New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 255—NO. 109

WEDNESDAY, JUNE 8, 2016

BANKRUPTCY PRACTICE

Expert Analysis

'In re Sabine': Gathering Agreements and Real Covenants

By **John J. Rapisardi**

And **Joseph Zujkowski**

In a number of recent chapter 11 cases filed by "upstream" energy and production companies, the debtor's rejection of "gathering agreements" or similar contracts with "midstream operators" has raised the issue of whether the debtor's mineral estate is free of obligations stemming from covenants that "run with the land" as either real covenants or equitable servitudes.[1] In *In re Sabine Oil and Gas Corp*., the U.S. Bankruptcy Court for the Southern District of New York held, in construing Texas law, that covenants that "run with the land" in four gathering agreements were not enforceable upon rejection of these agreements.[2]

The decision is on direct appeal to the U.S. Court of Appeals for the Second Circuit (with a request that the key issues on appeal be certified to the Texas Supreme Court for its review and guidance).[3] If the Bankruptcy Court's decision is upheld, the question for those in the oil and gas industry will be whether the Sabine decision is limited on its facts and not generally applicable to other oil and gas gathering agreements.

The Bankruptcy Court for the Southern District held, in construing Texas law, that covenants that 'run with the land' in four gathering agreements were not enforceable upon rejection of these agreements.

Gathering Agreements

Gathering agreements typically provide that the "upstream operator" dedicates, for the benefit of the "midstream operator," all oil and gas produced from certain designated areas. In return, the midstream operator agrees to gather and process oil, gas, and other products received from the upstream operator and to deliver the processed hydrocarbons to specified locations (in exchange for minimum monthly or annual payments). In order to perform these services, the midstream operator is required to construct pipeline systems and treatment facilities, often at its own expense. Critically, to protect its investment, the midstream operator may require the upstream operator to identify its delivery and payment obligations as covenants that "run with the land." If properly structured, these covenants should be binding on future owners of the upstream operator's "working interest" in the "mineral estate."[4]

Necessary Elements

Covenants that "run with the land" date back to 16th century English common law. The doctrine recognizes that certain promises related to real property must remain enforceable in the event of a sale or other disposition of the property in order to have value to the promisee. Additionally, because contracts were not

JOHN J. RAPISARDI *is a partner at O'Melveny & Myers.* JOSEPH ZUJKOWSKI *is a counsel at the firm.*

assignable under early English common law, the concept of real property covenants emerged to ensure that certain terms agreed to by the original covenanting parties passed to future owners of the real property.[5]

The requirements necessary to create a covenant that runs with the land under Texas law were summarized by the U.S. Court of Appeals for the Fifth Circuit in its 2013 decision in *In re Energytec*. In *Energytec*, Mescalaro Oil & Gas agreed to sell all of its interests in a gas pipeline to Energytec, and Energytec agreed to assume an obligation to pay a Mescalaro affiliate (Newco) a monthly transportation fee based on pipeline production. Newco also received the right to consent to future sales or assignments of the pipeline. The consent right and monthly payment obligations were expressly referred to as "running with the land."

Energytec subsequently filed for chapter 11 and received bankruptcy court approval of a sale of the pipeline system free and clear of Newco's interests.[6] On appeal, the Fifth Circuit overturned the lower court decision and held that, under Texas law, a covenant "runs with the land" when "(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."[7] In addition to the four generally agreed-upon requirements, the Fifth Circuit identified "horizontal privity" between the covenanting parties as a possible fifth requirement necessary to create a real and enforceable covenant under Texas law.[8]

Touch and Concern. As is self-evident from the above-listed requirements for a covenant to "run with the land," the covenant must "touch and concern" the land. A covenant "touches and concerns" the land if the performance of the covenant somehow relates to the use and enjoyment of the land.[9] Put differently, if the covenant either lessens or increases the value of land rights through respective burdens or benefits with respect to the land, then the covenant runs with the land. Examples include negative covenants restricting how the land may be used or affirmative covenants where the burdened party is required to do something on the land.

Horizontal and Vertical Privity of Estate. There are two types of privity of estate as it relates to covenants: horizontal and vertical privity. Horizontal privity of estate essentially means that at the time a covenant was agreed upon, the parties shared some existing interest in the real property independent of the covenant (e.g., as a landlord and tenant, or grantor and grantee). For example, assume A grants land to B, and within the deed between A and B there is a covenant from B to refrain from taking certain actions in respect of the land. In this example, because A and B share an interest in the land (the grantor/grantee relationship), there exists horizontal privity of estate between them as it relates to the covenant. Vertical privity of estate concerns successors in interest rather than the original covenanting parties. In order for vertical privity to exist with respect to a successor in interest, there must have been horizontal privity of estate between the original covenanting parties.

