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Client Alert

Financial Restructuring Practice Group

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Bankruptcy Court Rules Gathering Agreements Can Be Rejected

Potential Significant Impacts on Midstream Companies

On March 8, 2016, the United States Bankruptcy Court for the Southern District of New York (the "Court") ruled from the bench in *In re Sabine Oil & Gas Corp.*[1] in a case of first impression that a midstream gathering agreement could be rejected as an "executory contract" by a debtor in bankruptcy. While most practitioners and midstream companies had assumed that such agreements, if properly structured, were "bankruptcy proof," the Court's decision could significantly impact midstream gatherers and require more attention to the structure of transactions.

Background

Sabine Oil & Gas Corporation ("Sabine") was formed by the merger of Forest Oil Corporation and Sabine Oil & Gas LLC in December 2014. In July 2015, Sabine filed for bankruptcy, citing (among other things) the substantial declines in the price for oil and gas.

In early 2014, prior to filing for bankruptcy, Sabine had entered into a Gas Gathering Agreement and a Condensate Gathering Agreement (together, the "Gathering Agreements") with Nordheim Eagle Ford Gathering, LLC ("Nordheim"). Pursuant to the Gathering Agreements, Sabine dedicated to Nordheim's gathering system Sabine's full production of natural gas (as well as liquid hydrocarbons and other liquids) attributable to the interests of Sabine South Texas LLC ("SST") located in a specified geographical area in DeWitt County, Texas.

As part of its reorganization strategy, Sabine moved to reject the Gathering Agreements as "executory contracts" under the Bankruptcy Code and argued such rejection would save the company more than $35 million and adequate to build its own gathering and processing facility.[2] Nordheim objected to the proposed contract rejection, arguing (among other things) that the terms of the Gathering Agreements are covenants that "run with the land" and, therefore, cannot be rejected in bankruptcy. In response, Sabine argued the Gathering Agreements do not run with the land and that no privity exists between SST and Nordheim.

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The Decision

In its decision, the Court decided narrowly that the Gathering Agreements were executory contracts that are subject to assumption and rejection by a debtor in bankruptcy. To that end, Sabine satisfied the reasonable business judgment standard necessary to reject the Gathering Agreements.

The Court ruled, however, that it could not decide on a procedural basis whether covenants "run with the land" as a matter of governing Texas law in the context of a motion to reject a contract under binding Second Circuit precedent.[3] Regardless, the Court issued a non-binding ruling that the Gathering Agreements did not "run with the land" as binding real covenants or equitable servitudes under Texas law. The Court reasoned that there was no horizontal privity between SST and Nordheim because Nordheim was not granted property interests in the underlying mineral rights. More significantly, the Court also found the covenants in the Gathering Agreements did not "touch and concern" the land, nor did they affect the land.

Conclusion and Potential Implications

The Court's decision in *Sabine* is an opinion of first impression that could negatively affect many midstream companies and cause further distress and disruption in the oil and gas industry. At a minimum, the Court's decision will force companies to review how they have structured transactions and could impact counterparties' leverage in negotiations with distressed E&P companies who have sought bankruptcy. It is important, however, to understand that a determination as to whether a gathering agreement can be rejected by a debtor in bankruptcy will require a fact-specific analysis that depends on the precise contractual language at issue and applicable state law. Additional decisions on similar issues, such as the forthcoming ruling in *In re Quicksilver Resources Inc.*,[4] are likely to provide further guidance on debtors' ability to reject of gather agreements in bankruptcy.

For a further discussion of issues arising from the Court's decision, please join us for a webinar at **3:00 p.m. EDT on Thursday, March 10, 2016**. Instructions for the webinar can be found in the email and on our website.

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[1] Case No. 15-11835 (Bankr. S.D.N.Y.).

[2] Sabine also sought to reject gathering agreements with HPIP Gonzales Holdings, LLC ("HPIP"), which Sabine argued would result in an additional $80 million in savings to its bankruptcy estate. HPIP's gathering agreement specifically stated that "[Sabine] expressly does not by the terms of this Agreement, sell, transfer or assign unto [HPIP] any title or interest whatsoever in [its oil and gas leases]," and that "[t]itle to all [of Sabine's produced oil and gas] shall at all times remain with [Sabine]." HPIP also failed to complete construction of the facilities necessary to perform the services required of HPIP under its contracts, and thus, Sabine argued that such contracts were materially breached prior to the petition date. Moreover, Sabine argued that the facilities were built on non-estate property. For these reasons, HPIP did not object to Sabine's rejection of its gathering agreement; rather, it argued that Sabine could not alter HPIP's alleged ownership interests in the acreage dedication by rejecting the agreement.

[3] *See In re Orion Pictures Corp.*, 4 F.3d (2d Cir. 1993) (legal disputes cannot be adjudicated in contract rejection context).

[4] Case No. 15-10585 (LSS) (Bankr. D. Del.).