In a March 8, 2016 ruling from the bench, the U.S. Bankruptcy Court for the Southern District of New York issued a significant decision regarding the ability of a debtor in bankruptcy to reject gas gathering agreements and similar intrastate contracts. Judge Shelley Chapman, overseeing the bankruptcy case of In re Sabine Oil & Gas Corp., determined that those agreements could be rejected in bankruptcy, notwithstanding contractual provisions that purport to issue conveyances that run with the land. With similar issues pending in other courts around the country, the potential effects are far-reaching.

Sabine Oil & Gas Corporation (Sabine) filed a chapter 11 bankruptcy petition in July 2015. As part of its restructuring effort, it filed a motion on September 30, 2015, asking for court approval to reject four of its contracts: a gas gathering agreement with Nordheim Eagle Ford Gathering, LLC (Nordheim); a condensate gathering agreement with Nordheim; a gathering, treating and processing agreement with HPIP Gonzales Holding, LLC (HPIP); and a water and acid gas holding agreement with HPIP.

Section 365(a) of the Bankruptcy Code generally allows a debtor in bankruptcy to reject unfavorable executory contracts. The Bankruptcy Code does not define an executory contract, but it is generally understood to mean an agreement that has some material amount of performance still owing on both sides. The standard for whether a bankruptcy court will approve the rejection of a contract is the generally lenient “business judgment rule,” meaning that the bankruptcy court looks only to whether the debtor is employing its business judgment in deciding to shed the contract.

A gathering agreement generally refers to a contract that provides for collecting gas or other commodities at the point of production, and for moving it through a low-pressure pipeline system to a junction with a pipeline’s primary transmission system. Gathering agreements and other midstream contracts have been increasingly prevalent in recent years, because the shale boom gave rise to production in new areas that lacked the infrastructure needed to get gas and other commodities to market. As an oversimplification, the gathering agreements represented a bargain in which midstream companies agreed to invest significant resources to build out infrastructure, in return for a long-term payout from the producers to compensate for the creation and use of the infrastructure. Two portions of the typical gathering agreement are especially relevant to the Sabine case: contractual provisions that dedicate acreage to the midstream company, in the form of covenants that purport to “run with the land,” and a commitment of a minimum volume of oil or gas to flow through the system, which requires the producer to pay a fixed fee to the midstream company if that volume is not met.
volume is not met.

In *Sabine*, the Nordheim and HPIP agreements clearly met the definition of executory contracts. Instead, Nordheim first argued that rejection of its agreements was improper, because there was no business reason to reject those contracts after the dedication provisions were separated out. In other words, it contended that the conveyances were the key terms of the contracts, and regardless of rejection, the real property interest conveyances would survive rejection. Sabine responded that it sought to reject the contracts because of the minimum volume commitments, which obliged Sabine to make significant deficiency payments each month.

Nordheim and HPIP also argued that Sabine could not reject the portion of the agreements that purported to dedicate gas and other commodities to the midstream companies, because those portions of the contracts were conveyances of real property. Sabine asserted that rejecting the four contracts could save as much as $115 million.

As an example, the dedication language in the Nordheim gas gathering agreement was as follows:

> So long as this Agreement is in effect, the Agreement shall (i) be a covenant running with the Interests now owned or hereafter acquired by [Sabine] and/or its Affiliates within the Dedicated Area and (ii) be binding on [Sabine] and enforceable by [Nordheim] and its successors and assigns against [Sabine], its Affiliates and their respective successors and assigns.

Similar provisions were contained in each of the relevant contracts. Sabine, however, contended that those provisions did not meet the criteria under Texas law (which governed each of the relevant contracts) for a covenant running with the land. Under precedent from the Texas Court of Appeals, a contract must satisfy five requirements in order to constitute a covenant running with the land:

- There must be privity of the estate;
- The covenant must touch and concern the land;
- The covenant must relate to a thing in existence or specifically bind the parties and their assigns;
- The parties must intend the covenant to run with the land; and
- The successor to the burden must have notice.

Sabine contended that Nordheim and HPIP could not establish privity of estate, that the covenant “touches and concerns” the relevant land, or that the parties
intended the covenant to run with the land.

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One might infer that Judge Chapman sought to avoid a far-reaching decision. Approximately one month ago, she forecast her decision by stating she was inclined to rule in favor of Sabine. Some observers said at the time that her comment appeared to encourage the litigants to reach an out-of-court settlement. Similarly, her choice to read her decision from the bench suggests her desire to prevent the ruling from having precedential value. In addition, some of her comments from the bench indicate that she might have preferred for the issues to have arisen in a different procedural posture in the case.

Nevertheless, the ruling is likely to be highly influential. Regardless of whether it technically qualifies as precedent, the *Sabine* decision may affect other courts’ analysis and other exploration and production (E&P) companies’ decisions regarding whether to attempt to reject such contracts. A decision on similar issues is likely in two Delaware cases: the *Quicksilver Resources* bankruptcy court is likely to issue a ruling in the near future, while the issue recently arose in the *Magnum Hunter* bankruptcy as well.

As a result, despite Judge Chapman’s efforts to narrow the scope of the effects, her decision will likely have significant consequences. The development surely harms midstream companies that have front-loaded their investments in infrastructure projects, based on the assumption that the conveyance language in the gathering agreements would ensure their repayment over the longer term. As a result, pipeline companies could face increasing stress if they encounter an increasing number of E&P companies seeking to reject their contracts.

Ironically, however, the ruling could lead to more E&P bankruptcies as well. Producers that might have otherwise avoided bankruptcy must now consider the incentive to shed unfavorable gathering agreements. Those E&P companies that still refrain from seeking bankruptcy protection may suffer from a competitive disadvantage, continuing to retain gathering agreements that are based on an obsolete pricing model. Finally, the *Sabine* decision could spur increased interest among purchasers of assets in bankruptcy. Potential buyers may now find those assets more desirable if they are separated from burdensome midstream contracts.

On the other hand, there are several reasons to view the *Sabine* ruling in a more limited context. The issue concerning the treatment of the dedication provisions—and specifically whether they are conveyances running with the land—is a fact-intensive determination that may vary considerably from case to case. It would not be surprising to see courts reach different results based on differing contractual language. Similarly, the location of the wells and the governing law of the contracts will also drive certain differences in the analyses. While all of the *Sabine* contracts were subject to Texas law, it would not be surprising to see similar issues arise under other state laws, where the
precedents create different analyses for covenants running with the land.

Finally, it is worth noting the absence of regulatory oversight in the contracts. Gathering agreements are often intrastate and exempt from federal regulation, but the degree of state regulation varies significantly. It is quite possible that future bankruptcy cases involving the rejection or renegotiation of gathering agreements could feature interplay with regulators, further complicating the issues and potentially slowing the bankruptcy process for the producers.

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