Sabine Decision

As a result of the December 2014 merger of Sabine Oil and Gas LLC and Forest Oil Corporation, Sabine became party to two gas gathering agreements with Nordheim Eagle Ford Gathering, LLC, and two oil and gas gathering agreements with HPIP Gonzales Holdings, LLC. Pursuant to the agreements, Nordheim and HPIP agreed to construct, at their own expense, a series of pipelines and treatment facilities that would allow them to "gather, treat, dehydrate, and re-deliver" the hydrocarbons delivered by Sabine. In exchange, Sabine "dedicated" all hydrocarbons produced at certain well sites to Nordheim or HPIP, and agreed to pay monthly gathering fees (subject to specified minimum amounts).[10] The agreements also clearly stated that the dedication and payment obligations were covenants running with the land.[11]

After the chapter 11 filing, *Sabine* sought to reject the Nordheim and HPIP gathering agreements under Bankruptcy Code section 365, which generally provides a debtor

wide latitude to reject executory contracts and unexpired leases. Nordheim and HPIP objected, and contended that the dedication and payment provisions of the gathering agreements identified as covenants that "run with the land" were interests in the property that could not be shed through a section 365 rejection of the gathering agreements.[12]

The Bankruptcy Court determined that notwithstanding the reference in the agreements to "covenants that run with the land," the touch and concern and horizontal privity requirements were not satisfied when the gathering agreements were executed.[13] Therefore, the Bankruptcy Court held that the parties failed to create in each agreement a real and enforceable covenant that ran with the land.

Court's Definition of Touch and Concern. Citing *Energytec*, the Bankruptcy Court observed that under Texas law a covenant "touches and concerns" real property when it affects (1) both the value of the real property and (2) the owner's interest in or use of the real property.[14] However, in *Sabine*, the Bankruptcy Court stressed that, under Texas law, oil and gas reserves cease being real property and become personal property upon extraction.[15] As a result, the court held that the dedication and payment covenants in the Nordheim and HPIP agreements burdened personal property "produced and saved" by Sabine but not the land from which the oil and gas were extracted.[16]

The Bankruptcy Court further found that, in contrast to several seminal Texas cases where covenants in midstream agreements were found to touch and concern real property: (1) Sabine had a reservation of rights under the gathering agreements allowing it to operate its oil and gas properties independent of and without interference from Nordheim or HPIP; (2) Nordheim and HPIP's pipelines attached at " receipt" or "central delivery" points to pipelines and not directly to Sabine's wells; and (3) gathering fees were triggered by receipt of oil and gas by the midstream operator and not upon extraction of such oil and gas from the ground.[17] While these distinctions may seem minor, the Sabine decision suggests they are a critical part of determining whether covenants touch and concern real property under Texas law.

> Midstream operators generally amortize the costs of constructing pipelines and other infrastructure by structuring gathering agreements as long-term contracts. If under state law the operative covenants running with the land in these agreements are not real and enforceable, the substantial investments made by midstream operators could be wiped out in a future chapter 11 filing.

Court Finds Horizontal Privity Applies. As noted above, in determining whether a covenant "runs with the land," the Bankruptcy Court found that horizontal privity is a mandatory fifth element. The court observed that the "underlying purpose" of horizontal privity "is to ensure that a covenant that binds successors is formally recorded in connection with the real property that is being burdened by the covenant."[18]

The Bankruptcy Court noted that, unlike *Energytec*, the facts in *Sabine* did not fit within the "traditional model" for horizontal privity of estate because Sabine did not, in "the context of a relevant conveyance, reserve any interest for Nordheim or HPIP."[19] Instead, Nordheim and HPIP were "simply" engaged by the debtors "to perform certain services related to the hydrocarbons produced by Sabine from its property."[20] Therefore, the court found that the parties merely entered into service agreements for the transport and processing of oil and gas that, at the time of delivery, was personal property under Texas law.[21] As a result, the covenants at issue in the gathering agreements did not run with the land as either covenants or equitable servitudes in Sabine's real property.

