IN THE PIPELINE: UNDERSTANDING POST-SABINE MIDSTREAM CONTRACT REJECTION RISK

To Our Clients and Friends:

After a significant wave in 2015 and 2016, bankruptcy filings in the exploration and production (“E&P”) sector of the oil and gas industry temporarily leveled off. With sustained volatility in energy prices and a trend of increased leverage among borrowers, stakeholders in the sector would be well advised to prepare for the potential risks of any further E&P distress. The landmark decisions in the chapter 11 case of Sabine Oil & Gas Corporation established both a substantive precedent and a procedural template regarding bankrupt E&P debtors’ attempts to reject burdensome contracts with midstream services providers. Understanding both the applicable legal framework and procedural considerations that will govern future rejection disputes will be critical to strategic positioning ahead of the next wave of distress in the E&P sector.

Background: Rejection of Executory Contracts and Midstream Services Agreements

The Bankruptcy Code provides a mechanism for debtors to reject executory contracts, relieving the debtor from its future performance obligations thereunder and leaving the contractual counterparty with a prepetition claim against the debtor for breach of contract. Section 365(a) of the Bankruptcy Code allows a debtor in possession, “subject to the court’s approval,” to “assume or reject any executory contract.”[1] While the Bankruptcy Code does not define “executory contract,” most courts use the definition of a contract under which both parties have unperformed obligations where the failure of either party to complete performance would constitute a material breach excusing the performance of the other party.[2] In determining whether to approve a motion to assume or reject such a contract, courts evaluate whether the proposed assumption or rejection is a reasonable exercise of the debtor’s business judgment. Absent the involvement of certain types of contractual counterparties that receive special Bankruptcy Code protections, “the interests of the debtor and its estate are paramount; adverse effects on the non-debtor contract party arising from the decision to assume or reject are irrelevant.”[3]

Given the significant volatility in oil and gas prices and the structure of midstream services contracts—which typically require the producing company to either deliver a minimum production volume or pay a deficiency payment—the ability to reject contracts is a critical tool for an E&P debtor seeking to use chapter 11 of the Bankruptcy Code to restructure burdensome obligations. From midstream providers’ perspective, rejection is inappropriate because the agreements at issue provide them with not only contractual promises of payment, but also dedications of underlying oil and gas mineral rights and associated acreage; in other words, the agreements convey real property interests. Courts have generally held that real property interests cannot be rejected because they do not involve future material, reciprocal obligations.[4] Thus, midstream providers, which generally incur substantial up-front costs through
infrastructure investments in connection with their contracts, argue that permitting rejection upsets their (and their secured lenders’) business expectations that their dedications will remain in place and bind any successors to the subject mineral interests, even if the counterparty is reorganized under chapter 11 of the Bankruptcy Code.

During the 2015-16 wave of oil and gas bankruptcies, disputes frequently arose over whether midstream services contracts are executory contracts that can be rejected, or contracts containing real property covenants that “run with the land,” rendering the contract ineligible for rejection.[5] A series of decisions in the Sabine bankruptcy addressed this issue on the merits and the federal courts, applying their interpretation of Texas law, concluded that a group of midstream contracts did not include rights in favor of the service-prover that ran with the land, and therefore could be rejected.[6]

The Sabine Decisions

The rejection dispute in Sabine involved several contracts between the debtor, a Texas-based onshore oil and gas exploration and production company, and two midstream gathering service providers: Nordheim Eagle Ford Gathering, LLC (“Nordheim”) and HPIP Gonzalez Holdings, LLC (“HPIP”). Under each contract, Sabine agreed to deliver all gas and condensate that it produced in certain “dedicated” areas to Nordheim and HPIP, respectively, for gathering, transportation, and processing. Under each contract, Sabine paid monthly gathering fees and was further required to make deficiency payments to the extent that it failed to deliver certain minimum amounts of gas and condensate on an annual basis. In seeking to reject the contracts, the debtors argued that because of the substantial and sustained decline in gas prices, it was no longer financially viable to deliver the minimum amounts under the contracts, and the resulting deficiency obligations would impose a considerable and unnecessary drain on the estate’s resources. As a threshold matter, the bankruptcy court found the decision to reject was a reasonable exercise of the debtors’ business judgment.[7] However, both Nordheim and HPIP argued that certain covenants under the agreement, including Sabine’s dedication of the specified production areas, “ran with the land” and thus could not be rejected.

