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The Southern District of New York Authorizes the Rejection of Gas Gathering Agreements

By Zachary I. Shapiro – June 1, 2016

In *In re Sabine Oil & Gas Corporation*, No. 15-11835 (SCC) (Bankr. S.D.N.Y. Mar. 8, 2016), the U.S. Bankruptcy Court for the Southern District of New York issued a bench decision granting Sabine Oil & Gas Corporation's motion to reject three gas gathering agreements and a handling agreement that were governed by Texas law. In doing so, the bankruptcy court held that rejecting the gathering agreements was a proper exercise of Sabine's business judgment and, in a nonbinding decision, found that the obligations arising under the gathering agreements were not covenants that ran with the land.

Case and Procedural Background
Sabine is an "upstream" exploration and production company, which locates and extracts oil and natural gas. Sabine uses service providers, known as "midstream gatherers," to transport the oil and gas that it extracts to refining companies.

As part of Sabine's bankruptcy case and its restructuring efforts, Sabine filed a motion, pursuant to section 365 of the Bankruptcy Code, seeking to reject the gathering agreements with Nordheim Eagle Ford Gathering, LLC, and HPIP Gonzales Holdings, LLC. Both Nordheim and HPIP are midstream gatherers.

Generally, section 365(a) of the Bankruptcy Code permits debtors to evaluate their executory contracts and, with bankruptcy court approval, reject those contracts that are burdensome. Sabine argued that the gathering agreements were burdensome and, thus, properly subject to rejection. In addition, Sabine argued that rejection would allow it to enter into new contracts on better terms.

Both HPIP and Nordheim objected to the rejection motion and both argued—albeit for different reasons—that Sabine cannot use section 365 of the Bankruptcy Code to reject certain of the obligations under the gathering agreements because such obligations were covenants running with the land and therefore not subject to rejection.

HPIP did not oppose Sabine's rejection of the gathering agreements with HPIP but argued that certain "dedications" under the HPIP agreements (i.e., Sabine's dedication of its resources, leases, and products to be delivered to HPIP) were covenants that ran with the land that could not be stripped by rejection.

Nordheim, on the other hand, argued that rejection of the gathering agreements with Nordheim was not within Sabine's reasonable business judgment because even if Sabine was authorized to reject the Nordheim agreements, Sabine would still be bound by its dedications, which, according to Nordheim, were covenants that ran with the land and included, among other things, the requirement to pay certain fees to Nordheim. Therefore, according to Nordheim, rejecting the Nordheim agreements would provide the debtors with little or no benefit.

Sabine Satisfied the Standard for Rejection of the Gathering Agreements
At the outset of its analysis, the bankruptcy court noted that the question for the court on a motion to reject is whether a reasonable business person would make a similar decision under similar circumstances. The court also noted that the court generally defers to a debtor's determination as to whether rejection of an executory contract is advantageous, unless the decision to reject is the product of bad faith, whim, or caprice.

Because neither party provided any evidence that challenged Sabine's decision-making process, the court found Sabine's decision to reject the gathering agreements to be a reasonable exercise of Sabine's business judgment.

***Orion* Precluded a Binding Decision on Whether Covenants Ran with the Land**
While holding that the rejection of the gathering agreements was a proper exercise of Sabine's business judgment, the bankruptcy court declined to issue a binding ruling on whether the dedications under the gathering agreements were covenants that ran with the land. According to the bankruptcy court, the Second Circuit's decision in *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095 (2d Cir. 1993), precluded the bankruptcy court from making such a ruling in the context of a rejection motion unless such motion was scheduled to be heard simultaneously with an adversary proceeding or a separate contested matter to determine the substantive legal disputes related to the motion.

***Orion* Permitted a Nonbinding Decision on Whether the Covenants Ran with the Land**
The court did, however, note that *Orion* permitted it to undertake a "non-binding" analysis of the relevant provisions of the gathering agreements. After performing that analysis, the court concluded that, under applicable state law (i.e., Texas law), none of the obligations under the gathering agreements were covenants that ran with the land; therefore, the gathering agreements could be rejected pursuant to section 365. In particular, the court explained that the covenants merely identified the rights and obligations related to the services to be provided under the gathering agreements and did not convey interests in the underlying real property. The court recognized that, in the event that the gathering agreements are later determined to include covenants running with the land, Sabine will likely be required to work out a deal with Nordheim or HPIP (or both) on terms consistent with the covenants, notwithstanding Sabine's rejection of the agreements. If, however, it is ultimately determined that the gathering agreements do not contain covenants running with the land—which the court indicated in dicta was its understanding of Texas law—Sabine will be free to seek the services of other midstream gatherers.

Subsequent Developments
On March 18, 2016, Sabine commenced separate adversary proceedings against Nordheim and HPIP in the bankruptcy court, seeking declarations that, under Texas law, the Nordheim agreements and the HPIP agreements do not contain covenants running with the land. Both adversary proceedings remain pending as of the date of this article.

Significance of the Decision
The bankruptcy court's decision could negatively affect many midstream gatherers and thereby cause further distress and disruption in the oil and gas industry. In the very least, the court's decision will likely require upstream, midstream, and downstream companies to review how they have structured

transactions and affect such parties' leverage in negotiating such transactions. With that said, it should be noted that the ultimate determination as to whether a gathering agreement can be rejected by a debtor in bankruptcy will require a fact-specific analysis that depends on the precise contractual language at issue and the underlying state law.

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