Recent Case Highlights Opportunity for Distressed Exploration and Production Companies

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On March 8, 2016, a bankruptcy court in the Southern District of New York issued a much-anticipated decision, *In re Sabine Oil & Gas Corporation*,[1] that will undoubtedly influence the reorganization strategies of certain exploration and production (E&P) companies and have a significant impact on midstream companies. In particular, the *Sabine* court granted an E&P debtors' motion to reject certain midstream service agreements and made an initial determination that such agreements do not contain commitments that run with the land.[2] Although the court's holding focused narrowly on whether the debtors' decision to reject the agreements was an exercise of sound business judgment, the preliminary analysis set forth in *Sabine* on whether such agreements run with the land provides leverage to distressed E&P companies seeking to renegotiate more favorable terms with their midstream service providers.[3]

Background

It is common practice for E&P companies to contract with various midstream service providers to gather,[4] process, and transport their oil and gas from the point of production to the commercial market. In exchange for these services, the E&P companies often dedicate all of the oil and gas produced within a certain acreage to be serviced under the terms of the agreement. Such a dedication offers assurance to the service provider that it will be the exclusive provider of certain services for all of the oil and gas produced within a particular area. It also is common for E&P companies to commit to a minimum volume of oil and gas to be serviced under the agreement. In such minimum volume commitments, the E&P company often is required to pay the service provider a fixed fee if the minimum volume of oil or gas committed to is not produced or processed.

As distressed E&P companies look to reorganize in bankruptcy, one potential avenue to economize operations may be to reject unfavorable midstream service agreements,[5] in particular those with minimum volume commitments. Such commitments can tie up a disproportionate amount of liquidity, especially if the E&P company is required to pay a fixed fee to the midstream service provider even if the volume threshold is not satisfied. To be sure, many of these midstream service agreements were put into place under drastically different market conditions, as E&P companies strove to increase their capacity to process and transport minerals to market. As demand has fallen, E&P companies are aiming to streamline operations and reduce costs.

Through rejection, an E&P company in bankruptcy may elect to stop performing under an executory contract.[6] Although a debtor's decision to reject an agreement is subject to a bankruptcy court's approval, the court generally defers to a debtor's business judgment

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

[2] Midstream service providers gather, treat, transport and process minerals prior to sale on the commercial market. *Id.* at *1 n.3. Kurt L. Krieger, "Gathering and Transporting Marcellus and Utica Shale Natural Gas to the Market and the Regulation of Midstream Pipeline Companies," 19 Tex. Wesleyan L. Rev. 49 (2012).

[3] For reasons relating to bankruptcy procedure, the *Sabine* court's substantive analysis of the real property issues in question is nonbinding. The court could, in theory, revisit its conclusions at a later stage in the case. As a practical matter, however, it appears unlikely that the court will reverse course.

[4] Gathering refers to the process of collecting gas at the point of production and transporting it through a gas pipeline to market. Patrick H. Martin and Bruce M. Kramer, "Manual of Oil and Gas Terms 433" (15th ed. 2012).

[5] Rejection of a contract in bankruptcy relieves a debtor from its ongoing obligations to perform under the contract.

[6] *See* 11 U.S.C. § 365. Although an executory contract is not defined under the Bankruptcy Code, the widely accepted definition is "contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach." Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 Minn. L. Rev. 439, 460 (1973).

as to whether rejection would be beneficial to the debtor's estate.[7] Upon rejection, the debtor is free to negotiate a more economical midstream agreement or find a more efficient method to gather and transport its minerals. The original midstream service provider, in turn, would generally be left only with a claim for damages and an uncertain recovery.

Midstream service providers have argued that these dedications are real property covenants immune to rejection in bankruptcy.[8] Indeed, as a general matter, even if a bankruptcy court were to approve a debtor's rejection of an executory contract containing a covenant running with the land, it is likely that the debtor, its estate, its successors and interests may remain subject to the covenant.[9] Along these lines, the midstream service providers generally insist that the agreements remain in effect for a dedicated area despite contract rejection in bankruptcy, and even if a new E&P company acquires the dedicated area through a sale of the debtor's assets in bankruptcy.[10]

If a dedication is construed as a covenant running with the land immune from rejection in bankruptcy, as a practical matter, the E&P debtor may be locked into a contract with over-market terms.[11] Such a commitment also may dilute the recoveries of other creditors in the bankruptcy by siphoning value from the debtor's mineral estate. Although whether a midstream service agreement constitutes a contract for services or a covenant running with the land will ultimately turn on the specific language of the contract and applicable state law, *Sabine* provides a road map of how a bankruptcy court may analyze these issues.[12]

