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Second Circuit Affirms *Sabine*: New Focus on Horizontal Privity Requirement May Affect Oil and Gas Gathering Agreement Terms

By Jonathan Ayre, Robert Loeb, Douglas S. Mintz, and Darrell Thomas*

The U.S. Court of Appeals for the Second Circuit affirmed the lower court decisions in the Sabine *bankruptcy case, taking a new perspective on what is required to create covenants running with the land in midstream oil and gas agreements under Texas law. The decision is likely to impact commercial terms of midstream agreements. The authors of this article discuss the decision and its implications.*

The Sabine Oil & Gas Corporation Chapter 11 bankruptcy has been closely watched by many for guidance on how to structure midstream gathering agreements between upstream producers and midstream gatherers (who gather, transport and process oil and gas after it has been extracted from the land). The U.S. Court of Appeals for the Second Circuit recently held that the debtor, Sabine, had the right to reject gathering agreements with two midstream companies.[1] In the Sabine agreements, Sabine had agreed to dedicate all of the gas produced from a designated area for processing by one of the midstream gatherers.

Looking to Texas law, the Second Circuit ruled that for the agreements to be treated as covenants "running with the land" immune from such rejection by the debtor, there would have to be horizontal privity relating to the land. For horizontal privity to exist, there must be a common interest in the land in addition to the applicable covenant at the time of the agreement. For example, horizontal privity exists where Party A conveys a fee interest in real property in fee to Party B, if as part of the same transaction Party B grants Party A a leasehold interest over the conveyed real property. Because, in the view of the

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[1] *In re Sabine*, No. 17-1026 (2d. Cir. May 25, 2018), *available at* https://dlbjbjzgnk95t.cloudfront.net/1048000/1048138/2nd circ sabine.pdf.

Second Circuit, there was no such privity in the Sabine case, the agreements were subject to rejection.

The Second Circuit's rationale surprised some because the district court had relied on a different theory in allowing the rejection of the agreement. Because the Second Circuit's ruling was made by summary order and was not intended to have precedential effect, and because it speaks to Texas law, the decision will have limited, if any, precedential value. Nonetheless, this Second Circuit ruling will be looked at by other courts facing similar issues, and may have some persuasive value. As a result, practitioners may want to examine their approach to midstream gathering and services agreements and whether their agreements should be structured to ensure that horizontal privity exists between the parties.

CASE HISTORY AND DIFFERING GROUNDS FOR DECISIONS

In 2016, the U.S. Bankruptcy Court of the Southern District of New York (Bankruptcy Judge Shelley Chapman) held that debtor Sabine had the right to reject promises to dedicate leases and minerals to performance of its obligations under the Gathering Agreements.[2] Although those promises were called covenants, the bankruptcy court held that they were not real covenants that "ran with the land." The bankruptcy court explained that only covenants that run with the land are immune from rejection in a bankruptcy proceeding. Here, the bankruptcy court ruled that the covenants failed to qualify for that protected status because (1) they did not "touch and concern" Sabine's real property, as required by Texas law, and (2) if horizontal privity were a requirement of Texas law, it was not satisfied in this case.

On appeal to the U.S. District Court of the Southern District Court of New York (Judge Jed Rakoff), the district court affirmed.[3] The district court agreed that the Gathering Agreements at issue did not meet the "touch and concern" requirement. Judge Rakoff specifically declined to address the horizontal privity requirement, however, explaining that it was unnecessary given the conclusion that the covenants at issue did not meet the "touch and concern" requirement.

That ruling was appealed to the Second Circuit. The Second Circuit declined to address the "touch and concern" requirement, instead choosing to decide the case based on its finding that the covenants at issue did not meet the horizontal privity requirement.

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[2] *In re Sabine*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016), *available at* http://www.nysb.uscourts.gov/sites/default/files/opinions/264964_20_opinion.pdf.

[3] *In re Sabine*, 567 B.R. 869 (S.D.N.Y. 2017), *available at* https://dlbjbjzgnk95t.cloudfront.net/0901000/901320/https-ecf-nysd-uscourts-gov-doc1-127119883313.pdf.

A NEW FOCUS ON HORIZONTAL PRIVITY UNDER TEXAS LAW

Of the three courts considering this issue in the *Sabine* case, only the Second Circuit reached the issue of horizontal privity. The bankruptcy court declined to rule on the issue, although it did say that if horizontal privity were a requirement, that requirement was not fulfilled in this case. The district court decided the case on the basis of the "touch and concern" requirements, and expressly declined to address horizontal privity. The Second Circuit noted, "[t]he trend across the country is towards abolition of the horizontal privity requirement, as reflected in the Restatement (Third) of Property, which has eliminated the requirement," but held that the requirement still applied under Texas law.

On June 8, 2018, the midstream companies filed a petition seeking a panel rehearing by the Second Circuit. The petition[4] argued that the Second Circuit erred in its assessment of Texas law, and that, instead of adopting a horizontal privity requirement, it should instead certify the issue to the Texas Supreme Court for it to decide. The Second Circuit denied that petition in a single sentence order on June 27, 2018.

Even if the Second Circuit decision stands, it is not precedential in nature. First, the Second Circuit issued the decision as a "summary order." Even within the Second Circuit, such orders are not considered binding precedent. Courts can still, however, look at it for its persuasive value.

Second, as noted above, the case turned on an interpretation of Texas law, which is not a particular area of expertise of the Second Circuit. If going forward the Texas courts clarify their own view of the issue of whether horizontal privity is required to have a covenant that runs with the land, the rulings of the Texas courts will be given far greater weight than this appellate ruling.

IMPLICATIONS OF SECOND CIRCUIT'S DECISION FOR PRACTITIONERS

While of limited precedential value, to date the *Sabine* decisions are the only decisions that directly address the ability to reject midstream agreements in the bankruptcy context, and because the *Sabine* rulings are the only guidance on the topic, practitioners may want to consider their potential application when structuring gathering agreements.

After this most recent ruling in *Sabine*, it is possible that a court could rely on either the "touch and concern" requirement or the horizontal privity

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[4] https://dlbjbjzgnk95t.cloudfront.net/1052000/1052596/https-ecf-ca2-uscourts-gov-n-beam-servlet-transportroom-servlet-showdoc-00206223263.pdf.

requirement as a reason to rule in favor of a debtor's right to reject covenants in midstream gathering and services agreements on the basis that they do not run with the land. Those looking to create covenants running with the land, therefore, may attempt to satisfy both requirements to protect a contract from rejection. Creating horizontal privity is challenging in that it would require the midstream provider to obtain a contemporaneous conveyance of a real property interest in the producer's properties. Specific conveyances of rights under leases to midstream producers traditionally have not been part of the structure of these gathering agreements, and producers may resist them. Other alternatives, such as obtaining a security interest over the producer's real property, also may face resistance from producers or their lenders.

Since the initial bankruptcy court decision was issued in this case in May 2016, there have been multiple approaches proposed and taken to addressing rejection risk in midstream gathering agreements, many of them focused more on the "touch and concern" requirement than on the horizontal privity requirement. This Second Circuit decision may further impact the continually evolving market terms in the midstream space by causing practitioners also to focus on horizontal privity.