March 16, 2016

Sabine Court Issues Industry-Affecting Non-Binding Opinion

The financial pressure on the oil and gas industry is well known. Dozens of oil and gas companies have defaulted on credit facilities or filed bankruptcy recently and industry observers expect many more to follow.

On March 8, in *In re Sabine Oil & Gas Corp*., Case No. 15-11835 (Bankr. S.D.N.Y.), the US Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") added to the pressure on the energy sector when it issued a bench ruling and non-binding analysis on an issue of first impression that may significantly change industry typical practices—and potentially prompt more bankruptcy filings.

The Bankruptcy Court ruled that Sabine Oil & Gas Corporation may reject certain gathering agreements, which pertain to the collection of gas (or other commodities) at the production point and subsequent transmission, pursuant to section 365(a) of the Bankruptcy Code. The agreements contained provisions purporting to be covenants that run with the land. The Bankruptcy Court's non-binding analysis—that the provisions do not run with the land—surprised many industry participants. Such a result could particularly affect midstream companies, in light of persistent low oil prices and the recent influx of producer bankruptcies.

Section 365(a) of the Bankruptcy Code allows debtors to reject burdensome contracts. Generally, a rejected contract gives rise to a general, unsecured claim against the debtor. The resulting rejection claim is paid ratably with other general, unsecured claims, which typically means a non-debtor counterparty will receive "pennies on the dollar" in satisfaction of the claim. Whether the covenants run with the land is significant because, under the Bankruptcy Code and related case law, a covenant running with the land is a property interest and cannot be rejected. Thus, for example, a minimum delivery obligation found to be a property interest would remain a "dollar for dollar" burden on the debtor.

The Gathering Agreements' Provisions Do Not Run With the Land

Gathering agreements require, among other things, that an upstream oil producer dedicate land to the midstream gatherer and commit to deliver a certain amount of gas to the midstream gatherer. The dedication and delivery provisions of the agreements are typically defined as covenants running with the land, and the Sabine agreements expressly identified those provisions as running with the land.

In *Sabine*, certain of the rejected contracts have 10-year terms, and the minimum delivery requirements give rise to sizable deficiency fees if missed. Indeed, one counterparty acknowledged that if Sabine rejected the agreements, but remained bound by the covenants, it would provide little or no benefit to Sabine's estates.

This issue impacts varied industry participants because gathering contracts are common, particularly in areas lacking infrastructure to move the gas to market. Whether those

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contracts contain covenants running with the land—and the predictability that follows from that presumption—is now called into question by the *Sabine* ruling.

The *Sabine* Bankruptcy Court applied Texas law, which governed each gathering agreement. Under Texas law, a covenant runs with the land when:

1. it touches and concerns the land;
2. it relates to a thing in existence or specifically binds the parties and their assigns;
3. the parties intend the covenant to run with the land; and
4. the successor to the burden has notice.

The Bankruptcy Court also considered an additional requirement imposed by many courts, namely:

5. the parties must have horizontal privity of estate.[1]

The *Sabine* Bankruptcy Court determined that the covenants did not touch and concern the land because they neither affected the owner's interest in, or use of, the real property, nor impacted the value of the land "independent of collateral circumstances." The court determined that the triggers for the covenants in *Sabine* related to the products, rather than the land. The Bankruptcy Court further held that the parties lacked horizontal privity because the covenants merely set forth contractual obligations regarding the services and did not specifically reserve an interest in the real property. The Bankruptcy Court contrasted the provisions with those deemed to run with the land in *In re Energytec, Inc.*, 739 F.3d 215, 221 (5th Cir. 2013). In *Energytec*, a pipeline system owner assigned property rights to one party, while reserving a covenant for a third party to receive a fee for product transported on the pipeline. According to the court, the *Sabine* covenants simply ensured the performance of services related to Sabine's products on the midstream gatherer's property—they did not reserve an interest in the real property. Finding those two requirements lacking, the Bankruptcy Court did not extend its analysis further.

Why Is This Non-Binding Analysis Important?

The *Sabine* Bankruptcy Court was constrained from issuing a binding opinion because, under binding Second Circuit precedent, underlying substantive legal issues may not be decided in the context of a motion to assume or reject.[2] Nevertheless, the non-binding analysis is likely to be influential. The *Sabine* decision may influence two Delaware cases currently considering similar issues (*Quicksilver Resources* and *Magnum Hunter*).

If the *Sabine* Bankruptcy Court subsequently issues a binding ruling, parties should consider the fact-intensive nature of the inquiry into whether a covenant runs with the land and whether there are material differences in the relevant underlying laws of other states (and the likelihood that a bankruptcy court in another jurisdiction will rule similarly to the Bankruptcy Court). This analysis will be fact-specific and dependent upon the reviewing court's analysis of the evidence presented.

Regardless, one may expect parties to adjust their negotiations and expectations in the wake of the heightened risk that a covenant that was anticipated to run with the land may be deemed subject to rejection. The ability to reject such agreements likely would affect both upstream and midstream companies' decisions whether to file bankruptcy as a strategic approach to eliminating obligations under such gathering agreements.

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[1] Horizontal privity of estate means mutual privity, such as landlord-tenant or grantor-grantee.

[2] *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F. 3d 1095, 1099 (2d Cir. 1993). The Bankruptcy Court noted that it expects to resolve the underlying issues during the parties' litigation over the nature and extent of the claims resulting from Sabine's rejection of the gathering agreements.