumers from pipeline monopolies. Private parties are permitted to negotiate the terms of their midstream gas/transportation contracts, but they must file the contracts with FERC, and FERC has authority to hold public hearings to determine whether the contracts (including the "filed" rates) are just and reasonable. Once FERC accepts or approves a "filed" rate, it is given the force of law. Neither party can unilaterally modify the rate or the other contract terms without FERC's approval. Any party seeking to modify a filed rate has the heavy burden of proving that the existing filed rate harms the public interest, for example, that the contract party will go out of business and no longer be able to provide gas to consumers if it does not get a rate modification. Moreover, when asked to modify or abrogate a fixed rate, FERC must commence a statutorily mandated process that includes public hearings at which testimony is taken, requiring an application of the provisions in the FPA, NGA, and/or ICA and various FERC regulations, plus an understanding of FERC precedent and the regulatory scheme in general. Finally, as the court in *Ultra Petroleum* was informed, FERC cannot take a position on the merits of a public interest inquiry in a Chapter 11 case without first examining the relevant evidence and issuing an order based on that evidence after due deliberation by its Commissioners.[17]

The Fifth Circuit case, *In re Mirant*, is a helpful starting point in understanding the jurisdictional tug-of-war between FERC and the bankruptcy court system. Mirant and its affiliates, together then one of the largest regulated public utilities in the United States, filed for bankruptcy in 2003. The debtors filed a motion to reject their wholesale electric contracts with the Potomac Electric Power Company (PEPCO) and commenced an adversary proceeding to enjoin FERC from taking action with respect to the power contracts (not, as in some cases, for declaratory relief regarding whether covenants running with the land exist that would prohibit rejection – more on that later). PEPCO and FERC timely moved to withdraw the reference of both the rejection motion and the adversary proceeding, and, though the Bankruptcy Court recommended withdrawal of the adversary proceeding only, the District Court withdrew both matters.[18] The District Court then denied rejection of the electric contracts, finding that rejection was an unauthorized collateral attack on the FERC-approved contract rates.

The *Mirant* debtors appealed the District Court opinion, and the Fifth Circuit Court of Appeals reversed the District Court's decision. The Court of Appeals held that, while FERC has exclusive jurisdiction over contract rates, rejection of a contract does

[12] *See In re Vicars Ins. Agency, Inc.*, 96 F.3d 949, 953 (7th Cir. 1996).

[13] 16 U.S.C. § 824 *et seq*.

[14] 15 U.S.C. § 717 *et seq*. FERC's jurisdiction over natural gas sales is minimal because of the Natural Gas Wellhead Decontrol Act of 1989. *See* Pub. L. 101-60, § 3(b)(7), 103 Stat. 157, 159, amending 15 U.S.C. § 3431 (2012).

[15] 49 U.S.C. App. § 1 *et seq*. (1988).

[16] 15 U.S.C. § 717 *et seq*.

[17] *In re Ultra Petroleum Corp. et al.*, Case No. 20-32631, Emergency Motion for Reconsideration by Federal Energy Regulatory Commission [Dkt. No. 315] (Bankr. S.D. Tex., June 25, 2020) at ¶¶ 1, 22 and 49.

[18] For additional examples of cases where withdrawal of the reference was deemed mandatory, s*ee California Dep't. of Water Res. v. Calpine Corp. (In re Calpine Corp.)*, 337 B.R. 27 (S.D.N.Y. 2006) (court withdrew the reference of the debtors' motion to reject certain energy contracts, because rejection would require substantial and material consideration of the NGA); *In re Boston Generating LLC*, 2010 U.S. Dist. LEXIS 116073 (S.D.N.Y. Nov. 1, 2010) (withdrawal of reference mandatory because rejection of natural gas supply contract required interpretation of non-title 11 statute); *Enron Power Mktg, Inc. v. Cal. Power Exchange Corp. (In re Enron Corp.)*, 2004 U.S. Dist. LEXIS 23868 (S.D.N.Y. Nov. 23, 2004) (withdrawal of reference mandatory where court required to interpret FERC tariff and rate regulations).

