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ALERT MEMORANDUM

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# Rejection of Sabine's Gathering Agreements in Bankruptcy Unsettles Midstream Energy Sector

On March 8, 2016, Judge Shelley C. Chapman of the U.S. Bankruptcy Court for the Southern District of New York (the "Court") issued a bench decision (the "Decision"), granting Sabine Oil & Gas Corporation's ("Sabine") motion to reject four executory gathering agreements with pipeline operators in its chapter 11 bankruptcy case. More significantly, the Court found, on a preliminary basis, that Sabine's obligations to continue to deliver products and pay certain transaction fees were not "covenants running with the land," and therefore could be stripped away with rejection of the gathering agreements.[1] Given the near-ubiquity of such covenants, the Decision stirred up a renewed focus on these contracts and unsettled the midstream market.[2] It is likely these agreements will be subjected to increased scrutiny and rejection requests in future energy bankruptcy cases.

## Background

Sabine – formed through the December 2014 merger of Forest Oil Corporation and Sabine Oil and Gas LLC – is "an independent energy company engaged in the acquisition, production, exploration, and development of onshore oil and natural gas properties," largely in Texas.[3] In context of the energy value chain, Sabine is an upstream exploration and production ("E&P") company; it locates and extracts oil and natural gas. To transport its products to the downstream refining and marketing companies, Sabine contracts with midstream pipeline operators – in industry parlance, gatherers and producers ("G&P") – through so-called "gathering agreements."

Under the typical gathering agreements' division of labor, G&Ps construct pipelines and related facilities to transport and process the natural resources extracted by an E&P company in return for a long-term commitment by the E&P company to deliver the natural resources it produces in furtherance of the contract and associated fees for the G&Ps' activities. The G&Ps need to make significant upfront capital investments to support the contract, and the gathering agreements typically give the

1 In re Sabine Oil & Gas Corp., No. 15-11835 (SCC), 2016 WL 890299, at *4 n.19 (Bankr. S.D.N.Y. Mar. 8, 2016).

2 Gregory Meyer, Pipeline investors shaken by bankruptcy ruling, Financial Times, Mar. 8, 2016, http://www.ft.com/intl/cms/s/0/e66672c6-e575-11e5-a09b-1f8b0d268c39.html ("[a]fter the ruling, investors dumped shares and units of pipeline companies and partnerships, with Kinder Morgan down 5.3 per cent, Plains All American off 5.9 per cent and Williams Companies dropping 9.4 per cent.").

3 In re Sabine, 2016 WL 890299, at *1.

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G&Ps assurances by providing that the agreement itself and/or the E&P company's promise to deliver the natural resources dedicated to the contract are "covenants running with the land." Sabine's gathering agreements contained these provisions.

**Procedural History**

Sabine and certain of its affiliates commenced a chapter 11 proceeding on July 15, 2015. On September 30, 2015, Sabine filed a motion to reject four agreements entered into with two different counterparties – Nordheim Eagle Ford Gathering, LLC ("Nordheim") and HPIP Gonzales Holdings, LLC ("HPIP")[4] (collectively, the "Gathering Agreements") – pursuant to section 365 of the Bankruptcy Code. The Gathering Agreements governed certain gas, liquid hydrocarbons, oil and water produced by Sabine.[5] All four Gathering Agreements deemed the contracts or Sabine's commitment to deliver the products as "covenants running with the land."[6] Sabine asserted that rejection of each of the four agreements was well within its reasonable business judgment – the prevailing standard for rejection of an executory contract – as rejection would save its estate up to $115 million over the duration of the contracts.[7]

On October 8, 2015, Nordheim and HPIP each filed an objection to Sabine's motion to reject the Gathering Agreements. While the objectors took different approaches, both argued that Sabine should not be allowed to reject the covenants running with the land under their agreements. Nordheim argued that rejection was not within Sabine's reasonable business judgment because Sabine would still be bound by the covenants running with the land – including the obligation to deliver a pre-specified quantity of gas and to pay the transportation fee; thus, "rejection . . . would provide little or no benefit to the Debtors' estates."[8] By contrast, HPIP acknowledged that the

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4 Debtors' Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Executory Contracts, No. 15-11835 (Bankr. S.D.N.Y. Sept. 30, 2015), ECF No. 371.

5 While the four agreements have certain distinctive features, the Court's analysis did not turn on these differences between the agreements' terms.

6 As the Court noted: "[e]ach Nordheim Agreement specifically provides that the agreement itself is a 'covenant running with the [land]' within the designated area, and is enforceable by Nordheim against Sabine, its affiliates, and their successors and assigns." See In re Sabine, 2016 WL 890299, at *2; see also Nordheim Gas Gathering Agreement ¶ 1.6; Nordheim Condensate Gathering Agreement ¶ 1.6.