Overview of *Sabine*

Sabine is a critical, recent decision in which a bankruptcy court directly addressed the issue of whether midstream service agreements can be subject to rejection in bankruptcy or whether they are covenants running with the land.[13] In *Sabine*, the debtors — Sabine Oil & Gas Corporation and certain of its subsidiaries — are an E&P company engaging in the acquisition, production, exploration and development of onshore oil and natural gas.[14] Once in bankruptcy, Sabine moved to reject certain gathering agreements[15] with Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holding, LLC.[16]

Although the *Sabine* case involved several different agreements, all of the agreements at issue shared certain commonalities. In particular, all of the agreements were governed by Texas law; stipulated that the gatherer will provide certain services to Sabine in exchange for certain consideration; provided that Sabine would "dedicate" to the "performance" of the agreement all of the gas and/or liquid hydrocarbons produced by Sabine within a designated area;[17] and expressly stated that the dedications were covenants that run with the land and would be enforceable as to Sabine's successors and assigns.[18]

Relying on the dedication provisions, Nordheim and HPIP argued that agreements were immune to rejection, as they ran with the land as real covenants or equitable servitudes.[19] Nordheim also advanced a procedural argument that the court could not authorize rejection without first making a determination that the agreements did not contain a valid real covenant.[20]

[7] *See, e.g., COR Rte. 5 Co. v. Penn Traffic Co.* (*In re Penn Traffic Co.*), 524 F.3d 373, 383 (2d Cir. 2008).

[8] Unlike personal covenants, which operate like a general contract provision and bind only the actual parties to the covenant, real property covenants run with the land and, as such, burden or benefit the contracting parties' successors in interest. This remains true in bankruptcy. *See Banning Lewis Ranch Co. v. City of Colorado Springs* (*In re Banning Lewis Ranch Co.*), 532 B.R. 335, 346 (Bankr. D. Colo. 2015).

[9] *See, e.g., In re Raymond*, 129 B.R. 354, 358-59 (Bankr. S.D.N.Y. 1991) (holding that an obligation to pay common charges under a homeowner's association agreement is a covenant that runs with the land and, despite rejection, cannot be severed from ownership and remains binding on present owner and grantees of the owner); cf. *In re Energytec, Inc.*, 739 F.3d 215, 225 (5th Cir. 2013).

[10] Pursuant to Section 363 of the Bankruptcy Code, a debtor may move to sell its business "free and clear" of claims and interests. 11 U.S.C. § 363. Of particular relevance, in *In re Quicksilver Resources Inc.*, Case No. 15-10585 (LSS) (Bankr. D. Del.), an E&P debtor aimed to sell substantially all of its assets pursuant to Section 363 of the Bankruptcy Code, but the winning bidder conditioned its bid on the rejection of certain of the midstream service agreements with certain midstream service providers including Crestwood Midstream Partners LP. In addition to its substantive arguments that the agreements are subject to rejection, the debtor also contends that Crestwood has procedurally forfeited its objection by failing to timely object to the debtor's motion to sell its business "free and clear" of claims and interests pursuant to Section 363 of the Bankruptcy Code. Judge Laurie Selber Silverstein of the U.S. Bankruptcy Court for the District of Delaware reserved decision on the matter, but we continue to monitor the case and anticipate a decision by March 31, 2016, at which time we will issue a new client update.

[11] Midstream companies also have argued that they "may be entitled to an administrative claim, specific performance, injunctive relief, or other remedies," in the event the debtor rejects a midstream services agreement containing a valid real covenant and contracts with an alternative provider of midstream services. *See* "Objection to Debtors' Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Executory Contracts" (Nordheim Objection) at 7-8, *In re Sabine Oil & Gas Corp.*, No. 15-11835 (SCC) (Bankr. S.D.N.Y. Oct. 8, 2016), ECF No. 387.

[12] It is well-established that bankruptcy courts look to applicable state law to determine the nature of a debtor's interest in real property. *Butner v. United States*, 440 U.S. 48, 55 (1979); *Hannaford Bros. Co. v. Ames Dep't Stores, Inc.* (*In re Ames Dep't Stores, Inc.*), 316 B.R. 772, 788 (Bankr. S.D.N.Y. 2004) (citing *Butner*).

[13] *Sabine*, 2016 WL 890299.

[14] *Id.* at *1.

[15] "Debtors' Omnibus Motion for Entry of an Order Authorizing Rejection of Certain Executory Contracts," *In re Sabine Oil & Gas Corp.*, No. 15-11835 (SCC) (Bankr. S.D.N.Y. Sept. 30, 2015), ECF No. 371.

[16] The case pertains to two sets of gathering agreements. The first set of agreements are between the debtors and Nordheim. The second set of agreements are between the debtors and HPIP. *Sabine*, 2016 WL 890299, at *1-2.

[17] *Id.* at *1-2.