not have a *direct* effect on the rate of a particular contract, as PEPCO's rejection damage claim would still be calculated at the FERC-approved filed rate. The Court found that the FPA was not intended to preempt the Bankruptcy Code in situations where rejection might have an *indirect* effect on contract rates (e.g., lead to macroeconomic consequences in the industry), and, thus, the District Court maintained its authority to determine rejection under section 365(a).[19] The Court of Appeals remanded to the District Court for a determination on rejection, instructing it to use an "adjusted" approval standard that considers the public interest as well as the business judgment rule. From then on, the District Court and the Court of Appeals played hot potato with the case as decisions were parceled out by the District Court and appealed, appeals were rejected or granted, and new decisions were entered by the District Court, <u>but at no time did the rejection motion get referred back to the Bankruptcy Court, though the Court of Appeals, in a footnote, noted that it was not adverse to the District Court referring the case back to the Bankruptcy Court</u> (emphasis added).[20]

While *Mirant* has been cited by subsequent bankruptcy courts for the proposition that a debtor may reject FERC-regulated executory contracts without FERC approval, courts have ignored the jurisdictional elements of the case that may require District Courts, rather than Bankruptcy Courts, to decide rejection of FERC-approved contracts. For example, in *FirstEnergy*, the Sixth Circuit Court of Appeals adjudicated a direct appeal from the Bankruptcy Court (since, unlike in *Mirant*, the District Court did not withdraw the reference) and adopted the *Mirant* "adjusted" standard for approving rejection of electricity sale contracts, instructing the Bankruptcy Court, on remand, to consider the consequences to consumers and the potential harm to the public interest of such a rejection. In that case, as in *Mirant*, there was no question that the contracts at issue had little or no impact on the relevant market. The Sixth Circuit did conclude, however, that there might be cases where the impact on the market is much greater, and the court included not only FERC issues, but decommissioning, environmental, and future pension obligations as examples of factors that might need to be considered, given the facts of a particular case.[21] The difference between the facts of *Mirant* or *FirstEnergy* (where the midstream party's services were no longer needed or the impact of rejection on the market was nonexistent) and those of *Gulfport Energy* (where midstream counterparties contend that the evidence demonstrates that the debtors' entire operations rely on the services provided by the midstream contracts) may make the difference between a *Mirant* adjusted standard/public interest test that can be conducted by the Bankruptcy Courts and those that must be conducted by the District Courts.

Furthermore, though the Fifth Circuit and the Sixth Circuit invited FERC's participation in the rejection process so that FERC could "assist the court in balancing these equities,"[22] *Mirant* does not address what, if any, importance should be afforded prepetition orders issued by FERC. The standard that FERC considers in issuing its orders is different from, and more onerous than, the Section 365 rejection standard, and FERC's orders should not necessarily have any *res judicata* effect, though facts determined during FERC proceedings might be binding on the debtor. Indeed, the Sixth Circuit, in *FirstEnergy*, concluded that FERC orders might be "valuable or beneficial to the ultimate determination" of whether to approve rejection and suggested that giving FERC an opportunity to conduct its own hearings would have been appropriate.[23] Consideration of FERC's prepetition orders, however, appears to require an understanding and interpretation of non-Title 11 statutes and regulations, particularly

[19] *Mirant*, 378 F.3d at 520-21.
[20] *Id.* at 526.
[21] *FirstEnergy*, 945 F.3d at 454.
[22] *Id. See* footnote 10 *infra* regarding FERC's inability to take a position on the merits of a public interest inquiry in a Chapter 11 case without first conducting its own deliberative process.
[23] *FirstEnergy*, 945 F.3d at 452.

where the debtor's impact on consumers and the relevant market is substantial or where the debtor will continue to rely on the midstream companies' services. Under such facts, withdrawal of the reference appears to be required under Section 157(d).

Despite *Mirant* and *FirstEnergy*, the District Courts have been largely left out of the recent rejection decision-making cases. In both *Ultra Petroleum* and *Extraction*, two different bankruptcy judges (one in the Southern District of Texas and one in Delaware) exercised alleged core jurisdiction to approve rejection of FERC-governed oil and gas transportation agreements over the objection of the contract counterparties. None of the contract counterparties in those cases (and there were several) filed motions to withdraw the reference under 28 U.S.C. § 157(d), even though withdrawal had previously been granted by the District Court on the same issues in *Mirant*.[24] Moreover, in both *Ultra Petroleum* and *Extraction*, the courts discussed the history and purpose of the NGA (in *Ultra Petroleum*) as well as the ICA (in *Extraction*), analyzed FERC's responsibilities in implementing the relevant non-Title 11 statutes, and considered the effect that rejection would have on the public interest.[25] Arguably, both courts arrived at their decisions only after evaluating testimony that drew on non-Title 11 concepts and analyzing the effect that rejection would have in terms of non-Title 11 statutes.[26]

