
COURT FINDS DEBTOR CAN REJECT MIDSTREAM SERVICE AGREEMENTS IN BANKRUPTCY

On March 10, 2017, the District Court for the Southern District of New York entered an order affirming a bankruptcy court’s decision to allow an oil and gas producing debtor to reject gas gathering agreements with two midstream service companies pursuant to section 365 of the Bankruptcy Code [*See In re Sabine Oil & Gas Corp.*, No. 15-11835, 2017 WL 1093290 (S.D.N.Y. Mar. 9, 2017)]. The entry of the district court’s order further establishes a body of precedent in the Second Circuit that suggests midstream service companies are at risk of having their agreements rejected upon the bankruptcy of a debtor contract-counterparty. However, as discussed below, this outcome is dependent upon the particular language in a gas gathering agreement and the related conveyance documents.

I. BACKGROUND

On July 15, 2015, Sabine Oil & Gas Corp. (the “Debtor”) and its affiliates filed for relief under Chapter 11 of the Bankruptcy Code. The Debtor sought to reject four midstream service agreements (collectively, the “Agreements”) under section 365 of the Bankruptcy Code: two agreements with Nordheim Eagle Ford Gathering, LLC (“Nordheim”), and two agreements with HPIP Gonzales Holdings, LLC (“HPIP”). Section 365 of the Bankruptcy Code permits a debtor to reject certain executory contracts or unexpired leases and treats rejection of these contracts and leases as a pre-petition breach, thereby entitling a nondebtor-counterparty to a pre-petition claim for damages. Rejection excuses the debtor from further performance under the contract or lease. However, a debtor cannot reject a covenant that runs with the land or an equitable servitude because the law views these as interests in property that cannot be extinguished (*i.e.*, rejected) in bankruptcy.

Under the Agreements, the Debtor would deliver gas and condensate to Nordheim and HPIP, and Nordheim and HPIP would provide “gathering and processing services” to the Debtor in return. Notably, under the Agreements: (i) the Debtor retained title to the gas, condensate, and relevant hydrocarbon leases; (ii) the terms of the Agreements provided that they contain covenants that run with the land and related leasehold interests; (iii) the Debtor’s successors and assigns were bound by the Agreements; (iv) the Debtor conveyed to Nordheim a tract of land where Nordheim constructed the necessary facilities and pipelines to perform its obligations; and (v) HPIP agreed to construct necessary facilities to perform its obligations.

Nordheim and HPIP asserted that the Agreements could not be rejected under section 365 of the Bankruptcy Code and applicable Texas state law because the Agreements conveyed property rights (*i.e.*, covenants that run with the land or equitable servitudes) to the midstream operators.

In May 2016, the bankruptcy court entered a number of orders finding that the Agreements did not convey property rights under Texas law and held that the Debtor was allowed to reject the Agreements, despite the fact that their terms provided that they contain real covenants that run with the land.

II. THE APPEAL

In June 2016, Nordheim and HPIP appealed the orders of the bankruptcy court, raising three issues: whether the bankruptcy court erred in (i) deciding that the Agreements did not contain real covenants that run with the land, (ii) deciding that the Agreements did not contain equitable servitudes, and (iii) allowing the Debtor to reject the Agreements.

A. Whether the Agreements Contain Real Covenants

The district court analyzed whether the Agreements contained real covenants (*i.e.*, covenants that run with the land) and concluded that the covenants at issue did not “touch and concern” the land as required to run with the land under Texas state law. A covenant touches and concerns the land: (i) if either “the promisor’s legal relations in respect to the land in question are lessened” or “the promisee’s legal relations in respect to that land are increased”; or (ii) if the covenant “affect[s] the nature, quality or value of the thing demised, independently of collateral circumstances, or if it affect[s] the mode of enjoying it[.]” If either test is met, the covenant runs with the land [*See Inwood N. Homeowner’s Ass’n v. Harris*, 736 S.W.2d, 632, 635 (Tex. 1987)]. Specifically, the district court found that the Agreements (i) did not increase Nordheim or HPIP’s legal relation to the real property at issue, and (ii) had no effect on the nature, quality, or value of the Debtor’s interests in such property.

The district court found that the Agreements did not increase Nordheim or HPIP’s legal relation to the real property for three reasons: (i) the Debtor failed to convey real property interests to Nordheim and HPIP; (ii) the Debtor could produce as much gas and condensate from the property as it wanted (while the Debtor may have had to pay Nordheim and HPIP a deficiency payment, this was only a contractual obligation); and (iii) the Debtor’s obligations to Nordheim and HPIP were triggered only when the gas and condensate were produced, meaning that the gas and condensate were personal, not real, property under Texas law. The district court made the following key findings in support of its decision:

- The Agreements did not grant Nordheim or HPIP a royalty interest because the parties did not receive a right to any share of the gas or condensate from the particular properties.

- Nordheim and HPIP did not receive any other mineral rights or interests under Texas law. *See Altman v. Blake*, 712 S.W.2d 117, 118 (Tex. 1986) (listing those interests as “(1) the right to develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, and (5) the right to receive royalty payments”).
- Nordheim and HPIP “merely agreed to provide services to the minerals’ owner [*i.e.*, the Debtor].”
- While the HPIP agreements did “dedicate” the relevant leases to the “performance of the HPIP contracts,” the court held that the Debtor did not convey a property interest to HPIP because the agreements did not describe what property interests these dedications gave it.
- The district court distinguished *In re Energytec*, 739 F.3d 215 (5th Cir. 2013), a decision where the Fifth Circuit found that the covenant at issue touched and concerned the land. **First**, the Debtor’s obligation to pay Nordheim and HPIP “[was] only incurred upon delivery of produced gas and condensate,” while the debtor in *Energytec* “was entitled to [a] transportation fee upon a use of the land in question.” **Second**, although the Agreements provided the Debtor’s successors or assigns would remain bound by the Agreements, the debtor in *Energytec* had to consent to any assignment of the pipeline (which is a restraint on the owner’s right to sell or assign its interest).

B. Whether the Agreements Constitute Equitable Servitudes

The district court also analyzed whether the Agreements constituted equitable servitudes under Texas law and found to the contrary for two reasons. **First**, the court concluded that the Agreements did not restrict the Debtor’s use of its property interests for the reasons discussed above. **Second**, the Agreements only benefitted Nordheim and HPIP (not the land) because the Debtor was required to pay Nordheim and HPIP for processing delivered gas and condensate no matter where the processing actually occurred. Therefore, the court reasoned, the Agreements did not increase the value of the land where Nordheim and HPIP located their processing facilities.

Given the foregoing legal analysis, the district court concluded that the bankruptcy court was correct in authorizing the rejection of the Agreements under section 365 of the Bankruptcy Code. Both Nordheim and HPIP have appealed the district court’s decision to the Second Circuit Court of Appeals.

To view the full opinion in *In re Sabine Oil & Gas Corp.*, please follow this [link](#).

If you have any questions about the information contained in this Client Alert, please contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below for more information.

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