[18] *Id.*

[19] *See, e.g.*, Nordheim Objection at 5-6, *In re Sabine Oil & Gas Corp.*, No. 15-11835 (SCC) (Bankr. S.D.N.Y. Oct. 8, 2016), ECF No. 387; Transcript of proceeding at 84-85, *In re Sabine Oil & Gas Corp.*, No. 15-11835 (SCC) (Bankr. S.D.N.Y. Feb. 6, 2016), ECF No. 826.

[20] *Id.*

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In Nordheim's view, given the procedural posture of the case at the motion-to-reject stage, the only decision that the court could make at this time was whether the debtors' decision to reject the gathering agreements was a reasonable exercise of business judgment.

Ultimately, in a decision read from the bench, the *Sabine* court granted the debtors' motion to reject the agreements.[21] In so ruling, the court highlighted that no parties offered evidence or argument refuting that the debtors' decision to reject the agreements was an exercise of sound business judgment. But the court fell short of ruling with finality on the legal question of whether the agreements constituted covenants running with the land. Relying on U.S. Court of Appeals for the Second Circuit precedent, the court agreed with Nordheim that in view of the procedural posture of the case, it could not issue a final and binding decision as to whether the agreements contained covenants running with the land.[22]

Notwithstanding the court's acknowledgement of this procedural limitation, in its bench decision, the court announced a "preliminar[y] finding" that in its view, the agreements did not run with the land as real covenants under Texas law.[23]

In its analysis, the court explained that under Texas law, in order for a covenant to run with the land, it must: (1) touch and concern the land, (2) relate to a thing in existence or specifically binds the parties and their assigns, (3) be intended by the original parties to run with the land, (4) provide notice of the burden to the successor in interest, and (5) satisfy horizontal privity of estate.[24] In the court's view, the covenants could not run with the land because they failed to satisfy at least two of the aforementioned requirements: privity of estate, and touch and concern the land.

Addressing privity first, the court explained that traditionally, horizontal privity refers to the legal relationship created when a property owner conveys real property, but at the time of the conveyance, the owner reserves certain rights to that property either for itself or for a third party. The court's analysis suggests that at the very least, horizontal privity requires some conveyance of real property.[25] On this score, the court found that the gathering agreements came up short because the underlying subject matter of the agreements — the provision of services in connection with oil and gas already extracted from the ground — constituted personal property, not real property.[26] Indeed, under Texas law, once minerals are extracted from the ground, such minerals "cease to be real property and instead become personal property."[27]

Furthermore, the court explained that Texas law provides for only five real property rights pertaining to a mineral estate: (1) the right to develop, (2) the right to lease, (3) the right to receive bonus payments, (4) the right to receive delay rentals, and (5) the right to receive royalty payments.[28] Since the dedications did not constitute any of the five real property rights pertaining to mineral estates recognized under Texas law, the court reasoned that no interest in real property could have been conveyed.[29] In absence of any conveyance of real property, the court concluded that privity could not be satisfied.

The court also found that the gathering agreements cannot constitute real covenants, as they do not "touch and concern" the land.[30] In reaching this conclusion, the court acknowledged that akin to privity, the "touch and concern" doctrine is somewhat nebulous and lacks a precise definition. To this point, the court identified at least two tests recognized under Texas law that are used to determine if a covenant touches and concerns the land. The first test considers whether the covenant "affected the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affected the mode of enjoying it." The second test asks if the promisor's legal interest as owner is rendered less valuable by the promise. If so, the burden of the covenant touches or concerns that land. Likewise, under the second test, if the promisee's legal interest as owner is rendered more valuable by the promise, then the benefit of the covenant touches or concerns the land.[31]

Nordheim and HPIP contended that the midstream service agreements both affected the land and its value. Their position was that regardless of how Sabine sought to use its mineral estate, the estate was burdened by the dedication to use their services.[32] In their view, because the mineral estate was directly burdened with

[21] *Sabine*, 2016 WL 890299, at *9.

[22] *Id.* (citing *Orion Pictures Corp. v. Showtime Networks* (*In re Orion Pictures Corp.*), 4 F.3d 1095, 1098 (2d. Cir. 1993).)

[23] *Id.* at *4. The court noted that the substantive legal question of whether the covenants ran with the land would have to be resolved with finality in a subsequent contested or adversary proceeding, given the procedural posture of the case. *Id.*

[24] *Id.* at *6 (citing *Inwood North Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987)). The parties disputed whether Texas law imposes a requirement of horizontal privity of estate. Noting that the gatherers identified no Texas case law rejecting this requirement, the court stated that it would "consider[]" horizontal privity in its analysis. *Id.*

[25] *Id.* at *7.

[26] *Id.* at *8 n.43 (citing *inter alia Sabine Prod. Co. v. Frost Nat'l. Bank of San Antonio*, 596 S.W.2d 271, 276 (Tex. Civ. App. 1980)).