Perhaps if the courts had merely considered whether the supply of oil or gas would have been negatively affected by rejection, withdrawal would have seemed unlikely, but neither court restricted its inquiry and analysis to supply levels, even though Judge Sontchi explicitly stated that he was not bound by *Mirant* to consider the public interest. Moreover, in neither case was there a prepetition FERC order or proceeding or a prior factual determination to provide any guidance that would have rendered analysis of non-Title 11 statutes unnecessary (though whether such an order would have had any *res judicata* effect or provided any guidance is an open question, but factual testimony and determinations might have been binding on the debtors). It is difficult to imagine why these decisions should have remained in the Bankruptcy Courts or should not be subject to *de novo* review by the District Courts.

Practice Point: Midstream companies might consider commencing FERC declaratory proceedings against E&P companies that have indicated a Chapter 11 filing is or might be imminent. While a FERC order may not have a *res judicata* effect in a Chapter 11 case, it is evidence of FERC's opinion on whether modification or termination of the contract will have a negative effect on the public interest and may be helpful to a court in formulating and applying a *Mirant* adjusted standard. The timing of the FERC process may, however, make it difficult to obtain a FERC order before the debtor commences its Chapter 11 case, but it might yield relevant facts or admissions.

In addition to these jurisdictional issues, the date on which rejection is deemed to have occurred was addressed by Judge Sontchi in *Extraction*.[27] There, the debtors sought to have rejection "relate back" to the date the Chapter 11 case was commenced (which is the date the breach of contract is deemed to have occurred), even though rejection was not ultimately granted for over

[24] In *Extraction*, the debtors filed adversary proceedings against each counterparty seeking a declaratory judgment that none of the contracts contained covenants running with the land that would prohibit rejection. Unlike *Mirant*, *Extraction* raised core/non-core consent issues under 28 U.S.C. § 157 and Bankruptcy Rule 7008(a). Though at least two of the answering counterparties expressly withheld consent to the court's final order jurisdiction, the Bankruptcy Court, nonetheless, entered final orders against the parties declaring that no covenants running with the land existed and then granted the relief requested in the rejection motion as part of the contested matter proceedings. The core/non-core issues were later mooted by settlements of the parties' disputes. In *Ultra Petroleum*, no adversary proceeding was commenced, as the issue of covenants running with the land was not raised, and the court approved rejection in the context of a contested matter.

[25] Though Judge Sontchi noted that he was not bound by *Mirant* to consider the public interest, he nonetheless evaluated the effects rejection would have on public health and safety.

[26] Judge Isgur specifically discussed the "free-rider" problem that results from the interplay of contract rejection and FERC's policy of not discriminating against entities that have filed for bankruptcy, highlighting that the problem was an unfortunate consequence of rejection but holding that the concern was for Congress, and not the courts, to address and resolve.

[27] In *Southland*, the date of rejection as well as adequate protection was raised but not addressed by the court. The issues were mooted by subsequent settlement of the parties' disputes.

four months from the petition date and over two months from the date the latest motion to reject was filed. Most courts appear to use a standard for granting rejection *nunc pro tunc* that simply balances the equities of the case.[28] In *Extraction*, Sontchi granted rejection *nunc pro tunc* because the debtors had been using, and paying for the use of, the pipeline since the petition date, though they had not been satisfying the minimum volume and deficiency payment obligations. Without retroactive rejection, the debtors would incur "unnecessary administrative expense charges," whereas the midstream company had been paid for the use of its pipeline, a benefit in the court's eyes.[29] One wonders whether the court would have decided differently had the debtor used the pipeline but not paid for it. In any event, the longer the lag time between petition date and rejection date, the greater the expense borne by the midstream party, even if the debtor is paying for the use of the pipeline, as other contractual obligations are suspended during this time and may never be fully recouped.

Finally, Extraction's recently confirmed plan (now on appeal by FERC) raises a unique issue under Section 1129(a)(6) of the Bankruptcy Code. Just prior to confirmation, the debtors settled their long-standing disputes with all of their midstream contract counterparties (despite having been authorized to reject the transportation service agreements with these parties) and entered into either modified transportation service agreements or new ones. The midstream settlements were approved by the Bankruptcy Court as part of plan confirmation and were expressly incorporated into, and made part of, the confirmation order. Yet no reference was made to the debtors having obtained FERC approval of the rates set forth in these modified agreements, nor was FERC approval a condition to the effectiveness of the confirmed plan. Given that one of FERC's objections to confirmation of the Extraction plan was based on violation of Section 1129(a)(6) of the Bankruptcy Code, the issue appears to be a timely one.