Similarly, the HPIP Agreements stated that they shall run "with the lands and leasehold interests" and "shall be binding upon and inure to the benefit of the Parties hereto, their successors, assigns, heirs, administrators and/or executors." See In re Sabine, 2016 WL 890299, at *2; see also HPIP Gathering Agreement ¶¶ 1.2, 9.2.1; HPIP Handling Agreement ¶¶ 1.2, 8.2.1.

7 Sabine estimated that rejection of the Nordheim Agreements would save it $35 million, while rejection of the HPIP Agreements would save it at least $2.5 million, but up to $80 million. See Debtors' Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Executory Contracts at 4-6.

8 In re Sabine, 2016 WL 890299, at *3.

debtor's assumption of its agreements "wouldn't make any sense,"[9] but similarly argued that Sabine's dedication of its resources, leases and products to be delivered to HPIP are covenants that run with the land that could not be stripped by the debtors' rejection of the agreements.[10]

**The Decision**

Judge Chapman deferred to the debtors' business judgment and approved the rejection of the four Gathering Agreements. The Court concluded that a summary contract rejection procedure should not be used to finally determine a disputed substantive legal issue, such as whether the Gathering Agreements' delivery and fee provisions ran with the land.[11] However, the Court undertook a non-binding analysis of those provisions and preliminarily concluded that the Gathering Agreements' obligations did not run with the land and therefore could be rejected by the debtors.

Applying Texas law, which governs each of the Gathering Agreements, the Court identified a five-part test for whether a contractual covenant runs with the land.[12] To run with the land, the covenant must: (1) be made by parties with horizontal privity of estate; (2) touch and concern the land; (3) be intended by the original parties to run with the land; (4) relate to a thing in existence or specifically bind the parties and their assigns; and (5) require that the successor to the burden has notice.

The Court found that the Gathering Agreements did not have horizontal privity of estate or "touch and concern" the land – the first two elements of the test – and because of this, the Court did not need to consider the issue of the parties' intent.[13] The fourth and fifth elements were not disputed by the parties and thus were not addressed by the Court.[14]

(1) *Horizontal privity of estate between the parties*: Horizontal privity of estate requires "parties seeking to create a covenant 'running with the land' . . . to have some additional transactional element to their relationship, and not merely be two

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9 Transcript of Hearing, No. 15-11835 (Bankr. S.D.N.Y. Feb. 2, 2016), 97:20-23, ECF No. 816.

10 In re Sabine, 2016 WL 890299, at *4.

11 Id.

12 The standard test applied in Texas does not require horizontal privity; however, the Court found this element to be commonly utilized and incorporated it, in part based on the parties' pleadings. See Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 910-11 (Tex.1982) (articulating the four-part test).

13 In re Sabine, 2016 WL 890299, at *9.

14 Id. at *7.

parties seeking to covenant with one another."[15] The Court distinguished the terms of Sabine's Gathering Agreements from those at issue in the appeal before the Court of Appeals for the Fifth Circuit in In re Energytec, Inc., which found that a third-party's "right to transportation fees and its right to consent to assignment are covenants running with the land."[16] In Energytec, the debtor conveyed its property interests to one party while reserving another party's rights to receive fees for product transported on the property.[17] By contrast, under the Gathering Agreements, Sabine "simply engaged Nordheim and HPIP to perform certain services related to the hydrocarbon products produced by Sabine from its property," and the covenants did not reserve an interest in the property at issue.[18]

(2) *The covenant must "touch and concern" the land*: The Court described two tests under Texas law for whether a covenant "touches and concerns" the land: whether it impacts the value of the land, or whether it affects the promisor's legal interest in the real property.[19] The Court found that the Gathering Agreements satisfied neither test, holding that the Agreements impacted the value of the products – oil and gas – but not the value of the land itself, and further did not alter Sabine's legal interest in the property.[20]

The Court also did not accept Nordheim's alternative argument that the covenants at issue are equitable servitudes that cannot be rejected, holding that such rights would still need to concern the land or its enjoyment, rather than merely constitute contractual obligations.

**Significance of the Decision**

The Court's determination that Sabine's contractual covenants under the Gathering Agreement do not run with the land, while made only on a preliminary basis and on the specific facts of the contracts at hand, raises questions for G&Ps regarding whether their right to continue to receive an E&P's product may be subject to avoidance in a bankruptcy. Given the common use of such agreements between upstream and

15 Id.

16 In re Energytec, Inc., 739 F.3d 215, 225 (5th Cir. 2013)

17 Id. at 218-19.

18 In re Sabine, 2016 WL 890299, at *7.

19 Id.

20 Id. .

midstream companies – and the increasing financial strain on the energy sector – the impact of this decision may prove significant both to companies currently parties to such agreements and G&Ps contemplating potential new gathering agreements.

These considerations likely will grow in prominence as additional energy companies seek bankruptcy protection. For example, the Delaware Bankruptcy Court soon may need to consider a similar dispute in the Quicksilver Resources, Inc. bankruptcy case. If debtors are able reject their performance obligations under gathering agreements in bankruptcy, they are likely to pursue rejection of gathering agreements in order to bargain for better economic terms with their current G&Ps or other potential counterparties.

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