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Blog Post

Water Dedications in Bankruptcy May Be Less Secure than You Think

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Many water midstream agreements are built on the dedication technology that has long been used for oil and gas contracts. Water rights, however, are treated differently from mineral interests in most states. As a result, even though many water gathering contracts include dedications expressly intended to be covenants running with the land, such contracts may have a greater chance of being successfully rejected in bankruptcy on the theory that the covenant relates to personal property (i.e., produced water) and not real property.

Background: State Law on Ownership of Water

Each state handles water rights differently, and there is often ambiguity in the existing case law regarding ownership of water. For example, under Texas law, groundwater is defined as "water percolating below the surface of the earth." Like oil and gas, this water is real property when owned in place but becomes personal property at the wellhead (or when produced from the estate). Unless the mineral leases state otherwise, however, produced water is owned by the surface estate owner, and not the mineral estate owner. Similarly, Oklahoma differentiates between three primary types of water — stream water, groundwater and diffused surface water — but all three types (and potentially subsurface saltwater used for extraction) belong to the surface owner of an unsevered estate. Meanwhile, contract rejection case law to date (*Sabine*, *Alta Mesa*, *Badlands*) has only dealt with hydrocarbon interests.

Given this bifurcated ownership framework in many oil and gas producing states, even if the groundwater in place is dedicated by the mineral estate owner, it most likely was not the mineral estate owner's to dedicate because it was not the mineral estate owner's real property to dedicate. Furthermore, any attempt to dedicate "produced water" once it has been captured and reduced to personal possession would merely

constitute a dedication of personal property. For these reasons, the dedication in a water midstream agreement arguably does not touch and concern the land and, therefore, would not be considered a covenant running with the land.

What Should Midstream Water Companies Do to Address Risk That Water Rights Are Personal Property Rather Than Real Property?

Don't throw out the dedication quite yet — in a non-bankruptcy context, it's an enforceable provision between the contracting parties and provides good financial incentives for the midstream water operator to build the system. However, parties to midstream water contracts should recognize that, in a bankruptcy context, the rejection of the agreement as an executory contract is possible, and build that into their pricing and contract terms. In addition, water midstream companies should, as oil and gas midstream operators did with their contracts after *Sabine*, take a close look at what provisions could be added to strengthen the argument that the gathering agreement touches and concerns the land (e.g., including a conveyance of a real property interest as part of the economics).

Finally, even if rejection of the contract is possible, the party seeking to reject has to demonstrate to the bankruptcy court that doing so is a reasonable exercise of its business judgment, including by showing that there's a reasonable alternative to the services provided under the rejected contract. Often the existing system is the most economic method of transporting water or there is no great alternative, making rejection less likely at a commercial level. The moral of the story: Because every executory contract could potentially be rejected in a bankruptcy proceeding, the parties need to incorporate the risk of rejection into their pricing structures at the outset of a potential business relationship.

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