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## One Size Does Not Fit All Leases—It's Time to Amend Bankruptcy Code Section 365

Rachel Hudson

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# **ONE SIZE DOES NOT FIT ALL LEASES—IT’S TIME TO AMEND BANKRUPTCY CODE SECTION 365**

## **ABSTRACT**

*For far too long, Bankruptcy Code Section 365 has caused confusion among parties to oil and gas leases when one party files for bankruptcy. This section of the Bankruptcy Code is intended to provide relief to debtors who are party to an unexpired lease or an executory contract, allowing a debtor-in-possession or trustee to make the decision to either assume or reject the agreement. While this concept is straightforward for standard lease agreements and contracts, courts have struggled to determine whether oil and gas leases actually fall into the category of a “lease” per se, an executory contract, or neither.*

*Many courts have held that oil and gas agreements are not actually leases, despite their title, because they convey an interest in real property that exceeds that of a leasehold interest. Some courts, however, have chosen to categorize such agreements as unexpired leases, or even executory contracts. This variation in court decisions is problematic because determining what category to place an oil and gas agreement is of paramount importance in determining whether the debtor has the right to reject the agreement in a bankruptcy proceeding. Additionally, such variation has had the effect of producing shocking results during bankruptcy proceedings, leaving parties to current oil and gas agreements unsure of their contractual and property rights in the event that a counterparty experiences financial distress.*

*To alleviate the uncertainty caused by the current caselaw, this Comment proposes an amendment to Bankruptcy Code Section 365 that provides a framework for consistency in evaluating oil and gas leases moving forward and protections for the property rights of the contracting parties.*

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## INTRODUCTION

Historically, Bankruptcy Code (the “Code”) Section 365 has benefited debtors seeking relief of obligations under unexpired leases and executory contracts. However, despite this generally positive treatment of debtor interests, the issue of whether Section 365 should apply to relieve (debtor) parties to oil and gas leases remains a point of debate among the courts. Code Section 365 allows the trustee to assume or reject an executory contract or unexpired lease of a debtor.<sup>1</sup> More specifically, this section of the Code aims, not only to relieve debtors from their existing obligations under leases and contracts,<sup>2</sup> but also to prevent third parties from ceasing business dealings with debtors.<sup>3</sup> In furtherance of these goals, Section 365 gives debtors the option to either assume the contracts and/or leases that benefit their estate, or reject those that do not serve such interests.<sup>4</sup>

Agreements between landowners and producers of oil and gas are often memorialized in “leases.” A plain reading of the word “lease” in such agreements may cause one to assume that these agreements fall within the

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<sup>1</sup> 11 U.S.C. § 365(a) (2005).

<sup>2</sup> See *Cottman Transmissions, Inc. v. Holland Enterprises, Inc.* (*In re Holland Enterprises*), 25 B.R. 301, 302 (E.D.N.C. 1982).

<sup>3</sup> See *Richmond Leasing Co. v. Cap. Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir. 1985).

<sup>4</sup> See *River Prod., Co. v. Webb* (*In re Topco, Inc.*), 894 F.2d 727, 741 (5th Cir. 1990).

purview of Section 365, thereby allowing a trustee or debtor in possession to assume or reject an agreement in the case of a bankruptcy filing. Yet, some courts argue that, with respect to oil and gas leases, the term “lease” is misnomer because such leases are categorically different from the typical leases governed by landlord-tenant law.<sup>5</sup> This distinction hinges on the argument that the type of interest conveyed in an oil and gas lease is often more substantial than that of a typical lease agreement. Thus, the use of this terminology has led to disparate results when courts attempt to address how the agreements should be treated during a bankruptcy proceeding. Because it is often unclear what interest in real property has been conveyed to the “lessee,” courts are left to grapple with state property law when determining whether an oil and gas lease may be assumed or rejected under the purview of Section 365.<sup>6</sup>

The recent decline in oil and gas production,<sup>7</sup> paired with the economic downturn caused by the COVID-19 pandemic, will likely elicit an increase in bankruptcy litigation over oil and gas leases,<sup>8</sup> thus demanding a uniform standard for addressing the treatment of such leases under Section. Therefore, this Comment will explore the various positions taken by courts among the several states, exploit the problematic nature of a lack of consistency in those court rulings, and propose a solution that provides clarity to parties entering oil and gas leases in the future. Because the current Code does not provide courts with guidance on the treatment of oil and gas agreements, parties entering into oil and gas leases are often ill-equipped to plan for the possibility of insolvency by another contracting party. Consequently, the current Code should be amended to incorporate such guidance.

## I. BACKGROUND

In a bankruptcy proceeding, contract and property questions generally arise under state law and, therefore, must be evaluated pursuant to relevant state law unless a countervailing federal interest exists.<sup>9</sup> When evaluating Code Section 365 in the context of standard landlord-tenant agreements, the language and application of the statute is clear. With a few exceptions, and “subject to the

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<sup>5</sup> *Id.* at 739 n.17.

<sup>6</sup> *See generally id.*; *Texaco, Inc. v. La. Land & Expl. Co.*, 136 B.R. 658, 662 (M.D. La. 1992).

<sup>7</sup> *See U.S. Oil and Natural Gas Wells by Production Rate*, U.S. ENERGY INFO. ADMIN., <https://www.eia.gov/petroleum/wells/> (last visited Feb. 21, 2022).

<sup>8</sup> *See Bankruptcy Filings by US Energy Producers at Four-Year High*, OIL & GAS 360 (Aug. 2, 2020), <https://www.oilandgas360.com/bankruptcy-filings-by-us-energy-producers-at-four-year-high/>.

<sup>9</sup> *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010).

court's approval," the trustee in these standard agreements "may assume or reject any executory contract or unexpired lease of the debtor."<sup>10</sup> When adhering to the common use of the word "lease" to guide our understanding of this statute, there are certain scenarios in which the term has an obvious meaning. For example, a party to a standard lease agreement is unlikely to argue that a building lease for a term of years conveys any interest other than a leasehold interest in real property. However, because the interest conveyed in an oil and gas agreement differs from that of a landlord-tenant agreement, this understanding of the term "lease" fails to adequately capture the nature of such agreements.<sup>11</sup> A lessee in the example above has the right to occupy the building for a term of years, and at the end of the lease, he must either vacate the premises or renew the lease for another term. However, oil and gas leases are often structured in such a way that the "lessee"—who is typically an oil and gas producer—has the right to occupy and use the land until the oil reserve becomes depleted. This open-ended type of conveyance begs the question: is the conveyance actually a leasehold or something more?

Assuming that an oil and gas lease might be something other than a "lease," we must also determine whether such a "lease" might, instead, constitute an executory contract pursuant to the language of the statute.<sup>12</sup> When making this determination, the first question is: what is an executory contract? Unfortunately, the Code does not provide a definition. However, in an effort to ascertain its meaning from other sources, courts have looked to the "Countryman Definition" of executory contracts, which sets forth two distinct limitations for their scope.<sup>13</sup> First, contracts in which the obligations of both parties are materially underperformed at the time of the bankruptcy filing are executory contracts.<sup>14</sup> Second, contracts in which either party has fully performed do not constitute executory contracts, regardless of whether the nonperforming party is the bankrupt party<sup>15</sup> or the non-bankrupt party.<sup>16</sup> Additionally, while Section

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<sup>10</sup> 11 U.S.C. § 365(a) (2018).

<sup>11</sup> *In re Topco, Inc.*, 894 F.2d at 739 n.17.

<sup>12</sup> *Cf.* 11 U.S.C. § 365(a) (2018).

<sup>13</sup> *See generally* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 522 n.6 (1984) (citing S. Rep. No. 95-989, p. 58 (1977) ("The Bankruptcy code furnishes no express definition of an executory contract, see 11 U.S.C. § 365(a) (1982 ed.), but the legislative history of [Section] 365(a) indicates that Congress intended the term to mean a contract 'on which performance remains due to some extent on both sides.'").

<sup>14</sup> *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 461 (1973) ("[C]ourts have treated a variety of contracts as executory contracts under the Act where the obligations of both the bankrupt and the other contracting party remained at least partially and materially underperformed at bankruptcy.").

<sup>15</sup> *See id.* at 451.

<sup>16</sup> *See id.* at 458.

365 does not expressly state what definition courts should apply, legislative history suggests that Congress supports a definition consistent with the Countryman meaning, and notes that executory contracts do not typically consist of agreements in which the only obligation remaining for one party is payment to the other party.<sup>17</sup>

Because an oil and gas lease may be interpreted as conveying something other than a leasehold interest, the term “lease” within Section 365 must be interpreted in a way that makes sense within the legislative intent of the Code as a whole. A primary objective of the Code is to provide an “honest but unfortunate debtor” with a fresh start.<sup>18</sup> This purpose raises the question of whether the treatment of oil and gas leases as executory contracts or unexpired leases—subject to rejection pursuant to the debtor’s “business judgment”—is at odds with the idea of an “honest” debtor.<sup>19</sup> When courts decline to recognize that oil and gas leases convey anything more than a leasehold interest, they often defer to the debtor’s business judgment as to whether the lease should be assumed or rejected—opening up the possibility of a savvy lessee rejecting any lease on the table regardless of the actual feasibility of its continued performance or potential consequences of its rejection for other contracting parties.<sup>20</sup>

State courts vary in their level of experience interpreting oil and gas leases, and, consequently, tend to reach differing conclusions when determining whether such agreements convey a freehold interest, leasehold interest, or no interest at all.<sup>21</sup> Further, a court’s perspective as to whether an oil and gas lease is subject to Code Section 365 depends on whether state law recognizes such agreements as conveying a vested fee interest in real property.<sup>22</sup> Though many

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<sup>17</sup> See S. Rep. No. 95-989, at 58 (1978) (“Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides. A note is not usually an executory contract if the only performance that remains is repayment.”).

<sup>18</sup> *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (“[I]t gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.”).

<sup>19</sup> See Laura Coordes, *Don’t Assume It’s a Lease! Applying § 365 to Oil and Gas Conveyances*, AM. BANKR. INST. (May 3, 2017, 5:16 PM), <https://www.abi.org/committee-post/don-t-assume-it-s-a-lease-applying-§-365-to-oil-and-gas-conveyances> (discussing the decision in *In re Sabine Oil & Gas Corp.*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016)) (suggesting that the allowance of the rejection of a midstream oil and gas lease may encourage oil production companies to file for bankruptcy with the intention of rejecting undesirable leases).

<sup>20</sup> See *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 71 (Bankr. S.D.N.Y. 2016).

<sup>21</sup> See *supra* note 19.

<sup>22</sup> See *River Prod., Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990) (explaining that states which recognize oil and gas leases as conveying of a freehold interest in real property, it is unlikely that such agreements will be treated as unexpired leases).

jurisdictions do not view oil and gas leases as unexpired leases, exceptions do exist.<sup>23</sup>

To effectively discern each court's position on this issue, an understanding of how the property interests at stake are commonly defined becomes necessary. As noted *supra*, many courts begin their analysis by determining what interest in real property has been conveyed by the lease in question.<sup>24</sup> A fee interest in property, often referred to as a "fee simple," is defined as "[a]n interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs."<sup>25</sup> However, this definition of a fee interest is not helpful when discussing oil and gas leases. The fee interest, more commonly recognized in terms of oil and gas agreements, is that of the fee simple determinable. A fee simple determinable is "[a]n estate that will automatically end and revert to the grantor if some specified event occurs."<sup>26</sup> Although not every court uses the term "fee simple determinable" when discussing oil and gas leases, this type of interest makes the most sense in context, at least one court discusses the possibility of the interest in property ceasing at the time oil is no longer produced.<sup>27</sup> However, the time at which such an interest "vests" is also at issue in many of the cases discussed *infra*. Black's Law Dictionary defines the term "vested" as "[h]aving become a completed, consummated right for present or future enjoyment."<sup>28</sup> Additionally, it is helpful to know exactly what constitutes "real property." Real property is defined as "[l]and and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land."<sup>29</sup> Piecing together the above definitions, a "vested fee interest in real property" is a current or future right to enter and use land.<sup>30</sup>

Another type of interest commonly discussed by courts during analysis of oil and gas leases is that of the leasehold interest. A leasehold is "[a] tenant's possessory estate in land or premises."<sup>31</sup> This definition is vague,—it tells us very little about the type of interest conveyed. However, Black's Law Dictionary

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<sup>23</sup> See *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 678 (Bankr. W.D. Mich. 2010) (departing from the notions of other jurisdictions that oil and gas leases convey a freehold interest in real property).

