

Rejection Of Oil And Gas Contracts Can Only Go So Far

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On March 8, 2016, New York Bankruptcy Judge Shelley Chapman announced her much-anticipated decision in the Chapter 11 cases of Houston-based Sabine Oil & Gas Corp. and its affiliates (collectively, “Sabine”). She held that Sabine could reject two oil and gas gathering contracts (collectively, the “Agreements”) with Nordheim Eagle Ford Gathering LLC relating to Sabine’s oil and gas interests located on a third party’s real property (the “mineral interests”). However, Judge Chapman held that, as a procedural matter, she could not decide the underlying disputed real property issues of whether the rights granted under the Agreements are property rights (“covenants running with the land”), or mere contractual rights.



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Bankruptcy Code Section 365 permits a debtor to assume or reject an executory contract, subject to court approval. The debtor must show that its decision satisfies the business judgment standard, which requires that the decision benefit the debtor’s estate. In its motion to reject the Agreements, Sabine estimated that rejection of the Agreements would save Sabine at least \$35 million in deficiency payments over the term of the Agreements. Nordheim filed an objection, which questioned whether rejection was in the best interest of the estate, in light of Nordheim’s argument that property rights were conveyed by the Agreements and property rights are not extinguished by rejection.

Under Texas law, an interest in the mineral rights underneath a landowner’s property is an interest in real property. *Texas Co. v. Daugherty*, 176 S.W. 717, 720 (Tex. 1915). As is customary in the oil and gas industry, the Agreements gave Nordheim the right to gather, process and transport oil and gas obtained from the real property containing the mineral interests. These types of contracts are known as “midstream” agreements because they deal with the gathering portion of the exploration-production-gathering-processing-transportation continuum. The Agreements obligated Sabine to guarantee a minimum amount of oil and gas on an annual basis, and to pay Nordheim certain fees. To the extent Nordheim did not receive certain minimum amounts of oil or gas production, Sabine was required to pay Nordheim certain deficiency payments.

The underlying disputed issue between the parties is whether the Agreements granted Nordheim an interest in the mineral interests themselves, while they were in the ground. If so, it leads to the conclusion that Nordheim holds a real property interest. Or, did the Agreements grant Nordheim an interest in the mineral interests after they are extracted from the ground? If so, it leads to the conclusion that Nordheim holds a mere contractual interest.

Of course, whether a real property interest was conveyed has important practical consequences. If an

interest in real property was conveyed, then that interest is not property of Sabine's estate, and is not part of the secured lender's collateral package. This could significantly impact the value of secured claims, the recovery of unsecured creditors, and asset sale prospects. This issue already has made an impact in the Delaware Chapter 11 case of Fort Worth, Texas-based Quicksilver Resources Inc. where the high bidder at an auction sale made its offer contingent upon rejection of similar midstream pipeline agreements.

In her decision, Judge Chapman carefully reviewed the applicable Texas real property law and the history of covenants running with the land. Judge Chapman indicated that her decision contains only "preliminary" and "nonbinding" findings regarding the underlying Texas real property issues. However, she made it clear that her view is that the rights granted under the Agreements are not real property rights running with the land.

Mindful of the Second Circuit authority on the issue, Judge Chapman carefully avoided making a final determination of the underlying disputed real property issues. The Second Circuit has made clear that a motion to reject an agreement is a summary proceeding that cannot be used to determine a disputed factual issue under the contract. See, *Orion Pictures Co. v. Showtime Networks Inc.* (In re Orion Pictures Co.), 4 F.3d 1095 (2d Cir. 1993) In Orion Pictures, the debtor sought to assume a contract with Showtime despite Showtime's argument that the debtor had breached a material term of the contract. The debtor filed an adversary proceeding seeking to, among other things, assume the contract and for declaratory relief with respect to the alleged breach.

In Orion Pictures, the bankruptcy court ruled that the debtor had not breached the contract and could assume the contract. The bankruptcy court also ruled that the issues raised by the motion to assume and the adversary proceeding were identical and, therefore, its ruling on the assumption motion mooted the issues raised in the adversary proceeding. *Id.* at 1098.

The Second Circuit reversed and remanded holding that a motion to assume is a summary proceeding, which could not be used to resolve a disputed factual issue arising under the contract in question. *Id.* at 1099.

In Sabine, the underlying Texas state law issue is a narrow one that hinges on the Agreement's language. Nordheim argues that the Agreements define the interests granted as "any right, title, or interest in lands and the right to produce oil and/or gas therefrom, whether arising from fee ownership, leasehold ownership, or arising from any pooling, unitization, or communization of any of the foregoing rights." Thus, according to Nordheim, the interests conveyed are clearly real property interests.

In contrast, Sabine argues the interests conveyed are contractual interests that do not rise to the level of a real property interest. Sabine argues that the Agreements cannot convey to Nordheim any real property interest in any mineral estate because (1) the mineral estate is owned by Sabine South Texas, and Sabine South Texas is not a party to the Nordheim Agreements, and (2) the interest conveyed was to the minerals that were extracted from the ground — and the right to gather and transport those minerals is a contractual right, not a recognized part of the "bundle of sticks" that constitutes a real property interest under Texas law.

It is unclear whether Judge Chapman will have the opportunity to decide the underlying real property issue at a later date, or whether it will be settled. In either event, Judge Chapman's decision will certainly provide useful guidance to parties confronted with these issues in other energy-related Chapter 11 cases.

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