Section 1129(a)(6) permits confirmation of a plan only if, among other things, any government regulatory commission with jurisdiction, after confirmation, over the rates of the debtor (e.g., FERC) has approved any rate change provided for in the plan, or the plan is expressly conditioned upon such approval. FERC's plan objection, filed before the settlements were announced and approved, contends generally, that, by rejecting the midstream agreements, the plan violated Section 1129(a)(6). The debtors responded that (i) rejection of the midstream contracts, in litigation separate from the plan, does not constitute a rate change, (ii) nothing in the plan specifically provides for a rate change going forward, (iii) if there were any arguable rate change, it is not a rate change "of the debtor" but of the midstream party, and (iv) Section 1129(a)(6) applies only to government-regulated utility debtors to ensure they do not charge new rates to customers through a plan without seeking regulatory approval. Yet, nothing in Section 1129(a)(6) limits its application to utility debtors, by incorporating the midstream settlements into the confirmation order, the rate changes provided in the settlements become part of the plan, and, semantics aside, the rate changes are those charged to the debtors and are, therefore, arguably, *the debtors' rates* over which FERC has approval authority. More important, the modified/new agreements provided by the midstream settlements and the confirmation order are contracts with the debtors providing for rates that, under the ICA, must be approved by FERC, and yet FERC seems to be cut out of the process altogether to date.[30] The issue is no longer simply a rejection issue. Whether it is a Section 1129(a)(6) issue or a question of FERC's concurrent jurisdiction to approve the rates set forth in the modified and new agreements, it is one that appears to be ripe for adjudication on appeal.

Now that the Fifth Circuit Court of Appeals has granted the joint request of Ultra Resources and FERC for direct appeal of the confirmation order in the *Ultra Petroleum* Chapter 11 cases and may soon accept direct appeal of Judge Isgur's *Ultra* decision

[28] *See, e.g., Extraction*, 2020 Bankr. LEXIS at *33-4.
[29] *Id.*
[30] Similar issues are likely to be raised in *Gulfport Energy*, as the Restructuring Support Agreement and the Plan require, as preconditions, certain annual savings from reserve fees and a reduction in the minimum volume requirements.

applying the *Mirant* standard, and given that FERC has appealed the *Extraction* confirmation order, the jurisdictional landscape may shift as the Court expands its analysis of midstream contract issues. Until then, however, midstream parties, like those in *Gulfport Energy*, may find that exercising their jurisdictional rights to pursue withdrawal of the reference is a helpful option in leveling the playing field and defending against the onslaught of E&P debtor rejection motions.

Adversary Proceedings: Consent Under Bankruptcy Rule 7008

In addition to the FERC jurisdictional issues, midstream contract counterparties facing rejection motions (even those not involving FERC or interstate commerce) may also face the procedural question of whether an adversary proceeding must be commenced to determine the outcome of the rejection motion, especially where the prepetition contract contains language that arguably creates covenants running with the land. Where parties disagree as to the nature of the contract to be rejected, i.e., whether it is an executory contract under state law, the non-debtor contract party may demand that an adversary proceeding for declaratory relief be commenced (or even commence one itself) in the bankruptcy court. Indeed, at least one circuit (the Second Circuit) requires bifurcation of a motion to reject an executory contract under Section 365 from any disputes over the nature of the contract under state law.[31] Unlike contested matters, adversary proceedings must be commenced by the filing of a summons and complaint, are governed by bankruptcy rules that are very similar to the Federal Rules of Civil Procedure, often involve significant amounts of discovery, provide due process protections for both litigants that are sometimes overlooked in simple contested matters, often require adjudication of state law issues, and take much longer to adjudicate. As such, adversary proceedings tend to be more formal, and take longer to resolve, than contested matters.

