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PRATT'S

ENERGY LAW

REPORT



EDITOR'S NOTE: A BANNER YEAR FOR ENERGY M&A

Victoria Prussen Spears

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A YEAR IN REVIEW - PART I**

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*Power Companies and Generation Assets
Renewables*

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Midstream Gathering Agreements Rejected in Sabine Oil & Gas Bankruptcy

By *Kenneth E. Noble**

The Bankruptcy Court for the Southern District of New York determined that midstream gathering agreements are subject to rejection as executory contracts, based on the debtor's business judgment, to the extent the agreements do not create an interest in property. The author of this article discusses the decision and its implications.

In a much anticipated ruling from the U.S. Bankruptcy Court for the Southern District of New York, Judge Shelley C. Chapman determined that midstream gathering agreements are subject to rejection as executory contracts, based on the debtor's business judgment, to the extent those agreements do not create an interest in property. The court then determined in a "non-binding analysis" that the midstream gathering agreements at issue did not create an interest in property under Texas law because as drafted, and despite language to the contrary in the agreements, they did not create "covenants that run with the land" or equitable servitudes.¹

Gathering agreements generally provide that an energy and production company (upstream operator) agrees to pay certain amounts over a specified number of years, subject to certain minimum volume or payment requirements, to a gathering and processing company (midstream operator) to treat and transport oil and gas products from the well or extraction point to a refining company (downstream operator). In exchange, the midstream operator agrees to pay the upfront cost of building the necessary pipelines and treatment facilities with the expectation that those agreements would survive a bankruptcy of the upstream operator.

The critical legal issue with respect to such a gathering agreement relates to whether it constitutes an executory contract that is subject to rejection in bankruptcy by the upstream operator based on the exercise of its business judgment or, instead, constitutes an interest in real property that attaches to the

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¹ *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (Bankr. S.D.N.Y. March 8, 2016) [Doc. #872].

upstream operator's mineral estate and continues (or runs) with the land, unaffected by the bankruptcy.

The decision in *Sabine* does not resolve this critical legal issue given that the court's substantive analysis, by its terms, is non-binding (even on the parties to the case) and is limited to the application of Texas law to the actual provisions of the gathering agreements at issue in this case. However, the court's analysis may prove influential to other courts and create support for upstream operators seeking to renegotiate more favorable economic terms with respect to their gathering agreements.

The court's determination in *Sabine* that the midstream gathering agreements at issue did not create covenants that run with the land or equitable servitudes is not subject to appeal, given that the determination constituted "non-binding analysis." However, the treatment of gathering agreements in bankruptcy is also at issue in two other bankruptcy cases that are currently pending in the District of Delaware, *Quicksilver Resources* (Bankruptcy Judge Laurie Selber Silverstein) and *Magnum Hunter Resources* (Bankruptcy Judge Kevin Gross). Decisions in those cases are anticipated in the near future.

BACKGROUND

On July 15, 2015, Sabine Oil & Gas Company, an upstream energy company engaged in the exploration and production of onshore oil and natural gas in Texas, filed for bankruptcy in the Southern District of New York. Prior to filing, Sabine had entered into three gathering agreements which provided, among other things, that Sabine would dedicate all of the oil and gas produced from certain designated areas, subject to specified minimums, to certain midstream operators. The midstream operators, in turn, agreed to construct at their sole expense certain pipelines and treatment facilities that they would then use to gather and process the oil and gas received from Sabine. Each of the agreements provided that it was governed by Texas law and constituted a "covenant running with the land."

On September 30, 2015, Sabine filed a motion under Section 365 of the Bankruptcy Code seeking to reject the three gathering agreements as executory contracts. Sabine argued that rejection was a reasonable exercise of its business judgment because the agreements required the delivery of certain minimum amounts of gas and related products, which was unduly burdensome. Sabine also indicated that if rejection was authorized it would seek to enter into replacement gathering agreements with other midstream operators on more favorable terms.

The midstream operators opposed the motion and argued, among other things, that the gathering agreements constituted covenants that ran with the

land, or equitable servitudes, that could not be rejected in bankruptcy. The operators also argued that any action to challenge those covenants could not be done in the context of a motion to reject, which is summary proceeding, but could only be done in the context of a separate adversary proceeding or contested matter to determine the substantive issues relating to those covenants.

APPLICABLE BANKRUPTCY PROVISIONS

The substantive protections provided to a midstream operator vary significantly depending on whether the gathering agreement constitutes an executory contract, which is subject to Section 365(a) of the Bankruptcy Code, or instead creates an interest in property of the debtor (such as a covenant that runs with the land or an equitable servitude), which is subject to Section 363(f) of the Code.

