ABA PANEL – WHAT THE "FRACK" IS GOING ON?
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The Sabine Decision and its Effect on Midstream Agreements
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1. Introduction

Oil, gas, and produced water gathering, treatment, processing, and other midstream agreements commonly include "dedications," which are provisions pursuant to which a producer "dedicates" certain oil and gas interests within a specified area of land, including the producer's oil and gas leases, oil and gas in place, and oil, gas, and produced water produced from oil and gas operations, to a gatherer for the term of the midstream agreement. They are intended to ensure that the gatherer receives the full benefit of the producer's oil and gas operations, and that the producer does not send its product to another gatherer. And, producers often agree to dedications to avoid making a minimum volume commitment to a gatherer that could result in payment for unused services.

To ensure that a dedication applies to any third party that acquires a producer's oil and gas interests in the applicable area, and to prevent a producer from rejecting a dedication in bankruptcy, gatherers have generally included provisions that provide that a dedication is a covenant running with the land, and both producers and gathers have generally agreed that dedications are non-executory, real property covenants made by a producer. The landmark case, *In re Sabine Oil & Gas Corp.*,[1] put all of this into question, and the effect on the industry is seen in the negotiation of nearly every midstream agreement.

2. Sabine & What it Says

Section 365(a) of the Bankruptcy Code[2] forms the basis for the uncertainty arising from the *Sabine* cases. It provides that a trustee (or debtor-in-possession) may, subject to court approval, assume or reject any executory contract of the debtor. An "executory contract" is a contract under which there are material, unperformed obligations of both the debtor and the contract counterparty that are so far unperformed on the date the bankruptcy is filed that the failure of either party to complete performance would constitute a material breach excusing the performance of the other.[3] Courts routinely approve motions to reject executory contracts upon a showing that the debtor's decision to take such action will benefit the estate and is an exercise of sound business judgment.[4]

Sabine Oil & Gas Corp. ("Sabine"), an oil and gas producer, sought to exercise its rights under Section 365(a) and moved to reject its gathering agreements. In its determination, the Bankruptcy Court considered whether Section 365(a) of the Bankruptcy Code could be used to terminate an agreement with a midstream company by treating it as an executory contract. The agreements in contention were: (a) a Gas Gathering Agreement with Nordheim Eagle Ford Gathering LLC ("Nordheim"), (b) a Condensate Gathering Agreement with Nordheim, (c) a Production Gathering,

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[1] 547 B.R. 66 (Bankr. S.D.N.Y. 2016).
[2] 11 U.S.C. §§ 101 *et seq*.
[3] *Olah v. Baird (In re Baird)*, 567 F.3d 1207, 1210 (10th Cir. 2009) (citing Vern Countryman, *Executory Contracts in Bankruptcy: Part I,* 57 Minn.L.Rev. 439, 460 (1973)).
[4] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984) (recognizing that the business judgment test applies to authorize rejection of an executory contract under 11 U.S.C. § 365); *In re Spoverlook, LLC*, 560 B.R. 358, 361 (Bankr. D.N.M. 2016) (stating that under the business judgment test "[d]eference is given to the debtor's decision, provided it demonstrates" that rejecting the contract is advantageous).

Treating and Processing Agreement with HPIP Bonzales Holdings, LLC ("HPIP"), and (d) a Water and Acid Gas Handling Agreement with HPIP, all relating to Sabine's oil and gas interests located on properties owned by third parties. Memoranda of all four agreements were recorded, and all four agreements specifically stated that the agreements run with the land.

Sabine contended that the agreements were executory and represented that it had determined in a reasonable exercise of its business judgment that the agreements were burdensome to the bankruptcy estate (the standard under the Bankruptcy Code for determining whether a debtor may reject an executory contract). Neither Nordheim nor HPIP objected to the rejection of the agreements (HPIP in its filed pleadings and Nordheim at oral argument on the motions), but both asserted that rejection of the agreements as executory contracts had no effect on the fact that the agreements were "covenants that run with the land" that would still be enforceable regardless of their rejection.

On March 8, 2016, the Bankruptcy Court allowed Sabine to reject all four agreements as executory contracts. The Court's discussion did not include whether the agreements were (or were not) executory contracts. The parties did not dispute that they were, and the Court assumed that fact. The Court then concluded that Sabine exercised reasonable business judgment in rejecting the agreements as burdensome. In fact, neither Nordheim nor HPIP presented evidence to challenge that judgment. As a result, the Court concluded that the agreements could be rejected as a "reasonable exercise of business judgment."

But, the Court did not, for procedural reasons, make a final determination on the enforceability of the gathering agreement as a covenant running with the land. It stated that it was bound by Second Circuit precedent to limit its analysis to section 365 and could not decide whether the rights granted under the agreements are property rights ("covenants running with the land") or mere contractual rights. Despite this procedural limitation, the Court devoted significant effort to an analysis of Texas property law before concluding that "the Court preliminary finds that none of the covenants runs with the land either as a real covenant or as an equitable servitude." In fact, the Court said the agreements are not "covenants running with land" under Texas state law because they only concern the hydrocarbons being pulled out of the ground, not Sabine's land or its use of it.

