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Oil and Gas Gathering Contracts: Contracts Running with the Land or Running On Empty?

Authors: Edward Arnold

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*Honey you really tempt me
You know the way you look so kind
I'd love to stick around but I'm running behind
You know I don't even know what I'm hoping to find
Running into the sun but I'm running behind
-Jackson Browne*

In a much anticipated ruling, Bankruptcy Judge Shelley Chapman has granted the motion of Sabine Oil and Gas Corporation (No. 15-11835, USBC SDNY) to reject certain executory contracts with Nordheim Eagle Ford Gathering, LLC and HPIP Gonzales Holdings, LLC. The court issued its ruling noting that due to the procedural posture of the motion for rejection the decision was not binding on the underlying legal dispute of whether the covenants at issue run with the land. Rather, the ruling is limited to the rejection motion only and not binding on any future disputes involving the nature of the contracts at issue. Applying Texas law Judge Chapman's non-binding analysis concluded that the gathering agreements at issue were not covenants running with the land and could be avoided or terminated by the Debtor pursuant to §11 U.S.C. 365(a). Under the Gas Gathering Agreement and the Condensate Gathering Agreement Sabine exclusively dedicated all of its production from the covered areas to be shipped on Nordheim's gas and condensate gathering system. Under the agreements Sabine was also required to pay certain expenses and minimum transportation fees regardless of throughput.

The Production Gathering, Treating and Processing Agreement and the Water and Acid Gas Handling Agreements entered into with HPIP required similar exclusivity and performance obligations (i.e., obligatory payments even absent throughput). The Debtor sought to avoid the contracts as executory contracts on the basis of lack of privity and that the gathering agreements were not covenants running with the land. By rejecting the gathering contracts the Debtor would presumably be free to transport its production through other means at lower cost or renegotiate with the existing provider. The Debtor claimed it could save up to \$100 million dollars over the life of the contracts. The court noted that the purpose behind allowing the rejection or assumption of executory contracts is to permit the debtor to use valuable property of the estate and to renounce title to and abandon burdensome property. After reviewing the arguments presented, the Court concluded that the debtor's decision to reject each of the contracts was a reasonable exercise of business judgment.

Judge Chapman applied Texas law and it is important to note that the result may be different under the law of other states and, as expressly noted in the decision, under different contracts. Likewise, the outcome in other cases may be affected by the ownership structure and rights granted in connection with the operation of the pipeline. What is clear is that additional producers will seek relief under §11 U.S.C. 365 to shed onerous use-or-pay style contracts. Similar motions are pending in Quicksilver Resources, Inc. (No. 15:10585, USBC D. Del) and Magnum Hunter Resources Corp (No. 15:12533, USBC D. Del). In Quicksilver the rejection of the pipeline contracts is a condition to a proposed §363 sale of assets.

Pipeline operators, financial sponsors and their lenders who may have thought they were immune from the financial stress brought on by low commodity prices should continue to monitor pending rejection motions and review their contracts for potential rejection risks. Most analysts believe the ruling may prompt otherwise viable production companies to seek relief under Chapter 11 to avoid onerous contracts. With apologies to Jackson Browne, only time will tell whether other pipeline contracts are covenants running with the land or will be deemed by other bankruptcy courts to be merely "running on empty."