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Downstream Service Providers Hit a Dry Well: Bankruptcy Court Permits Rejection of Service Contracts in Sabine Oil & Gas

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March 11, 2016 - A recent decision by Judge Shelley C. Chapman of the Bankruptcy Court for the Southern District of New York in the Sabine Oil & Gas chapter 11 cases[1] could have significant commercial implications on a U.S. energy sector already stressed by an extended period of low commodity prices. Relying on Bankruptcy Code section 365(a)'s deference to a debtor's business judgment, the Bankruptcy Court authorized Sabine, a mineral exploration and production company, to reject pre-petition service contracts with its downstream service providers. The Bankruptcy Court also considered and rejected the providers' arguments that the service contracts could not be rejected under section 365(a) because they were covenants that ran with the land under Texas property law. Because the Bankruptcy Court's Texas-law analysis was non-binding as a result of the procedural posture of the case, however, future litigation or agreement will be necessary to resolve whether Sabine can, in full, reject "all or some of the terms of the [a]greements."

In the wake of the *Sabine* decision, vendors may see energy sector debtors, in particular, invoke the Bankruptcy Court's analysis to reject servicing contracts. In turn, debtors may expect that motions to reject executory contracts will be hotly contested – particularly under state property law. For all participants, the road ahead for executory contacts in energy sector chapter 11 restructurings may not be a smooth one, and parties should be cognizant of the possible implications of *Sabine*.

The contracts at issue in *Sabine* were between Sabine and two of its production service providers (the "Agreements" and the "Service Providers").[2] In reliance on various exclusivity, volume, and transportation guarantees from Sabine contained in the Agreements, the Service Providers each invested significant capital to develop infrastructure to support Sabine's mineral extractions and perform agreed services for Sabine. The Service Providers argued that the Agreements could not be rejected because, under governing Texas law, Sabine's obligations to the Service Providers were not just contracts but rather covenants that, akin to easements, ran with

the associated land. Sabine disagreed and characterized the Agreements as mere promises that could be rejected in bankruptcy under the business judgment standard.

Focusing first on the contract rejection standards of section 365(a), the Bankruptcy Court evaluated Sabine's determination to reject the Agreements under the business judgment test ("whether a reasonable business person would make a similar decision under similar circumstances"). The Bankruptcy Court also considered "whether the debtor's decision to assume or reject is beneficial to the estate," and that the "court generally defers to the debtor's determination ... unless the decision to reject is the product of bad faith, whim, or caprice." The Bankruptcy Court also noted that, unless a provision of the Bankruptcy Code specifically protects a non-debtor, "the interest of the debtor and its estate are paramount; adverse effects on the non-debtor contract party ... are irrelevant." Ultimately, the Bankruptcy Court determined that the Service Providers had not submitted any evidence challenging Sabine's business judgment and confirmed Sabine's decision to reject the Agreements.

The Bankruptcy Court then "reluctantly" bifurcated its decision to address separately, and in a "non-binding" manner, the disputed effect of Texas property law on the Agreements.^[3] Noting that "the law relating to covenants, while archaic, must still be faithfully applied," the Bankruptcy Court started with the sixteenth century origins of the concept of a covenant "running with the land" in British common law and carefully traced the law's development through to its present-day implementation in the segmented mineral extraction, shipment, and refinement process. The Bankruptcy Court determined that the Agreements did not run with the land as either real covenants or equitable servitudes.

Applying Texas case law on covenants, the Bankruptcy Court found that Sabine had "simply engaged [the Service Providers] to perform certain services related to the hydrocarbon products produced by Sabine from its property" and that, accordingly, "[t]he covenants at issue are properly viewed as identifying and delineating the contractual rights and obligations with respect to the services to be provided and not as reserving an interest in the subject real property." It also concluded that the Agreements did not grant the Service Providers with "a real property interest in [Sabine's] mineral estate" because the right to transport is not a recognized "stick" in Texas real property law. In Texas, a mineral, once extracted from the land, is no longer real property but converts to personal property, and a party's right to personal property cannot burden the real property from which it was extracted. Accordingly, rights to a produced mineral do not "touch and concern" the land, and the agreement granting that right cannot be converted into a covenant that runs with the land. That the Service Providers had not collateralized their rights to the extracted minerals with liens on the subject lands further supported the non-binding finding that the Agreements were not covenants that ran with the land. On this basis, the Bankruptcy Court also rejected the Service Providers' argument that the Agreements were equitable servitudes.

Sabine provides precedent for servicing contracts with downstream vendors to be rejected in bankruptcy pursuant to section 365(a). The limitation on the Bankruptcy Court's ability to enter a binding decision on certain issues outside the adversary proceeding framework could, however, invite counterparties to contest what are usually ordinary motions to reject executory contracts, with the effect of potentially slowing debtors' restructurings. In light of *Sabine*, downstream services vendors will likely reevaluate their current contracts to determine their exposure to the risk of rejection by counterparties. Savvy service providers may revise the drafting of future contracts (or modify existing contracts) to address the deficiencies identified in *Sabine* and strengthen basic property law protections in the event of future disputes. In addition, maturing debt obligations may lead lenders to require that downstream service providers differentiate their contracts from those at issue in *Sabine* – *i.e.*, show that they could not be rejected by a debtor-counterparty – to obtain favorable refinancing terms.

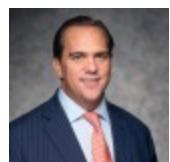
Footnotes

[1]. *In re: Sabine Oil & Gas Corporation, et al.*, Case No. 15-11835 (SCC), 2016 Bankr. LEXIS 720 (Bankr. S.D.N.Y., Mar. 8, 2016) ("Sabine").

[2]. As the Court explained, the Service Providers are midstream gathers that sit operationally between upstream companies like Sabine that extract minerals from the ground and downstream refining companies that bring the mineral products to market.

[3]. Pursuant to *Orion Pictures v. Showtime Networks, Inc. (In re Orion Pictures)*, rejection of executory contracts cannot be determined as a contested matter if there are disputed issues to be resolved; instead, an adversary proceeding must be initiated. 4 F.3d 1095 (2d Cir. 1993). However, under *In Re The Great Atlantic & Pacific Tea Co., Inc.*, the court may provide non-binding determinations on disputed legal issues, as it did in *Sabine*. 544 B.R. 43, at 52 (Bankr. S.D.N.Y. 2016). The Court noted that this bifurcation was "an inefficient use of judicial and private resources" and urged commercial resolution.

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