Have you protected your lien rights?

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With the steep decline in oil prices and the volatility in the oil and gas industry, producers are forced to attempt to balance diminished cash flows against substantial debt and operating costs. Over 85 exploration and production companies have filed Chapter 11 bankruptcy cases since 2015. Unless prices rebound dramatically, which is unlikely based on current predictions, many more producers will be faced with the prospect of having to file for bankruptcy protection. As producers address their financial distress and liquidity needs, the myriad of businesses that provide goods and services to exploration and production companies will likely face diminished cash flows which may lead to their own financial distress and inability to service their financial obligations.

The United States Bankruptcy Code and state lien laws can have a substantial impact on a party's rights in bankruptcy in connection with oil and gas agreements. In addition to consensual contractual liens, statutory liens can take the form of mechanic's liens, oil and gas liens, mineral liens, and possessory liens. State laws will determine the circumstances in which these liens arise, how they are perfected, and the priority or priming effect of such liens. Statutory lien laws vary significantly from state to state. Thus, parties must ensure that they understand and follow the particular laws of each state in which they are operating and/or providing services.

CONSENSUAL LIENS

The easiest way to become a secured creditor is to require that the obligor provide some collateral for the debt that will be incurred, including a security interest in personal property such as a security interest in goods sold or a "blanket" lien on all of the debtor's personal property, or a lien on real property such as a mortgage. The Uniform Commercial Code, as adopted and in effect under state law from time to time, disclaims any effect on security interests in real property, but expressly governs perfection of security interests in tangible and intangible personal property.

As a general rule, oil and gas in place constitutes land or real estate and belongs to the owner of the land so long as it remains under the land. Typically, an oil and gas lease, while not granting title to the oil or gas itself, grants to the lessee the right to enter upon the surface of the land to reduce the oil and gas to the lessee's possession. Because the lease concerns the right to oil or gas prior to extraction, courts generally classify oil or gas leaseholds as a real estate interest subject to applicable law. Consequently, secured lenders generally require as part of their financing facilities the execution and delivery of a mortgage containing fixture filing language which is filed in the county in which the real property is located. Once the oil or gas is extracted and reaches the surface, it is considered personal property and subject to the lien attachment and perfection requirements of the Uniform Commercial Code and applicable state law. In Ohio, under Ohio Revised Code Section 1309.102(A)(6), "as-extracted collateral means (a) oil, gas, or other materials that are subject to a security interest that: (i) is created by a debtor having an interest in the minerals before extraction; and (ii) attaches to the minerals as extracted; or (b) accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which the debtor had an interest before extraction. Pursuant to Ohio Revised Code Section 1309.502, to be sufficient, a financing statement that covers as-extracted collateral or timber to be cut, or that is filed as a fixture filing and covers goods that are or are to become fixtures, shall: (1) indicate that it covers this type of collateral; (2) indicate that it is to be filed in the real property records; (3) provide a description of the real property to which the collateral is related sufficient to give constructive notice of a mortgage under the laws of this state if the description were contained in a record of the mortgage of the real property; and (4) if the debtor does not have an interest of record in the real property, provide the name of a record owner. The UCC-1 financing statement should be filed in the recorder's office of the county in which the as-extracted collateral is located and at the office of the secretary of state in the state in which the debtor is incorporated or organized.

MECHANIC'S AND MATERIALMAN'S LIENS

Most states have adopted statutes that grant liens to parties who provide work or materials to upstream companies. The characteristics, duration, scope, attachment, perfection, and priority of such statutory liens vary from state to state. For example, in Texas and Colorado, the lien does not extend to a well's production. In Oklahoma, however, the lien attaches to the oil and gas produced from the well. Rules governing perfection of the liens also vary from state to state and must be analyzed to make sure that the proper procedures and deadlines are followed.

In Ohio, for projects that are for oil or gas well construction, operation, or repairs, or are for altering, repairing, or constructing oil derricks, oil tanks, or leasehold production pipelines, Ohio Rev. Code Section 1311.021(A) gives a subcontractor or material supplier a lien to secure payment of the contract on the oil and gas lease or leasehold estate, or if there is none, the oil or gas produced and the proceeds thereof, along with a lien on all materials located on the project or used in connection with the project. The lien is *not* effective against any purchaser of the oil and gas or pipeline carrier of the oil and gas until a copy of the lien affidavit has been delivered to the purchaser or pipeline carrier by certified mail. In this way, good faith purchasers of the oil and gas are protected from undisclosed liens. Pursuant to R.C. 1311.021(C), a mechanic's lien claimant is not required to record a notice of furnishing, nor is the owner, part owner, or lessee required to record a notice of commencement. The lien claimant has 120 days after the last work or the last materials were provided to perfect the lien by recording an affidavit of lien. For priority purposes, any properly filed lien affidavit is effective from the date that the first visible work or labor is performed, or the first materials are furnished at the site. Consequently, a properly perfected mechanic's lien relating to an oil and gas project will relate back to the date when services or materials were first provided and will have priority over a secured lender's lien in the same collateral if the lender's lien is perfected and filed after the mechanic or materialman first provided services or materials.