Each of the agreements was governed by Texas law. Under Texas law, in order for a covenant to “run with the land”, it must, among other things, “touch and concern the land.”[8] While the issue is not clearly settled, some Texas courts have also imposed a further requirement of “horizontal privity of estate,” which generally requires “simultaneous existing interests or mutual privity between the original covenants parties as either landlord and tenant or grantor and grantee.”[9] Because the midstream providers did not identify any governing authority rejecting the horizontal privity requirement, the Sabine bankruptcy court analyzed the issue and concluded that such privity was absent because the covenants at issue did not reserve any interest in the subject real property.[10]

The bankruptcy court further held that the covenants did not “run with the land,” finding that the covenants did not “touch and concern the land”. Citing Fifth Circuit precedent, the court explained that it is not enough for a covenant to “affect the value of the land,” and that it must “affect the owner’s interest in the property or its use in order to be a real covenant.”[11] The court further noted that under Texas law, minerals cease to be real property and instead become personal property once they are extracted from the ground.[12] Because the covenants concerned only Sabine’s interest in personal
property—i.e., the extracted gas and condensate—and did not affect its interest in the relevant real property—i.e., the “dedicated” land—the court held that the contractual dedication did not burden Sabine’s property interest in the land, but rather identified personal property that was subject to the agreements.

The bankruptcy court also focused on the fact that the dedication covenants were triggered not by any action on the dedicated land, but rather by the receipt or storage of the subject products by the midstream providers.[13] This distinguished the case from Energytec, where the Fifth Circuit concluded that certain covenants in an agreement relating to a pipeline system did run with the land, such that the debtors could not sell the pipeline free and clear of a creditor’s interest.[14] In Energytec, the obligation to pay a monthly transportation fee was triggered by the flow of gas through a pipeline on the subject property.[15] There, the agreement gave the contractual counterparty consent rights over any assignments—a clear burden on the producer’s interest—and provided that the contractual transportation fee was secured by a lien on the pipeline system. By contrast, the agreements in Sabine did not give consent rights to the midstream counterparties, and the fees payable thereunder were unsecured; in fact, the dedicated properties were separately pledged to the debtors’ secured lenders.[16] These diverging results illustrate the critical importance of the precise language employed in midstream services contracts; it is unclear whether the bankruptcy court in Sabine would have reached a different conclusion had the contracts at issue contained more specific dedication language.

The district court affirmed, basing its ruling on a finding that the covenants did not “touch and concern” the land and expressly declining to decide whether a real covenant under Texas law requires horizontal privity.[17] By contrast, the Second Circuit upheld the lower courts’ rulings that the covenants at issue did not “run with the land”, but based its holding on a lack of horizontal privity between the parties to the agreements rather than on whether the contracts “touched and concerned” the land.[18] After concluding that horizontal privity was a requirement of a Texas real covenant based on a lack of authority to the contrary, the appellate court held that such privity was absent because the real property involved in the contract—i.e., the land that was the subject of the dedicated leases—was not conveyed by the contracts or otherwise.[19] The court observed that it is not enough if the subject contract merely “involves” land; rather, horizontal privity must exist with respect to the specific land burdened by the covenant at issue.[20] Thus, it was of no moment that two of the contractual arrangements involved the conveyance of separate land adjacent to the dedicated land.[21]

**Post-Sabine Developments**

As of this writing, the substantive holding of Sabine has not been tested in any reported decision. Both shortly before and after the initial Sabine decision, midstream rejection disputes arose in numerous other E&P companies’ chapter 11 cases. While arising in different contexts, each dispute was settled before the nature of the underlying midstream contracts was adjudicated.

In Sandridge Energy, the bankruptcy court expressed skepticism regarding the Sabine holding; however, in announcing a settled resolution of the dispute, the debtors’ counsel explained that the amount at issue did not justify the expected cost of litigation.[22] In Quicksilver Resources, the issue arose in connection with a sale of the debtors’ assets under section 363 of the Bankruptcy Code, as the debtors’ success on
a motion to reject certain midstream contracts governed by Texas law was a condition precedent to closing the sale.[23] The initial Sabine decision was issued several days after oral argument on the Quicksilver rejection motion, and the parties settled shortly thereafter. The debtors withdrew the rejection motion, and the purchaser agreed to enter into replacement midstream agreements with a corresponding reduction of the agreed purchase price by $2.5 million. In several other cases, debtors resolved pending midstream rejection disputes by agreeing to assume the subject contracts on modified economic terms, while providing consideration for any prepetition deficiency or unpaid fee claims through an allowed general unsecured claim.[24]

