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Protecting O&G Security Interests — Lessons From SemCrude

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After years of spectacular domestic growth in tight shale oil production, oil prices have recently plummeted and price volatility, often present in oil and gas markets, is now on full display. Almost lost in the noise about oil prices is the fact that natural gas prices too are far lower now than they were a year ago. These depressed commodity prices have led to predictable results: slashed capital expenditure budgets, reduced drilling activity, delayed well completions and layoffs.

For many U.S. oil and gas companies — especially those operating in high-quality (e.g., low-cost) formations — cost cutting, careful capital management, and access to additional financing (whether debt- or equity-based) will probably see them through the current downturn, even if prices stay depressed for an extended period. But for some overleveraged operators and service providers, depressed oil and gas prices will inevitably lead to default, foreclosure and bankruptcy.

As a result, secured creditors and mineral rights owners entitled to statutory lien protection will increasingly need to enforce their rights in collateral. Furthermore, secured lenders and mineral rights owners may find themselves locked in a priority battle, with the winner made whole and the loser receiving far less than it is owed.

One of the best ways to prepare for the potentially difficult road ahead is to look to the past for valuable lessons. As to oil and gas collateral, one does not have to look very far into the past: The last significant drop in oil prices, in 2008, led to a spectacular bankruptcy, which generated a series of notable rulings concerning oil and gas security interests and the interplay of statutory liens arising in favor of mineral rights owners.

Oil and Gas Owners' Liens Under State Law

Frequently, oil and gas is sold at the wellhead by a producer to a first purchaser. This sale is often on 30-, 60-, or 90-day open account, but with title passing immediately. This system is efficient and decreases a first purchaser's capital requirements, but can leave interest owners high and dry when the first purchaser fails to pay or goes bankrupt. In bankruptcy, even an unpaid seller's right of reclamation, provided by Uniform Commercial Code 2-702 and 11 USC 546(c) (Bankruptcy Code), does not fit the oil

and gas situation very well and gives only limited protection.

To help protect interest owners (such as royalty and working interest owners) in the event of nonpayment by a first purchaser, a number of oil- and gas-producing states have enacted nonuniform amendments to Article 9 or other stand-alone acts that grant a lien to interest owners for the unpaid purchase price of hydrocarbons sold to a first purchaser. The statutes allow unpaid sellers to elevate themselves to secured status in the event of nonpayment or bankruptcy by the first purchaser.

States have taken a variety of approaches to perfection and priority of owners' liens. For example, in Texas, owners' liens automatically perfect and are treated like purchase money security interests (PMSI). Kansas, too, treats an owners' lien like a PMSI for priority purposes but requires the interest owner to perfect the lien by filing an affidavit of production, attesting that one or more "wells capable of producing in paying quantities has been completed on the pertinent oil and gas lease."

Oklahoma formerly required producers to file notices of unpaid claims and explicitly subordinated owners' liens to perfected Article 9 security interests. Recently, however, Oklahoma amended its owners' lien statute to remove these limitations, now granting interest owners automatically perfected superpriority liens.

The Giant SemCrude Bankruptcy as a Valuable Case Study

The respective rights of Article 9 secured creditors and oil and gas owner lienholders were tested in the giant bankruptcy of the SemGroup/SemCrude family of companies.SemCrude LP had purchased substantial volumes of oil and natural gas from working interest owners in eight states. SemCrude's primary business was providing midstream oil and gas services — moving petroleum products and natural gas via trucks and a network of pipelines and storing these products in Oklahoma and elsewhere. SemCrude didn't own wells or refineries but instead resold the oil and gas it purchased to various downstream purchasers, including refineries.

Volatility in oil prices in 2008 forced SemCrude to file for bankruptcy after it suffered massive trading losses and increased margin requirements on futures contracts it held kicked in. As of its July 22, 2008, bankruptcy petition, SemCrude had failed to pay the open accounts of more than 1,000 upstream producers. The total production that the debtor purchased, but failed to pay for, was valued in excess of $400 million. Working interest owners claimed that they had statutory owners' liens securing payment for oil and gas delivered to SemCrude.

Decisions by the Delaware Bankruptcy Court

In In re SemCrude LP, 407 B.R. 140 (Bankr. D. Del. 2009), the Delaware bankruptcy court held that perfected UCC security interests in extracted oil and gas and their proceeds asserted by various banks had priority over the competing claims of unpaid Oklahoma producers who relied upon Oklahoma's former owners' lien act.