JOINT OPERATING AGREEMENT LIENS

Parties to a joint operating agreement often seek to have their rights secured by contractual liens. The forms of joint operating agreements approved by the American Association of Professional Landmen provide for such contractual liens. Parties to joint operating agreements should file a memorandum of joint operating agreement as set forth above in the consensual liens portion of this article.

FIRST PURCHASER LIENS

An oil and gas sale transaction typically commences with a producer leasing mineral rights from mineral interest owners. Producers have an interest in the oil or gas when they are extracted, and similarly, mineral interest owners generally receive a royalty for the oil and gas produced from their mineral interests. Once the producers extract the oil or gas, first purchasers typically buy the oil or gas at the wellhead from tanks located on the leased premises or at hubs off site. Many first purchasers resell the oil or gas to downstream purchasers. The number of parties involved in the production and sale of oil and gas results in various competing interests.

Many states, including Texas, Kansas, Oklahoma, North Dakota, and New Mexico, have enacted statutes that grant a security interest to mineral interest owners (royalty owners) and producers on the oil and gas sold to the first purchaser until such time as the producer and/or mineral interest owners have been paid. The statutes governing the perfection, priority, scope and duration of these first purchaser liens vary from state to state.

If a first purchaser is financially distressed, various parties and lienholders may attempt to recover from the same collateral. These facts were addressed by the Delaware bankruptcy court in the *In re SemCrude, L.P.* case in 2009 (*SemCrude*). In *SemCrude*, the bankruptcy court held that the producers had a subordinate lien relative to a downstream purchaser who validly perfected its security interest by filing a financing statement in the debtor's state of incorporation. The Delaware district court adopted the Delaware bankruptcy court's findings. The District court held that the laws of the states where the debtors were located (incorporated) governed the method of perfection of the liens, not the laws of the states where the oil and gas were produced. In addition, the court held that the downstream buyer was a "buyer for value" and a "buyer in the ordinary course" because it purchased the oil and gas in good faith, without knowledge of the producers' security interests.

Semcrude highlights the needs for lenders, producers, mineral interest owners, and other parties to protect their interests and know the laws of the applicable states to make sure that their interests in a first purchaser's collateral is properly perfected. In addition, parties need to be aware of state statutory liens that are automatically-perfected and the priority of such liens. Producers and mineral interest owners should file a UCC-1 financing statement in the first purchaser's state of incorporation or organization to avoid conflict of laws principles that dictated the result in *SemCrude*.

BANKRUPTCY CODE IMPLICATIONS

When oil and gas companies file bankruptcy, a variety of important issues arise for creditors that require immediate attention. When a bankruptcy case is filed, the "automatic stay" under Section 362 of the Bankruptcy Code is imposed by operation of law, which prevents creditors from initiating or continuing acts to collect on pre-bankruptcy filing debts by the debtor or its assets constituting "property of the estate." Royalty owners, as lessors of oil and gas leases, are sometimes the largest type of creditors. Some oil and gas leases provide for automatic termination for unpaid royalties. When a condition precedent for termination of the lease is triggered prior to the bankruptcy filing or post-bankruptcy, the royalty owner may want to seek relief from the automatic stay to have the court determine that the lease is terminated. Creditors who supply goods to a debtor within 45 days of the bankruptcy filing have an ability to reclaim them (subject to certain limitations and lien priority rights), but must demand reclamation in writing by the 20th day after the bankruptcy filing. In addition, creditors who supplied goods within 20 days prior to the date of the bankruptcy filing have a priority administrative claim, senior in priority to payment of general unsecured claims, for the value of such goods.

Oil and gas creditors may also have consensual contractual or statutory lien rights that need to be perfected post-bankruptcy. Exceptions to the automatic stay and the trustee/debtor's lien avoidance powers under Section 544 of the Bankruptcy Code exist to permit the perfection of such liens after the debtor's bankruptcy filing without violating the automatic stay. Upon the filing of a petition, under Section 544(a) of the Bankruptcy Code the trustee automatically has a "strong arm" lien on all property of the debtor's estate, generally subject only to liens and security interests that are properly perfected and unavoidable as of the time of the filing. However, Section 362(b)(3) of the Bankruptcy Code states that the automatic stay does not apply "… to any act to perfect, or to maintain or continue the perfection of an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b)…" Section 546(b)(1) of the Bankruptcy Code states that Section 544's strong arm lien is subject to "any applicable law" that "permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection." Thus, if at the time of perfection post-bankruptcy the lien relates back to a time prior to the filing of the bankruptcy petition, the perfected lien will trump the trustee's strong arm lien. Lienholders must also carefully review post-bankruptcy financing facilities and requests by the debtor to use cash collateral to examine how such requests impact the priority and protection of their liens.

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