Sabine followed the Bankruptcy Court's lead and commenced adversary proceedings against Nordheim and HPIP, seeking a declaratory judgment that the covenants included in the agreements did not run with the land.[5] The Bankruptcy Court granted Sabine's motion for summary judgment in those adversary proceedings, concluding that the covenants in the rejected midstream gathering agreements "do not run with the land" as real covenants because they "do not touch and concern" the debtor's real property and because horizontal privity, as required by Texas law, was not satisfied.[6] The Bankruptcy Court also concluded that the covenants were not equitable servitudes because there were "fundamentally service contracts relating to personal property of Sabine" and did not limit the use of or burden Sabine's mineral estate.[7]

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[5] *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC (In re Sabine Oil & Gas Corp.)*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016)
[6] *Id*. at 66-70.
[7] *Id*. at 71.

The District Court affirmed the Bankruptcy Court's rulings in March 2017[8] and on May 25, 2018, the United States Court of Appeals for the Second Circuit affirmed the rulings of both the Bankruptcy Court and District Court.[9] The Second Circuit agreed that a midstream gathering agreement did not create a real covenant that ran with the land,[10] and therefore, a debtor may reject the agreement as an "executory contract" under Section 365 of the Bankruptcy Code.

In making its determination, the Second Circuit focused on whether horizontal privity remained a part of the legal test in Texas for establishing a real covenant that runs with the land and, if so, whether horizontal privity was satisfied by the gathering agreement. The Second Circuit adopted the Bankruptcy Court's analysis and concluded that horizontal privity remains a requirement under Texas law for a covenant to run with the land and that the requirement was not satisfied by the gathering agreement.[11]

Further, the Second Circuit recognized that horizontal privity requires "a common interest in the land other than the purported covenant," such as the conveyance of a fee interest in property.[12] Although the parties entered into separate agreements conveying a pipeline easement related to the applicable gathering system, the Second Circuit determined that the separate agreements were insufficient, as the land covered by the easements was different from the land burdened by the purported covenant.[13] Therefore, absent a common interest in the land, the gathering agreement did not establish horizontal privity of estate.[14]

The Second Circuit also concluded that a gathering agreement did not constitute an equitable servitude that could survive rejection under section 365 of the Bankruptcy Code.[15] Instead, it reasoned that the agreement benefited the midstream company as an entity and not the company's real property. Additionally, it declined to consider whether the agreement "touches and concerns" the land because horizontal privity was not satisfied under Texas law.[16]

3. Practical Effect and Risk Mitigation

The *Sabine* decisions are not binding outside of the Second Circuit and their analysis appears contrary to broadly understood treatment of acreage dedications in recorded midstream agreements as "covenants running with the land." Nonetheless, as a practical matter, midstream companies should take protective measures by revisiting their midstream agreements and improving their ability to establish horizontal privity and other elements reflecting interests that touch and concern the land. Whether an interest is a covenant running with the land is state specific, so practitioners should always consider the real property laws of the state in which the gathering system is located.

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[8] *HPIP Gonzales Holdings, LLC v. Sabine Oil & Gas Corp. (In re Sabine Oil & Gas Corp.)*, 567 B.R. 869 (S.D.N.Y. 2017)
[9] *Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC (In re Sabine Oil & Gas Corp.)*, 734 F. App'x 64 (2d Cir. 2018).
[10] *Id.* at 67.
[11] *Id*. at 66-68; *see Sabine Oil & Gas Corp.*, 550 B.R. at 68.
[12] *Id*. at 66.
[13] *Id*. at 67.
[14] *Id*.
[15] *Id*. at 67-68.
[16] *Id*. at 66.

The analysis should include determining the key elements of a covenant running with the land, and gatherers should consider specifically stating each of the elements that is applicable to the dedication at issue, including that the interest "touches and concerns the land" and "is binding on and enforceable by Producer and Gatherer and their successors and assigns."

Gatherers should take care to write dedications in a manner that clearly covers real property interests, including through references to the real property interests themselves and the oil and gas "in place" (rather than "as produced"). The agreements could provide that the producer will assist the gatherer in obtaining subordinating pre-existing liens of secured creditors to the real property interest granted through the dedication. And, midstream companies should consider the express creation of horizontal privity, whether through a producer's express grant of an easement over land on which it holds surface rights or a gatherer's receipt of a mortgage on the product in a pipeline. And last, to ensure that third parties are put on notice of the dedication and to further strengthen the assertion that a dedication is a real property interest, gatherers should consider recording a memorandum of agreement that includes all the provisions required to be on record pursuant to the laws of the state in which the gathering system is located or the midstream agreement itself in the real property records of the appropriate county.

Although the strategies above can help support the argument that a dedication is a covenant running with the land, the *Sabine* decisions continue to create uncertainty in the industry, and gatherers will continue to watch as courts in various states determine whether to apply its analysis.