

Deals Considered Bankruptcy-Proof Combust

Uncertainty heightens for midstream gatherers and processors after the Sabine decision

By Article: Inez M. Markovich & Arthur R. Armstrong / Anderson Kill

As the oil and gas industry continues to struggle in the face of the ongoing decline of commodity prices, a recent decision of the United States Bankruptcy Court for the Southern District of New York may have offered a glimmer of hope to upstream producers, while creating more uncertainty for midstream gatherers and processors and their lenders and investors.

Key Players and Agreements

Like many other oil and gas companies contemplating or already undergoing a restructuring pursuant to Chapter 11 of the Bankruptcy Code, Sabine Oil & Gas Corporation is an upstream energy company involved in the acquisition, production, exploration and development of oil and natural gas properties in the United States, otherwise known as an E&P company. Typically, an E&P company will enter into a lease with a landowner for the right to search for and extract minerals from the land. The lease may be a traditional surface lease or, in certain states, a subsurface lease giving rights to the underground property only.

After entering into such leases, an E&P company may conduct seismic testing, drill exploratory wells and engage in

other exploratory activities to locate and extract minerals. Once extracted, the minerals will be transferred to a “midstream gatherer,” which is a company that acts as an intermediary between the upstream gatherers and those “downstream,” namely refining, marketing and distribution outlets. Pursuant to a gathering and processing agreement, a midstream gatherer will handle the storage and transportation of the raw oil and gas products.

The bankruptcy court decided the processing agreements were executory contracts that Sabine could reject.

After suffering significant losses because of continually declining commodity prices, in 2015 Sabine commenced a voluntary Chapter 11 bankruptcy case in the United States Bankruptcy Court for the Southern District of New York. Prior to this case, Sabine had entered into gathering and processing agreements with Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holdings, LLC, two midstream gatherers.

Pursuant to the agreements with Sabine, Nordheim and HPIP agreed to build, at their expense, gathering systems of pipelines and treatment facilities for the gathering, treatment, disposal and re-delivery of gases, liquid hydrocarbons and other liquids produced by Sabine from certain defined tracts of land owned or leased by Sabine. The agreements obligate Sabine to “dedicate” to the performance of such agreements all of the gas, liquid hydrocarbons and other liquids it produced from such tracts of land. They specify minimum amounts of gas and other minerals that Sabine is obligated to deliver to Nordheim and HPIP and, in the event Sabine does not deliver them, require Sabine to make deficiency payments to Nordheim and HPIP. Sabine is also obligated to pay monthly gathering fees to Nordheim and HPIP. Both gathering agreements have 10-year terms, with automatic renewal subject to termination, and are governed by Texas law. Both agreements expressly provide that they are covenants “running with the land.”

Bankruptcy Court’s Decision

Having determined that the gathering agreements had become financially burdensome, Sabine filed a motion to reject both agreements pursuant to Section 365(a) of the Bankruptcy Code. Section 365(a) of the Bankruptcy Code allows debtors-in-possession to assume or reject executory contracts to maximize the value of the bankruptcy estate. Thus, to avail itself of the advantages offered by Section 365, Sabine argued that the processing agreements were execu-



Inez M. Markovich
A shareholder at Anderson Kill P.C., where she chairs the Banking and Lending practice.
imarkovich@andersonkill.com



Arthur R. Armstrong
An attorney at Anderson Kill P.C., participating in the Banking and Lending and Commercial Litigation practices.
aarmstrong@andersonkill.com

tory contracts and, therefore, Sabine could exercise its business judgment in rejecting them. In opposition, Nordheim and HPIP argued, among other things, that Sabine's obligations to "dedicate" all of the minerals produced from the designated tracts and to pay processing fees were covenants that "ran with the land" and could not be rejected even if the court found the other provisions of the agreements to be executory and subject to rejection.

On March 8, 2016, the bankruptcy court issued its decision on Sabine's motion, holding that the processing agreements were executory contracts that could be rejected in an exercise of Sabine's business judgment.¹ The court analyzed Texas law and concluded that the processing contracts were not covenants running with the land as either real covenants or servitudes. Interestingly, the court found it to be determinative that under Texas law, once minerals are extracted from the ground, they cease to be real property and instead become personal property. Therefore, the products at issue were deemed not to "touch and concern" the land and were open to rejection under the Bankruptcy Code.

Ramifications and Risk

First, it should be noted that the *Sabine* decision is not binding to the extent that the court recognized that under Second Circuit precedent, it could not decide a disputed

factual issue in the context of a motion to assume or reject an executory contract.¹ The reason for this prohibition is that resolution of a motion to assume or reject was intended to be only a summary proceeding and does not allow for lengthy discovery or trial.

Second, a decision made by a bankruptcy court for one federal district is not binding on courts in another district and thus, even if it was a precedential decision by its terms, its reach would be limited to the Southern District of New York.

Third, the *Sabine* decision is based on its interpretation of property law in Texas, and property law varies, sometimes significantly, from state to state. Therefore, a midstream gatherer is well advised to not only compare the terms of its contract with those at issue in *Sabine*, but also to consider whether the state law governing its contract is materially similar to the Texas law applied in *Sabine*.

While the bankruptcy court's opinion in *Sabine* demonstrates that every motion to assume or reject a gathering and processing agreement should be decided on the facts of each specific case, the general structure of the agreements in *Sabine* is rather typical for gathering and processing agreements. As such, this decision will certainly encourage other E&P companies to follow Sabine's example and minimize their losses by rejecting no-longer-profitable gathering and processing agreements.

In fact, the *Sabine* decision was no doubt a factor in the recent resolution of a dispute between Quicksilver Resources, Inc. and its midstream partners regarding certain gathering and processing agreements for which rejection was sought in Quicksilver's pending bankruptcy in Delaware. In that case, the parties resolved the outstanding motion by entering into new long-term agreements as part of a sale of Quicksilver assets to BlueStone Natural Resources II, rather than allow the bankruptcy court to potentially follow the example set by the Southern District.

The *Sabine* decision and others that may adopt its reasoning will very likely influence many an oil and gas company's decision whether to seek bankruptcy relief. Conversely, it increases the likelihood that midstream gatherers will lose the protection of the required minimum payments, further affecting midstream companies' valuations and the credit risk assigned to such companies by their lenders. Thus, to avoid an outright rejection of their contracts in the context of an upstream counterparty bankruptcy, a midstream gatherer would be well advised to evaluate the likelihood of rejection based on the underlying state property law and, should it not be favorable, strongly consider renegotiating a new contract in the manner of Quicksilver.

To review the footnote to this article, visit <http://www.metrocorp.counsel.com>