<sup>24</sup> See, e.g., *In re Topco, Inc.*, 894 F.2d at 740.

<sup>25</sup> *Fee Simple*, BLACK'S LAW DICTIONARY (11th ed. 2019).

<sup>26</sup> *Fee Simple Determinable*, BLACK'S LAW DICTIONARY (11th ed. 2019).

<sup>27</sup> See, e.g., *Frontier Energy, LLC*, 439 B.R. at 676.

<sup>28</sup> *Vest*, BLACK'S LAW DICTIONARY (11th ed. 2019).

<sup>29</sup> *Real Property*, BLACK'S LAW DICTIONARY (11th ed. 2019).

<sup>30</sup> See *Vest*, BLACK'S LAW DICTIONARY (11th ed. 2019); *Fee Simple*, BLACK'S LAW DICTIONARY (11th ed. 2019); *Real Property*, BLACK'S LAW DICTIONARY (11th ed. 2019).

<sup>31</sup> *Leasehold*, BLACK'S LAW DICTIONARY (11th ed. 2019).

provides that “[a]lthough a leasehold has some of the characteristics of real property, it has historically been classified as a chattel real.”<sup>32</sup> Looking to the definition of “chattel real,” one will find that it is defined as “[a] real-property interest that is less than a freehold or fee.”<sup>33</sup> In summary, many courts are looking to determine what level of interest is conveyed by an oil and gas lease.<sup>34</sup> If a fee interest is conveyed, the lessee has greater rights than those of a lessee who conveyed only a leasehold interest.

Due to the variety of oil and gas agreements currently used in the industry, it is also prudent to understand each type before exploring existing caselaw. Many of the cases discussed below relate to upstream oil and gas agreements. Upstream oil and gas agreements are agreements “[o]f, relating to, or involving the exploration and production activities of oil companies and their contractors, including the drilling of wells onshore, the use of land rigs, and onshore operations in support of offshore activities.”<sup>35</sup> On the other end of the spectrum, there are downstream agreements, which are agreements “relating to, or involving the process by which hydrocarbons are brought to market, including refining, processing, petrochemical transportation, and marketing of refined hydrocarbon products.”<sup>36</sup> Midstream, while not defined in Black’s Law Dictionary, is commonly understood as the part of the oil and gas chain where products of upstream operations are moved, stored, or processed to prepare such products for downstream use.<sup>37</sup> Moreover, while upstream agreements are likely to contemplate drilling operations, midstream agreements are more likely to pertain to pipeline transportation or well storage of oil and gas products intended to eventually be brought to the downstream market. Specifically, “gas gathering” agreements discussed below are midstream agreements pertaining to systems of pipelines with the intent to use such pipelines to gather and move gas.<sup>38</sup>

Having delineated the many concepts present in the caselaw surrounding oil and gas agreements, the next step in understanding the problematic nature of these agreements with respect to the Code is to explore the caselaw. Below are

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<sup>32</sup> *Id.*

<sup>33</sup> *Chattel Real*, BLACK’S LAW DICTIONARY (11th ed. 2019).

<sup>34</sup> *See generally In re Clark Res., Inc.*, 68 B.R. 358; *In re Frederick Petroleum Corp.*, 98 B.R. 762; *Energetics, Ltd. v. Whitmill*, 497 N.W.2d 497.

<sup>35</sup> *Upstream*, BLACK’S LAW DICTIONARY (11th ed. 2019).

<sup>36</sup> *Downstream*, BLACK’S LAW DICTIONARY (11th ed. 2019).

<sup>37</sup> Bethel Afework et al., *Midstream Oil and Gas Industry*, U. CALGARY: ENERGY EDUC., [https://energyeducation.ca/encyclopedia/Midstream\\_oil\\_and\\_gas\\_industry](https://energyeducation.ca/encyclopedia/Midstream_oil_and_gas_industry) (last updated Jan. 31, 2020).

<sup>38</sup> *See Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)*, 613 B.R. 90, 96 (Bankr. S.D. Tex. 2019) (“The intent of the parties was to build a gathering system of pipelines from the initial receipt points to market delivery points.”).

examples of how courts have ruled in such cases in a few states to demonstrate the varying outcomes.

#### A. Texas

As the nation's largest oil producer,<sup>39</sup> Texas seems the most appropriate starting point for identifying varying ways in which courts have chosen to handle property interests created by oil and gas leases. In Texas, oil and gas leases convey a freehold interest in land and therefore are not treated as unexpired leases or executory contracts.<sup>40</sup> In an oft cited footnote, the court in *In re Topco* noted that, "[t]he term 'oil and gas lease' is a misnomer because the interest created by an oil and gas lease is not the same as an interest created by a lease governed by landlord and tenant law."<sup>41</sup> Though the footnote in *Topco* is largely regarded as *dicta*, it is supported by the Texas Supreme Court decision in *Cherokee Water Co. v. Forderhause*, in which the court held that an oil and gas lease executed by a landowner and a third party violated a preemptive right to purchase oil and gas as granted in the original deed.<sup>42</sup> Perhaps providing the clearest explanation of how courts treat oil and gas leases in Texas, the court in *Good Hope Refineries, Inc. v. Benavides* noted that "Texas courts characterize the conveyance as creating a determinable fee interest in the minerals in place, which interest reverts automatically to the grantor upon failure to drill or pay."<sup>43</sup>

Although the aforementioned precedent exists in Texas with respect to upstream oil and gas agreements (agreements contemplating exploration and drilling),<sup>44</sup> the more recent decision in *In re Sabine Oil & Gas Corp.* has created new concerns for parties to similar midstream agreements.<sup>45</sup> Midstream agreements contemplate the transportation and storage of oil and gas products by way of pipelines, tanks and other infrastructure.<sup>46</sup> Despite the fact that the

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<sup>39</sup> *Oil and Petroleum Products Explained: Where Our Oil Comes From*, U.S. ENERGY INFO. ADMIN., <https://www.eia.gov/energyexplained/oil-and-petroleum-products/where-our-oil-comes-from.php> (last visited Feb. 13, 2021).

<sup>40</sup> *See River Prod., Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.17 (5th Cir. 1990).

<sup>41</sup> *Id.* at 739 n.17.

<sup>42</sup> *Cherokee Water Co. v. Forderhause*, 741 S.W.2d 377, 379, 380 (Tex. 1987).

<sup>43</sup> *Good Hope Refineries, Inc. v. Benavides*, 602 F.2d 998, 1001 (1st Cir. 1979).

<sup>44</sup> *Upstream? Midstream? Downstream? What's the Difference?*, ENERGYHQ, <https://energyhq.com/2017/04/upstream-midstream-downstream-whats-the-difference/> (last visited Feb. 13, 2021).

<sup>45</sup> James Roberts, *Trouble Down the Pipeline? What Sabine Oil & Gas Corp. May Mean For The Midstream Service Sector*, LEXOLOGY, <https://www.lexology.com/library/detail.aspx?g=2d632978-89cf-4ff6-916c-acc99075a25> ("Should the Court's decision be replicated by other bankruptcy courts, the threat to midstream service providers of not being able to recover the funds already spent could affect negotiation dynamics between distressed producers and service providers.").

<sup>46</sup> *Supra* note 44.

agreements in dispute concerned pipelines in Texas, Sabine Oil & Gas Corp. filed its bankruptcy petition in the Southern District of New York.<sup>47</sup> The court held that the debtor's midstream gas gathering agreements should be treated as executory contracts which could be rejected pursuant to Section 365 of the Code, noting that it would be a "reasonable exercise of business judgment."<sup>48</sup> The subsequent decisions of this case are of equal or perhaps greater importance in understanding the confusion surrounding these agreements with respect to Section 365 due to potential implications for third parties. Sabine sought and was granted a declaratory judgment stating that the agreements did not include covenants running with the land.<sup>49</sup> The decision was later affirmed by the Court of Appeals for the Second Circuit.<sup>50</sup>

### B. Louisiana

In Louisiana, there seems to be disagreement among the courts on how to treat oil and gas leases—in some cases, courts have ruled that Section 365 does not apply to oil and gas leases, whereas in others, they are treated as executory contracts subject to Section 365.<sup>51</sup> Louisiana derives its notions of property rights from the French Civil Code, creating an even broader variation in interpretation.<sup>52</sup> While some courts have ruled that oil and gas leases are not unexpired leases or executory contracts, at least one court has ruled that an oil and gas lease is in fact an executory contract.<sup>53</sup> In a somewhat perplexing decision, the court in *Texaco, Inc. v. Louisiana Land & Exploration Co.* described mineral leases as conveying "real rights,"<sup>54</sup> yet reached the conclusion that a mineral lease was an executory contract.<sup>55</sup> This decision seemingly

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<sup>47</sup> *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 69 (Bankr. S.D.N.Y. 2016).

<sup>48</sup> *Id.* at 79.

<sup>49</sup> *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC (In re Sabine Oil & Gas Corp.)*, 550 B.R. 59, 62 (Bankr. S.D.N.Y. 2016).

<sup>50</sup> *Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC (In re Sabine Oil & Gas Corp.)*, 734 F. App'x 64, 65 (2d Cir. 2018).

<sup>51</sup> *See Texaco, Inc. v. La. Land & Expl. Co.*, 136 B.R. 658, 668 (M.D. La. 1992) (holding that a mineral lease was an executory contract); *In re WRT Energy Corp.*, 202 B.R. 579, 585 (Bankr. W.D. La. 1996) (holding that mineral leases were not unexpired leases or executory contracts).

<sup>52</sup> *See generally* Leonard Oppenheim, *Louisiana's Civil Law Heritage*, 42 L. LIBR. J. 249, 253-54 (1949) (Property law in Louisiana finds its origins in the French and Roman Civil Codes, which in effect creates terminology and doctrines that differ from those of states with legal roots in English common law.).

<sup>53</sup> *See Texaco, Inc.*, 136 B.R. at 668 (holding that a mineral lease was an executory contract); *In re WRT Energy Corp.*, 202 B.R. at 585 (holding that mineral leases were not unexpired leases or executory contracts).

<sup>54</sup> *Texaco, Inc.*, 136 B.R. at 666. Louisiana courts use the term "real right" synonymously with "proprietary interest," implying that the term refers to an ownership interest in property. Edward C. Abell Jr., *Real Rights in Louisiana*, 21 LA. L. REV. 462, 463 (1960).

<sup>55</sup> *Texaco, Inc.*, 136 B.R. at 668.

suggests that even if a court recognizes an interest in real property other than a leasehold interest, that interest can be subverted simply by calling the agreement an executory contract. Additionally, in the courts analysis of executory contracts, the Countryman definition is discussed at length—yet the court reached the conclusion that the lessee had a continuing obligation to perform and deemed the agreement an executory contract.<sup>56</sup> The court, however, failed to recognize that the lessee's continuing obligations to make payments to the lessor is not typically considered underperformance pursuant to the Countryman definition of executory contracts.<sup>57</sup> The Texaco decision to treat a mineral lease as an executory contract has been met with criticism, particularly by the court in *In re WRT Energy Corp.*<sup>58</sup>

Judge Parker discussed the nature of the OG&ML [Oil, Gas and Mineral Lease] at length, and, further, discussed the difference between the mineral lease and other more standard lease contracts. Then, unexpectedly, he avoided deciding the issue . . . Judge Parker avoided deciding whether the OG&ML was an unexpired lease within the meaning of [S]ection 365(a), choosing instead to base his decision on a finding that the OG&ML was an executory contract.<sup>59</sup>

The court went on to discuss the decision in *In re Ham Consulting Co.* holding that a mineral lease in Louisiana is not an unexpired lease.<sup>60</sup> The *WRT Energy* court held that mineral leases at issue were not unexpired leases or executory contracts for purposes of Section 365.<sup>61</sup> The debate in the Louisiana courts exemplifies the broader debate and disagreement throughout the United States as a whole.

