

## Sabine Saga: 2nd Circuit Upholds Rejection, Cites Approach that Could Broadly Undercut Texas Gathering Agreements

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**By *Duston K. McFaul and  
Glenn L. Pinkerton  
of Sidley Austin***

(June 28) – Gathering agreements with dedications in Texas are under a heavy cloud as producers now appear to be able to avoid such agreements by filing for bankruptcy in the 2nd Circuit.

In an emphatic decision on May 25, the U.S. Court of Appeals for the 2nd Circuit affirmed a district court decision finding that producer Sabine Oil and Gas Corp. could reject certain midstream gathering contracts governed by Texas law in its bankruptcy case.

The 2nd Circuit found that fundamental features of the contracts at issue in the case, which resemble many contracts used throughout the industry in Texas, were legally invalid under Texas law, subjecting Texas midstream companies to the risk that their contracts could likewise be attacked by producers seeking to avoid contractual obligations in a bankruptcy proceeding or otherwise. The Texas Supreme Court, the ultimate arbiter of this issue, has not ruled and may not have a voice in the determinations unless the 2nd Circuit decides to ask for it.

A standard method for midstream contracting for gathering services in Texas – and the country at large – has been for the gatherer to contract with the producer to gather all the production from a given area in exchange for an agreed fee, and in reliance on the future cash flows from the gathering operations, invest the capital necessary to construct gathering lines to new

wells. In addition to the credit of the producer, the gatherer relies on a dedication of the relevant oil and gas interests.

The industry generally operated under the belief that dedications provide gathering firms property rights known as “real covenants” that run with the relevant land, meaning that the right was expected to persist even if the owner of the land files for bankruptcy protection or ownership of the land changes hands.



**Duston McFaul**

That strategy has been dealt a body blow by the 2nd Circuit, finding under Texas law that in order to be an effective covenant, the promise must comply with a centuries-old property requirement known as “horizontal privity.” Since that would require a producer to convey real property interests to a gatherer at the time the gathering agreement was executed (which is something that is not usually done), hundreds of existing agreements may now be subject to rejection in bankruptcy, putting the gatherer in a poor negotiating position with a new buyer of the relevant field in a distressed setting.

The lower court decisions avoided the horizontal privity issue as much as possible and instead focused primarily on the “touch and concern” requirement, which is a separate requirement for creating real covenants that is based on certain fact-specific issues that would be met in some cases and not met in others.

The 2nd Circuit decision, however, emphatically declares that horizontal privity continues to

apply under Texas law. Accordingly, unless the May 28th decision is reconsidered or otherwise overturned, virtually all existing gathering dedications in Texas are potentially at risk under the 2nd Circuit's reasoning.

### **The lower court decisions**

The initial bankruptcy decision in the case from 2016 sent shockwaves through the midstream sector as it appeared to call into question the industrywide practice of using dedication clauses in midstream gathering contracts, which are intended to provide gathering firms an exclusive right to transport and process all of the commodity produced in a particular area.

The Bankruptcy Court for the Southern District of New York found that the dedications in Sabine's midstream gathering contracts were not sufficient to create real covenants because they did not "touch and concern" the relevant land under Texas law. It also found that the dedications failed as real covenants because they were not granted in connection with a conveyance of a recognized property interest in the land, such as a conveyance of the relevant fee estate, as required under the principle of "horizontal privity."

When the bankruptcy decision was issued, it was unclear whether horizontal privity remained a requirement under Texas law given that recent Texas cases rarely discuss the doctrine. The bankruptcy decision acknowledged this uncertainty by noting that whether or not horizontal privity is a requirement under Texas law, it was not satisfied in this case.

In light of the fact that the legal issues were so Texas-centric, the defendants sought to directly appeal the bankruptcy decision to the 2nd Circuit, where the property law issues could be certified to the Supreme Court of Texas. The bankruptcy court denied this request, however, forcing the defendants to argue their appeal first in the District Court for the Southern District of New York, which ultimately affirmed the bankruptcy

court's decision.

### **The appeal to the 2nd Circuit**

In their appeal to the 2nd Circuit, the midstream companies – one of which later withdrew from the appeal – asserted in their consolidated opening brief that if the court "has any doubts regarding these issues of Texas law, it should certify them to the Texas Supreme Court." Given the importance of the case, the GPA Midstream Association and the Texas Pipeline Association both filed briefs in the case as *amicus curiae* similarly urging the 2nd Circuit to certify the issues to the Supreme Court of Texas.

The TPA noted that the "contractual provisions at issue in this case are functionally the same provisions as found in contracts covering thousands of wells in the state of Texas" and "it should be expected that the same issues will arise in courts in other circuits." The TPA warned that that "[d]iffering opinions as to the fundamental nature of such contracts would be extremely disrupting to the energy industry."



**Glenn Pinkerton**

The GPA Midstream Association argued that the case satisfied all the elements required for certification to the Supreme Court of Texas as the issues in the case would have "far-reaching impact . . . on producers and gatherers" in Texas; there currently is not authoritative Texas law on the matter; and certification would resolve the litigation. Despite these efforts by the midstream industry, the 2nd Circuit declined to certify the Texas property law issues for presentment to the Supreme Court of Texas.

The 2nd Circuit then applied the horizontal privity requirement to the facts at issue and found that because there was no conveyance relating to the land that was burdened by the applicable dedications, there was no horizontal privity and no real covenant was created.

The 2nd Circuit also rejected the remaining appellant's alternative argument that the dedication constituted an equitable servitude, another form of property right that usually cannot

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be rejected in bankruptcy. The 2nd Circuit noted that based on these conclusions, it did not need to determine whether the “touch and concern” requirement had been met.

On June 11, Nordheim Eagle Ford Gathering, the remaining appellant in the case, filed a petition in the 2nd Circuit for a rehearing by the panel that issued the May 25th decision. Nordheim emphasized the “far-reaching impact” of the 2nd Circuit’s decision and argued that the “horizontal-privity question impacts all Texas property disputes involving the enforceability of real covenants, not just those between producers and gatherers.”

It again argued that this issue and the “touch and concern” issue, the latter of which was not addressed in the 2nd Circuit’s decision, should be certified to the Texas Supreme Court so that it could definitively resolve these “foundational” Texas property law matters. The petition also states that the 2nd Circuit’s decision amounted to a “guess” as to how the Texas Supreme Court would rule and that such an outcome was improper given the “far-reaching impact” of the questions at issue.

If the 2nd Circuit again declines to certify the issues for consideration by the Texas Supreme

Court, the Texas Supreme Court likely will not have a chance to address such issues until a similar bankruptcy case winds its way through the courts. Sellers of oil and gas interests often require purchasers to expressly assume gathering agreements and the dedications therein, and it is only in distressed settings in which the producer can reject gathering agreements that such issues are litigated and thus subject to appellate court certification to the Texas Supreme Court.

*Duston McFaul is a partner advising energy clients on corporate reorganization and bankruptcy in Sidley’s Houston office. Glenn Pinkerton is a partner advising midstream and other clients on energy finance and a variety of matters in Sidley’s Houston office. David Kronenberg also contributed to this article and is a counsel advising energy companies and financial institutions on energy and bankruptcy matters in Sidley’s Washington, D.C., office.*

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