UPDATE

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Anderson Kill regularly represents banks and other financial institutions engaged in lending, as well as companies that engage in various types of financial transactions. In this issue of our Banking & Lending Update, *we spotlight the recent Bankruptcy Court decision in* Sabine *and its effects on the oil and gas industry, including lenders and investors, and chronicle a pair of recoveries obtained by our banking and lending attorneys on behalf of our clients.*

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Deals Considered Bankruptcy-Proof Combust: Uncertainty heightens for midstream gatherers and processors after the *Sabine* decision

By Inez M. Markovich and Arthur R. Armstrong

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.

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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 redelivery 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, which 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 executory 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.[2] 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.

ENDNOTES

[1] *In re Sabine Oil & Gas Corp.*, 2016 Bankr. LEXIS 1905, Case No. 16-11835 (Bankr. S.D.N.Y. 2016)

[2] *Orion Pictures Corp v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095, (2d Cir. 1993).

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Anderson Kill Successfully Obtains Full Asset Recoveries

A Long and Winding Road to Full Asset Recovery for National Bank

Anderson Kill's Banking & Lending attorneys, led by Frank Murphy and Inez Markovich, recently achieved a remarkable asset recovery for one of the firm's clients, a national bank, in a case that involved several distressed loans, multiple borrowers and guarantors, and properties located in several counties in two states. The dispute spanned several years and required strategic and aggressive representation in Pennsylvania state courts, bankruptcy court and orphans' court.

The case arose several years ago out of multiple loans made by the bank to several entities sharing a common shareholder and guarantor. Two loans were made to different restaurant and bar establishments, while the third loan was to a landscaping business. The loans were secured by blanket liens on the entities' business assets, including the restaurants' liquor licenses, and various real estate in different parts of Pennsylvania and New Jersey. After the borrowers defaulted on their respective payment obligations, the bank, with the help of Mr. Murphy and Ms. Markovich, negotiated a forbearance agreement with the obligors, which cross-collateralized the various subject loans. Although the obligors did not repay the loans as required in the forbearance agreement, the cross-collateralization proved critical to the bank's subsequent asset recovery strategy. After the obligors breached the forbearance agreement as well, the bank promptly confessed judgments against the borrowers and the guarantors and commenced mortgage foreclosure proceedings with respect to the real estate. After the bank successfully defeated the borrowers' defenses in the foreclosure actions, obtained final foreclosure judgments, and proceeded to sell the properties at sheriff's sale, both property owners sought protection under Chapter 11 of the Bankruptcy Code on the eve of the respective sheriff's sales.

The bank continued its recovery strategy in the bankruptcy court, successfully negotiating a cash collateral stipulation providing for regular payments to the bank and negotiating a potential sale of the mortgaged properties with both debtors. In the middle of these negotiations, one of the principals unexpectedly passed away, bringing an end to one of the bankruptcy cases and replacing the bankruptcy court's jurisdiction over one of the bars and two of the real properties with that of the orphans' court. After months of continued litigation in the bankruptcy court, the orphans' court, and the Philadelphia, Bucks, and Northampton counties' Courts of Common Pleas, coupled with relentless negotiations with the remaining principal and

the executor of the estate of the deceased principal, the bank successfully negotiated and closed two different workout deals. One of the loans was sold to a third-party investor for a purchase price sufficient to satisfy the outstanding principal balance of the largest loan, together with a substantial portion of the accrued interest. The principal balances of the other two loans, together with all accrued interest and late fees, were paid off in full from the sale of the other bar and property.

Anderson Kill's efforts on behalf of the bank have ended with the full repayment of principal plus significant interest and late fees received to date. Understanding that the bank has spent significant resources over the past years to pursue these defaulted loans, Mr. Murphy and Ms. Markovich explicitly included provisions in the final orphans' court order preserving the bank's right to recover its attorney's fees and costs. Thus, what were once several defaulted loans looming as significant losses for the bank, have been repaid nearly in full.

Full Asset Recovery Brought Home for Leading Merchant of Luxury Goods

Anderson Kill's attorneys, led by Inez Markovich, recently scored a major victory for a leading wholesale merchant of high-end luxury goods. This case arose out of a series of transactions between the client and one of its independent distributors, in which the client delivered high-end jewelry merchandise to the distributor on consignment for subsequent sales to the distributor's customers. The distributor was obligated to return the client's inventory not sold to the distributor's customers, as well as proceeds of sales, to the client. The distributor's obligations for the merchandise received on consignment were personally guaranteed by the distributor's owners, a husband and wife. Unbeknownst to the client, over several years the distributor withheld inventory and sales proceeds totaling a six-figure number from the client. In 2014, Anderson Kill commenced a civil action for conversion and breach of contract against the personal guarantors in the Law Division of the Superior Court of New Jersey in Middlesex County. The civil action was resolved through a stipulated judgment providing for the repayment of the full amount of the converted assets over several months, together with a mortgage on the guarantors' primary residence to secure the repayment of such obligation.

In late 2015, when the deadline for the repayment of the obligation approached, the personal guarantors filed a voluntary petition under Chapter 13 of the Bankruptcy Code in the U.S. Bankruptcy Court for the District of New Jersey. However, at this point, their debt to our client had been successfully restructured from a fully unsecured guaranty claim to a

claim secured by valuable real estate. To maximize the client's chances of recovery, Inez Markovich filed an objection to the discharge of the guarantors' obligation in bankruptcy, opposed their proposed Chapter 13 plan on the ground that it offered only an illusory promise of repayment to the client and the other secured creditors, and continued to put pressure on the debtors to satisfy the client's claim through negotiations of a sale of the debtor's real estate. The debtors agreed that their obligation to the client, including any potential deficiency portion, could not be discharged in bankruptcy, marking the client's first triumph in the bankruptcy case. In May 2016, less than six months after the commencement of the bankruptcy case, the debtors' primary residence was sold, and the client received payment of the entire principal balance of its claim, together with post-judgment interest and attorneys' fees.

Banking and Lending Seminars

On **May 19, 2016,** Anderson Kill attorneys Inez M. Markovich, Frank G. Murphy and Arthur R. Armstrong, along with John D. Baumgartner, Director, Dispute Advisory and Forensics Services Group at Stout Risius Ross, presented a seminar, "Oil and Gas Restructurings: Helping Financial Institutions Deal With The Impact of Declining Oil and Gas Prices." The program provided an update on restructuring issues for the oil and gas sector. The presenters provided insight to the issues faced by oil and gas exploration and production companies, other businesses affected by the decline in the energy sector, banks, leasing and finance companies, as well as other parties in the workout and restructuring process. The topics discussed included default and forbearance issues, valuations, issues in due diligence, debtor-in-possession financing, section 363 sales, and the importance of adequate insurance coverage.

Anderson Kill's Banking and Lending lawyers regularly provide "in-house" seminars addressing various topics in banking and lending, ranging from amendments to loan documentation, issues in insurance coverage, negotiations of debt restructuring agreements, and others, to our clients. If you are interested in having a Breakfast or Lunch & Learn presentation at your offices, contact Inez Markovich at (267) 765-8216 or imarkovich@andersonkill.com.

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