### C. Oklahoma

In Oklahoma, courts have found that oil and gas leases fall completely outside the scope of Section 365, holding that such agreements are neither unexpired leases nor executory contracts.<sup>62</sup> However, the analysis offered by the court in *In re Clark Resources* seems to be markedly different from Texas courts which have reached the same conclusion.<sup>63</sup> With respect to the unexpired lease

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<sup>56</sup> *Id.* at 667.

<sup>57</sup> *See Id.* at, 667–68; Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439 (1973).

<sup>58</sup> *In re WRT Energy Corp.*, 202 B.R. at 585.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *E.g., In re Clark Res., Inc.*, 68 B.R. 358, 360 (Bankr. N.D. Okla. 1986).

<sup>63</sup> *Compare In re Clark Res., Inc.*, 68 B.R. at 359–60 (holding that oil and gas leases create neither

portion of Section 365, Oklahoma courts have held that oil and gas leases do not give rise to an “estate in land”, but rather create an “interest or estate in realty.”<sup>64</sup> The interest created gives rise to a license to explore, but not a freehold interest or leasehold interest in real property.<sup>65</sup> In *Clark*, the court looked to the Countryman definition of executory contracts in making its final determination that the oil and gas lease could not be rejected.<sup>66</sup> The court ascertained that neither the lessee nor the lessor had complex underperformed obligations under the agreement.<sup>67</sup> The lessee’s only obligation to the lessor was to pay, and the lessor’s only obligation to the lessee was to “defend their title to the lease land and not to interfere with the lessee’s drilling operation.”<sup>68</sup> Thus, the agreement was not an executory contract.<sup>69</sup>

The court in *Clark* modeled much of its analysis after the slightly earlier decision in *In re Heston Oil Co.*, where the court noted that the term “lease” fails to adequately describe the relationship between parties to such agreements.<sup>70</sup> Both the court in *Heston* and the court in *Clark* discussed the prior decision in *In re J.H. Land & Cattle Co.*, noting that the *J.H. Land* court’s finding that oil and gas leases could be rejected pursuant to Section 365 was at odds with the Oklahoma Supreme Court’s view of the interests created by oil and gas leases.<sup>71</sup> Oddly, the court in *J.H. Land* did not hold that oil and gas leases create an interest in real property, but rather an “intangible personal property right.”<sup>72</sup> The court did not consider whether the agreement was an executory contract subject to rejection pursuant to Section 365.<sup>73</sup> Rather, the court held that the agreement

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freehold or leasehold interests) with *Good Hope Refineries, Inc. v. Benavides*, 602 F.2d 998, 1001 (1st Cir. 1979) (holding that oil and gas leases create a determinable fee interest in minerals).

<sup>64</sup> *In re Clark Res., Inc.*, 68 B.R. at 358.

<sup>65</sup> *Id.* at 359.

The interest created by an oil and gas lease in Oklahoma is not “real estate” and conveys no real interest in land itself, it is a chattel real, an incorporeal hereditament and a profit a’ prendre which is in the nature of a license to explore by drilling and permits the lessee to capture oil and gas which is then treated as personalty.

*Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 359–60.

<sup>68</sup> *Id.* at 360.

<sup>69</sup> *Id.*

<sup>70</sup> *In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (“The Oklahoma Supreme Court in several cases has considered the characteristics of an oil and gas lease and has found that use of the term ‘lease’ is more in ‘deference to custom’ than a description of the legal relationship involved.”).

<sup>71</sup> *Id.*; *In re Clark Res., Inc.*, 68 B.R. 358, 359 (Bankr. N.D. Okla. 1986).

<sup>72</sup> *In re J.H. Land & Cattle Co.*, 8 B.R. 237, 239 (Bankr. W.D. Okla. 1981).

<sup>73</sup> *Id.* at 238–39.

could be rejected pursuant to a business judgment test.<sup>74</sup> While the *J.H. Land* opinion has been unpopular and questioned by other courts within the state as well as courts outside of Oklahoma analyzing Kansas property law with respect to Section 365, it has not been overturned.<sup>75</sup>

Turning to the arguably more complex analysis of midstream gas gathering agreements, such as the agreement discussed above in *Sabine*,<sup>76</sup> the Bankruptcy Court for the Southern District of Texas recently had the opportunity to explore the analysis in *Sabine* while reaching a differing conclusion in *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res, Inc.)*.<sup>77</sup> The gas gathering agreement at issue in *Alta Mesa* concerned property in Oklahoma, and was therefore analyzed pursuant to Oklahoma property law.<sup>78</sup> The court in *Alta Mesa* held that gas gathering agreements convey a leasehold interest in real property rather than a fee interest,<sup>79</sup> however the court also found that this issue alone is not dispositive of whether the leases in question could be rejected.<sup>80</sup> The movant sought a declaratory judgment, arguing that the gas gathering agreements could be rejected as executory contracts.<sup>81</sup>

The court held that the gathering agreements could not be rejected because they were not executory contracts, but rather leases that formed “real property covenants running with the land.”<sup>82</sup> In its analysis, the court explained that three factors must be satisfied to form covenants that run with the land.<sup>83</sup> “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.”<sup>84</sup> The court went further to explain each of the elements, first stating that “[i]f the value of the owner’s interest in the land itself is affected by the covenant, either positively or negatively, the covenant touches and concerns the

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<sup>74</sup> *Id.* at 239.

<sup>75</sup> *See Baker Farms, Inc. v. Sandridge E&P, LLC (In re Sandridge Energy, Inc.)*, No. 16-32488, 2018 Bankr. LEXIS 318, at \*32–33 (Bankr. S.D. Tex. Feb. 5, 2018) (questioning the reasoning used in *In re J.H. Land & Cattle* and holding that “oil and gas leases are not subject to § 365”); *In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (questioning the reasoning used in *In re J.H. Land & Cattle*).

<sup>76</sup> *E.g., In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 70 (Bankr. S.D.N.Y. 2016).

<sup>77</sup> *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)*, 613 B.R. 90, 102 (Bankr. S.D. Tex. 2019).

<sup>78</sup> *Id.* at 99–100.

<sup>79</sup> *Id.* at 103.

<sup>80</sup> *See id.* at 103–07 (discussing whether the agreement constituted an executory contract).

<sup>81</sup> *Id.* at 100.

<sup>82</sup> *Id.* at 98.

<sup>83</sup> *Id.* at 99.

<sup>84</sup> *Id.* at 100.

land.”<sup>85</sup> In this case, the gas gathering agreement created a surface easement burdening Alta Mesa’s interest in the oil reserves by restricting use of the surface land.<sup>86</sup> During its analysis of whether such covenants touch and concern the land, the court noted that contrary to the *Sabine* court’s finding that “surface easement[s] do[] not touch and concern [] mineral estate[s,] . . . in the context of an oil and gas lease, the surface easement is integral to the lessee’s ability to realize the value of its mineral reserves.”<sup>87</sup>

In its discussion of the second element determining whether a covenant runs with the land, the court discussed vertical and horizontal privity, noting that “[v]ertical privity relates to the relationship between the present owner of the land and the original parties to the covenant[,]”<sup>88</sup> while horizontal privity relates to the “relationship between the original parties to the covenant.”<sup>89</sup> Vertical privity was not at issue in *Alta Mesa*, however, the parties disputed whether the existence of horizontal privity was required to create a covenant.<sup>90</sup> Ultimately, this dispute was inconsequential, as the court held that horizontal privity did exist because the surface easement discussed above relates not only to the surface of the land, but also to the mineral interests—without the easement, the lessee would not have the opportunity to realize the value in the deposits below the surface.<sup>91</sup> The court also noted that the *Sabine* court held that a surface easement did not create horizontal privity and seemed to suggest that the Sabine court mistakenly analyzed the easement with respect to a fee mineral estate rather than an oil and gas leasehold.<sup>92</sup>

Lastly, the court discussed the third element of covenants running with the land—intent to bind successors.<sup>93</sup> Here the court found that the language of the agreements was quite clear—each agreement specifically stated that it was “a

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<sup>85</sup> *Id.* at 102.

<sup>86</sup> *Id.* at 103–04.

<sup>87</sup> *Id.* at 104.

<sup>88</sup> *Id.* at 105.

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 102–03, 106.

<sup>92</sup> *Id.* at 106.

In *Sabine*, the court found that the gatherer’s surface easement did not create horizontal privity with respect to the producer’s mineral estate. However, *Sabine* centered its analysis around fee mineral estates, not oil and gas leaseholds. . . . Because a surface easement is a crucial component on an oil and gas lease, the Court does not view this conveyance as creating privity only with respect to the surface estate.

*Id.*

<sup>93</sup> *Id.*

covenant running with the land.”<sup>94</sup> In accordance with the analysis it provided, the court held that the agreements between Alta Mesa, LP and Kingfisher Midstream, LLC created covenants running with the land and thus they could not be rejected pursuant to Section 365.<sup>95</sup> Although this court recognized that *Sabine* was decided on its own facts, it also noted that “[t]o the extent that the pronouncements in *Sabine* were intended to be generalized, this Court must reject them”,<sup>96</sup> suggesting that perhaps if the *Sabine* case had been decided by a court in Texas rather than New York, the outcome may have been markedly different.

#### *D. Utah*

In Utah, courts have held that midstream oil and gas leases contain covenants that run with the land and therefore are not subject to rejection under Section 365.<sup>97</sup> In light of the above discussion of both *Sabine* and *Alta Mesa*, it is worth noting that the United States Bankruptcy Court for the District of Colorado also recently decided a case involving midstream gas gathering agreements concerning property in Utah.<sup>98</sup> *Badlands* and *Alta Mesa* were both decided after *Sabine*, and notably, both courts made little hesitation in distinguishing themselves from the *Sabine* decision.<sup>99</sup> Though the facts in *Badlands* vary slightly from those in *Alta Mesa*, the ultimate determination was the same—the agreements at issue were found to contain covenants running with the land and therefore, Section 365 does not apply.<sup>100</sup> The determination that covenants running with the land preclude a debtor from rejecting a lease that conveys such covenants is not at odds with the *Sabine* decision however—the *Sabine* court said as much itself.<sup>101</sup> The distinction between these cases can be found, rather, in the fact that the *Sabine* court found that the gas gathering agreements at issue in the case did not contain any covenants running with the land.<sup>102</sup>

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<sup>94</sup> *Id.*

<sup>95</sup> *Id.* at 98–100.

<sup>96</sup> *Id.* at 102.

<sup>97</sup> *E.g.*, *Monarch Midstream, LLC v. Badlands Prod. Co. (In re Badlands Energy, Inc.)*, 608 B.R. 854, 870 (Bankr. D. Colo. 2019).

<sup>98</sup> *Id.* at 861.

<sup>99</sup> *Id.* at 869 (Bankr. D. Colo. 2019); *In re Alta Mesa Res., Inc.*, 613 B.R. at 102.

<sup>100</sup> *In re Badlands Energy, Inc.*, 608 B.R. at 875.

