Insolvency &
Restructuring

March 11, 2016

New York Bankruptcy Court Authorizes Rejection of Midstream Contracts

By Andrew M. Troop, Christopher R. Mirick and Samuel S. Cavior

Bad news for midstream counterparties of bankrupt oil & gas producers: you may not be able to rely (as much as you might have expected) on covenants "running with the land" to save your contracts from rejection in bankruptcy.

One strategy commonly used by midstream counterparties of oil & gas producers to mitigate upstream risk has been to craft their contractual entitlements as covenants that "run with the land," generally expecting that these covenants are immune from rejection in bankruptcy. As with most things, however, the devil is in the details. After having heard argument on February 2, 2016, and considering the evidence presented, on March 8, 2016, Judge Shelley Chapman of the U.S. Bankruptcy Court for the Southern District of New York authorized Chapter 11 debtor Sabine Oil & Gas Corp. to reject gas and condensate gathering and treatment contracts, governed by Texas law and purporting to run with the land, with two midstream pipeline companies, Nordheim Eagle Ford Gathering LLC and HPIP Gonzales Holdings LLC—although the Court did not issue a definitive ruling that the covenants at issue do not run with the land ... yet.[1]

Background

In December 2014, as a result of Sabine's merger with Forest Oil Corp., Sabine became party to contracts with, separately, Nordheim and HPIP (the Counterparties). Under the contracts, Sabine agreed to "dedicate" to the Counterparties (as applicable) all of the natural gas and condensates produced by Sabine from certain designated areas. Sabine also agreed to deliver certain minimum volumes, make deficiency payments if the minimums were not met, and pay certain monthly fees.

The contracts expressly provided that Sabine's undertakings were covenants that run with Sabine's real property interests, and were binding on Sabine's successors and assigns. The Counterparties recorded a memorandum of each contract in the applicable local real property recording offices. And, in reliance on Sabine's covenants, the Counterparties agreed to construct, at their own expense, the necessary pipeline systems and facilities for gathering and treating the gas and condensates.

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

In July 2015, Sabine commenced its Chapter 11 bankruptcy case, and two months later sought Court approval to reject the Nordheim and HPIP contracts under section 365(a) of the Bankruptcy Code.

Contract Rejection in Bankruptcy

Section 365(a) of the Bankruptcy Code permits debtors to evaluate their executory contracts and, with Court approval, reject those that are burdensome or assume those that are beneficial. As long as it is not the product of "bad faith, whim or caprice" and reflects the sound judgment of a reasonable business person under similar circumstances, bankruptcy courts usually will not second guess a debtor's decision to reject or assume a contract.

In this case, Sabine explained that rejecting the Nordheim and HPIP contracts was a reasonable business decision because delivering the required minimum volumes of gas and condensates on the existing terms was not economic in the current market, and making the resulting deficiency payments would be an unnecessary burden on the bankruptcy estate that could be avoided by rejection. Sabine also argued that rejection would free the company to enter into new contracts on better terms.

HPIP did not object to the rejection of its contracts, arguing only that the rejection could not eliminate the covenants at issue because they expressly run with the land. Nordheim, however, in addition to making this argument, objected to the rejection of its contracts on the grounds that rejection was not a reasonable exercise of business judgment by Sabine because any replacement contract with a new counterparty would be uneconomic in light of Sabine's surviving covenants to deliver gas and condensates (or make deficiency payments) to Nordheim, which could not be rejected.

Judge Chapman reluctantly observed that Second Circuit precedent precluded her from deciding, in the "summary proceeding" context of a motion to reject, substantive legal issues such as whether the covenants in question truly run with the land under applicable Texas law.[2] She laid out the alternate paths ahead: "If it is ultimately determined that the covenants at issue…do not run with the land, as the Debtors argue and the Court believes to be the case, the Debtors will be free to negotiate new gas gathering agreements with any party…. If, however, the covenants are ultimately determined to run with the land, the Debtors will likely need to pursue alternative arrangements with Nordheim and HPIP consistent with the covenants by which the Debtors would remain bound."

Even with this contingency, however, Judge Chapman concluded that she could rule on rejection as a matter of Sabine's reasonable business judgment. On that basis, she held that Sabine could reject all of the contracts in question. Judge Chapman found that "there is no dispute with respect to the reasonableness of the Debtors' decision to reject the HPIP Agreements," and that despite Nordheim's arguments, it had not presented evidence that the proposed rejection failed the requisite business judgment test.

