An Uncertain Fate For Oil And Gas Midstream Agreements

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Over the last several months, a dispute has been brewing in the Sabine Oil & Gas Corporation bankruptcy that has potentially broad impact on midstream agreements throughout the oil and gas industry. In the bankruptcy court, Sabine seeks to "reject" three gas or condensate gathering agreements, meaning that it would no longer be bound by the contracts, with a plan to, in at least one instance, "enter into an agreement with an alternative gatherer to provide substantially similar services ... at market rates."

Sabine's midstream counterparties oppose this maneuver, arguing that the gathering agreements in question cannot be rejected in bankruptcy. Southern District of New York Bankruptcy Judge Shelley Chapman is set to rule on this dispute on March 8, 2016, and at a recent hearing indicated from the bench that she is "inclined" to rule in favor of Sabine. Whatever she decides, her ruling will impact counterparty insolvency risk in midstream agreements across an industry that is bracing for more and more bankruptcy filings. Indeed, the rapid plunge of Chesapeake Energy stock earlier this month on what turned out to be unfounded insolvency fears indicates that the market is ready to believe that more and larger bankruptcies are looming.

Midstream agreements like those at issue in the Sabine bankruptcy are generally based on financial models where the substantial capital outlays for building a gathering system are recouped over a period of years through fees on the volumes shipped. Changes in the applicable fees or rates, or wholesale switches to alternative midstream service providers via bankruptcy disrupt the economic models of the midstream companies that own and operate these systems. Though there are many varieties of gathering agreements — those with volume commitments, short- or long-term, or provisions allowing a gatherer to stop operation when the system is no longer profitable — it is apparent that both potentially insolvent production companies and gathering system operators need to pay attention to what is unfolding in New York City.

Sabine filed for bankruptcy in July 2015 amid the precipitous decline in oil and gas commodity prices over the last year and half. At the time, Sabine was a party to several relevant midstream agreements. Two of which were with Nordheim Eagle Ford Gathering LLC for gas and condensate gathering. Under these agreements, Sabine agreed to flow its production from certain “dedicated” areas through Nordheim’s gathering system and pay annual gathering fees in exchange for having its gas flowed through Nordheim’s system to downstream pipelines and eventually to market. Both agreements with Nordheim required Sabine to deliver a minimum annual volume of gas per year or else it would have to make deficiency payments. Another gathering agreement was executed with HPIP Gonzales Holdings LLC but the actual gathering system was still in the construction phase. The HPIP contract requires Sabine to, among other things, drill at least one well per year until 2017, or else Sabine must purchase the gathering system at a contractually determined price.

Given the decline in commodity prices and its financial condition, Sabine alleges that it should not be forced to fulfill its minimum volume or drilling obligations under these contracts. Sabine claims this would save it over $100 million. To avoid the obligations, Sabine has moved to “reject” the contracts under the Bankruptcy Code. In essence, bankruptcy law allows a party to terminate a contract that has some performance remaining on both sides. The counterparty then has a claim for breach of contract that it can bring against the debtor’s estate alongside the debtor’s other creditors. Nordheim and HPIP opposed Sabine’s motion to reject the contracts, arguing, as a general matter, that the contracts were so-called “covenants running with the land,” which cannot be rejected in bankruptcy. Alternatively, the midstream companies propose that the contracts are equitable servitudes which likewise cannot be rejected in bankruptcy.

The parties disagree over what the relevant test should be to determine how to classify the gathering agreements under Texas law. The exact details involve a foray in Texas real property law. Sabine argues that Sabine’s subsidiary Sabine South Texas LLC was the party to the gathering agreements, not the parent corporation. It further argues that the gathering agreements do not, in substance, “touch and concern the land,” as is required for covenants running with the land and equitable servitudes.

In other words, the gathering agreements are not the kind of real property-related agreements which are immune to bankruptcy rejection. On the other hand, the midstream companies argue that gathering agreements provide for, among other things, the filing of memorandums of agreement in the real property records in the counties where the "dedicated" lands are located. This conveys an intent that the agreements do concern real property and should be rightly classified as real property covenants or an equitable servitude. Nordheim and HPIP also counter that Sabine acted as its subsidiary's agent in the transaction, and thus the "privity" issues are satisfied. These are just a few of the most prominent legal theories in the dispute.

Significantly, the parties also disagree over how to interpret a 2013 decision by the Fifth Circuit — Newco Energy v. Energytec Inc. The gatherers characterize the case as holding that transportation agreements, which are analogous to gathering agreements, are covenants running with the land under Texas law. Sabine counters that the case actually concerned whether the transportation agreement ran with the pipeline itself, not lands which produced dedicated to shipping through the pipeline. Judge Shelley's interpretation of Energytec will be another significant outcome of the bankruptcy proceeding.

All told, Judge Shelley's decision is going to impact the underlying counterparty insolvency risk, especially under Texas law, in midstream agreements in an industry with many exploration companies on the precipice of bankruptcy. At a minimum, her decision will impact the starting place for potential renegotiations of midstream contracts.

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