<sup>101</sup> *HPIP Gonzales Holdings, LLC v. Sabine Oil & Gas Corp. (In re Sabine Oil & Gas Corp.)*, 567 B.R. 869, 874 (S.D.N.Y. 2017) (“[I]t is not possible for a debtor to reject a covenant that ‘runs with the land,’ since such a covenant creates a property interest that is not extinguished through bankruptcy.”).

<sup>102</sup> *Id.* at 877.

To determine whether the covenants in question were covenants that run with the land, the *Badlands* court used similar analysis to that in *Alta Mesa*.<sup>103</sup> In summary, the court looked to whether the covenants touched and concerned the land, whether both horizontal and vertical privity existed, and whether the parties to the agreement intended covenants to bind successors.<sup>104</sup> On all three parts of this test, the court determined that each requirement did exist, and therefore the covenants were covenants running with the land.<sup>105</sup>

### *E. Ohio*

In Ohio, it remains unclear whether oil and gas leases are subject to rejection under section 365. Despite Ohio's dominant presence in the oil industry, there is surprisingly little relevant case law discussing oil and gas leases with respect to Section 365. However, the court in *In re Frederick Petroleum Corp.* provided vast discussion on the topic, giving insight as to how such agreements are likely to be treated under Ohio law.<sup>106</sup> The court in *Fredrick Petroleum Corp.* reversed a subsequent order which held that oil and gas leases conveyed an interest in nonresidential real property.<sup>107</sup> In its discussion, the Ohio court seemingly gave deference to the decisions in both *In re Clark* and *In re Heston* regardless of the fact that those cases did not touch on Ohio property law at all, stating, “[t]he court feels that the Ohio courts, if given the opportunity to do so, would characterize the property interest involved as being like or similar to the interest recognized under Oklahoma law.”<sup>108</sup> In this case, the bankruptcy court held that certain oil and gas leases had been forfeited and deemed rejected due to failure of the trustee and the debtor to assume or reject the leases within the statutory 60 day period.<sup>109</sup> However, the district court noted that rejection of the leases could result in a “windfall to the lessor” and “deprive the estate” of a potentially “valuable asset.”<sup>110</sup> Furthermore, the court thoughtfully analyzed the effect of such a rejection or forfeiture on third parties to oil and gas leases.<sup>111</sup>

On the other hand, since interests in oil and gas leases may be divided through multiple assignments, the failure of the trustee to act within sixty days and the resultant forfeiture could result in a loss of assets

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<sup>103</sup> *In re Badlands Energy, Inc.*, 608 B.R. at 867.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 868–73.

<sup>106</sup> *See In re Frederick Petroleum Corp.*, 98 B.R. 762, 763 (S.D. Ohio 1989).

<sup>107</sup> *Id.* at 767.

<sup>108</sup> *Id.* at 766.

<sup>109</sup> *Id.* at 763.

<sup>110</sup> *Id.* at 767.

<sup>111</sup> *Id.*

assigned to third parties uninvolved in and perhaps without notice of the bankruptcy proceedings.<sup>112</sup>

Considering the above analysis, the district court reversed the bankruptcy court's ruling that the leases were deemed forfeited.<sup>113</sup>

#### *F. Michigan*

In Michigan, caselaw suggests that oil and gas leases are treated as actual leases subject to rejection under Section 365.<sup>114</sup> In a decision unrelated to Section 365, the Michigan Supreme Court attempted to provide guidance on what interests are created in an oil and gas lease.<sup>115</sup> In *Energetics*, the Court noted that oil and gas leases transfer only an interest in the oil and gas,<sup>116</sup> and in doing so, the Court cited a prior case in which the Court held that oil and gas remain part of the realty until they are severed from it.<sup>117</sup> The Court went on to state that lessors in an oil and gas lease retain a reversionary interest in the remaining minerals upon termination of the lease, characterizing such a reversionary interest as a leasehold interest reverting back to the property owner.<sup>118</sup> However, in support of this proposition, the Court cited two Texas cases.<sup>119</sup> As noted above, Texas law does not consider an oil and gas lease as conveying a leasehold interest, but rather a freehold interest in real property.<sup>120</sup>

It is unclear why the Michigan Supreme Court would choose to cite Texas law to support a proposition that is somewhat fundamentally at odds with the way in which Texas treats oil and gas rights, and this perplexing choice was noted and discussed by the United States Bankruptcy Court for the Western District of Michigan in *Frontier Energy, LLC v. Aurora Energy, Ltd.*<sup>121</sup> In *Aurora*, Section 365 was at issue, and the *Energetics* decision was one of many cases to which the court attempted to determine whether oil and gas leases could

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<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *See Energetics, Ltd. v. Whitmill*, 497 N.W.2d 497, 502 (Mich. 1993).

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* (citing *Jupiter Oil Co. v. Snow*, 819 S.W.2d 466, 568 (Tex. 1991) and *Kaiser v. Love*, 358 S.W.2d 586, 587 (Tex. 1962)).

<sup>120</sup> *See River Prod., Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 739 n.16 (5th Cir. 1990).

<sup>121</sup> *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 678 (Bankr. W.D. Mich. 2010) (“[T]he [Michigan] Supreme Court characterized the reversionary interest as a ‘leasehold’ interest that reverts to the ‘interest owner,’ even though it cited Texas law which generally treats a lessee’s interest as a fee.”).

in fact be rejected pursuant to the statute.<sup>122</sup> After discussing *Energetics*, the court turned to a 1942 Michigan Supreme Court decision in which the Court held that a lessee in an oil and gas agreement is “but a lessee for a determinable term and [is] not seised of an estate of inheritance.”<sup>123</sup> While not exactly on point (this case dealt with Michigan’s dower statute rather than the Code<sup>124</sup>), the Aurora court found the language helpful in determining that Michigan law “treats a lessee’s interest as a leasehold or *profit à prendre*, but not a freehold estate.”<sup>125</sup>

After having reached this conclusion, the court went on to discuss the plain meaning of the word “lease,” citing the United States Bankruptcy Court for the Northern District of Illinois, stating that lease commonly means:

[1] an agreement by the owner of property (the lessor) to allow exclusive possession of that property by another person (the lessee), [2] for a defined period of time, [3] in exchange for payment (“rent”) by the lessee, [4] with the property reverting to the lessor at the end of the lessee’s period of possession.<sup>126</sup>

The court then stated that the oil and gas leases at issue fell squarely within this definition of a lease, noting that the lessor conveyed an interest to the lessee in exchange for rent and royalty payments.<sup>127</sup> Holding that the interest conveyed amounted to a leasehold interest, and thus an unexpired lease subject to assumption or rejection under Section 365, the court declined to analyze the agreements with respect to executory contracts.<sup>128</sup>

### G. Pennsylvania

In Pennsylvania, caselaw seems to suggest that whether an oil and gas lease is deemed a lease or executory contract depends on the timing of the bankruptcy filing.<sup>129</sup> Much of what is understood about the current interpretation of oil and gas leases in Pennsylvania can be gleaned from the 2012 Supreme Court of Pennsylvania decision in *T.W. Phillips Gas & Oil Co. v. Jedlicka*.<sup>130</sup> Since the

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<sup>122</sup> See generally *id.* at 676.

<sup>123</sup> *Id.* at 678–79 (Bankr. W.D. Mich. 2010) (discussing *Redman v. Shaw*, 1 N.W.2d 555, 556–57 (Mich. 1942)).

<sup>124</sup> See generally *Redman v. Shaw*, 1 N.W.2d 555, 556 (Mich. 1942).

<sup>125</sup> See *In re Aurora Oil & Gas Corp.*, 439 B.R. at 678.

<sup>126</sup> *Id.* at 679 (Bankr. W.D. Mich. 2010) (citing *In re Res. Tech. Corp.*, 254 B.R. 215, 225–26 (Bankr. N.D. Ill. 2000)).

<sup>127</sup> *Id.*

<sup>128</sup> See *id.* at 680.

<sup>129</sup> See *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261, 267 (Pa. 2012).

<sup>130</sup> See generally *id.*

decision was published, it has been cited eighty times by lower courts and nearly 200 times in various other publications.<sup>131</sup> One of the hallmark principals of *Jedlicka* is the Court's determination that oil and gas leases should be construed in accordance with the terms contained within the agreement—that oil and gas leases are contracts by nature and should be evaluated pursuant to contract law.<sup>132</sup> Additionally, *Jedlicka* informs lower courts' understanding of habendum clauses in oil and gas leases—such clauses typically provide that parties to an oil and gas lease will continue to be bound by that agreement until such a time when oil and gas is no longer produced “in paying quantities.”<sup>133</sup>

Perhaps due to the extensive discussion of oil and gas leases construed as contracts in *Jedlicka*, at least one lower court reached a sweeping general opinion which was subsequently found to be erroneous.<sup>134</sup> In *Powell v. Anadarko E&P Co., L.P. (In re Powell)*, the Bankruptcy Court for the Middle District of Pennsylvania opined on the nature of oil and gas leases with respect to contract law.<sup>135</sup> Ultimately, the bankruptcy court reached the conclusion that all oil and gas leases commence as either executory contracts or leases, and only after oil and gas has been produced does an interest in property vest.<sup>136</sup> While this discussion is no more than *dicta* holding no precedential value, the lessor in the case appealed the decision, despite the fact that the final order was in his favor.<sup>137</sup> The district court, upon appeal, held that the lessor had standing to appeal the order, as such a determination by the bankruptcy court materially changed the lessor's interest in the property and could have a prejudicial effect should there be further proceedings.<sup>138</sup>

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<sup>131</sup> See, e.g., *SLT Holdings, LLC v. Mitch-Well Energy, Inc.*, 249 A.3d 888, 897 (Pa. 2021) (citing *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261 (Pa. 2012)).

<sup>132</sup> *T.W. Phillips Gas & Oil Co.*, 42 A.3d at 267 (“[A] lease is in the nature of a contract and is controlled by principles of contract law. It must be construed in accordance with the terms of the agreement...”).

<sup>133</sup> *Id.* at 268.

<sup>134</sup> See *Powell v. Anadarko E&P Co., L.P. (In re Powell)*, 482 B.R. 873, 878 (Bankr. M.D. Pa. 2012), *vacated in part, remanded to Chesapeake Appalachia, LLC v. Powell (In re Powell)*, No. 13-00035, 2015 U.S. Dist. LEXIS 152509, at \*13–17 (M.D. Pa. Nov. 10, 2015).

<sup>135</sup> See *id.* (noting that it is difficult to determine whether an oil and gas lease is an executory contract).

<sup>136</sup> *Id.*

That court concluded, until oil or gas is produced, no freehold estate vests in the lessee. Logically then, if, at the time bankruptcy was filed and there was no oil or gas produced—as is true in this case—then contract principles would apply including an interpretation of whether this was an executory contract or lease.

*Id.* (interpreting precedent).

<sup>137</sup> See *Chesapeake Appalachia, LLC v. Powell (In re Powell)*, No. 13-00035, 2015 U.S. Dist. LEXIS 152509, at \*1–2 (M.D. Pa. Nov. 10, 2015).

<sup>138</sup> *Id.* at \*10–12.