Non-Binding Analysis of "Running with the Land"

While the Court declined, for procedural reasons, to rule definitively on the underlying legal question of whether the covenants at issue "run with the land" under Texas law as Nordheim and HPIP had argued,

[2] Under the Federal Rules of Bankruptcy Procedure, disputes or requests for judicial relief are put before Bankruptcy Courts in one of two ways: by motion or by a separate lawsuit called an "adversary proceeding." In *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F. 3d 1095 (2d Cir. 1993), the Second Circuit held that a bankruptcy court had decided, in a binding manner impermissible outside of an adversary proceeding, a substantive legal dispute underlying a motion to assume a contract that should have been decided in the more plenary setting of an adversary proceeding.

Judge Chapman took the opportunity to present a "non-binding" analysis that these covenants do not "run with the land." Reading her decision into the record from the bench, she encouraged Sabine to take the necessary steps to present the question properly, but cautioned the parties that she did not intend to re-litigate the matter.

The Court introduced its "preliminary" conclusion by placing the question in historical context under English law, dating back as far as 1583,[3] and noted that "American jurisdictions have generally…adopt[ed] a policy that the requirements for running with the land should be more strictly applied to affirmative covenants [like the ones in the Nordheim and HPIP contracts] than to negative ones."

The Court next examined the elements necessary for a covenant to run with the land under Texas law, namely that: "(1) it touches and concerns the land; (2) it relates to a thing in existence or specifically binds the parties and their assigns; (3) it is intended by the original parties to run with the land; and (4) the successor to the burden has notice." Some courts also have required "horizontal privity of the estate," which Judge Chapman explained traditionally means "a property owner reserving by covenant, either for itself or another beneficiary, a certain interest out of the conveyance of the property burdened by the covenant."

Of these elements, the Court first considered whether horizontal privity exists. Judge Chapman concluded that the covenants in question do not fit the traditional model because (1) Sabine did not reserve any interest for the Counterparties in the context of conveying real property to a third party (instead, only defining the parties' contractual rights and obligations in their respective two-party transactions); and (2) Sabine did not convey to the Counterparties a real property interest in its mineral estate.

Looking to the "overarching purpose of the contract," the Court also concluded that the covenants in question do not "touch and concern" the land because they do not affect the value of the land or Sabine's interest in the land or its use. The covenants did not compel or preclude Sabine from doing anything on the land itself. They were exclusively personal undertakings by Sabine and the respective Counterparties "concern[ing] only the Products produced from real property and affect[ing] only Sabine's personal property rights," as were the actions triggering the covenants.

Having found two of the elements lacking, Judge Chapman did not reach the remaining elements, such as the issue of the parties' intent.[4]

More Bad News to Come?

Notwithstanding the "non-binding" nature of Judge Chapman's pronouncements on covenants (not) running with the land, the rejection of the Nordheim and HPIP contracts—and the consequences for those parties—appears to be all but set, absent appeal or a commercial resolution. It is unclear whether Judge Chapman intends to permit parties to litigate this issue again when it is brought before her by way of an adversary proceeding to satisfy the procedural requirements that would enable her to issue a binding decision.[5]

[3] *Spencer's Case*, 77 E.R. 72 (1583).

[4] Having found the covenants in question were merely personal covenants and not real property covenants, the Court also concluded they were not enforceable as equitable servitudes because, again, they do not "touch and concern" the land.

[5] Presumably, Judge Chapman felt that she had previously taken evidence on all the disputed issues at the February 2, 2016, hearing on Sabine's motion to reject, thus satisfying the discovery requirements of the adversary proceeding rules.

As a result, the consequences for other midstream counterparties are necessarily unsettling. Covenants which they thought ran with the land and could not be rejected have now been demonstrated to require contract terms that are, at the very least, very closely tailored to the circumstances to justify reliance in avoiding rejection and averting loss of investment. There may be many midstream contracts in force today that would not withstand Judge Chapman's analysis, although only a contract-by-contract review would reveal them, given the complexity of the Court's fact-intensive analysis and variation in applicable state laws.

Broadening our focus, Sabine is but one of several current cases—with probably more in the pipeline—considering (in varying settings) whether an interest held by a midstream company is a property interest that precludes rejection in bankruptcy. One such dispute, in *In re Magnum Hunter Resources Corp*., Case No. 15-12533 (KG), in the U.S. Bankruptcy Court for the District of Delaware, has been resolved consensually. Another similar dispute is pending a decision in *In re Quicksilver Resources Inc*., Case No. 15-10585 (LSS), also in the Delaware Bankruptcy Court.

We will continue to monitor the situation.

If you have any questions about the content of this alert please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Andrew M. Troop (bio)
New York
+1.212.858.1660
andrew.troop@pillsburylaw.com

Christopher R. Mirick (bio)
New York
+1.212.858.1333
christopher.mirick@pillsburylaw.com

Samuel S. Cavior (bio)
New York
+1.212.858.1146
samuel.cavior@pillsburylaw.com

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