[27] *Id.* at *8.

[28] *Id.* at *7 (citing *Lesley v. Veterans Land Bd.*, 352 S.W.3d 479, 481 n.1 (Tex. 2011)).

[29] *Id.*

[30] *Id.* at *7-9.

[31] *Id.* at *7 (citing *Westland Oil Development Corp v. Gulf Oil Corp.*, 637 S.W.2d. 903 (Tex. 1982)).

[32] *See, e.g.*, Nordheim Objection at 10-11, *In re Sabine & Gas Corp.*, Case No. 15-11835 (SCC) (Bankr. S.D.N.Y. Oct. 8, 2015), ECF No. 387.

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this promise, the impact on Sabine's property rights was clear.[33] But the court was not persuaded and once again emphasized the distinction between real and personal property. It explained that no matter what version of the touch and concern test was employed, the agreements could not affect the land "independently of collateral circumstances" because the agreements at issue pertained solely to personal property.[34] Indeed, as stated, under Texas law, once minerals are extracted from the ground, such minerals cease to be real property and transform into personal property. Because the subject matter of the agreements related to debtor's personal property (*i.e.*, minerals already extracted from the ground), the court concluded that the real property itself remained unburdened.[35]

In its decision, the *Sabine* court also distinguished the case before it from the U.S. Court of Appeals for the Fifth Circuit decision, *Newco Energy v. Energytec, Inc.* (*In re Energytec, Inc.*), which also examined covenants running with the land under Texas law.[36] *Energytec* involved a natural gas pipeline system conveyed to the predecessor of debtor Energytec, Incorporated.[37] At the time of the conveyance, the original real property owner carved out a "transportation fee" and a right to consent to future assignments of the pipeline. The agreement at issue was clear that the transaction involved both a conveyance of real property and "an agreement to convey certain interests" in the pipeline.[38] The agreement was also explicit that the covenants contained therein were to be regarded as partial consideration for the conveyance, supporting the conclusion that their commitments run with the land.[39] Although the Fifth Circuit ultimately held that the fee and consent right constituted obligations running with the land, the court in *Sabine* found the case to be readily distinguishable.[40] Among other facts, the *Sabine* court highlighted that *Energytec* clearly involved a conveyance of real property.[41] Moreover, in the *Sabine* court's view, it was clear that a right to consent to any future assignment of the pipeline more directly burdened the land than a contract for services.[42]

All considered, notwithstanding that the dedications in *Sabine* were expressly labeled as covenants running with the land, the court concluded that the actual language and subject matter of the agreements did not support the legal conclusion that such commitments qualify as covenants running with the land under Texas law. Therefore, the agreements at issue were susceptible to rejection in bankruptcy.

Implications of *Sabine*

The *Sabine* case provides distressed E&P companies with leverage to argue that these agreements may be vulnerable to rejection in bankruptcy. The decision also may be used to push midstream providers under the threat of rejection to provide E&P companies more favorable terms. That being said, the dust is far from settled on the issue, and the analysis is state law and contract-specific. E&P companies, their stakeholders and bankruptcy courts will certainly be unwinding these issues in the near future. In particular, several of the arguments advanced in Sabine were offered in *In re Quicksilver Resources* as well, when the E&P debtors there moved to reject certain midstream service agreements.[43] The litigation on this issue in *Quicksilver* is pending.

In sum, whether a midstream service agreement constitutes or contains a covenant running with the land, some other real property interest or merely a contractual right vulnerable to rejection, is fact-bound and will be highly dependent on the governing state law. Nonetheless, the *Sabine* case illustrates how a court may wrestle with these issues and should be used as a measure of guidance as distressed E&P companies and their stakeholders look to reorganize.

[33] Transcript of proceeding at 88-90, *In re Sabine & Gas Corp.*, Case No. 15-11835 (SCC) (Bankr. S.D.N.Y. Feb. 6, 2016), ECF No. 826.

[34] *Sabine*, 2016 WL 890299, at *7.

[35] *Id.* at *8 n.43 (citing, *inter alia, S. Frost Nat. Bank of San Antonio*, 596 S.W.2d at 276). The court also considered Nordheim's fallback theory that the dedications could run with the land as an equitable servitude. The court found this argument to be meritless because, *inter alia*, equitable servitudes, akin to real covenants, must also touch and concern the land. *Id.*at *9.

[36] 739 F.3d 215 (5th Cir. 2013).

[37] *Id.* at 217.

[38] *Id.* (internal quotations omitted).

[39] *Id.*

[40] *Id.* at 225.

[41] *Sabine*, 2016 WL 890299, at *7, 9.

[42] *Id.* at *7.

[43] *In re Quicksilver Resources Inc.*, Case No. 15-10585 (LSS) (Bankr. D. Del.).