Oil and Gas Alert: Bankruptcy Court Issues Opinion Allowing the Rejection of Certain Midstream Agreements

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On March 8, 2016, a New York Bankruptcy Court issued a bench decision in the Sabine Oil & Gas Corporation Chapter 11 case. The Court's decision concerning a producer's request to reject certain portions of its midstream agreements has sent shockwaves through the oil and gas industry. Although the decision is far more limited in scope than is being reported by many commentators and professionals, its impact may be far reaching. In fact, Sabine's request to reject certain portions of its midstream agreements alone has provided the impetus for other producers to seek the rejection of "burdensome" midstream agreements (see *Quicksilver Resources, Inc.* and *Magnum Hunter* -both pending in Delaware Bankruptcy Court).

The long-held assumption in the midstream industry was that midstream agreements were sacrosanct. These contracts as were regarded as bankruptcy-proof, if properly drafted, as they purportedly transferred a property interest to the midstream company that could not be rejected in bankruptcy. The most common description of the property interests purportedly conveyed by these agreements were "covenants running with the land" and "equitable servitudes."

The foundation of this long-held assumption cracked on September 30, 2015 when Sabine filed its motion seeking to reject the gathering agreements with Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holdings, LLC. Sabine argued that the Nordheim Agreements and HPIP Agreements were "unnecessary drains on the Debtors' resources" and that rejection would provide up to $115 million in cost savings over the life of the contracts. To illustrate, Sabine asserted that the Nordheim Agreements contained minimum volume commitments that it contended it could not meet that would ultimately require it to make deficiency payments to Nordheim.

Nordheim responded that Sabine could not satisfy the test for rejection of contracts, known as the business judgment test, as rejection would not benefit the estate. Nordheim argued that its agreements contained certain dedications of the hydocarbons and payment of transportation fees that created property interests, commonly known as covenants

running with the land or equitable servitudes, which would survive the rejection of the underlying contracts. Nordheim further contended that the interest conveyed was in the gas and other mineral interests "in place", *i.e.*, a real property interest. In a nutshell, Nordheim argued that the transfer of such a property interest may not be terminated, revoked or repudiated pursuant to a debtors' request to reject a contract. It should be noted that the HPIP gathering agreement's conveyance was more robust, containing dedication of certain leases owned by Sabine and the oil and gas produced from the wells.

In response, Sabine argued that the dedications constituted contractual promises, and not grants of real property interests. Those contractual promises related to minerals produced, rather than the real property itself, and, therefore, no interest in the real estate was conveyed by the agreements.

The Bankruptcy Court's decision was a half measure. The Court ruled that Sabine satisfied the standard for rejection of the midstream agreements. The Court explained that the business judgment test requires a determination as to whether the debtors' decision "is beneficial to the estate" and that courts generally defer to a debtors' determination. The Court also stated that "adverse effects on the non-debtor contract party from the decision to assume or reject are irrelevant."

Although the Bankruptcy Court ruled that Sabine's decision was a reasonable exercise of its business judgment, it also ruled that such rejection would only relieve it "of those terms that are subject to rejection" (*i.e.*, those terms not connected to a property interest conveyed to the midstream company), which would need to be decided in a subsequent proceeding. The Court concluded that it could not decide the underlying question as to the extent, if any, of any property interests conveyed in the context of a motion to reject based upon binding Second Circuit Court of Appeals authority. That decision, the Court reasoned, would require an adversary proceeding (which is a lawsuit within a bankruptcy case).

What followed in the remainder of the decision was the Court's "non-binding analysis" as to whether the covenants at issue run with the land or are equitable servitudes under Texas law. The Court made clear in its non-binding opinion that the Nordheim Agreements and HPIP Agreements did not give rise to such property interests. A few highlights from the opinion are as follows. First, the Court viewed the agreements as service contracts. The Court stated that the primary purpose of the agreements was to delineate "the contractual rights and obligations with respect to the services to be provided" by the midstream companies.

Second, the Court stated that the covenants only concerned the minerals "as produced." Once the minerals are extracted they cease being real property and instead become personal property. The Court stated that this was true of the HPIP Agreements even though such contracts contained dedications of certain of Sabine's leases. The Court viewed these dedications as simply identifying of the property that was subject to the contracts, and services to be provided, rather than constituting an actual burden on Sabine's property interests that might give rise to a property interest.

Finally, the Court noted that "the property subject to the Nordheim Agreements was subject to preexisting liens held by the Debtors' secured lenders." And that such lenders had not approved of the transfer of the interests asserted by Nordheim, nor been informed of the creation of those interests. These facts, the Court opined, "strongly militate" against a finding that a property interest was created by the Nordheim Agreements.

What does this all mean for the industry? In the short-term, many industry experts suggestthat this decision will create a domino effect. They say that additional producers will be convinced to file for bankruptcy in order to reject burdensome and uncompetitive midstream agreements. Others say that a wave of rejection motions and/or requested renegotiations of midstream contracts may tip more midstream companies into bankruptcy.

We believe those producers already subject to bankruptcy proceedings will be reaching out to their midstream partners, if they haven't already, to renegotiate any non-competitive terms of their midstream agreements. If such efforts are unsuccessful, we could see many more motions to reject midstream agreements, like in the *Sabine* case. We also believe that those producers not in bankruptcy may be emboldened by this decision and reach out to their midstream partners, pointing to the opinion as leverage, to renegotiate their deal in an effort to stave off a bankruptcy filing. However, keep in mind, the option, or threat, to reject is only useful if the producer has another alternative for transporting its product to market. If not, the producer will be compelled to renegotiate with the same midstream company whose contract it just rejected. Also, keep in mind the expression "what is good for the goose is also good for the gander." If the renegotiation of midstream agreements (through rejection or otherwise) creates amended or new contracts with terms unfavorable to midstream companies that ultimate result in midstream industry bankruptcies, the midstream companies should get a second bite of the apple utilizing the same game plan adopted by producers. That is, the midstream companies seeking, or threatening to seek, to reject the midstream agreements, only this time, in order to improve, their contract terms with the producers.

Lastly, keep in mind that these situations are highly fact-intensive. They involve careful analysis of the terms and conditions of the midstream contracts and applicable state law. State property laws often vary and, in some instances, materially differ. The *Sabine* Court applied Texas law in its "non-binding analysis" of the Nordheim Agreements and HPIP Agreements. Furthermore, midstream contracts are not boiler plate. The "conveyance" language in midstream agreements vary and may be significantly different from the language in the Nordheim Agreements and HPIP Agreements. Both midstream companies and producers should carefully review their contracts to determine how those agreements may be analyzed under applicable state law before engaging counterparties to those agreements.