KIRKLAND & ELLIS

Blog Post

Special Considerations for Protecting Interests under Water Agreements in Bankruptcy

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Companies engaged in the exploration and production ("E&P") of oil and gas often outsource certain services related to the extracted hydrocarbons and associated products (for example, produced water) to third-party companies engaged in gathering and transportation services. Similar to gathering and transportation services for produced oil and gas, gathering and transportation related to produced water often requires substantial upfront capital investment from the water midstream company, with the expectation that the investment will be recouped over time through fees charged to the E&P company (either through rate of service agreements or minimum volume commitments).

To protect the recoupment of the company's upfront investment, it is customary for a water midstream company to attempt to fashion their contracts with the E&P companies in a manner that insulates their risk in the event the E&P company becomes insolvent and declares bankruptcy. One common method used by the midstream companies to mitigate their risk and protect their investment in the gathering assets is to create (or attempt to create) a dedication of production from the E&P company structured as a covenant that runs with the land ("CRWTL"). A CRWTL serves as a powerful protection for a gathering company in the event of an E&P company's bankruptcy, because under Section 365 of title 11 of the U.S. Code (the "Bankruptcy Code"), a debtor may reject (i.e., elect not to perform its obligations under) any executory contract.[1] However, if a provision in an agreement is classified as a CRWTL, then a debtor may be restricted from rejecting such provisions.

While the classification of a midstream agreement as a CRWTL has been tested in recent bankruptcies in the oil and gas context, water disposal and gathering agreements ("Water Agreements") with similar language have not been tested and

there is reason to believe that such agreements may be treated differently than their oil and gas counterparts. Below, we discuss certain issues and considerations that are specific to Water Agreements and may affect whether such a Water Agreement is determined to contain a CRWTL that cannot be rejected under the Bankruptcy Code.

Elements for CRWTL Generally

Whether a contract imposes a CRWTL is a question generally decided under the laws of the state in which the debtor's property is located. While the specific requirements to create a CRWTL vary from state to state, in this post, we will discuss Texas law requirements. Generally speaking, the three frequently disputed elements necessary to establish a CRWTL are as follows:

- **Intent.** Did the parties ***intend that a particular covenant run with the land***? Intent may be determined by reference to the express language of an agreement as well as by assessment of the situation as a whole. Factors favoring intent include the contract (i) expressly stating the parties' intention to create a covenant running with the land, (ii) binding successors and assigns and (iii) requiring recording of the agreement / dedication (and proper recording actually occurring).
- **Touch and Concern.** Does the covenant ***touch and concern*** the land? In other words, does the covenant affect the nature, quality or value of the thing demised, independently of collateral circumstances, or affect the mode of enjoying it? A key factor to consider under this prong is whether the covenant concerns real or personal property. In the midstream context, emphasis is placed on whether the covenant relates to personal property (e.g., severed minerals that have been produced) or real property (e.g., minerals in place, prior to production). For example, dedication language that dedicates all minerals "produced and saved" has been held to relate to personal property, whereas dedication language that dedicates all minerals "reserved in and under the land" has been held, at least in one context, to relate to real property.
- **Privity.** Is there privity of estate, i.e., did one party grant or convey to the other party (when creating the covenant) an interest in the property to which the covenant is said to attach (***horizontal privity***) and is there a successive relationship to the same rights in property (***vertical privity***)?

Specific Considerations for Water Agreements

Mineral Estate vs Surface Estate

The applicable laws with respect to water ownership and rights vary from state to state. In Texas, groundwater (i.e., "water percolating below the surface of the earth"), including produced water, is owned by the owner of the surface estate.[2] While the use of ground water for production operations is considered part of the mineral estate holder's right to reasonably use the surface, the right does not include ownership of the groundwater.[3]

Any company that enters into a Water Agreement should understand whether (i) the water in place belongs to the surface estate or mineral estate and (ii) the grantor of a dedication of produced water actually owns the estate to which the water belongs. It is well established law in hydrocarbon producing states that a grantor cannot grant more property rights than it owns, so if a gathering company contracts for the dedication of produced water from an E&P company that does not actually own the rights to the produced water, a court may find the dedication ineffective without even determining whether such provision is a CRWTL.

Real Property vs Personal Property

Recent case law pertaining to a CRWTL in the bankruptcy context has generally assessed the creation of a CRWTL in the context of gas gathering agreements, rather than Water Agreements;[4] however, these cases offer insight into when a Water Agreement might create a CRWTL.

