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# **Bankruptcy Wildcatting:** Challenging **Midstream Contracts** In The Wake of Sabine

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SHUTTERSTOCK

Amidst the sometimes dramatic fluctuations in commodity prices that buffet the oil and gas industry, investors generally relied on one segment of the market to be safe and stable: so-called "midstream" companies that own the pipelines that transport oil and gas. The rationale was that the oil and gas had to travel, and the fare had to be paid, regardless of the commodity price – not to mention that "take or pay" contracts were the norm in the industry.

Investors' perception of the safety of investments in midstream companies – i.e. the owners of the pipelines – was shaken by a March 2016 decision out of the Southern District of New York Bankruptcy Court permitting a bankrupt oil exploration company to reject its midstream service contracts. *In re Sabine Oil & Gas Corp.*, (No. 15-11835 SCC) (Bankr. S.D.N.Y. March 8, 2016, ECF No. 872) ("*Sabine*"). *Sabine* set the stage for several heated battles over a debtor's ability to reject midstream contracts, and, in the process, introduced concern regarding midstream companies' cash flows. These conflicts arise at the intersection of the core bankruptcy tool of contract rejection, centuries-old state property law, and how the financing that supported the recent expansion of domestic oil and gas production was structured.

This article discusses the details of these conflicts and how the parties have achieved either resolution or the ability to move on despite the continuing lack of definitive answers in every case.

## Background

The three principal sectors of the oil and gas industry are "upstream" companies that explore and produce natural gas and crude oil (known as "E&Ps"), "midstream" players who transport the produced products from the wellheads, generally through complex systems of overland pipelines, and store the oil and gas, and "downstream" companies that refine, market, and distribute the end product.

Upstream E&Ps enter into long-term service contracts, known as "gathering agreements," with midstream companies. These contracts generally require the midstream companies to bear the significant capital cost of

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constructing pipelines and also include dedications from the E&Ps to the midstreams for the land under the pipelines and dedications of the minerals produced from the wells. A central component of these midstream contracts is a minimum volume commitment ("MVCs") from the E&Ps. These so-called "take or pay" provisions hedge the risk and expense of pipeline construction by requiring an E&P to send at least the specified amount of product through the pipeline at a price. The price that is locked in despite the actual commodity price prevailing at the time of actual transportation. The transportation must be paid regardless of actual volume and current market rate. In the current slump in the price of oil, E&Ps are paying higher than prevailing market prices.

Following 'Sabine', the **rejection of midstream agreements has been heavily litigated.** Generally the dispute takes center stage, captures the spotlight, and delays asset sales and plan confirmations until the E&P and its midstreams can find a practical resolution.

These contracts are central to the midstream's ability to raise capital for pipeline construction projects. Because the contracts are remote from spot commodity prices, a midstream's cash flows are considered highly stable. Lenders typically provide funding to midstreams on the basis of the volume, price, and duration of the MVCs. Historically, less weight has been given to the financial position of the E&Ps on the upstream side of the MVCs. But in the wake of *Sabine*, this is no longer the rule: the prolonged slump has led many E&Ps to take refuge in chapter 11, where they can, under *Sabine*, reject their midstream contracts and renegotiate them at or close to current market rates. The result is doubt and instability for the midstream's finances.

### Rejecting Executory Contracts Under Section 365

A core chapter 11 restructuring tool is the debtor's ability, in its business judgment, to either assume or reject its executory contracts. 11 U.S.C. § 365(a). A debtor's rejection of a contract is considered a breach of the contract as of the petition date, which then entitles the counterparty to a claim for damages in the bankruptcy case. 11 U.S.C. § 502(g); 11 U.S.C. § 365(g). But these unsecured damage claims are paid out at cents on the dollar in bankruptcy, significantly reducing the counterparty's recovery. Thus an E&P's chapter 11 may pose an existential threat to its midstream partners in that a debtor is highly likely to reject an uneconomic contract, depriving the midstream of its reason to exist. And having an unsecured claim drastically reduces the compensation paid to the midstream for that breach. It is no surprise that midstream companies have been fighting tooth and nail against rejection of their gathering agreements.

### Seminal Case: *Sabine Oil & Gas Corp.*

Sabine Oil & Gas, an E&P operating in Texas, sought to reject its gathering agreements with two midstream service providers. Fighting back, the midstreams argued that their contracts contained covenants that "run with the land," making them non-executory and therefore ineligible for rejection. In a decision that was non-binding for procedural reasons, the Bankruptcy Court found that Sabine could reject the contracts based on the Court's interpretation that, under Texas law, the covenants in the contracts did not "run with the land."