Critically, the issues in Sabine were governed by Texas law pursuant to choice-of-law provisions in the contracts, and even in Texas these issues have not been settled by the Texas Supreme Court. Midstream contracts providing for the application of another state’s law will require analysis of real covenants and equitable servitudes under such state’s law. For example, the chapter 11 case of Triangle USA Petroleum, LLC, an exploration and production company operating primarily in the Williston Basin of North Dakota and Montana, involved a dispute over certain midstream contracts governed by North Dakota law.[25] In contrast to Texas, where real covenant disputes are guided by common law principles, North Dakota statutes provide specific guidance on the requirements for a finding that a covenant “runs with the land.”[26]

Procedural Considerations

While its substantive result has generated debate, Sabine established a clear procedural roadmap for midstream contract rejection disputes that has served as a template in numerous cases. Before reaching the covenant issue, the Sabine court concluded that it could not “decide substantive legal issues, including whether the covenants at issue run with the land, in the context of a motion to reject, unless such motion is scheduled simultaneously with an adversary proceeding or contested matter to determine the merits of the substantive legal disputes related to the motion.”[27] Although rejection proceedings are designated as contested matters under the Federal Rules of Bankruptcy Procedure, the court held that these are summary proceedings intended to efficiently review the debtor’s decision to reject, and are inappropriate for resolving a lengthy trial with disputed issues.[28] Following Sabine, debtors seeking to reject midstream agreements have generally simultaneously filed a motion to reject and commenced an adversary proceeding seeking a declaratory judgment establishing that the relevant covenants do not “run with the land.”[29]

Like any potentially fact-intensive litigation, the resolution of an adversary proceeding seeking a declaratory judgment (or a similar state court suit) can take an extended period of time.[30] However, debtors may be able to ensure that such litigation does not slow the overall progress of their restructuring by pursuing plan confirmation in parallel with rejection and including a plan provision contemplating a conditional rejection based on the outcome of litigation still pending at the time of confirmation. The TUSA case involved such a provision, referred to as a “toggle”. [31]

In TUSA, the debtors sought to reject certain midstream services contracts with Caliber Midstream Partners, L.P. (“Caliber”). Prior to the petition date, Caliber commenced litigation in North Dakota state court seeking a declaratory judgment establishing that its contracts contained covenants that “ran with
the land” and thus could not be rejected.[32] The “toggle” provision in the debtors’ plan of reorganization provided that the Caliber contracts would be deemed rejected as of the effective date of the plan, conditional on (i) the debtors prevailing in the North Dakota declaratory judgment action, and (ii) the bankruptcy court determining or estimating the allowed amount of Caliber’s rejection damages claim at less than $75 million.[33] The failure of either condition to occur would result in the assumption of the Caliber contracts and payment of associated cure amounts. The plan further allowed Caliber to vote its potential rejection claim and participate in the rights offering contemplated under the plan.

Caliber objected to the plan, arguing that the conditional rejection provision allowed the debtors to indefinitely delay their decision to assume or reject, and that such decision could not be delayed past confirmation. In a bench ruling, the bankruptcy court sided with the debtors and confirmed the plan, noting that while the debtors were “asking for something that has never been done before,” this did not mean that the requested relief was prohibited. The court explained that the language of sections 365(d)(2) and 1123 of the Bankruptcy Code was permissive and not indicative of an absolute deadline for assumption or rejection.[34] Finding the conditions to be “simply a recognition that the debtor is not in a position to reject without knowing the effect of that rejection,” the court upheld the provision and confirmed the plan.

Practical Advice

The result in Sabine and the subsequent resolutions of midstream contract disputes in other chapter 11 cases provide several important lessons to guide future expectations. First, the issue of whether a particular midstream agreement can be rejected is a fact-specific question of state law. The principles of property and contract law guiding the inquiry, which vary from state to state, are uniformly complex and, in some cases, unsettled. Second, the prevailing procedural approach for such disputes established in Sabine and upheld by other bankruptcy courts requires a formal and potentially protracted litigation in the form of a declaratory judgment action asserted through an adversary complaint in bankruptcy court or a separate state court litigation. To the extent that litigation is pursued in the bankruptcy case, questions regarding bankruptcy courts’ statutory and constitutional authority to adjudicate these disputes create further potential for delay and uncertainty of venue. Third, notwithstanding these potential procedural delays, debtors may take advantage of Bankruptcy Code mechanisms, including claims estimation and the potential to confirm a “toggle” plan with a delayed conditional rejection provision, to ensure that their chapter 11 cases proceed expeditiously despite the pendency of rejection-related litigation. This represents a significant potential downside for midstream counterparties, who bear the burden of prolonged uncertainty as to the ongoing viability of their contracts even as the producer-debtor is able to consummate a restructuring or sale.