Practice Point: Most of the adversary proceedings filed in connection with midstream contract rejection motions have been styled as proceedings seeking a declaration under Bankruptcy Rule 7001(9) as to whether there exist covenants running with the land that would prohibit rejection, but Bankruptcy Rule 7001(2) also requires the commencement of an adversary proceeding to determine "interests" of midstream litigants in the debtor's property (real or personal). Where midstream parties, rather than the debtor, commence the adversary proceeding, some of them have used this latter section of the rules as the procedural predicate for their action. *See, e.g., Kinder Morgan Altamont, LLC v. EP Energy E&P Company L.P. (In re EP Energy Corporation)*, Case No. 19-03681, Complaint [Dkt. No. 1] (Bankr. S.D. Tex. Nov. 22, 2019); *Occidental Petroleum Corp. et al. v. Sanchez Energy Corp. (In re Sanchez Energy Corp.)*, Case No. 20-03198, Complaint [Dkt. No. 1] (Bankr. S.D. Tex. June 23, 2020). Additional relief requested in an adversary complaint might include a declaration that the contract cannot be rejected under Section 365 of the Bankruptcy Code, that the midstream party is entitled to an administrative expense claim for any post-petition use by the debtor of pipeline services subject to the contract, and that the debtor's property cannot be sold free and clear of the midstream company's interest without its consent under Section 363(f)

Since the *Stern v. Marshall* decision, the bankruptcy court's jurisdictional authority to enter final orders in many traditional adversary proceedings has been questioned, and there is still significant debate over the scope of the ruling. In response, Bankruptcy Rule 7008 was amended to require both parties to state in their pleadings whether they do, or do not, consent to the entry of final orders or judgments by the bankruptcy court. If either party does not consent (or is not deemed to have consented), the bankruptcy court can only make a report and a recommendation to the district court, and the district court has the final say on the matter.

[31] *See Orion Pictures v. Showtime Networks, Inc. (In re Orion)*, 4 F.3d 1095 (2d Cir. 1993) (rejection that involves disputed issues (other than the debtor's business judgment) that cannot be resolved as a contested matter but requires commencement of an adversary proceeding).

In *Extraction*, *Southland Royalty*, *Alta Mesa,* and *Badlands*, cases where the existence of contractually created covenants running with the land was an issue, the debtors or the midstream parties commenced a separate adversary proceeding seeking declaratory relief. In *Alta Mesa* and *Badlands*, the parties consented to the Bankruptcy Court's final order jurisdiction, but in *Extraction* and *Southland Royalty*, the midstream parties expressly withheld their consent (though the midstream party in *Southland* requested adequate protection of its alleged interest in the debtor's property). Yet, in both cases, the Bankruptcy Court adjudicated state law issues and entered final orders holding that no covenants running with the land were created and that, even if they had been created, they would not prohibit contract rejection under Section 365. Moreover, on October 28, 2020, Chief Bankruptcy Judge David Jones approved rejection of a gas purchase agreement in *Chesapeake*, finding, in the context of a 365 hearing (not an adversary proceeding), that the agreement did not contain covenants running with the land under Texas state law that would prohibit rejection.[32] No adversary proceeding was ever commenced. The procedural posture in these cases favored the E&P debtors and reduced the potential benefits these parties might have enjoyed from *de novo* review by the district court.

In *Alta Mesa* and *Badlands*, the courts found covenants running with the land existed that prohibited rejection of the midstream contracts. Indeed, in *Badlands*, the Colorado Bankruptcy Court held that these covenants create real property interests that cannot be alienated under applicable Utah state law, and the midstream party could not be forced to accept a monetary award. Thus the debtors could not sell their property free and clear of the midstream party's covenants under Section 363(f) of the Bankruptcy Code without consent. Judge Chapman alluded to this point in the *Sabine* decision, even though she found no covenants running with the land existed in that particular case.[33]

In other cases, however, courts have commented that, *if* they were to find that covenants running with the land did exist in the contracts before them, such covenants would not necessarily prohibit disposition of the property, as long as the plan provided for treatment of the rejection breach claim. In *Extraction*, for example, Judge Sontchi stated, "any covenant running with the land still exists (as the contract still exists) but it is unenforceable against the Debtors and their assigns after the [rejection] claims are satisfied as part of the reorganization process."[34] Indeed, because in *Extraction* the transportation services agreement permitted the debtors to unilaterally terminate the contract in exchange for payment of liquidated damages and not specific performance, the court found that even if covenants did exist, they were clearly contractual in nature and capable of rejection, and damages were clearly calculable for claim treatment purposes. The court did not comment on whether such an interest would be entitled to adequate protection, because Judge Sontchi repeatedly denied that any such covenants existed in the case, but the right to adequate protection and the form/nature thereof might be a pivotal one.

