



Dedication-of-Production Clauses in Gathering and Processing Agreements May Not Be Enforceable in Bankruptcy Court¹

By [Russ Miller](#)

In a controversial case that was closely watched by oil-and-gas producers and midstream companies, a federal bankruptcy court in New York ruled on March 8 that a natural gas producer seeking to reorganize as a Debtor under Chapter 11 could reject long-term gas gathering and processing agreements that it deemed burdensome, See *In re: Sabine Oil & Gas Corporation*, Case No. 15-11835 (Bankr., S.D.N.Y. March 8, 2016). In a non-binding advisory opinion, the court further concluded that the contract provisions dedicating the Debtor's natural gas production exclusively to those midstream contracts will not be binding if the midstream companies seek to enforce them. (Of course, since the court already announced what its decision would be, there is little reason for the midstream companies to seek to enforce them.) The practical result of the court's decision, assuming it stands, is that the clauses dedicating the Debtor's natural gas exclusively to its existing midstream contracts will be nullified. The Debtor will be allowed to terminate its existing midstream contracts and negotiate new ones with anyone it chooses.

The midstream contracts at issue in *Sabine* were governed by Texas law. The bankruptcy court interpreted Texas law to provide that the dedication clauses were personal obligations of the Debtor that could be rejected in bankruptcy unless they were "covenants running with the land." The court then concluded that the particular dedication clauses at issue in that case were not "covenants running with the land," because they only dedicated the hydrocarbons that the Debtor produced from its leases; they did not purport to dedicate the leases themselves. Because

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hydrocarbons become personal property under Texas law when they are severed from the ground, the bankruptcy court found that the contracts only affected the Debtor's personal property, and they did not "touch or concern" its real property.

The *Sabine* court's ruling strikes at the heart of one of the fundamental terms of most midstream contracts. Midstream companies typically require a producer to dedicate all of the gas it may produce or purchase from a given geographic area, now or in the future, to be gathered and processed exclusively at the midstream companies' facilities for a long term at a fixed rate, with adjustments for inflation. The dedication clause is intended to provide the midstream company with at least a reasonable expectation that it will receive sufficient throughput over time to recoup its capital investment in the midstream facilities and realize a reasonable profit. On the other hand, producers generally benefit from competition for midstream services, and they often want to avoid dedicating all of their production from a large area to an exclusive long-term contract. Thus, the dedication clause often is heavily negotiated, and it reflects a balance between the bargaining power of both sides.

The *Sabine* decision may provide producers that are struggling under the weight of midstream obligations with additional bargaining leverage to request that their midstream providers consider renegotiating those terms. But producers must consider several important aspects of the *Sabine* decision to determine just how much bargaining leverage it actually provides. The bankruptcy court may have ruled differently in the *Sabine* case if either: (1) the midstream contracts were governed by the laws of a jurisdiction other than Texas; (2) the midstream contracts dedicated the producer's leases, rather than the production from those leases; or (3) the midstream contracts included a conveyance of the producer's right to use the surface estate for purposes of constructing or operating pipelines to receive gas from wells drilled upon its leasehold. Also, it is uncertain whether other courts will agree with the *Sabine* court's conclusion that a dedication of production does not "touch or concern" a mineral lessee's real property rights under Texas law. Because the fundamental real property interest that a Debtor acquires under a mineral lease is the right to explore for hydrocarbons and to produce them if they are found, and because mineral lessees generally will not and cannot simply release their hydrocarbons into the environment, another court might reach a contrary conclusion that an

exclusive dedication of the mineral lessee's production to a particular midstream contract does "touch or concern" the lessee's real property rights.

It remains to be seen whether other courts will follow the *Sabine* court's lead, or whether its ruling will be limited strictly to the facts of that case. In the meantime, dedication provisions in midstream contracts may not be as iron-clad as the industry previously assumed. If presented with a request to renegotiate an existing contract, midstream companies will have to decide whether they would prefer to accommodate the request or test whether a different court would reach the same conclusion as the *Sabine* court under whatever circumstances exist with regard to the parties and the contracts at issue. The midstream companies' decision likely will depend upon how closely the terms of its contracts mirror those at issue in the *Sabine* case, how reasonable the changes requested by the producer might be, whether the midstream company will still be able to obtain a reasonable return on its capital investment if it agrees to those changes, and the likelihood that the producer actually will file for bankruptcy protection either with or without the changes.

For more information on the *Sabine* opinion, please contact [Russ Miller](#).