The district court went on to cite several prior Pennsylvania cases, holding that “an oil and gas lease conveys a fee simple determinable estate in the oil and gas to the lessee at the time the lease is executed.”<sup>139</sup> The district court also noted that *Jedlicka* was not the first Pennsylvania Supreme Court Case holding that a “lease is in the nature of a contract and is controlled by principles of contract law.”<sup>140</sup> However, the district court suggested that the two ideas above were not mutually exclusive.<sup>141</sup> In its analysis, the district court noted that in discussing oil and gas leases with respect to contract law, “[t]he Bankruptcy Court cited this as though it were a new principle that *Jedlicka* created to supersede preexisting case law and to transform oil and gas leases from real property conveyances to mere contracts.”<sup>142</sup> The court went further in noting that while Pennsylvania courts do interpret leases according to contract principles, that should not be interpreted to mean that any lease is nothing more than a contract.<sup>143</sup>

The district court then went on to analyze the importance of the language within the lease in determining how such an agreement should be treated.<sup>144</sup> Citing a prior opinion, the court noted:

[T]he Pennsylvania Supreme Court considered a conveyance of oil and gas rights to be a grant of fee simple when the conveyance did not use the term “lease,” but, like *Jedlicka*, included a “habendum clause which states: To have and to hold the said lands and rights unto the Grantee for the term of twenty years from the date hereof, and as much longer as . . . oil or gas is found or produced in paying quantities.”<sup>145</sup>

With this analysis, *In re Powell* and its subsequent appellate history does not necessarily provide guidance on exactly how Pennsylvania law interprets oil and gas leases with respect to Section 365, but rather how courts in Pennsylvania should not interpret *Jedlicka* and its predecessors and successors.<sup>146</sup> The district court did not take the time to analyze the agreement between the parties in dispute with respect to its opinion, but rather vacated the prior order in part and

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<sup>139</sup> *Id.* at \*8.

<sup>140</sup> *Id.* at \*13.

<sup>141</sup> *See also id.* at \*13–15.

<sup>142</sup> *Id.* at \*14.

<sup>143</sup> *See id.* at \*15 (M.D. Pa. Nov. 10, 2015).

<sup>144</sup> *See id.* at \*16–17 (M.D. Pa. Nov. 10, 2015).

<sup>145</sup> *Id.* at \*17–18 (M.D. Pa. Nov. 10, 2015) (citing *Brown v. Haight*, 255 A.2d 508, 511 (Pa. 1969)).

<sup>146</sup> *See id.* at \*22–23 (“In summary, there is nothing in *Jedlicka* or the later cases applying it that supports the Bankruptcy Court’s opinion that it created a general rule to apply to all leases regardless of the linguistics used in each one.”).

remanded the case back to the lower court to make a determination in accordance with the district court's analysis.<sup>147</sup>

Furthermore, the district court in *Powell* as well as the Pennsylvania Supreme Court failed to solve the ultimate question at hand—do all oil and gas leases in Pennsylvania convey a fee simple determinable interest in property at the moment they are executed?<sup>148</sup> “The Supreme Court’s decision in *Jedlicka* informs us that it has not adopted a general rule of law that would answer this question.”<sup>149</sup>

In summary, the above-mentioned cases span a variety of states and jurisdictions leading to a multitude of outcomes for lessors and lessees alike. Variation exists not only from state to state, but often within individual states. Interestingly, as demonstrated above, courts seem to be more than willing to cite to cases outside of their own jurisdiction when analyzing oil and gas leases, but often either misinterpret or misuse prior case history to reach their conclusions.<sup>150</sup> While the caselaw discussed above is somewhat dense and often confusing, that confusion speaks to the problematic nature of attempting to force oil and gas leases into categories where they do not belong. If, as it seems, courts cannot come to an agreement on the issue, how do we expect the average landowner to make an informed decision when entering into agreements with oil and gas producers? Below, this Comment will analyze why such dramatic variation exists and what that variation means for parties to oil and gas agreements.

## II. ANALYSIS

Before addressing the effect these disparities are likely to have on parties to oil and gas agreements and how to remedy those effects, the underlying causes of such disparities must first be addressed. The two most likely reasons for these disparities are: (1) state property law varies greatly throughout the country and bankruptcy courts are often asked to analyze leases pursuant to property laws in states other than the state in which the court sits; and (2) oil and gas law is incredibly complex, leaving courts in jurisdictions lacking experience in oil and gas law at a disadvantage when asked to provide analysis.

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<sup>147</sup> *Id.* at \*23.

<sup>148</sup> *See id.* at \*24.

<sup>149</sup> *Id.* at \*24–25.

<sup>150</sup> *See, e.g.,* *Energetics, Ltd. v. Whitmill*, 497 N.W.2d 497, 502, 506 (Mich. 1993) (looking to decisions from the Texas Supreme Court in its discussion of reversionary rights).

The most obvious reason why courts have reached varying conclusions about the nature of oil and gas leases is that property laws are state specific, and bankruptcy courts are bound to comply with the property laws of whichever state the property in question is located.<sup>151</sup> Oil and gas entities, such as the many noted above, may hold property in multiple jurisdictions, requiring bankruptcy courts to analyze each lease with respect to the laws of the state in which the property exists. In *Butner*, the Supreme Court declined to review the state law in question, noting that “federal judges who deal regularly with questions of state law in their respective districts and circuits are in a better position than we to determine how local courts would dispose of comparable issues.”<sup>152</sup>

If the Supreme Court recognizes that judges who are familiar with laws of their own jurisdictions are “better suited” to decide issues arising out of state law,<sup>153</sup> then why does our current bankruptcy system frequently allow out of state bankruptcy judges and district court judges to analyze property laws of far off jurisdictions?<sup>154</sup> In *Sabine*, the property in dispute was located in Texas and was thus governed by Texas property law.<sup>155</sup> Yet, because the debtor filed for bankruptcy in the Southern District of New York, all matters arising out of that petition were decided in New York by New York judges.<sup>156</sup> Similarly, in *J.H. Land & Cattle*, the property in dispute was located in Kansas but all matters concerning the property were decided in the Western District of Oklahoma.<sup>157</sup> It should be noted, however, that Oklahoma and Kansas fall within the same federal district.<sup>158</sup> Nonetheless, the analysis used in *J.H. Land & Cattle* has been subsequently questioned by other courts attempting to rule on oil and gas leases in Kansas.<sup>159</sup>

The *Sabine* decision has been discussed at great length in articles published by law firms working within the oil and gas industry and has been described as

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<sup>151</sup> See also *Butner v. United States*, 440 U.S. 48, 53, 55–56 (1979).

<sup>152</sup> *Id.* at 58.

<sup>153</sup> *Id.*

<sup>154</sup> See generally *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 69, 70 (Bankr. S.D.N.Y. 2016) (analyzing Texas property law); *In re J.H. Land & Cattle Co.*, 8 B.R. 237, 238 (Bankr. W.D. Okla. 1981) (analyzing Kansas property law).

<sup>155</sup> See *In re Sabine Oil & Gas Corp.*, 547 B.R. at 70.

<sup>156</sup> See *id.* at 69.

<sup>157</sup> *In re J.H. Land & Cattle Co.*, 8 B.R. at 238.

<sup>158</sup> See *Geographic Boundaries of United States Courts of Appeals and United States District Courts*, U.S. CTS., <https://www.uscourts.gov/about-federal-courts/federal-courts-public/court-website-links> (demonstrating that both Oklahoma and Kansas are located in the Tenth Circuit).

<sup>159</sup> See *Baker Farms, Inc. v. Sandridge E&P, LLC (In re Sandridge Energy, Inc.)*, 2018 Bankr. LEXIS 318, at \*32–33 (Bankr. S.D. Tex. Feb. 5, 2018); *In re Heston Oil Co.*, 69 B.R. 34, 36 (N.D. Okla. 1986) (questioning the reasoning used in *J.H. Land & Cattle*).

“unwelcome” to parties to gas gathering agreements.<sup>160</sup> However, it has also been noted that the decision has no precedential value outside of the Second Circuit<sup>161</sup>—but is that really a consolation to parties to oil and gas agreements? Many Chapter 11 cases are in fact filed in the Second Circuit,<sup>162</sup> implying that the precedent set in *Sabine* may continue to be a thorn in the side of parties to midstream gas gathering agreements and other similar agreements. On the contrary, the *Alta Mesa* and *Badlands* decisions tend to give a more favorable outlook to parties to midstream gas gathering agreements in places like Utah and Oklahoma, but again, such a consolation only goes so far as easing the concerns of parties in those very specific regions. Even so, as discussed in many cases above, the location of the property concerning the dispute seems to be a relatively small factor when compared with the venue in which such a dispute may be resolved.

Just like state property law, oil and gas law brings with it its own problems. The court in *Aurora* described oil and gas law as arcane.<sup>163</sup> It cannot be ignored that courts throughout the country undoubtedly have varying degrees of expertise in interpreting oil and gas agreements.<sup>164</sup> So, not only are bankruptcy courts expected to be able to decipher state property law from states outside of their normal purview, they also must interpret provisions in contracts touching on an area of law that is seen as “arcane.”<sup>165</sup> Considering the nature of oil and gas leases as having intertwined state property law with oil and gas law, it is unsurprising that courts seem to use varying methods of analysis and reach varying conclusions when asked to rule on these agreements with respect to Section 365.

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<sup>160</sup> Mark G. Douglas & Paul Green, *Oil and Gas Industry Update – Sabine Oil Not the Last Word on Treatment of Gathering Agreements in Bankruptcy*, JDSUPRA (Mar. 4, 2020), <https://www.jdsupra.com/legalnews/oil-and-gas-industry-update-sabine-oil-57893/> (“The decision was unwelcome news to gas gathering and handling agreement counterparties.”).

<sup>161</sup> Matt Ochs et al., *The Sabine Decision and its Effect on Midstream Agreements*, Address at ABA Panel: What the “Frack” is Going On? (Mar. 28, 2019) (transcript available at [https://www.hollandhart.com/files/78734\\_what\\_the\\_frack\\_is\\_going\\_on\\_lboyle.pdf](https://www.hollandhart.com/files/78734_what_the_frack_is_going_on_lboyle.pdf)).

<sup>162</sup> See *supra* note 160 (“The Southern District of New York and Delaware have long been the preferred forums for large chapter 11 cases.”).

<sup>163</sup> See *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 679 (Bankr. W.D. Mich. 2010).

<sup>164</sup> Number of Exploration and Production (E&P) Company Bankruptcy Filings in the United States from 2015 to June 2020 by State, Statista (July 15, 2021), <https://www.statista.com/statistics/1134295/us-upstream-oil-company-bankruptcy-filings-by-state/> (Showing that Texas led the nation in oil exploration and production bankruptcies with 109, while second place Delaware saw only 34 oil bankruptcies).

<sup>165</sup> *In re Aurora Oil & Gas Corp.*, 439 B.R. at 679.

As noted briefly above, forum selection plays a large role in predicting the outcomes of a bankruptcy proceeding. The savvy corporate debtor is likely well aware of its options when it considers how and where to proceed with a bankruptcy petition, but where does this leave other parties to oil and gas agreements?

With the exception of Chapter 15,<sup>166</sup> a corporation has the option of filing for bankruptcy in its state of incorporation, its principal place of business, or the district in which it holds its principal assets.<sup>167</sup> Although bankruptcy may not be on the minds of parties to an oil and gas agreement at the outset, failure to consider the implications of insolvency could prove detrimental to parties to such agreements. However, an individual landowner entering into an agreement with a large oil and gas corporation is unlikely to be aware of not only the state property laws concerning the agreement, but also of the fact that the “leased” property could become the subject of great dispute in the event that the corporate lessee finds itself in a precarious financial situation. Equal risk does not exist when the tables are turned—the corporation is far better situated in terms of predicting the outcome of a potential bankruptcy filing by the landowner.

#### *A. Effect on Parties to the Agreement*

It is important, not only to evaluate not only the effects of uncertainty surrounding Section 365 on parties to oil and gas agreements, but also the effect on each party with respect to each varying precedent.

In many jurisdictions, courts have ruled that oil and gas leases convey a freehold or fee interest in real property.<sup>168</sup> As noted above, some courts have held that this interest is conveyed at the time the agreement is made, whereas other courts have held that the interest vests in property vests when oil is produced on the property.<sup>169</sup> Regardless of when such an interest vests, if it has in fact vested, such holdings have strong implications for both the lessor and the lessee. When the debtor is the landowner (the “lessor”) in an oil and gas lease, a jurisdiction which views such a lease as conveying a freehold interest would act

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<sup>166</sup> See 28 U.S.C. § 1410 (2018).

<sup>167</sup> 28 U.S.C. § 1408 (2018).