The court held that the Oklahoma act, by its express terms, subordinated the owners' liens to other Article 9 security interests. The Delaware bankruptcy court, relying on the Tenth Circuit's decision in Arkla Exploration Co. vs. Norwest Bank, 948 F.2d 656, 16 UCC Rep. 2d 230 (10th Cir. 1991), concluded: "While the Lien Act, by its clear language, authorizes a lien to secure payment ... to an interest owner, it also insures that security interests under the Oklahoma UCC are not subordinated to that lien .... Any other reading of the Lien Act is simply contrary to the plain language used by the Oklahoma Legislature."

In response to the SemCrude and Arkla cases, Oklahoma legislators amended the owners' lien statute. Now interest owners in Oklahoma enjoy an automatically perfected oil and gas lien "incident to the ownership of oil and gas rights" that "takes priority over any other lien, whether arising by contract, law, equity or otherwise, or any security interest." Because the lien arises incident to real property ownership and not Article 9, Oklahoma should supply the governing law, without regard to UCC choice-of-law rules. The new statute turns the tables on secured lenders, who may now find themselves primed by later-in-time, unrecorded owners' liens.

In two companion decisions to the SemCrude Oklahoma owner's lien case, the Delaware bankruptcy court held that nonuniform amendments to Article 9 in Texas and Kansas, which did not specifically subordinate the owners' liens to other Article 9 security interests, may have left the producers empty-handed because of their failure to file financing statements in Delaware and Oklahoma, where the debtor entities were incorporated.

For example, in In re SemCrude LP, 407 B.R. 112, 69 UCC Rep. 2d 245 (Bankr. D. Del. 2009), the issue was whether security interests of Texas oil and gas producers allegedly perfected under the "automatic perfection" rules of Texas UCC 9-343 (a nonuniform amendment to the UCC) were subordinate to a competing security interest duly perfected by the debtors' banks in accordance with the filing rules of Article 9.

The Delaware bankruptcy court held that, based on the applicable UCC conflict-of-law rules, the Texas producers would have unperfected security interests in the assets of the first purchaser, SemGroup, if they failed to file financing statements in the states where the SemGroup debtor corporate entitles were "located" under UCC 9-301. For purposes of its decision, the court assumed that (1) the lending banks had filed financing statements in Delaware and Oklahoma where the debtor entities were incorporated and (2) the Texas producers had relied only on their automatic perfection in Texas, without making any filings in the other two states.

Takeaways From the Decisions

This decision, along with its counterpart interpreting Kansas' owners' lien provisions, shows the danger in relying on nonuniform amendments to the UCC without considering all the ramifications. See In re SemCrude LP, 407 B.R. 82, 69 UCC Rep. 212 (Bankr. D. Del. 2009). Statutory liens typically provide significant protection in intrastate transactions, where choice-of-law issues are unlikely to arise. Reliance on such liens in interstate transactions is perilous, as the SemCrude decisions reflect. The clear takeaway from these decisions is that any interest owner wishing to rely on statutory lien provisions like those at issue in the SemCrude litigation must carefully analyze whether filings must be made in the first purchaser's home state to perfect the lien rights.

On the flip side, secured lenders should be aware that, in the wake of the SemCrude decisions, mineral owners will be more likely to take the time to file the proper financing statements in the home state of their first purchaser. The analysis of the Delaware bankruptcy court indicates that priority would be based upon the date of filing, rather than special PMSI priority rules.

Back to Basics: Loan Documentation Audits

Right now is the time to reevaluate loan documentation and UCC filings, at least as to troubled debtors in the oil and gas industry, to make sure that all of Article 9's rules have been complied with. Simple

errors in documentation and filings can have disastrous consequences. The botched termination statement that inadvertently released a $1.5 billion security interest, which has been the recent subject of intense litigation in GM bankruptcy proceedings, is a sobering recent reminder of the importance of dotting all the i's and crossing all the t's.

Issues that can trip up lenders' efforts to perfect security interests in oil and gas collateral include changes to the debtor's name or location; the different offices in which financing statements for various types of collateral must be filed (e.g., local filing for as-extracted collateral and central filing in the debtor's home state for equipment); and the failure to identify a debtor as a transmitting utility and follow the applicable rules, to name just three examples. The trustee in bankruptcy's preference-avoidance powers make time of the essence: Any modifications to documentation or filings must occur more than 90 days before the filing of the bankruptcy petition.

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