Section 365(a) of the Bankruptcy Code provides, among other things, that a debtor can reject an executory contract, subject to bankruptcy court approval, if the contract is unduly burdensome to the debtor's estate, irrespective of the adverse impact that rejection may have on the non-debtor party. Courts generally defer to the debtor's exercise of its business judgment in determining whether to permit rejection of an executory contract, absent a showing that the debtor's decision was based on bad faith, whim or caprice. The non-debtor party to a rejected contract, in turn, receives an unsecured claim against the debtor's estate for breach of contract damages.

Conversely, Section 363(f) of the Bankruptcy Code provides that a debtor may not sell its property free and clear of an interest in that property held by a non-debtor entity, subject to limited exceptions if:

- the sale is consented to by the holder of the interest;
- a sale free and clear of the interest is otherwise permitted under non-bankruptcy law;
- the interest is a lien and the sale price is greater than the value of the lien;
- the holder of the interest could be compelled under non-bankruptcy law to accept the payment of money; or
- the validity of the underlying interest is subject to a bona fide dispute.

If the property is not sold free and clear of the interest, then the non-debtor entity continues to hold its interest in the property unaffected by the debtor's bankruptcy case.

The procedural protections provided to a non-debtor entity may also vary depending on whether the entity is party to an executory contract, which can

be resolved by motion in a summary proceeding as a contested matter under Bankruptcy Rule 9014, or instead holds an interest in property of the debtor, which is subject to resolution in a more formal adversary proceeding commenced by complaint under Bankruptcy Rule 7001 (absent consent by the non-debtor party to proceed as a contested matter).

BANKRUPTCY COURT DECISION

On March 8, 2016, Bankruptcy Judge Chapman issued the court's decision with respect to the treatment of the gathering agreements at issue in the *Sabine* bankruptcy case. The decision did not resolve the substantive legal issues that had been raised, but instead created a basis for Sabine to seek to renegotiate its gathering agreements on more favorable terms.

The court first determined that Sabine's decision to reject the gathering agreements was, to the extent those agreements constituted executory contracts, a reasonable exercise of its business judgment, and in the best interest of the estate, because they were unnecessarily burdensome. In reaching its decision, the court noted that one of the midstream operators had acknowledged during oral argument that rejection of the agreements was reasonable and that neither midstream operator had put forward any argument or evidence that Sabine's decision was based on bad faith, whim or caprice.

Next, the court agreed that, as a procedural matter, it could not decide the underlying substantive legal issues with respect to whether the gathering agreements constituted covenants that run with the land, or equitable servitudes, in the context of a motion to dismiss, but would instead require Sabine to commence a separate adversary proceeding or contested matter to obtain such a decision.

The court then went on to set forth its "non-binding analysis" as to whether the gathering agreements constituted covenants that run with the land or equitable servitudes. Initially, the court noted that the agreements were governed by Texas law and there is no binding decision on this issue by the Texas Supreme Court.

The court then found that the gathering agreements as drafted failed to satisfy two of the "arcane and anachronistic" requirements necessary to establish a covenant that runs with the land. First, the agreements as drafted failed to satisfy the requirement that the parties have "horizontal privity of estate" because Sabine had not reserved an interest in real property for the midstream operators in the context of a traditional conveyance. Moreover, Sabine had not granted an interest to the operators in the underlying mineral estate, but had instead only granted them the contractual right to gather and process gas, which was not a recognized interest in real property under Texas law. Second, the

agreements as drafted failed to satisfy the requirement (also applicable to create an equitable servitude) that they “touch and concern” the underlying mineral estate because they related solely to gas and products after they had been extracted from the ground, at which point they ceased to be real property and instead became personal property.

Finally, the court invited the midstream operators to file any claims against the debtor's estate that they believed were consistent with their legal rights so that those claims could, in turn, be promptly resolved by motion through the debtor's claim administration process.

CONCLUSION

While the decision in *Sabine* did not resolve the critical underlying legal issue with respect to the treatment of gathering agreements in bankruptcy, the court's decision may prove influential to other courts, particularly if presented with similarly drafted agreements governed by Texas law, and may create a more favorable environment for upstream operators seeking to renegotiate the economic terms of their gathering agreements.

In the meantime, and pending any subsequent decisions in the *Quicksilver Resources* and *Magnum Hunter Resources* bankruptcy cases, parties with an interest in midstream gathering agreements may be well advised to evaluate such agreements in light of the analysis provided in the *Sabine* decision.