These considerations make it essential for stakeholders to clearly understand the cost-benefit calculus of litigating the rejection of a midstream contract well in advance of a producer’s financial distress, and to frequently update such analysis as the dispute progresses. The parties must balance the significant legal and procedural uncertainty, including the potential for protracted and costly litigation, against the alternative cost of a consensual resolution that may involve modification of the agreement’s economic terms and satisfaction of prepetition amounts at a discount to their face value. In the 2015-16 cycle, this cost-benefit analysis, combined with the recovery in oil and gas prices, likely drove many of the post-
Sabine settlements. It remains to be seen whether economic circumstances in any future cycles of E&P distress will ultimately result in judicial decisions that shed more light on the underlying substantive issues.


[4] See, e.g., Glosser v. Maysville Reg’l Water Dist., 174 Fed. App’x 34, 38-39 (3d Cir. 2009) (holding that an easement could not be assumed and assigned under section 365 of the Bankruptcy Code because outstanding duties under the easement were “not material” and “ministerial” in nature); In re Copper Creek Estates-Grand Island LLC, No. BK11-40496-TJM, 2011 WL 2681224 (Bankr. D. Neb. Jul. 8, 2011) (builder that placed restrictive covenant on vacant lots in exchange for providing financing to landowner had no ongoing obligations under agreement, which was not executory in nature; thus, covenant ran with the land and could not be rejected).

[5] Midstream providers have also argued in the alternative that such covenants constitute equitable servitudes under applicable state law. See, e.g., Sabine at 79. Under Texas law, “a covenant that does not technically run with the land can still bind successors to the burdened land as an equitable servitude if: (1) the successor to the burdened land took its interest with notice of the restriction, (2) the covenant limits the use of the burdened land, and (3) the covenant benefits the land of the party seeking to enforce it.” Reagan Nat’l Advert. of Austin, Inc. v. Capital Outdoors, Inc., 96 S.W.3d 490, 495 (Tex. Ct. App. 2002) (internal citations omitted).

[6] There is no controlling Texas Supreme Court decision on point. Accordingly, the Bankruptcy Court predicted how Texas law would interpret the contracts at issue. If and when the Texas Supreme Court addresses this issue, a different result may ensue.


[8] Sabine at 75-76 (citing Inwood North Homeowners’ Ass’n, Inc. v. Harris, 736 S.W. 2d 632, 635 (Tex. 1987). In addition, the covenant must relate to a thing in existence or specifically bind the parties and their assigns and be intended to run with the land by the parties, and the successor to the burden of the covenant must have notice. Id. Because it concluded that the covenant did not “touch and concern the land”, the Sabine court did not specifically analyze these other elements.

[9] Id. at 76 (citing Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W. 903, 910-11 (Tex. 1982); Newco Energy v. Energytec, Inc. (In re Energytec, Inc.), 739 F.3d 215, 222 (5th Cir. 2013) (internal quotations omitted)).
[10] Id.

[11] Id. at 77 (quoting El Paso Refinery, LP v. TRMI Holdings, Inc. (In re El Paso Refinery, LP), 302 F.3d 343, 356 (5th Cir. 2002)).

[12] Id.

[13] Id. at 78.

[14] 739 F.3d at 222.


[16] Id. at 78-79.


[19] Id. at 66-67. The panel applied the same reasoning as the bankruptcy court, stating that “[i]t would be improper for us to read a traditional requirement of real covenants out of Texas state law when there is no Texas law instructing courts to do so.” Id. To the extent that the Texas Supreme Court rules on the issue—for instance, if that court accepts a certified question from a federal court—this aspect of the Sabine holding could potentially be overturned.

In connection with the midstream contract dispute in In re Quicksilver Resources, a Texas law expert advocating for the midstream providers observed that “[t]he Texas Supreme Court has had the opportunity to include horizontal privity as a requirement of a covenant running with the land, but it has not done so, and indeed, has found that covenants that would not otherwise meet the horizontal privity “requirement” were in fact covenants running with the land.” No. 15-10585-LSS, Dkt. No. 1189-1 at ¶ 61 (Bankr. D. Del. Feb. 29, 2016) (citing Inwood N. Homeowners’ Ass’n, Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987); Westland Oil Dev. Corp. v. Gulf Oil Corp., 637 S.W.2d 903, 910-11 (Tex. 1982)).

[20] Id. at 67.

[21] Id. Each of the Sabine courts further rejected the alternative argument that the midstream contracts constituted “equitable servitudes,” primarily because the agreements did not provide any benefit to any real property of the midstream providers. Id. at 68.

