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ALERT
ENERGY & NATURAL RESOURCES

Second Circuit Affirms Gathering Agreements can be Rejected in Bankruptcy

On May 25, 2018, in *In re: Sabine Oil & Gas Corporation*, 2018 WL 2386902 (2d. Cir. May 25, 2018), the United States Court of Appeals for the Second Circuit affirmed that a bankrupt energy and production company could reject its gas gathering agreements with a midstream company under Section 365 of the Bankruptcy Code because the gas gathering agreements did not create or involve an interest in real property.

Background

Sabine Oil & Gas Corporation (Sabine), an energy and production (E&P) company, filed for Chapter 11 bankruptcy protection in 2015 in the Southern District of New York. Prior to its bankruptcy filing, Sabine entered into gathering agreements (the "Agreements") with Nordheim Eagle Ford Gathering, LLC (Nordheim), whereby Sabine was required to "dedicate" all of the gas it produced in a designated area to Nordheim, which would then gather and treat the gas. If Sabine could not deliver the minimum required amounts of gas to Nordheim, it was required to make significant deficiency payments.

Section 365 of the Bankruptcy Code permits a debtor to reject pre-petition executory contracts and unexpired leases that the debtor deems to be burdensome, thereby relieving the debtor of the obligation to perform moving forward. Agreements that involve the conveyance or creation of interests in real property (other than unexpired leases) are generally not subject to rejection under Section 365.

Sabine sought to reject the Agreements under Section 365 because Sabine deemed the terms of the Agreements, including the requirement to make significant deficiency payments, overly burdensome. Nordheim argued that the "dedications" contained in the Agreements were "covenants that run with the land" and thereby constituted interests in real property that were not subject to rejection under Section 365.

Because the Agreements were governed by Texas law per their choice of law provisions, the determination of whether or not the Agreements were subject to rejection under Section 365 required the Bankruptcy Court to evaluate Texas real property law and to determine whether or not the Agreements created interests in real property. In May 2016, the Bankruptcy Court ultimately held that the Agreements

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did not create real property interests notwithstanding the express language in the Agreements that their obligations constitute "real covenants running with the land." Nordheim appealed to the District Court, which affirmed the Bankruptcy Court's decision in March 2017. Nordheim thereafter appealed to the Second Circuit Court of Appeals.

Second Circuit Analysis

In affirming the lower court decisions, the Second Circuit held that notwithstanding the express language of the Agreements, under Texas property law, the Agreements were not real covenants that run with the land. Both Sabine and Nordheim agreed that for a real covenant to run with the land under Texas law it must (1) touch and concern the land; (2) relate to a thing in existence or specifically bind the parties and their assigns; (3) be intended by the original parties to run with the land; and (4) the successor to the burden must have notice. *Sabine*, 2018 WL 2386902 *1. The parties acknowledged that the agreement satisfied prongs 2 through 4, but disagreed on whether the agreement "touches and concerns" the land and, on whether the legal test under Texas law also includes a requirement of horizontal privity. *Id.*

The Second Circuit held that it need not determine whether the agreement "touches and concerns" the land, because it could decide the case solely on the horizontal privity issue. In that regard, the Second Circuit found that Texas law requires that horizontal privity exist between the parties to an agreement and that requirement was not satisfied in the case. In order for the parties to the original agreement to have been in horizontal privity with one another, there must have been some common interest in the land other than the purported covenant itself at the time the agreement was executed. *Id.* at *2. The Court stated that horizontal privity typically exists when the original covenanting parties make their covenant in connection with the conveyance of an estate in fee from one of the parties to the other. *Id.* Although the trend across the country is towards abolition of the horizontal privity requirement, the Second Circuit stated that when applying state law, it is tasked with applying the law of the state as it exists, and that it agrees with the Bankruptcy Court that horizontal privity remains a requirement of Texas real covenant law. *Id.*

Nordheim argued that horizontal privity of estate was established through separate agreements between the parties which conveyed a pipeline easement and a separate parcel of land. The Bankruptcy Court determined that this separate conveyance was insufficient to establish horizontal privity with respect to the Agreements, and Nordheim failed to cite any authority for the proposition that horizontal privity is satisfied if the covenanting parties have horizontal privity of estate only with respect to property separate from the property burdened by the covenant at issue. The Second Circuit agreed that the separate conveyance could not establish horizontal privity between the parties with respect to the Agreements. *Id.* at *3.

Alternatively, Nordheim argued that even if the Agreements did not contain real covenants, they created equitable servitudes that nonetheless create a real property interest that cannot be rejected under Section 365. The parties were in agreement that under Texas law, a covenant that does not technically run with the land can still bind successors to the burdened land as an equitable servitude if: (1) the successor to the burdened land took its interest with notice of the restriction, (2) the covenant limits the use of the burdened land, and (3) the covenant benefits the land of the party seeking to enforce it. *Id.* The Second Circuit held that there was no colorable argument that the Agreements create an equitable servitude because there is no benefit to real property of Nordheim. The court stated, "it is Nordheim as an entity—not its real property—that is benefited by the agreement. Through the agreements, appellants are entitled to receive fees for processing delivered gas and condensate, regardless of where that process takes place, and thus the agreements themselves do not render more valuable land on which appellants have located their processing facilities." *Id.*

What's Next?

Nordheim now has the opportunity to appeal the Second Circuit's decision to the United States Supreme Court. While that decision remains, this issue will be front and center in the thoughts of E&P and midstream companies as E&P companies in bankruptcy may attempt to reduce costs by seeking to reject what they consider to be above market or commercially unreasonable gathering agreements with their midstream providers.

E&P companies may be motivated to reject such gathering agreements to gain leverage in negotiating more favorable terms such as minimum quantities, monthly gathering fees and deficiency payments or penalties. In contrast, midstream companies may prefer to preserve such agreements with their originally negotiated terms. In light of the Second Circuit's decision, protecting such agreements from rejection may require a conveyance of some real estate interest within the structure of the gathering agreement. For example, a structure involving the grant of an overriding royalty interest might be considered. Regardless, midstream companies must beware that, notwithstanding careful drafting and an intent by the parties that the agreements contain "covenants that run with the land," it is possible that such agreements may nonetheless be rejected in bankruptcy. Midstream companies may be wise, given such risks, to seek additional security in the form of mortgages, guaranty or surety agreements or letters of credit to protect themselves if ultimately faced with a financially troubled E&P company. From the viewpoint of the E&P companies, they should beware that midstream companies may seek additional security to protect themselves against potential future downturns in the market.

Babst Calland will continue tracking developments related to bankruptcy and creditors' rights matters. For more information regarding the intersection of bankruptcy and energy issues, please contact David W. Ross at 412-394-6558 or dross@babstcalland.com, Mark A. Lindsay at 412-394-6514 or mlindsay@babstcalland.com, or Erica K. Dausch at 412-773-8706 or edausch@babstcalland.com.