<sup>168</sup> E.g., *River Prod., Co. v. Webb (In re Topco, Inc.)*, 894 F.2d 727, 740 (5th Cir. 1990); *In re Heston Oil Co.*, 69 B.R. 34, 36 (Bankr. N.D. Okla. 1986); *Chesapeake Appalachia, LLC v. Powell (In re Powell)*, No. 13-00035, 2015 U.S. Dist. LEXIS 152509 (M.D. Pa. Nov. 10, 2015).

<sup>169</sup> *Chesapeake Appalachia, LLC v. Powell (In re Powell)*, No. 13-00035, 2015 U.S. Dist. LEXIS 152509, at \*5–7, 23 (M.D. Pa. Nov. 10, 2015) (suggesting that some agreements may be interpreted to convey an interest in property at the outset of the agreement, while others may be interpreted as vesting when oil and gas is produced).

to ensure that the lease is not considered unexpired leases or executory contracts pursuant to Section 365. As a practical matter, prohibiting the lessor from rejecting the lease would tend to ensure that the lessee continues to have the right to use the land and thus provide continuing royalty payments to the lessor, which generates income for the debtor. This continued income flow could arguably be construed as beneficial to the estate. Additionally, because the trustee or debtor in possession owes a fiduciary duty to the estate, rejecting such an agreement would likely be prohibited under the Code.<sup>170</sup>

In the event that the debtor is the lessee, designation of oil and gas leases as conveying freehold interests may create a less desirable effect. As noted in the discussion of many of the decisions above, agreements conveying a freehold or fee interest are not typically construed as unexpired leases or executory contracts, and thus they are not subject to rejection under Section 365. Because the bankrupt lessee is not free to simply walk away from leases which are deemed to convey a freehold interest, he may be obligated to continue to perform under the agreement even if it is financially burdensome. Although the trustee is burdened with the task of deciding what to do with leases and executory contracts to maximize the estate, the option to reject a lease that conveys a fee interest is, in most cases, decidedly off the table. While an unexpired lease or executory contract can be rejected at the discretion of the debtor in possession pursuant to the “business judgment” test,<sup>171</sup> no such test exists where an agreement is not considered a true lease. The lessor, on the other hand, enjoys the assurance of continued performance by the debtor or his assignees.

The effect on the parties is largely the same in jurisdictions which treat oil and gas leases as unexpired leases or executory contract. If the lease agreement is rejected, the debtor is considered to be in breach of the lease or contract, entitling the other party to sue for damages. If the debtor in such a jurisdiction is the lessor, although he is free to make an attempt to reject the agreement, such rejections must be approved by the court.<sup>172</sup> If the court finds that such a rejection would be in opposition to the best interests of the estate, then the debtor will likely be unable to reject the lease. It is not difficult to imagine a scenario in which such a rejection would work against the best interests of the estate, particularly if the debtor would continue to collect royalty payments from the lessee. Furthermore, allowing a landowner to reject such an agreement is likely

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<sup>170</sup> See generally 11 U.S.C. § 704 (2018).

<sup>171</sup> *In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 71 (Bankr. S.D.N.Y. 2016) (“The bankruptcy court generally defers to a debtor’s determination as to whether rejection of an executory contract is advantageous, unless the decision to reject is the product of bad faith, whim, or caprice.”).

<sup>172</sup> 11 U.S.C. § 365 (2018).

to lead to inequitable results for the lessee. Oil and gas exploration is expensive and time consuming, and such a breach by the lessor is arguably burdensome despite its ability to sue for damages. Furthermore, recovering damages from a bankrupt party is unlikely to be fruitful, potentially leaving the lessee with no equitable recourse.

When the debtor is the lessee, as is often the case, jurisdictions which consider oil and gas leases to be unexpired leases or executory contracts tend to lead to the most favorable results for the lessee. In such situations, the debtor has the discretion to either reject or assume the lease, and courts generally approve rejections as long as they satisfy the “business judgment” test.<sup>173</sup> This gives the corporate debtor the ability to free itself from the burden of performance under agreements which are less productive by rejecting them or continue to make use of fruitful agreements by assuming them. If the lease is rejected, then the lessor may exercise the reversionary right to his property and the ability to recover damages. However, depending upon the financial situation of the debtor, recovering damages may be difficult.

None of the aforementioned analyses has even begun to address the effect of each outcome on third parties who may also be involved in the exploration, production or gas gathering process. Midstream gas gathering agreements, such as the one discussed in *Sabine*, are often comprised of many parties working cooperatively to achieve a common goal.<sup>174</sup> The *Sabine* decision brings with it the implication that landowners as well as any other party to such an agreement might be left with little recourse if a party to the agreement files for bankruptcy in a jurisdiction following *Sabine*’s precedent.

In summary, the current system provides no consistency for lessors, lessees, and third parties to rely upon when entering into oil and gas agreements. Imagine the hypothetical landowner in Louisiana who enters into an oil and gas agreement with an oil and gas producer who has its principal place of business in Texas but whose assets are primarily held in New York. What should either party expect if its counterpart files for bankruptcy? The simple answer is: it depends. “It depends” is not uncommon in the law—we accept the ambiguity, understanding that it serves the adversarial process well. However, in this scenario, “it” depends on so many factors that the likelihood of accurately predicting the outcome is seemingly impossible. The potential for inequitable

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<sup>173</sup> *In re Sabine Oil & Gas Corp.*, 547 B.R. at 71 (explaining that the business judgment test is different from that of corporate law in that the decision must be beneficial to the estate).

<sup>174</sup> *Id.* at 69 n.3.

results is highly problematic and needs to be addressed not only to prevent disparities, but also to provide insight for future contracting parties.

### III. THE PROBLEM WILL PERSIST

The need for a solution is exacerbated by the fact that oil and gas companies will likely face financial struggles in the near future, leading to an increase in bankruptcy filings. The cases discussed above span from the mid-1900's all the way to 2019. Oil and gas has been a part of the national economy for at least a century, during which time the country has experienced so-called oil booms followed by so-called oil busts. Historically, these booms and busts have been cyclical—booms (periods where oil production results in a heavy inflow of income for oil producers) are followed by busts (periods where oil production yields low profits).<sup>175</sup>

There is not much debate about what causes oil booms and busts. When oil supply is low and demand is high, oil producers ramp up production to meet the demand, leading to increases in profits.<sup>176</sup> In contrast, when oil supply is high and there is a drop in demand, producers are forced to reduce the price of their product, leading to a decline in profits.<sup>177</sup> In the past there have been a variety of reasons for decline in oil demand, such as energy efficient measures aimed at reducing energy consumption.<sup>178</sup>

The last oil bust occurred in 2015 and 2016, leading to a huge spike in bankruptcy filings by oil and gas companies.<sup>179</sup> In 2015 alone, over sixty oil and gas companies filed for bankruptcy—a 379% increase over the prior year.<sup>180</sup> That round of bankruptcies was largely caused by plummeting oil prices during the infamous OPEC price war.<sup>181</sup> The oil slump eventually did see a rebound—

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<sup>175</sup> See Nawar Alsaadi, *Why Oil Booms And Busts Happen*, OILPRICE.COM (Feb. 25, 2016, 3:22 PM), <https://oilprice.com/Energy/Energy-General/Why-Oil-Booms-And-Busts-Happen.html>.

<sup>176</sup> *Oil Booms And Busts: What Causes Them?*, ENERGYHQ, <https://energyhq.com/2017/07/oil-booms-and-busts-what-causes-them/> (last visited Feb. 13, 2022).

<sup>177</sup> *Id.*

<sup>178</sup> *Id.*

<sup>179</sup> Matt Egan, *U.S. Oil Bankruptcies Spike 379%*, CNN: BUSINESS (Feb. 11, 2016, 10:59 AM), <https://money.cnn.com/2016/02/11/investing/oil-prices-bankruptcies-spike/index.html>.

<sup>180</sup> *Id.*

<sup>181</sup> OPEC refused to reduce production, leading to a dramatic decline in oil prices. See generally Alex Lawler et al., *Saudis Block OPEC Output Cut, Sending Oil Price Plunging*, REUTERS (Nov. 27, 2014), <https://www.reuters.com/article/us-opec-meeting/saudis-block-opec-output-cut-sending-oil-price-plunging-idUSKCN0JA00320141128> (OPEC's refusal to scale back oil production led to a reduction in global oil prices, placing competitive economic pressure on U.S. shale producers that contend with high production costs); *Oil Prices Plunge After OPEC Meeting*, BBC NEWS (Nov. 28, 2014), <https://www.bbc.com/news/business-30223721> (OPEC's decision to allow prices to continually decline was followed by a dramatic increase in oil

by 2018 U.S. oil markets were producing at all-time highs, signaling another oil boom.<sup>182</sup> But, oil booms are cyclical, and even before concerns about the COVID-19 pandemic began circulating, fears of an oil bust in 2020 were rumored.<sup>183</sup> The U.S. oil market became saturated with oil producers saddled in massive amounts of debt, and as the U.S. became the world's largest producer of oil, the increase in supply caused a decline in price, making investors nervous.<sup>184</sup>

When all was said and done, investors were right to be nervous in late 2019—the global pandemic all but laid waste to the oil and gas industry. Over 100 oil and gas producers filed for bankruptcy in 2020.<sup>185</sup> This round of bankruptcies seemed to be caused by the perfect storm. As mentioned before, the overwhelming supply of oil in 2019 was already causing a dip in prices, narrowing profit margins for producers. That coupled with the fact that the pandemic severely limited air travel and commuting, oil producers all over the world were suddenly sitting on enormous oil reserves and no one to buy the product.

In early 2021, a new presidential administration has emerged, bringing with it a high probability of new regulations on oil and gas producers in the United States.<sup>186</sup> While it still remains to be seen what effect proposed regulation might have on the industry as a whole, it can be assumed that broader regulatory schemes will come with costly changes for the nation's oil and gas producers. As a first step toward promoting clean energy, the Biden administration temporarily suspended oil and gas leasing on federal land, stoking fear among industry leaders that further restrictions may come in the near future.<sup>187</sup> To put

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and gas bankruptcies in the United States).

<sup>182</sup> David Blackmon, *New Report Details Record Oil Boom in 2018*, FORBES (Feb. 13, 2019, 12:59 PM), <https://www.forbes.com/sites/davidblackmon/2019/02/13/new-report-details-record-texas-oil-boom-in-2018/?sh=44e28ad57012> (“Texas is in the midst of the single largest oil boom its economy has ever seen.”).

<sup>183</sup> See Alex Kimani, *2020: The Year of the Oil Bankruptcies*, OILPRICE.COM (Dec. 27, 2019, 5:00 PM), <https://oilprice.com/Energy/Energy-General/2020-The-Year-Of-The-Oil-Bankruptcies.html>.

<sup>184</sup> See *id.*

<sup>185</sup> Paul Takahashi, *Over 100 Oil and Gas Companies Went Bankrupt in 2020*, HOUSTON CHRON. (Jan. 20, 2021, 12:09 PM), <https://www.houstonchronicle.com/business/energy/article/More-than-100-oil-and-gas-companies-filed-for-15884538.php?converted=1>.

<sup>186</sup> The Biden-Harris campaign emphasis on a need for clean and renewable energy sources has been effectuated by enacting a host of moratoriums on oil and gas leases as well as canceling the permit for the Keystone XL Pipeline – all of which has been a major concern for players in the oil and gas industry. See Bloomberg et al., *Biden Moves to Rapidly Adopt Climate Policies, Stunning the Oil and Gas Industry*, FORTUNE (Jan. 28, 2021, 6:01 AM), <https://fortune.com/2021/01/28/biden-climate-oil-and-gas/>.

