BURR ALERT

Trouble Down the Pipeline? What *Sabine Oil & Gas Corp.* May Mean for the Midstream Service Sector

By James P. Roberts May 2016

Recently, the Bankruptcy Court for the Southern District of New York issued an opinion in *In re Sabine Oil & Gas Corp.*[1] that permitted the debtor, Sabine Oil & Gas Corporation ("Sabine") to reject certain gathering and condensation agreements as executory contracts under 11 U.S.C. § 365. Because the midstream service sector finances the construction of pipelines, the costs of which are recovered over the life of gathering agreements, the Court's decision has the potential to lead to considerable upheaval in the energy sector.

Sabine, the representative debtor for some ten other corporate entities (collectively, the "Debtors"), is engaged in the acquisition, production, exploration, and development of onshore and natural gas properties in the United States. Following the merger of Sabine Oil & Gas, LLC and Forest Oil Corporation, Sabine became a party to two contracts with Nordheim Eagle Ford Gathering, LLC ("Nordheim").

Together, these contracts (the "Nordheim Agreements") obligated Nordheim to: (1) gather, treat, dehydrate, and re-deliver gas to Sabine; and (2) perform substantially similar tasks with respect to condensed liquid hydrocarbons and other non-gas liquids. Sabine, on the other hand, was required to pay certain gathering fees and either deliver minimum amounts of gas to Nordheim or make deficiency payments if these threshold amounts were not met. After the Debtors determined that they would likely be unable to deliver the minimum amounts of gas and condensate, and would then be required to make certain deficiency payments, the Debtors sought to reject the Nordheim Agreements, which they contended were executory contracts.

Nordheim objected to Sabine's attempts to reject the Nordheim Agreements, arguing that their decision to reject the agreements did not satisfy the business judgment standard imposed by case law. Nordheim submitted that Sabine's obligation to pay the previously discussed fees were real covenants that ran with the land and would survive rejection, or in the alternative that they were equitable servitudes. As such, Nordheim argued that the business judgment standard was not met because even if Sabine rejected the Nordheim Agreements, Sabine would still be bound by those covenants.

In issuing its narrow and nonbinding decision, the Court disagreed with Nordheim, finding that the agreements were executory contracts, and thus subject to rejection. In reaching this conclusion, the

[1] 547 B.R. 66, 74 (Bankr. S.D.N.Y. 2016).

Court found that the Nordheim Agreements were neither real covenants nor equitable servitudes because: (1) the Nordheim Agreements did not "touch and concern" the land, as required under Texas law; (2) there was no horizontal privity of estate between Nordheim and Sabine; and (3) only the gas, hydrocarbon, and non-gas liquid products, and Sabine's rights with respect to those products was affected by the "covenants," while the land itself remained unburdened by the Nordheim Agreements.

The Court was careful to limit its decision by cabining its analysis in Texas law, and by noting that its decision was nonbinding due to a procedural defect. Nevertheless, midstream service providers may begin to change their agreements to account for the Court's decision. However, the decision spells more trouble for midstream service providers such as Nordheim, who find themselves on the other side of distressed or opportunistic oil and gas producers. Nordheim had built the gathering system used by Sabine at the cost of some $84 million. Should the Court's decision be replicated by other bankruptcy courts, the threat to midstream service providers of not being able to recover the funds already spent could affect negotiation dynamics between distressed producers and service providers. These service providers may no longer feel as though gathering agreements are held in the sacrosanct regard they once were.

It is important to note that similarities exist between gathering agreements in the oil and gas industry and royalty agreements in the coal industry. Thus, within coal, as well as oil and gas, it will be important to both monitor bankruptcy courts' attempts to narrow, maintain, or extend the rationale in *Sabine*, and for corporate entities to account for the decision regardless of their alignment with midstream producers or service providers.

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