In *Southland*, where the midstream party argued that its interest was a covenant running with the land, Judge Owens followed Judge Sontchi's lead, finding the gas gathering agreement was a services contract relating to Southland's personal property (i.e., the gas it removed from the land, not the land itself) and not a covenant running with the land, but even if there had been a covenant running with the land, the land could be transferred free and clear of the midstream company's interests under Section 363(f).[35] Judge Owens made a thorough analysis of Section 363(f), and, unlike the Colorado bankruptcy judge in *Badlands*, she determined that (i) Wyoming law permitted a preexisting mortgage to extinguish a latter-created real property covenant at foreclosure, so 363(f)(1) was satisfied, (ii) a monetary remedy was calculable and available to the midstream party,

[32] *In re Chesapeake Energy Corp.*, 2020 Bankr. LEXIS 3022 (Bankr. S.D. Tex. Oct. 28, 2020).
[33] *In re Sabine Oil and Gas Corp.*, 547 B.R. 66, 72 at n.19 (2016) (covenants running with the land are property interests that cannot be extinguished through bankruptcy, citing *Gouveia v. Tazbir*, 37 F.3d 295, 298 (7th Cir. 1994).
[34] *Extraction*, 2020 Bankr. LEXIS at *17.
[35] *Southland Royalty Co. LLC v. Wamsutter LLC (In re Southland Royalty Co. LLC)*, 2020 Bankr. LEXIS 3185 (Nov. 13, 2020).

so 363(f)(5) was satisfied, and (iii) the current dispute that the court was addressing, once decided, was no longer a bona fide dispute for purposes of 363(f)(4) (though a stayed appeal might qualify as such).[36] Like the jurisdictional issues, the scope of Section 363(f) in terms of real property covenants remains a divided one, and whether such interests require adequate protection remains an open one.

Practice Point: Where a debtor files a midstream contract rejection motion early in a case, because of the milestones dictated by a restructuring support agreement or a DIP term sheet, or otherwise, and subsequently commences an adversary proceeding seeking a declaration that there are no covenants running with the land that would prohibit rejection, the midstream contract counterparty should consider filing motions to withdraw the reference of the rejection motion (if the contract is a FERC-regulated agreement) and the adversary proceeding. In such motions and in all subsequent pleadings filed by the midstream party (whether in the adversary proceeding or in the main bankruptcy case to the extent applicable), the midstream party should clearly state that it does not consent to the bankruptcy court entering final orders or judgments.[37] While it is difficult to obtain permission to withdraw the reference, if successful, these motions protect the counterparties' rights to determination of the issues by a district court.

Practice Point: The midstream party might also consider filing a counterclaim against the debtor seeking a determination of the midstream party's interest in property of the debtor (i.e., real property interest in the debtor's oil and gas leasehold interests) under Bankruptcy Rule 7001(2). If the district court finds that the midstream company does, indeed, have an interest in the debtor's property, then such interest is entitled to adequate protection under Section 361 of the Bankruptcy Code.

Practice Point: It might be beneficial to midstream parties to negotiate additional terms in their agreements that require E&P companies that seek a determination in bankruptcy of whether their agreements contain covenants running with the land to consent to arbitration and/or lifting of the automatic stay so that a state court can determine all state law issues.

Given the potential determination that a midstream company has obtained property rights in the debtor's property under state law that are entitled to adequate protection and that may be inalienable, it is important to explore these procedural options when rejection motions become pivotal aspects of an oil and gas Chapter 11 case.[38]

Conclusion

There may be options available to midstream owners that respect the importance of jurisdictional and procedural requirements in the federal court system. In achieving the twofold congressional purpose of ensuring an equitable distribution of assets among creditors in a Chapter 11 case and a fresh start for Chapter 11 debtors, practitioners and courts must give careful consideration to which forum has authority over contract rejection disputes, the circumstances under which a district court might be required to exercise authority over a bankruptcy court, what standards of approval may be required, and how differences in state law impact contract rejection. We expect these issues to continue to be addressed and resolved by the district courts and circuit courts. Until there is sufficient clarity, however, practitioners should explore the various procedural options available to them in this evolving area of bankruptcy law.

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[36] *Id.* at *58-62.

[37] Courts seeking to exercise core/final order jurisdiction strain to find implied consent, so expressly withholding consent reduces the likelihood that a court can find a basis to impute consent. *See, e.g., Chesapeake* at *10-11.

[38] It is beyond the scope of this article to explore the potential intercreditor issues that may arise between a midstream party and the debtor's secured lenders upon a finding of a covenant running with the land, though both the *Sabine* and *Southland* courts alluded to these issues in their rejection decisions.