<sup>187</sup> James Osborne, *Biden Suspends Federal Oil and Gas Leasing for 60 Days*, HOUSTON CHRON. (Jan. 21, 2021, 7:17 PM), <https://www.houstonchronicle.com/business/energy/article/Biden-suspends-federal-oil-and-gas-leasing-15888032.php>.

the temporary suspension into perspective, oil production on federal land makes up over twenty percent of production in the United States.<sup>188</sup>

While it remains to be seen what impact, if any, additional regulations might have on the economic health of oil and gas companies, it is clear that external factors such as a pandemic create an unpredictable economic environment for energy producers that could lead to additional increases in bankruptcies in coming years. Unfortunately, each of those potential proceedings is likely to be governed by the caselaw described above, with no uniform analysis or outcome.

In light of all of the above discussion, we must ask—are we ok with this? Are we willing to accept that sometimes bankruptcy operates as a zero-sum game where someone inevitably loses? Largely, the answer is likely yes. We know that creditors, for example, sometimes come out of a bankruptcy filing with no distribution. After all, if the purpose of bankruptcy is to give the honest but unfortunate debtor a fresh start, someone is going to lose. That's fine. What we should not accept is that parties to oil and gas agreements have no way of knowing how the potential insolvency of their counterparts might affect them, and thus no real way of guarding against it. One might suggest that parties to oil and gas agreements draft better contracts—plan for the uncertainty by way of extremely explicit agreements. It's not a terrible suggestion, but the reality is, individual landowners lack the information and resources necessary to effectively protect themselves when entering into oil and gas agreements. In fact, a landowner might actually be hesitant to enter into an agreement that grants freehold interests in his property to an oil and gas company. He may not realize that granting a freehold interest could potentially shield him from having the agreement rejected in a bankruptcy proceeding. Additionally, the argument for writing better contracts misses the point entirely. The problem isn't just about injustice and inequity, it's really about inefficiency. We need a solution to prevent courts from entertaining endless litigation in an attempt to figure out what an oil and gas lease actually is. Bankruptcy courts are often referred to as courts of equity, but that description fails to accurately capture what bankruptcy courts do.<sup>189</sup> Bankruptcy courts are not like other courts of equity—they are bound by complex rules including not only the Code, but also the Federal Rules of Bankruptcy Procedure, the Federal Rules of Civil Procedure, state and local rules<sup>190</sup>, and of course, as discussed above, state property laws.

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<sup>188</sup> *Id.*

<sup>189</sup> Marcia S. Krieger, “*The Bankruptcy Court Is a Court of Equity*”: *What Does That Mean?*, 50 S. C. L. REV. 275, 275–76 (1999).

<sup>190</sup> *Id.* at 309.

To sum it up, “[w]hen judges and attorneys recognize and acknowledge that the bankruptcy court is a statutory court charged with implementing social policy law, predictability in outcome will increase, and therefore, litigants’ confidence in the bankruptcy process will increase as well.”<sup>191</sup> If the court system hasn’t figured it out by now, maybe it’s time for a different approach. The legislature needs to recognize that Bankruptcy courts are trying to fulfill their duties by following the statutory construction of code Section 365, however, in doing so, too little guidance is given and disparate results are inevitably reached.

#### IV. IS THERE A SOLUTION?

The discussion below seeks to answer the following questions:

1. What type of legislation, if any, could resolve the problems surrounding the variation in the treatment of oil and gas leases as well as midstream gas gathering agreements under Section 365?
2. Would any such legislation be constitutional?

After digging deeply into the relevant caselaw surrounding oil and gas leases, one’s first impression is likely to be that however unfortunate some of the outcomes may be to lessors and lessees alike, not much can be done. After all, courts are bound by the principles set forth in *Butner*.<sup>192</sup> Disputes arising out of state property law must be decided by analyzing the laws of the state in which the property is located unless some countervailing federal interest exists.<sup>193</sup> Additionally, debtors are free to file for bankruptcy in any state that meets the statutory requirements set forth in U.S.C. 28 § 1408 or § 1410, depending on which chapter under which they have filed.<sup>194</sup> None of the decisions discussed above can be construed as examples in which a court or a debtor has run afoul of precedent or any federal statute. But alas, despite the fact that the actors mentioned above have acted inside the bounds of the law, the outcome is still problematic.

Perhaps then, it would be prudent to look to the *Butner* principle and determine if, in fact, some countervailing federal interest does exist in relation to oil and gas leases. When it comes to the oil and gas industry as a whole, there

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<sup>191</sup> *Id.* at 311.

<sup>192</sup> *See Butner v. United States*, 440 U.S. 48, 49 (1979).

<sup>193</sup> *Id.* at 55.

<sup>194</sup> *Compare* 28 U.S.C. § 1408 (2018) (specifying venue for Title 11 cases except those provided for in 28 U.S.C. § 1410), *with* 28 U.S.C § 1410 (2018) (specifying venue for chapter 15 cases).

is very little doubt that a federal interest exists. This has been evidenced by decades of fossil fuel subsidies provided by the federal government.<sup>195</sup> It is estimated that the United States currently subsidizes oil and gas production to the tune of some \$600 billion.<sup>196</sup> Subsidies aren't the only evidence of a strong federal interest generally in oil and gas. The Bureau of Land Management is tasked with managing millions of acres of oil and gas development activities.<sup>197</sup> Additionally, Title 43 of the Code of Federal Regulations contains several provisions dealing specifically with oil and gas leases.<sup>198</sup> Even current executive orders point to a federal interest in regulating oil and gas activities—the executive branch has gone back and forth between permitting the construction of the XL Keystone Pipeline and halting its progress over the last several years.<sup>199</sup>

The aforementioned federal interests demonstrate that a strong federal interest exists in the oil and gas industry in terms of production and regulation, but without further analysis, it fails to demonstrate an interest in the outcomes of individual bankruptcy cases that fall within the purview of oil and gas law. After all, much of the regulation could be attributed to a broad federal interest in protecting the environment or the economy. To make the connection between a federal interest with respect to bankruptcy, a further discussion of the scope of Code Section 365, as well as a discussion of congressional legislation aimed at the aggregate effect on interstate commerce, is required.

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<sup>195</sup> Clayton Coleman & Emma Dietz, *Fossil Fuel Subsidies: A Closer Look at Tax Breaks and Societal Costs*, ENV'T & ENERGY STUDY INST. (July 29, 2019), <https://www.eesi.org/papers/view/fact-sheet-fossil-fuel-subsidies-a-closer-look-at-tax-breaks-and-societal-costs> (“There is a long history of government intervention in energy markets. Numerous energy subsidies exist in the U.S. tax code to promote or subsidize the production of cheap and abundant fossil energy.”); Karl Evers-Hillstrom, *Oil Producers Push Democrats to Preserve Key Drilling Deduction*, THE HILL (Aug. 26, 2021, 2:31 PM), <https://thehill.com/business-a-lobbying/business-a-lobbying/569583-oil-producers-push-democrats-to-preserve-key-drilling> (discussing a provision within the U.S. tax code that allows oil companies to recover drilling costs).

<sup>196</sup> Coleman & Dietz, *supra* note 195.

<sup>197</sup> *Federal Laws*, U. COLO BOULDER: INTERMOUNTAIN OIL & GAS BMP PROJECT, [http://www.oilandgasbmps.org/laws/federal\\_law.php](http://www.oilandgasbmps.org/laws/federal_law.php) (last visited Feb. 22, 2022) (“The Bureau of Land Management (BLM) leases minerals and manages oil and gas development activities on over 570 million acres of BLM and other federal lands, as well as private lands where mineral rights have been retained by the federal government.”).

<sup>198</sup> *See generally* Issuance of Leases 43 C.F.R. § 3100, subpart 3101 (pertaining to the issuance of leases).

<sup>199</sup> *A Look at the History of the Keystone XL Pipeline Expansion*, CBC NEWS (Jan. 17, 2021, updated Jan. 18, 2021), <https://www.cbc.ca/news/canada/timeline-keystone-xl-pipeline-1.5877117> (In 2015, President Obama vetoed a bill approving construction of the pipeline. In 2017 and 2019, President Trump took steps to approve and speed up the construction of the pipeline. Then in 2021, President Biden revoked subsequent permits, halting construction.); Rob Gillies, *Keystone XL Pipeline Halted as Biden Revokes Permit*, ASSOCIATED PRESS (January 20, 2021), <https://apnews.com/article/joe-biden-alberta-2fbce48372f5c29c3ae6f6f93907a6d>.

At first glance, Section 365 seems like a somewhat broad provision, stating that with few exceptions, the trustee, may assume or reject any unexpired lease or executory contract, subject to the court's approval.<sup>200</sup> However, moving further down the statute, it becomes clear that Congress actually carved out specific provisions pertaining to leases specifically dealing with real property in shopping centers.<sup>201</sup> Additionally, the section contains additional provisions for the rejection of timeshare interests as well as intellectual property licenses.<sup>202</sup> To answer the first question of whether any legislation could be enacted to remedy the current problem, one could ask why Congress was willing to include such specific provisions regarding shopping centers, time shares, and intellectual property, and whether the same logical reasoning could then be extended to oil and gas leases.

With respect to shopping centers, Section 365 provides specifications on how to handle adequate assurances of future performance when such a lease has been assumed or assigned.<sup>203</sup> While such a provision does little to provide insight on the rejection of such leases, it is clear that Congress intended to provide some guidance on how this particular type of property should be handled during a bankruptcy proceeding. For instance, part of the provision states that “[a]dequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance . . . that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.”<sup>204</sup> This provision is specifically designed to protect not only landlords, but also other tenants operating within the same shopping center.<sup>205</sup> The question then becomes, why would Congress feel the need to protect third party tenants, when in non-bankruptcy law, such tenants would be unlikely to have a right to object to another tenant's assignment of a lease?<sup>206</sup> It has been suggested that the provision was intended to prevent landlords and tenants involved in shopping

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<sup>200</sup> 11 U.S.C. § 365(a) (2018).

<sup>201</sup> See 11 U.S.C. § 365(b)(3) (2018) (specifying adequate assurances of future performance with regard to shopping centers).

<sup>202</sup> See 11 U.S.C. §§ 365(h), (i), (n) (2018) (Subsection (i) pertains to timeshare interests and Subsection (n) pertains to intellectual property licenses).

<sup>203</sup> See 11 U.S.C. § 365(b)(3) (2018).

<sup>204</sup> 11 U.S.C. § 365(b)(3)(D) (2018).

<sup>205</sup> Pamela Smith Holleman & Magdalena Ellis, *Reexamining the Protections Afforded to Solvent Shopping Center Tenants Under § 365 in Light of In re Trak Auto Corp. Part II*, 24 AM. BANKR. INST. J. 12, 51 (2005) (“Not only does the plain language of §365(b)(3) in no way restrict its application to landlords, to the exclusion of non-debtor tenants, but the relevant legislative history strongly suggests that Congress intended that non-debtor tenants have standing pursuant to §365(b)(3).”).

<sup>206</sup> *Id.* at 52 (“Outside bankruptcy, however, a non-debtor tenant may not have a right to object to a proposed use of the lease to be assigned, if and to the extent that the landlord did not have a right to preclude that change in use.”).

center leases from suffering “devastating ripple effects of a debtor’s bankruptcy.”<sup>207</sup>

As discussed above, the rejection of an oil and gas lease or a gas gathering agreement has implications not only for the parties to the agreement, but also to third parties involved in the operation. While the industry itself, as well as the nature of the leases, is quite different from that of a shopping center, the rights of third parties are no less important, and yet no express provision exists to protect those rights. Undoubtedly, landowners and third parties to gas gathering agreements suffer a rippling effect when oil production companies are permitted to reject those agreements in bankruptcy.