### Restructuring In the Wake of *Sabine*

Following *Sabine*, the rejection of midstream agreements has been heavily litigated. Generally the dispute takes center stage, captures the spotlight, and delays asset sales and plan confirmations until the E&P and its midstreams can find a practical resolution. The most notable cases are below:

- *In re Quicksilver Resources Inc.*, No. 15-10585 (LSS) (Bankr. D. Del. filed Mar. 17, 2015). Seeking a quick exit from Chapter 11, E&P-debtor Quicksilver sought to sell substantially all its assets at auction. A condition to the sale was rejection of Quicksilver's midstream contracts. The sale did not proceed as planned: the midstream opposed the sale and argued that the contracts could not be rejected because they contained non-severable covenants that run with the land under Texas law. After a battle that delayed the sale closing by approximately two and a half months, Quicksilver, its purchaser at auction, and its midstream reached a practical solution that allowed the sale to proceed with the midstream retaining its role but with an altered MVC.
- *In re Magnum Hunter Resources Corp.*, No. 15-12533 (KG) (Bankr. D. Del. filed Dec. 15, 2015). Two of Magnum Hunter's midstream providers erected obstacles to confirmation of Magnum Hunter's Chapter 11 plan over the threatened rejection of their service contracts. After a heated battle that delayed Magnum Hunter's exit from bankruptcy, Magnum Hunter ultimately assumed these midstream contracts in its final plan proposal, alleviating the need for the Delaware Court to interpret West Virginia law.
- *In re Emerald Oil, Inc.*, No. 16-10704 (KG) (Bankr. D. Del. filed Mar. 22, 2016). Emerald Oil sought to reject its midstream contracts as part of its asset sale, seeking declaratory relief under North Dakota law. Heavily litigated, with several days of evidentiary hearings, depositions, and hundreds of pages of briefing on bankruptcy and North Dakota law, the midstream

obtained a TRO in Delaware Bankruptcy Court. The Court found that the midstream "stood the likelihood of prevailing on the merits … that the dedication agreements do not run with the land." Months later, Emerald and its midstream reached an accord that permitted the asset sale, with the midstream retaining its service contracts (with altered MVCs) and earning equity in the reorganized debtor and a board seat.

• *In re Triangle USA Petroleum Corp.*, No. 16-11566 (MFW) (Bankr. D. Del. filed June 29, 2016). Even before Triangle USA entered Chapter 11, its midstream sought a declaratory judgement in North Dakota state court that the covenants included in the parties' midstream services agreements "run with the land," which would exempt them from rejection. But a month later, Triangle USA entered Chapter 11 in Delaware and sought to reject its midstream contracts, seeking declaratory relief in Delaware under North Dakota law. The dispute is not showing signs of cooling: Triangle USA's recently-filed Chapter 11 plan provides for jurisdiction of the dispute in Delaware, but the Delaware Bankruptcy Court then sided with the midstream, granting its motion to lift the automatic stay to permit the North Dakota District Court (to which the state action was removed) to determine the status of the contracts under North Dakota law. As for Triangle USA's Chapter 11 plan, it leaves the issue of contract rejection in the Court's hands, meaning that the fate of the gathering agreements will follow the debtor out of bankruptcy if not resolved as part of the plan's confirmation.

• *In re Tristream East Texas, LLC*, No. 16-31521 (DRJ) (Bankr. S.D. Tex. filed Mar. 30, 2016). The Tristream bankruptcy is a twist on the general paradigm. In Tristream, the midstream-debtor obtained an order that conditionally rejected its midstream service contracts with its E&P but that did not make a finding "of any kind with respect to whether any provision of the [midstream agreement] constitutes a covenant running with the land, equitable servitude, or any other legal interest in real property …." The Official Committee of Unsecured Creditors opposed this rejection and is seeking declaratory relief under Texas law to clarify that the dedications embedded in the agreements cannot be rejected in bankruptcy. Recently, Tristream's E&P joined the fight, arguing that its gathering agreements were non-executory covenants running with the land, continuing the role reversal that this bankruptcy proceeding presents.

### Oil & Gas Lending in the Wake of *Sabine*

While *Sabine* has already played a major role in ongoing oil and gas restructurings, its more lasting impact may be on the structure and even the availability of capital for midstream companies. Though substantial investing assets remain on the sidelines awaiting a sustained rebound in oil prices, the investment approach in midstreams will necessarily require more diligence. Though *Sabine* is the only case to come to a written decision, the risk is real and substantial. It is not sufficient to place an investment in a midstream on the basis of long duration MVCs at suitable prices. Whether these contracts "run with the land" is state specific, with that determination being made by that state's court or by another state's federal court applying state law. There is a substantial possibility that state law varies on this point, and it is also possible that federal bankruptcy courts will have differing takes from state courts and even from each other.

Midstreams can address that uncertainty by assuring that newly entered service contracts' provisions hew to the property laws of the relevant state. How lenders diligence these contracts will likely affect lending terms well into the future.

### Conclusion

The effect of *Sabine* is far from settled. The bankruptcy decision is on appeal to the New York Southern District, direct certification to the Second Circuit having been declined. That appeal process could take many months. All the while, E&Ps and midstream companies will remain locked in a battle of leverage over the stability of midstream contracts with the potential for conflicting decisions out of the courts presiding over these cases. The business need to resolve chapter 11 cases may well impel parties to forgo the uncertainty of court determination and the lengthy appeal process and move them towards practical resolution of the issues. And the rubber will hit the road when midstream operators seek financing for new or existing projects, requiring lenders and investors to examine their appetite for risk and, perhaps, to specifically address and adjust for the possibility of rejection of their contracts.

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