[22] In re Sandridge Energy, Inc., No. 16-32488 (DRJ), Dkt. No. 460 at 13 (Bankr. S.D. Tex. Jul. 4, 2016) (court stating that it had “been looking for an opportunity to correct the State of New York” regarding a disputed issue of whether certain covenants “ran with the land”).
The midstream providers argued that the contractual dedications of the total volume of gas owned or controlled by the debtors in the Barnett Shale were covenants that ran with the land under Texas law, and thus could not be rejected. No. 15-10585-LSS, Dkt. No. 1189 (Feb. 2, 2016).

See In re Penn Virginia Corp., No. 16-32395 (KLP), Dkt. No. 524 (Bankr. E.D. Va. Aug. 5, 2016) (order approving settlement of rejection dispute contemplating assumption of midstream agreements with amended fee and minimum production terms and providing midstream counterparty with, among other things, $25 million allowed general unsecured claim and ability to participate in debtors’ rights offering based on 50% of such claim); In re Emerald Oil, Inc., No. 16-10704 (KG), Dkt. No. 754 (Bankr. D. Del. Sep. 28, 2016) (joint notice of global settlement providing that debtors will assume midstream contract with modified economic terms and provide counterparty with, among other consideration, 50% of crude sale proceeds, $2 million cash payment, and allowed unsecured damages claim for $10 million); In re Magnum Hunter Res. Corp., No. 15-12533 (KG), Dkt. Nos. 983, 1166, 1131, and 1214 (Bankr. D. Del.) (debtors reached separate settlement arrangements with four midstream providers, agreeing to assume two of the contracts on modified economic terms, reject a third in exchange for an allowed general unsecured claim of $15 million, and reject a fourth while withdrawing the related adversary complaint against the counterparty without prejudice).

In re Triangle USA Petroleum, LLC, , Case No. 16-11566 (MFW) (Bankr. D. Del.) (“TUSA”).

See N.D. Cent. C. § 47-04-25 (“The only covenants which run with the land are those specified in this chapter and those which are incidental thereto.”); id. § 47-04-26 (setting forth requirements for a covenant to run with the land and providing examples).

Sabine at73.

Id. (citing Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.), 4 F.3d 1095, 1098-99 (2d Cir. 1993); In re The Great Atlantic & Pacific Tea Co., 544 B.R. 43, 48 (Bankr. S.D.N.Y. 2016)).

See, e.g., In re Penn Virginia Corp., No. 16-32395 (KLP) (Bankr. E.D. Va.), Dkt. No. 320 (motion to reject filed contemporaneously with complaint commencing declaratory judgment adversary proceeding); In re Triangle USA Petroleum Corp., No. 16-11566 (MFW) (Bankr. D. Del.), Dkt. No. 67 (same); In re Magnum Hunter Res. Corp., No. 15-12533 (KG) (Bankr. D. Del.), Dkt. No. 1062 (order directing debtors to commence an adversary proceeding to determine state law contract issues).

Eureka Hunter, a midstream service provider in the Magnum Hunter chapter 11 case, raised additional procedural issues regarding bankruptcy court authority that have the potential to further delay the covenant determination. Eureka first argued that because its underlying contract claims did not invoke substantive rights provided by the Bankruptcy Code, they were “non-core” under the Bankruptcy Code, meaning that a bankruptcy court would only have the statutory authority to enter proposed findings of fact and conclusions of law subject to review by a district court. Eureka further argued that one aspect of its contract claims had to be adjudicated by an Article III court pursuant to the requirements of Stern v. Marshall and related Supreme Court decisions. 131 S. Ct. 2594, 2620 (2011). While Eureka’s claims
were settled, these arguments could be raised in nearly any contractual rejection dispute, inserting another layer of procedural uncertainty and potential delay into the proceedings.

[31] Gibson Dunn represented an ad hoc group of TUSA’s senior unsecured note holders.

[32] TUSA attempted to commence a declaratory judgment adversary proceeding in bankruptcy court and dismiss the state court action, but the bankruptcy court deferred to the first-filed state court action.

[33] Section 502(c) of the Bankruptcy Code provides for estimation for the purpose of allowance “any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case.” 11 U.S.C. § 502(c). The TUSA debtors requested that the court estimate the maximum amount of the potential rejection damages claim, establishing a cap on potential liability in order to facilitate plan negotiations that included a new money investment not conditioned on the final resolution of the Caliber litigation.


[35] The Caliber litigation was ultimately settled; the parties agreed to renegotiate the midstream contracts before the North Dakota state court adjudicated the declaratory judgment action. In re Triangle USA Petroleum Corporation, No. 16-11566 (MFW), Dkt. No. 1007.

Gibson, Dunn & Crutcher’s lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm’s Business Restructuring and Reorganization or Oil and Gas practice groups, or any of the following:

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