With respect to intellectual property, Section 365 carves out protections not for third parties, but for licensees.<sup>208</sup> Licenses for intellectual property are often deemed to be executory contracts, meaning that the broad language of Section 365 permits the rejection of such licenses in the event that a licensor files for bankruptcy.<sup>209</sup> This provision is concerning for licensees because their rights to intellectual property could be terminated upon the rejection of a license.<sup>210</sup> Recognizing those concerns, Congress amended the Code in 1988, adding section 365(n) to provide greater protection to parties to licensing agreements.<sup>211</sup> Under section 365(n), “a licensee can elect to retain its rights to the licensed intellectual property . . . [i]n return, the licensee must continue to make any required royalty payment.”<sup>212</sup> Although intellectual property licenses differ in many ways from oil and gas leases, the concerns for a licensee are not so different from the concerns of a lessee. As discussed above, if a lessor in an oil and gas lease files for bankruptcy and the court deems the lease to be either an unexpired lease or an executory contract, the lessee, who has poured time and resources into the development of the production project, could be left with no rights to continue to use the land. If this happens, the lessee would have no way of extracting oil and generating revenue that he was relying upon when he entered into the agreement. Creating some similar provision with respect to oil and gas lessees might remedy the potentially detrimental effect to oil and gas producers in the event of a bankruptcy on the part of the lessor. However, a

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<sup>207</sup> *Id.*

<sup>208</sup> 11 U.S.C. § 365(n) (2018).

<sup>209</sup> Bob Eisenbach, *Protecting IP Rights from A Licensor’s Bankruptcy: What You Need to Know About Section 365(n)*, COOLEY: IN THE RED (July 30, 2009), <https://bankruptcy.cooley.com/2009/07/articles/business-bankruptcy-issues/protecting-ip-rights-from-a-licensors-bankruptcy-what-you-need-to-know-about-section-365n/>.

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> *Id.*

provision this narrow would fail to address consequences when the tables are turned, and therefore might prove to be inadequate.

Although Section 365 itself seems to imply that there is some federal interest in the protection of parties to agreements that might fall under its purview, there is possibly a stronger argument in favor of amending the Code to account for problems encountered with oil and gas leases—interstate commerce. Even the most basic understanding of constitutional law points to the simple fact that Congress always has an interest in protecting commerce across state lines. Though there are many, one example of Congress’ interest in regulating interstate commerce is *Wickard v. Filburn* in which the Supreme Court held that Congress has the power to regulate local activity if the activity could have a substantial effect on interstate commerce.<sup>213</sup>

Allowing debtors to reject oil and gas agreements could arguably have a substantial effect on interstate commerce. As noted in the above analysis of caselaw, many gas gathering agreements and oil and gas leases are made between parties of different states.<sup>214</sup> Of course, the oil itself is then transported across state lines and subsequently refined and sold to consumers across the country. Narrowing our focus to midstream gas gathering agreements, there is ample evidence that allowing for the rejection of such agreements is cause for concern within the industry. After the *Sabine* decision,<sup>215</sup> articles began popping up all over the internet in which law firms and oil producers alike began expressing those concerns.<sup>216</sup> As noted in an article written in 2020:

[M]idstream companies make major, upfront financial commitments to build the gas gathering infrastructure and processing facilities necessary for the upstream producers to move their gas from the wellhead to market . . . . That key covenant allows the midstream company to recoup their investment over time.<sup>217</sup>

This observation points out what should be obvious—if bankruptcy courts continue to allow rejection of gas gathering agreements and oil and gas leases,

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<sup>213</sup> *Wickard v. Filburn*, 317 U.S. 111, 125 (1942).

<sup>214</sup> *See, e.g., In re Sabine Oil & Gas Corp.*, 547 B.R. 66, 69–70 (Bankr. S.D.N.Y. 2016).

<sup>215</sup> *Id.* at 79 (Bankr. S.D.N.Y. 2016) (The court held that gas gathering agreements did not contain covenants running with the land and therefore could be rejected.).

<sup>216</sup> *E.g., Sabine Oil & Gas Corporation: Rejection of Gas Gathering Agreements in a Restructuring*, NORTON ROSE FULBRIGHT (Mar. 2016), <https://www.nortonrosefulbright.com/en/knowledge/publications/609f5cf2/sabine-oil-gas-corporation-rejection-of-gas-gathering-agreements-in-a-restructuring>

<sup>217</sup> Sam Bacon, *What’s Next: Producers’ Ability to “Just Say No” to Gas Gathering Agreements in Bankruptcy*, WELLBORN SULLIVAN MECK & TOOLEY, P.C.: LEGAL UPDATES (Dec. 9, 2020), <https://www.wsmtlaw.com/blog/whats-next-producers-ability-to-just-say-no-to-gas-gathering-agreements-in-bankruptcy.html>.

fewer midstream companies will be willing to bear the risk of entering into the agreements, or they will come at a much higher cost to account for the possibility of insolvency.

Either possibility comes with a risk of having a substantial effect on interstate commerce. A one-off event like the *Sabine* decision may seem tolerable by itself, but decisions set precedent, and in the aggregate, there is potential for serious consequences to interstate commerce with respect to oil and gas. If fewer midstream companies are willing to enter into gas gathering agreements, it's likely to take upstream producers more time to find willing participants, meaning oil products take longer to reach the market and thus the consumer. At its most extreme, this means that there could be the possibility of a shortage of oil and gas products throughout the country. At best, delays caused by hesitance to enter into agreements might require upstream producers to slow production—they can only extract as much oil as they can move or store. Slowing production could lead to an increase in the cost of oil and gas products for consumers—low availability and high demand will inevitably lead to a higher price. Alternatively, midstream oil companies might choose to negotiate for a higher royalty payment to make up for the possibility that some of their contracts might end up being rejected in bankruptcy. Midstream companies that enjoy the benefit of multiple gas gathering contracts could hedge against potentially worthless agreements<sup>218</sup> by contracting for more money initially. That cost, of course would be pushed onto the consumer; regardless of what decision midstream companies make in response to the wrench thrown into the proverbial machine by the bankruptcy system, higher prices for oil and gas products is likely to be the result. Higher gas prices at a time where economic concerns abound is likely to lead consumers to make efforts to reduce their gas consumption if possible. This potential for a disruption in the efficiency of oil and gas production, as well as the potential negative effect on the consumer, should motivate Congress to take steps to intervene by amending the bankruptcy code.

## V. PROPOSED AMENDMENT

To solve the enigmatic problem of oil and gas leases with respect to bankruptcy code Section 365, any proposed legislation would need to accomplish several things. First and foremost, the amendment would need to seek to provide some level of consistency in bankruptcy proceedings. Contracting parties should not be expected to enter into agreements without

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<sup>218</sup> Or less than worthless if one considers the upfront cost of building infrastructure.

having a clear understanding of what might happen if the other party goes bankrupt. Regardless of any notions of injustice, the Code should provide clear and consistent outcomes so that parties are informed of all possibilities before they contract. The current system provides little to no consistency in proceedings regarding oil and gas lease analysis under Section 365.

Second, the amendment should provide some level of protection to actual or perceived property interests conveyed in oil and gas leases and gas gathering agreements. The argument has been made that contracting parties should contract better. They should make certain that their agreements convey covenants running with the land so courts don't have to analyze state property law to make a determination. That suggestion is far too lofty and unrealistic for many parties to these types of agreements, and unsurprisingly, it is often made by attorneys and judges without considering the audience. What such a suggestion fails to consider is people don't know what they don't know. The average landowner knows nothing of bankruptcy law, oil and gas law, or state property law and therefore cannot possibly be expected to know how to protect himself. Additionally, even in hiring an attorney, the average person is going to be out-lawyered by any entity with the resources to explore and extract oil and gas.

Lastly, any amendment should allow parties to agree contractually to the rejection of an oil and gas lease if they should choose to do so. It's possible that an amendment that seeks to solve the above two problems might be viewed as too rigid and at times impractical. If a proposed amendment disallows the rejection of oil and gas leases regardless of the language in the agreement (which might be necessary—the decision in *Sabine* was a direct result of the contractual language and sent shockwaves through the industry), we might end up with absurd results. This is true particularly in cases where a lease has been signed but no exploration has even begun. The parties might be content to agree to rejection and move on with their lives, and the Code shouldn't prevent them from doing so. Allowing the nonbankrupt party to provide express written consent to rejection would alleviate that concern.

Ultimately Congress has the responsibility of deciding what type of legislation would be sufficient to eliminate the problem of allowing the rejection of oil and gas leases in bankruptcy. However, one simple suggestion would be to add a provision within Code Section 365 that prohibits debtors who are parties to gas gathering agreements and/or oil and gas leases from rejecting such agreements without the express written consent of all parties to the agreement. If Congress were to enact an amendment such as the one suggested, it would

provide consistency and uniformity in the way oil and gas agreements are handled throughout the country as well as provide protections to landowners and oil production companies without being so restrictive as to produce an absurd outcome.

### CONCLUSION

The current language of Section 365 fails to adequately account for the interests conveyed in oil and gas lease and gas gathering agreements and therefore, an amendment is needed to counteract the overwhelming inconsistencies in outcomes caused by the caselaw surrounding the issue. Oil and gas leases are not leases at all—unlike the landlord-tenant relationship, lessors and lessees in oil and gas leases do not determine possessory rights to land based on a fixed term. Oil and gas leases can go on into perpetuity so long as the lessee continues to produce oil. This type of conveyance is better categorized as a fee simple determinable in which the lessee's interest in the property ends when he stops producing oil and that interest then reverts back to the lessor.<sup>219</sup> Nor are oil and gas leases properly categorized as executory contracts. Courts and Congress alike have historically looked to the Countryman definition which categorizes executory contracts as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”<sup>220</sup> While some oil and gas agreements *might* fit this definition, certainly, many do not.

Courts across the country have spent ample time mulling over state property law and oil and gas law only to reach varying conclusions regarding oil and gas leases in bankruptcy proceedings. There are likely several reasons for the varying outcomes. First, oil and gas agreements are traditionally called “leases,” which might signal a court to categorize them in that way despite the fact that the content of the agreement conveys something more than a leasehold interest. Second, the structure of the Code allows entities to potentially file for bankruptcy in a variety of jurisdictions. This leads to situations in which a court in one state is faced with the task of understanding property laws from whatever state the “lease” happens to concern. Third, sometimes courts are simply lazy with their analysis—citing cases from another state to support conclusions that are at odds with what the case actually represents or neglecting to conduct

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<sup>219</sup> John McFarland, *The Oil and Gas Lease – Part I*, GRAVES DOUGHERTY HEARON & MOODY: OIL & GAS LAW. BLOG (Nov. 26, 2014), <https://www.oilandgaslawyerblog.com/the-oil-and-gas-lease-part-i/>.

<sup>220</sup> Countryman, *supra* note 14, at 460.

property law analysis altogether and jumping straight to the conclusion that the agreement must be an executory contract.<sup>221</sup> And finally, oil and gas law is complex, yet we expect inexperienced courts to fully understand the nature of oil and gas agreements.

As a result of the problems faced by courts, the burden of shielding oneself against detrimental results falls to the contracting parties, some sophisticated and some less so. The current rise in bankruptcy filings by oil and gas companies only serves to exacerbate the problem in the coming years. The lack of predictability regarding oil and gas leases in bankruptcy proceedings needs to be rectified through legislation in the form of an amendment to Code Section 365 disallowing the rejection of oil and gas agreements without consent of all parties to the agreement.

RACHEL HUDSON\*

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<sup>221</sup> See *Texaco, Inc. v. La. Land & Expl. Co.*, 136 B.R. 658, 666–67 (M.D. La. 1992).

\* Notes & Comments Editor, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2022); B.A., Anthropology, University of Houston (2011). First, I would like to give my sincerest gratitude to Kamina Pinder for her mentorship and guidance throughout the development of this Comment. I would also like to thank the *Emory Bankruptcy Developments Journal* staff for the numerous revisions and hours spent bringing this Comment to publication. Finally, I would like to thank my husband, Bryce Hudson, for his tremendous support throughout each of my academic endeavors.