With respect to the intent and privity requirements, Water Agreements are not particularly unique or distinguishable from hydrocarbon gathering agreements. However, with respect to the "touch and concern" requirement, case law indicates that dedications under Water Agreements may not always be capable of satisfying the touch and concern requirement and, therefore, may fail to create a CRWTL, even if the dedication of water is granted by the proper owner of the water rights.

Texas courts have generally analogized groundwater rights to those of mineral interest owners.[5] In the context of mineral interest owners, oil and gas that has been extracted and then reinjected into underground reservoirs remains personal property.[6] Thus, in the context of produced water, if water *was injected into the subsurface prior to its re-extraction* (in connection with oil and gas production), that water may not be capable of satisfying the touch and concern requirement as it would continue to constitute personal property.[7] Since the focus of the touch and concern requirement in recent case law has been the nature of the property right, this classification of previously

injected water as personal property rather than real property is likely dispositive in the CRWTL analysis.

On the other hand, Water Agreements for the gathering or disposal of produced water that has yet to be severed or is owned in place may satisfy the touch and concern requirement under Texas law. If a Water Agreement includes a properly worded dedication of water that has not yet been reduced to personal property through extraction and the dedication rightfully belongs to the grantor's estate, then the Water Agreement may not be rejectable in bankruptcy in a similar manner as a hydrocarbon gathering agreement that grants an interest in minerals in place. However, even if a Water Agreement has the potential to touch and concern the land, in order to be a CRWTL, all other requirements discussed above must be met. While greater clarity on the touch and concern requirement is likely forthcoming in the near term given the surge of recent E&P bankruptcies, currently *Sabine* is the only ruling construing Texas law and, thus, whether a Water Agreement may satisfy the touch and concern requirement (even assuming the facts outlined above) is an open question.

How can Companies Structure Agreements to Better Protect Their Interests in Bankruptcy?

While the lack of case law regarding rejection of Water Agreements makes it difficult to avoid the risk of rejection, in light of the heightened risk with respect to Water Agreements, water gathering and disposal companies may consider alternative structures to strengthen the arguments that a Water Agreement contains a CRWTL, with particular emphasis on creating a real property interest that would satisfy the "touch and concern" requirement for a CRWTL. In doing so, particular emphasis should be placed on linking the CRWTL in the Water Agreement to some right owned by the E&P company in the water in place. To satisfy privity requirements, a water gathering and disposal company should also include a contemporaneous grant of the water in place from the proper grantor. Last, given the on-going uncertainty, if a large upfront capital spend is required, a water gathering and disposal company should consider alternate security in the event of an insolvency or bankruptcy, including a letter of credit or other credit assurance to support the future fee obligations.

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1. An executory contract is a contract where the obligation of both the debtor and its counterparty are unperformed to the extent that the failure of either to complete performance would constitute a material breach. If a contract

qualifies as "executory" in nature, bankruptcy courts are deferential to a debtor's business judgment in evaluating a request to assume or reject such contract.↩

2. Texas Water Code Section 36.001(5).↩

3. In order to encourage the recycling of produced water, the recently amended Chapter 122 of the Texas Natural Resources Code allows a producer to take possession of produced water as "fluid oil and gas waste….[when taken] for the purpose of treating the waste for a subsequent beneficial use." It is unclear how this recent addition to the code affects the rights of surface owners to the produced water.↩

4. The court in *In re Badlands Energy, Inc.*, 608 B.R. 854 (Bankr. D. Colo. 2019), did assess a saltwater disposal agreement, finding it could create such a covenant. However, the court also acknowledged that the finding would likely differ under Texas law as interpreted in *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC* (*In re Sabine Oil & Gas Corp.*), 567 B.R. 869 (S.D.N.Y. 2017). A water and acid handling agreement was also one of several contracts analyzed in *Sabine Oil & Gas Corp. v HPIP Gonzales Holdings*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016), but it was analyzed together with a gas gathering and processing agreement, without the court distinguishing between the two agreements.↩

5. *Edwards Aquifer Authority v. Day*, 369 S.W.3d 814, 829-33 (Sup. Ct. Texas 2012)↩
6. *Lone Star Gas Co. v. Murchison* - 353 S.W.2d 870 (Tex. Civ. App. 1962)↩

7. See *Sabine*.↩

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