Analysis

The economic stakes for midstream operators arising out of the Sabine decision are high. As noted above, midstream operators generally

amortize the costs of constructing pipelines and other infrastructure by structuring gathering agreements as long-term contracts. If under state law the operative covenants running with the land in these agreements are not real and enforceable, the substantial investments made by midstream operators could be wiped out in a future chapter 11 filing.

As to the outcome of the appeal, there is a good chance the Bankruptcy Court's decision will be ultimately affirmed. The Bankruptcy Court's "touch and concern" analysis in *Sabine* is seemingly consistent with the factors highlighted in other Texas cases, which include whether the pipeline in question was connected to the wells, the midstream operator's degree of control over well operations, and whether a right to payment arises upon extraction. Moreover, the Bankruptcy Court's conclusion regarding the necessity of horizontal privity, and its application of this doctrine to the facts at issue in *Sabine*, appears to be a correct application of hornbook real property law that has been embraced by some Texas courts.

Notably, in several other pending chapter 11 cases, the same issues related to covenants that run with the land have come up but were ultimately settled by the chapter 11 upstream operator and the midstream operator.[22] These settlements suggest that, while the Sabine decision in first instance gives significant leverage to upstream debtors, there are practical limitations that may create more of a level playing field. In certain circumstances, a new midstream operator may be willing to invest the capital necessary to build new pipelines and treatment facilities; but more often a debtor will prefer to engage the existing midstream operator in a renegotiation of the terms of the rejected gathering agreement and keep the existing infrastructure in place.

Conclusion

Regardless of the outcome of the current appeal, the Sabine decision is an important reminder that whether covenants that run with land are real covenants with respect to the real property/mineral estates they purportedly burden centers on a specific, fact-based analysis under state law. The outcome of that analysis will determine the economic impact on and leverage held by the respective parties to these agreements in the context of the bankruptcy case.

1. While many of the requirements for equitable servitudes and real property covenants are the same, a party seeking to enforce an equitable servitude may request only an injunction or other equitable remedy.

2. The Bankruptcy Court issued a non-binding bench ruling on March 8, 2016, on Sabine's motion to authorize rejection of certain executory contracts, which included the gathering agreements. See Bench Decision on Debtors' Omnibus Motion to Authorize Rejection of Certain Executory Contracts, dated March 8, 2016, Case No. 15-11835, ECF No. 872, *In re Sabine Oil & Gas Corp.*, –B.R.–, 2016 WL 890299 (Bankr. S.D.N.Y. March 8, 2016) (the "Bench Ruling"). The Bench Ruling was non-binding because the Bankruptcy Court held that a declaratory judgment with respect to whether the covenants at issue run with the land could only be issued as part of an adversary proceeding commenced under rule 7001 of the Federal Rules of Bankruptcy Procedure. An opinion issued on May, 3, 2016, granted the summary judgment motion filed by Sabine in connection with the adversary proceeding.

3. See Nordheim's Expedited Request for Certification of Rejection Order For Direct Appeal Pursuant to 28 U.S.C. §158(d)(2) and Fed. Bankr. R. 8006(f), Case No. 15-11835, ECF No. 1100, *In re Sabine Oil & Gas Corp.*, Bankr. S.D.N.Y. May 13, 2016).

4. Bench Ruling at 2.

5. Margot Rau, "Covenants Running with the Land: Viable Doctrine or Common-Law Relic," Hofstra Law Review: Vol. 7: Iss. 1 (1978).

6. *Newco Energy v. Energytec* (*In re Energytec*), 739 F.3d 215 (5th Cir. 2013).

7. Id. at 221.

8. Id.

9. Bench Ruling at 14.

10. Id. 2.

11. Id. at 3.

12. Id. at 4-5.

13. Opinion at 4.

14. *Newco Energy v. Energytec* (*In re Energytec*), 739 F.3d 215, 223 (5th Cir. 2013).

15. Bench Ruling at 15.

16. Id.

17. Opinion at 10 (citing *American Refining Co. v. Tidal Western Oil Corp.*, 264 S.W. 336, 336 (Tex. Civ. App. 1924), and *Wimblery v. Lone Star Gas Co.*, 818 S.W.2d 868 (Tex. App. 1991)).

18. Opinion at 13.

19. Bench Ruling at 13.

20. Id.

21. Id.

22. See e.g. "Magnum Hunter, Pipeline Co. Ink Midstream Deal In Ch. 11," Law360.com, March 10, 2016.

Reprinted with permission from the June 8, 2016 edition of the NEW YORK LAW JOURNAL © 2016 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-06-16-15