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New York Bankruptcy Decision Puts Pipeline Contracts in Jeopardy

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The judge overseeing the bankruptcy of Sabine Oil & Gas Corp. ruled on March 8, 2016, that the debtor may reject two pipeline contracts that the industry had generally thought of as bankruptcy proof. The 21-page opinion by U.S. Bankruptcy Judge Shelley C. Chapman in the Southern District of New York appears to be the first major test of whether bankruptcy may be used to end an unfavorable pipeline contract with companies in the mid-stream sector of the energy industry.

Section 365 of the Bankruptcy Code allows a debtor to assume or reject its executory contracts. As a practical matter, this means the debtor will live with favorable contracts and try to shed or breach unfavorable contracts.

In *Sabine Oil*, the debtor sought to reject contracts it had with Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holdings, LLC pursuant to §365(a). Both Nordheim and HPIP were midstream "gatherers" that gather, treat, transport and process mineral products produced from a well before the products enter the commercial market. The agreements with both parties had multiple components, including transporting oil and gas produced at the debtor's wells by the pipeline companies to a designated area. The agreement with HPIP also included services related to the handling of water and gas produced by the debtor from the same land.

The agreements generally provided that Nordheim and HPIP would construct, at their sole cost and expense, a gathering system of pipeline and treatment facilities to provide the agreed upon services. In exchange, Sabine agreed to deliver a certain minimum amount of product to the pipeline companies on an annual basis, and if the minimums were not met, Sabine would be required to make a minimum deficiency payment. The agreements also provided that Sabine's undertaking to deliver the products to the pipeline company was a covenant running with the land and leasehold interest identified in the agreement.

Judge Chapman noted that neither pipeline company truly challenged the debtor's business judgment as to whether the contracts were burdensome; there was no dispute that from a business perspective, the pipeline contracts were no longer economically viable for the debtors. Neither pipeline company put forth any argument or evidence that the debtor's decision to reject the agreements was a product of bad faith, whim or caprice. Instead, the pipeline companies focused arguments on the assertion that the debtor's obligations under the agreements constituted covenants running with the land that would survive rejection of the contract in bankruptcy.

Ultimately Judge Chapman concluded that the debtor was permitted to reject the agreements with

both pipeline companies. She determined, however, that it was procedurally improper to make a final determination on whether the contracts constituted covenants running with the land such that, even if rejected, the debtor would not be able to walk away from its obligations. The court reasoned that such a ruling would require a separate action to be filed with the court.

Nevertheless, Judge Chapman provided an advisory, nonbinding ruling that under Texas law, the agreements at issue would not satisfy the requirements to establish that they were covenants running with the land. She made clear that this was not a final ruling and invited the parties to engage in meaningful settlement discussions, failing which issues should be joined in a separate action.

What Does the *Sabine Oil* Decision Mean?

First, the ruling is subject to reconsideration or appeal, so the ultimate outcome of this issue is yet to be determined. However, the decision may encourage other exploration and production (E&P) companies to file bankruptcy if they are faced with onerous pipeline contracts. Alternatively, the ruling may provide E&P companies with a powerful new tool to negotiate with pipeline companies for more favorable terms.

Nevertheless, even if Judge Chapman's analysis of Texas law is correct, it may not hold for other states as the judge's analysis was limited to Texas law. E&P companies operating in different states should closely examine the law in each state to determine whether they would be able to gain additional leverage in a bankruptcy case. This also means that companies in this space need to carefully review their contracts to determine if they come with rejection risks in a bankruptcy. If they do, that may provide an ideal opportunity for renegotiation.

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