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For more information, contact:

Ed Ripley
+1 713 276 7351
eripley@kslaw.com

Thad Wilson
+1 404 572 4842
thadwilson@kslaw.com

Sarah Borders
+1 404 572 3596
sborders@kslaw.com

King & Spalding

Atlanta
1180 Peachtree Street, NE
Atlanta, Georgia 30309-3521
Tel: +1 404 572 4600

Houston
1100 Louisiana Street
Suite 4000
Houston, Texas 77002-5213
Tel: +1 713 751 3200

Second Circuit Affirms Debtors' Ability to Reject Gathering Agreements in Bankruptcy Cases

On May 25, 2018, the United States Court of Appeals for the Second Circuit (the "Court") affirmed a district court's affirmance of a bankruptcy court's decision in *In re Sabine Oil & Gas Corp.* that permitted a debtor to reject a midstream gathering agreement as an "executory contract."[1] The Court's decision, which is the first Court of Appeals to address the rejection of a midstream gathering agreement, firmly establishes a debtor's right to do so under certain circumstances.

BACKGROUND

A summary of the decision of the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") from our prior Client Alert can be found here and here. A summary of the decision of the United States District Court for the Southern District of New York (the "District Court") from our prior Client Alert can be found here.

Sabine Oil & Gas Corporation ("Sabine") and its co-debtors (collectively, the "Debtors") initiated adversary proceedings in the Bankruptcy Court seeking declaratory judgments that the covenants contained in gathering agreements with Nordheim Eagle Ford Gathering, LLC ("Nordheim") and HPIP Gonzales Holdings, LLC ("HPIP") did not run with the land, and thus, the Debtors could reject the agreements. Nordheim and HPIP opposed the Debtors' proposed relief. On May 11, 2016, the Bankruptcy Court granted summary judgment to the Debtors, sustaining its oral ruling that the Debtors could indeed reject the gathering agreements because the agreements did not contain covenants running with the land.[2]

Nordheim and HPIP timely appealed. On March 10, 2017, Judge Jed Rakoff affirmed the Bankruptcy Court's decisions, thus upholding the Debtors' decision to reject the gathering agreements. The District Court's opinion focused on its conclusion that the agreements at issue did not "touch and concern the land" because the agreements did not "affect the nature, quality or value of the things demised."[3] Nordheim timely appealed. The Second Circuit affirmed.

THE DECISION

The Second Circuit focused on whether Texas state law requires "horizontal privity" between the parties to the original agreement creating the covenant for the covenant to run with the land—in other words, "must [there] have been some common interest in the land other than the purported covenant itself at the time it was executed."[4] Agreeing with an alternative rationale from the Bankruptcy Court's decision, the Court concluded that Texas law requires "horizontal privity" for a covenant to run with the land. Accordingly, the Debtors could reject the Nordheim gathering agreement because "horizontal privity" between Nordheim and the Debtors did not exist.

In reaching its conclusion, the Court also affirmed the District Court's holding that the gathering agreement did not create an equitable servitude because only Nordheim benefited by the agreement—not the underlying real property. The Court, however, did not comment on, or undertake an analysis of, the District Court's conclusions regarding whether the agreement "touched and concerned" the property because the Court determined that "horizontal privity" did not exist.

CONCLUSION AND POTENTIAL IMPLICATIONS

While the *Sabine* Bankruptcy Court's opinion was the subject of significant discussion when it was first issued, the Second Circuit's affirmance now firmly cements its holding that under similar circumstances, these types of gathering agreements can be rejected by a debtor in bankruptcy. Although the recent wave of oil and gas bankruptcies has crested and prices have somewhat rebounded, the Second Circuit's decision may have a lasting impact on future bankruptcies in the industry. The *Sabine* decisions provide debtors with leverage to force midstream companies to renegotiate the terms of existing gathering agreements and cause the same companies to consider modifying the structures of their current and future transactions to address "horizontal privity" and "touch and concern" issues. Whether a gathering agreement can be rejected by a debtor in bankruptcy, however, will continue to require a fact-specific analysis that depends on the precise contractual language at issue and applicable state law.

[1] Case No. 17-1026, 2018 U.S. App. LEXIS 13975 (2d Cir. May 25, 2018).

[2] *In re Sabine*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016).

[3] *In re Sabine*, 567 B.R. 869, 874 (S.D.N.Y 2017).

[4] To establish "horizontal privity" for purposes of demonstrating a covenant runs with the land, courts generally require the covenant to be created in connection with a conveyance of an estate or interest in real property.