The Covenants May Not Run, but Sabine's Ruling Won't Hide

March 15, 2017 Charles Beckham, Ian Peck, Ellen Conley

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In the most recent ruling arising from the now infamous Sabine case (*In re Sabine Oil & Gas Corp.*, 547 BR 66 (Bankr. SDNY 2016)), in which New York bankruptcy Judge Shelley Chapman held in favor of Sabine Oil & Gas Corp. ("Sabine"), Southern District of New York Judge Jed Rakoff entered a memorandum order late last week affirming the bankruptcy court orders permitting Sabine to reject certain gas gathering agreements, and held that those agreements did not run with the land under Texas law.

The pertinent question from the bankruptcy hearing was at the forefront of this appeal: whether the aforementioned gas gathering agreements, in which Sabine dedicated to the appellants production from wells within a designated area where Sabine held leases, constitute covenants running with the land, a real property interest that cannot be rejected or accepted as an executory contract in bankruptcy.

The opinion notes the four common elements required for a covenant to run with the land under Texas law: (1) it "touches and concerns" the land; (2) it relates to a thing in existence, such as a tangible piece of property, or specifically binds the parties and their assigns; (3) the original parties to the covenant intend for it to run with the land; and (4) the successors to the burden have notice. Although not discussed in the opinion, in addition to the four criteria above, the parties must be in privity of estate at the time the covenant was made. A footnote in the opinion, however, states, "[b]ecause the Court finds that the covenants do not meet the touch and concern requirement, it need not reach the issue of whether a real covenant under Texas law requires horizontal privity, and, if so, whether such privity exists here."

Judge Rakoff concluded that the agreements did not "touch and concern" the land because the agreements failed to satisfy either of the two tests used in relevant case law to determine whether a covenant touches and concerns the land: (1) if the covenant burdens the covenantor's interest or benefits the covenantee's interest in the estate or (2) if the covenant affects the nature, quality or value of the subject of the covenant.

With respect to the first test, the opinion states that one of the appellants, Nordheim Eagle Ford Gathering ("Nordheim"), argued that Sabine's dedication of the gas and condensate that was "produced and saved" from the dedicated area for gathering conveyed an interest in the minerals in the ground, and therefore, a real property interest. Distinguishing this described interest from a royalty interest, Judge Rakoff stated the appellants "received no right to any share of the gas and condensate . . . but rather were entitled to process those minerals in exchange for a fee and obligated to re-deliver them to Sabine."

The other appellant, HPIP Gonzales ("HPIP"), argued that by dedicating leases to the performance of the agreements, Sabine implicated some interest in those leases. Given that HPIP did not identify "what kind of property interest it might have obtained in the leases from the HPIP

Agreements' vague 'dedication' of them to Sabine's performance of those agreements, the Court [was] unable to conclude that HPIP's legal interest in the leases did in fact increase."

The Court found that the agreements did not burden Sabine's interest in the dedicated areas because (1) Sabine did not convey a real property interest to appellants, (2) Sabine, notwithstanding the agreements, was free to produce as much or as little gas and condensate from the dedicated areas as it chose and (3) Sabine's obligations under the agreements were triggered only once the gas and condensate were produced, constituting personal, rather than real, property.

Under the second test, the Court found that the agreements did not reduce Sabine's ability to make use of or alienate its real property interests, despite Nordheim's contention that the agreements make Sabine's interests "more or less valuable, depending on the price of hydrocarbons and the market rates for gathering."

The Court ultimately concluded that the "appellants [had] not shown that the Agreements either increased their legal relations to the real property interests at issue or decreased Sabine's . . . [and] that the Agreements do not have such effects on Sabine's interests;" therefore, the agreements do not touch and concern the land and thus do not run with the land.

In the alternative, the appellants argued that the agreements were equitable servitudes. In Texas, an equitable servitude exists when: (1) a prior agreement imposes a restriction, limiting the use of burdened land; (2) the restriction benefits the land of the party seeking to enforce it; and (3) if the agreement was made by a predecessor in title, the successor to the burdened land took its interest with notice of the restriction. The Court rejected this argument, stating that the agreements not only failed to limit Sabine's use of its property interest in the dedicated areas, but also benefitted the appellants themselves, and not their land.

While this decision is not binding on courts outside the jurisdiction of the Southern District of New York, its reasoning could compel other courts to render similar opinions should the opportunity arise. Judge David Jones, however, from the bankruptcy court for the Southern District of Texas welcomed the opportunity to correct Judge Chapman's ruling in the SandRidge Energy, Inc. bankruptcy, but the covenant dispute settled out-of-court.

For more information, please contact one of the lawyers listed below.